DECEMBER 7, 2015

AGENDA ITEM 04
INFORMATION ITEM

CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD

Legal Analysis Update

This item will be presented verbally at the meeting.

Attachments:

- Attachment #1: California Secure Choice Retirement Savings Program Federal Securities Law Considerations
- Attachment #2: California Secure Choice Trust Federal Securities Law Considerations Diagram

K&L GATES

November 25, 2015

TO: California Secure Choice Retirement Savings Investment Board ("Board")

FROM: K&L Gates LLP

SUBJECT: **California Secure Choice Retirement Savings Program ("Program") Federal Securities Law Considerations**

This is an overview of basic elements of the Program likely to be considered relevant for purposes of the federal securities laws. An important working assumption is that the Board would prefer to avoid registration and regulation of the Program under such laws. (We would be glad to provide additional information regarding the securities law registration process at your request.)

For the reasons described below, we recommend that the Board authorize us to request the staff of the Securities and Exchange Commission ("SEC") to issue a "no-action" letter or other appropriate confirmation of our view that the California Secure Choice Retirement Savings Trust ("Trust") should be viewed as an "instrumentality" of the State of California and, therefore, not subject to regulation or registration under the federal securities laws.

Program Overview

The California Secure Choice Retirement Savings Trust Act will require all employers in California that do not offer a retirement program and have at least five employees in California to allow their employees to contribute, through a payroll deduction program, a designated portion of their annual salary or wages to individual retirement accounts ("IRAs"). Each IRA must satisfy applicable requirements of the Internal Revenue Code ("Code"). A substantial financial institution (e.g., bank, insurance company, broker-dealer) will be designated to act as trustee or custodian of each IRA established under the Program. Employees will be enrolled in the Program automatically, subject to each employee's right to opt-out or select a different contribution rate before enrollment or at any time thereafter.

The Trust is the key component of the Program. It will operate under the overall management and direction of the Board, which may engage third-party investment advisers and administrators to manage and administer the Program and Trust investments. The Board will consist of the State Treasurer, the State Director of Finance (or designee), the State Controller, and six other individuals appointed by the Governor or Legislature. The Trust will (i) receive and hold employee contributions to their IRAs, and (ii) facilitate the implementation and administration of an investment program established by the Board. Benefit payments to IRA owners will be made solely from the assets of the Trust. The assets of the Trust will be segregated from other assets of the State and, with

the limited exception of the "SCRF bonds" described below, the State will have no obligation for the payment of benefits or costs associated with the Program.

The Board, or a financial institution appointed by the Board, will act as trustee of the Trust. The Board's responsibilities will include, among others, preparing a written statement of investment policy and retaining or contracting with outside professional investment managers and administrators, the State Treasurer, and/or the CALPERS Board of Administration to manage Trust investments. Permissible investments may include, among other things, stocks, debt instruments, mutual funds (including money market funds, exchange-traded funds ("ETFs")), fixed and variable insurance contracts, and interests in pooled investment vehicles. In fulfilling their responsibilities, the Board and the trustee of the Trust will be subject to ERISA-like standards of fiduciary conduct.

The Board may establish "proprietary" accounts or separately managed "model portfolio" accounts within the Trust. Examples of such accounts include target date funds. Such an account may serve as a "default" investment for the IRAs. IRA owners also may be given the opportunity to allocate their IRA investments among the investment options. However, neither employees nor employers will have authority to limit investment options offered under the Trust or to select investments in which the assets of the Trust (or any proprietary account or model portfolio) are to be invested. Such investments instead will be designated by the Board or selected by an outside investment manager appointed by the Board.

Specific Trust investments the Board is considering include products currently available in the marketplace, such as (i) SEC-registered mutual funds or ETFs pursuing target date and/or target risk strategies, (ii) SEC-registered variable annuities (with guaranteed minimum asset or withdrawal benefits) underwritten or guaranteed by insurance companies, and (iii) unregistered stable value funds underlying insurance company contracts. Alternatively, Trust assets may be invested in bonds issued by an entity established by the State, e.g., the Secure Choice Reserve Fund ("SCRF"). SCRF bonds would be obligations of the State, but would be limited to Trust/IRA assets used to purchase the bonds, with an adjustment based on the investment return (positive or negative) on such assets.

A diagram illustrating the structure of the Trust and the investment program under consideration is attached to this memorandum.

Federal Securities Laws

Longstanding interpretations of the federal securities laws by the SEC suggest that (i) an investment arrangement like the Trust may be considered an "investment company" under the Investment Company Act; (ii) interests in vehicles or arrangements similar to the Trust may be viewed as "securities" under the Securities Act and other statutes regulating securities; and (iii) persons engaged in activities similar to those the Board

(and its members) will perform once the Trust is implemented may be considered "investment advisers" under the Investment Advisers Act. If so, the Trust (or the Program) and the Board may be required to register with and be subject to regulation by the SEC, unless an exemption applies.

In general, a State and any political subdivision, agency, authority or instrumentality of a State ("State Entity"), any security issued by a State Entity, and any officer or employee of a State Entity performing his or her duties as such is exempted from regulation under the federal securities laws. Thus, the State of California should be viewed as a State Entity exempt from federal securities law regulations.

