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Analysis

**Am. Sub. H.B. 151 – Reps.
Mandel and Jones**
*(As Reported by the House Financial
Institutions, Real Estate and Securities
Committee)*

June 13, 2007

Staff Recommendation

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Am. Sub. H.B. 151 would generally prohibit the treasurer of state, the state board of deposit, the bureau of workers' compensation and the five state retirement systems from investing in the stocks and bonds of publicly traded companies with "scrutinized business operations" in Iran or Sudan, and would require them to divest any existing investments in such companies. This analysis is limited to the provisions of the bill that relate to the five state retirement systems: the Public Employees Retirement System (PERS), the Ohio Police and Fire Pension Fund (OP&F), the State Teachers Retirement System (STRS), the School Employees Retirement System (SERS) and the State Highway Patrol Retirement System (HPRS).

Within 90 days after the effective date of the bill, each state retirement system would be required to make its best efforts to identify all companies having "scrutinized business operations" in Iran or Sudan.¹

"Scrutinized business operations" is defined as a company that meets any of the following criteria:

1. The company has business operations that involve contracts with or provision of supplies or services to the government of Sudan, companies in which the government of Sudan has any direct or indirect equity interest, consortiums or projects commissioned by the government of Sudan, or companies involved in consortiums or projects commissioned by the government of Sudan, **and** one of the following apply:
 - a. More than 10% of the company's revenues or assets linked to Sudan involve oil-related activities or mineral-extraction activities; less than 75% of the company's revenues or assets linked to Sudan involve contracts with or provision of oil-related or mineral-extracting products or services to the regional government of southern Sudan or a project or consortium created exclusively by that regional government; and the company has failed to take substantial action specific to Sudan; **or**
 - b. More than 10% of the company's revenues or assets linked to Sudan involve power-production activities; less than 75% of the company's power-production activities include projects whose intent is to provide

¹ "Best efforts" shall include reviewing and relying on publicly available information regarding companies having business operations in Iran or Sudan, including information provided by nonprofit organizations, research firms, international organizations, and government entities; contacting asset managers that invest in companies having business operations in Iran or Sudan; contacting other institutional investors that have divested or engaged with companies that have business operations in Iran or Sudan; and reviewing the laws of the United States regarding the levels of business activity that would cause application of sanctions for companies conducting business or investing in countries that are designated state sponsors of terror.

- power or electricity to the marginalized populations of Sudan; and the company has failed to take substantial action specific to Sudan.²
2. The company is complicit in the Darfur genocide.³
 3. The company supplies military equipment within Sudan unless it clearly shows that the military equipment cannot be used to facilitate offensive military actions in Sudan or it implements rigorous and verifiable safeguards to prevent use of that equipment by forces actively participating in armed conflict.
 4. The company has business operations that involve contracts with or provision of supplies or services to the government of Iran, companies in which the government of Iran has any direct or indirect equity interest, consortiums or projects commissioned by the government of Iran, or companies involved in consortiums or projects commissioned by the government of Iran, **and** one of the following apply:⁴
 - a. More than 10% of the company’s revenues or assets linked to Iran involve oil-related activities, mineral-extraction activities, or petroleum resources;
 - b. The company has, with actual knowledge, on or after August 5, 1996, made an investment of \$20 million or more, or any combination of investment of at least \$10 million each, which in the aggregate equals or exceeds \$20 million in any twelve-month period, and which directly or significantly contributes to the enhancement of Iran’s ability to develop petroleum resources in Iran; **or**
 - c. The company is engaged in business with an Iranian organization labeled as a terrorist organization by the United States government.

Within 90 days after the effective date of the bill, each retirement system would be required to create a list of “scrutinized companies,” make it available to the public and update it annually. The retirement system would be required to provide written notice to any company on the list with inactive business operations in Iran or Sudan to encourage it to continue refraining from initiating active business operations in Iran or Sudan. Each retirement system would be required to continue such notice semiannually.

² “Substantial action specific to Sudan” means adopting, publicizing and implementing a formal plan to cease scrutinized business operations within one year and refrain from any new business operations; undertaking humanitarian efforts in conjunction with an international organization, the government of Sudan, the regional government of southern Sudan, or a nonprofit entity evaluated and certified by an independent third party to be substantially in a relationship to the company’s Sudan-related business and of benefit to one or more marginalized populations of Sudan; or, through engagement with the government of Sudan, materially improving conditions for the genocidal victimized population in Darfur.

³ A “social development company” that provides humanitarian goods or services to the people of Sudan and is not complicit in the Darfur genocide is excluded.

