



## Agenda Item 6

May 14, 2013

**ITEM NAME:** Proposed Regulations to Implement PEPRA

**PROGRAM:** Customer Account Services, Benefit Services

**ITEM TYPE:** Action

### **RECOMMENDATION**

Approve the proposed regulations and the initiation of the rulemaking process to add subdivision (b) to section 579.2 and add sections 579.3, 579.21, 579.22, and 579.25 to Chapter 2 of Division 1 of Title 2 of the California Code of Regulations (CCR). These proposed regulations establish the California Public Employees' Retirement System's (CalPERS) implementation and interpretation of certain provisions within Assembly Bill (AB) 340, known as the California Public Employees' Pension Reform Act (PEPRA) of 2013, and related pension reform changes to the Public Employees' Retirement Law (PERL) and law governing the Legislators' Retirement System (LRS).

### **EXECUTIVE SUMMARY**

Staff recommends the proposed regulations be additions to the CCR. The proposed regulations are intended to assist with the implementation and administration of the new pension reform statutes by clarifying CalPERS interpretation of certain PEPRA provisions and by outlining certain procedures now necessary as a result of pension reform. Some of the PEPRA statutes do not fully define certain terms and phrases and accordingly require retirement systems to interpret how those phrases will be defined. It is necessary for CalPERS to interpret these words and phrases so it can properly implement pension reform and administer the System. These regulations will also assist CalPERS staff, employers, members and other stakeholders to gain uniform compliance with the new statutory provisions by providing clarity for terms and phrases that might have more than one meaning and by detailing CalPERS processes. The proposed regulations are consistent with the PEPRA provisions described below and are reasonably necessary to effectuate the purpose of these statutes.

### **STRATEGIC PLAN**

This item is presented in support of CalPERS implementation of PEPRA and related pension reform changes to the PERL and LRS law and in accordance with two of CalPERS Strategic Plan Goals. First, within Goal A which is to improve the long-term pension and health benefit sustainability, the proposed regulations support the Strategic Objective by implementing the new pension reform changes and by educating employers and other stakeholders of the new provisions and CalPERS interpretations so they can make informed decisions about retirement security and

understand how pension reform changes may impact retirement benefits. Second, within Goal C which is to engage in State and national policy development to enhance the long-term sustainability and effectiveness of our programs, this item supports both objectives by clarifying and communicating CalPERS interpretation of certain pension reform provisions, and providing education and outreach to members, employers, and stakeholders to promote the uniform application of certain pension reform provisions.

### **BACKGROUND**

On September 12, 2012, Governor Brown signed into law AB 340 which included the PEPRA and related pension reform changes to the PERL and LRS law. These statutory provisions became effective on January 1, 2013. This legislation adds, amends, and repeals numerous sections of the Government Code (GC) relating to public employees' retirement benefits. This agenda item is the second in a series of agenda items that will bring forth proposed regulations necessary to implement and administer the System as a result of the changes mandated by the new pension reform laws. In February of this year, the Board approved the initiation of the regulatory process for six proposed regulations which serve to establish the scope and authority of the regulations related to pension reform, in addition to providing CalPERS interpretation of certain terms and processes it will use for the purposes of implementing the pension reform provisions.

Staff has developed an additional five proposed regulations, which include one amendment to a previously approved proposed regulation, attached hereto as Attachment A for the Board's approval. These proposed regulations serve to provide formal notice to employers, members, and stakeholders of CalPERS interpretation on these issues, to ensure consistency in the application and implementation of the new statutory provisions for all employers and members, and to minimize the risk of potential litigation over the meaning of certain undefined statutory terms. It is anticipated that these proposed regulations will also help avoid confusion associated with the new statutory language and should assist CalPERS-covered employers and other stakeholders in complying with the new laws.

### **ANALYSIS**

Many of the new pension reform provisions apply to "new members" (a term defined by GC section 7522.04(f)) and not to existing or "classic members" (those members who entered into membership with a retirement system on or before December 31, 2012, who do not meet the definition of a "new member" in Section 7522.04(f) as defined in previously-proposed regulation section 579.1). The distinction between the two types of members is very important when it comes to determining the member's appropriate retirement formula, final compensation periods, caps on compensation, and other rights to and limitations on retirement benefits. It is therefore important CalPERS have a well-defined implementation plan

to establish the clear meaning of key terms that will be required to make such determinations.

