

PROFESSIONAL STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: Governmental Operations Committee

BILL: CS/CS/SB 2250

INTRODUCER: Governmental Operations Committee, Military Affairs and Domestic Security Committee, Senator Deutch and others

SUBJECT: Iran/Economic Sanctions

DATE: April 18, 2007 REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Skelton	Skelton	MS	Fav/CS
2.	Wilson	Wilson	GO	Fav/CS
3.			GA	
4.				
5.				
6.				

I. Summary:

This bill requires the State Board of Administration (SBA) to perform certain tasks related to the "Public Fund." The Public Fund is defined as all funds, assets, trustees, and other designates under the State Board of Administration.

Within 90 days of the effective date of this bill, the SBA is required to make its best efforts to identify all "scrutinized companies" in which the Public Fund has direct or indirect holdings or could possibly have such holdings in the future. "Scrutinized company" is defined as a company that has business operations involving contracts with or provision of supplies or services to the Government of Iran, a company in which the Government of Iran has any direct or indirect equity share, consortiums or projects commissioned by the Government of Iran, or companies involved in such consortiums or projects if more than 10 percent of the company revenues or assets linked to Iran involve oil-related activities or mineral extraction activities, less than 75 percent involve such activities and the company has failed to take substantial action, or if the company has made an investment of \$20 million or more since August, 1996 which directly or significantly contributes to the enhancement of the development of petroleum resources in the country.

By the first meeting of the SBA after the 90 day period, the SBA is required to assemble a list of "scrutinized companies." The list shall be updated quarterly.

The Public Fund is required to provide written notice to any company on the list with inactive business operations to encourage the company to continue to refrain from initiating active business operations. A new written notice is to be sent semiannually.

For a company which is newly identified on the list as having active business operations, the Public Fund is required to send the company a written notice of its status as a scrutinized company and the possibility that it may become subject to divestment by the Public Fund. The notice is to inform the company of actions it can take to avoid qualifying for divestment. The requirement is that the company must cease active business operations or convert to inactive operations within 90 days.

If a company on the “Scrutinized Companies List” fails to take action within 90 days after engagement through written notice, the Public Fund is required to sell, redeem, divest, or withdraw all publicly traded securities of the company within 12 months of the company’s most recent appearance on the list. A company that the U.S. government affirmatively declares to be excluded from federal sanctions is exempt from such divestment.

If a company resumes active business operations in Iran, it is to be added back to the Scrutinized Companies List immediately. The written notice process begins again for that company.

The Public Fund is prohibited from acquiring securities of any companies on the list which have active business operations in Iran.

The divestment provisions do not apply to indirect holdings in actively managed investment funds. The Public Fund is required to send letters to the managers of such funds requesting that they consider removing those companies from the fund or create an alternative fund. If an alternate fund is created, the Public Fund is required to replace all applicable funds with the new fund.

The Public Fund must file a report to each member of the SBA, the Senate President and House Speaker which includes the Scrutinized Countries List within 30 days of the creation of the list. The report is a public document. A further report is required annually. In addition to the above, the annual report is to be sent to the U.S. Presidential Special Envoy to Iran. The annual report is to include a summary of all correspondence with companies; all investments sold, redeemed, divested; or withdrawn; all prohibited investments; and any progress made in engagement of actively managed investment funds.

The act expires if the United States revokes all sanctions against Iran, if the Congress or President declares that Iran has ceased to acquire weapons of mass destruction and support international terrorism, or Congress or the President declare that mandatory divestment of the type required in this act interferes with the conduct of U.S. foreign policy.

With respect to this act, the Public Fund is exempt from any conflicting statutory or common law obligations, including any obligations with respect to choice of asset managers, investment funds or investments for the Public Fund’s security portfolios.

The Public Fund may cease divesting, or reinvest, in certain scrutinized companies if the value of all assets under management by the Public Fund becomes equal to or less than 99.50 percent, or 50 basis points, of the hypothetical value of all assets under management. Such activities require an additional report to the SBA, Senate and House.

The act includes a severability clause.

The bill takes effect upon becoming law and remains in effect until certain conditions are met at the federal government level.

The act creates an unnumbered section of the Florida Statutes.

