BILL NUMBER: SB 457 (Portantino) as introduced February 16, 2021

SUMMARY

SB 457 requires CalSTRS to provide a school district an option to elect an investment portfolio that does not contain investment vehicles that are issued or owned by the government of the Republic of Turkey. The bill extends the same provision to school districts and cities participating in CalPERS.

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 and legislation that infringes on the investment authority of the board.

REASON FOR THE BILL

According to the bill’s author, the Republic of Turkey is engaged in ongoing denial of the Armenian Genocide and has conducted unprovoked attacks on Armenians in the Republics of Artsakh and Armenia, and allowing California school districts and cities to opt out of investment vehicles issued or owned by the Republic of Turkey would impose economic consequences on the Republic of Turkey and encourage its government to reach a fair and just resolution for the survivors of the Armenian Genocide.

ANALYSIS

Existing Law:

CalSTRS is a cost-sharing multiple-employer defined benefit pension plan that covers almost 2,000 school districts, community college districts and county offices of education across California. The CalSTRS Defined Benefit (DB) Program is funded by contributions from employers, members and the State of California, as well as investment returns from those contributions. The CalSTRS Funding Plan established that employers and the state are each responsible for a share of the DB Program’s unfunded liability. However, as the plan sponsor and guarantor of the DB Program, the state has the legal obligation to pay benefits accrued under the plan on a pay-as-you-go basis if the Teachers' Retirement Fund is ever insufficient to pay promised benefits. As a cost-sharing multiple-employer plan, all assets are pooled for purposes of both investment and payment of benefit liabilities, and individual benefit payments are debited from the fund as a whole rather than from individual employer accounts, which do not exist.

Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, as well as the Teachers’ Retirement Law, the Teachers’ Retirement 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 investments 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.

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.

Government Code section 7513.74 establishes multiple requirements for the CalSTRS and CalPERS boards to divest from Turkish government 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. Neither board shall be required to take action unless the board determines in good faith that the action is consistent with its fiduciary responsibilities. Current law also indemnifies present, former and future board members, officers and employees of and investment managers under contract with those retirement systems for related actions. Because such a federal law has not been enacted, these requirements are not currently operative. These provisions will be repealed on the earlier of either a determination that the government of Turkey has officially acknowledged its responsibility for the Armenian Genocide or January 1, 2025.

This Bill:

SB 457 requires the board to provide an employer that is a school district an option to elect an investment portfolio that does not contain investment vehicles that are issued or owned by the government of the Republic of Turkey.

The board's policy is to oppose legislation that restricts or infringes upon its plenary authority to administer the retirement plan. Existing laws that restrict CalSTRS' investment authority acknowledge 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. This bill does not recognize this constitutional requirement.

This bill could directly impact foreign relations with the Republic of Turkey and, in doing so, would interfere with the federal government's exclusive authority under the U.S. Constitution to manage foreign affairs. The courts have held that, even in the absence of express federal policy, a state law still may be preempted if it intrudes on the field of foreign affairs without addressing a traditional state responsibility. While this bill does not require individual employers to elect a portfolio without Turkish investment vehicles, the purpose and effect of the bill is to make it easier for individual employers to pressure the Republic of Turkey to take specific actions. As such, a court inquiring into the "real purpose" of this bill would arguably conclude that it does not concern an area of traditional state responsibility.

Moreover, SB 457 would require significant and costly modifications that would fundamentally change CalSTRS' operations. Because the DB Program is a cost-sharing multiple-employer defined benefit pension plan, CalSTRS does not currently maintain a separate portfolio with a discrete value and asset allocation for each participating employer. The contributions made by employers and members are pooled together and invested jointly in a single portfolio, with investment returns being credited to the system rather than to individual employer accounts. If employers had the option to elect a separate portfolio, CalSTRS would have to establish separate and distinct accounts to account for each employer's share of investment returns. Contributions and benefit payments would be credited and debited to individual employer accounts, rather than the fund as a whole. Such requirements would necessitate substantial and costly changes to CalSTRS' new pension administration system.

