BILL NUMBER: SB 1328 (McGuire) as amended April 19, 2022

SUMMARY

SB 1328 prohibits the boards of specified state and local retirement systems from investing in companies with business operations in Russia or Belarus if the companies: provide revenue to the governments of those countries; are engaged in oil-related activities or energy or power-related operations or contract with another company with business operations in the oil, energy and power sectors of those countries, and the company failed to curtail business in those countries; have demonstrated complicity in the invasion of Ukraine; or supply military equipment to Russia or Belarus. It also prohibits all state agencies from investing in investment vehicles issued or owned by the governments of Russia or Belarus. The bill establishes reporting requirements and criteria for determining whether a company is subject to divestiture, but only when such divestment is consistent with fiduciary responsibilities. In addition, SB 1328 prohibits companies that conduct business with the governments of Russia or Belarus from bidding on contracts with state agencies.

BOARD POSITION

Oppose. The board's policy is to oppose legislation that restricts or infringes on the plenary authority of the board to administer the retirement plans as provided in Section 17 of Article XVI of the California State Constitution. It is also the board's policy to oppose legislation that infringes on the investment authority of the board or is inconsistent with the investment policy adopted by the board as presented in the CalSTRS Investment Policy and Management Plan.

REASON FOR THE BILL

As stated in the findings and declarations of the bill, in order to defend the democratic values of the people of California and ensure their security and the security of the state's public pension systems, it is necessary to cut all economic investment in Russia and Belarus and stand with Ukrainian President Zelenskyy, the people of Ukraine and all the people who support liberal democracy, peace and freedom.

ANALYSIS

Existing Law:

Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, the CalSTRS board has plenary authority and fiduciary responsibility over the investment of retirement plan assets and is required to discharge its duties solely in the interests of its members and beneficiaries for the exclusive purpose of providing benefits. The board must invest the assets of the plan with the care, skill and diligence of a prudent person engaged in a similar enterprise so as to maximize the investment gains and minimize the risk of loss. When considering investments, the preservation of principal and maximization of income is the primary and underlying criteria for the selection and retention of securities. The Constitution states, however, that the Legislature may by statute prohibit certain investments by a retirement board when it is in the public interest to do so and provided the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

Under the provisions of the U.S. Constitution, federal laws preempt state laws, and the federal government maintains responsibility over foreign affairs and has the power to regulate commerce with foreign nations. More specifically, the Supremacy Clause (Article VI, Clause 2) establishes that federal laws and treaties made under its authority constitute the supreme law of the land. Also, the Constitution gives the president authority over foreign affairs (Article II, Section 2, Clause 2). Lastly, the Commerce Clause (Article I, Section 8, Clause 3) gives Congress the power to regulate commerce with foreign nations.

This Bill:

Specifically, SB 1328:

- Prohibits the board from investing in a company with business operations in Russia or Belarus, if any of the following apply:
  - The company's business operations provide revenue to the government of Russia or Belarus.
  - The company either:
    - Is engaged in 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 curtail business in those countries, or
    - Has demonstrated complicity in the invasion of Ukraine.
- Prohibits the board from investing in a company that supplies military equipment to Russia or Belarus.
- Within one month of the bill being chaptered:
  - Requires the board to contract with a research firm to determine those companies that have business operations in Russia or Belarus and for the firm to report its findings to the board.
  - Requires the board to:
    - Review publicly available information regarding companies with business operations in Russia or Belarus.
    - Contact other institutional investors that invest in companies with business operations in Russia or Belarus.
    - Send a written notice to a company with business operations in Russia or Belarus that may be subject to this bill.
- Requires the board to determine, by the next applicable board meeting, whether a company meets the criteria for being a prohibited investment and do the following:
  - Liquidate its investments, consistent with its constitutional fiduciary duties, and prohibit additional or new investments in a company that supplies military equipment to Russia or Belarus.
  - Engage with any other company and request that it curtail its business in Russia or Belarus within 30 days.
  - Prohibit additional or new investments and, within six months, liquidate existing investments after determining a company with business operations in Russia or Belarus has not curtailed its business in Russia or Belarus.
- Requires the board to take specified actions to limit its investments in a prohibited company when it has an investment in such a company via an externally and actively managed commingled fund or an alternative fund or account.

