

I TOBACCO-FREE PUBLIC INVESTMENTS



The main goal of the first chapter of the Divestment Action Guide is to help the reader understand the legal and financial principles supporting tobacco divestment. It summarizes the purposes of divestment by drawing a comparison to the divestment action against South Africa, and provides tips for community organizers, retirement board members, and

their staff. The chapter discusses the following topics: the policy goals for tobacco divestment; the government funds targeted for divestment action; how to define a tobacco company; how to organize a divestment campaign; and responding to opposition against a divestment campaign. The chapter ends with a series of fact sheets that provide further detail about tobacco divestment. The fact sheets also serve as stand-alone documents for use in public presentations and educational seminars.

The subsequent chapters of the Divestment Action Guide provide in-depth discussion regarding the financial implications, legal standards, government targets and public health significance of divestment. These chapters explore divestment from many perspectives and support tobacco control activists in their campaigns.

The authors of this guide suggest that readers begin with a careful review of this first chapter. The following chapters are designed for those who want or need a more complete understanding of the financial, legal and moral background supporting a call for tobacco divestment. The staff of the Council for Responsible Public Investment (CRPI) and the Technical Assistance Legal Center (TALC)¹ are available to organizers, elected officials, retirement board members, financial managers and attorneys to research and develop legally sound divestment resolutions.

¹ CRPI can be reached at (510) 208-0400 or by e-mail at crpi@publicinvestment.org, or visit CRPI's website at <http://www.publicinvestment.org>. TALC can be reached at (510) 444-8252, or by e-mail at talcc@phi.org, or visit TALC's website at <http://www.phi.org/talc>.

I. OVERVIEW OF THE DIVESTMENT STRATEGY

Tobacco divestment has become part of the overall strategy for tobacco control in California. It means both selling existing holdings in tobacco company stocks and bonds and pledging not to invest in tobacco companies in the future. Around the nation, a number of public and private pension plans, universities, and others have already adopted tobacco divestment policies. See Fact Sheets I and 2 at the end of this chapter for lists of public and private funds that have divested from tobacco.

Tobacco divestment, like the South Africa divestment movement of the 1970s and 1980s (see box below), pressures investors to sell their tobacco stock. Many of these California investors are state, county, and city governments and their pension plans currently own close to \$1 billion of stock in American tobacco companies and their foreign competitors. Even though tobacco stock generally is a very small percentage of their investments, the dollar value is large because these plans have enormous holdings overall. The purpose of this Guide is to provide assistance and tools for tobacco divestment advocates as they work to make these public funds tobacco-free.

DIVESTMENT: THE SOUTH AFRICA AND TOBACCO CAMPAIGNS

The tobacco divestment effort is broadly modeled on the South Africa experience, to date the most politically widespread divestment campaign. The two campaigns have very similar goals and justifications. Below is a comparison of the two efforts, showing how moral, political, and economic considerations are dominant in both campaigns.

South Africa Divestment Campaign

Moral: Divestment was seen as a way of ridding a fund of investments that were tainted through involvement with a racist government.

Political: Political action around divestment and adoption of divestment policies raised public consciousness and stigmatized the South African government in the hopes of bringing about change in that nation. It included a wider stigmatizing strategy such as getting entertainers to refuse to perform in South Africa and banning South Africa from the Olympics.

Economic: Divestment put financial pressure on the supporters of apartheid. South Africans who would be hurt the worst by divestment were most likely those who supported apartheid. These South Africans therefore had a financial incentive to pressure their government to reform.

Tobacco Divestment Campaign

Moral: Divestment is seen as a way of ridding a fund of investments that are tainted with involvement in an industry that has knowingly marketed an addictive and lethal product to children. Only some companies ever have admitted to these practices, and then only under the threat of crippling litigation.

Political: Political action around divestment and adoption of divestment policies raises public consciousness and stigmatizes the industry, thereby furthering anti-smoking social norms and increasing public support for additional tobacco control measures.

Economic: Divestment puts financial pressure on the tobacco industry by imposing economic sanctions, by denying them investors, and perhaps by reducing the value of stock options held by tobacco executives.

II. ORGANIZING A TOBACCO DIVESTMENT CAMPAIGN

Government bodies are trying to discourage tobacco use through lawsuits, regulations, taxes, and public education campaigns. Divestment advocates believe it is inconsistent, perhaps counterproductive, for a government body at the same time to expect to profit from investments in tobacco stocks. Government leadership in the public health campaign against tobacco use should not be undercut by having some government agencies support tobacco companies by investing in them.

Readers of this Guide are likely to be veterans of efforts to change public policy. Convincing local retirement systems to pass a divestment resolution is similar to getting government to pass policies regarding any other public health protection measure. A proponent of a new policy must identify the policy goals, conduct background research, organize the community, and prepare for opposition.

A. SET POLICY GOALS

California tobacco divestment advocates are pursuing the goal of tobacco-free public investments. To achieve this goal, divestment advocates propose the following, which can be adapted to the needs and perspectives of the particular community that is being organized:

- Public pension funds should divest themselves of tobacco securities and declare future tobacco investments off limits. If a county or city participates in the California Public Employees' Retirement System (CalPERS), advocates may want to persuade the county board of supervisors or city council to write CalPERS a letter in support of tobacco divestment.
- Governments and public agencies, which invest short-term funds, should not invest them in tobacco companies. Appendix A provides information regarding several pension plans in California which have social screens on their investment portfolios.
- State and local governments should also divest and remain free from tobacco in longer-term, non-pension investments such as university endowments and the proceeds of funds received from Proposition 10.
- Public pension funds that allow employees themselves to direct the investment of some or all of their pension money should offer and publicize at least one tobacco-free fund as an alternative to whatever non-screened investment vehicles the board offers.
- In addition, divestment advocates can encourage individuals to direct their own investments away from tobacco related funds.

CASE STUDY: TOBACCO DIVESTMENT IN FLORIDA

Background

On May 28, 1997, the board of the Florida State Retirement Trust Fund voted to divest \$833 million of tobacco stock holdings from the state pension fund. The State Board of Administration (SBA) governs the Florida State Retirement Trust Fund. Of the three-member SBA, Governor Lawton Chiles and Treasurer Bill Nelson voted in favor of divestment; Comptroller Bob Milligan voted against the resolution.