II. Present Situation:

State Sponsors of Terrorism

Countries which are determined by the United States Secretary of State to have repeatedly provided support for acts of international terrorism are designated as “State Sponsors of Terrorism” and are subject to sanctions under the Export Administration Act¹, the Arms Export Control Act² and the Foreign Assistance Act³. The four main categories of sanctions resulting from designations under these acts are: restrictions on U.S. foreign assistance, a ban on defense exports and sales, certain controls over exports of dual use items, and miscellaneous financial and other restrictions.⁴ Some of the miscellaneous restrictions include opposition to loans by the World Bank and other financial institutions, removing diplomatic immunity to allow victims of terrorism to file civil lawsuits, denial of tax credits to companies and individuals for income earned in named countries, authority to prohibit U.S. citizens from engaging in transactions without a Treasury Department license, and prohibition of Department of Defense contracts above \$100,000 with companies controlled by terrorist-list states.⁵

The five countries currently designated by the U.S. Secretary of State as “State Sponsors of Terrorism” are Cuba, Iran, North Korea, Sudan and Syria.⁶

In its April 2006 “Country Reports on Terrorism,” the U.S. Department of State indicated that “(The Islamic Republic of) Iran remained the most active state sponsor of terrorism.”⁷ Iran has maintained a high-profile role in encouraging anti-Israeli terrorist activity; has reportedly provided funding, safe passage, and arms to insurgent elements in the ongoing war in Iraq;⁸ and continues to defy attempts to assure its participation in nuclear non-proliferation activities.⁹ Iran has been designated as a State Sponsor of Terrorism continuously since 1984.

Under Secretary of State for Political Affairs, R. Nicholas Burns, testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs on March 21, 2007, regarding the ongoing efforts of the federal government to address the “profound challenges posed to our national

¹ Section 6(j), U.S. Export Administration Act.

² Section 40, U.S. Arms Export Control Act.

³ Section 620A, U.S. Foreign Assistance Act.

⁴ U.S. Department of State website, <http://www.state.gov/s/ct/c14151.htm>, Office of Coordinator for Counterterrorism, “State Sponsors of Terrorism.”

⁵ U.S. Department of State website, <http://www.state.gov/s/ct>, “Country Reports on Terrorism.”

⁶ See Footnote 4 above.

⁷ See Footnote 5 above.

⁸ Ibid.

⁹ Comments by Supreme Leader Ayatollah Ali Khamenei, Associated Press, “Iranians threaten ‘illegal actions’ if provoked”, by Ali Akbar Dareini, March 21, 2007.

security interests by Iran.”¹⁰ In his testimony, Secretary Burns asserted that “(u)nder the radical leadership of President Mahmoud Ahmadi-Nejad, Iran directly threatens vital U.S. interests in multiple arenas and through a variety of instruments – its defiance of the international community in pursuit of a nuclear weapons capability; its efforts to sow chaos and instability throughout the region; ... repressive treatment of its own citizenry; its support for international terrorism; and its long-standing and violent rejection of any Middle East peace.”

Further, Secretary Burns stated that U.S. policy towards Iran is “clear and focused.” The U.S., and other international partners continue to show the Iranian regime that, “...its provocative and destabilizing policies will entail painful costs for Iran, including financial hardship, diplomatic isolation, and long-term detriment to Iran’s prestige and fundamental national interests.”

The United States is working with its United Nations Security Council partners, the United Kingdom, France, Germany, Russia, and China, on a new sanctions resolution by the United Nations that would enhance those already applied in Resolution 1731, which was adopted in December 2006. Work is ongoing to have the new sanctions resolution brought before the Security Council in the coming days or weeks. In addition, United States Secretary of State Condoleezza Rice made an offer to Iran in June 2006 to engage in direct discussions with Iran “at any place and at any time,” provided Iran completely, verifiably suspends its (uranium) enrichment activities, to discuss ways to improve U.S. – Iranian relations.¹¹ To date, the Islamic Republic of Iran has not agreed to any of these requirements.

IRAN¹²

Iran is officially known as the “Islamic Republic of Iran.” It is located on the Caspian Sea and is immediately adjacent to Iraq. The current government was formed in 1979. The Supreme Leader is head of state, while the President is head of government. The legislative branch consists of a 290 member Majles (National Assembly) and the judicial branch consists of a Supreme Court.

The Gross Domestic Product as of 2005 was \$561.6 billion, with agriculture (19%), industry (26%) and services (55%) making up the work product. Natural resources consist of petroleum, natural gas, coal, chromium, iron ore, lead manganese, zinc and sulphur. Leading industries in the country are petroleum, petrochemicals, textiles, and building materials.

