

## **Initial Statement of Reasons**

### **Proposed amendment to amend Section 558.1 of Article 1 of Subchapter 1 of Division 1 of Title 2 of the California Code of Regulations (CCR).**

By proposing this amendment, the California Public Employees' Retirement System ("CalPERS") seeks to ensure that (1) CalPERS fully complies with federal and state laws around the misuse of material, non-public information; and, (2) CalPERS' employees and their spouses have a clear understanding of the agency's personal trading requirements. The proposed regulation is consistent with existing law and is reasonably necessary to establish fair and transparent processes.

### **PROBLEM THE PROPOSED AMENDMENT INTENDS TO ADDRESS**

Existing law recognizes the Board's authority to regulate the personal trading of identified Covered Employees. Section 20120 and 20121 of the California Government Code permits the Board to make such rules as it deems proper. Rule 204A-1 under the Investment Advisers Act of 1940 ("Advisers Act") requires each registered investment adviser to adopt a written code of ethics. A code of ethics must require that employees comply with applicable federal securities laws and impose restrictions and monitoring requirements over the personal trading of securities by certain employees. Although CalPERS is not governed by the Advisers Act, CalPERS is still bound by the anti-fraud provisions of the federal securities laws, including the prohibition on insider trading and other forms of market manipulation. The need to ensure compliance with the federal securities laws through compliance programs and appropriate regulations was underscored in 2008 when the Securities and Exchange Commission issued a report of investigation concerning potential violations of federal securities laws by the Retirement System of Alabama (<https://www.sec.gov/litigation/investreport/34-57446.htm>), that all "access persons" report their personal securities transactions and holdings to the chief compliance officer for review. (17 CFR § 275.204A-1(a)(3)). This provision is modeled on Rule 17j-1 under the 1940 Act, which requires that investment companies have procedures in place to prevent their personnel from abusing their access to information about the investment company's securities trading and requires access persons to submit reports periodically containing information about their personal securities holdings and transactions. (17 CFR § 270.17j-1(c)(2)). To meet these requirements, the proposed regulation provides as follows.

First, the proposed regulation seeks to refine the definition of "Covered Persons" in a manner that more closely aligns with SEC recommendations and that addresses various functional re-organizations that have occurred in CalPERS since the adoption of the regulation in 2012.

Second, the proposed regulation seeks to align CalPERS rules with recent SEC guidance. This includes guidance around Exchange Traded Funds (ETFs) and Managed Accounts.

Third, the proposed regulation seeks to clarify areas of the previous regulation that caused confusion or were open to multiple interpretations. This includes clarifications around holding periods for derivatives, accounts held at non-designated brokerages, and certification of managed accounts.

## **PURPOSE, BENEFITS, OR GOALS OF THE AUTHORIZING STATUTES**

The primary purpose and benefit of the proposed regulation is to ensure that (1) CalPERS complies with federal and state laws prohibiting the misuse of material, non-public information; and, (2) CalPERS' employees and their spouses have a clear understanding of the agency's personal trading requirements. The federal and state laws are designed to ensure that the marketplace for securities is fair and to deter individuals from improperly utilizing non-public information to the detriment of other market participants.

There are two principal authorizing statutes. The statutes vest in the Board management and control of the retirement system, and authorize the Board to make such rules as it deems proper, respectively. (Cal. Gov. Code §§ 20120, 20121.)

## **RATIONALE FOR DETERMINATION THAT AMENDMENT IS REASONABLY NECESSARY TO ADDRESS THE PROBLEM**

The proposed regulation is necessary to continue protecting against the misuse of material, non-public information by CalPERS access persons. Existing law requires that asset managers like CalPERS have processes in place to prevent their personnel from abusing their access to information about the firm's securities trading, but only provides limited guidance on how those processes should be constituted. Standardized rules would allow for a process that is both simple to administer and easy for employees to follow.

