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SWIB and Sudan: Why Divestment Is Not the Answer

What's the Issue?¹

- Sudan is an east African country designated by the US as a terrorist-sponsoring country. The country has been involved in a civil war most of the time since independence from the United Kingdom in the 1950s. Initially, the conflict involved primarily Arab Muslims in the north versus primarily Christians, non-Arab Muslims, and Animists in the south. An unsteady truce now exists between the Sudanese government in the north, with Khartoum as its capitol, and groups in the south. As a part of the truce signed in 2005, the south has autonomy with a referendum for independence to be held toward the end of this decade. At that time, the south is expected to secede from the government in Khartoum. The civil war, together with a concurrent famine and drought, left the entire country devastated. Millions of Sudanese were killed or left homeless; crops and cattle were destroyed; homes, schools, hospitals and businesses were burned or destroyed; and the infrastructure was in ruins.
- A separate conflict broke out in 2003 in Darfur in western Sudan. It has gained worldwide attention because of the large number of individuals who have been killed or made homeless by government forces or militias supported by the government. Most recently, the United Nations described actions by government forces and pro-government Arab militias against non-Arab tribes in Darfur as genocide. The United Nations has not given a definitive number for those killed but has indicated that the conflict in Darfur has resulted in scores of thousands of deaths and more than 2 million persons displaced since the conflict began.
- The UN worked to negotiate a truce in May 2006 between the government and rebel groups in Darfur. However, the truce has not been effective as only one group signed the agreement. The African Union has a small peace keeping force in Sudan, but it is not strong enough to protect the individuals in Darfur. In addition, the government has tightened restrictions on non-governmental organizations supplying aid to the refugees. To add to the instability, the rebel groups in Darfur have further splintered along ethnic or tribal lines. This has hindered their ability to act as a united group to counter the government's attacks. The African Union and the UN confirmed in early 2007 that the government bombed refugee sites in Darfur in violation of the May 2006 truce and has been attacking relief sites and workers.
- Sudan has extensive oil reserves, which are largely untapped. A few international companies, interested in oil exploration and extraction, have developed business operations in Sudan. American and European oil companies have had some operations in Sudan, and some still have exploration rights in certain areas. However, it is companies from China, India and the Middle East that are currently the most active and pay royalties to the

¹ Information secured from the United Nations and Sudan Tribune websites.

government for rights to the oil reserves. The royalties supposedly are split proportionately with the south, where large oil reserves exist and some exploration is taking place. There are doubts, however, that the south is getting its fair share and suppositions that the government in Khartoum is taking more than its share of the revenues. If tribes in the south exercise their right to independence from the government in the north after scheduled elections or within the next few years, as is expected, the government in Khartoum will suffer a loss of oil revenues. Some speculate that this will shift the conflict from Darfur back to the differences between the north and south. In the meantime, the government in Khartoum is able to build up its military and support militias that are attacking the rebel groups and refugees in Darfur.

US Government Trade Sanctions²

- In 1997, President Clinton issued a presidential order declaring a national emergency to deal with the threat to US security and foreign policy caused by the policies and actions of the government of Sudan. The order imposed a trade embargo against Sudan and a total asset freeze against the Government of Sudan. In addition, the order prohibited any US person from performing any contract in support of an industrial, commercial, public utility or governmental project in Sudan as well as the extension of any loan to the Government of Sudan and any transaction relating to transportation of cargo to, from or through Sudan. These sanctions were imposed during the civil war between the north and the south, prior to the Darfur situation.
- In 2006, President Bush issued a presidential order removing certain areas of Sudan (Darfur, the south and other specified regions) from the prohibitions and specifically prohibiting all transactions by US persons relating to the petroleum or petro-chemical industries in Sudan. The US Treasury promulgated regulations to implement the presidential orders in 31 CFR part 538.
- SWIB understands the US Treasury Department does not apply the restrictions to publicly traded companies organized elsewhere other than under US state and federal laws, even if those companies are doing business in the US. For example, Treasury has not fined European companies listed on US stock exchanges that are doing business in Sudan.

How Does This Affect the Trust Funds?

- Like others, SWIB finds the atrocities committed against the Sudanese people living in Darfur abhorrent. As with any investment it makes, however, SWIB has a fiduciary responsibility to invest in the best financial interest of the trust funds it manages. Wisconsin Stat. sec. 25.15(2)(c) requires SWIB “to administer the assets of each trust or fund solely for the purpose of ensuring the fulfillment of the purpose of each trust or fund ...and not for any other purpose.” This means that SWIB may not make investments based on political, social or personal reasons. The largest fund that SWIB invests is the public employee trust fund of the Wisconsin Retirement System (WRS). Wisconsin Stat. sec. 40.01 (2) states that the public employee trust fund is “...a public trust and shall be managed, administered, invested and otherwise dealt with solely for the purpose of ensuring the fulfillment at the lowest

² US Department of the Treasury, Office of Foreign Assets Control.

possible cost of the benefit commitments to participants ... and shall not be used for any other purpose.”