- Requires the board to make a good faith effort to identify any private equity investments that involve prohibited companies.
- Requires the board to liquidate its investments, consistent with its constitutional fiduciary duties, and prohibit additional or new investments held in an alternative fund or account or through a private equity investment when the investment involves a company that supplies military equipment to Russia or Belarus.
- Requires the board to report to the Legislature by January 1, 2023, and annually thereafter, on its investments with companies with business operations in Russia or Belarus.
- Specifies that this bill does not require the board to take any action unless the board determines the action to be consistent with its fiduciary responsibilities under Section 17 of Article XVI of the California Constitution.
- Exempts divestment from companies that supply goods or services intended to relieve human suffering in Ukraine, promote health, education, journalistic or religious activities in or welfare in Ukraine.
- Excludes products or activities listed in the Ukraine General License Number 18 or Russia General License Number 6A issued by the U.S. Department of Treasury, Office of Foreign Assets Control, from the divestment provisions.
- Prohibits the State Treasurer from making additional or new investments of state funds in an investment vehicle issued or owned by the government of Russia or Belarus.
- Prohibits a state agency from making additional or new investments of state funds in an investment vehicle issued or owned by the government of Russia or Belarus or from a Russian or Belarusian financial institution currently under sanctions imposed by the U.S., and requires liquidation within six months of the bill being chaptered.
- Requires a state agency to submit a report to the Legislature and the Governor one year after the bill being chaptered on the investment vehicles subject to these provisions and another report to the Legislature three years after the chaptering of the bill on the merit of continuing the prescribed divestment action.
- Urges companies operating in California and the University of California to divest and separate themselves from the governments, financial institutions and businesses of Russia and Belarus and requests companies doing business in California report their investments in and contracts with the governments, financial institutions and businesses of Russia and Belarus, as specified.
- Specifies that this bill does not require a state agency to take any action unless the state agency determines the action to be consistent with its fiduciary responsibilities.
- Makes a company that conducts business with the government of Russia or Belarus (scrutinized company) ineligible to bid on or submit a proposal for a contract with a state agency for goods or services.
- Requires a state agency to require a company that submits a bid or proposal concerning a contract for goods or services to certify that the company is not a scrutinized company.
- Makes a company that submits a false certification under these provisions liable for a civil penalty and requires the Department of General Services to report the company to the Attorney General.
- States that the California Constitution requires the state to reimburse local agencies and school districts for certain costs mandated by the state.

- Makes the provisions related to the board's investments in prohibited companies, a state agency's divestment from prohibited investment vehicles, or a state agency's contracts with a scrutinized company effective only until either:
    - Russia and Belarus halt the invasion and occupation of Ukraine as determined by the U.S. Department of State, or
    - The U.S. revokes all sanctions against Russia and Belarus imposed because of its participation in the February 24, 2022, invasion of Ukraine.

Discussion

CalSTRS shares the sense of urgency regarding Russia's brazen and lawless military assault on Ukraine. Staff follows all current developments and is committed to fulfilling its fiduciary duty to protect the pensions of California's public educators and their beneficiaries. Since Russia initiated its war on Ukraine, the CalSTRS Chief Investment Officer has moved to:

- Cease all new purchases of Russian and Belarusian securities and bonds, which has stopped the flow of funds within the Teachers' Retirement Fund into any new investments in the country.
- Coordinate with all external managers to assess the financial situation on an ongoing basis and protect fund assets.
- Follow all regulatory requirements from the U.S. Treasury's Office of Foreign Assets Control and required sanctions.

CalSTRS holdings in Russian assets totaled $171.5 million as of February 28, 2022, within our $319 billion portfolio. The value of Russian stocks and bonds have fluctuated widely since the crisis began. As of early March, the estimated value of public market holdings was less than $100 million, which are held through Depository Receipts, not directly in the local Russian market. Private assets total approximately $11,000. However, the bill broadly prohibits investments in a company with business operations that provide revenue to the governments of Russia or Belarus. Since the term "revenue" is not defined, this would include any company whose business operations generate tax revenue for the Russian or Belarusian governments. Therefore, the universe of investments affected by this bill is significantly larger and includes multinational corporations that are not domiciled in Russia or Belarus but have business operations in those countries.