## **SPECIFIC PURPOSE FOR THE AMENDMENT OF THE PROPOSED REGULATION**

### **Purpose of the Proposed Amendment of Section 558.1, "Personal Trading Regulations"**

The proposed regulation contains several non-substantive amendments consistently made throughout and necessary to simplify the language used in the regulation. For example, the phrase "Covered Person Employee and Board Member" has been replaced with the more succinct "Covered Person" and "The Division of Enterprise Compliance" has been replaced with "Enterprise Compliance."

Proposed amendments to subdivision (a) are necessary to provide definitions for terms that are used throughout the regulation. The definition of "Automatic Investment Plan" in subdivision (a)(1) is necessary to clarify what transactions are exempt from pre-clearance requirements, holding period, blackout period, and reporting provision in section (h).

The amendments to subdivision (a)(4) are necessary to address various functional re-organizations that have occurred since the regulation was first issued in 2012, as well as changes made to various civil service classifications.

The various amendments to subdivision (a)(5) are necessary to clarify which securities qualify as a “Covered Security”. Despite the replacement of existing language with revised formulations, the majority of these changes are non-substantive in effect and designed to consolidate existing provisions and make existing definitions more coherent. One substantive change is the addition of Exchange Traded Funds (ETFs) to subdivision (a)(5)(A)(v), which results in index-based ETFs becoming subject to the various requirements of the regulation (e.g., preclearance and holding and blackout periods). This change is based on SEC guidance provided around the Investment Advisers Act of 1940 - Rule 204A-1, 206(4)-7 and Section 204A, 203(e)(6), and the Investment Company Act of 1940 - Rule 17j-1 (*National Compliance Services No Action Letter*, Ref. No.: 20053291111, File No. 132-3)

The amendment to subdivision (a)(9) is necessary to comply with SEC guidance around managed accounts. The SEC feels that the fact that a third-party manager has initially certified management or discretionary investment authority over an access person’s trust or personal account would not, by itself, enable the employer to rely on the reporting exception. The SEC believes that the employer should implement additional controls to establish a reasonable belief that an access person continues to have no direct or indirect influence or control over the trust or account in order to rely on the exception. (SEC Guidance Update No. 2015-03, June 2015). For these reasons, the regulation is amended to require annual re-certification by the investment advisor that the advisor has full discretion to manage any investments or trading.

The amendment to subdivision (a)(11) is necessary to clarify what is meant by a “Money Market Fund” in subdivision (a)(5)(B)(i).

The amendment to subdivision (a)(12) is necessary to clarify what is meant by a “Non-Volitional Transaction” in subdivision (h)(2).

The amendment to subdivision (a)(14) is necessary to clarify how options on securities will be treated for holding period purposes. The treatment of options here derives from subdivision (h) (now (i) in the proposed amendment) which prohibits Covered Persons from executing transactions involving derivatives of any kind (including options) to avoid the requirements or prohibitions in the regulation.

The amendment to subdivision (a)(15) is necessary to clarify what is meant by “Private Placement Offering.”

The amendment to (a)(17) is non-substantive and necessary to avoid any ambiguity in the previous formulation.

The amendment to (b)(3) is non-substantive and necessary to simplify the language in the regulation.

The amendment to (b)(4) is necessary to clarify the reporting obligations of a Covered Person who is given an exception to maintain a Covered Account at a non-Designated Brokerage, consistent with (k)(4).

The first amendment to (d) is necessary because it corrects an omission that was missed when the regulation was first promulgated. The holding period requirement, like the blackout period requirement in (e), was always intended to apply to the buying of securities, and this amendment makes that clear. The second amendment is non-substantive and necessary to clarify that the transfer of Covered Securities means the transfer *to another person* of said Covered Securities.

The amendment to (e) is non-substantive and necessary to clarify that the transfer of Covered Securities means the transfer *to another person* of said Covered Securities.

Subdivision (g) is necessary because it clarifies the requirements around the buying and selling of options. This is an area that has caused some confusion under the current regulation. The treatment of options here derives from subdivision (h) (now (i) in the proposed amendment) which prohibits Covered Persons from executing transactions involving derivatives of any kind (including options) to avoid the requirements or prohibitions in the regulation.

