
February 13, 2017

Item Name: Assembly Bill 20 (Kalra) Dakota Access Pipeline: Divestment

Program: Total Fund

Item Type: Action

Recommendation

Adopt an **Oppose** position on Assembly Bill (AB) 20 as recommended by the California Public Employees' Retirement System (CalPERS) Legislative and Policy Engagement Guidelines for a proposal that imposes an investment mandate on the CalPERS Board of Administration (Board).

Executive Summary

Among other things, AB 20 prohibits CalPERS and the California State Teachers' Retirement System (CalSTRS) from renewing or making any additional investments in any company constructing, or funding the construction of, the Dakota Access Pipeline on and after January 1, 2018. It also requires CalPERS and CalSTRS to liquidate any existing investments in such companies on or before July 1, 2018.

CalPERS Board and staff have fiduciary obligations to the participants and beneficiaries of the retirement system. These fiduciary obligations generally preclude CalPERS from sacrificing investment performance for the purpose of achieving goals that do not directly relate to CalPERS operations or benefits. AB 20 would impede CalPERS ability to maximize risk-adjusted returns, and minimize risk through diversification, potentially imposing additional costs on California's public employers and agencies, civil servants, and impairing CalPERS' ability to pay promised benefits.

Strategic Plan

Divesting in response to external initiatives is outside the scope of the CalPERS 2012-17 Strategic Plan.

Investment Beliefs

This agenda item supports Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

Background

Constitutional Authority and Fiduciary Responsibility

Article XVI, Section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement boards of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. In accordance with California Constitution Article XVI, Section 17, the Board's constitutional duties take precedence over any other considerations.

The Constitution, however, also provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

California Divestment Legislation Trends

Divestment, or pressuring institutional investors to divest of securities, is a method that attempts to apply economic stress on companies, groups, or countries whose practices are not condoned by investors or interest groups. In California, the practice of requiring pension funds to divest began in 1986 with the passing of legislation to divest from firms doing business with South Africa. From that point, the California Legislature has introduced dozens of bills that would encourage or require divesting from various companies and countries. The South Africa, Arab League's economic boycott, Sudan, Iran and Thermal Coal bills were the only successful divestment proposals passed by the Legislature and signed by the Governor.

In October 2015, Wilshire Associates presented a review of CalPERS divestments affecting the Global Equity Program. As of December 31, 2014, the potential impacts related to all current and prior CalPERS divestment initiatives, including foregone performance and transaction costs, were estimated to exceed \$8 billion dollars. These estimates do not include the potential impacts to employer and employee contribution rates that may have been incurred through the divestment initiative impacts on the CalPERS funded ratio and total assets under management.

Dakota Access Pipeline

The Dakota Access Pipeline is a 1,168 mile-long underground pipeline that will, when completed, carry crude oil from Stanley, North Dakota to Bakula, Illinois, passing through South Dakota and Iowa. The \$3.78 billion project began construction in 2016 and as of November, 2016, was 87 percent completed.



Objections to the pipeline have been raised over concerns about water contamination in the case of a spill or rupture. Also, some Native American Tribes have objected to the route selected, both on environmental grounds and based on the pipeline's path through culturally significant areas. In July of 2016, the Standing Rock Sioux Tribe sued the US Army Corps of Engineers (Corps) in federal court, seeking to stop construction. The suit was dismissed by the trial judge in September. The case was heard on appeal in October but no decision has been handed down.

To date, the Corps has not granted an easement for the pipeline to cross federal lands it manages at Lake Oahe near Standing Rock Sioux tribal lands. The pipeline's application for the required easement is under review, and on December 4, 2016, the Assistant Secretary of the Army for Civil Works stated that the consideration of alternative routes for the pipeline crossing would be best accomplished through an Environmental Impact Statement (EIS) with full analysis and public input. These decisions are subject to review by the United States Army and the President, with Congress providing a 14-day notification.

On January 24, 2017, President Trump issued a Memorandum for the Secretary of the Army regarding the construction of the pipeline, directing the Secretary of the Army and the Corps to, among other things, expedite the review and approval of any request for approvals to construct and operate the pipeline, including easements, and consider whether to rescind prior Memoranda and withdraw the Notice of Intent to prepare an EIS in connection with the pipeline's request for an easement to cross Lake Oahe.

Analysis

Specifically, AB 20:

- Prohibits CalPERS and CalSTRS from making additional or new investments in any company constructing, or funding the construction of, the Dakota Access Pipeline on or after January 1, 2018.
- Requires that CalPERS and CalSTRS liquidate any investment in any company constructing, or funding the construction of, the Dakota Access Pipeline on or before July 1, 2018.
- Defines "investment" as the purchase, ownership, or control of publicly issued stock, corporate bonds, or other debt instruments issued by a company.
- Defines "company" as a sole proprietorship, organization, corporation, partnership, venture, or other entity, or subsidiary or affiliate, that exists for profit-making purposes or otherwise to secure economic advantage.
- Specifies that its provisions do not require a retirement board to take any action if it determines and adopts findings, in good faith and based on publicly available information, that the action would violate the board's fiduciary responsibilities described in Section 17 of Article XVI of the California Constitution.