The board's policy is to oppose legislation that restricts its ability to invest in specific areas because, as described in its divestment policy, such restrictions could impair the board's ability to exercise its fiduciary obligation to act exclusively for the benefit of the retirement plan members and beneficiaries. Divestment carries the risk of adversely affecting an investment portfolio. This is especially concerning as investment returns affect the CalSTRS Funding Plan (AB 1469–Bonta), which placed CalSTRS on a trajectory toward full funding. Divestment removes investment choices and adds risk to the fund, while also severely limiting CalSTRS' ability to shape corporate behavior for long-term sustainable growth. If CalSTRS divests of a company and another entity acquires those shares, CalSTRS no longer has a seat at the table and cannot influence change in that company.

As with all other laws that restrict CalSTRS' investment authority, SB 1328 provides that, per the California Constitution, the board shall not be required to take action unless the board determines in good faith that the action is consistent with its fiduciary responsibilities. Accordingly, and consistent with its divestment policy, CalSTRS has responded to previously enacted bills by rigorously evaluating *all* relevant factors and only divesting after determining that retaining the asset would pose an economic risk or was de minimis to the plan. CalSTRS has also initiated the divestment policy in the absence of legislation, most notably regarding tobacco. Similarly, CalSTRS only divested when, after a thorough financial analysis considering *all* factors, such an action was deemed to be consistent with its fiduciary responsibilities.

While the provisions of this bill would be effective only until the U.S. government makes a determination as to the status or lifts all sanctions imposed because of the invasion of Ukraine, this bill might not align with the specific provisions of potential federal sanctions. For example, sanctions under federal law could be narrowly crafted to impact individuals or financial institutions with specified ties to the Russian government, while the provisions of this bill are much broader. Under the provisions of the U.S. Constitution, the federal government maintains authority over foreign affairs and commerce with foreign countries. Prior legislation prohibiting investments in Sudan and Iran did not come into constitutional conflict with federal authority because Congress granted authorization to the states to enact such legislation in accordance with specific parameters. In contrast, a much broader law in Illinois called the Illinois Sudan Act, which contained provisions that were not authorized by Congress, was ruled unconstitutional because it interfered impermissibly with the federal government's power over foreign affairs and commerce with foreign countries. No such legislation has been enacted concerning Russia or Belarus. In addition, by restricting investments in any company with operations in Russia or Belarus, SB 1328 goes far beyond the scope of current U.S. sanctions.

The requirements of this bill are likely to be administratively unfeasible. For example, SB 1328 requires CalSTRS to contract with a research firm to determine which companies have business operations in Russia or Belarus, to send a written notice to those companies stating they may be subject to this bill's provisions, and to engage with other institutional investors within one month after the bill is chaptered. Although competitive bidding is waived, these requirements constitute a significant undertaking with potential for additional costs due to the size and scope of the CalSTRS portfolio.

In addition to the extremely short timeframes, SB 1328 would subject numerous companies to its provisions regardless of their involvement or connection to the Russian or Belarusian governments. The bill specifically prohibits investments in a company that: is engaged in 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 failed to curtail business in those countries; has demonstrated complicity in the Russian invasion of Ukraine; or supplies military equipment to Russia or Belarus. Under these prohibitions, a company unrelated to the oil, energy or power sector of Russia or Belarus that contracts with a company with business operations in one of those sectors would be subject to divestment.

Finally, CalSTRS follows an investment strategy, adopted by the board, of diversification and passive index management that does not generally exclude or include any investments in companies, industries or geographic areas. SB 1328 would require CalSTRS to actively exclude new, additional or renewed investments in Russia- and Belarus-related investments, reducing the diversification of the portfolio, increasing risk, and creating opportunity costs as well as costs to customizebenchmark indices. While a specific investment restriction may be intended to address a concern associated with only a fraction of the portfolio, there can be cumulative effects from multiple investment restrictions that may even require the board to reevaluate its assumed investment return and lead to contribution rate increases. In spite of these concerns, SB 1328 does not provide indemnification from the General Fund for CalSTRS' actions in compliance with its requirements.

LEGISLATIVE HISTORY

AB 1320 (Nazarian, Chapter 459, Statutes of 2019) prohibited the CalSTRS and CalPERS boards from making additional or new investments or renewing investments in Turkish investment vehicles, if a federal law is passed to impose sanctions on the government of Turkey for failure to officially acknowledge its responsibility for the Armenian Genocide, and required divestment from such investments within 18 months of the passage of such a federal law, subject to the fiduciary duty of the boards. The bill also required a report to the Legislature and provided for indemnification and repeal, as specified.