In 2005, Iran had exports of \$55.42 billion, with petroleum (80%) and chemical / petrochemical products leading those exports. Major export partners were Japan (16.9%), China (11.2%), Italy (5.9%), South Korea (5.8%) and South Africa (5.8%). Likewise, in 2005, Iran had imports of \$42.5 billion in industrial raw materials, intermediate goods, capital goods, foodstuffs, technical services and military supplies. Major import partners were Germany (13.7%), United Arab Emirates (8.3%), China (8.2%), Italy (7%), France (6.2%), South Korea (5.3%), and Russia (4.8%).

Oil was first discovered in Iran in 1908. This natural resource has played a major role in the history of the country throughout the 20th century and continues to have impacts into the 21st

¹⁰ Testimony by R. Nicholas Burns to the U.S. Senate Committee on Banking, Housing and Urban Affairs, “Minimizing Potential Threats from Iran: Assessing the Effectiveness of Current U.S. Sanctions on Iran,” March 21, 2007.

¹¹ Ibid.

¹² U.S. Department of State, Bureau of Near Eastern Affairs, October 2006, “Background Note: Iran.”

century. In 1951, the government nationalized the British owned Anglo-Iranian Oil Company (AIOC). Several years later, the company was renamed British Petroleum, known today as BP. BP is now a publicly held company. There was huge growth in the country's economy during the 1960s and 1970s fueled by the development of petroleum reserves, the third largest reserves in the world. This economic growth slowed considerably in the late 1970s prior to the 1978 revolution and formation of the current government.

A combination of factors, including fluctuations in the world oil markets, and a border war with Iraq in the late 1980s kept the economy depressed until a windfall in oil prices in 1990. Oil revenues fell again in 1991 and the country has been afflicted with mismanagement and inefficient bureaucracies that have not allowed for the maximization of the oil industry potential into the 21st century. Increased oil prices beginning in 2003 have increased state revenues, but that has not eased high unemployment rates or inflation in the country.

Banks and some industries, such as petroleum, transportation, utilities and mining sectors, were nationalized after the 1978 revolution. There have been some attempts to privatize the industries, but low labor productivity and shortages of materials have kept Iran uncompetitive against foreign imports.

Current U.S. Sanctions against Iran

Pursuant to Presidential Executive Order 13059, its precedents and associated statutes, the United States Government imposes specific trade sanctions against the Islamic Republic of Iran. These sanctions include an import embargo on Iranian-origin goods and services, prohibition of U.S. involvement with petroleum development in Iran, prohibition of virtually all trade and investment activities with Iran by U.S. persons, wherever located (exceptions made for agriculture, medical and humanitarian purposes by license only). By amendment, sanctions are eased to allow for the import of carpets, dried fruits, nuts and caviar from Iran.

Corporate criminal penalties for violations of the Iranian Transactions Regulations can range up to \$500,000 with individual penalties up to \$250,000 and 20 years in jail. Civil penalties of up to \$50,000 may be imposed by the U.S. Department of Treasury.¹³

In addition, the United States is a signatory partner and abides by the United Nations Resolution 1737 (2006) which provides international sanctions against trade with Iran. The United Nations Security Council adopted a further resolution to endorse Res. 1737 and affirm further sanctions against Iran for its failure to divest of nuclear materials and technology on March 24, 2007. The new sanctions include freezing of assets of 28 persons and organizations involved in Iran's nuclear and missile programs, 10 additional key Iranian companies and 12 new individuals.¹⁴ It is assumed that the United States will honor those sanctions.

Florida State Pension Funds and Annuities

The State Board of Administration is created in Article IV, Section 4 (e) of the State Constitution. Its members are the Governor, the Chief Financial Officer and the Attorney

¹³ U.S. Department of Treasury, Office of Foreign Assets Control, "Iran – What You Need to Know About U.S. Economic Sanctions".

¹⁴ "U.N. imposes sanctions on defiant Iran," by Alexandra Olson, Associated Press, March 25, 2007.

General. The Board derives its powers to oversee state funds from Article XII, Section 9 of the Constitution.

The State Board of Administration (SBA) has responsibility for oversight of the Florida Retirement System (FRS) Pension Plan and the FRS Investment Plan, which represent approximately \$129 billion or 73% of the \$177 billion in assets managed by the SBA (as of December 31, 2006.) The Pension Plan is a defined benefit plan and the Investment Plan is a defined contribution plan that employees choose in lieu of the Pension Plan.¹⁵ The FRS receives employer contributions from approximately 950 employers (local government entities). The state share of the FRS totals approximately 25% of total annual contributions with the remainder coming from other government sources.¹⁶

Investment decisions for the pension plan are made by fiduciaries hired for that purpose by the state. Investment decisions for the investment plan are made by individual employees who may design their own portfolios based on participating offering companies.