Potential Scope and Impact

Research by the Investment Office indicates a number of financial institutions may be providing financing to Dakota Access LLC (the builder of the pipeline) and/or to Sunoco Logistics, Energy Transfer Partners, and Energy Transfer Equity (the majority members



of Dakota Access LLC). These institutions are believed to include Bank of America, Wells Fargo, JPMorgan Chase, and Citibank. An initial analysis of companies potentially subject to divestment indicates AB 20 could affect approximately \$4 billion in Public Employees' Retirement Fund (PERF) holdings. The estimated impact to the PERF may be subject to change based on the addition or removal of companies that are potentially subject to divestment, and fluctuations in the market value of PERF holdings in those companies at the time any possible divestment action may be taken by the Board.

There is no apparent connection between the activities targeted by AB 20 and the future financial performance of the affected industry sectors. In the absence of demonstrable evidence, and investment professional conviction, that the industries and companies potentially identified for divestment in AB 20 pose an economic risk to the PERF, the Investment Office is unable to identify how proposed divestment will enhance the PERF's risk and return profile.

Divestment, as an active investment decision, represents a form of active risk-taking that must be considered, first and foremost, within the context of the Board's fiduciary duty. As a mature, cash-flow negative system, CalPERS is obligated to seek out and implement the portfolio construction methods that best serve our mission – the sustainable delivery of promised benefits. In efficient markets, however, limiting the opportunity set for investments has generally been shown to have a detrimental effect on performance.

AB 20 would cause CalPERS to have a portion of its current investment universe permanently removed from its investment opportunity set, which would not be consistent with facilitating CalPERS' achievement of its investment objectives. Furthermore, CalPERS' experience to date has shown that divestment tends to harm investment performance and increase transaction costs.

For those reasons, AB 20 is expected to have a detrimental effect on investment performance. In consideration of CalPERS' asset and liability management, every dollar in investment returns that is foregone, or expended in unnecessary transaction costs and fees, must be made up for in employer and employee contributions. Therefore, AB 20 could be expected to contribute to an increased burden on employees and employers through increased contribution rates, and potentially impair CalPERS' ability to deliver promised benefit payments.

Furthermore, while existing divestment statutes indemnify present, future, and former board members of CalPERS and CalSTRS, jointly and individually, along with state officers, employees, and investment managers for any decision to restrict, reduce, or eliminate investments in targeted companies, AB 20 does not. In addition, the bill does not provide for reimbursement to the System for potential investment losses. Should AB 20 be enacted and the Board approve its implementation, the absence of such indemnification provisions could pose legal and financial risks to the System, and, in turn, CalPERS members and employers.

Engagement More Productive than Divestment

There is considerable evidence that divesting is an ineffective strategy for achieving social or political goals, since the consequence is generally a mere transfer of ownership of divested assets from one investor to another. Investors that divest lose their ability as shareowners to influence the company to act responsibly.

Unlike other recent divestment proposals, AB 20 does not permit CalPERS to engage with companies involved in the construction and financing of the Dakota Access Pipeline, and instead requires liquidation of all assets. This removes any opportunity for CalPERS to exert influence over a company through direct shareholder engagement – including any ability to effect changes in company behavior to strengthen management of environmental and human capital factors. The end result is a potentially adverse impact on the PERF, with little or no effect on the companies being divested from, or any impact on the situation the bill appears to want to influence.

CalPERS wants companies in which it invests to meet high corporate governance, ethical, and social standards of conduct. CalPERS has a distinguished history of constructively engaging companies that fail to meet CalPERS' standards of conduct. Consistent with our Investment Beliefs, CalPERS' preferred approach to effecting changes and improvements in corporate behavior is through constructive engagement.

Fails to Provide Authority or Criteria for Re-Investment

AB 20 makes no provision for CalPERS to resume investing in the companies funding or constructing the Dakota Access Pipeline. With limited chances for engagement, and no way for the equity and debt of targeted companies to once again become part of the CalPERS investment portfolio, the Board would be required to seek legislative repeal or modification of the statute if it later determines that resuming investment in these companies is appropriate.

Budget and Fiscal Impacts

If AB 20 is enacted, CalPERS will likely need to undertake additional research and analysis to determine whether the statute can be implemented consistent with the Board's fiduciary obligations. This will include an analysis of the extent to which AB 20 may impair CalPERS' ability to maximize risk-adjusted returns, and minimize risk through diversification, both of which have a direct impact on the retirement benefit costs borne by California's public employers, agencies, and civil servants, as well as CalPERS' ability to pay promised benefits.