By way of background, the term “new member” (as defined in GC section 7522.04(f)) includes three groups:

- An individual (with no prior membership in any public retirement system) who becomes a member of any public retirement system for the first time on or after January 1, 2013.
- An individual (with prior membership in a public retirement system) who becomes a member of any public retirement system for the first time on or after January 1, 2013, provided the person is not subject to reciprocity (under 7522.02(c)).
- An individual who was an active member in a public retirement system and who, after a break in service greater than six months, returns to active membership in that system with a new employer. However, a person who moves between State agencies or departments within the State, or from one school employer to another is not considered to be a “new member” regardless of the length of the break in service.

Similar to the proposed regulations the Board approved in February, these five proposed regulations (which include one amendment to a previously approved proposed regulation) interpret and clarify various terms used to: 1) categorize members as new members or classic members; 2) identify the required contribution rates and compensation limits for purposes of calculating final compensation; 3) determine the required level of retirement benefits and benefit limitations; and, 4) apply the restrictions on post-retirement employment.

CalPERS is continuing to engage in outreach to educate our members, employers and stakeholders on changes related to pension reform and the regulatory development process. The outreach includes training classes, materials posted on the CalPERS website, meetings with stakeholders, and presentations. As previously mentioned, we will continue outreach throughout the regulatory process.

As noted above, staff determined many regulations will be required to implement the new pension reform requirements. The proposed regulations discussed below are the second set of such regulations and staff anticipates returning to the Board in the coming months with additional proposed regulations.

### **PROPOSED REGULATIONS**

This set of five proposed regulations which are necessary to implement and administer the pension reform statutes are discussed individually below.

**Amendment of Proposed Section 579.2 Additional Definitions**

The proposed amendment of section 579.2 to the CCR seeks to add subdivision (b) to define the term “retirement plan” as it is used in GC section 7522.02(c).

“Retirement plan” is not a statutorily defined term in PEPRA or the PERL, and since the definition of this term impacts the benefits available to employees who are “subject to reciprocity,” (itself a defined term in proposed regulation section 579.3 below) it is crucial a consistent definition be applied. Since CalPERS determines the benefits available to employees, the purpose of this regulation is to define for CalPERS members, employers and other stakeholders how CalPERS intends to determine which benefits the employees are eligible to receive.

CalPERS has determined that “retirement plan” shall include all “benefits” as that term is defined by GC section 20020 and “optional benefits” which are additional benefits established by the PERL that agencies may offer their employees. In GC section 20020, “benefit” is defined as the “retirement allowance, basic death benefit, limited death benefit, special death benefit, any monthly allowance for survivors or a member or retired person, the insurance benefit, the partial disability retirement program payments, or refund of accumulated contributions.” The optional benefits exist in numerous sections in the PERL and may be provided to employees either by contract amendment (through the GC section 20474 amendment process), by resolution (as provided for Employer Paid Member Contributions through regulation section 569), or by statute.

For this proposed regulation, there was particular concern regarding individuals employed after January 1, 2013, with a new agency who are subject to reciprocity or have a break of service of six months or less and are eligible to receive benefits that existed on December 31, 2012, (pursuant to GC section 7522.02(c)), who then might be considered somehow eligible to receive benefits that have been reduced for “classic members” since December 31, 2012. For example, where an individual is hired on September 1, 2013, and is subject to reciprocity so that he or she is eligible for the benefits in existence of December 31, 2012, if Employer Paid Member Contributions (EPMC) were paid at one hundred percent on December 31, 2012, but were reduced to zero percent on June 30, 2013, for the classic member counterparts of this individual, the individual should not be eligible to receive EPMC at 100 percent even though that benefit existed on December 31, 2012. For avoidance of doubt, the proposed regulation to define “retirement plan” does not entitle new employees who are subject to reciprocity to benefits that are otherwise not available to their classic member counterparts who have been continuously employed by the same employer since December 31, 2012.

This proposed regulation is necessary to make clear to members, employers, and stakeholders, how CalPERS will determine what benefits are available to new employees who are classic members.

**Addition of Proposed Section 579.3 Subject to Reciprocity Defined**

The proposed addition of section 579.3 seeks to clarify CalPERS' interpretation of the phrase "subject to reciprocity" as used in GC sections 7522.02(c) and 7522.04. In that regard, section 579.3 also provides a definition for the term "reciprocity" as used in this context, and establishes the procedure for determining whether a newly hired individual is "subject to reciprocity."

As noted above, reciprocity is an important concept in determining the scope of PEPRAs applicability and determining whether an individual is a "new member" or "classic member." The implications of the use of the term "subject to reciprocity" under PEPRAs are far reaching. However, this phrase is not clearly defined in statutes, which results in additional ambiguity for purposes of determining who would be considered a "new member" or "classic member."

In an attempt to resolve this ambiguity, the proposed language of section 579.3 defines the term "reciprocity" as the recognition by CalPERS of certain reciprocal benefit rights available to members who move from one public retirement system to another public retirement system. At a minimum, "reciprocity" means recognition by CalPERS of a member's payrate during a period of service as a member of the other public retirement system for purposes of computing final compensation upon retirement. The proposed language of section 579.3 further clarifies that "reciprocity" is established by statute or by an agreement between CalPERS and the other public retirement system, which includes agreements between CalPERS and the California State Teachers' Retirement System, the Legislators' Retirement System, the Judges' Retirement System I and the Judges' Retirement System II.

Additionally, incorporating the term "reciprocity" as defined above, the proposed language of section 579.3 defines the phrase "subject to reciprocity" as used in GC sections 7522.02(c) and 7522.04. "Subject to reciprocity" means that, on the "applicable date", an individual is eligible for reciprocity pursuant to the terms of a statute or reciprocal agreement to which CalPERS is a party, provided he or she did not have a break in service of more than six months immediately preceding the "applicable date." "Applicable date" for purposes of this section, shall mean the individual's appointment date for the most recent employment resulting in active membership in CalPERS; the "applicable date" may be a date later than the individual's original CalPERS membership date, such as when an individual was employed by a CalPERS-covered employer prior to being a member of the reciprocal retirement system. Section 579.3 further clarifies that to be "subject to reciprocity," an individual need not have made an affirmative election to invoke reciprocity rights on the "applicable date," nor must the individual actually exercise the reciprocity rights when he or she retires.

Lastly, the proposed language of section 579.3 outlines the procedure that shall be used to determine whether a newly hired individual is "subject to reciprocity" pursuant

to GC sections 7522.02(c) and 7522.04. Section 579.3 also provides a list of information that the newly hired individual must provide to his or her employer to assist CalPERS in making such a determination, and states that the information shall be retained by the employer.

#### **Addition of Proposed Section 579.21 Determination of Final Compensation**

The proposed addition of section 579.21 to the CCR seeks to clarify how CalPERS will determine the final compensation amounts for new members as required by GC section 7522.32. GC section 7522.32 establishes a 36-month final compensation period for new members. GC section 7522.10 caps the amount of pensionable compensation that can be used for the purposes of calculating retirement benefits for new members. Therefore, read together, these provisions require CalPERS to establish the process it will use to calculate final compensation for new members.

CalPERS will use the process articulated in the proposed regulation to determine final compensation for new members. Under the process in the proposed regulation, CalPERS will determine the new member's final compensation by calculating the member's total final compensation and divide it by three to represent the annual average of the member's total final compensation over the three year period; CalPERS will use three years instead of 36-months because final compensation is calculated on an annual basis and not monthly.

CalPERS chose the calculation method as set forth in the proposed regulation because this is the most reasonable interpretation for both new members and employers to ensure members will receive benefits no higher or lower than what was contemplated based on actual contributions to the System. This proposed regulation is necessary to make clear to members, employers, and stakeholders, how CalPERS will determine final compensation amounts for new members.

#### **Addition of Proposed Section 579.22 Application of Pensionable Compensation Cap**

The proposed addition of section 579.22 to the CCR seeks to clarify the process to be used to limit pensionable compensation and associated contributions for new members. GC section 7522.10(a) requires each public retirement system to modify its plan to comply with the requirements of section 7522.10. This regulation seeks to accomplish that requirement.

GC section 7522.10 establishes caps on the amounts of pensionable compensation that can be used to calculate retirement benefits for new members. It also requires retirement systems to adjust the cap each year as provided for in the statute on January 1. The final compensation period for a new member will span either the 36-month period immediately preceding the member's retirement date, or the 36-month period resulting in the highest pensionable compensation earned while a new member, if different. Since the 36-month period typically begins on a date other

than January 1, CalPERS must establish the process to be used for determining the caps on pensionable compensation for new members so the member's final compensation can be appropriately calculated. The method in this proposed regulation section 579.22 works in tandem with the proposed regulation section 579.21 above regarding the calculation of final compensation.

If the 36-month final compensation period spans four calendar years (where the final compensation period begins on a date other than January 1), one hundred percent of the pensionable compensation cap will be applied for each of the two full calendar years within the 36-month period. For the two portions of the remaining calendar years within the 36-month period, CalPERS will take the maximum pensionable compensation cap for the particular calendar year, and multiply the cap by a fraction (which is the number of days of the final compensation period falling within that calendar year divided by the total number of days of that calendar year). The resulting amount will be the portion of the pensionable compensation cap that applies for purposes of determining a new member's final compensation calculation according to the method described in proposed regulation section 579.21. This interpretation provides the highest possible final compensation for the new member based on actual contributions made to the retirement system.

Additionally, because retirement benefits cannot be earned on pensionable compensation above the cap in any given year, the proposed regulation also confirms that contributions paid by new members into the retirement system are not required on any earnings over the pensionable compensation cap in a calendar year. This confirmation is necessary so it will be clear for all members, employers, stakeholders and CalPERS staff that contributions are not required on any earnings above the cap for the balance of the calendar year at issue. Additionally, this proposed regulation includes a provision to ensure in the future, if some situation occurs whereby a calculation using compensation in excess of the cap can be accomplished by means not previously contemplated by CalPERS in this proposed regulation, the pensionable compensation cap will in no way exceed the maximum cap imposed on contributions made by, or on behalf of, the member for that calendar year or portion of the calendar year.

This regulation is necessary to make clear how CalPERS will apply the pensionable compensation cap and how it the cap will be applied in terms of calculating the final compensation for new members subject to the cap. This proposed regulation should help avoid any confusion for new members at the time that they retire and should help avoid possible legal challenges.

**Addition of Proposed Section 579.25 Public Safety Officer Exception to the 180-day Wait Period**

The proposed addition of section 579.25 to the CCR seeks to implement CalPERS interpretation of the phrase "public safety officer" as that phrase is used in GC section

7522.56(f)(4). The proposed regulation defines the phrase “public safety officer” to include all peace officers identified in GC section 3301 for purposes of the exception to the 180-day wait period required by PEPRA for post-retirement employment. GC section 3301 defines the scope of the term “public safety officers” in the Public Safety Officers Procedural Bill of Rights Act (GC sections 3000-3313).

The phrase “public safety officer” could be subject to more than one meaning since that term is not statutorily defined in PEPRA. As such, it is necessary for CalPERS to define the phrase to ensure consistent compliance by employers. CalPERS staff, in conjunction with the California Department of Human Resources, determined this definition is the most reasonable interpretation. Pending legislation (Senate Bill 13) proposes an amendment to GC 7522.56(f)(4) to provide that the exception to the wait period shall apply to those public safety officers whose post-retirement employment includes the function or functions of public safety officers. Since the term “public safety officer” and “the functions of a public safety officer” are not statutorily defined in PEPRA, CalPERS believes this regulation to be necessary and the most reasonable interpretation is to use GC section 3301 as guidance because it identifies public safety officers as peace officers who are generally required to have the Peace Officer Standards and Training (POST) certification. Since retired peace officers who are afforded this exception will perform peace officer work requiring the POST certification, a broader definition of public safety officer that includes every CalPERS safety classification would give non-POST-certified safety members an unfair advantage in competing for certain retired annuitant positions over the non-safety retirees who are required to serve the full 180-day wait period.