⁴ Any company that takes substantial action specific to Iran with respect to 4(a) or (b) shall not be deemed as a “scrutinized company.” “Substantial action specific to Iran” means adopting, publicizing and implementing a formal plan to cease scrutinized business operations within one year and refrain from any new business operations.

For any company on the list that has active business operations in Iran or Sudan, each retirement system would be required to send written notice informing the company of its status as a “scrutinized company,” the opportunity to clarify its Iran-related or Sudan-related business activities and the requirement to cease active business operations or convert such operations to inactive business operations within 90 days in order to avoid becoming subject to divestment by the retirement system.

Each retirement system would also be required to submit letters to the managers of actively managed investment funds containing indirect holdings in companies that have scrutinized active business operations requesting them to consider removing such companies from the fund or create a similar actively managed fund having indirect holdings devoid of such companies.⁵ If the manager creates a similar fund, each retirement system would be required to replace all applicable investments with investments in the similar fund in an expedited timeframe consistent with prudent investment standards. For the purposes of this provision, a private equity fund is deemed to be an actively managed investment fund.

If any company on the list fails to take action within 90 days, the retirement system would be required to divest all direct holdings in the publicly traded company (i.e., stocks and bonds) within 12 months.⁶ The retirement system would also be prohibited from acquiring any direct holdings in publicly traded companies on the list with active business operations in Iran or Sudan. The bill would provide an exception for any “private holdings” of a public investor. A limited exception is also provided under the divestment mandate and investment prohibition for any company that is headquartered in the United States and complies with all relevant United States foreign trade controls relating to Iran or Sudan.

Am. Sub. H.B. 151 would provide that the retirement systems may cease divestment and reinvest in scrutinized companies if clear and convincing evidence shows that the value of all assets under management becomes equal to or less than 99.50%, or at least 50 basis points, of the hypothetical value of all assets under management assuming no divestment for any company had occurred. In advance of any reinvestment, each retirement system would be required to provide a written report to the President of the Senate and the Speaker of the House, setting forth the reasons and justification for the

⁵ “Indirect holdings” means all stocks and bonds of a company that are not direct holdings and are held in an account or fund in which the public sector owns shares or interests together with other investors not subject to the provisions of this act, as well as any private equity fund, private equity fund-of-funds, venture capital fund, hedge fund, hedge fund-of-funds, real estate fund, or other investment vehicle that is not publicly traded, mutual funds, and pooled or securitized investment vehicles.

⁶ “Direct holdings” means all stocks or bonds of a company held directly by a public investor or held in an account or fund of which the public investor owns all of the shares or interests.

retirement system's decision to cease divestment or begin reinvestment in otherwise scrutinized companies.

If any company resumes active business operations in Iran or Sudan, each retirement system shall reinstate the company on the list and shall send written notice to the company, as described above.

Within 30 days after creating and updating the list, each retirement system would be required to file a report with the President of the Senate, the Speaker of the House, the Minority Leader of the House, the Minority Leader of the Senate, the ORSC and the Workers' Compensation Council that includes the list of scrutinized companies and make it available to the public. Annually, each retirement system would also be required to send a report to the President of the Senate, the Speaker of the House, the Minority Leader of the Senate, the Minority Leader of the House, the ORSC, the Workers' Compensation Council and the United States presidential special envoys to Iran and Sudan. Such report shall also be made available to the public. The report shall include the following information:

1. A summary of correspondence with companies provided written notice by the state retirement systems;
2. All investments divested under the provisions of the bill;
3. All prohibited investments under the provisions of the bill;
4. Any progress made with managers of actively managed investment funds containing indirect holdings in companies having scrutinized business operations;
5. A list of all publicly traded securities held directly the state retirement systems.

The bill would provide that the board of a state retirement system is not liable for breach of fiduciary duty if the board complies in good faith with the requirements of the bill and that the board is not liable for slander or libel if the board makes determinations in good faith regarding the status of a company as required under the bill. Also, the bill would provide that all members, officers, employees and agents of the board shall be indemnified for all claims, demands, suits, actions, damages, judgments, costs, charges and expenses, including court costs and attorney's fees, and against all liability, losses and damages of any nature that may be incurred by reason of any decision to restrict, reduce or eliminate investments in scrutinized companies. A member, officer, employee or agent of the board shall be indemnified by the retirement system in which they serve.

Am. Sub. H.B. 151 would also provide that the provisions of the bill prevail over any conflicting provisions with the state retirement systems' governing investment statutes. The Attorney General shall enforce the provisions of the bill and may bring an action in court to enforce such provisions. Should the Attorney General bring an action against the retirement boards, the retirement boards may obtain outside legal counsel.

