CalPERS

CALIFORNIA ASSEMBLY COMMITTEE ON ACCOUNTABILITY AND ADMINISTRATIVE REVIEW
INFORMATIONAL HEARING – IMPLEMENTATION OF AB 221 (ANDERSON)

Question Response of California Public Employees' Retirement System

CalPERS appreciates the opportunity to support the Committee on Accountability and Administrative Review (Committee) information hearing to explore issues associated with efforts to eliminate to eliminate investments in Iran in keeping with the California Public Divest from Iran Act (AB 221, the Iran Act), Chapter 671, Statues of 2007. CalPERS is the largest public pension system in the United States with a total fund market value of approximately $213 billion. CalPERS distributes over $18 billion a year to pensioners and employees for their health and retirement needs. Our mission is to advance the financial and health security for over 1.6 million public employees, retirees, and their families. CalPERS Board is responsible for ensuring that these assets are managed with prudence and care, in the sole interests of its beneficiaries, who rely upon these investments to finance up to three quarters of the benefits they receive.

On May 6, 2010, CalPERS received an invitation to attend a Committee hearing scheduled for May 12, 2010, and was requested to address the following nine questions.

1. How does CalPERS identify companies as having direct or relevant ties to investments in Iran?

Although the Iran Act also does not require third party verification, CalPERS has contracted with an external research group Risk Metrics Group (RMG) to expand staff's capacity to fully identify companies that meet the criteria in the Act.

Beginning with the universe of non-U.S. domiciled companies in CalPERS global equity benchmark, RMG has developed a variety of ways of identifying companies doing business in Iran. These methods have included regular monitoring of specialized news sources dealing with the energy industry, searches of Securities and Exchange Commission and International regulatory public filing databases, web-crawling technology (enabling RMG to search the websites of thousands of companies with relative speed), cooperation with non-governmental organizations concerned with this issue and review of documents produced by publicly traded companies.

2. How deep are the links to business dealings in Iran for a firm using foreign subsidiaries?

The concept of a subsidiary is an entity that is controlled by another entity. RMG looks through and consolidates the activity of subsidiaries when determining if any company has business dealings in Iran. Some company subsidiaries are publicly traded themselves and are linked by RMG to the activities of the parent even if the subsidiary itself has no business activity in Iran. An example of such subsidiary/ parent relationship is CNOOC Ltd. CNOOC is a Hong Kong company majority owned by China National Offshore Oil. CNOOC Ltd. has no identified business activity in Iran but is ensnared by the activities of the parent company.

3. How are companies and their holdings, contracts, and investments tracked?

RMG periodically reviews the relevant universe of companies for potential ties to Iran. Upon discovery of such possible tie, RMG conducts deeper research to determine if a company's activity encompasses the specific categories included in AB-221. RMG communicates this information to CalPERS staff and then proceeds to monitor the activity of the identified firms. This monitoring process is continual.

4. If a company removes itself from Iran, how do we know they do not go back under different names? Are they still tracked?

RMG's worldwide organization has staff dedicated to tracking company name changes, mergers, acquisitions and corporate divestments, allowing RMG to ensure correct company identification even in the case of corporate changes. RMG also subscribes to proprietary databases that track corporate affiliations and enable RMG to ensure subsidiaries operating in Iran are correctly matched with their ultimate parent companies.

Companies that have exited Iran entirely would still be the subject of the search processes and would be added again as new evidence of involvement emerged.

5. How many companies/investments were identified as subject to the Act in the CalPERS portfolio initially in January 2008 and how many now?

The Iran Act required CalPERS to identify which companies are subject to the Act by June 30, 2008. CalPERS identified 47 companies that met the criteria of the Iran Act as of that date. CalPERS 2009 Legislative Report listed 23 companies with business operations in Iran, a significant reduction.

6. What activities does the Risk Metrics Group undertake and what activities does CalPERS undertake on this issue?

As explained in question #1, RMG executes screening and research to determine which of the companies in CalPERS universe is potentially subject to the provisions of AB-221. RMG communicates the results of this effort to CalPERS staff.

As the Act specifies, written correspondence is then sent to each identified company by CalPERS staff. The initial letters state that the Iran Act requires that consistent with fiduciary duty, CalPERS disinvest from companies with specific business operations in Iran unless certain conditions are met including a boycott of the Iranian government, curtailment of business in Iran, sale of Iranian assets, or proof that the company is engaged in humanitarian efforts in Iran or "substantial action" towards the above. We request a written response on each company's plan of substantial action or sufficient progress toward compliance. Companies are also told that if substantial action or sufficient progress does not occur, then the CalPERS Board would be required to consider divestment of the company's shares consistent with the Board's fiduciary duty.

We follow up initial letters for companies that do not respond to earlier requests with additional letters, emails and phone calls.

The process of engagement and review is continuous, and companies in turn, replied to our enquiries, some taking action and others entering into a discussion about their plans.

Our objective is to obtain an exacting level of detail. For example, Danieli and Co was contacted because RMG had identified a customer of theirs as being located in Iran. That was the extent of their involvement. By contrast, Total had significant operations in Iran where it was operating under a waiver from the US State Department. They explained to us that they were not going ahead with new investments, and furthermore they were simply collecting royalties from the government of Iran on projects they had already invested in. to walk away before they had collected these payments would simply leave money on the table for the Iranian government, rather than returning it to the shareholders.

At its February, 2009, meeting, the Investment Committee of the CalPERS Board of Administration determined that 28 companies had not taken substantial action or made sufficient progress toward meeting the Iran Act's goals. As required under the Iran Act, the Board considered divestment of the shares in light of its fiduciary duty. At the heart of this was the question of whether sales of the shares would impose unnecessary costs, increase risk, and hurt returns. To help the Board consider this, CalPERS asked Wilshire Associates to calculate costs. Wilshire is an external adviser to the Board, and their expertise is in measuring the fund's performance relative to risk. The Board also took external and internal legal advice to help it form a view as to whether these costs, additional risk, and potential impact on returns could be taken on. They concluded that those costs could not be incurred under their fiduciary responsibility as required by the AB-221. The Act specifies it does not "require the board to take action as described…unless the board determines, in good faith, that the action…is consistent with fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution (section 7.K 7513.7 California Divest From Iran Act)."

Throughout 2009 and 2010, we have kept the pressure on to press the case for these companies to reassess their positions as it concerns their work in Iran. With phone calls, certified letters, e-mails and one-on-one meetings, we have communicated with these firms at the highest levels. And we have continued to diligently follow the time provisions detailed in the Act. Within the last year, Joe Dear, CalPERS Chief Investment Officer, met with senior staff at the Russian oil company, Lukoil at their European offices and also with the French oil company, Total. Both companies have since wound down their activities in Iran. CalPERS joined with our colleagues at CalSTRS in a meeting here in Sacramento with Royal Dutch Shell for the purpose of updating us on the company's business operations in Iran. Royal Dutch Shell is currently considering its position.

At all levels and by every tool available, CalPERS staff is in frequent communication with companies around the world about committing to and fulfilling the intent of the California Iran Act.

As required, CalPERS reports annually to the Legislature on companies in our portfolio with business operations that subject them to the provisions of the Iran Act and provides additional information to the Legislature as requested.

7. What are the costs associated with conforming to the Act -- internal and external?

CalPERS incurs significant internal costs in complying with the Iran Act which encompasses a cross-enterprise approach to implementing the Act's requirements. Compliance with the act involves staff from the Investment Office, Legal Office, and Government Affairs. The annual costs of complying with the Iran Act are estimated at approximately $425,000.

External costs of complying with the provisions of the Iran Act are the engagement of an external research group to identify companies that meet the criteria of the Iran Act, its external pension consultant to calculate the cost and assess the impact on CalPERS risk and return profile if CalPERS were to divest its shares in the Covered Companies, and external fiduciary counsel. These annual external costs associated with conforming to the Iran Act are approximately $125,000.

CalPERS has not incurred any divestment costs or losses. CalPERS engages its external pension consultant, Wilshire Consulting, to calculate the cost and assess the impact on CalPERS' risk and return profile from a potential Iran divestment. The most recent analysis, completed in late 2009, projected transaction costs of divestment ranging from a low of $5.83 million to a high of $23.32 million. In addition, the projected annual impact of divestment and exclusion of these investments from the CalPERS portfolio, assuming optimized reinvestment, ranged from +/- $127 million to +/- $194 million.

8. Have there been any attempts to inform your members of companies that have holdings in Iran via on line or print material?

CalPERS annual legislative reports on compliance with the Iran Act are presented and approved by the CalPERS Investment Committee in Open Session. These agenda items are available to the public including CalPERS members through the web site or in hard copy form at the meeting.

9. Do your analysts provide any advice with respect to activities that might aid in encouraging companies to withdraw?

CalPERS engagement strategy for companies involved in Iran is discussed at the highest levels of the Investment Office including Senior Portfolio Managers, Senior Investment Officer and Chief Investment Officer. In addition, company engagement is discussed within the Senior Executive Corporate Governance Working Group which includes the Board President, the CEO, the General Counsel, the CIO and other senior staff.

CalPERS believes that constructive engagement through share ownership is a powerful tool investors can use to effect change at those portfolio companies whose corporate governance, social, or environmental practices could lead to value destruction. CalPERS company engagement is ongoing via letter, teleconference, and in-person meetings with respect to activities that might aid in encouraging companies to withdraw pursuant to the Iran Act.

CalPERS will continue its constructive engagement initiatives to effect change at those portfolio companies subject to the provisions of the Iran Act.