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BILL ANALYSIS

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House Bill 4903 (Substitute H-3 as passed by the House)
Sponsor: Representative Marty Knollenberg
House Committee: Government Operations
Senate Committee: Homeland Security and Emerging Technologies

Date Completed: 5-5-08

CONTENT

The bill would amend the Public Employee Retirement System Investment Act to do the following:

- **Require a fiduciary (i.e., the State Treasurer with respect to various retirement systems, and the Michigan Legislative Retirement System board of trustees) to make its best efforts to identify all companies in which it had holdings that did business with or were located in Iran ("scrutinized companies") and create a list of those companies.**
- **Within 15 months after a company appeared on the list, require a fiduciary to sell, redeem, divest, or withdraw all of the securities of the company if it continued to have scrutinized active "business operations" (engaging in commerce with Iran).**
- **Except for indirect holdings in actively managed investment funds, prohibit a fiduciary from acquiring securities of companies on its list that had active business operations.**
- **If the manager of a publicly traded, actively managed fund in a fiduciary's portfolio created a similar fund not associated with scrutinized active business operations, require the fiduciary to replace its existing investments with investments in the new fund.**
- **Require a fiduciary to file with the Legislature and the U.S. Presidential Special Envoy to Iran a report regarding investments under the bill,**

as well as the replacement of existing investments.

- **Exempt a fiduciary from any statutory or common law obligation that conflicted with the bill.**
- **Provide immunity from liability for action taken to comply with the bill.**

Identification of Scrutinized Companies

Within 90 days after the bill took effect, a fiduciary would have to make its best efforts to identify all scrutinized companies in which it had direct or indirect holdings or possibly could have such holdings in the future. The efforts could include one or more of the following:

- Reviewing and relying, as appropriate in the fiduciary's judgment, on publicly available information regarding companies with business operations in Iran, including information provided by nonprofit organizations, research firms, international organizations, and government entities.
- Contacting asset managers contracted by the fiduciary that invested in companies with business operations in Iran.
- Contacting other institutional investors that had divested from or engaged with companies that had business operations in Iran.
- Reviewing the laws of the United States regarding the levels of business activity that would cause application of sanctions against companies conducting business or investing in countries that were designated state sponsors of terror.

"Fiduciary" would mean the Michigan Legislative Retirement System board of trustees for the Tier 1 plan for the Michigan Legislative Retirement System; and the State Treasurer for the retirement systems created under the State Police Retirement Act, the Judge's Retirement Act, the State Employees Retirement Act, and the Public School Employees Retirement Act.

"Scrutinized company" would mean any company that has business operations that involve 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 Iranian government; or a company involved in consortiums and projects commissioned by the Iranian government to which one or both of the following apply:

- More than 10% of the company's total revenue or assets are linked to Iran, and involve oil-related activities or mineral extraction activities, and the company has failed to take "substantial action" (i.e., adopting, publicizing, and implementing a formal plan to cease scrutinized business operations within one year and to refrain from any new business operations).
- The company, with actual knowledge, on or after August 1, 1996, made an investment of at least \$20.0 million, or any combination of investments of at least \$10.0 million each, that in the aggregate equals or exceeds \$20.0 million in any 12-month period, and that contributes directly or significantly to the enhancement of Iran's ability to develop petroleum resources (i.e., petroleum, petroleum byproducts, or natural gas).

"Oil-related activities" would include 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 by providing supplies or services in support of them, provided that the mere retail sale of gasoline and related consumer products would not be considered oil-related activities.

"Mineral extraction activities" would include exploring, extracting, processing,

transporting, or wholesale selling or trading of elemental minerals or associated metal alloys or oxides, including gold, copper, chromium, chromite, diamonds, iron, iron ore, silver, tungsten, uranium, and zinc, as well as facilitating such activities, including by providing supplies or services in support of them.

"Business operations" would mean engaging in commerce in any form in Iran, including by acquiring, developing, maintaining, owning, selling, possessing, leasing, or operating equipment, facilities, personnel, products, services, personal property, real property, or any other apparatus of business or commerce.

Scrutinized Companies List; Notice

At the end of the 90-day period after the bill took effect or by the first meeting of a fiduciary following that period, the fiduciary would have to assemble all identified scrutinized companies into a list. The fiduciary would have to update the list on a quarterly basis based on evolving information from, among other sources, those specified in the bill. The fiduciary would have to make the list freely available to the fiduciaries of other public retirement systems in Michigan if doing so did not violate any agreements with third parties or reveal a third party's proprietary information.

The fiduciary immediately would have to determine the companies on the list that the fiduciary oversaw pursuant to its responsibilities.

For each identified company with only inactive business operations, the fiduciary would have to send a written notice informing the company of the bill's requirements and encourage it to continue to refrain from initiating active business operations in Iran until it was able to avoid scrutinized business operations. The fiduciary would have to continue the correspondence on a semiannual basis.

("Active business operations" would mean all business operations that are not inactive. "Inactive business operations" would mean the mere continued holding or renewal of rights to property operated previously for the purpose of generating revenue but not deployed presently for that purpose.)

For each company newly identified with active business operations, the fiduciary would have to send a written notice informing the company of its scrutinized company status and that it could become subject to divestment by the fiduciary. The notice would have to offer the company the opportunity to clarify its Iran-related activities and would have to encourage the company, within 90 days, either to cease its scrutinized business operations or to convert those operations to inactive business operations in order to avoid qualifying for divestment.

Within 90 days following the fiduciary's first engagement with a company, if the company ceased scrutinized business operations, the company would have to be removed from the list and the bill's provisions would cease to apply to it unless it resumed scrutinized business operations. If the company converted its scrutinized active business operations to inactive business operations, it would be subject to the bill.

Divestment

If a company continued to have scrutinized active business operations 90 days after the fiduciary's first engagement with the company, and only while it continued to have those business operations, the fiduciary would have to sell, redeem, divest, or withdraw all publicly traded securities of the company, according to the following schedule:

- Within nine months after the company's most recent appearance on the scrutinized companies list, at least 50% of the assets would have to be removed from the fiduciary's assets under management.
- Within 15 months after the company's most recent appearance on the list, 100% of the assets would have to be removed from the fiduciary's assets under management.

Except as provided below, at no time could the fiduciary acquire securities of companies on the list that had active business operations.

No company that the U.S. government declared affirmatively to be excluded from its present or any future Federal sanctions regime relating to Iran would be subject to

the divestment requirement or the investment prohibition.

The schedule and the prohibition would not apply to indirect holdings in actively managed investment funds. For purposes of this provision, actively managed investment funds would include private equity funds and publicly traded funds. Before investing in a new private equity fund that was not in its portfolio as of the bill's effective date, the fiduciary would have to perform due diligence to prevent investment in any private equity fund where the offering memorandum or prospectus identified the purpose of the fund as investing in scrutinized companies with active business operations in Iran. The fiduciary would not have to identify holdings in private equity funds or submit engagement letters to those funds. If the manager of a publicly traded, actively managed fund that was in the fiduciary's portfolio on the bill's effective date created a similar fund with indirect holdings devoid of identified scrutinized companies with scrutinized active business operations, the fiduciary would have to replace all applicable investments with investments in the similar fund in an expedited time frame consistent with prudent investment standards.

("Indirect holdings" in a company would mean all securities of that company held in an account or fund, such as a mutual fund or other commingled fund, managed by one or more people not employed by the fiduciary, in which the fiduciary owns shares or interests together with other investors not subject to the Act.)

Reports

The fiduciary would have to file a publicly available report to the Legislature that included the scrutinized companies list within 30 days after the list was created. Annually, the fiduciary would have to file a publicly available report to the Legislature that included all of the following:

- A summary of correspondence with companies engaged by the fiduciary under the bill.
- All investments sold, redeemed, divested, or withdrawn in compliance with the bill.
- All prohibited investments made under the bill.
- Any progress made in replacing existing investments with similar investments in publicly traded, actively managed funds.

The fiduciary would have to send a copy of this report to the U.S. Presidential Special Envoy to Iran.

Legislative Analyst: Julie Cassidy

Discontinuation

The bill's provisions would no longer be effective upon the occurrence of one or more of the following:

- The Congress or President stated affirmatively and unambiguously, through legislation, executive order, or written certification from the President to Congress, that the government of Iran had ceased to acquire weapons of mass destruction and support international terrorism.
- The U.S. revoked all sanctions imposed against the government of Iran.
- The Congress or President stated affirmatively and unambiguously, through legislation, executive order, or written certification from the President to Congress, that mandatory divestment of the type provided for in the bill interfered with the conduct of U.S. foreign policy.

Exemption from Liability

With respect to actions taken in compliance with the bill, including all good faith determinations regarding companies as required, a fiduciary would be 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 fiduciary's securities portfolio.

A fiduciary, members of an investment advisory committee, and any person with decision-making authority with regard to the fiduciary's investments could not be held liable for any action undertaken for the purpose of complying with or executing the mandates of the bill.

Severability

If any provision, section, subsection, sentence, clause, phrase, or word of the bill or its application to any person or circumstances were found to be invalid, illegal, unenforceable, or unconstitutional, it would be declared to be severable and the balance of the bill would remain effective and functional notwithstanding the invalidity, illegality, unenforceability, or unconstitutionality.

Proposed MCL 38.1133d

FISCAL IMPACT

The bill would have an indeterminate fiscal impact on State government. The Department of Treasury has explored the impact of this and other proposals with respect to its investments. For the Department's investments alone, Treasury has estimated that it would cost approximately \$30,000 per year per country to ensure compliance with the proposed restrictions. That amount would cover the cost of hiring a private company to monitor compliance, and would be ongoing. Additionally, the Department could incur significant costs to determine those companies that qualified as scrutinized under the bill. There also could be additional up-front transaction costs to comply with these restrictions.

Although it is difficult to quantify the precise fiscal impact of this bill on the State, it could be substantial. The Department of Treasury has indicated that not only would there be immediate transaction costs involved in the divestiture, there also would be compliance costs going forward as well. According to the Department, transaction costs could be considerable, particularly because the affected funds often invest in indices and mutual funds that contain many companies, which would make singling out individual companies more difficult. In addition to these more measurable costs, the Department predicts that the lost opportunity costs of prohibited investments could be high as well, thereby affecting the overall value of State investments; however, these potential costs or gains could only be determined retrospectively.

As of September 30, 2007, the State Employees' Retirement System, Public School Employees' Retirement System, State Police Retirement System, and Judges Retirement System had combined total assets of approximately \$76.5 billion.

Fiscal Analyst: Stephanie Yu

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.