



Board of Administration

Agenda Item 9e

April 19, 2022

Item Name: Senate Bill 1328 (McGuire) - Divestment from Russia and Belarus

Program: Legislation

Item Type: Action

Recommendation

Adopt an **OPPOSE** position on Senate Bill (SB) 1328 (McGuire), as amended March 23, 2022, because it imposes a divestment mandate on the California Public Employees' Retirement System (CalPERS) Board of Administration (Board).

Executive Summary

Among other things, SB 1328 prohibits the board of any public retirement system from investing public employee retirement funds in a company with business operations in Russia or Belarus, as specified, and requires the boards to liquidate investments in companies within specified timeframes that meet the criteria of this bill. It requires the boards to file an annual report, regarding this divestment, with the Legislature beginning on or before January 1, 2023. The bill also prohibits companies that conduct business with the Russian government from bidding on goods or services contracts with state agencies.

As further described below, the Investment Office estimates that \$185 billion of the market value of its public equity and fixed income holdings derive revenue from Russia and/or Belarus and are therefore likely subject to the divestment provisions of SB 1328.

Should SB 1328 be enacted in its current form, and the Board direct team members to divest from companies which team members cannot determine have taken "complete substantial action," team members would likely need to revise recently approved asset allocation targets given the large amount of investments subject to potential divestment and communicate potential impacts to stakeholder groups, such as employers.

Strategic Plan

Divesting in response to external initiatives is outside the scope of the 2017-22 CalPERS Strategic Plan.

Investment Beliefs

This agenda item supports CalPERS' Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided that they are consistent with its fiduciary duties to its members and beneficiaries.

Background

CalPERS Actions to Date

The CalPERS Board and organization stand in solidarity with the citizens and country of Ukraine. CalPERS understands its obligation to address Russia's aggression, support Ukraine, and protect its members' assets. The actions of Russia have left an indelible mark on the world and have created instability in the global financial markets and addressing CalPERS' investments in Russia is a top priority for the CalPERS investment team. As a result, CalPERS has taken the following actions to date:

- CalPERS has ceased all transactions in Russian publicly traded equity and has stopped the flow of any new investments into the country.
- CalPERS is actively assessing its real estate investments and determining a path forward.
- CalPERS is reviewing all its investments in emerging markets, including Russia, due to the impacts the crisis has had on all financial markets.
- CalPERS is following all regulatory requirements promulgated by U.S. Office of Foreign Assets Control and the sanctions that are in place.

It is important to note that current sanctions, market restrictions, and the closure of the Russian stock market have placed significant constraints on CalPERS' ability to liquidate its Russian holdings. CalPERS continuously monitors evolving sanctions and federal actions, which can have direct or indirect impacts on its investment activities.

Constitutional Authority and Fiduciary Responsibility

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement boards of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires board members of a public pension or retirement system to discharge their duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the system to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. In accordance with California Constitution Article XVI, section 17, the Board's constitutional duties take precedence over any other considerations.

The Constitution also, however, provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

CalPERS Divestment Policy

The call for divestment has become an increasingly popular tool for promoting a cause or belief. As laudable as the underlying motivations may be, divestment for the purpose of achieving certain goals, such as promoting social justice, focus on companies that do business in a specified country or are engaged in a specified industry that do not appear to be primarily investment-related (Divestment Initiatives) has unintended consequences for the CalPERS fund and its members. CalPERS wants companies in which it invests to meet high corporate governance, ethical, and social standards of conduct and CalPERS' investment in a company does not necessarily signify that it approves of all the company's policies, products, or actions.

However, fiduciary obligations generally preclude CalPERS from sacrificing investment performance for the purpose of achieving goals that do not directly relate to CalPERS' operations or benefits. Divesting appears to almost invariably harm investment performance by, for example, causing transaction costs (e.g., the cost of selling assets and reinvesting the proceeds) and compromising investment strategies. In addition, there appears to be considerable evidence that divesting is an ineffective strategy for achieving social or political goals, since the usual consequence is often a mere transfer of ownership of divested assets from one investor to another. Investors that divest lose their ability as shareowners to influence the company to act responsibly.