The State of Florida has adopted federal fiduciary standards for management of the FRS funds. The Employee Retirement Income Security Act of 1974 (ERISA) is regulated by the U.S. Department of the Treasury and is the Florida standard for management of public funds.¹⁷ The Trustees of the SBA and all fiduciaries who manage Florida funds are bound by law to follow the standards established in ERISA.

The SBA investment managers are contractually bound to follow all federal and state laws in performance of their services to the state. The SBA does not invest in the securities of any company domiciled in countries on the U.S. State Department list of State Sponsors of Terrorism.¹⁸

Divestment of Securities

Divestment of securities is one method of applying economic pressures to companies, groups or countries whose practices are not condoned by shareholders. Divestment may be used in conjunction with or in lieu of other sanctioning methods such as economic embargoes, diplomatic and military activities. Alternatively, divestment may be used as protective device if a particular investment carries a high level of risk to the performance of a fund.

Several tools are available to fund managers, and their trustees, to protect funds against harm. The federal government has established the Office of Global Security Risk within the Securities and Exchange Commission to provide information to funds managers about potential risks of securities becoming unstable or losing value due to risk conditions, either political, or economic, that might exist in certain circumstances or locations around the world. Since fiduciaries are required to divest using prudent expert standards, they must have valid economic reasons for making decisions related to investment, divestment or repositioning in any particular security. The purpose of the Office of Global Security Risk is to provide fund managers with the information needed to make those decisions; however, the SEC does not take a position about

¹⁵ SBA Staff Analysis of HB 703, February 9, 2007.

¹⁶ Ibid.

¹⁷ Section 112.63(f), Florida Statutes.

¹⁸ SBA Staff Analysis of HB 703, February 9, 2007.

investing in individual companies.¹⁹ There is no known definitive federal list of companies that have equity ties to, or do business with, Iran. Several organizations provide lists of companies suspected of doing business in or with these countries, but none are definitive. The Department of Treasury does keep a list of “Specially Designated Nationals” (SDN) made up of companies or individuals who are not authorized to do business with the United States or its citizens. These SDN lists are either specific to a particular country designated as a State Sponsor of Terrorism or generic to the Global War on Terrorism.²⁰ On March 24, 2007, the United Nations Security Council adopted new sanctions which included freezing of assets of 28 persons and organizations involved in Iran’s nuclear and missile programs, 10 additional key Iranian companies and 12 additional individuals.²¹ It is assumed that the United States will honor those sanctions.

“Engagement” is a tool that fund managers can use to attempt to change the behavior of a company that appears to be at high risk of exposure to losses. This process involves a direct conversation with a company by stockholders to express concerns about the high risk activity of the company. Companies may be asked to change their behavior to reduce investment risk. Engagement has been credited with changing the investment strategies of several large companies over time. Recently, ABB (Swiss power engineering group) and Siemens AG (German electronics and electrical engineering company) have suspended business operations in Sudan as a result of the engagement process which included the possibility of divestment.²²

If the engagement process fails, or if it is not used, the next tool available to fund managers is to divest of a security. Generally, this practice is only used in the most dire circumstances.²³ Divestment, or “Targeted Divestment,” may be used to illustrate to an offending country that the actions of its government are causing companies that do business with the country to lose money. Divestment on a large scale may apply enough economic or political pressure to change the behavior of a country.

The State of Florida has practiced divestment twice in modern history. From 1986 to 1993, the Legislature directed the SBA to divest of companies doing business with South Africa. From 1997 until 2001, the SBA made a decision to divest of 16 tobacco stocks due to pending litigation involving the state and those companies. There are no specific records to quantify the impact of the South Africa divestment by Florida, but the overall boycott campaign was successful in changing the social environment in South Africa.²⁴ The tobacco divestment was done relative to a court case and was not directed toward a specific social change.

Organized Divestment Movements

Several states, local governments and universities have initiated efforts to practice divestment of their holdings to protest the ongoing genocide and atrocities against humanity in the Darfur

¹⁹ Phone conversation with Cecelia Blye, Chief of the Office of Global Security Risk, Division of Corporate Finance, Securities and Exchange Commission; cited in SBA Staff Analysis of HB 703, February 9, 2007.