Prior to the vote to divest the fund's tobacco holdings, the SBA sought the legal opinion of Florida's attorney general, Robert A. Butterworth.^a The SBA asked a series of questions concerning the board's fiduciary duty and tobacco divestment.^b Butterworth's opinion stated that tobacco divestment would be consistent with the SBA's fiduciary duty if the SBA made an independent decision based on all the required considerations under Florida law.^c

In a public statement, Governor Chiles said, "Tobacco has proven that it is not only bad for health, it's a bad investment, too. This is a clear vote of no confidence in the future performance of the cigarette industry. I've been concerned that Florida's landmark tobacco lawsuit could spell disaster for the state's tobacco investments. Florida stands to win billions in its lawsuits. This would cause tobacco stocks to plummet. This vote will help the people vested in the Florida Retirement System know their pensions are not threatened by the state's tobacco suit."^d

Comptroller Bob Milligan was quoted as saying that he abhorred cigarette smoking, but felt it was his fiduciary duty to vote against tobacco divestment because the stocks had historically produced a large return that outperformed the Dow Jones Index.^e

Divestment Action

Unlike other divestment actions, Florida only concerned itself with domestic equities. Florida held stock in the following domestic tobacco companies: American Brands, Inc.; Dimon, Inc.; Loews Corp.; Mafco Consolidated Group, Inc.; Philip Morris Co.s, Inc.; Nabisco Holdings Corp.; RJR Nabisco Holdings Corp.; UST, Inc.; and Universal Corp.^f

The board instructed the fund to divest its tobacco holdings within three years. Between June 1 and June 20, 1997, most of the domestic tobacco stocks were sold at high market prices. On June 20, the tobacco settlement between the tobacco industry and 40 states

^a See Chap. 3, Legal Standards, for discussion of this legal opinion.

^b Letter from Tom Herndon, Executive Director, State Board of Administration of Florida, to Robert A. Butterworth, Attorney General of Florida (May 14, 1997) (on file with Council for Responsible Public Investment, (510) 208-0400).

^c 97 Op. Att'y Gen. 29 (Fla. 1997), 1997 WL 348030, at *3.

^d Executive Office of the Governor of Florida, Press Release, *Florida's State Board of Administration Votes to Fully Divest the State's Tobacco Stocks*, May 28, 1997) (on file with Council for Responsible Public Investment (510) 208-0400) [hereinafter 'Governor's Press Release'].

^e Tyler Bridges, *State Agrees to Divest Its Stock in Tobacco*, THE MIAMI HERALD, May 29, 1997, at 5b.

^f See Governor's Press Release *supra* note d, at I.

was announced, halting the remaining divestment until the fall. By the end of 1997, the retirement systems' index funds had become tobacco-free indexes by the sale of the tobacco holdings and reapportionment of the resulting money throughout the rest of the indexes.^g

Post-Divestment Performance

Florida continues to track the performance of its tobacco-free fund, which uses the benchmark of the Wilshire 2500 Ex-Tobacco. As of March 2000, the fund has seen an increase of 46 basis points versus the tobacco-inclusive Wilshire 2500.^h The Florida fund contains approximately \$100 billion of which the domestic equities portfolio is approximately \$58 billion. Based on those figures, the fund roughly increased an estimate of approximately \$267 million over the last three years due to tobacco divestment. The commission costs of divestment totaled \$1.75 million, and the estimated market impact costs totaled \$4.79 million.ⁱ Florida has not only paid for the cost of divestment but also reaped a significant reward.

^g INVESTOR RESPONSIBILITY RESEARCH CTR., TOBACCO DIVESTMENT AND FIDUCIARY RESPONSIBILITY: A LEGAL AND FINANCIAL ANALYSIS D-9 (Douglas G. Cogan ed., 2000) [hereinafter IRRC].

^h Personal Communication with James Francis, Chief Economist, Fla. State Bd. of Admin. (May 11, 2000). Performance figures are since inception of tobacco-free portfolio.

ⁱ IRRC *supra* note g, at D:9–10.

B. TARGET LOCAL GOVERNMENTS AND STATE AGENCIES:

BACKGROUND RESEARCH

Two questions need answers before starting a local divestment campaign:

- Which city, county, or state agency funds have been invested in the tobacco industry? State and local governments can hold tobacco stocks or bonds in several ways—through pension plans, short-term accounts, or foundations. Learning which pool of tax dollars are invested in the tobacco industry will identify the target of a divestment campaign. See Fact Sheet 3 at the end of this chapter for basic information about the financial markets, including tobacco industry stock.
- Who controls those funds? Because of strict investment guidelines, many local governments do not own or control tobacco holdings. Sorting out which local governments to target with a divestment campaign is therefore an important first step.²

I. Public Pension Funds

Government employee pension plans are the main, but not exclusive, target for tobacco divestment in California. These pension plans are professionally man-

² See Chapter 4 for more in-depth information regarding government investments.

aged investments on behalf of government employees. Upon retirement or disability, the pension plan pays a prescribed amount of money to the employee each month. The pension plans are governed by a retirement board which has appointed and/or elected members.

California has three large statewide pension plans. The largest is the California Public Employees' Retirement System (CalPERS), which covers both state employees, many local

government employees, and employees of the California State University System. The second largest plan is the California State Teachers' Retirement System (CalSTRS), which covers most schoolteachers in California. The third largest plan is the University of California Retirement Plan (UCRP), which covers most employees at the various UC campuses and the three national laboratories that the University manages (at Berkeley, Livermore, and Los Alamos in New Mexico). Most of the other substantial public pension plans in California are county and city plans that cover the employees of those jurisdictions.

Most government investments in the tobacco industry lie in pension plans. CalPERS has over \$600 million in tobacco holdings.³ A local government contracting with CalPERS does not have direct control over those funds. Therefore, the goal of a divestment campaign in such a locality is to pass a resolution urging CalPERS to divest its tobacco holdings. The Cities of Oakland and El Cerrito have approved such resolutions.⁴

Public school instructors who teach kindergarten through community college are part of CalSTRS. As of November 30, 1999, the total market value of the CalSTRS fund was about \$105 billion. CalSTRS manages a retirement plan for about 448,000 current and 158,000 retired public school teachers and other beneficiaries. On June 7, 2000, CalSTRS voted to divest \$238 million of tobacco

COUNTIES THAT CONTRACT WITH CALPERS

Alpine, Amador, Butte, Calaveras, Colusa, Del Norte, El Dorado, Glenn, Humboldt, Inyo, Kings, Lake, Lassen, Madera, Mariposa, Modoc, Mono, Monterey, Napa, Nevada, Placer, Plumas, Riverside, San Benito, San Francisco, Santa Clara, Santa Cruz, Shasta, Sierra, Siskiyou, Solano, Sutter, Tehama, Trinity, Tuolumne, Yolo, Yuba.

Source: <<http://www.calpers.ca.gov/employer/agylists/colist.htm>>

CITIES THAT CONTRACT WITH CALPERS

Hundreds of cities contract with CalPERS including Alameda, Bakersfield, Burbank, Burlingame, Fremont, Malibu, Oakland, Redding, and San Jose.

Source: <<http://www.calpers.ca.gov/employer/agylists/citylist.htm>>

³ See Andrew LePage, *CALPERS Delays Action on Tobacco Stocks Bill*, SACRAMENTO BEE, Apr. 18, 2000.

⁴ See City Council Res. No. 74074 (Oakland, Cal., 1998); City Council Action, (El Cerrito, Cal., 1998).

stocks in its passively held investments. They divested from both domestic and international stocks.⁵

The University of California has not invested recently in the tobacco industry through its endowment funds, pension plan (UCRP), or its defined contribution (403(b)) funds.⁶ While there has been no official screening out of tobacco stocks and bonds, the

University of California has avoided these investments. Unfortunately, under a new asset allocation plan adopted by the University Regents, the University of California could acquire tobacco investments. The plan makes the Russell 3000 index the new benchmark for the university.⁷ That index usually contains stock in tobacco companies such as Philip Morris.⁸

Large counties and cities often control their own retirement systems independently from CalPERS. The goal of a divestment campaign in these communities is for the retirement board to pass a resolution to divest all of their tobacco holdings and prohibit future investments in the tobacco industry. For example, the San Francisco City and County Employees' Retirement System divested in April 1998,⁹ and the Contra Costa County Employees' Retirement Association divested its tobacco holdings in March 2000.¹⁰

If a city or county has an independent retirement plan, inquire if the plan has any tobacco investments. Since public retirement plans are made up of tax dollars, information regarding their investments is public. Anyone can request this information by contacting the retirement plan, preferably by a formal letter and a follow-up call. If that route proves difficult, there are many other avenues to obtain

COUNTY RETIREMENT SYSTEMS

Alameda, Contra Costa, Fresno, Imperial, Kern, Los Angeles, Marin, Mendocino, Merced, Orange, Sacramento, San Bernardino, San Diego, San Joaquin, San Mateo, Santa Barbara, Sonoma, Stanislaus, Tulare, Ventura

CITY RETIREMENT SYSTEMS

Sacramento, San Diego, San Francisco, San Jose, Los Angeles

Source: <<http://www.calpers.ca.gov/benefits/bncalprs/memsvcs/reciproc/reciproc.htm>>

⁵ See Andrew LePage, *CalSTRS Letting Go of Tobacco: Fund's \$238 Million In Shares to be Shed*, SACRAMENTO BEE, June 8, 2000.

⁶ See Personal Communication from Matthew R. Scoble, Univ. of Cal. Treasurer's Office, ("As of May 12, 2000, the portfolios of the Regents of the University of California do not own any tobacco company securities.") (May 12, 2000) (on file with Technical Assistance Legal Ctr., (510) 444-8252); See *UC Regents' Portfolios, December 31, 1999* (visited May 24, 2000) <<http://www.ucop.edu/treasurer/portfolios.html>>.

⁷ See THE REGENTS OF THE UNIV. OF CAL., THE UNIVERSITY OF CALIFORNIA ASSET ALLOCATION PLAN (2000) (visited June 15, 2000), <<http://www.ucop.edu/regents/policies/asset.pdf>>.

⁸ See RUSSELL 3000 INDEX MEMBERSHIP, June 30, 1999, (visited May 24, 2000) <http://www.russell.com/us/content/russell_indexes/us_indexes/index_membership/r3000.pdf>.

⁹ See Edward Epstein, *City Fund to Sell Off Tobacco Stocks*, S. F. CHRON., Apr. 1, 1998, at A17.

¹⁰ See CONTRA COSTA EMPLOYEES' RETIREMENT ASS'N, RESOLUTION TO DIVEST FROM TOBACCO (2000).

the information including city treasurers, elected officials, public employees, or CRPI.¹¹ CRPI can also help analyze any investment information.

2. Short-Term Investments

Cities and counties also hold large amounts of money in other accounts for more short-term expenses such as payroll, public works, and other public purposes. These short-term funds may include payments from the Master Settlement Agreement (MSA) negotiated in November 1998 with major tobacco companies.

Many cities and counties deposit their money needed for short-term expenses in the Local Agency Investment Fund (LAIF), which is in the Pooled Money Investment Account (PMIA), operated by the State of California. In December 1999, California State Treasurer Phil Angelides, placed a moratorium on investments in tobacco companies in the PMIA.¹²

Other cities and counties manage their own short-term money. County boards of supervisors and city councils supervise these funds. Any resolution to place a tobacco screen on local investments must be approved by those elected officials. Like the PMIA, this short-term money is often invested in commercial paper. The City of Oakland passed a resolution in 1998 to exclude such investments in tobacco companies.¹³

3. Proposition 10 Funds

Proposition 10 was enacted by the voters of California in November 1998. It created the California Children and Families First Program that funds early childhood development programs from a 50 cents per pack increase in state excise taxes on tobacco products. Many county Proposition 10 commissions are planning to invest some of these tax dollars. Conceivably, they could be invested in the tobacco industry. The Alameda County Children and Families Commission has already proposed that none of its funds be invested in the tobacco industry.¹⁴

Each California county has its own commission to administer Proposition 10 monies. These commissions consist of elected officials, public health officials, and others.¹⁵ The commissions are responsible for creating guidelines for their county, including how Proposition 10 funds will be handled. Any proposal to place a tobacco screen on Proposition 10 funds must be approved by these commissions.

¹¹ See *supra* note 1.

¹² See *California Treasurer Favors Selling Off Tobacco Stocks*, S. F. CHRON., Dec. 25, 1999.

¹³ City Council Res. No. 74074 (Oakland, Cal., 1998).

¹⁴ ALAMEDA COUNTY CHILDREN AND FAMILIES COMM'N, EVERY CHILD COUNTS STRATEGIC PLAN 42 (1999) (visited June 15, 2000) <<http://www.ackids.org/strategicplan.pdf>>.

¹⁵ See CAL. LEGIS. ANALYST'S OFFICE, PROPOSITION 10: HOW DOES IT WORK? 4 (1999) (visited June 15, 2000) <http://www.lao.ca.gov/011399_prop10.html>.

CASE STUDY: TOBACCO DIVESTMENT IN MASSACHUSETTS

Background

After two years in legislative limbo, on October 15, 1997, Massachusetts Governor Paul Cellucci signed into law tobacco divestment legislation. A diverse coalition of public health organizations lobbied for the legislation, spearheaded by the Massachusetts Legislative Tobacco Control Caucus.

Unlike many other fiduciaries, Massachusetts unashamedly pursued divestment purely for public health reasons without regard to the financial reasons. Massachusetts Treasurer Joe Malone stated, "There are some things more important than making money and one of them is protecting the health and well-being of our citizens, particularly our children. Divestment is the only way to get tobacco companies to finally wake up to the fact that they sell a dangerous product."^a

Divestment Action

The legislation mandated that the state make no new investments in tobacco and divest within three years its current holdings in companies that derived more than 15 percent of revenue from tobacco sales.^b Massachusetts divested from both domestic and international tobacco companies. In December 1997, the Public Employee Retirement Administration Commission (PERAC) decided that commingled funds (pooled money accounts similar to a mutual fund) made up of many investments were not subject to divestment unless 15 percent or more of the pooled fund's value was held in tobacco.^c Because of this caveat, Massachusetts did not divest from a commingled emerging markets fund because their tobacco holdings totaled only 3.6 percent of their total holdings in the fund. At the time the legislation was signed into law, Massachusetts held about \$268 million in actively managed tobacco holdings, representing 1.3 percent of the total fund. The state sold all securities subject to Massachusetts' divestment law within three months of the governor signing the divestment legislation into law.^d

Post-Divestment Performance

Massachusetts has tracked the performance of its tobacco-free portfolio compared to a similar benchmark with tobacco. For the one year ending March 31, 2000, Massachusetts' Custom S&P 500 Ex Tobacco outperformed the regular S&P 500 by 0.34 percentage points. (S&P Ex Tobacco produced an 18.28% annual return versus the regular S&P 500 of 17.94%.)^e

^a The Commonwealth of Massachusetts, Executive Department, Press Release, *Cellucci Signs First-in-Nation Tobacco Divestiture Bill*, Oct. 15, 1997 (on file with Council for Responsible Public Investment, (510) 208-0400).

^b See MASS. GEN. LAWS ANN. ch. 32 §23 (2A) (h) (West 2000).

^c Memorandum from Robert F. Stalnaker, Executive Director, Pub. Employees Retirement Admin. Comm'n, to All Retirement Boards (Dec. 18, 1997) (on file with Council for Responsible Public Investment, (510) 208-0400).

^d INVESTOR RESPONSIBILITY RESEARCH CTR., TOBACCO DIVESTMENT AND FIDUCIARY RESPONSIBILITY: A LEGAL AND FINANCIAL ANALYSIS D-II (Douglas G. Cogan ed., 2000).

^e MASS. PENSION RESERVES INV. TRUST, QUARTERLY INDEX SUMMARY RATES OF RETURN FOR PERIOD ENDING MARCH 31, 2000) (on file with Council for Responsible Public Investment, (510) 208-0400).

4. Pension Funds Controlled by Employees

Public employers generally offer a defined contribution plan that permits employees to direct the investment of their individualized retirement account. Typically, these pension monies are put in a money market, bond, or mutual fund, or in some combination of these investment options. The investment firms that manage these options are selected by the employer.

Tobacco divestment advocates ask that at least one, and preferably several, of the investment options are tobacco-free. This goal may be achieved by offering employees access to one or more “socially screened” mutual funds. Although such options are invariably tobacco-free, they often screen for other criteria of social responsibility as well. Appendix B provides information regarding several defined contribution plans in California which offer social screens on investment opportunities.

C. WHAT IS A TOBACCO COMPANY

Setting policy on how to define a tobacco company will determine the breadth and depth of the ultimate divestment action. Divestment could affect all holdings or just domestic companies, and passively as well as actively managed funds. The language of the divestment resolution or ordinance should be carefully worded to specify the intent of the board to cut ties to the tobacco industry and affiliated companies.

Financial managers must identify the specific stocks in an overall portfolio that would have to be sold and avoided in future stock purchases. The Investor Responsibility Research Center (IRRC) provides updated information on the multitude of companies that have connection to the tobacco industry.¹⁶ Appendix C provides selected excerpts from this document with information on several of the largest tobacco companies. Fund managers should consult the Investor Responsibility Research Center (IRRC) and/or other similar resources prior to drafting an ordinance requiring divestment and while implementing a divestment decision.

