



<b>FROM</b>	NAME & TITLE	N. Anthony Calhoun, Executive Director 	CITY of BALTIMORE <b>MEMO</b>	
	AGENCY NAME & ADDRESS	Fire and Police Employees' Retirement System 7 E. Redwood Street, 18th Floor		
	SUBJECT	City Council Bill 21-0066		

**TO** The Honorable President and Members  
of the Baltimore City Council  
Attn: Natawna Austin, Executive Secretary  
Room 409, City Hall  
100 N. Holliday Street  
Baltimore, Maryland 21202

DATE: May 24, 2021

Re: City Council Bill 21-0066 – Retirement Systems –  
Precluded Investment and Divestment – Fossil Fuel Companies

Dear Mr. President and City Council Members:

City Council Bill 21-0066 (the Bill) has been introduced to amend certain provisions of the Employees' Retirement System (ERS), Elected Officials' Retirement System (EOS), Fire and Police Employees' Retirement System (F&P) law to (1) prohibit new actively- managed investment of ERS, EOS and F&P retirement funds in certain fossil fuel companies on after January 1, 2022 and (2) require actively-managed investment funds to gradually divest from fossil fuel companies, at the rate of 20% per year, within a 5-year timeframe beginning July 1, 2022 and ending June 30, 2026.

### Legislation Summary

#### Fossil Fuel Company Defined

The Bill would prohibit new investment in, and require divestment from, any company listed in the 200 publicly traded coal, oil, and gas companies that hold reported fossil fuel reserves with the largest potential carbon emissions, as ranked and updated annually in the Fossil Free Indexes US ("FFIUS") or any successor index.

#### Actively-Managed Investment Prohibited

Only ERS, EOS, or F&P assets that are actively-managed and held in a separate account would be subject to the Bill's prohibition on new investment and the requirement to divest. The Bill defines "Actively Managed Separate Account" to not include the following accounts: (1) an indexed fund; (2) a private equity fund; (3) a hedge fund; (4) a real estate fund; or (5) any other commingled or passively ERS, EOS or F&P managed fund.

#### Reporting Requirement

The Bill would require the ERS and F&P Boards of Trustees (Trustees) to file with the Mayor and the City Council, on or before June 30th of each year, an annual report detailing any

new investment in, and any divestment from, fossil fuel companies during the past fiscal year, and a calculation of the administrative cost of compliance with fossil fuel divestment. Any decision to delay divestment during the fiscal year would also have to be described.

### Divestment Notice to Fossil Fuel Companies

The Bill provides that no ERS, EOS, or F&P divestment action may be taken until Trustees provides written notice and an opportunity to respond to each company subject to a proposed divestment action and waits 90 days from the written notice. If the subject company demonstrates to the Trustees that it is exempt from divestment, no divestment action may be taken. A subject company will be exempted from divestment if it can demonstrate that it: (1) has stopped exploring for new hydrocarbons; (2) contractually agrees not to develop or sell 80% of its current proven fossil fuel reserves; and (3) has ceased lobbying or attempting to influence city, state, or federal government officials to preserve fossil fuel subsidies, tax breaks, or the company's competitive advantage with respect to clean, renewable energy.

### Fiduciary Duty

Trustees need not take any divestment action under the Bill if it is determined in good faith by either Board of Trustees that divestment would be inconsistent with that Board's fiduciary responsibilities. If a Board of Trustees determines that its fiduciary duties require that it delay a divestment action, it must report that determination to the Mayor, City Council and Board of Estimates, along with an estimated timeline for resuming divestment.

## **Law and Analysis**

In *Board of Trustees of Employees' Retirement System of Baltimore, et al. v. Mayor and City Council of Baltimore, et al.*, 317 Md. 72, 562 A.2d 720 (1989) (the South Africa case), the Maryland Court of Appeals upheld a City Council ordinance prohibiting retirement system investment in, and requiring divestment from, companies doing business in South Africa. The court defended the law against numerous challenges posed by the retirement systems Boards of Trustees. In part, the Trustees claimed that requiring divestiture would compel the Trustees to violate their fiduciary duty to prudently invest retirement system funds "for the exclusive purpose" of providing member benefits. The court agreed that the City adopted common law fiduciary investing standards in the retirement systems provisions, see, Art. 22, Sections 7(h) and 35(h), but nevertheless upheld the ordinance, concluding that the South Africa divestiture mandate did not change the Trustees' duties of prudence and loyalty under the pension contracts.