²⁰ <http://www.treasury.gov/offices/enforcement/ofac/sdn/index.shtml>

²¹ “U.N. imposes sanctions on defiant Iran,” by Alexandra Olson, Associated Press, March 25, 2007.

²² <http://www.sudandivestment.org/divestment.asp#q6>

²³ Ibid.

²⁴ “The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott,” 1999 Journal of Business.

region of the Republic of Sudan.²⁵ Some states have used the Sudan Divestment Task Force Model Legislation,²⁶ while others have drafted legislation or policy that is either more or less restrictive than the model legislation. In addition, there are multiple resolutions and bills filed in the 110th Congress calling for divestment of public funds by federal, state and local government entities to protest the Sudan situation. H.R. 1357, by Representative Ileana Ros-Lehtinen and others, specifically calls for U.S. Government divestment of securities of companies that do business with Iran. The U.S. Senate Banking Committee has held hearings this month to discuss increasing pressure on Iran through the Iran Sanctions Act. The committee heard testimony from the Departments of State, Treasury and Commerce and expressed concern that the federal government was not applying enough economic pressure on Iran.²⁷ To date, no states have passed divestment legislation related to Iran.²⁸

The State of Illinois passed a broad divestment bill, which addressed the deposit of certain funds in banks in the state as well as securities which were prohibited. The U.S. District Court for the Northern District of Illinois found the legislation to be unconstitutional, in full and in part.²⁹ A permanent injunction against implementation of the legislation was ordered. In the portion of the finding related to the prohibited actions on the part of the state managed pension funds, the Court held that the Illinois law violated the Foreign Commerce Clause of the U.S. Constitution.

III. Effect of Proposed Changes:

The bill requires the State Board of Administration managed funds, herein described as the “Public Fund”, to actively identify, engage with and divest of securities from companies that have active business operations with the oil-production and mineral extraction industrial sector in Iran. The bill requires the state to proactively create a list of companies with which it will limit investment.

The SBA is required to identify all companies in which the state has direct or indirect holdings (or could have such holdings in the future) that meet specific criteria, designated as “scrutinized companies” and to create a “Scrutinized Companies List” within 90 days of the effective date of this legislation. The criteria for scrutinized companies are:

- Has business operations that involve contracts with or provision of supplies or services to the Government of Iran;
- Government of Iran holds direct or indirect equity share;
- Consortium or project commissioned by the Government of Iran;
- Any company involved in such consortiums or projects;

And,

- More than 10 percent of the company’s revenues or assets linked to Iran involve oil-related activities or mineral-extraction activities;

²⁵ www.SudanDivestment.org

²⁶ Ibid.

²⁷ “Lawmakers See Lax Enforcement of Iran Sanctions Act,” by Jon Fox, Nuclear Threat Initiative Global Security Newswire, March 23, 2007.

²⁸ CNNMoney.com, “An anti-terrorist divestment campaign fires blanks” by Marc Perlman, *Fortune*, March 21, 2007.

²⁹ U.S. District Court for the Northern District of Illinois, Eastern Division. Case No. 06C 4251, National Foreign Trade Council, Inc., et.al v. Alexi Giannoulis, et. al

- Less than 75 percent of the company's revenues or assets linked to Iran involve contracts with or provision of oil-related or mineral-extraction products or services to the Government of Iran or a project or consortium created exclusively by that government, and the company failed to take substantial action³⁰; or
- The company has made an investment a \$20 million or more since August 1996 or any combination of at least \$10 million each, which the aggregate meets or exceeds \$20 million in any 12 month period, which directly or indirectly contributes to the enhancement of Iran's ability to develop petroleum resources of Iran.

At the first meeting following the initial 90 day period, the Public Fund shall create and publish a "Scrutinized Companies List." The list is to be updated quarterly.

For companies on the Scrutinized Companies List, the Public Fund is required to provide written notice to all companies on the list with inactive business operations in Iran to let them know that any change to active business operations will result in possible divestment of state funds. This notification is to be repeated semiannually. Companies with active business operations in Iran shall receive written notice that they are on the list and failure to take action to cease operations or achieve and maintain an inactive status within 90 days of notice will result in divestment of state funds.

Any company which is removed from the Scrutinized Companies List may be placed back on the list at any time if its business operations indicate prohibited activity in Iran.

If a company fails to cease active business operations within 90 days of notice, the Public Fund is required to divest of that company's securities within one year after the company's most recent appearance on the list.

The Public Fund may not acquire securities of companies on the list which have active business operations unless the companies are affirmatively declared to be excluded from the U.S. Government federal divestment or investment prohibition sanctions relating to Iran. All such affirmatively declared companies are exempt from state divestment.

