

Testimony of James L. McAneny
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The Public Hearing on
Divestment: Pa's Public Retirement Systems
Conducted by the Senate Finance Committee
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Chairman Browne and Honored Members of the Committee:

I thank you for the opportunity to address the Senate Finance Committee on this important issue.

On October 23, 2007, the Public Employee Retirement Commission adopted and issued a report entitled *Special Report: Divestment and Pennsylvania's Public Employee Retirement Systems*. The report concerns one element of economic sanctions intended to influence the policies and practices of foreign governments: divestment of securities and shares of companies that do business with targeted nations.

Most divestment proposals have dealt with corporations or other entities that engage in business activities in or with 1) certain countries regarded as hostile to U. S. interests; 2) countries with oppressive regimes that routinely violate international norms and fundamental human rights; or 3) engage in business activities which themselves could be considered harmful to society or which are regarded as having no redeeming social value.

There are three divestment proposals currently before the Pennsylvania General Assembly that affect the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS). House Bill Number 1140 is limited in scope, imposing a targeted divestment mandate against corporations that have business relationships directly with the Sudanese government or government-created projects, impart minimal benefit to Sudan's underprivileged, and have demonstrated no substantial corporate governance policy regarding the Darfur situation. The bill requires divestment only from those companies that have proven unresponsive after a period of shareholder engagement. The bill also contains a "stop-loss" provision that permits the cessation of divestment activities under certain conditions and effectively limits the liability of the affected public funds. The bill also contains a provision requiring annual reimbursement from the Commonwealth General Fund for losses suffered by the affected public funds as a result of divestment.

Two other bills, House Bill Numbers 1085 and 1087, impose broad divestment mandates upon SERS and PSERS, respectively, allowing no discretion and few exceptions, and requiring immediate divestment of all holdings in entities engaged in business with a designated state sponsor of terrorism following a 90-day review by the Boards of PSERS and SERS.

Other recent and current divestment efforts have included actions targeting Myanmar (formerly Burma), Saudi Arabia, and Israel (both for and against in the last case). Certain industries have also been the target of divestment efforts in the U. S., most notably the tobacco industry, certain sectors of the entertainment industry and the firearms industry.

Divestment proponents argue ethics and morality: something must be done to stop the genocide, terror, or other wrongdoing. Opponents tend to argue cost and practicality. Essentially, the arguments for and against divestment focus on the relative merits or difficulties inherent in the choice between isolation and engagement. A major shareholder can exert substantial influence on corporate policies, but a former investor has no voice in its operations. Still, the threat of divestment, or publicity surrounding a divestment campaign, may cause a corporation to amend its policies to avoid public opprobrium.

While the usefulness of international economic sanctions in foreign relations is not disputed, the value of divestment, alone, has not been substantiated. Moreover, there are issues of federal preemption, fiduciary responsibility, and the lack of a recognized and verified list of corporate targets, which must be considered.

One of the biggest problems with divestment legislation is the difficulty of determining exactly which companies from which to divest (recognizing that inadvertently divesting a non-mandated company could constitute a breach of fiduciary duty for which there would be no statutory protection). This is a matter of concern because no authoritative, universally agreed upon list exists. Further, because the mandate would be dependent upon the business activities of multi-national companies, any list would have to be continuously updated; a stock purchased today might have to be divested tomorrow; stock divested today might go off the list and need to be repurchased tomorrow.

Various advocacy groups, such as the Sudan Divestment Task Force (SDTF), The Center for Security Policy, and The Israel Project, generate lists, as do commercial vendors. The available lists are inconsistent in their criteria and conclusions and may not provide pension funds with a valid basis on which to act. In addition, the methodology that various groups use in developing their lists often is not fully disclosed.

For purposes of researching this issue for the Commission, PSERS and SERS subscribed to a list generated by one of the most reputable private vendors, Institutional Shareholder Services (ISS). The ISS list includes the names of more than 400 companies, many of them prominent Pennsylvania employers, that in the estimation of ISS, would meet the criteria of being “engaged in business with a state sponsor of terror” and would have to be divested.

Because its list is a commercial product, ISS prohibits subscribers from sharing the full list with third parties. However, at the request of the Commission, PSERS and SERS secured ISS’ permission to disclose the names of all those companies on the list in which either PSERS or SERS currently holds stock. That list was set forth in the Special Report as Appendix VI.