Therefore, CalPERS' Investment policies generally prohibit divesting in response to Divestment Initiatives, but permit CalPERS to use constructive engagement, where consistent with fiduciary duties, to help Divestment Initiatives achieve their goals.

Divestment from Russia and Belarus

According to the author,

“The State of California has incredible economic power and strength and we must use this clout for good. The people of California will not stand idly by while an autocratic thug attacks the innocent people of Ukraine and attempts to destroy their country. Democrats and Republicans alike are working together on SB 1328. The Golden State stands strong for Ukraine and we'll do everything in our power to usher in debilitating economic consequences on Russia for this horrific and bloody war.”

Analysis

As the bill relates to divestment, SB 1328 does the following:

- Finds and declares, among other things, that the State of California is a “constituent part of” and an “ally and partner of” the United States that “has unparalleled international economic influence that can assist the United States government in achieving its foreign policy objectives toward the aggressor countries”.
- Defines the following terms:
 - “Aggressor countries” means Russia and Belarus.
 - “Active business operations” means a company engaged in business operations that provide revenue to aggressor countries.
 - “Business operations” means maintaining, selling, or leasing equipment, facilities, personnel, or any other apparatus of business or commerce in the aggressor

- countries, including the ownership or possession of real or personal property located in aggressor countries.
- “Substantial action” means a boycott of the aggressor countries, curtailing business in those countries until the U.S. has lifted sanctions or determined the invasion and occupation of Ukraine has halted, selling company assets, equipment, or real and personal property located in Russia or Belarus, or undertaking significant humanitarian efforts in Ukraine.
 - Prohibits any public retirement system board from investing in a company with business operations in aggressor countries that meets either of the following criteria:
 - The company is engaged in active business operations in Russia or Belarus,
 - The company is engaged in either of the following:
 - oil-related activities or energy or power-related operations, or contracts with another company with business operations in the oil, energy, and power sectors of Russia or Belarus, and the company failed to take substantial action, as defined.
 - demonstrated complicity in the Russian invasion of Ukraine.
 - Prohibits any public retirement system board from investing in a company that supplies military equipment to Russia or Belarus.
 - Prohibits the boards from making additional or new investments or renewing existing investments in that company.
 - Requires the boards to liquidate investments no later than one month after this provision applies to the company consistent with the board’s fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.
 - Does not provide for any engagement exceptions to divestment for these companies.
 - Requires public retirement system boards to contract, as specified, with a research firm or firms to determine those companies that have business operations in aggressor countries and within one month of this section being chaptered, the research firm or firms are required to report their findings to the board and subsequent findings if there is a change in circumstances in Ukraine.
 - Requires the public retirement system boards to take the following actions no later than one month after this section is chaptered:
 - Review publicly available information regarding companies with business operations in aggressor companies.
 - Contact other institutional investors that invest in companies with business operations in aggressor companies.
 - Send written notice to a company with business operations in the aggressor countries that the company may be subject to this section.
 - Requires the public retirement system boards to determine by the next applicable board meeting if a company meets the criteria stipulated in this section based on the information and reports required by this section.
 - If the public retirement system boards plan to invest or continue to invest in a company that meets the criteria stipulated in this section:

- The boards, in each board's capacity of shareholder or investor, shall notify the impacted company that the company is subject to this section and allow that company to respond to the information and reports required by this section.
- The boards shall request that the company take substantial action, as defined, no later than 30 days from the date the board notified the company.
- If the board(s) determine that the company has taken substantial action or made sufficient progress towards substantial action before the end of the 30-day period prescribed by the section, the company will not be subject to this section.
 - For companies who have made sufficient progress on substantial action, the board(s) are required to continue to monitor and review, in intervals not to exceed 30 days, the progress of this company until the company has taken substantial action.
 - For companies that fail to complete substantial action or continue to make sufficient progress towards substantial action, the company will remain subject to this section.
- If the public retirement system board's investment in a company is limited to investment through an externally and actively managed commingled fund, the boards shall contact the fund manager in writing and request that the fund manager remove that company from the fund.
 - Within two months of this section being chaptered, if the fund or account manager creates a fund or account devoid of companies that meet the criteria of this section, the transfer of board investments from the prior fund or account to the fund or account devoid of companies with business operations in Russia or Belarus shall satisfy the provisions within this section.
- If the public retirement system board's investment in a company is limited to an alternative fund or account, the alternative fund or account manager creates an actively managed commingled fund that excludes companies that meet the criteria of this section, and the new fund or account is deemed to be financially equivalent to the existing fund or account, the transfer of board investments from the existing fund or account to the new fund or account shall satisfy the provisions within this section.
 - If the board determines that the new fund or account is not financially equivalent to the existing fund, the board shall include the reasons for that determination in the subsequent report required by this section.
- Requires the board to make a good faith effort to identify any private equity investments that involve companies that meet the criteria of this section or are linked to the government of Russia or Belarus or any sanctioned person.
 - If the board determines that a private equity investment clearly involves a company that meets the criteria of this section or is linked to the government of Russia or Belarus or a sanctioned person, the board is required to, at its discretion, determine if the company is subject to the prohibitions and liquidations outlined in this section.
 - If the board does not take action to cease investments in the impacted company, the board is required to include the reasons for its decision in the subsequent report required by this section.

- If the board determines that an investment in an alternative fund or account or through a private equity investment clearly involves a company that supplies military equipment to Russia or Belarus, the board is:
 - Prohibited from making additional or new investments or renew existing investments in that company.
 - Required to liquidate investments no later than one month after this provision applies to the company consistent with the board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.
- If a company meets the criteria of this section and fails to complete substantial action in the time prescribed, the boards are required to take the following actions:
 - Prohibit the boards from making additional or new investments or renewing existing investments in that company.
 - Require the boards to liquidate investments no later than six months after this provision applies to the company consistent with the board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.
- Requires the boards to submit a report to the Legislature on or before January 1, 2023 and annually thereafter that includes the following information:
 - A list of investments the boards have in companies with business operations in Russia or Belarus, including, but not limited to, the issuer, by name, of the stock, bonds, securities, and other evidence of indebtedness.
 - A detailed summary of the business operations a company, that meets the criteria of this section, has in Russia or Belarus.
 - Whether the boards have reduced their investments in a company that meets the criteria of this section.
 - If a board has not completely reduced its investments in a company that meets the criteria of this section:
 - When the board anticipates it will reduce all its investments in the impacted company, or
 - The reasons why the sale or transfer of investments is inconsistent with its fiduciary duty.
 - Any reports or information used to determine that the company meets the criteria of this section.
 - A detailed summary of investments that were transferred to funds or accounts devoid of companies with business operations in Russia or Belarus or with a sanctioned person.
- If the board voluntarily sells or transfers all of its investments in a company with business operations in Russia or Belarus or with a sanctioned person, this section shall not apply except the report required by this section.
- Permits the Board to refrain from any such actions if it determines in good faith that such action would be inconsistent with the Board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.
- Prohibitions and liquidations shall not apply to:
 - Investments in a company that is primarily engaged in supplying goods or services intended to relieve human suffering in Ukraine

- Investments in a company that promotes health, education, journalistic, or religious activities in or welfare in Ukraine.
- States that this section shall only remain in effect until one of the following occurs, and as of the date of that action is repealed:
 - The aggressor countries halt the invasion and occupation of Ukraine as determined by the U.S. Department of State, or
 - The U.S. revokes all sanctions against the aggressor countries imposed because of their participation in the February 24, 2022, invasion of Ukraine.