Divestment and investment prohibitions in this legislation do not apply to indirect holdings in actively managed investment funds, but the state is required to notify those funds of its concerns related to any holdings of companies on the Scrutinized Companies List and to request the investment funds to remove those companies from their holdings or create an alternative fund without those companies included. If an actively managed investment funds does create an alternative funds, the Public Fund is required to reposition its holdings into that fund.

The Public Fund must report on the creation of the Scrutinized Companies List to the SBA, Senate President and House Speaker no later than 30 days after the creation of the list. Annually thereafter, the Public Fund must provide a report to those entities and to the U.S. Presidential Envoy to Iran, which includes a summary of correspondence with companies engaged by the Public Fund; all investments sold, redeemed, divested, or withdrawn in compliance with this law;

³⁰ Substantial action is defined in the bill as adopting, publicizing, and implementing a formal plan to cease scrutinized business operations with one year and to refrain from any such new business operations.

all prohibited investments, and any progress made to engage actively managed investment funds to divest of scrutinized companies from their portfolios.

The act expires only under certain conditions:

- The United States revokes all sanctions imposed against the Government of Iran;
- The Congress or President of the United States declares that the Government of Iran has ceased to acquire weapons of mass destruction and to support international terrorism; or
- The Congress or President, through legislation or executive order, declares that mandatory divestment of the type provided for in this act interferes with the conduct of United States foreign policy.

With respect to actions taken in compliance with this act, the Public Fund is exempt from any conflicting statutory or common law obligations, including any such obligations with respect to choice of asset managers, investment funds, or investments for the Public Fund's security portfolios.

If divestment causes the Public Fund to lose value in the amount of equal to or less than 99.50 percent, or 50 basis points, of the hypothetical value of all assets under management by the Public Fund, cessation of the divestment may occur. In the event that such actions are taken, the Public Fund must report all related activity to the SBA, the Senate President and House Speaker in advance of the cessation actions and semiannually for the duration of the cessation.

The bill contains a severability clause.

The bill takes effect upon becoming law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

Unknown. Divestment may result in investment loss which would be passed on to all participating units of government.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

D. Other Constitutional Issues:

The U.S. District Court of the Northern District of Illinois, Eastern Division, has recently ruled that Illinois legislation which required broad divestment activities in the banking sector, as well as prohibitions in its pension funds, is unconstitutional. The section of the ruling related to the pension funds indicated that state limitations on trade with

companies that do business with foreign countries is a violation of the U.S. Constitution.³¹

The bill appears to have addressed this concern in (6)(d) wherein the law is considered to be expired if either Congress or the President, through legislation or executive order, declares that mandatory divestment interferes with the conduct of United States foreign policy.

It is not clear whether the requirement for the federal government to take definitive action declaring the activity as interference would absolve the immediate concerns cited in the Court's finding in the Illinois case, or whether those findings are applicable to the proposed legislation in Florida.

The Florida Retirement System is itself a product of financial stress. Created almost two generations ago, this multi-employer pension plan was the successor to four smaller ones, at least one of which was unable to satisfy the financial demands of its future pensioners. Benefits were promised to those who served in World War II but no employer contributions were made. By the end of the 1960s the first wave of pensioners presented their demands for retirement income and the deficiencies in the financial base soon became apparent. That financial experience caused the Florida Legislature to enact a number of procedural and substantive checks and balances on the preservation of capital within fiduciary funds especially when they involve pension plans. Among them are:

Article X, Section 14, State Constitution

This article placed on the ballot by the 1976 Legislature and approved by the voters effective January 1, 1977, provides that all government pension plans in Florida must be prefunded on a sound actuarial basis. Benefits promised must be concurrently funded.

Part VII of Chapter 112, Florida Statutes

This part implements the above constitutional amendment and also requires adherence to the fiduciary standards in federal law, specifically, the Employee Retirement Income Security Act of 1974, as amended. That federal statute imposes four principal duties on pension plan fiduciaries: Fiduciaries must act with prudence and loyalty for the sole and exclusive benefit of pensioners, for the defraying of the reasonable expenses of administration, and for the diversification of assets consistent with the plan's investment policy statement.

Section 112.661, Florida Statutes

This section and like sections for other units of local government, were enacted in the 1990s in the aftermath of investment irregularities experienced with the demise of brokerage institutions and their marketing of derivative securities to unsophisticated public and private investors. This statute emphasized that public fiduciaries must emphasize diversification and internal controls in their management of fiduciary assets.