The amendment to (h) is non-substantive and necessary to improve the clarity of the regulation. Bullets (1) and (3) that have been struck have been incorporated into the definition of automatic investment plan (already exempted under (h)(1)). “Mergers” and “acquisitions” were added to (h)(2) to further illustrate the types of non-volitional transactions.

The amendment to (i) is non-substantive and necessary to clarify that the regulation only prohibits transactions that violate federal *securities* laws and not any other federal laws.

The amendment to (k)(3) is non-substantive and necessary to simplify the language in the regulation.

The first amendment to (k)(4) is necessary to clarify that the attestation requirement is an annual obligation and not something that must be done both annually and quarterly. The second amendment to (k)(4) is necessary to clarify the manner in which a Covered Person complies with their reporting obligations when they maintain a Covered Account at a non-Designated Brokerage.

The amendment to (l) is non-substantive and necessary to simplify the language in the regulation.

## **BENEFITS ANTICIPATED FROM THE REGULATORY ACTION**

The primary benefit of the proposed amendment is that it will help ensure that CalPERS complies with federal and state laws around the misuse of material, non-public information. The proposed amendment will also provide CalPERS' employees and their spouses with a clearer understanding of the agency's personal trading requirements.

## **TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS RELIED UPON BY THE AGENCY**

N/A

## **ECONOMIC IMPACT ASSESSMENT**

In accordance with Government Code section 11346.3(b), CalPERS has made the following assessments regarding the proposed regulation:

### **Creation or Elimination of Businesses and Jobs within the State of California**

The proposed amendment is not intended to create or eliminate any jobs or businesses within the State of California. It will only impact CalPERS Board members, Covered employees, and their spouses, and not private businesses.

### **Expansion of Businesses within the State of California**

The proposed amendment will not expand or prevent the expansion of any existing businesses within the State of California. The proposed regulation will only directly impact CalPERS Board members, Covered employees, and their spouses, and not private businesses.

### **Benefits of the Regulation to the Health and Welfare of California Residents, Worker Safety, and the State's Environment**

The proposed amendment is intended to ensure that CalPERS complies with federal and state laws around the misuse of material, non-public information. The proposed amendment will not adversely impact the health and welfare of California residents, worker safety or the State's environment

## **EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS**

The proposed amendment will not have a significant statewide adverse economic impact directly affecting business, including the ability of businesses in California to compete with businesses in other states. The intent of the proposed amendment is to ensure that CalPERS complies with federal and state laws governing the misuse of material, non-public information. The proposed regulation will only directly impact CalPERS Board members, Covered employees, and their spouses, and not private businesses.

## **ALTERNATIVES TO THE REGULATORY ACTION AND CALPERS REASONS FOR REJECTING THOSE ALTERNATIVES**

CalPERS considered the alternative of keeping the regulation in its current form without any amendments. CalPERS' goals are to ensure that (1) CalPERS complies with federal and state laws prohibiting the misuse of material, non-public information; and, (2) CalPERS' employees and their spouses have a clear understanding of the agency's personal trading requirements. However, the alternative of not making any changes would not help to address some of the common questions CalPERS receives from Covered Persons and would also leave CalPERS out of sync with the latest standards outlined by the SEC and other regulators. CalPERS has decided that the amendment to the proposed regulation creates the best path forward to meet this goal.

## **ALTERNATIVES TO THE REGULATORY ACTION THAT WOULD LESSEN ADVERSE IMPACT ON SMALL BUSINESS**

The proposed regulation is designed to apply to CalPERS Board members, Covered employees, and their spouses. CalPERS has not identified any adverse impacts on small businesses. As such, reasonable alternatives that would lessen the impact on small businesses were not considered.

## **DUPLICATION OR CONFLICT WITH OTHER STATE AND FEDERAL REGULATIONS**

The proposed amendment does not duplicate and is not in conflict with other State and federal regulations.