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***H.J.R. 6 of the 131st
General Assembly***

Rep. Johnson

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Staff Recommendation

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Summary of H.J.R. 6

House Joint Resolution 6 proposes to enact Section 18 of Article VIII of the Constitution of the State of Ohio to restrict the investments of state agencies and the state public retirement systems. If passed by the General Assembly and adopted by the majority of electors, not later than December 31, 2018, the constitutional amendment would prohibit a state agency or public retirement system from conducting any business with, or having *direct* investment in, any entity that has any commercial association with the strategic industries of specific countries. The countries are those that are either designated by the United States Department of State as a state sponsor of terrorism or were once designated as such on or after January 1, 2015, but have not been removed by a two-thirds vote of the General Assembly. Currently three nations, Iran, Sudan, and Syria,¹ are on the Department of State's list, and Cuba, removed from the state sponsor list on May 29, 2015, would be included in the amendments restrictions.²

Specifically, the amendment would prohibit a state agency or public retirement system from knowingly: 1) entering into, extending, or renewing a contract with a designated company to acquire, provide, or dispose of services, supplies, or information technology to the agency or retirement system, or 2) investing in stocks, bonds, or any other direct holdings in a designated company.

The amendment defines all of the following, which has a large impact on its substantive effect:

- 1) "Active business operations" means engaging in commerce in any form in a designated country, including by maintaining, selling, acquiring, developing, owning, possessing, operating, or leasing equipment, facilities, personnel, products, services, personal or real property, or any other apparatus of business or commerce.
- 2) "Company" means any sole proprietorship, organization, association, corporation, partnership, joint venture, limited partnership, limited liability partnership, limited liability company, or other entity or business association, including all wholly-owned subsidiaries, majority-owned subsidiaries, parent companies, or affiliates of those entities or business association, that exist for the purpose of making a profit.
- 3) "Designated company" means a company with active business operations in a strategic industry in a country designated on or after January 1, 2015, as a state sponsor of terrorism by the United States Department of State.
- 4) "Direct holdings" means all publicly traded securities of a company that are held directly by a state agency or public retirement system in an actively managed account or fund in which the agency or retirement system owns all shares or interests.
- 5) "Strategic industry" *includes*³ all of the following:

¹ <http://www.state.gov/j/ct/list/c14151.htm>

² <http://www.state.gov/r/pa/prs/ps/2015/05/242986.htm>

³ Because the amendment states that strategic industry "includes" these items, it does not specifically delineate the precise extent of "strategic industries." Instead, the amendment is only a partial list of potentially greater whole of items.

A) Military equipment, such as weapons, arms, military supplies, and equipment, including radar systems or military-grade transport vehicles, that readily may be used for military purposes;

B) Mineral extraction activities, which include exploring, extracting, processing, transporting, or wholesale selling or trading of elemental minerals or associated metal alloys or oxides, also known as ore, including gold, copper, chromium, chromite, diamonds, iron, iron ore, silver, tungsten, uranium, and zinc; and including facilitating such activities, including by providing supplies or services in support of such activities;

C) Oil-related activities,⁴ which include owning rights to oil blocks; exporting, extracting, producing, refining, processing, exploring for, transporting, selling, or trading of oil; constructing, maintaining, or operating a pipeline, refinery, or other oil-field infrastructure; or facilitating such activities, including by providing supplies or services in support of such activities;

D) Petroleum resources, such as petroleum, petroleum byproducts, and natural gas;

E) Power production activities, which include any business operation that involves a project commissioned by the government of a designated country whose purpose is to facilitate power generations and delivery, including establishing power-generating plants or hydroelectric dams, selling or installing components for a project, providing service contracts related to the installation or maintenance of a project, or facilitating any of these activities, including providing supplies or services in support of such activities.

Staff Comments

This analysis will be restricted to an analysis of the amendment's provisions *as they relate to the retirement systems*. This analysis will not address questions of foreign policy, nor will it analyze the potential consequences of the amendment on meeting the conditions of the Joint Comprehensive Plan of Action (JCPOA; also referred to as the "Iran Deal"), or potential effects on existing commitments or contracts with foreign or domestic companies located in Ohio.

Trusts and Prudent Person Investing

H.J.R. 6 Violates Basic Tenants of a Trust

Historically, the Ohio General Assembly has rejected any type of investment mandates upon the retirement boards' "full power to invest the funds,"⁵ including several proposed divestiture bills in the early 1980s related to South Africa, bills in the

⁴ "Oil-related activities" does not mean engaging in only the retail sale of gasoline and related consumer products.

