



## FULL ANALYSIS

### I. SUBSTANTIVE ANALYSIS

#### A. HOUSE PRINCIPLES ANALYSIS:

Provide limited government – The bill requires the State Board of Administration (SBA) to sell, redeem, divest, or withdraw any investment in violation of this act. In addition, it creates reporting requirements for the SBA.

Maintain public security – The bill prohibits the SBA from investing pension or annuity fund assets in companies with ties to or engaged in business with known state sponsors of terror. This would prevent those funds from reaching entities that may harm the United States, including Florida.

#### B. EFFECT OF PROPOSED CHANGES:

##### **BACKGROUND**

##### State Board of Administration

The State Board of Administration (SBA) is created in s. 4(e), Article IV of the State Constitution. Its members are the Governor, Chief Financial Officer, and the Attorney General. The SBA derives its powers to oversee state funds from s. 9, Article XII of the State Constitution.

The SBA manages the Florida Retirement System (FRS) Pension Plan and FRS Investment Plan represent, which represents approximately \$129 billion or 73 percent of the \$177 billion in assets.<sup>1</sup> The Pension Plan is a defined benefit plan and the Investment Plan is a defined contribution plan that employees choose in lieu of the Pension Plan.

##### FRS Pension Plan

The Florida Retirement System (FRS) is a multi-employer, non-contributory pension plan providing retirement income benefits to more than 625,000 active and 210,000 retired members and beneficiaries of its 900 state and local government public employers. Originally established in 1970 as the successor to the Teachers' Retirement System and the State and County Officers' and Employees' Retirement System, today the FRS is a combination of four previously separate pension plans. Benefit payments are administered by the Department of Management Services through its Division of Retirement while investment management is undertaken by the SBA. Established as a Section 401(a) government plan under Title 26 of the United States Internal Revenue Code, its benefits are exempt from federal taxation until received by the employee.<sup>2</sup>

##### FRS Investment Plan

The 2000 Legislature enacted sweeping changes to the FRS by creating the Public Employees Optional Retirement Program,<sup>3</sup> an alternative defined contribution or "Investment Plan," for its members. While a defined benefit plan provides an annuitized monthly benefit expressed as a percent of final pay, a defined contribution plan gives members an equity interest in their employer's payroll contributions and their earnings, although it does not assure a guaranteed result. All new FRS-covered employees were given the option to enroll in the new plan and existing employees were provided a one time opportunity to change their current enrollment.

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<sup>1</sup> State Board of Administration, HB 703 (2007), Bill Analysis (Feb. 9, 2007) (on file with the board and the Committee on State Affairs) [hereafter referred to as "SBA Analysis"]

<sup>2</sup> Part I, chapter 121, F.S.

<sup>3</sup> Part II, chapter 121, F.S.

## Investments

Investment decisions for the Pension Plan are made by fiduciaries hired by the state, while investment decisions for the Investment Plan are made by individual employees who may design their own portfolios based on participating offering companies.

Investment managers, as well as the SBA Trustees and staff, are contractually bound to follow Federal law, Florida law, and the fiduciary standards of the Employee Retirement Income Security Act (ERISA).<sup>4</sup> Such fiduciaries are legally required to act solely in the interest of the beneficiaries of the FRS and for the exclusive purpose of providing benefits to participants and defraying reasonable administrative expenses. Under Florida law, an SBA fiduciary charged with an investment decision must act as a prudent expert would under similar circumstances, taking into account all relevant substantive factors. Staff and consultants regularly review managers' investments, performance, and compliance with contractual and legal requirements.<sup>5</sup>

Currently, the SBA does not invest in the securities of any company domiciles in countries on the U.S. State Department's list of countries that are state sponsors of terrorism.<sup>6</sup> The list presently includes Cuba, Iran, North Korea, Sudan, and Syria.<sup>7</sup>

In 2006, the SBA took a number of proactive steps to specifically address the investment risks that may be associated with companies having business operations in or economic ties to countries that are designated state sponsors of terrorism.<sup>8</sup> For example, in early 2006, staff met with a small group of large peer organizations regarding investments with ties to Sudan. As part of the Council of Institutional Investors (CII) Spring Conference in Washington, D.C., staff attended a special meeting with CalPERS<sup>9</sup> and other members of CII<sup>10</sup> to discuss their group initiative to engage companies with operations in the Sudan as well as tactics to engage regulatory bodies and other stakeholder organizations.<sup>11</sup>

While the SBA was but one of several large institutional investors to conduct outreach to foreign corporations following the Spring 2006 CII Conference, two of the largest companies contacted have recently announced plans to end or suspend business relations in Sudan. On January 4, 2007, ABB, the Swiss power engineering group, announced it had decided to suspend its business in Sudan. On January 20, 2007, Siemens AG, Europe's largest electronics and electrical engineering company, indicated it would pull all business operations out of Sudan by mid-summer 2007.<sup>12</sup>

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<sup>4</sup> The ERISA is a United States federal statute which sets minimum standards for pension plans in private industry and provides for extensive rules on Federal income tax effects of dealings in connection with various employee benefit plans.

<sup>5</sup> SBA Analysis at 1.

<sup>6</sup> *Id.* at 1.

<sup>7</sup> U.S. Department of State website, <http://www.state.gov/s/ct/c14151.htm>, Office of Coordinator for Counterterrorism, "State Sponsors of Terrorism."

<sup>8</sup> In mid 2006, SBA staff surveyed SBA investment managers regarding investments in companies having business operations in or ties to countries designated as state sponsors of terrorism. Staff inquired regarding the managers' investment strategy, risk controls and execution. The vast majority of SBA managers, particularly those following a "fundamental" and "bottoms-up" investment process, use prudent country and/or political risk factors (in Sudan and other countries) as a component of their investment decision making process. Many managers use either Institutional Shareholder Services or KLD Research & Analytics as their primary source for information on company operations, although several use proprietary sources. In mid 2006, SBA staff initiated an outreach campaign to 19 multinational companies whose securities were held in SBA portfolios and which were reported to have business relations or ties in Sudan. Staff received responses from the majority of the companies and were able to clarify the extent of the companies' business relationships (often small, indirect, via an "agency" or nonexistent), as well as obtain the companies' perspectives regarding the potential for elevated business risks and the impact of their activities on the people of Sudan. SBA Analysis at 1 and 2.

<sup>9</sup> California Public Employees' Retirement System.

<sup>10</sup> The other members included California Teachers and Connecticut, Missouri, New York, and Illinois.

<sup>11</sup> SBA Analysis at 1.

<sup>12</sup> *Id.* at 2.

## Divestment

Divestment of securities is one method of applying economic pressures to companies, groups, or countries whose practices are not condoned by shareholders. Divestment may be used in conjunction with or in lieu of other sanctioning methods such as economic embargoes and diplomatic and military activities. Alternatively, divestment may be used as a protective device if a particular investment carries a high level of risk to the performance of a fund.

Throughout its 65-year history, the FRS has been subjected to only two broad-based divestitures: South Africa<sup>13</sup> from 1986 to 1993, and the more recent tobacco divestiture, which took place from June 1, 1997 to June 30, 2001. Deleting only 16 tobacco stocks from the portfolio resulted in a \$470 million direct investment loss and an additional expense of \$12 million in transaction cost from security sales and purchases associated with divestiture and reinvestment.<sup>14</sup> These losses and costs are borne directly by the tax payers of the state through higher employer contributions that would otherwise be necessary.

## **EFFECT OF BILL**

The bill prohibits the investment of assets of any pension or annuity fund, under the jurisdiction of the SBA, in any company<sup>15</sup> that has an equity tie<sup>16</sup> to or is engaged in business with known state sponsors of terror.<sup>17</sup> In essence, the bill mandates the divestment of at least \$22 billion of FRS Pension Plan equity investments. It would cost in excess of \$180 million to sell the divested securities and reinvest the proceeds in other equity assets. The SBA would be prevented from using low-cost commingled international investment vehicles and would pay \$3 million to \$4 million annually in additional investment management fees from the FRS trust fund.<sup>18</sup>

The bill requires the executive director and board of trustees of the SBA, after reviewing recommendations of and consulting with an independent research firm specializing in global security risk, to sell, redeem, divest, or withdraw any investment in violation of this act. The sale, redemption, divestment, or withdrawal must be completed not later than one year following the effective date of this act.

Within 60 days of the effective date of this act, the executive director of the SBA must submit to the Governor, the President of the Senate, and the Speaker of the House of Representatives a report of all investments that violate this act. One year after the effective date, the executive director must report on the completion of all sales, redemptions, divestments, or withdrawals of such investments that are in compliance.

