Agenda Item 10
December 6, 2016
Public Hearing

MEMORANDUM

December 2, 2016

TO: County Council

FROM: Robert H. Drummer, Senior Legislative Attorney

SUBJECT: **Public Hearing:** Bill 44-16, Retirement – Fossil Fuel Investments – Restrictions

Bill 44-16, Retirement – Fossil Fuel Investments - Restrictions, sponsored by Lead Sponsors Council Vice President Berliner and Councilmember Navarro and Co-Sponsor Councilmember Elrich, was introduced on October 25, 2016. A Government Operations and Fiscal Policy (GO) Committee worksession is tentatively scheduled for January 26, 2017 at 10:30 a.m.

Bill 44-16 would restrict the Board of Investment Trustees and the Consolidated Retiree Health Benefits Trust Board of Trustees from investing in certain businesses holding the largest amount of fossil fuel reserves under certain circumstances. The Bill would also require both Boards to research and adopt a socially responsible policy for investing.

Background

The Board of Investment Trustees (BIT) manages prudent investment programs for the trust fund established to pay retirement benefits guaranteed under the Employees' Retirement Plans. The Consolidated Retiree Health Benefits Trust Board of Trustees (CRHBT) Board is responsible for investing the funds designated to pay for all or a portion of benefits provided under the County retiree benefit plans or a County-funded agency retiree benefit plan, such as retiree health insurance.

Bill 44-16 would be the third time the County enacted a law requiring the BIT to sell certain types of investments to further important government objectives. In 1986, the Council, in Bill 23-86, restricted certain investments in companies doing business in the Republic of South Africa or Namibia due to the apartheid laws mandating racial segregation in those nations. This restriction on certain investments was repealed when those nations repealed their apartheid laws. The Maryland Court of Appeals upheld a similar restriction on investments in companies doing business in the Republic of South Africa and Namibia in *Board of Trustees v. Mayor & City Council of Baltimore City,* 317 Md. 72 (1989).

In 2008, the Council, in Bill 3-08, restricted certain investments in companies doing business in Sudan in order to influence the Government of Sudan to end the atrocities in Darfur. State and local laws requiring the divestment of holdings in companies doing business in Sudan or other nations had been challenged in court on the basis of Federal preemption. The Supreme Court struck down a Massachusetts statute that required the state to boycott certain companies doing business with or in Burma in *Crosby v. National Foreign Trade Council*, 530 US 363 (2000). The Supreme Court held that the Massachusetts law was preempted by federal statutes imposing sanctions on Burma and therefore violated the Supremacy Clause of the U.S. Constitution. Similarly, the U.S. District Court in Illinois issued an injunction against the Illinois Sudan Act in *National Foreign Trade Council v. Giannoulias,* 523 F.Supp.2d 731 (N.D. Ill. 2007). The Illinois statute in question prohibited the state from depositing funds in any financial institution unless it could certify that it did not loan money to the government of Sudan or certain companies doing business in Sudan and also prohibited state and local pension funds from investing in certain companies doing business in Sudan. The Court held that this statute violated the Supremacy Clause and the Foreign Commerce Clause of the U.S. Constitution.

In response to these decisions, Congress enacted the Sudan Accountability and Divestment Act of 2007. The President signed this Act into law on December 31, 2007. The Act expressly authorizes state and local governments to divest in companies doing business in Sudan and grants investment managers who implement these laws immunity from suit under certain circumstances. The Act establishes guidelines for the state or local government to follow in taking these divestment actions. The Act also requires a state or local government to submit written notice describing a Sudan divestment law to the Attorney General of the United States within 30 days after the enactment of the law. Bill 3-08 was consistent with the guidelines for divestment laws authorized by the Sudan Accountability and Divestment Act of 2007.

Unlike the laws restricting investments in companies doing business in the Republic of South Africa or Sudan, the investment restrictions in Bill 44-16 is unrelated to any actions by a foreign government formally opposed by the United States Government. It would be the first time the Council restricted an investment in a company due to the type of business a company was engaged in.

Both the BIT and the CRHBT Board hire professional investment managers to buy and sell securities. Bill 44-16 would limit the restriction to actively managed separate accounts and would exclude investments in an index fund, private equity fund, real estate fund, mutual fund, or other commingled or passively managed fund. The Bill would define a fossil fuel company as:

> *... a company listed in the 200 publicly traded coal, oil, and gas companies that hold reported fossil fuels reserves with the largest potential carbon emissions, as ranked in the Fossil Free Indexes US (FFIUS) published by Fossil Free Indexes LLC or a successor index, as updated annually.*

The Bill would also require the Boards to divest in these companies gradually over the next 5 years and would permit the Boards to delay the sale of any individual security if necessary due to its fiduciary duty.