Am. Sub. H.B. 151 would permit, *but not require*, the Ohio Public Employees Deferred Compensation Program, the alternative retirement program sponsored by public

institutions of higher education in Ohio, and the Ohio Tuition Trust Authority to offer participants a “terror-free investment option.”⁷ None of these public entities would be subject to the divestment mandates or prohibited investments proposed under the bill. The Ohio Public Employees Deferred Compensation Board and the Ohio Tuition Trust Authority would be required to prepare and submit an annual report to the President of the Senate and the Speaker of the House regarding their efforts to identify and provide a “terror-free investment option.” Public institutions of higher education in Ohio, as the plan sponsors of the alternative retirement plans, are exempted from this requirement.

The provisions of the bill would expire with respect to Sudan upon the occurrence of any of the following:

1. Congress or the President determines that the government of Sudan has sufficiently halted the genocide in the Darfur region for at least 12 months;
2. The federal government revokes all sanctions against the government of Sudan;
3. Congress or the President, through legislation or executive order, declares that mandatory divestment of the type provided under the bill interferes with United States foreign policy;
4. Congress or the President declares that the government of Sudan has honored its commitments to cease attacks on civilians, demobilize and demilitarize the Janjaweed and associated militias, grant free and unfettered access for deliveries of humanitarian assistance, and allow for the safe and voluntary return of refugees and internally displaced persons.

The provisions of the bill would expire with respect to Iran upon the occurrence of any of the following:

1. Congress or the President determines that the government of Iran has ceased to acquire weapons of mass destruction and support terrorism;
2. The federal government revokes all sanctions against the government of Iran;
3. Congress or the President declares that mandatory divestment of the type provided under the bill interferes with United States foreign policy;

Staff Comments – Am. Sub. H.B. 151 is modeled after Florida legislation (S.B. 2142) recently passed by the Florida legislature and signed by the Governor, and still raises a number of significant financial, legal and public policy issues that merit serious consideration. While the substitute bill limits the scope of scrutinized companies to those involved in oil-related, military supply, mineral-extraction and power production activities, the substitute bill expands the number of countries to include Iran as well as Sudan.

⁷ “Terror-free investment option” means an account or fund that excludes from its portfolio any company that has scrutinized business operations in Iran or Sudan.

Investment Mandates

Historically, the Ohio General Assembly has rejected any type of investment mandates upon the retirement boards’ “full power to invest the funds,” including several proposed divestiture bills in the early 1980’s relative to South Africa and in the early 1990’s relative to Northern Ireland. Most recently, the Ohio General Assembly reaffirmed its longstanding policy of rejecting proposed legislative mandates in S.B. 133 (eff. 9-15-04) by eliminating language that would have required the retirement boards to use a specified percentage of Ohio-based asset managers and brokers for their investment transactions.

The Ohio General Assembly has considered such legislative investment mandates to be inconsistent not only with the fiduciary duties of the retirement boards to act “... solely in the interest of the participants and beneficiaries ...” but also with the legal status of the retirement systems as trust funds. Once contributions are transferred to the state retirement systems, they belong solely to the members as required under federal tax law to remain a “qualified plan” and to receive favorable tax treatment on the contributions and earnings thereon. While individuals are free to manage their own assets as they see fit, attempting to achieve foreign policy or other social objectives with other people’s money violates basic trust law principles and intercedes in the fiduciary responsibilities of the retirement boards who are vested under current 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.⁸

Prudent Person Investment Authority

S.B. 82 (eff. 3-7-97) abolished the “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 and 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 earnings and diversification of plan assets.

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 up to 80 percent of benefit costs. Simply put, the less revenue generated by investments, the more contributions required from employers and employees, and ultimately Ohio taxpayers.

⁸ Public accountability for board actions is ensured by each board having one investment expert appointed by the Governor, one investment expert appointed by the State Treasurer, and one investment expert jointly appointed by the Ohio General Assembly.

Sub. H.B. 151 would mark the first set of restrictions placed upon the retirement systems' investment authority since the adoption of the "prudent person rule," and could set a dangerous and costly precedence for further restrictions upon the retirement systems' investment authority. This bill is a prime example. While the bill, as introduced, would have prohibited investments in certain companies doing business in Iran only, the substitute bill would extend a similar prohibition to certain companies doing business in Sudan. Other divestiture initiatives throughout the country include, but are not limited to, companies doing business in other terrorist states (e.g., Cuba, North Korea, Syria), companies operating in other conflict zones (e.g., Burma, Israel), and companies engaged in certain industries (e.g., alcohol, firearms, gambling, tobacco, weapons manufacturing). There simply is no logical end to such restrictions once they are established as precedence.