- To meet its responsibility, SWIB must base its investment decisions on economic factors that will ensure the funds and trusts fulfill the purposes for which they were established. That said, SWIB does consider the economic effects of humanitarian and other social issues in its analysis of investments. An administrative rule, which has the force of law, directs SWIB to “...seek investments in organizations that respect basic human rights ...” Wis. Admin. Code sec. IB 2.02(7). As a part of routine annual reviews, investment managers are asked to explain what steps they take to comply with the rule.
- To screen potential stock investments in companies domiciled in foreign countries, SWIB uses rating systems developed by Freedom House and the Index of Economic Freedom. SWIB’s investment guidelines preclude SWIB’s portfolio managers from purchasing corporate bonds or stocks issued by companies domiciled in countries that are rated “not free” by the Freedom House and “repressed” by the Index of Economic Freedom. The purpose of using these screens is to determine whether the rule of law, civil liberties, securities regulations, accounting standards, the banking system and other factors are adequate to safeguard an investment in a particular country. In addition, SWIB’s investment guidelines do not permit SWIB to invest in government debt rated below B3/B-. No emerging market sovereign debt, including Sudan’s, is rated above this level.
- SWIB has no direct investment in any Sudanese company or any bonds issued by the Sudanese government. Because Sudan’s bonds are not rated and the country is rated “not free” by Freedom House and not rated by the Index of Economic Freedom, SWIB investment guidelines do not permit investments in any Sudanese company or in any bonds issued by the government.
- SWIB, however, is indirectly invested in a few companies located in the US or foreign countries that have limited business ties to Sudan. This includes a few companies involved in oil exploration or other companies with distributors in Africa or the Middle East that market the company’s products, including medical products. Through index funds, exchange traded funds and other commingled funds, SWIB is also invested less directly in companies that may have business ties to or operations in Sudan. SWIB has no authority to decide which companies are in these funds, and it is difficult to determine the activities of each company in a fund.

What Steps Is SWIB Taking?

- SWIB has gathered additional information to better understand the nature and extent of business dealings that companies in our portfolios may have in connection with Sudan. SWIB’s purpose is to provide this information to portfolio managers to evaluate as they conduct investment due diligence. SWIB also seeks to identify companies that may be in violation of government sanctions and to evaluate how those violations may affect our investment.
- Because there is relatively little public investment in Africa as a whole, public documents filed by companies in which SWIB invests do not typically disclose information to investors about the extent of their business in any particular African country, such as Sudan. Because of the small size of the operation in relation to the company’s total revenues or

capitalization, any operations a company may have in Africa are usually reported on a combined basis and may include not only all of Africa but other developing markets.

- In June 2005, SWIB and the Department of Employee Trust Funds joined more than 40 other public retirement systems in calling on four federal agencies, which are involved with implementing the sanctions program or preventing terrorism, to provide information about whether companies doing business in sanctioned countries like Sudan are complying with federal restrictions. Like other institutional investors, SWIB believes that the federal government is the only credible authority to provide this information. To date, however, SWIB has received no response, and the federal government has provided no comprehensive list or report.
- In 2004, Congress created the Office of Global Security Risk (OGSR) within the Securities and Exchange Commission (SEC) to ensure that appropriate information about companies doing business with sanctioned countries is provided to investors. However, OGSR has failed to provide the anticipated information to SWIB and other institutional investors. Part of the reason for the failure is that Congress and the administration failed to provide adequate funding. Rather than researching the companies itself and making the information available, OGSR has indicated it will require companies to publicly disclose in SEC filings material operations in sanctioned countries, but OGSR will not provide additional information to investors.
- As part of a regular annual review, SWIB discusses with its external managers the due diligence process they use in selecting investments in companies that have business dealings in developing nations, including Sudan.
- SWIB gathered information from a number of sources, including Institutional Shareholder Services (ISS), KLD Research and Analytics, various publications and advocacy groups. Some of the information collected identified companies that currently have or have had business dealings in Sudan in the past. Some were one-time transactions; many others were either not material to the company's total operations or involved the sale of food, medical or other products of a more humanitarian nature. Some of the information indicated OFAC had fined several US companies for violating the sanctions against Sudan and other countries. However, many of the violations took place several years ago, and either the fines were relatively small or there was no indication the violations have continued. The information SWIB collected also provided data about some foreign companies that have business operations in Sudan or with the Sudanese government.
- As with any investment, SWIB must be able to assess any potential risk it may have because of a company's connection with Sudan. Therefore, SWIB contacted some of the companies in which SWIB held direct investments that appeared on the ISS screen as having Sudan-related ties to determine the nature of the business the company has or had with Sudan. SWIB chose to contact only those companies where SWIB's direct investment was \$1 million or more or the OFAC fine was \$25,000 or more. SWIB evaluated each company's reply to determine any potential investment risk and if the company's relationship with Sudan complies with SWIB's investment guidelines and directives to invest in organizations that respect basic human rights. In a few cases, SWIB has requested additional information from the company. All information secured is share with the portfolio managers for further review.

