SB 543

Department of Legislative Services

Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 543 (Senator Jones, *et al.*)
Budget and Taxation Appropriations

2007 Darfur Protection Act - Divestiture from the Republic of Sudan

This bill requires the Board of Trustees of the State Retirement and Pension System (SRPS) to encourage companies held by actively traded accounts in its portfolio that conduct business in Sudan to act responsibly and avoid actions that promote or enable human rights violations in Sudan. It further authorizes the board to divest from companies that conduct business in Sudan and from any security or instrument issued by Sudan, based on factors outlined in the bill.

The bill takes effect July 1, 2007, but is subject to abrogation if the President of the United States rescinds his Executive Order banning American firms from conducting business in Sudan or with the government of Sudan.

Fiscal Summary

State Effect: Minimal or no impact on State pension contribution rates, assuming that the SRPS board exercises its fiduciary responsibilities, as permitted by the bill, in limiting the system's losses stemming from divestment of firms conducting business in Sudan.

Local Effect: None.

Small Business Effect: None.

Analysis

Bill Summary: In deciding whether to divest from a company conducting business in Sudan, the board may consider the following factors:

- revenues paid directly to the government of Sudan;
- whether the company provides resources used to carry out genocide in Darfur or other regions;
- whether the company seeks to circumvent American sanctions against Sudan;
- the extent of humanitarian actions the company takes in Sudan;
- whether the company is engaged solely in humanitarian activities in Sudan;
- whether the company is authorized by the American government to conduct business in Sudan;
- evidence that the company is working to stop genocide in Sudan;
- whether the company is conducting only journalistic activities in Sudan; and
- any other factors it considers prudent.

The board must notify any company from which it divests of its decision and provide an explanation. It must also submit quarterly reports to the General Assembly summarizing its activities with respect to companies doing business in Sudan.

Current Law: There is only one statutory restriction on the investment of SRPS assets: only up to 25% of assets invested in common stocks may be invested in nondividend paying common stocks.

Chapter 775 of 1985 prohibited SRPS from investing any net new assets (employee and employer contributions) in companies doing business in South Africa for two years, subject to certain exemptions.

Background: In 1997, President Clinton issued an Executive Order banning American companies and individuals from doing business with the government of Sudan because of its repressive human rights record. Since then, the Sudanese government has been linked to ongoing attacks against civilians in the country's Darfur region. By some estimates, at least 200,000 Sudanese have been killed in Darfur and 2.5 million have been left homeless. Many observers believe the killing is being driven by the Sudanese government's search for untapped oil reserves in the region. Many of the firms that maintain economic ties to Sudan are in the energy sector. Former Secretary of State Colin Powell and President Bush have referred to the situation in Darfur as "genocide."

Several states, led by Illinois, New Jersey, California, and Vermont, have already enacted legislation or taken steps to divest from companies with economic ties to the Sudanese government. Several investment research firms have compiled lists of companies that continue to have ties with the government of Sudan. A list compiled by KLD Analytics applied the criteria in the Illinois bill to identify approximately 130 foreign companies, of which about 80 are traded on American stock exchanges. Institutional Shareholder Services (ISS) has developed a more flexible list that identifies firms that meet multiple sets of criteria established by different States and advocacy groups. Illinois' divestment legislation was recently declared unconstitutional by a state court, on the basis that it interferes with the President's authority to conduct American foreign policy.

As a result of the sanctions imposed by President Clinton, U.S. companies do not have economic ties to Sudan. However, some foreign companies that are traded on domestic stock exchanges maintain business ties with the government of Sudan. The Morgan Stanley Capital International (MSCI) Europe, Australasia, and Far East (EAFE) index is the most commonly used index to measure the performance of international investment funds, and many asset management firms offer passively-managed investment funds that track the index. KLD and ISS have both identified firms included in the MSCI EAFE index with economic ties to Sudan.

Several asset management companies have developed investment instruments that mirror the index while excluding those firms. Northern Trust, which manages foreign holdings for the Illinois pension system, developed a series of Sudan-free funds (also called ex-Sudan funds) based on the KLD list. Northern Trust reports that its MSCI EAFE ex-Sudan fund, in its second year of existence, has generated returns that are identical to the MSCI EAFE index. However, Northern Trust cautions that, under the Illinois legislation, full divestment is not mandated until July 2007, so those results are likely to change. It projects that its EAFE ex-Sudan fund, when mature, will generate returns within 50-75 basis points of the MSCI EAFE index. With guidance from ISS, State Street Global has also developed one ex-Sudan fixed income fund, but has not developed any ex-Sudan equity funds.

State Fiscal Effect: Investment returns by SRPS can have a profound effect on State pension contribution rates. This is best illustrated by examining the years bracketing the stock market downturn of 2001-02. Prior to the downturn, State pension contributions had declined as a percentage of payroll for four consecutive years, as SRPS enjoyed robust investment returns that exceeded its investment assumptions by considerable amounts. In the two years following the downturn, when SRPS investments lost money, State pension contributions increased by 9.0% the first year and would have increased by another 8.4% the following year if the State had not acted to restrict their growth.

SRPS relies on external managers selected by the board of trustees to manage all its assets, so the system has no direct equity holdings. The bill applies only to "actively traded separate accounts" held by the board, and specifically excludes indexed funds, real estate funds, private equity funds, and other commingled or passively managed funds. A review by the Department of Legislative Services (DLS) of the system's holdings as of June 30, 2006 revealed that 20 funds totaling $14.4 billion in assets, or 42% of the system's holdings, are actively traded public equity or fixed income funds. However, two of those funds, totaling $880.1 million in assets, are commingled funds, and are therefore excluded from the bill. The remaining 18 funds, totaling $13.5 billion in assets (39% of total assets), are separately held for SRPS.

SRPS was not able to provide DLS with an analysis of which of those funds hold shares of companies that conduct business in Sudan in time for the preparation of this fiscal and policy note. Assuming that at least some of the funds hold shares in those companies, the bill authorizes, but does not require, SRPS to divest from those companies. Selling off those shares would involve transaction costs, possible capital gains losses, and possible foregone returns in the future if the divested assets are not reinvested in other funds that perform at least as well. If those transaction costs and potential losses are sufficiently large, they could affect State pension contribution rates, as explained above. Since the bill gives SRPS discretion in deciding from which companies it chooses to divest, if any, it can limit the system's losses. Therefore, DLS assumes that the bill would have minimal, if any, fiscal impact on State pension contribution rates.

Additional Information

Prior Introductions: HB 1001 of 2006, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: HB 1336 (Delegate Branch, *et al.*) – Appropriations.

Information Source(s): Mercer Human Resources Consulting, Maryland State Retirement Agency, Department of Legislative Services

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