In order to achieve the best risk-adjusted returns available, the state retirement systems must include foreign companies in their investment portfolios to take advantage of the diversification and risk reduction benefits offered through global investment. It should be noted that international equity has been one of the largest contributors to the state retirement systems' double-digit total fund returns over the last three years that have outperformed the domestic equity and fixed income markets. The semi-annual performance evaluation prepared by Evaluation Associates for the period ending December 31, 2006 indicates that the rates of return for *international equities* for the five state retirement systems ranged from 24.90% to 28.23% for the past year and from 18.60% to 23.75% for the past three-year period. For comparative purposes, the rates of return for *fixed income* for the five state retirement systems ranged from 5.28% to 5.78% for the past year and from 4.38% to 5.45% for the past three-year period. The rates of return for *domestic equity* ranged from 14.54% to 16.21% for the past year and from 11% to 12.19% for the past three-year period.

Foreign Companies in Ohio

The Ohio Department of Development maintains 11 offices around the world not only to promote exports of Ohio goods and services abroad but also to promote new or expanded foreign investment in Ohio. Foreign companies in Ohio employ over 200,000 Ohioans, and provide the livelihood for more than four percent of Ohio's private sector workforce. These foreign companies support 95,000 manufacturing jobs in Ohio, and tend to have a strong "multiplier" effect on the economy by stimulating a substantial amount of activity and jobs in other sectors through their demand for inputs from other suppliers. Over 45% of the jobs at these foreign companies are in manufacturing industries and pay significantly higher than average compensation.

China has significant business ties with both Iran and Sudan. Ohio's Department of Development addressed the Forum on Chinese Trade and Investment hosted by the Council of Great Lakes Governors in May, lauding Ohio's nearly 30-year business ties with China and encouraging more. GE Aviation and Chinese airline companies signed agreements for the purchase of Ohio-made jet engines. Moreover, the Department of

Development International Trade Division signed a memorandum of understanding with the Chinese Ministry of Commerce, urging strong business ties between Ohio and China. China is Ohio's fourth largest export market. The substitute bill could work at cross-purposes with these efforts to encourage Chinese firms to invest in Ohio by prohibiting Ohio's state pension funds from investing in these Chinese firms.

Attached is a list of 22 companies investing in Iran's energy sector that was initially given to us. As shown, most, if not all, of these companies involve "oil-related activities" in Iran. However, Am. Sub. H.B. 151 is limited neither to Iran nor to companies in the oil and gas industry. It includes under the divestment mandate and prohibited investment section of the bill companies with ties to Sudan as well as companies involved in military supply, mineral extraction and power production activities. Based upon this analysis, a subsequent list of 52 companies investing in Iran and Sudan was provided to us; this list apparently identifies prohibited companies under Am. Sub. H.B. 151 (See attached).

Independent Shareholder Services (ISS), an independent research provider, was asked by SERS to screen their Iran and Sudan universes according to the criteria established under Am. Sub. H.B. 151. ISS came up with 75 foreign companies under the Iran screen and an additional 30 foreign companies under the Sudan screen for a total of 105 companies that would be illegal investments under Am. Sub. H.B. 151 (See attached). ISS is doing some or all of the screening for Florida, California and Colorado.

Missouri Plan and S.B. 133

The Missouri State Employees' Retirement System (MOSERS) anti-terrorist policy and screening process, which has received considerable attention in Ohio and throughout the nation, is fundamentally different from what is being proposed under Am. Sub. H.B. 151. It is **not** a legislative investment mandate, but rather a policy adopted by the retirement board that retains the board's broad discretion to make the ultimate investment decision as to whether to divest consistent with its fiduciary duties.⁹ Under that policy, the retirement staff identifies the universe of investment securities that will be subject to screening. The staff then compares the universe of investment securities to be screened with a list of companies identified by two independent research providers. Where there are matches, the staff will further investigate by asking the portfolio manager for any information known about the company and the reason for owning the security. After receiving any requested reports from the portfolio manager on specific companies, the staff will prepare a report for the board indicating whether the staff believes the security should be held or should be sold. The board retains discretionary authority to agree or disagree with the staff recommendation to hold or sell the security. If the board votes to sell, the portfolio manager will be directed to sell the holding. If the board does not vote to sell, the company will remain in the portfolio and will be subject to routine monitoring.

⁹ A *non-binding resolution* was recently introduced in the Missouri legislature that would call on all Missouri public retirement plans to divest funds in any terrorist-sponsoring state.

This anti-terrorist policy and screening process clearly recognizes the fiduciary duties of the retirement board by allowing the board to conduct its due diligence and retaining the board's discretionary authority to decide whether to hold or sell the security. This anti-terrorist policy and screening policy is significantly different from the legislative investment mandate proposed under Am. Sub. H.B. 151.