This proposed regulation is necessary so CalPERS can properly administer the PEPRA provisions that restrict members’ employment within 180 days after retirement for a CalPERS-covered employer, and so employers will have the details necessary to comply with the new statutory provisions. It is also necessary to ensure all CalPERS-covered employers are using the same definition of “public safety officer” that CalPERS is using to avoid the inconsistent application of the new restrictions.

### **BENEFITS/RISKS**

The proposed regulations are designed to implement the new pension reform provisions. By interpreting certain phrases and outlining processes, the proposed regulations will provide clarity and uniformity for CalPERS, its members, employers and stakeholders and should help avoid protracted litigation over disputes relating to how the new pension reform provisions should be interpreted. The proposed regulations will also ensure individuals are properly enrolled into membership from the start of their employment so that proper contributions are collected on their behalf, and the proposed regulations will help ensure the correct level of benefits will be provided to these individuals at the time they retire and that the appropriate restrictions on post-retirement employment are observed. Additionally, the proposed

regulations make clear various processes that will be used by CalPERS to implement the pension reform laws which should make administration of these new statutes more efficient.

Without the adoption of the proposed regulations, there are significant risks. Not all CalPERS-covered employers may interpret the new legislation consistent with CalPERS interpretation, and that could lead to inconsistent application of these new laws. Moreover, without the proposed regulations, employers might interpret certain phrases in a manner that could be potentially detrimental to CalPERS members. Further, should the proposed regulations not be promulgated, there could be confusion amongst CalPERS-covered employers when enrolling members, which could lead to members being improperly enrolled as new members when they should have been enrolled as classic members, or vice versa. Proper enrollment is critical to ensuring members receive the correct benefit formula, final compensation period, and applicable cap on pensionable compensation, as well as ensuring that members pay the statutorily required amount of member contributions amounts. Finally, without the proposed regulations, legal challenges may be undertaken to resolve disputes over the meaning of various key phrases used in the pension reform statutes.

#### **NEXT STEPS**

If the Board approves the proposed regulations and the initiation of the regulatory process, CalPERS staff will request the publication of the Notice of Proposed Regulatory Action in the California Regulatory Notice Register. A minimum 45-day written comment period will be followed by a public hearing, which is anticipated to be scheduled for the August 2013 PHBC meeting. If any public comments require revisions to the proposed regulations, the revised proposed regulations may require an additional 15-day or 45-day comment period and may require additional Board approval. If no additional comment period is required, or after final Board approval, the final proposed regulations may be transmitted to the Office of Administrative Law (OAL) for review, approval and filing with the Secretary of State and publication in the CCR. The proposed regulations will then become effective in accordance with the OAL calendar, which as of January 1, 2013, now uses a quarterly effective date schedule; because the regulations apply to the PEPRA laws already in effect, staff intends to request an earlier effective date from OAL so that the proposed regulations will become effective immediately upon transmittal to the Secretary of State. If no additional comment periods are necessary, the earliest effective date for the proposed regulations could be in November of 2013, however, should additional comment periods become necessary due to modifications to the regulatory text or should the request for an earlier effective date not be approved by OAL, the effective date would be pushed back accordingly.

As mentioned previously with the proposed regulations the Board approved in February, CalPERS will incur some costs in order to comply with the PEPRA legislation. Notwithstanding this fact, staff has attempted to identify the fiscal impact

associated with implementing the proposed regulations. In general, certain administrative costs will be attributable to the proposed regulations, including education outreach and training, programming costs to the my|CalPERS system, publication costs, and postage. In some instances, CalPERS-covered employers may also incur certain administrative costs for training or enhancements to their own systems, and costs associated with complying with the proposed regulations; however, staff may be unable to quantify all of these costs incurred by CalPERS-covered employers. As this information must be provided to OAL and the Department of Finance as part of the regulatory process, staff continues to work on quantifying the above costs, and determining whether there may be additional costs to CalPERS and CalPERS-covered employers associated with individual proposed regulations, including evaluating whether there may be a need to hire additional staff to complete the necessary processes associated with PEPPRA as outlined in the regulations.

**ATTACHMENTS**

Attachment A – Proposed Regulatory Action by CalPERS

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RENEE OSTRANDER  
Assistant Division Chief  
Customer Account Services Division

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ANN BOYNTON  
Deputy Executive Officer  
Benefit Programs Policy and Planning