While the Commission believes the ISS list to be credible, there are significant differences between it and other lists. For example, 13 companies on the SDTF list do not appear on the ISS list, and of the 24 companies identified by The Israel Project as being “most active” in Iran, six do not appear on the ISS list. And, since the release of the Special Report, the Commission has received objections from certain named corporations.

Numerous major public employee retirement systems, including PSERS and SERS, in addition to national associations, such as the National Association of State Retirement Administrators (NASRA), have repeatedly urged the U. S. government to identify companies whose actions may be undermining U. S. foreign policy, but to date, the federal government has failed to do so. Efforts are also underway in Congress to require the federal government to produce lists of companies whose activities in Sudan and Iran meet specified criteria. As products of the federal government, such lists could obviate many of the problems attendant to the reliance on privately generated lists.

The Pennsylvania Department of Community and Economic Development (DCED) is actively engaged in ongoing efforts to promote exports of Pennsylvania goods and services abroad and to encourage new or expanded foreign investment and business operations in the Commonwealth. According to DCED, Pennsylvania ranks third in the northeastern U. S., and ninth out of the 50 U. S. states in the total number of foreign-owned firms operating in the Commonwealth. Foreign-owned companies are major Pennsylvania employers. Approximately 1,400 foreign companies with subsidiaries in the Commonwealth employ over 249,400 Pennsylvanians, representing 5% of Pennsylvania’s private sector workforce. Approximately 38% of foreign-owned firms in Pennsylvania are in the manufacturing industry and account for nearly 12% of the Commonwealth’s total manufacturing employment. Many of these companies have been encouraged to locate, remain or expand in Pennsylvania through state grant and loan programs, and in some cases, through special legislation.

In addition, the Commonwealth is a customer of many of the listed companies. Thus, the prospect exists that the Commonwealth would continue providing cash directly to these companies in return for products and services, even as it seeks to indirectly deny the companies’ access to capital by preventing pension fund investment in their stocks.

Requiring PSERS and SERS to divest from holdings in these and other companies while the Commonwealth is attempting to induce these same companies to invest, locate in, or expand their presence in Pennsylvania (and employ Pennsylvania residents) is inconsistent and contradictory to public policy and may serve to undermine Pennsylvania’s economic development efforts.

The issue of the potential effectiveness of any proposed divestment mandate is central to a rational discussion of the merits of divestment as public policy. If a divestment campaign is unlikely to achieve its stated goals, the enactment of such divestment legislation would be illogical and would represent little more than a symbolic gesture rather than a rational strategy for achieving beneficial political, social or economic change.

There is a wealth of literature on all sides of the divestment issue. Although there is substantial information supporting the effectiveness of economic sanctions, there appears to be little empirical evidence to support the position that divestment has any

significant economic effect on the company whose stock is sold, let alone on the country or individuals whose behavior is intended to be influenced. The economic reality is that divestment involves selling stock in the public markets, at market prices, to willing buyers. As such, it has very little impact on the company itself, much less the country or individuals whose behavior has prompted the divestment. Some companies targeted by divestment campaigns have changed business practices, but those actions appear to have been more in response to the negative publicity generated from business ties to certain countries, rather than any actual economic impact.

The United States Constitution provides that the U. S. federal government has authority over foreign affairs and commerce with foreign countries. The federal government alone has the power to decide whether U. S. companies can do business in other countries based on national security interests. 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.

Two recent federal court decisions, *National Foreign Trade Council v. Giannoulias*, striking down an Illinois divestment statute on Constitutional grounds and *Crosby v. National Foreign Trade Council*, striking down a Massachusetts statute imposing sanctions on Burma, both rely upon the issue of federal preemption in the sphere of foreign affairs. (This is the same legal principle that underlies the recent Pennsylvania Middle District Court decision regarding Hazleton's immigration ordinance.) It is unlikely that the proposed Pennsylvania legislation would survive a similar challenge.

The speculative nature of divestment and replacement investment precludes precise actuarial estimates. The State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS) project a general 0.5% reduction in the assumed rates of return, or an increase in employer contributions of approximately 3.5% of payroll (\$198,170,000 for SERS and \$449,000,000 for PSERS). Just the transaction costs necessary to divest from the "highest offenders" in Sudan would be \$183,000 for SERS and \$831,000 for PSERS (\$7,270,000 for SERS and \$53,549,000 for PSERS if all companies divested that "engage in business" with terror sponsoring states). A sampling of school districts indicates increased annual taxpayer costs ranging from \$100,000 (Cumberland Valley) to \$3,000,000 (Philadelphia) for each 10 basis point decrease in investment earnings.