The bill does not apply to the activities of any company providing humanitarian aid<sup>19</sup> to the people of state sponsors of terror through either a governmental or nongovernmental organization.

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<sup>13</sup> Records do not exist to quantify the impact of SBA's South Africa divestiture, but see the discussion of the 1999 Journal of Business article: "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott."

<sup>14</sup> SBA Analysis at 6.

<sup>15</sup> The bill defines "company" to mean any entity having business ties of any nature, scope, and type affecting commerce, including, but not limited to, a government, government agency, corporation, firm, subsidiary, financial institution, provider of financial services, joint venture, trade association, or affiliate.

<sup>16</sup> The bill defines "equity tie" to mean any facility, plant, employee, or advisor or an investment, fiduciary, monetary, or physical presence of any kind.

<sup>17</sup> The bill defines "state sponsor of terror" to mean any country determined by the Secretary of State to have repeatedly provided support for acts of international terrorism. At present, state sponsors of terror as designated under these authorities are Cuba, Iran, North Korea, Sudan, and Syria.

<sup>18</sup> SBA Analysis at 2.

<sup>19</sup> The bill defines "humanitarian aid" to mean the provision of goods and services intended to relieve human suffering due to natural disasters, war, or civil unrest.

The bill provides legislative findings.

C. SECTION DIRECTORY:

Section 1 creates an unnumbered section of law relating to State Board of Administration investments.

Section 2 provides an effective date of upon becoming a law.

## II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

Indeterminate.

2. Expenditures:

Indeterminate. Expenditures will depend on actual divestment costs and forgone investment returns as they impact FRS contributions.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

Indeterminate. Actual fiscal impact will depend on actual divestment costs and forgone investment returns as they impact FRS contributions.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

Some private companies could suffer losses due to divestment.

D. FISCAL COMMENTS:

According to International Shareholder Services, roughly 90 U.S. domiciled corporations and 350 foreign corporations would be considered "forbidden entities" under this bill. In terms of market value,<sup>20</sup> these corporations represent 23.4 percent of the universe of investable domestic corporations and 32.7 percent of the universe of investable foreign corporations.

The 442 corporations required to be divested under the bill include numerous well-known global companies (e.g., Bank of America, Bristol-Myers Squibb Co., Coca-Cola, General Electric Co., Honda Motor Co. Ltd., Procter & Gamble Company, Schlumberger Ltd., and Sony Corp.) Some of the direct cost impacts of the required divestment:

- The SBA would be required to divest \$22.3 billion (about 18 percent of the fund) in assets from the FRS Pension Plan trust fund, and redeploy proceeds in other assets.
- A transition broker estimates it would cost \$184 million<sup>21</sup> to sell the divested securities and reinvest the proceeds. The cost estimate includes all commissions, taxes, spreads, and market impact to sell the 442 names and purchase remaining stocks in the Russell 3000 and the MSCI ACWI v US indices.<sup>22</sup>

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<sup>20</sup> Market value means the total value of the corporations' outstanding shares of stock.

<sup>21</sup> This is the mean expected cost which can change significantly contingent upon market volatility.

<sup>22</sup> The bill requires 100 percent of the affected securities to be divested within 12 months of the effective date, irrespective of market conditions.

- The SBA would be prevented from using low-cost commingled international investment vehicles. These vehicles, managed by external organizations and holding the assets of a variety of clients, would contain forbidden securities. The Pension Plan trust fund would see higher fees on about \$7.5 billion of assets which could equate to \$3 million to \$4 million annually in additional fees for customized investment vehicles.<sup>23</sup>

To assess the potential impact of the bill on FRS Pension Plan investment returns, the SBA removed the prohibited 442 companies from the applicable equity asset class indexes for five years.<sup>24</sup> The table represents the results in terms of “annualized returns and the annual and 10-year dollar-equivalent consequence of earning disappointing returns on a \$130 billion trust fund.”<sup>25</sup>

	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>
<i>Annualized Return Impact</i>	<i>-0.54%</i>	<i>-0.11%</i>	<i>-0.16%</i>
<i>1 Year Impact on \$130 Billion Fund</i>	<i>-\$698.1 Million</i>	<i>-\$142.7 Million</i>	<i>-\$214.3 Million</i>
<i>10-Year Impact on \$130 Billion Fund</i>	<i>-\$13,364.5 Million</i>	<i>-\$2,781.6 Million</i>	<i>-\$4,167.3 Million</i>