- Based on the information SWIB has received and analyzed to date, SWIB has investments in relatively few of the foreign oil and power production companies on the list of companies identified by the Sudan Divestment Task Force as having ties to the Sudanese government and from which investors have been encouraged to divest.³ SWIB estimates that as of December 31, 2006, these holdings totaled less than \$109.6 million or 0.12% of the \$88.4 billion of the assets under management on that date. These figures include direct investments held in SWIB's name as well as SWIB's investments in index and other funds in which SWIB's monies are pooled with other investors.
- SWIB continues to screen its investments against ISS' data base and OFAC files and to provide all relevant information to the portfolio managers. SWIB will continue to work with other institutional investors to seek more information from the federal government and also provide an update on these efforts in its annual investment report to the Legislature in March.
- As described above, SWIB has already communicated with companies in which it is invested that have been fined by OFAC or appear to have some business operations in Sudan. This engagement will continue. If a decision is made to sell the assets of any company, it will be made on risk and economic factors that are relevant to investment decision-making.
- SWIB continues to review all relevant information, federal laws and regulations that apply to Sudan and other countries subject to US sanctions. Given the ever changing political situation in these countries, SWIB will remain vigilant and continuously evaluate their impact on SWIB's investments.

Is Divestment the Answer? How Would It Affect the Trust Funds?

- Some groups and individuals are urging public pension funds to divest from any company in which they are invested that have business ties to Sudan. Others are supporting more targeted divestment. SWIB opposes divestment, whether total or targeted, because it infringes on SWIB's fiduciary responsibility to invest solely to fulfill the purposes for which the funds were created. It also removes SWIB's ability to work with a company to act responsibly in Sudan or any other country in which the company has operations. For the same reasons, certain non-governmental organizations that provide humanitarian aid to the country have suggested that companies not cease all operations in the country.
- A few states have enacted laws that require pension funds to divest from any company doing business with Sudan. Others have enacted or are considering bills that are supposedly intended only to target companies doing business in Sudan that the Sudan Divestment Task Force identified as needing to be "scrutinized". The bills require investors to have constructive engagement with those companies, establish various restrictions on investments, and divest from the company if it fails to withdraw its operations from Sudan. However, some bills reaffirm that such actions are only required to the degree they do not violate fiduciary standards.

³ The Task Force has provided various lists to SWIB that contain the names of different companies. The companies and SWIB's investments referenced in this paragraph are based on a list of companies attached to a letter from Senator Sheila Harsdorf and Representative Fred Kessler to David Mills, dated January 31, 2007.

- Legislation that requires the use of the Wisconsin Retirement System (WRS) trust fund for any purpose other than the purposes for which the trust was established may be subject to legal challenge. The Wisconsin Supreme Court has found that WRS members have a property interest in the trust fund and, on a number of occasions, has found that a law that requires the use of the trust fund for a non-trust purpose is invalid as an unconstitutional taking of private property. The use of the WRS trust fund for the purpose of a social or political cause, no matter how worthy, is a use for a non-trust purpose. In addition, a social purpose law could be subject to challenge as an unconstitutional impairment of contract. Wisconsin Stat. Chapter 40 has been recognized as a contract between the state and public employees. A unilateral change of that contract by the legislature would be subject to challenge by WRS members. Finally, the Illinois anti-Sudan investment statute currently is being challenged in federal court on the basis that the statute is preempted by federal law. This argument was a basis of another federal court's decision to overturn a Massachusetts law that restricted investments in Burma.
- Any restriction on investment opportunities may adversely affect the returns earned by the WRS trust funds or other trust funds managed by SWIB. In addition, requirements to divest on an arbitrary timetable, without consideration of market conditions, could result in significant losses on the sales. In turn, that would result in higher costs to taxpayers through higher contribution rates to fund WRS liabilities. Instead, SWIB believes it is preferable to review each investment to determine: (a) the nature of the company's operations in Sudan; (b) the economic risk that may create for our investment; and (c) the effect that divestment would have on the trust funds. If SWIB determines the risk is too great and could be harmful to the trust funds, SWIB will make the decision to sell its investment in that company in a manner and time that produces the best result for the trust funds.

February 2007