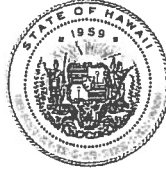


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DEPARTMENT OF BUDGET AND FINANCE

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EMPLOYEES' RETIREMENT SYSTEM
HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND
OFFICE OF THE PUBLIC DEFENDER

ADMINISTRATIVE AND RESEARCH OFFICE
BUDGET, PROGRAM PLANNING AND
MANAGEMENT DIVISION
FINANCIAL ADMINISTRATION DIVISION
OFFICE OF FEDERAL AWARDS MANAGEMENT (OFAM)

December 31, 2015

The Honorable Ronald D. Kouchi, President
and Members of the Senate
Twenty-Eighth State Legislature
State Capitol, Room 409
Honolulu, Hawaii 96813

The Honorable Joseph M. Souki, Speaker
and Members of the House of
Representatives
Twenty-Eighth State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear President Kouchi, Speaker Souki, and Members of the Legislature:

For your information and consideration, I am transmitting a copy of the Direct Holdings in Sudan Scrutinized Companies 2015 report, as required by Act 192, Session Laws of Hawaii 2007. In accordance with Section 93-16, Hawaii Revised Statutes, the report may be viewed electronically at <http://ers.ehawaii.gov/resources/reports-to-legislature>.

Sincerely,

WESLEY K. MACHIDA
Director of Finance

Enclosure

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII
DIRECT HOLDINGS IN SUDAN SCRUTINIZED COMPANIES

Act 192, Session Laws of Hawaii 2007, expresses the State's desire to not participate in ownership of companies that provide significant practical support for genocide activities being conducted by the Sudanese government in the Darfur region.

The Board of Trustees of the Employees' Retirement System recognizes the intent of Act 192 and will abide by its requirements. The Board, however, must also apply a decision framework to act for the exclusive benefit of ERS Plan participants. In this respect, the Board recognized that divestment activities could potentially increase the portfolio's idiosyncratic investment risk. Divestment guidelines and procedures, codified in the ERS' *Sudan Investment Policy* ("Policy"), were therefore developed to minimize the impact of the Sudan divestment policy upon the investment results of the ERS portfolio. The Sudan divestment policy is intended to also avoid:

- Discriminating against companies whose Sudan-related business activities are supported by the U.S. government;
- Discriminating against companies whose Sudan-related business activities do not support genocide activities;
- Unnecessarily harming U.S. companies and jobs; and
- Compromising the Board of Trustees' duties to the beneficiaries of the ERS.

The ERS was required to make its best efforts to identify all of its direct holdings in scrutinized companies within 180 days after July 1, 2007. Those efforts were to include:

- Reviewing publicly available information regarding companies with business operations in Sudan provided by nonprofit organizations and other appropriate parties;
- Contacting ERS' asset managers with investments in scrutinized companies; and
- Contacting other institutional investors that have divested from or engaged with companies that have business operations in Sudan.

Each year thereafter, Act 192 requires the ERS to provide to the legislature a publicly-available report that includes activity under section 4, to include: 1) A summary or correspondence with companies engaged by the public fund; 2) All investments sold, redeemed, divested, or withdrawn; 3) All prohibited investments; and, 4) Any progress made. The ERS respectfully reports all pertinent activity in 2015 related to Sudan Scrutinized Companies as outlined in Act 192.

The ERS relied on the *Sudan Company Report* prepared by the EIRIS Conflict Risk Network (CRN) to determine “scrutinized companies,” that certain business activities in Sudan may determine their status as a “highest offender.” Highest offenders are subject to possible divestment in accordance with the Policy.

Before taking any action against the company, the ERS Board considers any additional information they may provide. The ERS will send a letter to the scrutinized company to inform them of their Sudan-related activities, and encourage them to cease their scrutinized active business operations within 90 days. If the company continues to have scrutinized active business operations after ninety days following the first engagement by ERS, the Board will consider divestment or other corrective actions to the extent possible with due consideration from among other things, return on investment, diversification, and the ERS’ other legal obligations. Failure to respond to the ERS letter may lead to divestment action.

The scrutinized companies Qatar Islamic Bank and Qatar National Bank were temporarily held in a fund manager’s account for the ERS for several days in 2015. The violation was discovered by ERS staff conducting routine monitoring of the ERS investment portfolio. Upon informing the fund manager of the infraction, the manager decided to sell both securities. The net gain to the ERS from the sales was \$38,494.