AB 498 (Hernandez, Chapter 272, Statutes of 2008) required a company that bids or submits a proposal for a contract for goods and services with a state agency to self-certify that it is not a scrutinized company engaged in specified activities in Sudan.

AB 221 (Anderson, Chapter 671, Statutes of 2007) required CalSTRS and CalPERS, when it is consistent with their fiduciary responsibilities, to divest from companies, as specified, that are invested in or engaged in business operations with entities in the defense, nuclear, petroleum or natural gas sectors of Iran, or that have demonstrated complicity with an Iranian terrorist organization.

AB 2941(Koretz, Chapter 442, Statutes of 2006) prohibited CalPERS and CalSTRS from investing in companies with business operations in the Sudan that are complicit in the Darfur genocide or have specified relationships with the Sudanese government or military. It also required the boards of both retirement systems to divest from such companies, consistent with their fiduciary obligations.

AB 2251 (Margolin, Chapter 1351, Statutes of 1992) prohibited state trust funds from making new or additional investments in business firms or financial institutions that engage in discriminatory business practices after January 1, 1994, relating to the Arab League's economic boycott of Israel. The California Attorney General concluded that this bill was pre-empted by federal law and, therefore, not subject to implementation by CalSTRS.

AB 134 (M. Waters , Chapter 1254, Statutes of 1986) required state pension systems to divest state trust moneys annually by one-third the value of their investments in firms with business operations in South Africa or business arrangements with the government of South Africa and in financial institutions making or increasing loans or extensions of credit to the government of South Africa or a South African corporation. The bill specified exemptions and granted board indemnification.

PROGRAM BACKGROUND

ESG Policy

CalSTRS has its own well-established and longstanding process for thoroughly vetting the environmental, social and governance (ESG) risks of potential investments. The board adopted its Statement of Investment Responsibility in 1978, making CalSTRS an industry leader as one of the first pension funds to adopt a written policy to navigate these complex issues. As a key component of that process, the board has developed a list of risk factors as part of its Investment Policy for Mitigating ESG Risks. The ESG Risk Factors help the board to identify and evaluate investment risks relating to the existence of certain conditions, such as recognition of the rule of law, internal or external conflict, war, human rights, the environment, acts of terrorism, and other unsustainable practices and governance crises with the potential to hurt long-term profits.

Divestment Policy

In addition to the CalSTRS ESG policy, the board has adopted a Divestment Policy, focusing on engagement, to respond to external or internal initiatives to divest of specific companies or industries. In accordance with this policy, CalSTRS has historically taken the position that active and direct engagement is the best way to resolve issues. Divestment bears the risk of adversely affecting an investment portfolio and severs any chance to advance positive change through shareholder advocacy. Meetings with shareowners and senior management, or the board of directors, are generally more effective in bringing about change in a corporation. Under the policy, the board will only consider divestment after all efforts at engagement have failed, and only then in cases where at least one of the ESG Risk Factors is violated over a sustained timeframe to the extent that it becomes an economic risk to the fund, creates a potential for material loss of revenue and weakens the trust of a significant portion of CalSTRS members. Finally, the Divestment Policy sets forth that the board will only instruct staff to divest of a security when it determines that continuing to hold a security is imprudent and inconsistent with its fiduciary duty.

OTHER STATES' INFORMATION

Legislatures in several states have reacted to the Russian invasion of Ukraine, as follows:

- In Alaska, HB 396 requires the Alaska Permanent Fund Corp. and state retirement funds to not invest further in Russian entities and to divest their current Russian holdings within 180 days of identifying an entity as a Russian entity.
- In Illinois, legislation adds Russia-domiciled companies to an existing list of prohibited holdings maintained by the Illinois Investment Policy Board.
- In Minnesota, a bill was passed and signed into law requiring its public employee pension funds to divest of direct holdings in publicly traded companies and governmental entities that have their principal places of business in Russia and Belarus.
- In New Jersey, a bill was passed and signed into law preventing the New Jersey Pension Fund from investing in any company owned or controlled by the government of Russia or Belarus, or an instrumentality of the government of Russia or Belarus, or engaged in business in or with either of those governments or their instrumentalities.
- In North Carolina, the House of Representatives adopted a resolution asking Congress to amend the Foreign Sovereign Immunities Act of 1976 to allow for state pension funds and other institutional investors to hold "corrupt regimes and foreign sate-owned corporations accountable in U.S. Courts for their actions."

