



Illinois Department of Financial and Professional Regulation

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The Siren

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ADVISORY SERVICES BULLETIN Update Prohibition On Sudan Investments

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The Public Pension Division and the Illinois Department of Financial and Professional Regulation have received numerous inquiries regarding Public Act 094-0079, An Act to End Atrocities and Terrorism in the Sudan. Many questions have been raised as to the requirements placed on the Article 3 and Article 4 pension funds by this Act and how the Article 3 and Article 4 pension funds are to comply with the Act. The following are a few of the questions we have received along with their corresponding answers regarding the implementation of this Act. The purpose of this Siren is to address inquiries regarding the implementation of Section 1-110.5 of the Illinois Pension Code. This information is provided as guidance to you in accordance with our statutory mandate in Section 1A-105 of the Code (40 ILCS 5/1A-105).

Briefly, the law prohibits pension funds from engaging in financial or investment transactions with any entity unless the company charged with managing the pension fund assets certifies to the pension fund's fiduciary that it has not transacted business with a forbidden entity, as defined by the law, and that as of January 27, 2007, 60% of the fund's assets are not invested in forbidden entities. The percentage increases to 100% on July 27, 2007. The law also allows the plan fiduciary to void any transactions violating the provisions of the law. The manner and form of the certificate are established by the State Treasurer. The Treasurer's Office has drafted the forms for the required certification, and they are available on the Public Pension Division's webpage.

The following are some questions received by the Division with our advisory opinion responses:

1. Does 40 ILCS 5/1-1 13, (16) stating, "Any limitations herein set forth shall be applicable only at the time of purchase and shall not require the liquidation of any investment at any time." apply to all pension plan assets purchased before January 26, 2006 so that securities purchased before January 26, 2006 are "grandfathered in" and avoid the new divestment requirement?

The 12 and 18 month (60% and 100%) asset compliance certification requirements, under Section 1-110.5(a)(2)&(3) of the new law, appear to directly conflict with any notion of grandfathering. There cannot be both 100% compliance and grandfathered securities. Where two laws are repugnant, and the provisions of both cannot be carried into effect, the later law must prevail. *People ex rel. Adamowski v. Metropolitan Sanitary Dist. Of Greater Chicago*, 14 Ill.2d 271, 150 N.E.2d 361 (1958). Applying this rule, it appears that the later enacted law requiring divesture controls the earlier provision, and divestiture of non-complying investments is required.

2. Does the change in the statute restricting investments in forbidden entities require that each pension plan amend and re-submit to the state an updated investment policy statement reflecting the new restrictions and reporting requirements?

Yes. Pension funds should submit updated investment policy statements reflecting the new restrictions to the extent that their currently filed statements are inconsistent. This will remind the fiduciaries and asset managers what their responsibilities are, and help inform the Division of those noncompliant funds that have not amended their investment policies.

3. The statute requires that the company charged with managing the pension fund assets certify to the fiduciary (pension fund trustees) that the portfolio is not invested in forbidden entities. Who is considered the "company charged with managing the pension fund assets"?

The Act requires that the company charged with managing the assets provide the certification. The word "company" is broadly defined under the Act as "any entity capable of affecting commerce, including but not limited to (i) a government, government agency, natural person, legal person, sole proprietorship, partnership, firm, corporation, subsidiary, affiliate, franchisor, franchisee, joint venture, trade association, financial institution, utility, public franchisor, provider of financial services, trust, or enterprise; and (ii) any association thereof."

Taking into account the definition of “company” and the operation and purpose of the Act as a whole, the certificate must be provided by a “company” that is engaged in activities as the pension fund’s directly authorized agent with discretionary authority over pension fund assets and investment decisions. Proper certifying “companies” include, but are not limited to (1) a provider of financial services who chooses pension fund investments within the parameters of the investment policy established by a pension fund; and (2) in the absence of a provider who has the aforementioned authority, a pension fund board or a pension fund member, officer, or investment committee having that authority.

4. If there are differences between the stocks listed on the Sudan forbidden entity list provided by one of the “independent research firm specializing in global security risk management” and another firm’s list, will an Illinois pension fund be considered out of compliance with the statute if the pension fund’s portfolio manager with discretion chooses a research firm’s list and follows just that particular research firm’s list?

If there are differences between the lists of independent research firms specializing in global security management, a fund that follows a particular list should only be considered out of compliance where it has reason to know that the particular firm’s list that it uses is in error; for instance, if it has been publicized in the media that a particular holding of the pension fund does business in the Sudan, or if the fund’s independent research firm has been discredited.

5. How often is the portfolio manager with discretion required to review and update the restricted list from the “independent research firm specializing in global security risk management”, monthly, quarterly, or annually?

The list should be consulted, reviewed and updated, if applicable, whenever a trade is made. Otherwise, there is risk of compliance failure for the time between reviews.

6. How often is the pension fund board required to confirm with the investment manager that there are no restricted investments, annually, quarterly or monthly? Should that reporting requirement be detailed in the investment policy statement?

Given that pension funds must file an annual statement with the Division, it would be consistent that the certification also be on an annual basis, and confirmation thereof made part of the annual audit. Of course, if the fund changes investment managers, the certification should also be obtained before any trades are made by the new manager, so the new manager is made aware of their responsibilities.

7. When a security is added to a restricted list after the initial screening, how long does the portfolio manager have to divest the newly restricted security? If there are losses in the market value of a security from the time of purchase to when it is added to the restricted list and subsequently divested, who bears the loss, the pension fund or the portfolio manager who executes the transactions in the portfolio? Is there a hold harmless time frame for the board and the portfolio manager with discretion in this situation?

How long a manager has to divest a newly restricted security is largely dependent upon the nature of the security. Publicly traded equities are much more liquid than certain bonds or mortgages. In any case, a reasonable standard may require that the investment be divested as soon as practicable, not to exceed 30 days. For an exchange-listed security, this would generally be on the same day that the investment manager was made aware of the security's restricted status. The pension fund would, of course, bear the loss as with any trade in the normal course of business.

8. Does the definition of pooled or commingled funds managed by a bank, trust company, registered investment companies or separate accounts of insurance companies as written in the statute section 40 ILCS 5/1-113, (13) describing equity investments and fixed income investments in common funds apply to Article 3 and 4 pension funds?

Since the first sentence of Section 1-113 specifically states that the section regards the investment authority of certain pension funds not including those established under Article 3 or 4, the definition for pooled or commingled funds found in that section should not be relevant to those types of funds. Moreover, Article 3 and 4 funds have their own pooled asset provisions in Section 1-113.2.(8).

9. Does the statute look through the mutual fund, exchange traded fund, index, unit investment trust or annuity structured investments to the individual stocks held by that structure to determine if the investment violates the statute?

Yes. The spirit of the law should not be frustrated or avoided by doing indirectly what can't be done directly. Put another way, the statute should be liberally construed to prohibit such practices in accordance with 5 ILCS 70/1.01.

10. Does ownership of the shares of a mutual fund which in turn owns the individual shares of stock that are restricted securities violate the statute and require divestment of the mutual fund shares?

Yes, for the same reason as that stated in the answer to question No. 9.

11. Does ownership of shares of a mutual fund which holds a Sudan restricted stock and is reinvesting dividends into more shares of the same mutual fund constitute a new purchase of a restricted stock violating the statute's deadline of no new investment after January 26, 2006? Will stopping dividend reinvestment into the mutual fund comply with the "no new investment after January 26, 2006"?

Again, the answer is yes. The method of purchase should not be allowed to launder the substance of the transaction. Simply stopping the dividend reinvestment program will not bring the mutual fund in compliance, so long as the fund maintains a position in the forbidden entity's securities.

12. Does ownership of shares or units of a variable annuity that has mutual fund investment choices which hold Sudan restricted stocks constitute a violation of the statute and require divestment?

Yes, for the same reason as that stated in the answer to question No. 9.

13. Does ownership of shares or units of a variable annuity that has mutual fund investment choices which hold Sudan restricted stocks and is reinvesting dividends back into the same annuity constitute a new purchase of a restricted stock violating the statute of no new investment after January 26, 2006? Will stopping dividend reinvestment into the annuity comply with the "no new investment after January 26, 2006"?

Yes, this is essentially just another version of question No. 11, and the answer is the same. Simply stopping the dividend reinvestment is not satisfactory, so long as the underlying funds contain a position in the forbidden entity's securities.

14. Does ownership and dividend reinvestment in an exchange traded fund or index that holds a Sudan restricted stock violate the statute and require divestment?

Yes. Again, the answer is essentially the same as that given in question Nos. 9, 11 and 13.

15. If a pension board hires an advisor, portfolio manager or consultant of a financial services company whose parent company is on the list of forbidden entities does that constitute a violation of the statute because pension assets are used to pay for those services?

Yes. The definition for the word "Company" found in Section 1-110.5.(b) includes affiliates.

16. If a pension board divests of investments which are not compliant with the statute and incurs an exit fee, surrender charge, deferred sales charge or cancellation fee are the trustees of the pension violating their fiduciary duties to ‘Control and account for investment expenses’ and the “Prudent Expert Standard”? If this is a breach of fiduciary duty are the trustee protected from consequences because they were complying with the Sudan Divestment Statute?

In general, trustees do not breach fiduciary duties by following the law.

17. For a pension plan whose assets are under \$2,500,000 and can only invest in mutual funds with a 5 year track record or annuity products for their equity portion of the pension plan and there are no funds or annuity products that comply with the new statute are the trustees violating their fiduciary duties of prudence to diversify because under that scenario the only investments available to the smaller plans would be fixed income investments in government bonds? If this is a breach of fiduciary duty are the trustee protected from consequences because they were complying with the Sudan Divestment Statute?

In general, trustees do not breach fiduciary duties by following the law.