In a 2008 opinion, the Maryland Attorney General followed and analyzed the South Africa case in advising the Maryland State Retirement System (MSRS) Board of Trustees to implement a state law requiring MSRS to divest from companies doing business in Iran or Sudan, finding that the divestiture law was not in conflict with Trustees' fiduciary duties. 93 Md. Op. Atty. Gen. 168 (2008). The AG found that divestment could be accomplished without interfering with trustees' fiduciary responsibilities "if:

- The System receives fair market value for the interests divested.
- The costs of divestment are *de minimis* as compared to total fund assets.
- Substitute investments are available that will yield competitive returns at a comparable level of risk.
- The fiduciaries exercise their discretion regarding the timing and manner of divestment so that they are able to avoid imprudent transactions.
- The fiduciaries otherwise act in accordance with the duties of loyalty and prudence - *i.e.*, ascertain relevant facts, investigate alternatives, obtain appropriate expert analysis, diversify appropriately, and act for the benefit of the beneficiaries.”

Attached is a review of the Bill from F&P’s investment advisor, NEPC. NEPC concludes that the fossil fuel divestiture program proposed by the Bill creates a potential for lower investment returns and that the amount of such lower returns is unknown. Also attached is a summary of F&P’s Exposure to Fossil Fuel Securities as of April 30, 2021.

Using NEPC’s review and the Maryland AG’s opinion as a framework for its review, the F&P Board cannot state with certainty that the Bill will not interfere with its fiduciary duty to prudently invest plan assets for the exclusive benefit of its membership. Specifically,

- The 5-year divestment timeframe, annual divestment goals, and 90-day divestment freeze mandated by the Bill may potentially interfere with the Board’s discretion regarding the timing and manner of divestment and its ability to sell fossil fuel securities while realizing “best price, best execution”. Those mandates may thus affect F&P’s ability to receive fair market value for divested securities, albeit, in NEPC’s view, marginally.
- Because the opportunity costs of divestment are unknown, it cannot be said with certainty that the cost of divestment will be *de minimis* nor that substitute investments will yield adequate competitive returns at a comparable level of risk.
- The Bill’s reliance on a no-invest list compiled by outside experts and the Bill’s criteria for allowing an exemption from divestment hinder the F&P Board’s discretion to weigh the investment and social attributes of a security against its investment risk and potential social cost. The F&P Board finds particularly onerous and intrusive the Bill’s requirements allowing a subject fossil fuel company to be exempted from divestment: (1) stop exploring for hydrocarbons, (2) contractually agree not to develop or sell 80% of its fuel reserves, and (3) cease lobbying governmental officials to preserve a company’s competitive advantage - even with regard to corporations which are actively and sincerely, but gradually, developing renewable energy sources and environmentally responsible practices, albeit not on pace with the Bill’s requirements.

On the other hand, it is apparent that the Bill’s sponsors were mindful of, and sensitive to, the F&P Board’s fiduciary duties inasmuch as the Bill attempts to ensure that those duties will not be violated. The Bill (1) mandates divestment over a 5-year timeframe, thus spreading the financial impact of divestment over time, (2) requires that the F&P Board communicate with subject corporations prior to divestment while freezing divestment for 90

days, and – most importantly - (3) allows trustees to suspend divestment action under the Bill upon a good faith determination that divestment would be inconsistent with their fiduciary responsibilities. While those assurances are commendable and would, in theory, allow the F&P Board to legally implement the Bill, the Board believes that the Bill is nevertheless ill-advised.

The F&P Board supports the social concerns of investors, and believes, as was noted by NEPC, “that, in the long run, fossil fuel will be rejected in favor of renewable energy sources, and, in future new economies, will not necessarily be optimal investments.” However, rather than being mandated by legislation, the Board prefers to implement divestment through an internal process favoring timely and prudent investment in renewable and alternative energy and divestment from fossil fuels based on the recommendations of F&P’s investment managers. It is the general view of the F&P Board that external, time-constrained restrictions on its discretion to invest, even if legal, are imprudent.

In summary, the F&P Board states for that record that it unequivocally supports the principles embodied in the Bill, namely, that fossil fuel exploration and extraction is anathema to the core values of the residents of Baltimore City and should thus be avoided while taking reasonable steps to minimize the financial cost to the retirement systems and the City. However, while the Bill may be feasible to implement, the F&P Board cannot state with certainty that the Bill will not impair its duty of prudence and loyalty, given unknown future determinants and adequate available substitute investments.

### **Amendments**

If the Bill is voted favorably out of committee, the F&P Board respectfully proposes that it be reported out with the following amendments:

#### **Reporting but not Mandating Divestment**

As stated above, the F&P Board is generally opposed to mandated divestment of fossil fuel companies but supports prudent and gradual divestment implemented over time pursuant to internal investment and divestment guidelines.

