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## Public Pension Fund Investments.

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## Official Title and Summary Prepared by the Attorney General

**PUBLIC PENSION FUND INVESTMENTS. LEGISLATIVE CONSTITUTIONAL AMENDMENT.** Deletes constitutional provisions specifying percentage and type of stocks and corporations in which public pension funds may invest. Substitutes provisions empowering Legislature to authorize investment of public pension funds by fiduciary who must discharge duties solely in interest and for exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions, and defraying reasonable administrative expenses; discharge duties pursuant to specified prudent person standard; and diversify investments pursuant to specified standard. Declares public pension funds assets are trust funds held for exclusive purpose of providing benefits and defraying reasonable administrative expenses. Summary of Legislative Analyst's estimate of net state and local government fiscal impact: This measure would have no direct fiscal effect on the state or local governments. The indirect fiscal effect of this measure would depend on the extent to which the rate of return on the investments of public retirement funds is higher or lower than what it would have been in the absence of the additional flexibility authorized by this measure.

## Final Vote Cast by the Legislature on ACA 16 (Proposition 21)

Assembly: Ayes 71	Senate: Ayes 38
Noes 2	Noes 0

## Analysis by the Legislative Analyst

## Background

The State Constitution generally prohibits state and local agencies from buying stock in corporations. The Constitution, however, allows the Legislature to authorize public pension or retirement systems to buy stock in corporations, subject to various restrictions. For instance, no retirement system may invest more than 25 percent of its assets in common stock or more than 5 percent of its assets in preferred stock. In addition, no system may invest more than 2 percent of its total assets in the common stock of any one corporation or own more than 5 percent of any company's outstanding common stock shares.

The Constitution also limits the types of stocks which may be held by the retirement systems. In general, to be eligible for purchase by a public retirement system:

- The stock must be registered on a national securities exchange;
- The company must have total assets of at least \$100 million; and
- The company must meet a specified common stock dividend history.

The Constitution does not specify that assets of a public pension or retirement system are trust funds held for specified purposes, and it does not provide for particular fiduciary responsibilities for trustees of such pension or retirement systems. Fiduciary responsibilities are the special obligations which people in positions of trust have toward those whose interests are affected by their actions.

## Proposal

This measure would delete the specific constitutional restrictions and limitations on the purchase of corporate stock by public retirement systems. Instead, it would allow the Legislature to authorize any investment of a public retirement system's funds, subject to specified standards of fiduciary responsibility. This measure also specifies that the assets of public pension and retirement systems are trust funds and requires that these assets be held for specified purposes.

The major public retirement systems that would be affected by this amendment are: (1) the Public Employees' Retirement System, which covers state and many local government employees, (2) the State Teachers' Retirement System, which covers public school teachers, and (3) systems established under the County Employees' Retirement Law of 1937. These systems currently have assets totaling approximately \$40 billion.

## Fiscal Effect

This measure would have no *direct* fiscal effect on the state or local governments. The indirect fiscal effect of this measure would depend on the extent to which the rate of return on the investments of public retirement funds is higher or lower than what it would have been in the absence of the additional flexibility authorized by this measure.

## Text of Proposed Law

This amendment proposed by Assembly Constitutional Amendment 16 (Statutes of 1983, Resolution Chapter 105) expressly amends the Constitution by amending a section thereof; therefore, existing provisions proposed to be deleted are printed in *strikeout type* and new provisions proposed to be inserted or added are printed in *italic type* to indicate that they are new.

### PROPOSED AMENDMENT TO ARTICLE XVI, SECTION 17

SEC. SEC. 17. The State shall not in any manner loan its credit, nor shall it subscribe to, or be interested in the stock of any company, association, or corporation, except that the state and each political subdivision, district, municipality, and public agency thereof is hereby authorized to acquire and hold shares of the capital stock of any mutual water company or corporation when *such the* stock is so acquired or held for the purpose of furnishing a supply of water for public, municipal or governmental purposes; and *such the* holding of *such the* stock shall entitle *such the* holder thereof to all of the rights, powers and privileges, and shall subject *such the* holder to the obligations and liabilities conferred or imposed by law upon other holders of stock in the mutual water company or corporation in which *such the* stock is so held.

Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund; ~~not to exceed 25 percent of the assets of such fund determined on the basis of cost in the common stock or shares and not to exceed 5 percent of assets in preferred stock or shares of any corporation; provided:~~ *system, subject to all of the following:*

a. ~~Such stock is registered on a national securities exchange, as provided in the "Securities Exchange Act of 1934" as amended, but such registration shall not be required with respect to the following stocks:~~

1) ~~The common stock of a bank which is a member of the Federal Deposit Insurance Corporation and has capital funds, represented by capital, surplus, and undivided profits, of at least fifty million dollars (\$50,000,000);~~

2) ~~The common stock of an insurance company which has capital funds, represented by capital, special surplus funds, and unassigned surplus, of at least fifty million dollars (\$50,000,000);~~

3) ~~Any preferred stock;~~

b. ~~Such corporation has total assets of at least one hundred million dollars (\$100,000,000);~~

c. ~~Bonds of such corporation, if any are outstanding, qualify for investment under the law governing the invest-~~

~~ment of the retirement fund, and there are no arrears of dividend payments on its preferred stock;~~

d. ~~Such corporation has paid a cash dividend on its common stock in at least 8 of the 10 years next preceding the date of investment, and the aggregate net earnings available for dividends on the common stock of such corporation for the whole of such period have been equal to the amount of such dividends paid; and such corporation has paid an earned cash dividend in each of the last 3 years;~~

e. ~~Such investment in any one company may not exceed 5 percent of the common stock shares outstanding; and~~

f. ~~No single common stock investment may exceed 2 percent of the assets of the fund, based on cost.~~

Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund, in stock or shares of a diversified management investment company registered under the "Investment Company Act of 1940" which has total assets of at least fifty million dollars (\$50,000,000); provided, however, that the total investment in such stocks and shares, together with stocks and shares of all other corporations may not exceed 25 percent of the assets of such fund determined on the basis of the cost of the stocks or shares.

(a) *The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.*

(b) *The fiduciary of the public pension or retirement system shall discharge his or her duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.*

(c) *The fiduciary of the public pension or retirement system shall discharge his or her duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.*

(d) *The fiduciary of the public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.*

### Argument in Favor of Proposition 21

Proposition 21 was written to give public pension assets full constitutional protection as trust funds. It guarantees that neither the Governor nor future Legislatures will ever be able to use this money for other purposes. Proposition 21 also adopts federally tested investment safeguards to replace existing guidelines. The current provisions, designed in a different era, often defeat retiree interests today. *In addition, these old guidelines senselessly raise the cost of pension administration for all taxpayers.*

Existing law guides state pension investments by listing allowed investments and the limitations on each.

While this approach has helped keep investment holdings diversified, *other needs equally essential to pension plan well-being have suffered because of these provisions.*

No one writing the old rules foresaw the recent major changes in the national financial markets: accelerated deregulation, an expanding financial services industry, and many new, special-purpose investment instruments.

Because of these changes, the old investment list no longer serves as an adequate guide to today's safe investment options. Instead, the list's restrictions now hinder similarly prudent investments which would benefit the long-term interests of the pension plan and its retirees.

Proposition 21 corrects this unanticipated problem by making retiree and pension plan benefits the only proper investment criteria. It does this by replacing the old approach with tested investment decision rules which are modeled on the extensive federal government experience in this area.

Specifically, Proposition 21:

- Declares all assets of a public pension or retirement plan to be *trust funds*. It provides that, apart from reasonable administrative costs, the *only purpose* for which these trust assets can be used is the delivery of retirement benefits.

- Enacts the *sole and exclusive purpose rule* which imposes on fund trustees the legal obligation to perform their duties *solely* in the interest of plan beneficiaries.
- *Makes trustees personally liable* if they invest funds without exercising, as federal law requires, the degree of care expected of a *prudent person, who is knowledgeable in investment matters.*
- *Retains the requirement that investments be diversified* so as to minimize risk. Instead of using current law's category approach to diversification, Proposition 21 makes diversification choices subject to the prudent person/personal liability rule.

These four elements have proven effectiveness. They are the key parts of a federal law which safeguards the funds in over 600,000 private pension plans.

By adopting these rules, Proposition 21 meets California's pressing need for investment guidelines which do not undermine retiree interests merely by the passage of time.

This tested federal approach solves this problem because it places stringent controls, not on the available choices, but upon the persons and methods of choosing. This approach recognizes that, when the duty to choose is linked to personal responsibility for the choice, the highest level of independent, professional judgment is exercised.

Proposition 21 gives Californians the benefit of this proven approach so that state pension fund managers can take the best tools of today and turn them to the advantage of tomorrow's retirees. It deserves your support.

LOUIS J. PAPAN  
*Member of the Assembly, 19th District*

LARRY STIRLING  
*Member of the Assembly, 77th District*

### Rebuttal to Argument in Favor of Proposition 21

Proponents of Proposition 21 advocate increased speculation in the stock market to allow for a greater rate of return through so-called "innovative" investments. They fail to mention, however, that such speculation is accompanied by a high degree of risk and a greatly increased danger of financial loss.

