

Department of Legislative Services
Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE

Senate Bill 344

(Senator Garagiola, *et al.*)

Budget and Taxation

Divestment from the Republic of Sudan

This bill requires the State Retirement and Pension System (SRPS) to encourage companies in its portfolio that have business or economic ties to the government of Sudan to cease business activity in or with Sudan. If the companies maintain business or economic ties with the government of Sudan, SRPS must, in specific cases, divest completely from those firms.

The bill takes effect July 1, 2007.

Fiscal Summary

State Effect: Potential short-term increase in State expenditures (all funds) for employer pension contributions stemming from initial transaction costs related to divestment from companies with economic ties to the government of Sudan. Long-term effects on State pension contributions depend on the relative performance of Sudan-free investment funds compared with current SRPS holdings. Net investment losses would result in higher State pension contribution rates, while net investment gains could reduce State pension contribution rates or slow their growth.

Local Effect: None.

Small Business Effect: None.

Analysis

Bill Summary: The bill applies to “scrutinized companies,” which are defined as those that have business operations in Sudan, are complicit in the genocide occurring in the Darfur region, or supply military equipment to Sudan, unless the military equipment cannot be used for offensive military action or is safeguarded against use by parties engaged in armed conflict. By October 1, 2007, SRPS must identify scrutinized companies in which the board of trustees has direct or indirect holdings. Based on the companies’ status and level of activity in Sudan, SRPS must follow different procedures to encourage companies to end their business or economic ties to the government of Sudan or, ultimately, face divestment by the system.

Inactive Businesses

With respect to companies that have only an inactive presence in Sudan (*i.e.*, have suspended their business operations), the board must send letters to those firms every six months encouraging them to remain inactive until they can ensure that they can avoid all scrutinized business practices.

Active Businesses

SRPS may not acquire shares of a scrutinized company with active business operations in Sudan. In addition, SRPS must send letters to companies with active business operations in Sudan alerting them to their scrutinized status, allowing them to explain their Sudan-related business activities, encouraging them to cease scrutinized business practices, and warning them that they may be subject to divestment. If a company ceases scrutinized business practices within 90 days of receiving the letter, it is removed from the list of scrutinized companies. If it converts active practices to inactive practices, it becomes subject to the provisions related to inactive businesses. However, if a company resumes active scrutinized practices after suspending them, it immediately becomes eligible for divestment, subject to written notification by SRPS.

If an active company does not cease scrutinized practices after 90 days, SRPS must divest 50% of its holdings in the company within 9 months, and 100% of its holdings in the company within 15 months. However, SRPS is exempt from divesting from companies if they are held indirectly in an account or fund that is actively managed by an external manager. Private equity holdings are also exempt. Companies that the U.S. government deems to be excluded from federal sanctions are also not subject to divestment. Also, SRPS may cease divesting from companies if the value of its total assets under management becomes equal to or less than 99.5% of the value of assets prior to divestment.

SRPS must petition external fund managers to remove scrutinized companies with active operations in Sudan from their funds, or to create similar actively managed funds that exclude those companies. If external managers create such alternative funds, SRPS must transfer holdings from the affected funds to the Sudan-free funds.

The bill includes requirements for periodic reports that SRPS must submit to the General Assembly's Joint Committee on Pensions and to the U.S. Presidential Special Envoy to Sudan.

The bill's provisions expire if the U.S. Congress or President:

- declare that genocide in Darfur has been halted for 12 consecutive months;
- revoke sanctions imposed against the government of Sudan; or
- declare, through legislation or Executive Order, that divestment interferes with the conduct of U.S. foreign policy.

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, as many as 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 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.

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 MSCI 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. State Street Global has also developed one ex-Sudan fixed income fund, but has not developed any ex-Sudan equity funds.

State Fiscal Effect: SRPS relies on external managers selected by the board of trustees to manage all its assets, so the system has no direct equity holdings. As of June 30, 2006, approximately half of SRPS' \$34.4 billion portfolio is invested in passively-managed commingled funds administered by State Street Global. Two are domestic equity funds (\$9.4 billion combined), one is an international fund that tracks the MSCI index (\$3.3 billion), and one is a fixed income fund (\$4.5 billion). The remainder of SRPS' holdings, including all private equity holdings, are in actively managed funds, which the Department of Legislative Services (DLS) believes are exempt from the divestment mandate under the provisions of this bill.

State Street Global advises that the smaller of the two domestic equity funds held by SRPS and the fixed income fund have no Sudan-related firms. The larger domestic equity fund has four to six Sudan-related firms among its holdings, but State Street notes that SRPS is the only participant in that fund, so it has sole discretion over the funds holdings. The costs of divesting from the few Sudan-related firms in the fund would be negligible, according to State Street.

Therefore, the bill would have the largest effect on the State Street international fund, which ISS reports has holdings in multiple scrutinized companies. This fund commingles assets from multiple large institutional investors, so SRPS exercises minimal control over its investment strategies. It is therefore likely that SRPS would have to divest completely from State Street's international fund. That fund returned 22.2% in the year ending June 2006, and had average annual returns of 25.0% over the last three years. SRA's investment division estimates that the transaction costs associated with that sell-off could be as high as \$2.5 million. Since State Street Global does not currently offer an ex-Sudan international equity fund, SRPS would have to transfer its assets from that fund to a new asset manager. Changing asset managers could involve additional administrative fees.

SRA advises that its interpretation of the bill leaves it unclear whether its actively managed funds would be subject to the divestment mandate. Those funds are held separately for SRPS by external managers, so the system has more discretion in establishing their investment guidelines. If the bill is interpreted to apply to those funds, SRPS would have to sell its holdings in scrutinized companies held by those funds. SRA estimates that transaction costs resulting from the sale of scrutinized companies could be between \$900,000 and \$1.4 million, depending on market conditions at the time of the sale. However, DLS does not believe that the system's actively managed funds are subject to divestment.

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.

The transaction costs involved in divesting from scrutinized companies represent initial investment losses to the system. If they are sufficiently large, those initial losses could affect State pension contribution rates in the short term. However, without knowing whether ex-Sudan equity funds will outperform or under-perform the system's current holdings, it is difficult to predict the bill's long-term effect on State pension contributions. If ex-Sudan funds under-perform current assets, State pension contribution rates would rise, but if ex-Sudan funds outperform current assets, State pension contribution rates would fall or would grow at a slower pace. Under the bill's cap, investment losses resulting from divestment would not exceed \$187 million.

SRA can carry out the bill's reporting requirements with existing resources.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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