The Ohio General Assembly has consistently recognized the fiduciary duties of the retirement board as being paramount to other policy objectives. The General Assembly has enacted legislation encouraging the retirement boards to give consideration to investments that enhance the general welfare of the state, that involve minority owned and controlled firms and that involve firms owned and controlled by women, *provided such investments offer quality, return and safety comparable to other investments available to the board.* Similarly, the General Assembly enacted S.B. 133 (9-15-04) which required each retirement board to adopt a policy with the goal of increasing utilization of Ohio-based asset managers and brokers, including minority business enterprises, *provided such asset managers, brokers and enterprises offer quality, services, and safety comparable to other managers, brokers and enterprises available to the board.* S.B. 133 and prior legislation strikes the appropriate balance by recognizing the retirement boards' fiduciary duties in pursuing certain policy objectives established by the legislature, and holding the retirement boards accountable to the legislature through annual reporting to the ORSC and legislative committees on their progress in implementing these legislative policies.

Attached is a proposed amendment (127 HB151-3262/KB) modeled after S.B. 133. It would require each retirement board to adopt and implement a written policy, within 90 days after the effective date of the bill, to address investments in scrutinized companies with certain ties to Iran or Sudan. The policy shall address each of the following:

- A screening process by which one or more independent research providers shall identify scrutinized companies;
- A review process by which scrutinized companies may challenge or appeal the determination made by the independent research provider;
- A process by which the retirement board determines whether divestment or prohibition of direct holdings in forbidden entities is consistent with the board's fiduciary duty, subject to replacement holdings that offer quality, return and safety comparable to other holdings otherwise available to the board. The board's determination shall be final;
- A requirement that the initial screening be completed within 90 days after the policy is adopted.

The proposed amendment modeled after S.B. 133 would further require each board to submit an annual report to the governor, president of the senate, speaker of the house, and the ORSC containing the following information:

- The name of the independent research provider selected;
- The list of scrutinized companies identified;

- The result of written notice process to scrutinized companies;
- The list of forbidden entities from which the board divested;
- Any other information requested by the ORSC regarding the board's implementation of its policy.

It should be noted that both Congress and other states have recognized the inherent conflict between the fiduciary duty of retirement boards established under federal and state law and the mandatory divestment provisions applicable to such boards, such as under Am. Sub. H.B. 151. Last month federal legislation entitled Iran Sanctions Enabling Act of 2007 (H.R. 2347 and S. 1430) was introduced **permitting, but not mandating**, public and private fund managers to divest in companies that support Iran's oil and gas industry. Moreover, Sudan divestment legislation recently enacted in California and pending Iran divestment legislation recently passed by the House specifically provides that the California Public Employees' and State Teachers' Retirement System shall not be required to divest unless the board determines, in good faith, that such divestment is consistent with the fiduciary duties of the board.

Foreign Policy

The United States Constitution provides that the federal government has authority over foreign affairs and commerce with foreign countries. The federal government has the power to decide whether U.S. companies can do business in other countries based on national security interests. State and local retirement systems are neither positioned nor equipped to make foreign policy judgment calls as to which multi-national companies (foreign and domestic) are operating for or against the national security interests of the United States. The federal government should provide guidance to ensure that any divestment efforts to influence foreign policy are uniform throughout the nation and consistent with the objectives of the United States. Last month federal legislation was introduced to require the U.S. Treasury, in consultation with other federal agencies, to create a list of companies investing over \$20 million in the Iranian energy sector, and update it every six months. The federal legislation would **permit, but not require**, both public and private fund managers to divest in such companies listed.

Governmental Defined Contribution Plans and Other Institutional Investors

Am. Sub. H.B. 151 creates an unfair bias against governmental defined benefit plans, such as the five state retirement systems, and in favor of governmental defined contribution plans, such as the alternative retirement plan sponsored by public institutions of higher education in Ohio, by requiring the state retirement systems to divest in scrutinized companies but allowing governmental defined contribution plans sponsored by public entities to continue investing in such companies. Other public entities **excluded** from the proposed divestment mandates include, but are not limited to, the following:

- The alternative retirement plans of public institutions of higher education as the plan sponsor (e.g., TIAA-CREF, AIG/VALIC);

- The endowments of public institutions of higher education;
- The Ohio Public Employees Deferred Compensation Plan (administered by the PERS Board, plus two legislators appointed by leadership);
- The Ohio Tuition Trust Authority; and
- The 403(b) tax-sheltered annuity plans and other supplemental retirement plans sponsored by school districts and other political subdivisions in Ohio.

Am. Sub. H.B. 151 would **permit, but not require**, the alternative retirement plans of public institutions of higher education in Ohio, the Ohio Public Employees Deferred Compensation Plan and the Ohio Tuition Trust Authority to offer a “terror-free investment option.” Moreover, the bill would exclude alternative retirement plans sponsored by public institutions of higher education from reporting to the legislature on their efforts to identify and provide “terror-free investment options” to their participants. At a minimum, the same reporting requirements should apply to alternative retirement plans as are applicable to the Ohio Public Employees Deferred Compensation Plan and Ohio Tuition Trust Authority under the amended substitute bill.

Mandating the state retirement systems to divest securities that these other public entities can then buy is not only a contradictory state policy but also likely to be an ineffective state policy in achieving its purported purpose. For example, mandating defined benefit managers, such as STRS, to divest securities that defined contribution managers, such as TIAA-CREF, can buy on behalf of public employees of state universities makes absolutely no sense as a matter of public policy.

The bill would also **not** apply to private pension plans, other institutional investors and just about everyone with a 401(k) pension plan or mutual fund in Ohio.

Cost to the State Retirement Systems

As indicated above, an initial list of 22 companies investing in Iran’s energy sector was given to us. A subsequent list of 52 companies with certain ties to Iran and Sudan was provided last week. ISS, an independent research provider, has identified for SERS 105 foreign companies that would be prohibited investments under the current criteria established under Am. Sub. H.B. 151. ISS is currently doing some or all of the screening for Florida, California and Colorado.

Requiring the state retirement systems to divest of the securities in these companies will impose at least trading costs as they sell the securities and buy replacements. Further, there will likely be market impact cost as traders, knowing that the retirement systems must sell these holdings within 18 months after the effective date of the bill, drive down the prices of the securities being sold. Moreover, the retirement systems will be required to contract with one or more independent research providers to prepare accurate lists of prohibited investments and monitor them on a continuous basis as foreign companies cease or commence business ties with Iran or Sudan. Also, divestiture will reduce the opportunity set of investments, which has an implicit cost in terms of lower returns and higher risk. It should be noted that any investment losses incurred by any of the five state

retirement systems would further reduce the limited resources available for discretionary retiree health care benefits as each retirement system has a statutory obligation to fund mandated pension benefits within a 30-year funding period.

While it is certain that Am. Sub. H.B. 151 would impose additional costs to the retirement systems as described above, the amount of those costs are uncertain because the lists of scrutinized companies differs significantly, ranging anywhere from 52 to 105 foreign companies, and the future opportunity costs of a limited international investment universe is unknowable. Based on the list of 52 scrutinized foreign companies, the estimated direct holdings of the state retirement systems are as follows:

- STRS - \$771 million representing about 22 foreign companies;
- PERS - \$267 million representing about 30 foreign companies;
- OP&F - \$131 million representing about 8 foreign companies;
- SERS - \$120 to \$130 million representing about 18 companies.

Indemnification

As noted above, any investment losses incurred by the five state retirement systems as a result of Am. Sub. H.B. 151 would further reduce the limited resources available for discretionary retiree health care benefits as each retirement system has a statutory obligation to fund mandated pension benefits within a maximum 30-year funding period. While the bill provides that members, employees and agents of the retirement board shall be indemnified for any losses incurred as a result of the investment restrictions proposed under the bill, the bill provides no indemnification for the retirement systems themselves, meaning the members, retirees and their beneficiaries shall bear the financial burden for any losses. Legislation in California provides that the State of California shall provide indemnification to the state retirement systems for any losses incurred as a result of a similar investment mandate. Consideration should be given to do the same for the five state retirement systems in Ohio.

Fiscal Impact – See Cost to the State Retirement Systems.

Staff Recommendation – That the Ohio Retirement Study Council recommend that the 127th Ohio General Assembly disapprove Am. Sub. H.B. 151 for the reasons cited above and that the General Assembly consider the attached amendment that would require the retirement boards to adopt and implement a written policy, within 90 days after the effective date of the bill, to address investments in scrutinized companies doing business in Iran and Sudan and report annually to the Governor, President of the Senate, Speaker of the House, and the ORSC on their progress in implementing such policy. The amendment is modeled after S.B. 133 (eff. 9/15/04), and would allow the boards to make any divestment decisions consistent with their fiduciary duties.

ORSC Position - At its meeting of May 22, 2007 the Ohio Retirement Study Council recommended by a vote of 9 to 0 that the 127th Ohio General Assembly disapprove Sub. H.B. 151 (LSC 127 0911-7) for the reasons cited above and that the General Assembly

consider the attached amendment that would require the retirement boards to adopt a policy to address investments in scrutinized companies doing business in Iran and report annually to the ORSC on their progress in implementing such policy. The amendment is modeled after S.B. 133 (eff. 9/15/04), and would allow the retirement board to make any divestment decisions consistent with their fiduciary duties.