⁵ R.C. 145.11, 742.11, 3307.15, 3309.15, and 5505.06.

early 1990s related to Northern Ireland, and bills in the 2000s related to Iran, Sudan, Ohio-based asset managers, and hedge funds. The Ohio General Assembly has recognized that such investment mandates are inconsistent with the fiduciary duties of the retirement boards to act "...solely in the interest of the participants and beneficiaries..." and would also fail to recognize the systems as trust funds. As trust funds, once contributions are transferred to the state retirement systems, they belong solely to the members as required under federal tax law; they are not state assets. While individuals are free to invest assets as they see fit and in accordance with generally applicable rules, investment mandates controlling another person's property because that property happens to be in a specific trust violates basic principles of trust law. The amendment also intercedes in the fiduciary responsibilities of the retirement boards who are vested under state law with plenary power to invest the funds solely in the interest of and for the exclusive purpose of providing benefits to participants and their beneficiaries. The General Assembly has consistently opposed opening the door to investment mandates that would break this fundamental tenant of trusts.

Most recently, an attempt to mandate divestiture in Iran and Sudan under H.B. 151 of the 127th General Assembly resulted in four retirement systems establishing their own internal policy related to investments in Iran and Sudan. This policy has resulted in a reduction of the market value of scrutinized Iran and Sudan businesses between 2007-2014 of 97.1% (PERS), 97.58% (OP&F), 88.46% (STRS), and 93% (SERS).⁶ Each of these boards, through its own internal policy and in accordance with its own fiduciary responsibility, was able to successfully alter its investment exposure.

Investment Mandates and Prudent Person Investment Authority

S.B. 82 (1997) abolished the investment "legal lists" and adopted the "prudent person rule." The former legal lists placed significant restrictions on the retirement boards' investment authority and impeded the boards' ability to respond to changes in the economy and financial markets. Instead, the rule allows the systems to rely upon professional investment managers and economic advisors to guide their investment decisions. The current prudent person rule is modeled after the standard established in the Employees Retirement Income Security Act (ERISA) that governs most private pension plans and provides for greater flexibility in asset allocation and selection of investment vehicles so as to achieve further growth in investment earning and diversification of plan assets. At the same time, the rule is intended to protect investors by requiring that assets be invested in a manner that seeks to achieve reasonable income and preservation of capital.

In adopting the prudent person rule, the Ohio General Assembly recognized the critical role investments play in the funding of benefit costs. Investment earnings constitute the largest source of revenue for all five state retirement systems, funding the majority of benefit costs. The less revenue generated by investment, the more that

⁶ SHPRS does not hold any direct investments, relying instead on comingled funds.

further reductions in the benefits provided to those employees or additional contributions required from employers and employees will be required.

H.J.R. 6 would mark the first set of restrictions placed upon the retirement systems' investment authority since the adoption of the prudent person rule and would set a precedent for further restrictions upon the retirement systems' investment authority. Once the prudent person rule is modified, the less an argument can be made against each additional restriction or requirement. Current divestment initiatives throughout the country are dizzying, ranging from restrictions related to the actions of other states, including Israel, Russia, and Egypt, but also sector specific activities, such as fossil fuels (including oil, gas, and coal), guns and ammunition companies, and the financial industries that support them. This doesn't even include the myriad of social justice and twitter campaigns to boycott Hobby Lobby, Starbucks, Disney, Koch, Toyota, Duck Dynasty, or Cabela's. Once the precedent of the General Assembly modifying the prudent person rule is made, there is no logical public policy end to those restrictions.

H.J.R. 6 and Ohio Retirement Public Policy

H.J.R. 6 therefore violates two aspects of Ohio retirement law. First, by using another's property for public policy objectives, it violates fundamental principles of a trust being for the exclusive benefit of the trust's beneficiaries. Second, by modifying the prudent person rule of investments, it opens the door to a nearly infinite universe of potential mandates, with each additional mandate weakening the argument against future mandates. Fiduciary responsibility and the prudent person rule are designed to prevent exactly this type of exploitation of another's property for personal or political objectives.

Potential Effects of Amendment

Uncertainty

Beyond the issue of the amendment altering Ohio retirement public policy, a valid question is the potential direct effects of the proposed amendment. International equities, the component most likely to be affected by the constitutional amendment, have been one of the top two performers in half of the last 10 years.⁷ However, the uncertainties regarding the amendment make assessing the effect on this top performer challenging.

Foremost is the question of who determines whether an entity's action constitutes "active business operations." A number of questions rise from this basic uncertainty:

⁷ RVK Investment Portfolio Analysis, Period Ending: June 30, 2015, 41.

1) In the case of a dispute, who resolves the dispute? As an example, if a subsidiary of Honda, located in Italy, makes a part that it then sells to an Iranian oil company, is Honda involved in active business operations?

2) What is the process by which a disagreement on a company's status as an active business resolved? It is important to note that, as a constitutional provision, any adverse unintended consequence or disagreement could not be resolved with any alacrity.

3) In the interim, what is the responsibility of the retirement system regarding the investment? Should the system conduct an immediate sale until the dispute is clarified?

4) What if an entity had, in the past, been considered to be involved in active business operations, but did not plan to do so in the future? What if their plans change? If the Italian plant sells a part in June, is it no longer restricted in July? December? Never? The potential disputes arising from a concrete constitutional amendment could be significant.

Disputes that do arise with this policy will be administratively unmanageable. The proposed constitutional amendment is five pages long. In dealing with regulating similar types of restrictions, the federal government enacted three separate provisions of law: Section (6)(j) of the Export Administration Act of 1979, Section 40 of the Arms Export Control Act, and Section 620 of the Foreign Assistance Act. Each of these laws has corresponding regulations to address the intent of the policy. A constitutional change will have none of this flexibility or specificity, thereby making any disputes nearly impossible to address except through interpretation by the Ohio Supreme Court or an additional amendment to the state constitution. It is almost certain that the amendment would increase litigation, with no conforming benefit for beneficiaries, for the retirement systems.

Biased restrictions

H.J.R. 6 also creates a bias against *some, but not all*, governmental defined benefit plans and the active management of funds by those plans. It appears that the amendment would not affect any of the following:

- 1) Defined contribution (DC) plans (private or public);
- 2) Alternative retirement plans (ARP) offered through PERS, STRS, and SERS;
- 3) The endowments of public institutions of higher education;
- 4) Personal investors in Ohio;
- 5) The Ohio Public Employees Deferred Compensation Plan (index funds);
- 6) The 403(b) tax-sheltered annuity plans and other supplemental plans sponsored by school districts and other political subdivisions in Ohio;
- 7) The Cincinnati Retirement System;
- 8) Index or other passive investment vehicles held by a state retirement system.

In the above Honda scenario, while a state system would be prohibited from directly holding equity interest in Honda, they could participate in comingled index funds (which would likely include Honda). But the active, rather than passive, management of funds by qualified investment managers provides added value to the retirement systems. This can be significant. OP&F international active managers added *78 basis points* of value in the year ending June 30, 2015.⁸ The deliberate exclusion of investor expertise is a potential extraordinary loss of value and cuts against the 18-year history of prudent person rule of retirement law. This loss of added value would be at a time when any passive index investments, personal investors, DC investments, ARP contributions, and various other institutional investments would be completely unaffected by the constitutional amendment; those entities would be playing by a separate set of rules than the state retirement systems.

As a result the amendment is a highly biased, highly unusual partial restriction on a portion of the property held, in trust, by state retirement systems, *but applies to no other trusts*. This puts the retirement systems at a severe disadvantage to other investors in Ohio and the nation. The systems will also almost certainly be placed in forced sell situations when a company conducts business in certain countries, of which other short sell investors will be perfectly aware. This is, again, an extraordinary disadvantage in the equity markets.

Proper Fiduciary Divestments

Nothing in this analysis is to support the actions of these state actors or to endorse or condemn any of the other myriad of divestment movements. Nor is it to imply that the retirement boards, by their own action, cannot determine that divestment is in the best interests of their beneficiaries. The federal government has, in fact, explicitly stated that a fiduciary may consider the values of its membership in making investment decisions.⁹ But these decisions must be made by the boards consistent with fiduciary responsibilities. Should a board make that decision, those actions must be justified, and as fiduciaries, members could be individually subject to sanction should they fail in their fiduciary responsibilities.

These boards are composed from nine to eleven members, a majority composed of the system's membership and additional appointed members representing the interests of the Governor, General Assembly, and State Treasurer. The central premise of the 2007 Iran/Sudan agreement was that the decision to gradually divest was made by the board, in their beneficiaries' best interest, and implemented in a manner that would not harm beneficiaries. If the will of beneficiaries is to adopt a policy of

⁸ PERS achieved .34%, STRS.36%, and .45% SERS added value (RVK, 35-43). HPRS, which does not actively manage any funds, has .01% added value (RVK, 45).

⁹ Department of Labor, Interpretive Bulletin 2015-01 (October 22, 2015). The bulletin reinstated a 1994 bulletin that had been amended in 2008.

divestment, for any objective, they have the power to effectuate that policy. That is the appropriate location for those decisions.

ORSC Recommendation

ORSC staff recommends that the Ohio Retirement Study Council disapprove of H.J.R. 6 for the following reasons:

- 1) H.J.R. 6 establishes a precedent that trust funds and trust fund property may be used for purposes other than the exclusive benefit of the trust funds' membership;
- 2) H.J.R. 6 undercuts an 18-year policy of prudent person rule of investment with the establishment of an investment mandate which, conceptually, has no logical public policy end;
- 3) H.J.R. 6 provisions of divestment are unclear and unwieldy, highly challenging for the systems to administer, and, as a constitutional amendment, enormously difficult to correct or modify if unintended consequences are discovered;
- 4) H.J.R. 6 creates a bias against *some, but not all*, governmental defined benefit plans and the active management of funds by those plans, minimizing the value added through active, professional management of funds and creating a system where different entities invest with different sets of rules;
- 5) H.J.R. 6 does not encourage the long term, consistent, conservative stewardship of retirement system funds and modifies the long-term stability and consistency of state policy regarding the systems.