The Lead Sponsors, Council Vice President Berliner and Councilmember Navarro explained their reasons for introducing Bill 44-16 in ©8-9.

The County Attorney's Office (OCA) prepared a comprehensive bill review memorandum finding that Bill 44-16, as introduced, may be held unlawful for several reasons. OCA found that the Bill contains an unlawful delegation of legislative authority to a private third party by requiring the Boards to rely on a list of fossil fuel companies published by Fossil Free Indexes LLC. OCA also found that prohibiting a company to lobby government officials in order to avoid these investment restrictions would violate the company's First Amendment rights. Finally, OCA found that the provision permitting the Board to delay divestment in a company was inconsistent with the statutory fiduciary duty imposed on the Boards in other provisions of the Code. For a complete discussion of these issues, see the OCA opinion at ©10-17. OCA suggested that these legal issues could be resolved by amending the Bill. These issues will be discussed at the GO worksession scheduled for next month. Finally, the Board of Investment Trustees and the Board of Trustees for the Consolidated Retiree Health Benefits Trust adopted a resolution opposing Bill 44-16. See ©18.

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Bill No. 44-16
Concerning: Retirement – Fossil Fuel Investments - Restrictions
Revised: October 21, 2016 Draft No. 5
Introduced: October 25, 2016
Enacted: April 25, 2018
Executive:
Effective:
Sunset Date:
Ch. _____, Laws of Mont. Co.

COUNTY COUNCIL
FOR MONTGOMERY COUNTY, MARYLAND

Lead Sponsors: Council Vice President Berliner and Councilmember Navarro
Co-sponsor: Councilmember Elrich

AN ACT to:

(1) prohibit the Board of Investment Trustees and the Consolidated Retiree Health Benefits Trust Board of Trustees from investing in certain businesses holding certain amounts of fossil fuel reserves under certain circumstances;
(2) require the Boards to research and adopt a socially responsible investing policy; and
(3) generally amend the law governing the investment of funds held in trust for the employees' retirement system and the consolidated retiree health benefits trust.

By adding
Montgomery County Code
Chapter 33, Personnel and Human Resources
Section 33-60C

By amending
Montgomery County Code
Chapter 33, Personnel and Human Resources
Sections 33-61A and 33-165

Boldface	*Heading or defined term.*
Underlining	*Added to existing law by original bill.*
[Single boldface brackets]	*Deleted from existing law by original bill.*
Double underlining	*Added by amendment.*
[[Double boldface brackets]]	*Deleted from existing law or the bill by amendment.*
* * *	*Existing law unaffected by bill.*

The County Council for Montgomery County, Maryland approves the following Act:

Sec. 1. Section 33-60C is added and Sections 33-61A and 33-165 are amended as follows:

33-60C. Fossil Fuel Investments – Restrictions

(a) *Definitions.* In this Section, the following words have the meanings indicated:

Actively managed separate account means assets held in a separate account by an investment manager hired by the Boards. *Actively managed separate account* does not include an index fund, private equity fund, real estate fund, mutual fund, or other commingled or passively managed fund.

Boards means the Board of Investment Trustees established by Section 33-59 and the Consolidated Retiree Health Benefits Trust Board of Trustees established by Section 33-160.

Company means any sole proprietorship, organization, association, corporation, partnership, joint venture, limited partnership, limited liability partnership, limited liability company, or other entity or business association, including any wholly-owned subsidiary, majority-owned subsidiary, and parent company of any of them, or business association, that exists for profit-making purposes.

Divest means selling, redeeming, transferring, exchanging, or otherwise disposing of, and refraining from further buying of, certain investments.

Fossil Fuel Company means a company listed in the 200 publicly traded coal, oil, and gas companies that hold reported fossil fuels reserves with the largest potential carbon emissions, as ranked in the Fossil Free Indexes US (FFIUS) published by Fossil Free Indexes LLC or a successor index, as updated annually.

Trust funds means the assets held for the Employees' Retirement System and the assets held for the Consolidated Retiree Health Benefits Trust.

(b) *Review of investments.* Each Board must review the investment holdings in each actively managed separate account of the trust funds and identify each investment in any fossil fuel company. Each Board must review its investment holdings in these accounts periodically and update the list of fossil fuel companies at least every 6 months.

(c) *Divestment.* Except as provided in subsection (d), each Board:

(1) within 1 year after the date this law takes effect, must divest at least 20% of its investments in fossil fuel companies held in an actively managed separate account as of the date this Act takes effect:

(2) within 2 years, must divest at least 40% of its investments in fossil fuel companies held in an actively managed separate account as of the date this Act takes effect;

(3) within 3 years, must divest at least 60% of its investments in fossil fuel companies held in an actively managed separate account as of the date this Act takes effect;

(4) within 4 years, must divest at least 80% of its investments in fossil fuel companies held in an actively managed separate account as of the date this Act takes effect; and

(5) within 5 years, must divest 100% of its investments in fossil fuel companies held in an actively managed separate account; and

(6) must not make any new investment in an actively managed separate account in any fossil fuel company.