The ORSC has not yet reviewed Am. Sub. H.B. 151 as reported by the House Financial Institutions, Real Estate and Securities Committee, but the mandate to divest remains a part of the bill. Additionally, the systems' actuaries have not yet had an opportunity to review this version of the bill.

Sub. H.B. 151
As Reported by H. Financial
Institutions, Real Estate, and
Securities

Topic: Public investors to adopt an Iran/Sudan policy

Rep. Wachtmann moved to amend as follows:

In line 13, delete "sections" and insert "section"; delete ", 2
148.04, 3305.01, 3305.02," 3

In line 14, delete "and 3334.02"; delete "sections" and 4
insert "section"; delete ", 137.02, 137.03," 5

In line 15, delete everything before "of" 6

In line 94, delete "Chapter 137." and insert "section 137.01" 7

In line 198, after "137.01." insert "(A)"; delete "chapter" 8
and insert "section" 9

Delete lines 199 through 825 and insert: 10

"(1) "Business operations" means a foreign-based company 11
engaged in business operations that provide revenue to the 12
government of Iran or a foreign-based company engaged in oil 13
related activities. 14

(2) "Direct holdings" as it relates to a foreign-based 15
company means all stocks and bonds of that foreign-based company 16
that are held directly by a public investor or in an account or 17
fund in which the public investor owns all shares or interests. 18

(3) "Forbidden entities" means a scrutinized foreign-based company that a public investor determines is a forbidden entity pursuant to division (B)(1)(c) of this section. 19
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(4) "Foreign-based company" means any company that is headquartered, domiciled, and incorporated under the laws of any country other than the United States. 22
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(5) "Government of Iran" means the government of Iran, its instrumentalities, and companies owned or controlled by the government of Iran. 25
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(6) "Government of Sudan" means the government in Khartoum, Sudan, that is led by the national congress party, formerly known as the national Islamic front, or any successor government formed on or after October 13, 2006, including the coalition national unity government agreed upon in the 2005 comprehensive peace agreement, and does not include the regional government of southern Sudan. 28
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(7) "Indirect holdings" as it relates to a foreign-based company means all stocks and bonds of that company that are not direct holdings and that are held in an account or fund managed by one or more persons not employed by the public investor; in which the public investor owns shares or interests together with other investors not subject to the provisions of this section; any private equity fund, private equity fund-of-funds, venture capital fund, hedge fund, hedge fund-of-funds, real estate fund or other investment vehicle that is not publicly traded; mutual fund; or any other pooled or securitized investment. 35
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(8) "Iran" means the Islamic republic of Iran. 45

(9) "Public investor" means the treasurer of state, the state board of deposit, the workers' compensation oversight commission, the administrator of workers' compensation, and the board of each 46
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of the state retirement systems.

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(10) "Oil-related activities" include, but are not limited to, 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; and facilitating such activities, including providing supplies or services in support of such activities, except that the mere retail sale of gasoline and related consumer products is not considered an oil-related activity.

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(11) "Scrutinized company" means any foreign-based company that meets any of the following criteria:

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(a) The company has business operations that involve contracts with or provision of supplies or services to the government of Sudan, companies in which the government of Sudan has any direct or indirect equity share, consortiums or projects commissioned by the government of Sudan, or companies involved in consortiums or projects commissioned by the government of Sudan, and more than ten per cent of the company's revenues or assets linked to Sudan involve oil-related activities or mineral-extraction activities; less than seventy-five per cent of the company's revenues or assets linked to Sudan involve contracts with or provision of oil-related or mineral-extracting products or services to the regional government of southern Sudan or a project or consortium created exclusively by that regional government; or more than ten per cent of the company's revenues or assets linked to Sudan involve power-production activities; less than seventy-five per cent of the company's power-production activities include projects whose intent is to provide power or electricity to the marginalized populations of Sudan; and the company has failed to take substantial action specific to Sudan.

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(b) The company is complicit in the Darfur genocide. 80

(c) The company supplies military equipment within Sudan, 81
unless it clearly shows that the military equipment cannot be used 82
to facilitate offensive military actions in Sudan or the company 83
implements rigorous and verifiable safeguards to prevent use of 84
that equipment by forces actively participating in armed conflict. 85
Examples of safeguards include post-sale tracking of such 86
equipment by the company, certification from a reputable and 87
objective third party that such equipment is not being used by a 88
party participating in armed conflict in Sudan, or sale of such 89
equipment solely to the regional government of southern Sudan or 90
any internationally recognized peacekeeping force or humanitarian 91
organization. 92

(d) The company has business operations that involve 93
contracts with or provision of supplies or services to the 94
government of Iran, companies in which the government of Iran has 95
any direct or indirect equity share, consortiums, or projects 96
commissioned by the government of Iran, or companies involved in 97
consortiums or projects commissioned by the government of Iran, 98
and more than ten per cent of the company's total revenues or 99
assets are linked to Iran and involve oil-related activities, 100
mineral-extraction activities, or petroleum resources; 101

(12) "Sudan" means the republic of the Sudan. 102

(B)(1) Each public investor, within ninety days after the 103
effective date of this section, shall adopt and implement a 104
written policy to address investments in scrutinized foreign 105
companies. The policy shall address each of the following: 106

(a) A screening process by which one or more independent 107
research providers shall identify scrutinized companies; 108

(b) A review process by which scrutinized companies may

challenge or appeal the determination under division (B)(1)(a) of this section: 110
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(c) A process by which the public investor determines that a scrutinized company is a forbidden entity: 112
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(d) A process by which the public investor determines whether divestment or prohibition of direct holdings in forbidden entities is consistent with the public investor's fiduciary responsibilities, subject to replacement holdings that offer quality, return and safety comparable to other holdings otherwise available to the public investor. The public investor's determination shall be final. 114
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(e) A requirement that the initial screening pursuant to division (B)(1)(a) of this section be completed within ninety days after the policy is adopted pursuant to this division. 121
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(2) The public investor may rescind its policy addressing investments in scrutinized foreign companies related to Iran if any of the following occur: 124
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(a) Congress or the president of the United States affirmatively and unambiguously states, by means including, but not limited to, legislation executive order, or written certification from the president to congress, that the government of Iran has ceased to acquire weapons of mass destruction and support international terrorism. 127
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(b) The federal government revokes all sanctions imposed against the government of Iran. 133
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(c) Congress or the president of the United States affirmatively and unambiguously states, by means including, but not limited to, legislation, executive order, or written certification from the president to congress, that divestment of the type provided for by this section interferes with the conduct 135
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of United States foreign policy. 140

(3) The public investor may rescind its policy addressing 141
investments in scrutinized foreign companies related to Sudan if 142
any of the following occur: 143

(a) Congress or the president of the United States determines 144
that the government of Sudan has sufficiently halted the genocide 145
in the Darfur region for at least twelve months. 146

(b) The federal government revokes all sanctions imposed 147
against the government of Sudan. 148

(c) Congress or the president of the United States, through 149
legislation or executive order, declares that mandatory divestment 150
of the type provided for in this chapter interferes with the 151
conduct of United States foreign policy. 152

(d) Congress or the president of the United States declares 153
that the government of Sudan has honored its commitments to cease 154
attacks on civilians, demobilize and demilitarize the Janjaweed 155
and associated militias, grant free and unfettered access for 156
deliveries of humanitarian assistance, and allow for the safe and 157
voluntary return of refugees and internally displaced persons. 158

(4) A public investor, annually, shall submit to the 159
governor, the president of the senate, and the speaker of the 160
house of representatives a report containing the following 161
information, and in the case of a board of a state retirement 162
system, also to the Ohio retirement study council: 163

(a) The name of the independent research provider selected by 164
the public investor under this section: 165

(b) The list of scrutinized companies identified under this 166
section: 167

(c) The result of written notice process to scrutinized

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| <u>companies:</u> | 169 |
| <u>(d) The list of forbidden entities from which the public investor divested or was forbidden from investing in:</u> | 170 |
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| <u>(e) In the case of a board of a state retirement system, any other information requested by the Ohio retirement study council regarding the board's implementation of its scrutinized foreign companies policy.</u> | 172 |
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| <u>(5) This section does not apply to indirect holdings."</u> | 176 |
| In line 826, delete "sections" and insert "section"; delete ", 148.04, 3305.01," | 177 |
| | 178 |
| In line 827, delete "3305.02, and 3334.02"; delete "are" and insert "is" | 179 |
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| In line 1 of the title, delete "sections" and insert "section"; delete ", 148.04, 3305.01, 3305.02," | 181 |
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| In line 2 of the title, delete "and 3334.02"; delete "sections" and insert "section"; delete "to 137.09" | 183 |
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| In line 3 of the title, delete "to specify procedures for" | 185 |
| Delete lines 4 and 5 of the title | 186 |
| In line 6 of the title, delete "specified types of business" and insert "to require public investors to adopt and implement a written policy to address investments" | 187 |
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| In line 7 of the title, delete the second "and" | 190 |
| Delete lines 8 through 11 of the title | 191 |
| In line 12 of the title, delete everything before the period | 192 |

The motion was _____ agreed to.