LAO
65 YEARS OF SERVICE

March 1, 2010

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative related to certain investments of two state pension systems (A.G. File No. 10-0004).

Background

This measure concerns investments of the state's two largest public pension systems—the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS)—relating to Israel. In this section, we provide background information on the two systems and on Israel.

CalPERS and CalSTRS Are Among the World's Largest Investors. The State Constitution and statutes authorize the establishment of systems to provide pension and other benefits to retired public employees, as well as public employees retiring with certain disabilities and survivors of some public employees. About 2.4 million Californians—6 percent of the state's population—are now members of either CalPERS or CalSTRS. These members generally are active or former employees of: (1) state government, California State University, or various local government entities in the case of CalPERS or (2) school districts, community college districts, or other educational entities in the case of CalSTRS. Members of CalPERS and CalSTRS' pension systems now receive or, in the future, are eligible to receive defined pension benefits from one or both of these systems. To fund the benefits, CalPERS and CalSTRS collect contributions from the state, other public employers, and/or public employees themselves. The systems invest these contributions, and the investments grow over time to cover a large portion of the total costs of the pension benefits. As such, CalPERS and CalSTRS are among the largest investors in the world. According to recent data, CalPERS has about $200 billion of investments under its management, and CalSTRS' investments have a value of about $130 billion. These investments include stocks, bonds, real estate investments, private equity investments, hedge funds, and commodities. The systems' investments are global in scope, and accordingly, the systems each are recognized to be among the world's largest investors.

Israel Attracts International Investors, Including CalPERS and CalSTRS. Israel has a diversified, technologically advanced economy with a strong technology sector. Israel is one of 33 countries, including the United States, characterized as having an "advanced economy" by the International Monetary Fund. For these and other reasons, Israel attracts substantial international investment. Investments come from certain United States-based and multinational companies, in which both CalPERS and CalSTRS invest. These companies may sell products in Israel, base employees there, operate or invest in facilities in Israel, or allow their franchisees to operate in the country. Pension systems also may invest directly from time to time in Israeli-based companies. It appears that tens of billions of dollars worth of CalPERS and CalSTRS investments are related to entities that have one or more of these types of connections—or similar connections—to Israel.

Proposal

Requires CalPERS and CalSTRS Divestment, Subject to Certain Conditions. Subject to certain conditions, the measure prohibits CalPERS and CalSTRS from investing in companies that have "business operations in Israel." ("Business operations" include "maintaining, selling, or leasing equipment, facilities, personnel, or any other apparatus of business or commerce in Israel, including the ownership or possession of real or personal property located in Israel." The measure defines Israel to include the State of Israel and territories under the administration or control of Israel.) Under the measure, the systems would have up to two years to determine whether specified investments meet the divestiture criteria. Thereafter, if the companies associated with the investments do not end their Israeli business operations or take other such actions, the systems generally may have to liquidate such investments within about 18 months. The measure exempts from this divestiture requirement certain companies primarily engaged in relieving human suffering in Israel, companies that promote health activities in Israel, and companies authorized by the federal government to have business operations in Israel, among others.

Constitutional Exemption Related to "Fiduciary Care" Would Remain. The Constitution requires that the governing boards of CalPERS, CalSTRS, and other public retirement systems have "sole and exclusive fiduciary responsibility over the assets" of their respective systems. Fiduciary responsibilities are legal obligations that the systems have for the safekeeping and management of their members' retirement funds. The Constitution further provides that each system's "duty to its participants and their beneficiaries shall take precedence over any other duty." Pension systems also must diversify their investments so as to minimize investment risks and maximize return. Accordingly, the ability of the Legislature or the electorate (through the statutory initiative process) to restrict the system's investments is limited. The Constitution does allow the prohibition of certain retirement system investments "where it is in the public interest to do so." Such investment restrictions, however, must satisfy "the standards of fiduciary care and loyalty required" of a retirement system under the Constitution. This measure, as a statutory initiative, cannot override these constitutional provisions. In fact, this measure refers to the systems taking actions consistent with those provisions.

Divestiture Requirements End Upon Certain Conditions Being Met by Israel. The measure's requirements would end if one of the following events take place:

- Israel's removal of settlements and settlers from territories occupied by Israel since 1967.
- Israel's conclusion of a peace treaty that leads to the establishment of a Palestinian state in Palestine that is recognized by the United States government.

Fiscal Effects

Large-Scale Divestiture Could Diminish Investment Returns of the Systems. The measure's provisions are subject to some interpretation. Therefore, it is uncertain exactly how many of the systems' tens of billions of dollars of Israeli-related investments would be subject to divestiture. A large-scale divestiture of many billions of dollars of stock, bond, and other investments by CalPERS and CalSTRS would most likely increase the overall risk profile and perhaps reduce diversification of the systems' investment portfolios. In many circumstances, this could reduce the earnings of system investments. If the systems' investments earned substantially less money in the future than currently anticipated by actuaries, state and local contributions to the systems would have to increase above the level that would otherwise occur to make up the difference.

Proposal Appears to Be Inconsistent With Systems' Fiduciary Obligations. We are not aware of any way that the systems could implement the large-scale divestiture in Israeli-related business activities that is contemplated by this measure without altering the risk profiles of their portfolios, affecting the diversification of their investments, and either violating or putting at serious risk their fiduciary obligations to members. Our assessment, therefore, is that CalPERS and CalSTRS likely would not comply fully with this statutory measure's divestiture requirements in light of their constitutional fiduciary duties. Alternatively, the systems could choose to interpret the divestiture requirements very narrowly to require divestment in only a small portion of Israeli-related enterprises specified in the measure. In this case, given the relatively small divestiture that would occur, potential changes in state and local government pension contributions would be negligible or small.

Possibility That Measure Could Prompt Changes in Corporate or Israeli Activities. If this measure is approved, there is a possibility that it—perhaps in conjunction with divestiture activities by other investors—could prompt more companies to curtail business operations in Israel or increase the likelihood of diminished tensions in Israel (which could lead to the end of this measure's requirements). Should either of these events occur quickly, the systems would not be required to engage in large-scale divestitures, and there would be little or no change in state and local government pension contributions.

Summary of Fiscal Effect

This measure would result in the following fiscal effect:

- Assuming that provisions of the State Constitution or other factors result in pension systems divesting only a limited portion of their Israeli-related investments, there probably would be little or no change in state and local government pension contributions.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance