HB 371

Department of Legislative Services
Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE
Revised

House Bill 371 (The Speaker, *et al.*) (By Request – Administration)
Appropriations Budget and Taxation

Divestiture from Iran and Sudan

This Administration bill requires the Board of Trustees of the State Retirement and Pension System to notify any company whose shares are held in an actively traded separate account in its portfolio that is doing business in either Iran or Sudan that the board will divest all holdings in the company unless the company releases a plan to cease its business with Iran or Sudan within one year. The bill exempts from the divestment requirement any company that is excluded from U.S. government sanctions against Iran or Sudan and whose divestment cannot be executed for fair market value or greater. It requires the board to act in good faith and in a manner consistent with its fiduciary responsibilities in carrying out the bill's divestment requirement. The board is inured against liability associated with actions made in good faith to comply with the bill. The bill's provisions are severable if any are held invalid in court.

The bill takes effect January 1, 2009.

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 Iran and Sudan.

Local Effect: None.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). Legislative Services concurs with this assessment. (The attached assessment does not reflect amendments to the bill.)

Analysis

Bill Summary: The bill defines doing business in Iran as having invested, in any given 12-month period since August 1996, more than $20 million in Iran's petroleum or natural gas industries. Doing business in Sudan is defined as maintaining or leasing equipment, facilities, personnel, or other apparatus in oil-related, mineral extraction, power production, or military production activities in Sudan.

The bill establishes a timeline for carrying out divestment from Iran and Sudan. Within 30 days of completing a review of its holdings to identify eligible businesses doing business in either Iran or Sudan, the board must provide written notice to those companies that they will be subject to divestment unless they respond within 90 days and:

- can demonstrate that they do not do business in either country; or
- state that, within 60 days, they will produce a plan to end doing business in Iran or Sudan within one year.

The board must divest from any notified company that does not abide by these conditions, and from any notified company that does not cease doing business in Iran or Sudan within one year.

The bill requires the board to recommend amendments to the law to the Joint Committee on Pensions if conditions warrant the repeal of either divestment mandate.

Current Law: Chapters 39 and 40 of 2007 authorize the SRPS Board of Trustees to divest its holdings in companies that do business in Sudan after engaging those companies in an effort to encourage them to act responsibly and refrain from any activities that promote or enable abuses of human rights in the Darfur region of the country. Like this bill, the Sudan divestment laws also apply only to shares of companies held in actively managed separate accounts. In deciding whether to divest from a particular company, the board must act in accordance with its fiduciary responsibilities. To date, SRPS has divested from one company: Schlumberger is the largest oil field services firm operating in Sudan. Divestment was carried out with minimal transaction costs to the system.

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.

In a 1989 ruling involving divestment from companies doing business in South Africa by three Baltimore City public pension funds, the Maryland Court of Appeals ruled that pension plan fiduciaries could consider the social consequences of investment decisions if the fiscal consequences are *de minimis*. Although the court did not explicitly define what constitutes a *de minimis* effect, it noted that the projected ongoing annual costs of divestment were one-twentieth of 1%.

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."

The federal Sudan Accountability and Divestment Act of 2007 permits, but does not require, state and local governments to divest from companies doing business in Sudan.

In 2005, the Missouri State Treasurer adopted a terror-free investment policy that barred the state from investing in companies with business ties to four countries that the U.S. government has deemed to be state sponsors of terrorism (Iran, North Korea, Syria, and Sudan). At her urging, the Missouri State Employees Retirement System adopted a similar policy the following year. Since then, four states (Florida, New Jersey, California, and Illinois) have enacted legislation to divest their pension plans of companies that do business in Iran and 22 states have enacted divestment policies with regard to Sudan.

Some Iran divestment or terror-free measures in other states have targeted only actively traded funds, as does this bill, while others have taken a more comprehensive approach. Missouri's approach was the most far-reaching in that it targeted about 190 companies in both actively and passively managed international funds, and is the only approach that has had enough time to develop a track record. State Street Global Assets, the Missouri fund's sole passive manager of international assets, created a tailored index fund to conform to the Missouri Treasurer's terror-free "do-not-buy" list. According to the Missouri Treasurer's office, since inception, the terror-free tailored index fund has outperformed the Morgan Stanley Capital International (MSCI) index by almost 400

basis points. Legislative Services notes that State Street is also the only passive international asset manager for SRPS.

Several investment advisory firms either offer or have plans to offer lists of firms with business ties to Iran and other state sponsors of terrorism. Current industry leaders include Conflict Securities Advisory Group and Institutional Shareholder Services (ISS), which has previously advised SRPS on Sudan divestment. Risk Metric's Group, the board's current corporate governance advisor, has identified 80 companies involved in Iran's petroleum-energy sector, but has been unable to identify which of those firms meets the $20 million threshold established by the bill. The American Israel Public Affairs Committee also developed a list of 22 companies with business ties to Iran.

Given the novelty of terror-free investing, asset managers have been slow to develop terror-free investment vehicles for large institutional investors, but that is beginning to change. Until recently, there were only a handful of niche companies offering terror-free products. However, the FTSE Group, a global leader in the development and management of international equity indices, is currently developing a terror-free index series to parallel its Global Equity Index series that includes more than 2,000 international firms. Northern Trust, a major asset management firm that currently coordinates the SRPS Emerging Manager program, is also exploring terror-free investment products.

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 2001-2002. 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.

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 of the system's holdings as of December 31, 2007 revealed that 31 funds totaling $16.6 billion in assets, or 42% of the system's holdings, are actively traded public equity or fixed income funds.

SRPS indicates that, as of December 31, 2007, it held 32 of the 80 companies identified by Risk Metrics Group as being involved in Iran's petroleum-energy sector in its actively managed separate accounts, with a total value of $524.9 million. This represents 3.1% of assets held in those accounts. However, SRPS cannot determine which of those

companies would meet the $20 million threshold that would make them eligible for divestment. It has been advised that the information necessary to make that determination should be available by the bill's effective date. In the absence of that information, and due to the inherently speculative nature of projecting future investment returns, SRPS cannot provide a reliable estimate of the potential transaction, management, and opportunity costs associated with divestment from Iran and Sudan.

DLS notes, however, that the costs associated with divestment under the 2007 Darfur Protection Act (Chapters 39 and 40) have been negligible to date. Prior to the law's enactment, SRPS received an estimate that transaction costs associated with divestment could be as high as $900,000, with the potential for additional management and opportunity costs. To date, those estimates have proven to be inflated. Moreover, the *de minimis* standard contained in the Court of Appeals' 1989 ruling, combined with the flexibility the bill provides to the board to act in good faith, should result in the bill having minimal, if any, fiscal impact on SRPS assets. Therefore, it would have no discernable effect on State pension liabilities or contribution rates.

The State Retirement Agency advises that it will need one new full-time position to implement the bill's provisions. DLS notes that the agency already contracts with Risk Metrics Group to monitor firms doing business in Iran and Sudan and advise the board on divestment issues. Therefore, DLS does not believe a new position is warranted.

Additional Information

Prior Introductions: None.

Cross File: SB 214 (The President, *et al.*) (By Request – Administration) – Budget and Taxation.

Information Source(s): Maryland State Retirement Agency, Office of the Missouri State Treasurer, Conflict Securities Advisory Group, National Conference of State Legislatures, Department of Legislative Services

Fiscal Note History: First Reader - February 21, 2008
ncs/jr Revised - House Third Reader - April 22, 2008

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