Defining a tobacco company is explained in Fact Sheet 4 which also provides examples of communities that have employed various definitions in their divestment action. A retirement board may choose any combination of the definitions to achieve the scope of divestment deemed appropriate for that fund. “Tobacco Divestment and Fiduciary Responsibility: A Legal and Financial Analysis,” also published by IRRC, further details the scope of and rationale for the major government divestment actions to date.¹⁷

¹⁶ See AMY WILSON & JAN DEGGER, INVESTOR RESPONSIBILITY RESEARCH CTR., *THE TOBACCO INDUSTRY: PROFILES OF DOMESTIC AND INTERNATIONAL PUBLICLY TRADED TOBACCO COMPANIES* (9th ed. 2000). For subscription information call (202) 833-0700 or visit the IRRC website at <<http://www.irrc.org>>.

¹⁷ INVESTOR RESPONSIBILITY RESEARCH CTR., *TOBACCO DIVESTMENT AND FIDUCIARY RESPONSIBILITY: A LEGAL AND FINANCIAL ANALYSIS* (Douglas G. Cogan ed., 2000) [hereinafter IRRC].

D. ORGANIZE THE COMMUNITY

After learning what tobacco holdings a county or city owns and deciding upon a policy goal, the next step is to build a coalition in support of a tobacco divestment campaign.

Tobacco divestment campaigns are often started by local public health coalitions. These issues are usually new to them, and a successful divestment campaign requires some education. A glossary of terms and frequently asked questions that can be used when training tobacco control activists about divestment can be found in Fact Sheets 5 and 6. Invite speakers from other successful divestment campaigns, socially responsible financial professionals, or financial officers from cities or counties that have already divested from tobacco to help a community get started. CRPI can help in finding those speakers.

Tobacco divestment campaigns create opportunities to work with new allies in addition to the traditional friends of tobacco control. New allies may include unions, educational institutions and organizations, investment professionals, and faith-based groups. For instance:

- The United Teachers of Los Angeles (UTLA) spearheaded the tobacco divestment campaign with the California State Teachers' Retirement System.¹⁸ UTLA's leadership brought even larger teachers' unions on board, such as the California Teachers' Association and the California Federation of Teachers.¹⁹ Many school districts are also now involved, including the Unified School Districts of San Francisco, Los Angeles, and Sacramento.
- Many socially responsible investment firms provide in-depth financial analysis and investment options to communities seeking to divest funds and reinvest in tobacco-free investments.
- Faith-based groups like the Interfaith Center for Corporate Responsibility have experience in organizing shareholder actions and divestment actions. CRPI can help in reaching out to members of these groups.

After building a community coalition, the next step is to find an elected official or retirement board member who will become a champion for tobacco divestment. Look first to the tobacco control allies at the city council or board of supervisor levels. These same elected officials may sit on the local retirement board, or they will know retirement board members who may be sympathetic to tobacco divestment.

With these leaders, determine the positions of the other decision makers. Identify the most skeptical or sympathetic to the proposals, and those who may be sitting on the

¹⁸ See Doug Smith, *L.A. Teachers Want Pension Fund to Dump Tobacco Stocks*, L.A. TIMES, Nov. 3, 1999, at B3.

¹⁹ See *California and the West: Fund Urged to Dump Tobacco Stock*, L.A. TIMES, Feb. 11, 2000, at A3.

CASE STUDY: TOBACCO DIVESTMENT IN SAN FRANCISCO

Background

After a protracted battle of wills between the San Francisco City and County Board of Supervisors and the San Francisco Employees' Retirement System (SFERS), the SFERS board voted on March 31, 1998, to divest from US-based companies involved in the production of tobacco products. The issue of tobacco divestment was first proposed in 1993 by Supervisor Angela Alioto, but did not pass until three years later. In 1996, the San Francisco Board of Supervisors passed a divestment resolution, again proposed by Supervisor Alioto, urging the retirement board to take up tobacco divestment. But the retirement board voted five-to-one against divestment. In February 1998, the Board of Supervisors again passed a divestment resolution calling on the retirement board to honor the 1996 resolution. After much pressure from the Board of Supervisors and public health advocates, the retirement board voted four-to-two in favor of divestment in March 1998.^a

Prior to the retirement board's vote, the staff at SFERS engaged in the requisite due diligence according to SFERS' social investment policy guidelines.^b SFERS previously had classified tobacco as a Level I issue which meant that it would engage in some monitoring of the industry and shareholder activism. The financial staff disagreed with promoting tobacco to Level III, which required divestment. The staff stated, however, that it was the board's prerogative to go against the staff recommendation. The board exercised that prerogative with its vote to divest.^c

Divestment Action

SFERS divested tobacco holdings from six domestic portfolios, including two index portfolios (an S&P 500 and a Russell 1000). SFERS divested its shares of Philip Morris, RJR Tobacco Holdings, Loews, and US Tobacco. SFERS held about \$16 million in tobacco holdings, or about .18 percent of the total assets of the fund.

Post-Divestment Performance

In August 1999, SFERS staff issued an annual report on its tobacco stock divestment. The report showed tobacco divestment had had a modest positive impact on the portfolio for the year: the tobacco-free portfolio was worth \$4.9 million more than the old portfolio that had included tobacco.^d

^a Edward Epstein, *S.F. Retirement Fund Votes to Sell Off Tobacco Stocks*, S. F. CHRON., Apr. 2, 1998, at A-3.

^b See *infra* Appendix D.

^c SFERS Staff Memorandum, Mar. 31, 1998 (on file with Council for Responsible Public Investment, (510) 208-0400).

^d SFERS, ANNUAL REPORT ON TOBACCO STOCK DIVESTMENT, August 31, 1999 (on file with Council for Responsible Public Investment, (510) 208-0400).

fence. The coalition and/or related allies need to meet with and educate them about tobacco divestment.

Finally, use the media to build general public support for divestment. Offer opinion pieces and letters to the editor to local newspapers. Examples are provided in Fact Sheets 7 and 8. Organize a press conference highlighting the amount of money invested by the local government in tobacco compared to the amount of money that is spent on tobacco control. Inform the media of the dozens of communities throughout California and the nation who have called for tobacco divestment. A sampling of divestment policies and resolutions is provided in Appendix D.

E. PREPARE FOR OPPOSITION: DEALING WITH ARGUMENTS AGAINST DIVESTMENT

Some retirement boards are reluctant to take advice from outsiders. Their most common objections are presented below with counterarguments for each.

ARGUMENT ONE: TOBACCO DIVESTMENT LEADS TO A “SLIPPERY SLOPE”

Board members may oppose tobacco divestment because it introduces social or moral decision-making into what they argue should be purely financial decisions. There is concern that if a retirement board divests from tobacco stock, it may be forced to consider many different shareholder actions or divestment requests that come from proponents of other social or political causes (such as unfair or child labor practices, gun manufacturing, etc.) which could detract from the day-to-day responsibilities of the retirement board.

RESPONSES TO THE SLIPPERY SLOPE ARGUMENT

Retirement boards can establish policies to guide their investment decisions. Retirement boards are empowered to make decisions about how to invest fund assets. Some boards, such as the California State Teachers’ Retirement System (CalSTRS)²⁰ and the San Francisco Employees’ Retirement System (SFERS),²¹ have established policy guidelines for deciding which non-financial considerations will guide their investment decisions. CalSTRS also has adopted a financial policy

²⁰ CALSTRS SUBCOMM. ON CORPORATE GOVERNANCE-ITEM 4, CALIFORNIA STATE TEACHERS’ RETIREMENT SYSTEM STATEMENT OF INVESTMENT RESPONSIBILITY (1999) (on file with Technical Assistance Legal Ctr., (510) 444-8252).

²¹ See Memorandum from the San Francisco City and County Employees’ Retirement Sys. Inv. Div. to the Members of the Retirement Bd. (Mar. 31, 1998) (on file with Technical Assistance Legal Ctr., (510) 444-8252). The Board’s Social Investment Policy for tobacco stocks is based on a three tier system. Level I, the current policy, relies on the exercise of voting rights to support initiatives which are proactive concerning issues of social concern. Level II calls for actively expressing concerns, dialogue with corporation managers, joining with other shareholders to create resolutions and soliciting support on proxy votes jointly determined to be reasonable. Level III sets restrictions on investment activities and reserves divestment of tobacco holdings for when Level I and Level II policies do not adequately address the investment concerns of shareholders.

regarding which stocks to exclude in its benchmark for passive investments.²² This policy led CalSTRS to divest its passively held funds from its passively held tobacco stocks.²³ Other boards have implemented tobacco divestment in conjunction with specific findings regarding public health concerns and financial uncertainty of the investment. Either a pre-existing policy or specific findings accompanying a divestment action can be used later to distinguish why the board took a particular action to divest, and/or why a new divestment request is or is not being taken.

Tobacco products are uniquely deadly, and the industry is distinctly unethical. Once a board recognizes that it has the power to draw the line on divestment requests, the question remains whether tobacco divestment is warranted. Chapter 5, Public Health Rationale for Divestment, illustrates the unique toll placed on human life and well-being by tobacco products, the addictiveness of the product, the fact that the industry historically has marketed to children, and the duplicity of the industry in obscuring scientific facts and moral debates.²⁴

These problems, coupled with the uncertainty associated with regulation and litigation risks, have led many board members to endorse divestment from tobacco companies even if they generally do not support such an action for other reasons.

Shareholder resolutions generally have not been effective. Some skeptics may want to side-step divestment by sponsoring shareholder resolutions that call upon tobacco companies to change their practices.²⁵ Unfortunately, past efforts of this sort have been fruitless, and those who have participated in the shareholder resolution effort believe that obtaining the approval of such resolutions by tobacco company shareholders is unlikely for now.²⁶ For example, the state treasurer of Massachusetts, Joseph Malone, had been opposed to divestment. He eventually became an avid supporter in part because shareholder resolutions proved to be ineffectual. At a legislative hearing on divestment Malone testified, “Unfortunately, the shareholder resolutions that we supported to get the companies to act more responsibly were all defeated, and our letters to management went unanswered.”²⁷

²² See TEACHERS’ RETIREMENT BD. INV. COMM., BENCHMARK POLICY ACTION (2000). This policy excludes stocks of industry sectors that have exposures to product liability judgments, significant threat of industry-wide bankruptcy filings, the potential for regulatory or legislative action that could substantially impair industry earnings, and have been targets of divestment by institutional investors (on file with Technical Assistance Legal Ctr., (510) 444-8252).

²³ See LePage *supra* note 5.

²⁴ See *infra* Chap. 5.

²⁵ One example of this sort of resolution asks the tobacco company to do more to reduce youth smoking and to agree to voluntary penalties if its effort fails; another example asks the tobacco company to change its marketing efforts so as to make cigarettes less attractive to minors.

²⁶ See Dow Jones News Serv., *Reynolds Opposes Shareholder Proposals to Curb Youth Smoking* (Mar. 14, 2000) (on file with Technical Assistance Legal Ctr., (510) 444-8252); *CalPERS Challenge Fails at Philip Morris*, SAN JOSE MERCURY NEWS, Apr. 28, 1995; Catherine Wilson, *Priest: Tobacco Companies Have Consistently Opposed Change*, AP NEWS SERVICE, June 1, 2000, (on file with Technical Assistance Legal Ctr., (510) 444-8252).

²⁷ IRRC *supra* note 17, at B-39.

ARGUMENT TWO: TOBACCO DIVESTMENT IS ILLEGAL

Another common argument against tobacco divestment is that making financial decisions based on anything other than financial criteria is a violation of the legal duty that each board member owes to the beneficiaries. This argument holds that since the California Constitution demands that board decisions be made “solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries,”²⁸ that tobacco divestment is not allowed since it does not pass the “exclusive purpose” test. Therefore, if the board votes to divest, they could be sued and may be forced to pay for damages out of their own pockets.

RESPONSES TO THE ILLEGALITY ARGUMENT

Divestment from tobacco is legal. It is legal for public pension funds and other public bodies to divest from tobacco so long as the retirement board members faithfully carry out their fiduciary duties as trustees. The first duty of trustees of pension plans is to act in the sole interest and for the exclusive purpose of providing benefits to plan beneficiaries.²⁹ This means that the trustees may not sacrifice financial return for the sake of tobacco divestment. Similar duties apply to public officials managing short-term funds, public endowments, etc. The California Constitution and other California laws recognize that financial decisions can be made “in the public interest” so long as they are made without compromising the duties to the beneficiaries to protect the fund’s investments.³⁰

But where financial returns are judged to be generally equivalent, trustees are permitted to make choices among options. That is, they are free to make investments in pursuit of other social values, provided that those investments promise generally equivalent returns. Of course, if trustees believe that tobacco stocks are unduly risky and financially unwise for their fund to hold, they are justified in ordering their sale, quite apart from considerations of socially responsible investing. (For further discussion of the legal considerations surrounding tobacco divestment, see Chapter 3, Legal Standards of Tobacco Divestment. In addition, TALC is available to work with communities who wish to explore pertinent legal issues in more depth.)³¹

Courts have upheld divestment actions. Courts in jurisdictions outside California have upheld divestment actions of pension funds. Maryland’s highest court upheld an ordinance of the City of Baltimore that required employee pension funds to divest from companies doing business in South Africa even though the fund would divest from more than 40 percent of the Standard and Poor’s 500 Index (S&P

²⁸ CAL. CONST. art. XVI, § 17(d).

²⁹ See *id.*

³⁰ CAL. CONST. art. XVI, § 17(g) (“The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.”).

³¹ See *supra* note I.

500).³² Similarly, a federal appeals court upheld a retirement board's decision to lend retirement fund money to employees covered by the fund at mortgage rates that were less than the prevailing rates in the community.³³

If board members adhere to their fiduciary duties, they should not be personally liable for any losses. Courts will strike down retirement board action that involves a board member personally benefiting from a board decision. So long as board members act within their fiduciary duties—i.e., they do not personally benefit and they make reasoned decisions supported by valid research—courts have upheld board action even if the decision, seemingly a good one at the time, was proved to be financially detrimental in hindsight. Furthermore, state statutes offer protection from liability to board members who act within the scope of their duties.³⁴

ARGUMENT THREE: TOBACCO DIVESTMENT IS TOO COSTLY

Another concern of divestment skeptics is that it will create new costs to the pension fund. These new costs could arise in three ways: increased transaction costs, less diversification, and lost investment revenues.

RESPONSES TO COSTLINESS ARGUMENT

Public pension plans may be “actively” or “passively” managed, usually a combination of the two. In the actively managed portion of their funds, board members (or, more likely, the financial managers the trustees have hired) may conclude that tobacco stocks are a good investment and will include these stocks in their portfolio. Most plans also passively manage a portion of their funds by investing in a wide range of companies that are part of an index such as the S&P 500. The goal of passive investment is to hold a diversified portfolio that rises and falls with the stock market as a whole as reflected in the index. The pension fund would own tobacco stocks if those companies happened to be included in the selected index. (For further discussion of pension plans and stock market terms, see Fact Sheet 3).

Diversification can be achieved without tobacco. It is true that removing stocks from passive indexes is not the norm. In practice however, achieving this outcome usually will be easy. If the pension plan has created its own index fund comprised of all the stocks making up the S&P 500, the plan can sell the stock of the three tobacco companies that are in that index, and from then on simply passively hold

³² See *Board of Trustees v. Baltimore*, 317 Md. 72, 562 A.2d 720 (1989).

³³ See *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986). The court cited several factors that weighed in favor of upholding the mortgage lending rates, including: the trustees consulted professionals including lawyers, accountants, actuaries, and mortgage bankers in developing the program; the interest rates were at a higher rate of return than any of the assets in the other 90 percent of the fund's portfolio; and the interest rates were in excess of the fund's actuarial and funding requirements.

³⁴ See CAL. GOV'T. CODE § 820.2 (West 1995) (“Except as otherwise provided by statute, a public employee is not liable for an injury resulting from his act or omission where the act or omission was the result of the exercise of the discretion vested in him, whether or not such discretion be abused.”).

an index designated as the S&P 497 (or the S&P 500 Ex-Tobacco). CalSTRS has done this with a modified Russell 3000 index fund.³⁵ This strategy still provides sufficient diversification and hence lowered risk, as well as the low administrative expenses that come with passive investment. If tobacco stocks ultimately do worse than the rest of the S&P 500, the fund will actually be better off having divested. If the pension plan invests in a fixed index rather than creating its own, the plan should investigate new tobacco-free indexes being marketed to government investors by some of the largest investment management firms.

Furthermore, because the tobacco companies currently comprise such a tiny share of the overall value of the S&P 500, it is extremely unlikely that the return from the S&P 497 will significantly differ from the S&P 500 regardless of how tobacco stocks do in the future.

Incremental selling can minimize costs. Pension funds that gradually divest from tobacco stocks will be successful in minimizing or avoiding transaction costs. Selling a large block of stock in a short period of time can negatively impact a stock's market value, resulting in a potential loss of funds for the portfolio. This is typical supply and demand: if a product is scarce, its value increases; if a product is abundant—as can be the case when large stock holdings are sold quickly—its value decreases.

To avoid this, fund managers can sell the tobacco holdings slowly, so as not to glut the market and decrease the value of the stock. Incremental selling of tobacco stock is the best strategy to protect the assets of the fund. Stocks can be sold selectively so that those with highest priority are sold first, and tobacco holdings are sold at a time that is most cost-effective for the fund.

A divestment resolution or ordinance adopted by a retirement board should direct financial managers to divest within a certain time frame. For example, California's South Africa divestment law set forth a period of several years by the end of which divestment should be completed.³⁶ Likewise, Massachusetts required that its tobacco holdings be sold within a three-year period. The executive director of the retirement board instructed fund managers to sell all tobacco-related holdings subject to the divestment law "as quickly and prudently as practicable" within the three-year period.³⁷ The managers were given discretion as to how and when the stocks would be sold, with the proviso that they not delay the sale unless they could make a compelling case for doing so. In fact, all of the state's tobacco-related holdings subject to the divestment law were sold within three months of the governor signing the law.³⁸

³⁵ See *supra* notes 8, 22.