Actual experience will depend on market conditions, specific excluded securities over time, and manager portfolio construction. For a longer-term perspective, Ennis Knupp and Associates has projected the future contribution requirements of the FRS Pension Plan assuming that divestiture reduces returns by only one-quarter of one percent annually (25 basis points). According to the SBA consulting actuary, required contributions as a percent of FRS payroll would rise by 40 to 50 basis points (by 0.40 percent to 0.50 percent). With payroll growth at three percent per year, the present value of required additional contributions by Florida governments would be \$2.0 to \$2.5 billion.<sup>26</sup>

### III. COMMENTS

#### A. CONSTITUTIONAL ISSUES:

##### 1. Applicability of Municipality/County Mandates Provision:

This bill does not require counties or municipalities to spend funds or take an action requiring the expenditure of funds. The bill does not reduce the percentage of a state tax shared with counties or municipalities. The bill does not reduce the authority that municipalities have to raise revenue.

##### 2. Other:

This bill may conflict with existing federal law. Mainly, there could be constitutional concerns related to the Supremacy Clause and the foreign commerce clause, as well as an intrusion on the federal government’s exclusive authority to conduct foreign affairs.

For example, a constitutional challenge to an Illinois Sudan-divestiture statute (similar to the bill’s provisions) was recently ruled on by the U.S. District Court for the Northern District of Illinois. In *National Foreign Trade Council (NFTC), et al. vs. Topinka*,<sup>27</sup> the NFTC used many of the same

<sup>23</sup> SBA Analysis at 5.

<sup>24</sup> The SBA used years 2002, 2003, 2004, 2005, and 2006.

<sup>25</sup> The estimates in the table do not factor in transaction costs or elevated management fees. The estimates are intended to be good faith estimates of what might have occurred had the bill been applicable in prior periods. SBA Analysis at 6.

<sup>26</sup> Defined benefit pension obligations are formula based, and determined by the service life, salary, and ultimately longevity of plan participants. These obligations are funded from only two sources: tax dollars, coming into the system through employer contributions, and investment earnings. To the extent the latter is diminished, the former must be increased. Each year the system actuary compares liabilities to returns. If the latter are sub-par, an increase in contributions is required.

<sup>27</sup> Case #06CV42511, USDC of Illinois (2007).

arguments that persuaded the U.S. Supreme Court, in 2000, to overturn a Massachusetts law requiring state agencies to maintain a secondary boycott of Burma. NFTC and its co-plaintiffs, a variety of state pension funds and pension beneficiaries, contended that the law unconstitutionally intruded on the federal government's exclusive authority to conduct foreign affairs and that it violated the foreign commerce clause of the U.S. Constitution, as well as the Supremacy Clause by interfering with the federal government's regulations regarding Sudan.<sup>28</sup> The lawsuit also alleged that the statute burdened state and local pension funds with an arbitrary and poorly understood compliance process.

In *Board of Trustees of the Employee's Retirement System of the City of Baltimore v. Mayor and City Council of Baltimore City*,<sup>29</sup> however, the court found that there is a strong presumption against finding federal preemption in areas traditionally regulated by state and local governments. In such circumstances, there must be compelling evidence of congressional intent to preempt.<sup>30</sup>

**B. RULE-MAKING AUTHORITY:**

This bill does not appear to create, modify, or eliminate rulemaking authority.

**C. DRAFTING ISSUES OR OTHER COMMENTS:**

Other Comments: Companies having an equity tie or engaging in business with sponsors of terror

There is no definitive list of companies having an equity tie or engaging in business with known state sponsors of terror. Many have recommended that the Federal Government compile and publish such a list for use by all investors, "given their capability of understanding both the national security and human rights implications of company operations as well as directing appropriate prohibitions and sanctions against these companies."<sup>31</sup> In June 2005, 50 institutional investors formally urged the U.S. Department of State, the U.S. Department of Commerce, the U.C. Department of the Treasury, and the U.S. Securities and Exchange to provide guidance on this matter. The Federal Government has not provided a list.