(d) *Divestment delay.* Nothing in this Section must require a Board to take action as described in this Section unless the Board determines in good faith that the action described in this Section is consistent with the fiduciary responsibilities of the Board described in Section 33-61C or Section 33-163. If the Board determines that a delay in divesting from a fossil fuel company is necessary due to its fiduciary duty, the Board must report this delay within 30 days to the Executive and the Council along with an estimated timeline for the resumption of divestment.

(e) *Research on socially responsible investing.* Each Board must:

(1) review academic and professional literature on socially responsible investing;

(2) investigate the benefits and disadvantages of socially responsible investing of public trust funds; and

(3) adopt a Socially Responsible policy for investments.

(f) *Exemption.* The divestment or investment prohibition under this Section must not apply to a company that can demonstrate that it:

(1) has stopped exploring for new hydrocarbons;

(2) agrees contractually to not develop or sell 80% of its current proven fossil fuel reserves; and

(3) has stopped lobbying or attempting to influence government officials to preserve its special treatment, including subsidies, tax breaks, or competitive advantage with respect to clean, renewable energy.

(g) *Notice.* Each Board:

(1) before divesting from a fossil fuel company under this Section, must provide written notice and an opportunity to comment in writing to each company subject to the action;

(2) must not divest until 90 days after written notice is provided to the company; and

(3) must not divest if the company shows that it is exempt from divestment under subsection (f).

(h) *Report.* The Board must report annually to the Council and Executive on the operation of and compliance with this Section. The report must:

(1) identify each investment in a fossil fuel company held in an actively managed separate account of the trust funds;

(2) list each divestment action taken under this Section

(3) describe each decision to delay investment under Subsection (d); and

(4) calculate the administrative cost of compliance.

33-61A. Indemnification of trustees

(a) *Authorized.* The County must indemnify every member of the Board who is or may become a party to any action, suit, or proceeding, including administrative and investigative proceedings, because of service as a member of the Board, including any action taken to comply with [Section] Sections 33-60A and 33-60C, subject to the conditions stated in this Section.

* * *

33-165. Indemnification of Board Members.

(a) *General.* The County must indemnify each member of the Board who is or may become a party to any legal action, including any administrative or investigative proceeding, because of service as a Board member, including any action taken to comply with Sections 33-60A and 33-60C, subject to the conditions in this Section.

* * *

Sec. 2. Initial review. Each Board must complete its initial review of the investment holdings in all actively managed separate accounts of the trust funds and identify all investments in fossil fuel companies within 90 days after the date this Act takes effect.

Approved:

____

Nancy Floreen, President, County Council Date

Approved:

____

Isiah Leggett, County Executive Date

This is a correct copy of Council action.

____

Linda M. Lauer, Clerk of the Council Date

LEGISLATIVE REQUEST REPORT

Bill 44-16
Retirement – Fossil Fuel Investments - Restrictions

DESCRIPTION:	Bill 44-16 would restrict the Board of Investment Trustees and the Consolidated Retiree Health Benefits Trust Board of Trustees from investing in certain businesses holding the largest amount of fossil fuel reserves under certain circumstances. The Bill would also require both Boards to research and adopt a socially responsible policy for investing.
PROBLEM:	Investing in fossil fuel companies is inconsistent with the County's established policies to be environmentally responsible.
GOALS AND OBJECTIVES:	Encourage fossil fuel companies to move into more environmentally responsible renewable energy sources.
COORDINATION:	Board of Investment Trustees, Office of Human Resources, County Attorney.
FISCAL IMPACT:	To be requested.
ECONOMIC IMPACT:	To be requested.
EVALUATION:	To be requested.
EXPERIENCE ELSEWHERE:	To be researched.
SOURCE OF INFORMATION:	Robert H. Drummer, Senior Legislative Attorney
APPLICATION WITHIN MUNICIPALITIES:	Not applicable.
PENALTIES:	None.

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MEMORANDUM

October 11, 2016

TO: Council President Nancy Floreen
Council Colleagues

FROM: Council Vice President Roger Berliner
GO Chair Nancy Navarro

SUBJECT: Fossil Fuel Divestment and Socially Responsible Investing

Colleagues, we are writing to ask for your support for legislation we plan on introducing that more closely aligns our values with our role as a major financial investor of nearly $4 billion -- *without sacrificing the returns on those investments.* We would do this in two distinct ways: (1) directing the county's Board of Investment Trustees (BIT) to divest from the 200 publicly traded fossil fuel companies that hold reported reserves with the largest potential carbon emissions; and (2) directing the BIT to study adopting a Socially Responsible Investing screen for its portfolio.