³¹ U.S. District Court for the Northern District of Illinois, Eastern Division. Case No. 06C 4251, National Foreign Trade Council, Inc., et.al v. Alexi Giannoulis, et. al

Seventeen specific standards were established for all pension plans in their execution of investment operations.

Sections 518.11 and 518.12, Florida Statutes

These two sections of Florida law provide the clearest statement of fiduciary duty: to manage as a prudent investor with the knowledge and business expected of one in such circumstance. The prudence standard embodies loyalty and exclusivity of purpose; that is, the achievement of an objective indistinguishable and uncompromisable from that of serving the best interests of the pension plan and its participants while defraying the reasonable costs of administration. The final duty, diversification, requires the fiduciary to not imperil the plan due to its concentration of investment decision-making in narrow choices or limited markets.

Chapters 175, 185, and 121, Florida Statutes

Many of these statements listed above can be found in the organic laws affecting municipal police and firefighter pension plans, as well as the Florida Retirement System itself.

Florida's experience with divestment is limited in part due to the cumulative effect of the above legal standards. While there have been statutes enacted dealing with the Republic of South Africa, Cuba, or Northern Ireland, the circumstances of their operation stand them apart from this bill. The restrictions on South Africa, since repealed, had to do with the direct ownership of government debt. For Cuba the restrictions in Florida law repeat similar restrictions enacted by Congress in federal statute and, therefore, constrain state action. For Northern Ireland, the restrictions required adherence to the Sullivan principals, multi-party aspirational statements of normalized social, economic, and electoral expectations. The literature on the impact of divestment as a precursor event to the abolition of Apartheid in South Africa is inconclusive at best. One commentator who analyzed its equivocal effects is today a principal with the firm that bears his name and who provides consultant services to the Board of Administration. The challenge for fiduciaries in such divestment situations, particularly when actions are constrained by ERISA, is the avoidance of foreign policy or political considerations or their capture by external interests in either the acquisition or disposal of securities.

The South African experience has been instructive on a number of dimensions. *First*, it did provide an impetus for the development of social activism in the investment community. There are now almost one hundred mutual funds that specialize in ethical, socially responsible, or values-based investing principles. *Second*, it suggested that principles-based investing, tailored at the time to adherence to the Sullivan Principles,³² could be made a complementary duty of institutional investors that, when properly

³² The Sullivan Principles are: (1) Nonsegregation of the races in all eating, comfort, locker rooms and work facilities; (2) Equal and fair employment practices for all employees; (3) Equal pay for all employees doing equal or comparable work for the same period of time; (4) Initiation and development of training programs that will prepare blacks, coloreds and Asians in substantial numbers for supervisory, administrative, clerical and technical jobs; (5) Increasing the number of blacks, coloreds and Asians in management and supervisory positions; (6) Improving the quality of employees' lives outside the work environment in such areas as housing, transportation, schooling, recreation and health facilities.

executed, would not antagonize their fiduciary obligations. And, *third*, it emboldened large institutional investors - pension plans, insurance companies, mutual funds, and endowments - to engage in the difficult discussions on the proper role of an investor in a market society, discussions that today can be considered the precursors to contemporary statutes and investor regulations on corporate governance.³³

The United States Congress has not seen fit to enact any federal law that would permit states to engage directly in foreign commerce restrictions. Nor has it provided a method under ERISA by which plan fiduciaries may countenance a nation-specific divestment without imperiling their own fiduciary duties. The Illinois case and its related case references do not suggest such divestment actions are unachievable, simply that they must correspond with the plan's own estimation of the risk associated with such actions. This risk assessment practice - whether geo-political, currency, market, credit, or the like - when properly executed may yield a result consistent with the divestment objectives.

The critical distinction appears to be the development of a process that permits fiduciaries, *and not the state legislature*, from conditioning a divestment action. In 1997 the Florida Attorney General opined that the Board of Administration *could* properly discharge its duties and divest the Florida Retirement System of tobacco stocks, notwithstanding their significant income producing and appreciation history. This result was further influenced by a concurrent series of events which saw Florida achieve a large financial settlement from such tobacco companies relative to the documented adverse health effects of their products. The complicating factor which presented itself was that the logical result of divestiture would imperil the ability of the companies to service the payments they had committed to make under the settlement agreement. A similar divestment strategy deployed today could further imperil the ability to make payments since the underlying financial support of the funded health initiatives in state law are conditioned on the achievement of a certain level of worldwide tobacco sales of these same unhealthy products. An essential element in the tobacco divestiture was the Board's exercise of judgment in picking the proper timing of the securities' disposal and reassembly of suitable replacement assets. As presently drafted, SB 2142 makes the process virtually automatic once certain statutory thresholds are reached.