Other Comments: Global security risk

The bill states: "The Securities and Exchange Commission determined that companies with business operations in states that sponsor terrorists are exposed to a special risk category known as global security risk." It is not clear that such a "determination" has been made by the Securities and Exchange Commission. For instance, the following appears in a May 8, 2001 letter from Acting SEC Chairman Laura Unger to U.S. Representative Frank Wolf:

The fact that a foreign company is doing material business with a country, government or entity on OFAC's sanctions list is, in the SEC's staff's view, substantially likely to be significant to a reasonable investor's decision about whether to invest in that company.

The SBA, however, contacted Cecilia Blye, Chief of the Office of Global Security Risk, Division of Corporate Finance, Securities and Exchange Commission.<sup>32</sup> She indicated the following:

The Office of Global Security Risk is concerned that investors be fully informed about any connections individual companies might have with countries that sponsor terrorism because of possible increased risk. While the Office of Global Security Risk is concerned about individual companies disclosing information to investors, the SEC does not take a position about investing

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<sup>28</sup> See also *Crosby vs. National Foreign Trade Council*, 530 U.S. 363 (2000).

<sup>29</sup> 317 Md. 72 (1989).

<sup>30</sup> *Id.*

<sup>31</sup> SBA Analysis at 5.

<sup>32</sup> *Id.* at 5.

in individual companies. Individual SEC commissioners may have personal positions, but the commission itself does not.<sup>33</sup>

### Other Comments: Fiduciary Issues

The State Board of Administration stated:

Motivations for divestiture fall broadly into two categories: (1) to advance social goals or objectives; or (2) to improve investment performance. It is sometimes argued that divestiture serves both goals. In this bill, the "whereas" clauses identify national and state security issues, while Section 1 Findings identify investment risks for pension assets.

The distinction is an important one, since divestiture that is solely motivated by social considerations is fiduciarily impermissible for monies held in trust for vested plan participants and their beneficiaries. To the extent that investment actions are based on impermissible considerations, participants and beneficiaries may have grounds for recompensation against fiduciaries of the retirement plan.

Divestiture can be considered with the intent to improve investment performance. However, from experience, and by the rules of prudence, it is known that fiduciaries must take into account all relevant substantive factors in arriving at an investment decision. Simplified rules about which companies should and should not be in a diversified investment portfolio are typically inconsistent with weighing the many factors that in concert must be considered when prudently investing plan assets. Further, the issue of whether the policies of any foreign nation are such as to make an investment in companies with ties to that country imprudent is itself complex, involving the nature of the linkage, the type of activity, its materiality to the company and to the country, and a variety of other case-specific considerations.

Academic evidence does not support the assertion that broad-based divestment would preserve the value of FRS investments. "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott," published in the Journal of Business in 1999 by Siew Hong Tech, Ivo Welch, and C. Paul Wazzan concluded:

...We find no support for the common perception, and often vehement rhetoric in the financial media, that the anti-apartheid shareholder and legislative boycotts affected the financial sector adversely: the announcement of legislative or shareholder pressure has no discernible effect on the valuation of banks and corporations with South African operations or on the South Africa financial markets.

...The sanctions may have been effective in raising the public moral standards or public awareness of South African repression, but it appears that financial markets managed to avoid the brunt of the sanctions. This may be an important point for future activists who are considering using the tools of the boycott for other causes. [page 79]

Importantly, fiduciaries with discretion can weigh the various investment factors highlighted above and make prudent decisions without a material fear of litigation. Case law is well evolved regarding the standards of prudence and diversification in the normal course of investing a trust. However, fiduciaries subject to ad hoc statutory investment restrictions could be exposed to heightened risk of litigation.<sup>34</sup>

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<sup>33</sup> *Id.* at 4

<sup>34</sup> *Id.* at 7 and 8.



Other Comments: Amendment by the Sponsor

The Sponsor of the bill intends to file a strike-all amendment that would significantly narrow the scope of the bill, making it applicable only to Iran.

D. STATEMENT OF THE SPONSOR

All concerns raised in the staff analysis have been addressed in strike all which has been narrowly tailored to limit any possible negative effects on the pension fund. To continue investments in Iran's energy/petroleum sector is an irresponsible and negligent use of our civil servant's funds, putting their money at risk, and our soldier's lives in harms way.

Because of the risks inherent in these particular market segments, due to existing federal legislation, the proposed bill is consistent with the fiduciary responsibility to our investors.

**IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES**

Not Applicable.