

# MEMORANDUM

To: Senate Federal and State Affairs Committee

From: Alan D. Conroy, Executive Director

Date: March 7, 2023

Subject: Opponent testimony on SB 291; Environmental, Social and Governance (ESG) Investments

On behalf of the KPERS Board of Trustees, I respectfully appear before the Committee today to request that SB 291 not be passed as introduced.

Senate Bill 291 prohibits the State, any state agency, subdivision or instrumentality of the State from giving preferential treatment or discriminating against bidders or contractors based on environmental, social and governance (ESG) criteria, which are defined in the bill.

SB 291 also defines “fiduciary commitment” to establish when a fiduciary, like KPERS investment managers, has taken action on or considered ESG criteria in the management of assets.

SB 291 also limits the delegation of voting proxies without written commitment from a fiduciary to consider only financial factors consistent with the policy objectives of the System.

## **KPERS Investments History**

Since 1961 when the Retirement System was created, the Legislature has delegated Trust Fund oversight and investment decisions to the Board of Trustees. The Board has carefully built the KPERS portfolio to provide the highest returns with the least amount of risk.

The KPERS Board of Trustees and all the Board’s investment managers are fiduciaries (highest moral, ethical, and legal standard) to our members. All investment decisions are made for the sole purpose of providing promised benefits.

In support of this duty, the Legislature already addressed the issue of social investing in 1992 by prohibiting investments “if the sole or primary investment objective is for economic development or social purposes or objectives.” K.S.A. 74-4921(3).

## **Fiduciary Definition**

Through the definition of “fiduciary” in Section 1(b)(5), “Fiduciary commitment” in Section 1(b)(6) and “financial” in Section 1(b)(7), SB 291 creates a definition for fiduciary that does not allow for any advertisements, statements, explanations, reports, or participation in coalitions, initiatives, or joint statements on ESG. We believe all current investment managers would be disqualified as fiduciaries under these new definitions. If an investment manager is disqualified as a fiduciary, the Board of Trustees, acting in its own fiduciary capacity, would have no choice but to terminate the management contracts with those investment managers.

If SB 291 disqualifies the current investment managers, the Board of Trustees would have to divest the existing positions with those investment managers, review what similar investment managers and funds are available that meet the new fiduciary requirements, and restructure the portfolio based on what investment options are available.



Such divestment would incur asset losses of approximately \$1.14 billion due to the early sale of assets from illiquid investments and is estimated to reduce future investment returns by 0.85% based on a restructured investment portfolio of 60% equities/40% bonds. Over the next 10 years, the restructured portfolio is estimated to earn \$3.6 billion less than the existing investment portfolio.

The combined impact of the lost assets due to divestment and increased liabilities due to lower future investment returns could lower the funded ratio by 10%, which would be close to 60%. KPERS was last 60% funded in the 12/31/2013 valuation, meaning SB 291 could negate 10 years of funding progress made by the State. The past decade included extraordinary focus by the Legislature on improving the funded status of the System, including a new plan design (KPERS 3 cash balance plan), two pension funding bond issues, and several extraordinary contributions to the Trust Fund totaling more than \$1.5 billion.

### **Proxy Voting**

As investors in public markets, KPERS is entitled to voting common stock proxies. However, KPERS delegates that responsibility to the investment managers with guidelines provided by KPERS.

In FY 2022, the number of proxy votes cast by KPERS investment managers totaled nearly 100,000. For KPERS to research and evaluate each of the nearly 100,000 proxy votes based solely on financial factors, an entire team of investment professionals would have to be hired to manage proxy voting. This is not economically practicable. We anticipate engaging with a proxy advisor to comply with the new requirements in SB 291.

The proxy voting requirements in SB 291 are applied universally but are not germane to most of the System's private market managers. The requirements create an unnecessary layer of bureaucracy that will make KPERS less competitive with private market and real estate investments, a valuable part of KPERS' investment earnings. These requirements could also prevent the System from using commingled investment accounts that often provide a more efficient, low-cost way of investing Trust Fund assets.

### **Indemnity Language**

As fiduciaries, the Board of Trustees are bound to make decisions based solely in the interests of members. SB 291 creates a set of criteria that legally must be considered by the Board but may conflict with their fiduciary duty (e.g., an investment manager may offer the lowest investment management fees but is disqualified as fiduciary under SB 291).

For this reason, we believe it is important that the law indemnifies the Board of Trustees and KPERS staff from complying with the law.

We would be pleased to work with the Committee on bill language to address the issues discussed in this memorandum. We have included proposed amendatory language in Attachment A to this memorandum.

I respectfully request that the Committee not recommend SB 291 as it was introduced and would stand for questions at the appropriate time.