Foreign Policy Legal Implications

The federal government has exclusive jurisdiction over foreign policy. Within the U.S. Department of the Treasury is the Office of Foreign Assets Control (OFAC) which administers and enforces economic and trade sanctions based on U.S. foreign policy and national security. In prior years Congress enacted the Sudan Accountability and Divestment Act of 2007 (P.L. 110-174) and the Comprehensive Iran Sanctions, Accountability, and Divestment Act (P.L. 111-195) authorizing state and local governments to adopt divestment prohibitions. To date, Congress has not enacted such legislative authority for Russian or Belarusian divestment. The prohibitions and liquidations found within SB 1328, which go well beyond sanctions that have been provided for under the jurisdiction and authority of the OFAC, may lead to legal implications regarding the legislative authority provided under the California Constitution and federal jurisdiction over international affairs. Additional investment prohibitions and liquidations not approved by the OFAC may inadvertently affect existing foreign policy and relations by the State of California establishing its own foreign policy.

CalPERS and OFAC Sanctions

Sanctions relating to Ukraine and Russian Federation began on March 6, 2014, when President Barack Obama issued Executive Order (E.O.) 13660 that imposed sanctions against certain persons whose actions and policies threatened and undermined democratic processes and institutions in Ukraine. Since that time, four additional executive orders (E.O. 13661, 13662, 13685 and 14065) have been issued building upon the original sanctions in response to the escalating national emergency in Ukraine.

On February 21, 2022, President Joseph Biden Jr., issued E.O. 14065 that expanded the scope of prior sanctions in response to the Russian Federation, along with the Republic of Belarus, invasion on the sovereign nation of Ukraine. On March 2, 2022, OFAC issued new public guidance on these sanctions and how investors shall comply.

As a U.S. institutional investor, CalPERS is required to comply with OFAC sanctions. CalPERS continuously monitors sanctions and implements trading restrictions as needed. The Investment Office has taken the following actions with respect to Ukraine-related sanctions:

- Prohibition of secondary trading of Russian sovereign debt,
- Prohibition of acquisitions of equity and debt of certain Russian banks,
- Authorization to divest of equity and debt (including derivatives) of certain Russian banks, and
- Prohibition on transactions with the Russian Central Bank and Russia's sovereign wealth fund.

SB 1328 seeks to impose divestment mandates that extend well beyond current sanctions imposed by the federal government, most particularly by requiring divestment from any company that has business operations, i.e., generates any revenue in Russia or Belarus, which would appear to include thousands of companies that CalPERS invests.

Administrative and Timeline Challenges

SB 1328 has several provisions relating to engaging companies about their business operations in the Russian Federation or the Republic of Belarus. CalPERS strongly advocates for corporate engagement over divestment; however, the scope of companies to be engaged and timelines provided by SB 1328 appear to include potentially thousands of companies, which presents such a significant implementation challenge that it is unclear how many resources, both team member workload and external contractors, would be needed for compliance. It is also unclear how (or whether) team members could adequately evaluate whether each company's actions complied with the spirit of SB 1328. In many cases, companies may be faced with "stranded assets" and be unable to effectively wind down operations in Russia and/or Belarus.

For example, one provision of SB 1328 stipulates that within one month of this section being enacted, CalPERS must contract with a research firm to identify companies that meet the criteria of SB 1328. In that same month timeline, the research company must provide a report to the CalPERS Board of its findings and submit subsequent findings to the Board if "there is a change in circumstances in Ukraine". In addition to contracting with a research firm, CalPERS must, also within one month of this section being enacted, have team members review publicly available information regarding companies that meet the criteria of this section, contact other institutional investors that invest in companies that meet the criteria of this section, and send a written notice to these companies notifying them that they may meet the criteria of this section.

Slippery Slope Issue

According to a February 9, 2021, letter from the investment firm Wilshire as part of its review of CalPERS divestment programs, "Since inception, the active divestment programs have reduced the potential market value of the CalPERS Total Fund by an estimated \$2.18 billion in present value terms." In recent years, the Legislature has introduced bills that have or would have required CalPERS to divest from the Governments of Turkey, Azerbaijan, Russia and Belarus, private prison companies, thermal coal, fossil fuel companies, firearms, and the Dakota Access Pipeline.