³⁶ See CAL. GOV'T. CODE § 16644, added by Stats. 1986, c. 1254, section 2; repealed by Stats. 1994, c. 30 (S.B. 1285), § 4, effective March 30, 1994; Stats. 1994, c. 31 (A.B. 2448) § 4, effective March 30, 1994; recodified as CAL. GOV'T. CODE § 16640 (West 1995).

³⁷ See IRRC *supra* note 17, at D-II.

³⁸ See *id.* at D-I2.

Cross-trading can nearly eliminate costs. Pension funds regularly incur transaction costs based on how often they buy and sell stock. However, if the shares are cross-traded with other portfolios under an investment manager's control, the market impact and transaction costs can be reduced to practically zero.³⁹

Negotiate no- or low-cost swap of index funds into tobacco-free funds. To handle the problems associated with divesting from passively managed funds, some in-house fund managers have negotiated special terms with the managers of the indexed funds. For example, the State of Texas negotiated with Barclays Global Investors (BGI) to create a passive fund that mimicked the standard passive index except for tobacco holdings. BGI allowed the Texas Permanent School Fund (and offered the same to the State of Washington) to transfer their passive holdings to the new tobacco-free accounts at no cost.⁴⁰ BGI offers institutional investors a series of tobacco-free indexes in which to place passively managed funds.⁴¹

ARGUMENT 4: RETIREMENT BOARDS MUST FOLLOW THE ADVICE OF THE FINANCIAL ANALYSTS

Retirement board members who are used to following the advice of their financial analysts may be disinclined to make an exception if their analysts believe that it would be imprudent to divest.

RESPONSES TO ALWAYS FOLLOWING ANALYSTS' ADVICE

Financial analysts are not always right. Recently, stock analysts have been analyzing not only the financial outlook of the tobacco companies but also the legal, legislative, and regulatory outlook. Analysts know a great deal about markets, production costs, management strengths, and the other factors that typically go into determining how good a company is, its future prospects, and hence the value of its stock. However, for tobacco companies, these analysts also have to be able to predict the litigation and regulatory future of an industry in an unprecedented political environment. Even seasoned litigators and expert legal analysts have been unable to accurately predict the outcomes of trials or legislative action. Financial analysts do not necessarily have special expertise that would make them any more skilled than others at making these sorts of predictions. Indeed, over the past few years leading investment advisors have been quite wrong in what they predicted about the risks faced by the industry. A comparison of analysts' predictions and the actual performance of Philip Morris stock is provided in Fact Sheet 9.

³⁹ See *id.* at A-7, D-7.

⁴⁰ See *id.* at B-19, B-41.

⁴¹ See BARCLAYS GLOBAL INVESTORS (BGI), TRANSITION SERVICES (visited May 22, 2000) <<http://www.barclaysglobal.com/siteinfo/map/us/customservices>>.

The fiduciary duty may require independent judgment. Retirement board members are encouraged to conduct a due diligence inquiry by seeking the counsel of skilled financial and other advisors. But, even after the inquiry, the trustees retain a nondelegable duty to act in what they believe to be the best interest of the beneficiaries regardless of the opinion of financial advisors. Therefore, if a trustee is concerned that the advice offered by financial advisors may be incomplete, misinformed, or potentially unsound, the trustee has a duty to investigate further and form an independent decision on the prudent and proper course of action under the circumstances.

ARGUMENT FIVE: TOBACCO STOCKS ARE A GOOD INVESTMENT, ESPECIALLY WHEN THE PRICE IS LOW

Some note that tobacco stocks, and in particular the stock of Philip Morris, maker of Marlboro cigarettes, were a good financial investment for most of the 1970s, 1980s, and 1990s. Because the tobacco industry has good fundamentals (i.e., it is a well-capitalized industry with a strong potential for international growth and a secure market due to the addictive nature of the products), some believe tobacco stocks will rebound to their historically high value. They may argue that because tobacco stocks have performed so well historically, now is a good time to buy the stocks while the price is low, or at least to hold onto the investment to benefit from the future rebound in value.

RESPONSE TO GOOD INVESTMENT ARGUMENT

Tobacco stock likely will remain volatile for the foreseeable future. Investment managers who currently hold tobacco stocks made what now appears to be a very poor investment decision. Most tobacco companies have lost significant share value since mid-1999 (typically in excess of 50 percent) in an otherwise strongly upward market. In other words, those who divested from tobacco in 1997 or 1998 are probably better off financially for having done so. Indeed, the Maryland treasurer's office began reinvesting in tobacco in March 1999 after the Master Settlement Agreement between tobacco manufacturers and forty-six states was signed because the treasurer assumed the stock would rebound after settlement of that major litigation risk.⁴² Maryland's pension fund reentered the tobacco market just as the value of tobacco stock suffered its largest loss in history. Such risks remain for current and future investors.

No one predicts a quick end to the industry's troubles. The public health community is steadfast in its organized resistance to the industry, the *Engle* class action case may

⁴²E-mail from Douglas Cogan, Director, IRRRC Tobacco Information Service, Investor Responsibility Research Ctr. (May 16, 2000) (on file with Council for Responsible Public Investment, (510) 208-0400) ("Maryland's trustees voted to go back into tobacco stocks in March 1999, mainly as a result of the Master Settlement Agreement. The investments are almost entirely on the passive side and account for less than 1/2 of 1% of portfolio holdings.").

take years to resolve,⁴³ private litigants have been successful, and the legislative and regulatory environment remains uncertain. Many believe it is prudent to divest from tobacco to not only maximize the interests of beneficiaries, but to do the morally right thing in support of the public's health and well-being.

III. CONCLUSION

Divestment campaigns appeal to government workers, teachers, parents, taxpayers, and students—anyone with a stake in a system invested in tobacco stock. Because divestment campaigns are a new strategy, they can mobilize new areas of the community to work on tobacco control issues. CRPI and TALC provide resources to any California community wishing to look at how their government agencies are financially supporting tobacco companies.

⁴³ See *Engle v. R.J. Reynolds Tobacco Co.*, No. 94-08273 CA-22, (Fla. Cir., Dade Co.).