August 17, 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. 10-0020).

Background

This measure concerns certain 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)—related 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 the systems.

Pension Financing and Investments. To fund the benefits, CalPERS and CalSTRS collect contributions from the state, other public employers, and/or public employees themselves. State and local governments, for example, made $10.4 billion in contributions to the two systems in 2008-09. 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 $210 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 to Israel.

Israeli-Palestinian Relations. According to the U.S. Department of State, Israel occupied the Gaza Strip, Golan Heights, the West Bank, and East Jerusalem during the 1967 War. Over 4 million Palestinians live in the occupied territories (including areas subject to the jurisdiction of the Palestinian Authority). Israel's domestic and international policies are marked by tensions related to the occupied territories and nearby Arab states, among other issues. Israeli settlement activity in the occupied territories has been one of these tensions. An over 400-mile-long "separation barrier" has been under construction by Israel. According to the State Department, once completed, approximately 85 percent of the barrier's route will run inside the West Bank and Jerusalem, thereby isolating portions of the West Bank and restricting Palestinian movement and access to West Bank land west of the barrier.

Proposal

Under this proposed statutory measure, within six months of this measure's passage, CalPERS and CalSTRS each would be required to publicly identify their investments in companies that (1) "provide products or services that contribute to the construction or maintenance of Israeli settlements and/or the Separation Wall in the Palestinian Territories" or (2) "provide military supplies, equipment, and services to the State of Israel." The measure would allow, but not require, the systems to use information from the United Nations and nongovernmental organizations to help them identify these companies. The retirement systems would be required to notify these companies and "urge them to stop supplying their goods and services to Israel." If the companies do not stop supplying these goods and services within six months after such notification, CalPERS and CalSTRS would be required to divest from these companies subject to the standards of fiduciary care described below. The systems would be prohibited from making "any new investments in companies" that provide the goods and services described above.

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 divesting from specified Israeli-related companies "within the constraints of their fiduciary responsibility."

Fiscal Effects

Divestiture Could Affect Investment Returns of the Systems. The measure's provisions are subject to considerable 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. The measure's language, however, restricts the systems' ability to invest in companies undertaking a limited number of activities related to the Israeli military and activities concerning the occupied territories. Moreover, some companies initially identified as providing targeted goods and services to Israel may cease to do so, given this measure's threat of divestiture by CalPERS and CalSTRS. Accordingly, it is possible that the measure would be interpreted as requiring divestiture from a limited number of companies. Divestiture from these companies could reduce the earnings of the systems' investments. Assuming that the number of affected companies is small, the net negative effect on system returns likely would be negligible, as would the resulting increase, if any, in state and local government pension contributions to the systems. On the other hand, if (1) the measure is interpreted as requiring divestiture of a larger portion of the systems' tens of billions of dollars of Israeli-related assets and (2) this interpretation is deemed by the systems to be consistent with fiduciary requirements, the potential effect on system returns—and, therefore, on state and local government pension contributions—could be more significant. An exact estimate of this more significant effect is impossible to make. Each 0.1 percent annual increase in state and local government payments to the systems, however, would have totaled around $10 million, as of 2008-09.

Uncertainty About Future Termination Date of This Measure. This measure states that "it is intended that the need for this initiative would cease to exist" if several specified developments occur, such as Israel's removal of its citizens from West Bank settlements, the end of Israeli occupation of specified territories, and the dismantling of the separation barrier. This measure's statutory provisions, however, contain no specific mechanism to effectuate this intent. Actions by the courts or the Legislature—or further actions by the electorate through the initiative process—may be required to terminate this measure's divestiture requirements in the event that the specified developments described above occur.

Summary of Fiscal Effect

This measure would result in the following fiscal effect:

- Potential increase in state and local government pension contributions, the amount of which would vary from negligible to more significant based on how this measure's divestiture requirements are interpreted and implemented.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance