House Bill 1330
North Dakota Retirement and Investment Office (RIO)
Testimony before Industry, Business and Labor
Representative Jonathan Warrey, Chair

Jodi Smith – Interim Executive Director
Scott Anderson, CFA, MBA – Chief Investment Officer

I. RIO Statutory Authority and Responsibilities

The Retirement and Investment Office (RIO) was created by the 1989 Legislative Assembly to capture administrative and investment cost savings in the management of the investment program of the State Investment Board (SIB) and the retirement program of the Teachers' Fund for Retirement (TFFR). Statutory authority for the agency is found in North Dakota Century Code chapter 54-52.5 and the programs are governed by chapters 21-10 (SIB) and 15-39.1 (TFFR).

The SIB has the statutory responsibility to administer the investment program for 31 funds including the Legacy Fund, TFFR, PERS, and WSI. It also maintains contractual relationships for the investment management of multiple political subdivisions and governmental funds. Currently SIB is responsible for the investment of the Legacy Fund, seven pension funds and 23 other non-pension funds for a total of 31 separate client funds with an overall fund value of roughly $23 billion as of October 31, 2024.

II. Testimony Opposed to H.B. 1330

Pursuant to NDCC Section 54-03-35, any bill which potentially affects the Legacy Fund, the advisory board shall request the state RIO to arrange for the preparation and submission of a cost-benefit analysis (CBA). The investment consultancy RVK has been retained to provide business cases for this purpose.

That CBA analysis is attached and provides an analysis for two scenarios:

1) The bill as currently written includes the definition:

   > "Chinese company" means a company publicly known to be majority-owned by, controlled by, or subject to the jurisdiction or direction of China.

   Many global companies, likely representing most global market capitalization, can be considered "subject to the jurisdiction of China" simply by selling products or otherwise conducting business in China. The scope of this definition would have a large cost, increase the complexity of managing investment portfolios and impact the ability to invest in developed market companies in an agile way. The bill would impact more than $6 billion of the current investment funds in RIO's care and have a fee cost of more than $5.6 million per biennium in addition to adding to the complexity of operations and the inability to separately manage developed market funds.

2) If the language in the bill can be edited to clarify only a prohibition of direct investment in securities of companies “domiciled in China,” the portion of the portfolio impacted could be reduced considerably. The definition of a “Chinese company” may be changed to:

   "Chinese company" means a company domiciled in China.

   Bloomberg defines domicile as the place where a majority of company executives are located. The cost in fees would be reduced considerably to about $1.9 million per year and the change of portfolios would be much easier to implement and maintain as the legislation would not impact developed market company equity portfolios. The bill would meet the requirements of divesting of Chinese domiciled direct investments.

III. <u>Other Considerations</u>

The SIB complies with state and federal law as well as investor best practices. There are several other considerations regarding a China divestment bill:

- Fiduciary duty
  Due to the size of the Chinese economy, its exposure in the markets, and its prominence in the major indexes, it is difficult as a fiduciary to exclude China from a portfolio if there is no directive from U.S. Treasury or federal legislation. Two of our investment consultants have stated that the “Prudent Investor Rule” requires fiduciaries consider the long-term health of investments and the portfolio as a whole and not individual investments; removing Chinese holdings for reasons not supported by long-term risk-adjusted returns seems to run counter to this guidance. The country exposure of funds managed by the SIB is a byproduct of and determined as part of the asset allocation process and the benchmark assignment considering long term risk adjusted returns and best practice.

- Federal Foreign Policy Controls
  The Office of Foreign Asset Control (OFAC), a division of the US Department of the Treasury, administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States. OFAC provides directive and enforcement of actions for national interest that an investment organization would not be able to determine. Investors normally refer to OFAC to determine legal restrictions on investing in securities. Index providers and investment managers also comply with OFAC directives. Over 700 Chinese entities are restricted from investments by the OFAC. Further, the US government has banned 11 Chinese firms from investment due to Human Rights Violations of the Uyghurs.

- Economic Considerations
  China continues to represent a meaningful share of the world’s population, GDP and capital markets. Prominent developed market companies like Apple, Tesla, Air Products, General Electric, etc. have revenue and operations in China. According to two investment consultants, not investing in China reduces the expected overall return per risk of a fully diversified portfolio. The Chinese market offers significant diversification benefits.

Investment managers consider the directives from OFAC, political risks and economic prospects of Chinese companies when investing.

- Country Risk Management
  After the Russian invasion of Ukraine, the RIO investment team has developed a country risk framework and tool for the SIB to monitor and manage country risk. In addition to the development of the country risk assessment tools, RIO has begun to structure the international portfolios in its care to be more flexible to international events.

IV. Summary

The SIB is in opposition in its current version based on the CBA outlining the significant cost per biennium, increase the complexity of managing investment portfolios and impact the ability to invest in developed market companies in an agile way.

If the bill’s definition of a Chinese company were to be amended to: "Chinese company" means a company domiciled in China, then the SIB would support the bill.