Each individual divestment proposal may impose a small or theoretically manageable impact on the CalPERS trust fund. Regardless of the relative impact on the fund's investment portfolio, each divestment would reduce fund diversification. As such, each divestment proposal signed into law weakens CalPERS' ability to be a responsible fiduciary of the System by limiting investment opportunities, decreasing diversification, limiting returns, and increasing risk in its investment portfolio.

Advocates for each individual divestment proposal argue that CalPERS can implement each individual proposal without fundamentally damaging the trust fund, and often cite other alternative investment sectors that would be better suited for CalPERS investment. However, these suggestions ignore the cumulative impact of divestment mandates, as noted above, and ignore the realities of shifting public attitudes. Today, divestment advocates are focused on fossil fuels and U.S. foreign policy, but tomorrow it may be social media platforms, vehicle manufacturers, or the meat industry. The ultimate effect of such divestment mandates may

create increasing economic inefficiencies that may compound or damage the ability of the overall System to meet its obligations to its members.

Divestment Mandate Without Repeal

The provision in SB 1328 to repeal its divestment mandate contains two potential trigger events. However, neither trigger event is likely to occur in the foreseeable future. The first trigger event is that the U.S. State Department determines that Russia and Belarus have halted their invasion and occupation of Ukraine. As far as CalPERS is aware, the State Department does not make such determinations. The second trigger is the federal government revokes all sanctions imposed because of the invasion of Ukraine. With the extensive number of individuals subject to sanctions, it is not clear that all these sanctions would ever be revoked in the lifetimes of those individuals.

Even if the Russian economy were otherwise normalized into the global economy, it is possible that the CalPERS Board would be required to choose to reject or end the legislatively mandated divestment and all the associated engagement and reporting, because the repeal trigger events may never occur.

Budget and Fiscal Impacts

CalPERS does not have any holdings in Russian government debt. As of March 2, 2022, CalPERS owned approximately \$420 million in public stocks for Russian companies and \$345 million in illiquid real estate assets. Investments in Russia represent about 0.17% of the CalPERS total investment portfolio.

As currently written, SB 1328 goes beyond CalPERS' current investments in Russia and Belarus.

Approximately 69% (or \$171 billion) of the publicly traded global companies in the Public Employees' Retirement Fund's Global Equity and 10% (or \$14 billion) of the Global Fixed Income portfolios derive revenue from Russia and/or Belarus and are therefore subject to the divestment provisions. Due to how "active business operations" is defined, the divestment provisions would presumably apply to all companies which (1) pay income or excise tax to Russia and/or Belarus due to revenue earned there, (2) employ one or more individuals in Russia and/or Belarus, and/or (3) own or operate any type of retail, commercial, or industrial facility in Russia and/or Belarus.

It is also unclear whether the affected companies would cooperate with, or respond to, ongoing, monthly letters which would potentially complicate a team member's ability to assess whether each company has engaged in "substantial action," as defined.

Aside from potential investment losses, both from initial and future divestment, CalPERS expects to incur additional significant staffing costs, contracting costs, and investment transactions costs with initial costs in the hundreds of millions of dollars.

Finally, if SB 1328 is enacted in its current form, the total fund's investment target and discount rate may need revision to reflect a lower expected return due to the removal of holdings of large corporations from the trust fund's portfolio. A lower discount rate would increase the normal cost and contribution rates paid by employers and potentially increase the contribution rates paid by members subject to the Public Employees' Pension Reform Act of 2013.

Benefits and Risks

Benefits:

- None identified. The divestment mandates that extend beyond federal sanctions do not appear likely to have any impact on the actions of Russia or Belarus.

Risks:

- Compromises CalPERS' investment strategies by eliminating alternatives from the investment opportunity set and reducing diversification, which may have a detrimental effect on investment returns over the long term.
- Imposes financial risks on CalPERS members and employers.
- Increases risk to the system.
- Reduces alignment of current Investment Office practices with CalPERS' Investment Beliefs and Investment Policies.
- Increases future likelihood of external parties directing portfolio activities.

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