Attachment

## **Proposed Amendatory Language to SB 291 Addressing Impacts to KPERS**

### **Amendment 1: Fiduciary Duties**

If New Section 1 is narrowed to apply to only KPERS assets, this would address the disqualification of investment managers for not meeting the new fiduciary definition.

On page 2, in line 25, after “fiduciary” by inserting “, specifically of any assets managed on behalf of the system.”

(6) "Fiduciary commitment" means any evidence of a fiduciary's purpose in managing assets as a fiduciary, including, but not limited to, any of the following in a fiduciary's capacity as a fiduciary, specifically on assets managed on behalf of the system:

On page 2, in line 43, after “requires” by inserting “, specifically of any assets managed on behalf of the system.”

(C) A fiduciary may reasonably be determined to have taken an action or considered a factor with a purpose to further social, political or ideological interests based upon evidence indicating such a purpose, including, but not limited to, any fiduciary commitment to further, through portfolio company engagement, board or shareholder votes or otherwise as a fiduciary, any of the following beyond what controlling federal or state law requires, specifically on assets managed on behalf of the system:

### **Amendment 2: Proxy Voting**

The regulation of proxy voting in New Section 3 could be adjusted to allow KPERS to engage with a fiduciary who commits in writing to follow the provisions of the act and to exclude private market and real estate investments, which rarely have proxy votes due to the nature of the investment.

On page 4, in line 13, after “factors” by inserting “, in which case the system may grant proxy voting authority to such person”

(e) Unless no economically practicable alternative is available, the system shall not grant proxy voting authority to any person who is not a part of the system, unless such person has a practice of, and in writing commits to, follow guidelines that match the system's obligation to act solely upon financial factors, in which case the system may grant proxy voting authority to such person.

On page 4, in line 19, after “system” by inserting “, in which case the system may engage a proxy voting advisor”

(f) Unless no economically practicable alternative is available, in the selection of any proxy advisor, the system shall give preference to a proxy advisor service that commits in writing to engage in voting shares and making recommendations in a strictly fiduciary manner, and without consideration of policy objectives that are not the express policy objectives of the system, in which case the system may engage a proxy voting advisor.



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On page 4, in line 26, after “system” by inserting “, in which case the system may entrust engagement and share voting to a fiduciary”

(g) Unless no economically practicable alternative is available, system assets shall not be entrusted to a fiduciary, unless such fiduciary has a practice of, and in writing commits to, following guidelines, when engaging with portfolio companies and voting shares or proxies, that follow the system's obligation to act solely upon financial factors and not upon policy considerations that are not the express policy objectives of the system, in which case the system may entrust engagement and share voting to a fiduciary.

On page 4, in line 32, after “factors” by inserting “, in which case the investment manager or contractor may follow the recommendations of a proxy advisor or other service provider”

(h) Unless no economically practicable alternative is available, an investment manager or contractor shall not adopt a practice of following the recommendations of a proxy advisor or other service provider, unless such advisor or service provider has a practice of, and in writing commits to, following proxy voting guidelines that follow the system's obligation to act solely upon financial factors, in which case the investment manager or contractor may follow the recommendations of a proxy or other service advisor.

On page 4, following line 38, by inserting “(j) Sections (e) through (i), above, are applicable only to assets managed on behalf of the system and are not applicable to shares held indirectly, or to alternative and real estate investments as defined in K.S.A. 74-4921(5), and amendments thereto.”

(j) Sections (e) through (i), above, are applicable only to assets managed on behalf of the system and are not applicable to shares held indirectly, or to alternative and real estate investments as defined in K.S.A. 74-4921(5), and amendments thereto.

### **Amendment 3: Indemnification Language**

We request language indemnifying the Board of Trustees of the KPERS staff from making decisions or taking actions in compliance with this act, similar to what was included in other legislation regarding this topic (HB 2404, SB 224).

On page 5, after line 43, by adding

“New Sec. 7. With respect to actions taken in compliance with this act, including all good faith determinations and any reliance on such determinations, the state, the board, the system and the treasurer are exempt from any conflicting statutory or common law obligations, including any obligations with respect to making investments, divesting from any investment or choosing asset managers, investment funds or investments for the system's securities portfolios.

New Sec. 8. In a cause of action based on an action, inaction, decision, divestment, investment, report or other determination made or taken in compliance with this act, without regard to whether the person performed services for compensation, the state shall indemnify and hold harmless for actual damages, court costs and attorney fees adjudged against, and defend:

(a) An employee, a member of the board or any other officer of the system;

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(b) a contractor of the system;

(c) a former employee, a former member of the board or any other former officer of the system who was an employee, member of the board or other officer when the act or omission occurred on which the damages are based;

(d) a former contractor of the system who was a contractor when the act or omission occurred on which the damages are based; and

(e) the system.”

And renumbering sections accordingly.