On April 18, 2007, the Division of Retirement transmitted a statement dated April 16, 2007 from its consulting actuary assessing compliance of this divestment legislation, CS/SB 2250, with the pension funding requirements contained in s. 10, Art. X, State Constitution and part VII of ch. 112, F.S. That statement, believed to be similar to one forthcoming on CS/SB 2142, made the following declarations:

³³ Two other principles-based statements have attracted considerable interest in the institutional investor community: the CERES principles on the development of sustainable environmental government actions and the Principles for Responsible Investment issued by the United Nations' secretary-general. Both organizations suggest that disclosure, engagement, and the participation in recognized market-based actions, such as proxy-voting, are appropriate means of addressing contemporary corporate governance and social issues.

... This analysis is focused upon impacts on the Florida Retirement System. An actuarial special study is required to determine the fiscal impact resulting from the changes proposed by CS/SB 2250.

...

- a. This bill does not comply with the requirements of Article X, Section 14 of the Constitution.*
- b. This bill does not comply with the provisions of Chapter 112, Part VII, Florida Statutes.*

...

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

The intended impact of the legislation is to reduce the state's participation in companies that have equity ties to Iran's oil-production or mineral extraction industries. Depending on the size of such holdings in the FRS portfolio, some private companies could suffer losses from divestment.

C. Government Sector Impact:

The SBA will be required to divest of any holdings that have equity ties to Iran's oil-production or mineral extraction industries. If this activity results in lost investment income, or administrative costs associated with divestment and replacement of the divested funds, those costs will have to be absorbed by the FRS in the form of a revised investment policy statement, by higher employer payroll contribution rates, or both. The below tables reports what are believed by the named parties to be the scale and scope of the divestitures affected by this bill, assuming that there is no disengagement by the named companies from the Republic of the Sudan or the Islamic Republic of Iran.

There is considerable disagreement among the parties as to the scale and scope of the effects, including the names of the affected companies. Attempts to narrow the differences are ongoing but there remains factual uncertainty since the assumptions of the parties and the data sources used cannot be presently reconciled:

	Sponsor List SB 2142	Sponsor List SB 2250	SBA Estimate SB 2142	SBA Estimate SB 2250	Revised SBA Estimate CS/SB 2142 [CALPERS]	Revised SBA Estimate CS/SB 2250 [NY]
Number of Companies	20	20	45	130	20	15
FRS Costs of Divesting	\$ 3 MM	\$ 7 MM	\$20 MM	\$ 45 MM	N/R	N/R
Upper End Estimated Asset Values	\$ 525 MM	\$ 1 B	\$ 3.5 B	\$ 6 B	\$ 1 B	\$ 600 MM
Historical Performance Results	N/R	N/R	-2 to -38 basis points	+2 to -53 basis points	N/R	N/R

As reported, above, the consulting external actuary to the Division of Retirement concluded that this legislation conflicted with the two legal standards upon which the Florida retirement System is based. The actuary further concluded:

A special actuarial study is required to determine the fiscal impact that CS/SB 2250 would have on the system. However, the SBA would first have to identify the impact or ranges of divestiture on the assumed rate of return to be able to perform the required special study.

VI. Technical Deficiencies:

The bill uses the term “Public Fund” to describe what is later referenced as the State Board of Administration.

VII. Related Issues:

It appears that Section 1, subsection (6), entitled “OTHER LEGAL OBLIGATIONS” is an attempt to assert supersession. It appears that Section 1, subsection (6), entitled “OTHER LEGAL OBLIGATIONS” is an attempt to assert supersession of this legislation over other legislation related to state fund investment. Because the state has adopted by reference the federal ERISA law, it is unclear if this proposed state law could supersede the federal law inherent in the current state law. This is significant in that Part VII of ch. 112, F.S., implements s. 14, Art. X, State Constitution, and its requirement that pension plans are to be funded in a sound actuarial manner, which the consulting actuary concludes this bill violates.

This Senate Professional Staff Analysis does not reflect the intent or official position of the bill's introducer or the Florida Senate.

VIII. Summary of Amendments:

None.

This Senate Professional Staff Analysis does not reflect the intent or official position of the bill's introducer or the Florida Senate.