We are proposing this measure fully aware of the Board's fundamental fiduciary responsibilities. Our legislation would address this explicitly by allowing the BIT to waive the divestment requirement if the Board were to certify to the Council that in its judgment alternative investments in non-fossil fuels are not available that would meet or exceed the returns of the $65 million in fossil fuel stocks currently in its portfolio. Given the strength of portfolios without fossil fuels, and the relatively poor performance of fossil fuel stocks, we are confident that the Board will be able to harmonize our county's values with its fiduciary duties.

We are also very mindful of the "slippery slope" argument – i.e., that there are a host of serious moral and ethical issues that have been put forward over the years as a justification for divestment, and we have said no. We believe climate change is different: it represents an existential threat to the entire planet. It is, in our view, in a class by itself, and its correlation with the companies principally responsible for creating climate change is direct. We know it is caused by the burning of carbon-heavy oil, coal, and natural gas. It is why our Council has passed literally dozens of measures to support clean energy and energy efficiency. We should not be investing in the very companies that undermine our commitment to sustainability.

Specifically, this legislation would prohibit the BIT from purchasing any new stocks or bonds in the fossil fuel industry and phase in over a 5 year time line divestment of the $65 million worth of holdings in the coal, oil and gas companies in the Carbon Underground 200, a list of fossil fuel companies ranked by their potential carbon emissions. As noted, the 5 year phase-in would be subject to an off-ramp if the Board can certify divesting these funds would reduce the return of the portfolio.

More broadly, this legislation would also address longer term issues related to how we invest our money by requiring the BIT to study the impact on its portfolio of adopting a Socially Responsible Investing (SRI) approach, expanding on its current policies in this area. This approach considers environmental, social and corporate governance issues in determining whether to make an investment while seeking to maintain strong returns for investors. It is widely used today by investors: more than $6.57 trillion in the United States is already invested using socially responsible practices.

SRI is based on the belief that we should use our investments to bring about positive change by aligning our investments with companies that achieve good returns by being a good corporate citizen. Given the ever increasing role corporations have in our world today, exercising that prerogative is important. The latest example of this can be seen in the Wells Fargo scandal in which more than 2 million bank accounts or credit cards were opened without customers' knowledge or permission. An SRI "screen" could result in shifting investments from companies like Wells Fargo to more socially responsible companies, and that would be a good thing.

We thank you in advance for your consideration of this legislation and we look forward to working with you as it moves forward.

Roger Berliner
Council Vice President

Nancy Navarro
Chair, GO Committee

OFFICE OF THE COUNTY ATTORNEY

Isiah Leggett
County Executive

Marc P. Hansen
County Attorney

MEMORANDUM

TO: Linda Herman, Executive Director
Montgomery County Employee Retirement Plans

VIA: Marc P. Hansen *Marc Hansen*
County Attorney

FROM: Edward B. Lattner, Chief *EBL*
Division of Government Operations

Amy Moskowitz *AM /EBL*
Associate County Attorney

DATE: November 15, 2016

RE: **Bill 44-16, Retirement - Fossil Fuel Investments - Restrictions**

Bill 44-16 prohibits the Board of Investment Trustees and the Consolidated Retiree Health Benefits Trust Board of Trustees (collectively referred to as "the Boards") from investing in fossil fuel companies—businesses holding the largest amount of fossil fuel reserves. We conclude the Bill, as presently drafted, (1) unlawfully delegates legislative authority to a private third party to determine whether an entity is a fossil fuel company, (2) violates the unconstitutional conditions doctrine by permitting the Boards to invest in a fossil fuel company if it gives up certain First Amendment rights, and (3) is inconsistent with the Boards' present statutorily-imposed fiduciary duties. But all of these infirmities can be remedied by amendment. We also have some suggested technical amendments.

I. BACKGROUND

The Bill would prohibit the Boards from investing in businesses holding the largest amount of fossil fuel reserves.[1] A fossil fuel company is defined as "a company listed in the 200 publicly traded coal, oil, and gas companies that hold reported fossil fuels reserves with the largest potential carbon emissions, as ranked in the Fossil Free Indexes US (FFIUS) published by Fossil Free

[1] Each Board hires professional investment managers to buy and sell securities. Bill 44-16 would limit the prohibition to actively managed separate accounts and would exclude investments in an index fund, private equity fund, real estate fund, mutual fund, or other commingled or passively managed fund.

