

Virginia Retirement System 2016 Fiscal Impact Statement

1. Bill Number: SB 462

House of Origin Introduced Substitute Engrossed
Second House In Committee Substitute Enrolled

2. Patron: Carrico

3. Committee: Finance

4. Title: Investments by the Virginia Retirement System.

5. Summary: Prohibits the Virginia Retirement System (VRS) from investing in companies with current substantial business operations in Iran and requires VRS to divest itself of any current holdings in such companies by January 1, 2017, and within six months of identifying any such company.

6. Budget Amendment Necessary: In order to implement the divestment provisions of this bill, VRS would enter an agreement with a third-party vendor to screen for the affected securities held in the VRS portfolio. Due to the broad scope of investments that would likely be prohibited if this bill passed, VRS may also require additional staff time for purposes of continued monitoring of securities held and investment opportunities presented.

7. Fiscal Impact Estimates: It is difficult to quantify the future impact on the Trust Fund and VRS members, beneficiaries, retirees and employers of the broad limitations on investment opportunities set forth in this legislation.

8. Fiscal Implications: See “Other Comments” below.

9. Specific Agency or Political Subdivisions Affected: VRS, all VRS members, and all VRS-participating employers.

10. Technical Amendment Necessary: See recommended amendments below. Further explanation follows in the Other Comments section.

Recommendation – In the proposed § 51.1-124.38, add a new section:

D. The Board’s compliance with this section shall satisfy the standard of care described in subsection C of § 51.1-124.30.

Recommendation – Add a sentence to the end of § 51.1-124.30(C):

The Board's compliance with § 51.1-124.38 shall satisfy the standard of care described in this subsection.

11. Other Comments: The VRS Board of Trustees has concerns about this bill and divestment legislation in general:

Fiduciary/Constitutional Concern

Article X, Section 11 of the *Constitution of Virginia* sets out an important fiduciary standard that requires VRS Trust Funds to be “invested and administered solely in the interests of the members and beneficiaries thereof.” Divestment is contrary to this principle as it requires the Board to consider interests other than the sole interest of members. The Board opposes divestment legislation in general as it would lead to investment decisions that are not strictly based on the best interests of the members and beneficiaries, and would create a precedent for the use of VRS Trust Funds as an instrument of foreign policy for the purpose of influencing the behavior of foreign governments or domestically with regard to particular industries or products. Further, VRS’ long-standing position is that ensuring access to the broadest opportunity set possible is in the best interest of members and beneficiaries.

If passed, SB 462 would restrict the VRS Board’s ability to manage investments within its statutory standard of care. This standard of care (i.e., the “prudent person standard”) is outlined in the *Code of Virginia* § 51.1-124.30(C):

The [VRS] Board shall discharge its duties with respect to the Retirement System solely in the interest of the beneficiaries thereof and shall invest the assets of the Retirement System with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. The Board shall also diversify such investments so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

As this legislation would mandate certain investment decisions that would not necessarily be based on the prudent person standard, VRS requests that SB 462 be amended to include statutory language that divestment pursuant to this bill would satisfy the standard of care to avoid liability concerns. These recommended amendments can be found in the Technical Amendments section above.

VRS Engagement Already In Effect

In June 2009, pursuant to a request from the then-Chairman of the House Appropriations Committee, the VRS Board of Trustees adopted an engagement policy for companies doing business in Iran related to its oil and natural gas industry. Under the policy, a company was targeted for scrutiny if it (1) had made an investment of \$20 million or more in Iran's oil and natural gas sector, (2) actively conducted business activities subject or liable to sanctions under the Iran Sanctions Act of 1996, as amended, and (3) had business activities that directly or significantly contributed to the enhancement of Iran's ability to develop its petroleum resources. In order to be engaged under the policy, the scrutinized company held by VRS had to represent at least 10 basis points (0.1%) of the VRS Trust Fund.

Any engagement required VRS to contact each scrutinized company each year asking officials to: (1) provide more information about its Iran-related activities, (2) explain how it was using its influence with the Iranian government to advocate against objectionable activities, and (3) identify any associated shareholder risks. The policy also required VRS to annually request external investment managers with exposure to scrutinized companies to articulate their investment case for holding these securities. As long as VRS held direct investments in securities issued by a scrutinized company valued at one-tenth of one percent of the total fund, VRS would continue engagement activities with the subject company.

Over the past three fiscal years, VRS' analysis pursuant to the engagement policy has produced zero holdings that exceed the 10 basis point threshold. For FY 2015, a list of companies meeting the substantive criteria (but not percentage threshold) of the engagement policy showed that VRS held 16 such securities. Some of these securities are well-known companies, such as British Petroleum and Nokia, which represented an 8 basis point and a 5 basis point share, respectively. In total, the 16 securities on the FY 2015 list represented a 33 basis point share of the VRS Trust Fund, which equaled approximately \$218 million at the time the list was created.