- In South Carolina, a bill was introduced that would require the Retirement System Investment Commission to divest from companies owned in whole or in part by Russia or whose principal place of business is located within Russia.

In addition, authorities overseeing retirements systems in other states have taken action, as follows:

- The Colorado Public Employees' Retirement Association indicated it would divest $7.2 million from a Russian bank due to federal sanctions.
- The Connecticut State Treasurer directed state pension funds to sell assets in Russia-domiciled entities, which totaled $218 million in late February.
- In Georgia, the Governor's Office announced in late February that the state, which appears to mean the Employees' Retirement System of Georgia, would fully divest from Russian investments, which are held through an exchange-traded fund that includes a variety of Russian companies.
- The Kansas Public Employee Retirement System Board of Trustees, which holds $35.9 million in Russian securities, voted to make no new investments in Russian securities.
- The Kentucky Teachers' Retirement System held a $15 million investment in a Russian bank that it sold at a loss of $3 million by the time the invasion of Ukraine occurred.
- The Michigan Investment Board voted unanimously to divest the State of Michigan Retirement Systems from any institutions based in Russia or Belarus.
- In New York, the Governor issued an executive order directing stat agencies to divest from Russian-related assets, and the New York State Teachers' Retirement System restricted all further investments in Russia and is in the process of divesting from investments in Russia
- In North Dakota, the State Investment Board voted to divest its investments in Russian entities or securities.
- The Oregon State Treasurer announced he directed staff to work with federal agencies and regulatory authorities to dispose of assets in Russian companies and government entities that have been sanctioned by the U.S. Department of Treasury, Office of Foreign Assets Control or any other relevant federal agencies.
- The Pennsylvania State Employees' Retirement System Board directed staff and hired managers and consultants to take all actions necessary to divest of Russia-related assets "in a prudent manner and within a reasonable time."
- The Rhode Island State Investment Commission voted unanimously to pull state pension fund investments from all Russian financial assets.

FISCAL IMPACT

Program Costs/Savings – CalSTRS exposure in global equity and fixed income investments that derive revenue from Russia and Belarus is approximately $96 billion. Of that amount, approximately $90 billion is in global equity investments, representing about 66% of the Global Equity Portfolio, and approximately $6 billion is in fixed income investments, representing about 18% of the Fixed Income Portfolio. The divestment required by this bill, combined with existing CalSTRS divestments, would create a tracking error, or deviation from the benchmark. Potential costs resulting from tracking error place the CalSTRS Funding Plan at risk. Any resulting costs would increase the unfunded liability and also may result in an increase in the state's contribution to the Defined Benefit Program.

Administrative Costs/Savings – Initial divestment costs of $821 million, which includes staff time, research costs, benchmark costs and anticipated losses associated with selling private asset holdings at a discount to market value. This figure does not include transaction costs to sell the public holdings, which would be additional significant costs. Ongoing annual costs of $63,000 for continued compliance and monitoring.

SUPPORT

California Newspapers Association
California News Publishers Association
California Climate Reality Coalition
Climate Reality Project, California Coalition
Climate Reality Project, Silicon Valley
Conejo Climate Coalition
Cool Planet Working Group of First Presbyterian Church of Palo Alto
First Presbyterian Church of Palo Alto
Fossil Free California
Indivisible CA Green Team
Indivisible Ventura
Rooted in Resistance
Santa Cruz Climate Action Network
Stand.earth
Sonoma Clean Power
350: Conejo/San Fernando Valley; Riverside; Sacramento Legislative Team; Silicon Valley; South Bay Los Angeles; Ventura County Climate Hub

OPPOSITION

CalSTRS
CalPERS

ARGUMENTS

Pro: May reduce the perception that CalSTRS is contributing to inadvertently supporting Russia and Belarus.

Con: Infringes upon the investment authority of the board.

Reduces the investable universe, potentially adversely affecting portfolio performance and risk.

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