There will, of course, be ongoing costs of monitoring investments for compliance with the legislation as companies cease or begin to do business with prohibited nations. The following cost information was supplied to the Commission by PSERS and SERS and summarizes and discusses those costs by type and, where possible, by amount.

- Combined, PSERS and SERS held public equity investments valued at approximately \$10 billion on June 30, 2007, in companies identified as "being engaged in business with" terror sponsoring states according to the list compiled by Institutional Shareholder Services (\$8B for PSERS and \$2B for SERS).
- Narrowed to Sudan divestment, PSERS' and SERS' public equity holdings that would be subject to divestment under the SDTF criteria total \$139 million.

- Particularly with regard to the larger list of companies “engaged in business with” terror sponsoring states, these public equity investments represent a substantial portion of each system’s total public equity exposure (approximately 10% for SERS and 15% for PSERS).
- The equities potentially targeted for divestment have been highly profitable investments for both PSERS and SERS (\$2.36 billion for PSERS and \$558 million for SERS). Realized gains earned on the sale of investments in these companies for the period January 2003 through June 2007 is approximately \$2.3 billion (\$1.75 billion for PSERS, \$572 million for SERS). The total investment gains for both Funds were approximately \$5.2 billion.
- State Street Global Advisors has estimated that if all companies with ties to Iran were removed from the MSCI EAFE index and replaced with similar performing companies, it would introduce a tracking error of up to 200 basis points (2.0%). By comparison, the tracking error on a typical index is between five and ten basis points (.05% to 0.1%).
- Statutory restrictions on investments may also require PSERS and SERS to liquidate up to \$7.8 billion of investments in commingled funds. Commingled funds provide a cost-efficient means of investing in both domestic and global markets. Similar to mutual funds, commingled funds deploy commingled assets from multiple investors across an array of investments (for instance, a commingled fund may invest in all stocks in the EAFE index). “Terror free” commingled funds are available, but at a far higher price, and with higher risk and volatility.
- If investment opportunities available to PSERS and SERS are statutorily restricted, both may be required to lower their actuarially assumed rates of investment return. For both SERS and PSERS, the current 8.5% assumed rate of return would have to be reduced to 8.0%, according to their respective consultants. Any reduction in the assumed rate of return would result in a seven times greater increase in employer contribution rates: that is, decreasing assumed investment returns by 1% would increase employer contribution rates by an additional 7.0% of payroll.
- In the case of PSERS, the burden of any increase in employer contributions would fall in significant part on the local school districts, which pay approximately half the employer cost.
- In the case of PSERS and SERS, if actual annual earnings were reduced from 8.5% to 8.0% (50 basis points or 0.5%), the effect over a 10-year period would be to reduce PSERS’ investment earnings by approximately \$6.9 billion and reduce SERS’ investment earnings by approximately \$3.5 billion, for a total combined reduction in PSERS’ and SERS’ investment earnings of \$10.4 billion.
- In addition to any losses incurred as a result of lost investment opportunities, both systems would incur significant transaction costs to dispose of the prohibited investments and replace them in the portfolios, and to ensure ongoing compliance.

- If House Bill Number 1085 and House Bill Number 1087 were to be enacted in their present form, the total additional cost for both Funds to divest and reinvest their \$10 billion elsewhere is estimated at \$61 million: \$54 million for PSERS and \$7 million for SERS. If House Bill Number 1140 were to be enacted in its present form, the total additional cost to both Funds to divest and reinvest their \$139 million of holdings in companies categorized as the highest offenders is estimated at \$1 million: \$831,000 for PSERS and \$183,000 for SERS.
- The total additional administrative and monitoring cost is conservatively estimated at \$100,000 annually per system under a “terror sponsoring state” divestment bill.

Obviously, no one supports terror, genocide, deprivation of human rights, or other wrong doing. That is not the issue. What is the issue is the propriety and effectiveness of pension fund divestment as a means to deter such conduct. It is the Public Employee Retirement Commission’s responsibility to draw attention to specific matters that deserve consideration in making that decision. It is the function of the General Assembly to determine the appropriate policy.