If the Board takes action to divest, program costs would include investment transaction and administrative costs to divest from investments that meet the stated criteria, and then subsequently complete any reporting the Board requires. The most significant up-front costs consist of brokerage commissions incurred to sell the securities. It is important to note that, while foregone performance and opportunity cost estimates may fluctuate, transaction costs are "gone for good" and are forever removed from CalPERS' portfolios, and therefore, from any potential enhancements to the CalPERS assets through compounding or reinvestment benefits. Total costs will depend on the number of CalPERS holdings that meet the criteria for divestment pursuant to AB 20.



While the Investment Office does not anticipate hiring any additional staff in order to implement the bill in its current form, AB 20 will require a significant amount of staff time and resources to implement, which will be redirected away from existing Investment Office priorities, and at additional cost to the System.

Benefits and Risks

Benefits:

- May reduce stakeholder perception that CalPERS' investments contribute to climate change.

Risks:

- Compromises CalPERS investment strategies by eliminating alternatives from the investment opportunity set and reducing diversification, which is expected to have a detrimental effect on investment returns over the long term.
- Imposes financial risks on CalPERS members and employers.
- Increases risk to the System.
- Reduces CalPERS' ability to change corporate behavior through engagement.
- Reduces alignment of current Investment Office practices with CalPERS' Investment Beliefs and Investment Policies.
- Increases future likelihood of external parties directing portfolio activities.

Attachments

Attachment 1 – Legislative History

Mary Anne Ashley, Chief
Legislative Affairs Division

Wylie Tollette
Chief Operating Investment Officer

Legislative History

- 2016 AB 1551 (Allen) – Requires California public retirement funds, on or after January 1, 2017, to make no additional investments or renew existing investments in business firms or financial institutions that engage in business practices in furtherance of the boycott of Israel. This prohibition would not apply to any business firm or financial institution that adopts a resolution stating that they will not engage in any business activity in furtherance of the boycott against Israel. Failed passage
- AB 2283 (Calderon) – Requires CalPERS and CalSTRS to cease making new or additional investments in single-family home rental properties located in California that are aggregated with other properties to produce income that funds publicly traded investment products on or after January 1, 2017, and to liquidate existing holdings in any such securitized home rental properties on or before January 1, 2018. Failed passage
- AB 2650 (Nazarian) – Prohibits CalPERS and CalSTRS from investing retirement funds in any investment vehicle issued, owned, controlled, or managed by the government of Turkey, as defined. Specifically, it requires the governing Board of each respective System to constructively engage the government of Turkey to accept responsibility for the Armenian genocide of 1915 and, if not successful, then to liquidate assets subject to divestment by January 1, 2018, and to report to the Legislature regarding its actions by January 1, 2019. Failed passage
- 2015 Chapter 605 (SB 185, De Leon) -- Requires CalPERS and CalSTRS to constructively engage in publicly traded coal companies that generate 50 percent or more of their revenue from mining thermal coal. If following engagement, a company is not transitioning its business model to adapt to clean energy generation, it requires CalPERS to sell or transfer any investments in that company, and report to the Legislature and the Governor regarding these investments within specific timeframes. It does not require divestment if CalPERS determines, in good faith, the action would not be consistent with its fiduciary responsibilities. This bill also requires a report on the feasibility of divesting from additional fossil fuel investments such as natural gas and petroleum. *CalPERS Position: No Position.*
- 2007 Chapter 671 (AB 221, Anderson) – Prohibits CalPERS and CalSTRS from investing public employee retirement funds, as defined, in a company with business operations in Iran that meets the following criteria: is invested in, or is engaged in, business operations with entities in the defense or nuclear sectors of Iran, or invested or engaged in the development of petroleum or natural gas resources of Iran and that company is subject to sanctions by the Federal Government; or in a company engaged in business operations with an Iranian Organization that has been labeled a terrorist organization by the US

Government. The provisions of this act are considered severable. If any provisions are deemed invalid, the remaining provisions remain in effect. This bill would require the Boards of these retirement systems to sell or transfer any investments in these companies within specific timeframes and report to the Legislature regarding these investments. *CalPERS Position: Oppose.*

- 2006 Chapter 442 (AB 2941, Koretz) – Prohibits CalPERS and CalSTRS from investing public employee retirement funds, as defined, in a company with business operations in the Sudan, that meet specified criteria, and would require the Boards of these retirement systems to sell or transfer any investments in these companies within specific timeframes and report to the Legislature regarding these investments. *CalPERS Position: Neutral, with suggested amendments.*
- 1992 Chapter 1351 (AB 2251, Margolin) – Prohibited state trust fund and state money 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. *CalPERS’ Position: Oppose*
- 1986 Chapter 1254 (AB 134, Waters) – Prohibited the use of state trust funds or state moneys to make additional or new investments, or to renew existing investments in firms doing business with or in South Africa as of January 1, 1987. *CalPERS Position: Neutral*