The scrutinized company of Volkswagen AG was temporarily held in the a fund manager’s account for the ERS for a period of several months as the ERS conducted is policy procedure to evaluate the security for divestment. The investment manager was informed of the violation on May 12, 2015, shortly after the ERS received an updated scrutinized list from CRN. The investment manager believed that the company was of good value, but was being penalized for a majority owned subsidiary group (MAN SE) that was no longer active in Sudan related business. The violation stemmed from the subsidiary continuing to service existing contracts in the disputed region. The fund manager experienced significant positive performance from holding the security, and requested to continue to hold the position.

The ERS initiated standing policy to contact the parent firm, and the chairman of the board, Martin Winterkorn, was informed in-writing on June 23, 2015. Not receiving a reply, ERS sent a second letter on August 23, 2015 to raise the same concerns about activities in Sudan’s Darfur region. In the meantime, Andreas Buchta from the Volkswagen investor relations group sent an email response noting that “Volkswagen AG hereby undertakes and confirms to make sure – to the extent legally feasible for all concerned group companies - that related transactions and business relations are checked according to national, EU and US export control regulations and are compliant with these legislations.”

The ERS elected to allow the fund manager to not be forced to divest as continued monitoring occurred. A subsequent market event caused by alleged abuses in a different division at Volkswagen caused the fund manager to sell the entire position on September 21, 2015. The gain to the ERS for the transaction was \$2,516,702.96

On May 13, 2015, a fund manager notified the ERS of holdings in newly listed scrutinized companies Harbin Electric and Bharat Heavy Electricals. ERS staff did not initially find the violation in its monitoring system, and began an investigation with the custodial bank, BNY Mellon, to determine the discrepancy. The fund manager initially requested to trim the position.

ERS staff confirmed that the monitoring system needed to be programed in a timely manner. Subsequent scrutinized lists from CRN became available and were distributed to ERS fund managers. At a subsequent exchange on December 21, 2015, the fund manager decided to liquidate the position without further consideration. The particular fund manager's investment process involved rebalancing the portfolio on a quarterly basis, and to provide the optimal selling procedure for the ERS, recommended the securities be sold in early 2016.

Of further note, the head of CRN and contact for the ERS, Kathy Mulvey left the organization as of November 2015. Ms. Mulvey was at the organization since 2012. As of October 15, Kathryn Allan has been responsible for EIRIS Conflict Risk Network research and corporate engagement. Ms. Allan joined CRN in December 2008 as a research analyst for the US team. Prior to joining CRN Ms. Allan worked as a researcher with EIRIS Conflict Risk Network member-subscriber Calvert Asset Management. She earned an MA in International Relations from the University of Chicago, and a BA with Distinction in Foreign Affairs and Spanish from the University of Virginia.

I All Investment Sold, Redeemed, Divested or Withdrawn

<u>Action</u>	<u>Company Divested</u>	<u>Market Value</u> ¹
Sold: February 16, 2015	Qatar Islamic Bank	(\$1,825.00)
Sold: February 16, 2015	Qatar National Bank	\$40,319.00
Sold: September 21, 2015	Volkswagen AG	\$2,516,702.96
To Sell: February 2016	Bharat Heavy Electrical Ltd.	NA
To Sell: February 2016	Harbin Electronics Ltd.	NA

II All Prohibited Investments

Companies held in the 2015 calendar year

Qatar Islamic Bank
 Qatar National Bank
 Volkswagen AG
 Bharat Heavy Electrical Ltd.
 Harbin Electronics Ltd.

¹ Net Market Value in US Dollars at time of divestment .

III Any Progress Made

<u>Company</u>	<u>Status</u>
Qatar Islamic Bank	The scrutinized company was held in an active emerging markets equity strategy. The manager decided to sell the position upon notification of the scrutinized status of the security.
Qatar National Bank	The scrutinized company was held in an active emerging markets equity strategy. The manager decided to sell the position upon notification of the scrutinized status of the security.
Volkswagen AG	The scrutinized company was held in an active developed non-US markets equity strategy. The manager requested to hold the position and staff initiated a policy defined process to inform the company of concerns. The manager sold the position after a subsequent market event unrelated to the Sudan policy requirements.
Bharat Heavy Electrical Ltd.	The scrutinized company was held in an active emerging markets equity strategy. The manager decided to sell the position upon the next portfolio rebalancing, expected in early 2016.
Harbin Electronics Ltd.	The scrutinized company was held in an active emerging markets equity strategy. The manager decided to sell the position upon the next portfolio rebalancing, expected in early 2016.