

Fiscal Estimate Narratives

SWIB 7/30/2021

LRB Number	21-2774/1	Introduction Number	SB-460	Estimate Type	Original
Description prohibiting the Investment Board from making certain investments relating to China and Iran					

Assumptions Used in Arriving at Fiscal Estimate

BACKGROUND ON SWIB AND THE WRS:

As of Dec. 31, 2020, the State of Wisconsin Investment Board (SWIB) managed nearly \$144 billion of trust fund assets. The Core Fund, the larger of the two Wisconsin Retirement System (WRS) trust funds, had net assets of over \$120 billion, and the Variable Fund, an optional stock-only fund, ended 2020 with net assets of about \$9.6 billion. The WRS is one of the top ten largest public pension funds in the U.S.

Investment earnings generated by SWIB comprise about 80% of the revenues needed to fund the WRS, which reduces the burden on public employers and employees. SWIB has helped fuel one of the only fully funded pension systems in the U.S. during a time when many public pension plans are struggling with underfunding.

The overall statutory standard of care governing SWIB's investment decisions is the "prudent investor" (sometimes called "prudent expert") standard. This is the highest standard of fiduciary responsibility and the same standard imposed on plan sponsors under the federal Employee Retirement Income Security Act. This well-established legal standard requires that SWIB trustees and staff exercise the care, skill, prudence, and diligence that an institutional investor acting in a like capacity with similar goals would exercise. The law also requires that trust funds be invested solely for the purpose of ensuring the fulfillment of the purpose of the trust and for no other purpose. In the case of the WRS, that means investing solely to earn the returns necessary to fund the pension obligations to more than 648,000 beneficiaries. This bill creates carve outs to this fiduciary standard, which would require SWIB to consider factors other than investment risk, return, and cost when selecting investments.

BILL SUMMARY:

This bill prohibits SWIB from engaging in securities transactions involving certain companies associated with China and Iran. Under current law, federal Executive Order 14032 of June 3, 2021, imposes certain restrictions related to the purchase or sale of securities in specified Chinese companies. The bill prohibits SWIB from purchasing or selling any publicly traded security of a Chinese military-industrial complex company. The bill defines "Chinese military-industrial complex company" as a company listed in the Annex to Executive Order 14032 or later identified by the federal Secretary of the Treasury as such a company. SWIB holds no positions in its portfolio in the Chinese companies named in Executive Order 14032.

The bill also generally prohibits SWIB from investing in securities of any company that has various relationships with Iran. SWIB does not have investments in any Iranian companies. However, the bill as written would prohibit investments with "any company that contracts with the government of Iran or provides goods or services within Iran." This clause could prohibit SWIB from investing in over 2,200 non-Iranian companies according to Iran Business Registry, which "seeks to be a complete and comprehensive database encompassing all international Iran business and trade activity." Among these 2,200 companies are many American businesses that are household names: 3M, AT&T, Coca-Cola, Johnson & Johnson, Kraft, Tyson, Whirlpool, and more.

SWIB ALREADY CLOSELY MONITORS PROHIBITED INVESTMENTS:

Per the U.S. Constitution, foreign policy is a federal government matter. If the federal government has a foreign policy or national security reason to prohibit a specific investment, it does so via the U.S. Treasury's Office of Foreign Asset Control (OFAC). SWIB closely monitors executive orders from the federal government and updates to the OFAC list.

SWIB has put in place rules in its order management system that would alert SWIB's Compliance Division if a security was of a company incorporated in Iran, or any other OFAC sanctioned country, as well as countries that are designated as high-risk for money laundering (AML) by the Financial Action Task Force (FATF). SWIB maintains lists of the OFAC and AML countries and reviews and updates them quarterly. These compliance rules run on a pre-trade, post-trade and overnight basis on SWIB's internally managed accounts. In addition, the broker-dealers that SWIB transacts with are subject to rigorous requirements relating to their OFAC/AML

programs and would not transact with SWIB on a security subject to sanctions.

POTENTIAL COST TO SWIB AND WRS PARTICIPANTS:

SWIB's investment costs are lower than its peers. These cost savings have generated \$1.3 billion in savings for the WRS over the past ten years. Any new state law that could require SWIB to build customized portfolios and benchmarks could substantially increase costs, which are ultimately borne by WRS participants.

SWIB anticipates that divestment from the companies implicated by this proposed legislation would have a material negative impact on investment returns to the WRS. However, even if this divestment would not result in poorer investment returns, custom portfolios, benchmarks, and screening services would be necessary to ensure SWIB's compliance with the bill's requirements.

An estimate of initial costs (nearly \$23 million) would include:

- Engaging a third-party for identifying investments covered by the legislation: \$100,000
- Configuration of order management systems for restricted list (pre- and post-trade): \$5,000
- Transaction costs to sell existing holdings: \$2,650,000
- Estimated market impact of sales: \$19,750,000
- Purchasing custom benchmarks and related data: \$150,000
- Benchmarking consultant and SWIB staff time to implement: \$200,000
- Total Initial Costs: Nearly \$23 million

Long-Range Fiscal Implications

SWIB would incur ongoing (annual) costs of roughly \$750,000 per year to comply with this legislation. These costs would include the time of existing SWIB staff (Investment Management, Risk Management, Internal Audit, and Corporate Governance), continual third-party identification of companies covered by the legislation, a new SWIB Compliance FTE, and a new SWIB Performance FTE.

This ongoing cost estimate does not include lost profits associated with the WRS trust funds no longer holding identified companies in its portfolio.