Separate portfolios would also require CalSTRS to unitize its portfolio holdings in order to account for each employer's portfolio holdings and valuation. Unitizing is a process similar to the one used by mutual funds to report daily value of assets by units. Unitizing cannot be easily achieved with asset classes such as private equity and real estate, which have less liquidity and do not report valuation on a daily basis. SB 457 could prevent CalSTRS from investing in these asset classes for employers who elect the proposed investment choice. Because these asset classes provide for increased diversification and have some of the highest expected returns across CalSTRS' portfolio, investment performance could be significantly lower for employers electing this option. This would increase the cost of funding retirement benefits and would present significant obstacles to maintaining CalSTRS' diversified portfolio and achieving the investment returns necessary for the success of the CalSTRS Funding Plan. Even when CalSTRS would be able to pool investments across multiple accounts, CalSTRS would need a significant increase in accounting resources to account for each employer's individual share of affected investments.

SB 457 would also necessitate a redesign of the CalSTRS Funding Plan and could materially impact how CalSTRS performs its actuarial duties. If employer assets are separated in individual portfolios, employers would then be responsible for the funding of the retirement benefits of their employees only, resulting in varying funding levels across employers and varying contribution requirements. This scenario is fundamentally incompatible with the existing funding plan. Separate portfolios would require separate actuarial valuations for each employer, which would require a significant increase in staffing and resources.

Finally, separate investment portfolios could lead to significant increased costs for the state. Because school districts are not fiduciaries for the plan, they are not bound by the same legal responsibilities to preserve the assets of the plan and could make decisions that would decrease their investment returns. If an employer ceased operations and had an increased unfunded liability due to their portfolio election, CalSTRS does not have statutory authority to collect from the employer the funds necessary to offset this employer-caused unfunded liability, and the state would be responsible for making up the difference. This bill would allow school districts to elect investment portfolios with increased risk and lower expected returns, and the state could incur the costs of that risk because it is the plan's fiscal guarantor.

Because of the multiple ways this bill would increase CalSTRS' administrative costs and decrease investment returns, this bill would likely increase both the employer and state contributions needed to achieve full funding by 2046 and would increase the risk that the DB Program would not reach full funding by 2046.

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 1597 (Nazarian, 2018) would have prohibited the CalSTRS and CalPERS boards from making additional or new investments or renewing existing investments in any Turkish investment vehicle, immediately upon passage of a federal law imposing sanctions on Turkey for failure to acknowledge the Armenian Genocide, and would have required divestment from such investments within six months of the passage of such a federal law, subject to the fiduciary duty of the boards. The bill also would have required a report to the Legislature and provided for indemnification and repeal, as specified. This bill was vetoed.

AJR 3 (Nazarian, Resolution Chapter 56, Statutes of 2017) designated 2017 as "State of California Year of Commemoration of the Anniversary of the Armenian Genocide of 1915-1923" and April 24, 2017, as the "State of California Day of Commemoration of the 102nd Anniversary of the Armenian Genocide of 1915-1923" and called upon the U.S. President and Congress to formally and consistently reaffirm the Armenian Genocide.

AB 1410 (Nazarian, 2015) would have sought to encourage the government of Turkey to acknowledge, and to reach resolution on reparations for survivors of, the Armenian Genocide by requiring CalSTRS and CalPERS to divest of any Turkish investment vehicle. The bill also would have required a report to the Legislature and provided for indemnification, as specified. This bill was held in the Assembly Appropriations Committee.

H.Res.154 (Dold, 2015) would have called on the U.S. President to work toward equitable, constructive, stable and durable Armenian-Turkish relations based upon Turkey's full acknowledgment of the facts and ongoing consequences of the Armenian Genocide and a fair, just and comprehensive international resolution of this crime against humanity. This resolution was held in the House Committee on Foreign Affairs.