There is no such thing as a "guaranteed return" in stock market speculation.

Our current policy of requiring that pension moneys be placed in stable, prudent investments is the best method of safeguarding the financial interests of our state's retirees and the taxpaying public. Isn't it wiser to continue putting these moneys in prudent, safe investments rather than engage in a stock market gamble?

The State Teachers' Retirement Board recently lost millions of dollars on a get-rich-quick oil investing scheme. Allowing further questionable investment strategies could well jeopardize the fiscal security of all public pension funds. And we all know who pays the bill for any losses incurred through poor investments—that's right—the taxpayer!

Let's not take chances with our public pension funds.  
VOTE NO on Proposition 21.

PAT NOLAN  
*Member of the Assembly, 41st District*

JAKE PETROSINO  
*Member, Board of Administration, Public Employees' Retirement System, State of California*

## Argument Against Proposition 21

Proposition 21 allows investment in common stocks by the state's public pension systems to jump from the present 25 percent of assets to as much as 100 percent of pension funds.

A similar measure, Proposition 6, was rejected in 1982 with 61 percent of the voters against it. That reflected a well-deserved negative response based upon a track record beginning in 1968 when the current 25-percent limit was established.

Earnings from our pension systems' common stock investments have consistently failed to meet the modest earnings levels necessary to help fund California's public pension systems. Using any comparative criteria, the returns on common stock investments made by the public pension systems have been dismal when compared to other types of investments by both public and private sector pension systems across the nation. The economic security of retirees is too important to be gambled away in the stock market.

Assets of public pension funds should continue to be placed in mortgages and other more consistently profitable types of investments to provide a prudent "mix" that safeguards the long-term financial needs of public pension systems. If approved, Proposition 21 could drastically reduce other types of investments.

Public Employees' Retirement System (PERS) earnings from common stock have been less than 4 percent annually during the entire period that the system has been investing in common stocks. Other types of investments have averaged in excess of 9 percent per year. The entire 15-year PERS record stands as undeniable proof that an increase in common stock holdings to an unlimited per-

centage of pension fund assets is a serious mistake. In these difficult and uncertain economic times, we hardly need to permit a questionable fiscal practice.

The trust fund language proposed in Proposition 21 already exists in current retirement law, yet public pension systems have been "creatively" raided by past Legislatures and Governors. The simple fact is, there is no language in the State Constitution which can effectively protect public pension funds from politically enacted thievery.

The so-called "prudent" investment rules proposed by Proposition 21 allow a wider variety of "high-risk" investments. This is unwise for a pension fund which MUST minimize risk in order to preserve assets used to pay pensions which are long-term, contractual obligations to the retirement system members. It would be better to retain conservative investment requirements for public pension systems of present law.

The dismal record in stock market speculation stands as proof that there is no good reason to relax existing restraints on public pension fund investments.

Approval of Proposition 21 will be a costly mistake for the public sector workforce and the California taxpayer, all of whom will be economically damaged by reduced retirement fund earnings in future years.

Vote NO on Proposition 21.

PAT NOLAN  
*Member of the Assembly, 41st District*

JAKE PETROSINO  
*Member, Board of Administration, Public Employees' Retirement System, State of California*

## Rebuttal to Argument Against Proposition 21

Proposition 21 is as critical to taxpayers and retirees as any pension measure of the last 10 years—but all the opponents offer is rhetoric and wild claims.

Proposition 21 is not a rerun of any ballot measure. While current law increases risk by forcing all pension moneys into a few investments, this measure adopts the proven, conservative federal approach which cuts risk by allowing greater variety *if the dictates of prudent judgment are met*.

And the charge that Proposition 21 will lead to 100% stock ownership is totally misleading. Total reliance on stocks *would be legally impossible under Proposition 21* for the very reason the opponents cite—it would be foolhardy and imprudent.

The fact of Proposition 21 is that it will subject every investment decision to *greater prudence*, not less.

Proposition 21 should be approved because, unlike the opponents, it is *absolutely realistic* about how prudent investments are made.

The opponents talk lightly of "consistently profitable" investments. If such surefire formulas exist, why aren't we all millionaires? The fact is the only protection in any investment is the care and thought which go into it. That's why Proposition 21 places this requirement of prudent judgment into the Constitution where it can't be tampered with.

Taxpayers and retirees alike have a big stake in the efficient management of the state pension funds.

Your "yes" vote on Proposition 21 will give fund managers *realistic tools to keep benefits up and costs down*.

LOUIS J. PAPAN  
*Member of the Assembly, 19th District*