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Indexes LLC or a successor index, as updated annually."[2] The Bill would also require the Boards to divest in these companies gradually over the next 5 years and would permit the Boards to delay the sale of any individual security if necessary due to its fiduciary duty.

A fossil fuel company can avoid the investment prohibition/divestment if it can demonstrate that it (1) has stopped exploring for new hydrocarbons; (2) agrees contractually to not develop or sell 80% of its current proven fossil fuel reserves; and (3) has stopped lobbying or attempting to influence government officials to preserve its special treatment, including subsidies, tax breaks, or competitive advantage with respect to clean, renewable energy.

The Bill would also require the Boards to research and adopt a socially responsible policy for investing.

II. ANALYSIS

A. Delegation Of Legislative Authority

The Bill's reliance upon a private third party to determine when a company is a "fossil fuel company" represents an impermissible delegation of legislative authority. Subject to certain exceptions, a legislature may not delegate its lawmaking function to others. *See Pressman v. Barnes*, 209 Md. 544 (1956).

The Maryland courts have allowed legislative bodies to delegate rule making authority to executive branch officials. *Pressman*, 209 Md. 544, 552 (the Director of Traffic, who was appointed by the Mayor, could prescribe speed limits for Baltimore streets); *see also*, *Andy's Ice Cream v. City of Salisbury*, 125 Md. App. 125, *cert. denied*, 353 Md. 473 (1999). But delegations of rulemaking authority to executive officials must be limited. Insofar as a delegation "requires the exercise of a certain amount of discretion which may be regarded as part of the police power . . . , such discretion [must be] guided and restrained by standards sufficient to protect the citizens against arbitrary or unreasonable exercise thereof." *Pressman*, 209 Md. at 552; *see also West Montgomery Citizens Association v. Maryland-National Capital Park and Planning Commission*, 309 Md. 183 (1987).

Although the concept of delegating government authority to executive branch officials is well established, the premise of delegating government power to private persons does not rest on a similarly firm constitutional foundation. The Maryland Court of Appeals has discussed the concept of whether government power may be "lodged in and permitted to private persons . . . ." *Board of Trustees of the Employees' Retirement System v. Mayor and City Council of Baltimore*

[2] According to its website, Fossil Free Indexes LLC is a company that delivers research, consulting and investment solutions to investors concerned about climate and environmental risk. It publishes the "Carbon Underground 200" on its website, a list of the 100 largest public oil and gas and the 100 largest public coal companies globally, as measured by the potential CO2 emissions of their reported fossil fuel reserves. It is updated quarterly and serves as the basis for a negative screen on the S&P 500 to create the FFIUS Index, a fossil free index.

City, 317 Md. 72, 94 (1989). In *Board of Trustees*, the Court addressed a challenge to a Baltimore City ordinance instructing the City's retirement system to divest its investment holdings in companies doing business in South Africa. Among various challenges to this ordinance, the plaintiffs challenged as an unconstitutional delegation of government power to private persons a provision in the ordinance that companies doing business in South Africa "shall be identified by reference to the most recent annual report of the Africa Fund entitled 'Unified List of United States Companies with Investments or Loans in South Africa and Namibia"' *Id.* at 81.

The Court began its analysis of the delegation issue by noting that "the legislature acts in the exercise of a power conferred upon it by the people." *Id.* at 93. The Court observed that "this principle follows from the nature of representative democracy" and that the "City Council members generally have no authority to substitute the judgment of others for their own judgment." *Id.* at 94. The Court acknowledged that "our cases have long sanctioned delegations of legislative power to administrative officials where sufficient safeguards are legislatively provided for the guidance of the agency in the administration of the statute." *Id.* With respect to the delegation of authority to private persons or entities, however, such delegation is "strictly scrutinized because, unlike governmental officials or agencies, private persons will often be wholly unaccountable to the general public." *Id.*

In this context, the Court cited with approval a New York case, *Fink v. Cole*, 302 N.Y. 216, 224, (1951), where the New York Court of Appeals struck down a statute that vested the Jockey Club with authority to license owners, trainers, and jockeys at horse races in the state. *Id.* n. 23. The Maryland Court of Appeals went on to note that legislation may sometimes incorporate fixed standards created by private entities,[3] but with respect to delegating future revision of regulatory standards to a private entity, the courts have only approved such delegation "in limited circumstances such as where the standards are issued by a well-recognized, independent authority . . . [that] provide guidance on technical and complex matters within the entity's area of expertise." *Id.* at 96. This type of delegation usually involves accreditation programs established by professional organizations, such as the accreditation of law schools by the American Bar Association.

As currently drafted, Bill 44-16 is an unconstitutional delegation of the Council's legislative power because it prohibits the Boards from investing, and requires them to divest, from any company identified in the Fossil Free Indexes US (FFIUS) published by Fossil Free Indexes LLC or a successor index, as updated annually. This delegation of discretion is similar to the authority invalidly transferred to the Jockey Club to license horse trainers and jockeys, and is far removed from the delegation of authority to a "well-recognized, independent authority" that "provides guidance on technical and complex matters within the entity's area of expertise." It is in short, permitting a private party to determine what investments are in the public interest—a practice condemned by the Court of Appeals in *Board of Trustees of the Employees' Retirement*

[3] An example of incorporation of a fixed standard created by a private entity can be found in § 22-14, which requires the Fire Chief to recommend that the Executive adopt by regulation parts of the National Fire Code as published by the National Fire Protection Association.

System v. Mayor and City Council of Baltimore City, 317 Md. at 94.

But, this infirmity can be remedied. In *Board of Trustees*, the court saved the city ordinance by interpreting it to require the Trustees to **refer** to a list prepared by a private organization of companies doing business in South Africa, rather than blindly follow that list. Thus, the list amounted to a mere reference, which the Trustees could accept or reject. *Id.* at 97-98. Bill 44-16 could be amended to similarly provide that the Boards may use the Fossil Free Indexes US as a reference rather than a mandated list of prohibited companies.

> Fossil Fuel Company means a publicly traded coal, oil, and gas company holding fossil fuel reserves with one of the 200 largest potential carbon emissions. The Boards may refer to the Fossil Free Indexes US (FFIUS) published by Fossil Free Indexes LLC or a successor index, as updated annually, to determine if a company is a fossil fuel company. In addition, the Boards may hire a consultant to assist in identifying Fossil Fuel Companies.

By making the Fossil Free Indexes a mere reference, this amendment should eliminate any issue surrounding an unlawful delegation of legislative authority.

B. First Amendment Issues.

Bill 44-16 violates the "unconstitutional conditions" doctrine when it allows a fossil fuel company to avoid the divestment/investment prohibition by giving up its right to petition the government. The "unconstitutional conditions" doctrine provides that the government may not deny a benefit to a person on a basis that infringes his constitutionally protected freedom of speech. *Perry v. Sindermann*, 408 U.S. 593, 597 (1972). The doctrine recognizes that constitutional violations may arise from the deterrent, or chilling, effect of governmental efforts that fall short of a direct prohibition against the exercise of First Amendment rights. *Laird v. Tatum*, 408 U.S. 1, 11 (1972).

> For at least a quarter-century, this Court has made clear that even though a person has no right to a valuable governmental benefit and even though the government may deny him the benefit for any number of reasons, there are some reasons upon which the government may not rely. It may not deny a benefit to a person on a basis that infringes his constitutionally protected interests—especially, his interest in freedom of speech. For if the government could deny a benefit to a person because of his constitutionally protected speech or associations, his exercise of those freedoms would in effect be penalized and inhibited. This would allow the government to produce a result which it could not command directly. Such interference with constitutional rights is impermissible.

Perry, 408 U.S. at 597 (internal citations and quotations omitted). Thus, "[a] predicate for any unconstitutional conditions claim is that the government could not have constitutionally ordered the person asserting the claim to do what it attempted to pressure that person into doing." *Koontz v. St. Johns River Water Mgmt. Dist.*, 133 S .Ct. 2586, 2598 (2013).

As noted above, the Bill provides a fossil fuel company with a means of avoiding the divestment/investment prohibition. The divestment or investment prohibition does not apply to a company that can demonstrate that it (1) has stopped exploring for new hydrocarbons; (2) agrees contractually to not develop or sell 80% of its current proven fossil fuel reserves; and (3) has stopped lobbying or attempting to influence government officials to preserve its special treatment, including subsidies, tax breaks, or competitive advantage with respect to clean, renewable energy. It is this latter requirement, codified as § 33-60C(f)(3), that infringes on the First Amendment's guarantee of freedom of speech, including the freedom to petition the government.

The First Amendment protects the right to lobby legislators and administrators. *See*, *e.g.*, *Cal. Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 510 (1972). Certainly, the County could not enact a viewpoint-based prohibition against petitioning the government to preserve certain tax breaks. When the government targets not subject matter, but particular views taken by speakers on a subject, the violation of the First Amendment is all the more blatant. *Rosenberger v. Rector & Visitors of Univ. of Va.*, 515 U.S. 819, 829 (1995).

The government does have greater leeway to regulate private conduct when those restrictions are attached to the use public funds.[4] For example, in *Regan v. Taxation With Representation*, 461 U.S. 540 (1983) (TWR), the Court held that an IRS provision that only granted tax exemptions to non-profit corporations that did not lobby (501(c)(3) organizations) did not violate TWR's First Amendment rights because "Congress chose not to subsidize lobbying as extensively as it chose to subsidize other activities that non-profit organizations undertake to promote the public welfare." *Id.* at 544. Moreover, TWR was not subject to a blanket prohibition on lobbying. The Court noted that it could create a separate 501(c)(4) organization to conduct its lobbying activities, so long as the 501(c)(3) organization did not subsidize the 501(c)(4) organization; otherwise, public funds might be spent on an activity Congress chose not to subsidize. *Id.* at 544. Likewise, in *Rust v. Sullivan*, 500 U.S. 173 (1991), the Court upheld certain conditions on federal funds for family planning services that required that service providers not use those funds to advocate for abortion or provide abortion counseling; the service providers were not subject to a blanket prohibition on providing abortion-related services.

But Bill 44-16 does not present a situation where the government is limiting the use of public funds spent to subsidize a particular program. In fact, it is not a subsidy program at all. Rather, it is a the provision of a benefit (participation in the Boards' investments) conditioned upon the limitation of certain First Amendment rights (lobbying or attempting to influence government officials to adopt policies favoring a specific viewpoint). This is impermissible.

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[4] "Determining the constitutionality of government subsidization of expression is one of the most frustrating tasks . . . of the First Amendment." Martin H. Redish & Daryl Kessler, *Government Subsidies and Free Expression*, 80 Minn. L. Rev. 543, 544 (1996).

The remedy, however, is rather straightforward. The unconstitutional provision in § 33-60C(f)(3) must be deleted.

C. Fiduciary Issues.

1. Standard of Care.

The Maryland Court of Appeals has recognized that while a trustee is not blindly obligated to maximize the return on investment, a social investment policy that has a greater than *de minimis* impact upon return on investment may violate a trustee's duty of prudence and loyalty. We understand that Bill 44-16 may have a greater than *de minimis* impact upon return on investment and is therefore inconsistent with the duty of prudence and loyalty currently impressed upon the Boards in the County Code. Assuming more than a greater then de minimis impact, the Council must either amend that statutory duty to allow for investment decisions driven, in part, by the presence of fossil fuels or the Council can preserve the investment policy underlying Bill 44-16 by incorporating the Department of Labor's guidance for the use of economic, social, and governance factors when making investments for retirement plans.

County Code Sections 33-61C and 33-163 set forth the standard of care under which the Boards operate the trust funds. Among other requirements these provisions require that the Boards make investments "with the care, skill, prudence, and diligence under the circumstances that a prudent person acting in a similar capacity and familiar with the same matters would use to conduct a similar enterprise with similar purposes" and "only in the best interest of the participants and their beneficiaries." Although the Employee Retirement Income Security Act (ERISA) does not apply to governments, the standard of care in County Code Sections 33-61C and 33-163 are virtually identical to the standard applicable to ERISA fiduciaries, set forth in ERISA Section 404.

In *Board of Trustees of the Employees' Retirement System of the City of Baltimore v. Mayor and City Council of Baltimore City*, 317 Md. 72 (1989), the Court of Appeals held that legislation requiring divestment of investments in South Africa did not interfere with these fiduciary duties because of certain factors, the most significant factor being that the cost of the social investing was *de minimis*. The initial cost of divestment was $750,000, or 1/16th of 1% of the fund's value. The on-going cost was $1.2 million per year, or 1/10th of 1% of the fund's total value. Thus, only if the impact to the ERS and CRHBT would be *de minimis*, will the Boards satisfy their fiduciary standards under the County Code. But we understand that divestment under Bill 44-16 is likely to cause more than a *de minimis* impact to the trusts.

By requiring divestment from "fossil fuel companies, Bill 44-16 compels the Boards to deviate from the currently applicable prudent investor standard and duty of loyalty standard Therefore, the legislation should modify the standard of care and expressly state that the Council intends that the Board is authorized to ignore the prudent investor standard and duty of loyalty standard in order to comply with the divestment requirement of the legislation.

Alternatively, rather than amend the fiduciary duty applicable to the Boards, the Council can preserve the investment policy underlying Bill 44-16 by incorporating Department of Labor's (DOL) recent guidance for the use of economic, social, and governance factors when making investments for retirement plans. Over the years, DOL, the agency which regulates ERISA, has published guidance with regard to investments which allow fiduciaries take into account non-economic factors and still satisfy their fiduciary duties. Most recently the DOL issued Interpretive Bulletin 2015-01 in which the DOL states that fiduciaries can take into account economic, social and governance (ESG) issues when making investment decisions, as the DOL recognized that these factors can influence investment performance. ESG factors should not be the sole consideration in making the investment, but may be considered in addition to other factors influencing risk and return. The DOL also stated that the fiduciaries' focus is the plan's financial returns so that fiduciaries cannot use plan assets to promote social, environmental, or other public policy causes at the expense of the plan's participants. In other words, fiduciaries may not accept lower returns in order to obtain collateral benefits.

Because County law uses the same standard of care as ERISA, it may be presumed that the County should adhere to the DOL's guidance for the use of ESG factors when making investment decisions. Although the DOL guidance is not binding, a court may recognize that the DOL guidance regarding ESG issues was issued subsequent to *Board of Trustees of the Employees' Retirement System of the City of Baltimore* and take the DOL guidance into consideration. Bill 44-16 does not satisfy the DOL's interpretation because social and policy factors are the sole reason for divestment. To incorporate the DOL standard, the Bill would have to be amended to provide that fossil fuel is not be the sole consideration in making the investment, but may be considered in addition to other factors influencing risk and return. The Boards have adopted an ESG policy which incorporates various ESG factors in evaluating investments and managers since they believe that these factors may have the potential to influence risk and return characteristics.

2. Discretion.

The legislation (lines 51-58) provides that the Boards must divest unless the Boards "determine that a delay in divesting from a fossil fuel company is necessary due to its fiduciary duty." But the Boards' present fiduciary duty is incompatible with the initial decision to divest from fossil fuel companies. Why would the Boards determine that their fiduciary duty requires a delay in divestment if their fiduciary duty would counsel against divestment in the first place? If the Council wants to impose an investment restriction, the Council should explicitly do so and alter the Boards' fiduciary duties.

In addition, as required under the County Code, investment managers, not the Boards, make individual investments. Because the Boards do not make decisions to invest in individual companies, such as fossil fuel companies, the Boards do not have the knowledge to "determine a delay in divesting from a fossil fuel company" is necessary due to its fiduciary duty." Investment managers making investments on behalf of the trusts are subject to the fiduciary duties set forth in

County Code Section 33-60C and 33-163. The Boards provide the investment managers with guidelines and/or policies. While the Boards could amend the contracts to direct managers to divest from fossil fuel companies, presumably the Board could not give the investment managers discretion on delaying divestment and requiring the managers to justify the delay. Presumably, if they would agree, the investment managers would request indemnification and an altered fiduciary duty standard. Therefore, the Council should delete the "divestment delay" provision found in Lines 51-58 of the legislation.

C. Technical Issues.

Additional County Code Section: The legislation adds Section 33-60C (although Line 3 has 33-60A) to the County Code which is in Chapter 33, Article III and contains the Employees' Retirement System whose investments are overseen by the Board of Investment Trustees. However, the Section includes the Consolidated Retiree Health Benefits Trust, which provisions are in Chapter 33, Article XI. To avoid confusion, another Code Section should be added to the Consolidated Retiree Health Benefits Trust and its governing provisions which are in Chapter 33, Article XI.

Definition of Actively Managed Account, Lines 6-10: Private real assets, private debt funds, and hedge funds should be added to the definition of actively managed separate accounts.

Divestment, Lines 34-50: This provision requires divestment of 20% each year. This provision should specifically provide how divestment should occur. For example, should 20% from each actively managed separate account be divested, or is it the portfolio as a whole? Also, due to market fluctuations the percentage will vary, when should the 20% be measured, at the beginning of each calendar year? The Council should direct how divestment is accomplished.

Divestment, Lines 49-50: Are reinvestments of dividends considered a new investment? The Council should clarify if dividends are excluded.

Research on socially responsible investing, Lines 59-64. As noted above, the Boards adopted an ESG policy which incorporates various ESG factors in evaluating investments and managers since they believe that these factors may have the potential to influence risk and return characteristics.

cc: Timothy Firestine, CAO
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Bill 44-16 OCA analysis

MONTGOMERY COUNTY EMPLOYEES' RETIREMENT SYSTEM

CONSOLIDATED RETIREE HEALTH BENEFITS TRUST

On November 18, 2016 the Board of Investment Trustees for the County's Retirement Plans and the Board of Trustees for the Consolidated Retiree Health Benefits Trust each unanimously approved the following resolution on Bill 44-16:

Resolved, that the Board opposes Bill 44-16, Retirement – Fossil Fuel Investments – Restrictions, which mandates divestment from certain fossil fuel companies. The Board considers the bill legally flawed, as outlined in the November 15, 2016 memo from the Office of the County Attorney; operationally unworkable; and inconsistent with the fiduciary duties outlined in the County Code. The Standard of Care requires the Board to act "only in the best interest of the participants and their beneficiaries." The Board requests the Executive Director to prepare a memo informing the County Council of its views. The memo should also indicate that the Board currently considers Environmental, Social and Governance (ESG) factors in its investment process and monitoring efforts, as set forth in Board policies, and that the bill's requirement that the Board do so is therefore unnecessary.

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