S.Res. 410 (Menendez, 2014) would have expressed the sense of the U.S. Senate: (1) in remembrance of the anniversary of the Armenian Genocide on April 24, 2014, and (2) that the U.S. President should ensure that U.S. foreign policy reflects appropriate understanding and sensitivity concerning issues related to human rights, crimes against humanity, ethnic cleansing and genocide documented in the U.S. record relating to the Armenian Genocide. This resolution was held on the Senate Floor.

SB 424 (Poochigian, Chapter 9, Statutes of 2005) established April 24 of each year as the "California Day of Remembrance of the Armenian Genocide" and the period beginning on the Sunday before that day through the following Sunday as the days of remembrance of the Armenian Genocide.

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.

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, shareholder rights, 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.

Armenian Genocide

The Armenian Genocide is largely believed to have begun on April 24, 1915, when hundreds of Armenian intellectual, political, religious and business leaders were arrested and deported from Constantinople. In acknowledgment of its 100th anniversary, California enacted Resolution Chapter 30, Statutes of 2015 (AJR 2, Nazarian), to recognize the Armenian Genocide as a series of events occurring between 1915 and 1923 in which the rulers of the Ottoman Turkish Empire and its successor state, the Republic of Turkey, subjected its Armenian citizens to torture, starvation and murder. Successive Turkish governments have failed to acknowledge the Armenian Genocide and have even convicted journalists and scholars for making reference to the Armenian Genocide. In the fall of 2020, an armed conflict broke out with Azerbaijan fighting against Armenia as well as ethnic Armenians in the breakaway state of Artsakh. National governments, human rights organizations and international observers have generally recognized that Turkey provided military support to Azerbaijan during the conflict, although both Azerbaijan and Turkey deny this.

FISCAL IMPACT

Program Cost – Unknown but significantly lower investment returns resulting from decreased ability to invest in asset classes that cannot be easily unitized. CalSTRS exposure to currency and debt securities directly issued by the government of Turkey is approximately $2.2 million. Additional exposure in global equity and infrastructure investments in which the government of Turkey is the majority owner are approximately $717,000 and $9.7 million, respectively. CalSTRS may incur opportunity costs if suitable alternative investments are unavailable or if such alternative investments do not provide an investment return that meets or exceeds those of the divested securities. Any resulting costs would be passed along to the state and employers in the form of higher contributions to the DB Program.

Administrative Costs/Savings – Unknown but significant costs ranging from hundreds of millions of dollars to $1 billion for significant reprogramming of and associated delays to

CalSTRS' new pension administration system as well as increased staffing and workload for Investments and Actuarial Resources.

SUPPORT

Ardy Kassakhian, Glendale City Councilmember
Armenian National Committee of America – Western Region

OPPOSITION

CalSTRS
California Professional Firefighters
California Retired Teachers Association
California Teachers Association
Consul General, Los Angeles, Republic of Turkey

ARGUMENTS

Pro: Could eliminate the perception that CalSTRS and individual school districts are contributing to a continuing denial of the Armenian Genocide by Turkey.

Con: Delegates some investment decisions to school districts that do not have fiduciary responsibility over the investment of CalSTRS' assets.

Infringes upon the plenary, fiduciary and investment authority of the board.

Reduces the investable universe and adversely affects portfolio performance.

Is incompatible with CalSTRS' current portfolio management and benefits administration models.

Creates additional unfunded liability not accounted for in the CalSTRS Funding Plan.

Lacks clear definition of affected investment vehicles.

LEGISLATIVE STAFF CONTACT

Arthur Shemitz
Legislative Analyst,
CalSTRS Governmental Relations,
916-414-1186
ashemitz@calstrs.com

John Maradik-Symkowick
Manager,
CalSTRS Governmental Relations,
(916) 414-1977
jmaradik-symkowick@calstrs.com

Joycelyn Martinez-Wade
Director,
CalSTRS Governmental Relations,
(916) 414-1980
jmwade@calstrs.com