Accordingly, delete all provisions of the Bill mandating divestment and prohibiting investment; retain only: the definitions set forth on page 2, lines 1 – 29 and page 5, lines 1 – 30 and reporting sections set forth on page 4, lines 17 – 27 and page 7, line 22 – 32.

#### **Fossil Fuel Company Definition**

F&P’s due diligence has revealed that the reference by the Bill to “Fossil Free Indexes US (FFIUS)” as referring to the index of the 200 listed companies with the largest carbon potential carbon emissions is outdated. The current and commonly referred-to fossil fuel company index is known as “Carbon Underground 200 (CU200)”.

Accordingly, on page 2, line 28 and page 5, line 29, “Fossil Free Indexes US (FFIUS)” should be changed to “Carbon Underground 200 (CU200)”.

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To the extent the City Council rejects the above amendments, the F&P Board respectfully proposes that the Bill be reported out of committee with the following amendments:

Fossil Fuel Company Definition (see above explanation)

On page 2, line 28 and page 5, line 29, “Fossil Free Indexes US (FFIUS)” should be changed to “Carbon Underground 200 (CU200)”.

Divestment Timeframe and Annual Goals

The F&P Board is generally in favor of divesting from fossil fuel but would like to do so in a manner which provides flexibility to reduce the cost of divestment and maximize the retirement systems’ ability to find alternative investments. Therefore, the F&P Board suggests increasing the divestment timeframe to 10 years and eliminating annual goals during the timeframe to provide the Board its legal discretion over the timing and manner of divestment.

Accordingly, on page 3, beginning with line 8, delete the entirety of sub-subparagraphs 1 through 4; on line 20, delete the number “5”, replace “2026” with “2031”, after “divest”, delete “at least 100%” and replace with “all”. Make the same amendments to subparagraph (iv) on page 6.

90-Day Notice Period

The F&P Board is in favor of exercising due diligence prior to divestment to ensure that each fossil fuel company subject to divestment is resolute in desiring to continue to engage in exploration, development, or sale of fossil fuels or lobbying to preserve governmental advantages for fossil fuels. However, the Board opposes the imposition of a 90-day period to accommodate communication with a subject fossil fuel company. Any time frame imposed by law could potentially interfere with an advantageous sell strategy and execution.

Accordingly, on page 4, lines 1-2, and on page 7, lines 6-7, delete in its entirety sub-subparagraph 2.

**Resolution**

At their meeting of May 18, 2021, the F&P Board of Trustees neither opposed nor supported the Bill.

I will be available to provide testimony at the hearing scheduled for CC Bill 21-0066. Please call me at 410.497.7929 if you would like additional information.



**KEVIN M. LEONARD**  
Partner, Head of Public Funds Team

**NEPC, LLC**  
255 State Street  
Boston, MA 02109

May 12, 2021

**Peter Keith**  
Chairman, Board of Trustees  
Baltimore Fire & Police Employees' Retirement System  
7 East Redwood St  
18<sup>th</sup> Floor  
Baltimore, MD 21202

**RE: Bill 21-0066**

Dear Mr. Keith:

NEPC was asked to review City Council Bill 21-0066 (Retirement Systems-Precluded Investment and Divestment – Fossil Fuel Companies), as well as the two requested amendments by the F&P Board, and comment on potential costs to the F&P investment portfolio. The comments below reflect our opinion of the financial or investment implications of the legislation.

In any divestment, there are three major costs:

- **Hard Dollar Costs** – Hard dollar costs being the commissions paid to execute such a sale(s) and the associated custodial costs to book/account for the sale(s).
- **Realized Losses** - When force selling an asset within a given time period, an investor is at the discretion of the markets. Meaning that if the average cost of sale is lower than the average cost of purchase, it will result in a realized loss on investment.
- **Opportunity Cost** – When divesting from a company, or an industry, there is always potential for that company/industry to perform strongly into the future. This results in an investor missing out on investment return if the dollars that had been invested in said company/industry are re-invested into a lower performing investment.

Given the language, and requested amendments, in the Bill that limits divesture to actively managed traditional asset class (stocks and bonds) separate accounts, requires divestment notice to fossil fuel companies allowing them to respond prior to divesture, and most importantly the ability for Trustees to not take action under the Bill if it is determined in good faith that divestment would be inconsistent with the Board's fiduciary responsibilities, NEPC feels the "costs" listed above can be prudently minimized/managed. To NEPC the biggest potential cost would be "opportunity cost". This is also the biggest unknown as it is determinant on the future which is an unknown or a guarantee. The Bill ostensibly represents the view that, in the long run, fossil fuel will be rejected in favor of renewable

energy sources, and, in future new economies, will not necessarily be optimal investments. Although NEPC, given today's social views towards fossil fuel, somewhat agrees with the premise, there is not 100% certainty that this in fact will transpire. Therefore, if one were to fully divest from and prohibit investment in any company listed in the 200 publicly traded coal, oil, and gas companies that hold reported fossil fuel reserves with the largest potential carbon emissions, as ranked and updated annually in the Fossil Free Indexes (or any successor index) there is potential for lower investment returns.

Best Regards,

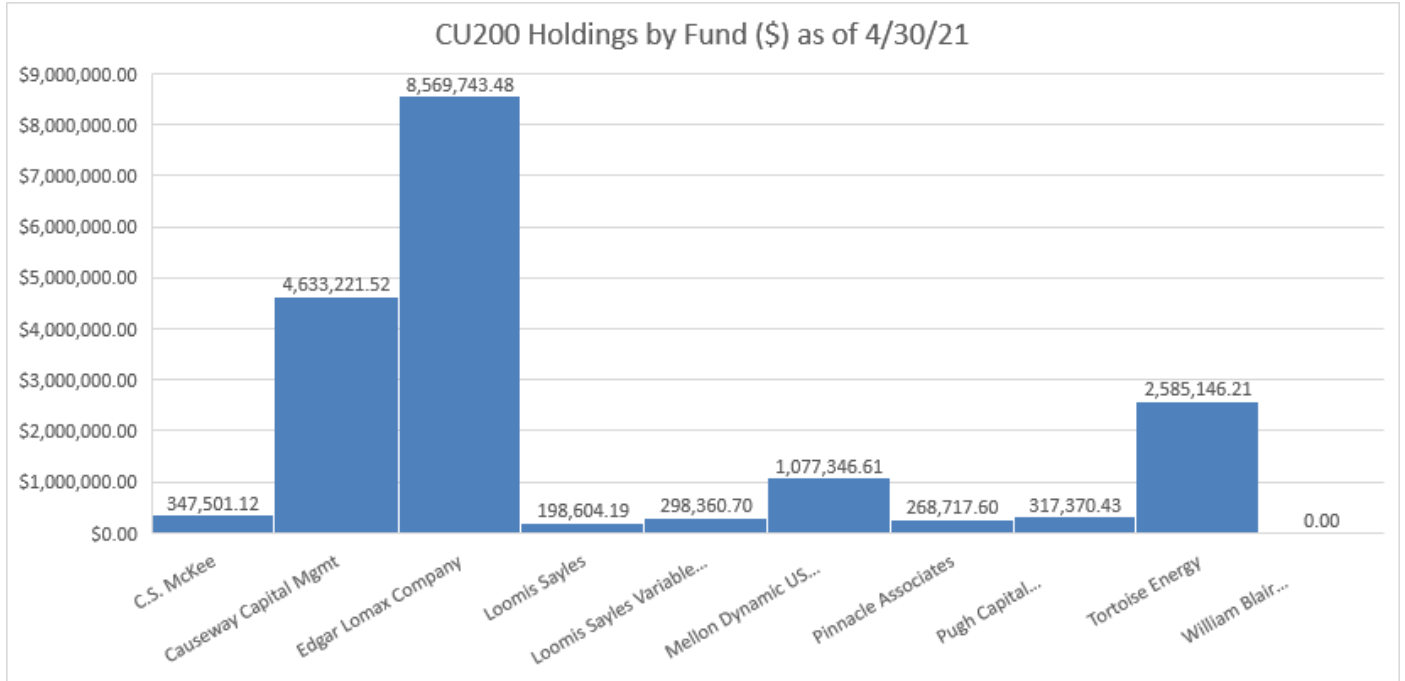
A handwritten signature in black ink, appearing to read 'K.M. Leonard', with a stylized flourish at the end.

Kevin M. Leonard, Partner

**FIRE AND POLICE EMPLOYEES' RETIREMENT SYSTEM OF THE CITY OF BALTIMORE**

**EXPOSURE TO CU200 SECURITIES**

**AS OF APRIL 30, 2021**



<b>CU200 Total</b>	<b>18,296,012</b>
<b>Fund Total</b>	<b>3,264,253,851</b>
<b>CU200 Percentage of Fund Total</b>	<b>0.56%</b>