Potential Impact of Iran Nuclear Deal

In 2015, the United States and other countries entered an agreement with Iran, the Joint Comprehensive Plan of Action (JCPOA). Generally, the JCPOA requires Iran to restrict its nuclear program in exchange for relief from various economic sanctions.

In exchange for Iran restricting its nuclear program, the U.S. committed to "seek such legislative action as may be appropriate to terminate, or modify to effectuate the termination of, all nuclear-related sanctions as specified" in the JCPOA. For example, the JCPOA cites sanctions imposed through the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA) of 2010. Section 202 of the CISADA includes provisions that permit a state or local government to impose qualifying measures that prohibit the investment of public funds in certain persons or entities that engage in investment activities in Iran.

These provisions are provided only to provide background and context on the current international landscape involving sanctions against Iran.

Unclear Definition of Target Companies

The language used in the bill is very broad and does not provide VRS with a clear definition of which investments would be prohibited. For example, the defined term “business operations” is broad, but is modified in context as relating to a company that has “substantial business operations in Iran.” However, SB 462 does not define the term “substantial.” Assessing the substantial nature of business operations, therefore, may yield a large number of possible scenarios that would require divestment. Estimating the scope and potential impact on the VRS investment portfolio is challenging given the lack of specificity related to the companies subject to divestment. Since the criteria is broad and lacks specificity, theoretically almost all of the public equity portfolio—one-third of the Trust Fund—could potentially be subject to divestment.

Potential Adverse Impact on the Investment Program

In 2012, legislation was proposed that was not enacted that was more narrow in scope and limited to operations related to petroleum. At the time, there were a number of companies that fit that screening criteria and the impacts to VRS-- had it been directed to sell--could have been significant.

This bill, which is much broader in scope than the 2012 legislation, would require VRS to sell potentially profitable investments and restrict future investment opportunities. Some of the largest companies from most of the developed economies in the world could be placed off limits to the VRS investment program.

The recent Iran nuclear agreement has resulted in a lifting of certain sanctions and could result in a considerable increase in the number of companies pursuing business opportunities in Iran. A recent Wall Street Journal article (Iran Opening Stirs New Interest From Businesses, 1/22/16) noted that following the recent Iran nuclear agreement, a number of large businesses are interested in and that General Electric has “begun looking at ways to do business in Iran while fully complying with the rules laid out by the U.S. government. . . .”¹

To further illustrate, Airbus recently announced tentative plans for Iran to purchase 127 planes from the company². Should this legislation pass, VRS would potentially be unable to invest in Airbus. In addition, Apple has reportedly been in talks with Iran since July of 2015

¹ The Wall Street Journal, “Iran Opening Stirs New Interest From Businesses,” Benoît Faucon, Business, January 22, 2016. <http://www.wsj.com/articles/iran-opening-stirs-new-interest-from-businesses-1453505438> (accessed January 27, 2016).

² CNBC.com, “Iran, Airbus strike deal for 8 A-380, 16 A-350 jets,” Reuters, Industrials, January 24, 2016. <http://www.cnbc.com/2016/01/24/iran-airbus-strike-deal-for-8-a-380-16-a-350-jets.html> (accessed January 27, 2016).

related to the potential sale of Apple products in Iran³. If such an arrangement is finalized, this legislation could require VRS to divest from Apple, one of the Trust Fund's largest equity investments.

Customized Implementations Have Higher Costs

In addition, the restrictions contained in SB 462 would increase the costs associated with certain investment vehicles. External investment companies would have to build custom funds or other investment vehicles that satisfy the restrictions contained in SB 462 (i.e., an option that excludes companies that have "substantial business operations in Iran"). This customization would increase the costs associated with the investment options, which would be passed on to VRS and its members and beneficiaries. Estimating costs associated with these potential changes is challenging given the lack of specificity related to the companies subject to divestment.

Potential Unintended Consequences

Some of the large firms that could potentially be subject to divestment operate in Virginia, pay Virginia taxes, and employ thousands of Virginians. As such, they support the Commonwealth of Virginia and its citizens, in addition to the VRS Trust Fund. Divestment from these firms could have unintended consequences outside of the context of VRS.

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Document: SB462.DOC/VRS

³ BusinessInsider.com, "Apple is reportedly in talks with Iranian distributors to start selling products there," James Cook, Tech, July 15, 2015. <http://www.businessinsider.com/apple-in-talks-to-start-selling-products-in-iran-2015-7?r=UK&IR=T> (accessed January 27, 2016).

Investor's Business Daily, "Iran To Open Up, As Apple, GE, Oil Giants Line Up," Bill Peters, News, January 13, 2016. <http://www.investors.com/aapl-rdsa-tot-iran-sanctions/?ven=investopediacp&src=aurlagy> (accessed January 27, 2016).