The Investment Company Act provides that a segregated pool of investments may be treated as an investment company (and interests in such company may be treated as securities under other securities laws), separate and apart from the institution that sponsors or manages the pool. Thus, although the State of California itself should be exempt from federal securities law regulation, the primary issue presented is whether the Trust and the Program, as well as the Board, also should be able to rely on securities law exemptions applicable to a State Entity.

The SEC staff has provided no-action assurances to investment programs we believe are analogous to that presented here. These include college tuition programs qualified under Code Section 529 and deferred compensation plans for governmental employees under Code Section 457.

The Program presents unique issues in that it involves centralized investment management -- through the Trust -- of IRAs established for private sector employees. With very limited exceptions, the SEC staff traditionally has viewed IRA owners as "retail" investors that need the protections afforded by the federal securities laws. Consequently, we recommend that the Board seek a "no-action" or other appropriate assurances from the SEC staff that the Trust should be viewed as a State Entity (i.e., an "instrumentality" of the State of California) and, therefore, not subject to regulation or registration under the federal securities laws. (Communications with the SEC would emphasize ample protections afforded to IRA owners by the State of California and the Program's enabling legislation.)

Board Guidance Requested

The nature and scope of no-action relief requested from the SEC staff will depend primarily on the details of the structure of the Trust and the investment program. The Board can facilitate the process by confirming the accuracy of the Program description above and providing final or tentative guidance on key investment aspects of the Program, including the following:

- Whether "proprietary" accounts or separately managed "model portfolio" accounts will be established and, if so, the nature of such account(s) (e.g., target

date options) and whether IRA owners will be given the opportunity to allocate IRA investments among the accounts.

- As noted above, the costs of operating and maintaining the Program generally and the Trust investment program in particular (e.g., third-party advisers and administrators, fees and expenses charged to mutual funds and similar investment vehicles the Board or outside adviser may select, etc.), including any increases in such fees and expenses over time, will be borne solely by the IRA owners. (As also noted above, it is expected that the State will not be obligated to pay such costs.) The Board should note that the SEC staff may expect that IRA owner consent will be required for any fees or fee increases to take effect with respect to an IRA owner.

- What types of investments will be held by the Trust (and its constituent IRAs)? In general, marketplace investments currently under consideration (i.e., SEC-registered mutual funds, ETFs, and variable annuities, unregistered stable value funds) should not present significant securities law issues or concerns. However, it would be helpful to know which specific types of investments are intended before reaching a conclusion. (Depending on the nature of the investments or investment vehicles ultimately selected by the Board, additional securities law issues may be presented. For example, if it is intended that Trust assets will be invested in unregistered investment vehicles sponsored by banks (collective investment funds) or insurance companies (pooled separate accounts), further analysis will be necessary to determine whether the Trust is eligible to invest in such vehicles under separate exclusions or exemptions relied upon by those vehicles.)

- If the Board decides to have Trust investments in SCRF bonds, what will be the basic terms and conditions of the bonds? In general, such bonds should not be subject to SEC registration, but additional details are needed before reaching a conclusion.

- Whether the Board will act as trustee of the Trust (as is currently provided under the Secure Choice Act) or will appoint a third-party financial institution as trustee. If the latter, whether the same financial institution may be designated as IRA custodian.

Next Steps

Assuming Board wishes to pursue our recommendation of seeking no-action or other appropriate relief from the SEC staff, we would propose next steps along the following lines:

(1) Provide decisions or guidance on the matters outlined above (Board).

(2) Subject to further discussion of the details, high-level contact between the State and SEC requesting the SEC staff's consideration of the Program and guidance or assistance in achieving our objectives (Board or other).

(3) Prepare a "position paper" outlining the basic aspects of the Program that are likely to be relevant to the SEC and providing a preliminary analysis along the lines outlined above (K&L Gates).

(4) Contact SEC staff informally to discuss the proposal, requesting a meeting to discuss the issues (K&L Gates).

Given the relatively unique nature of the Program, it is not feasible to provide an accurate prediction of how long the process of obtaining no-action or other relief from the staff may take. Based on our experience, however, we believe the process could be expected take at least several months to a year.

Attachment:

Diagram "California Secure Choice Trust -- Federal Securities Law Considerations

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K&L GATES

California Secure Choice Trust – Federal Securities Law Considerations

Employers with 5 or more employees and no retirement program establish payroll deduction program.

IRA CUSTODIAN

(BOARD-APPOINTED INSTITUTION ELIGIBLE UNDER IRC 408)

TRUSTEE

(BOARD, OR BOARD- APPOINTED INSTITUTION ACTING UNDER BOARD SUPERVISION. TRUSTEE MAY BE SAME INSTITUTION AS IRA CUSTODIAN.)

↓ ↓

EMPLOYEES $ → **IRAS** $ → **SECURE CHOICE TRUST**

Employees may be given a choice to allocate their IRA assets among investment options established by the Board.

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Trust investments and options will be managed by Board or third-party appointed by Board. Eligible investments and options may include one or more of the following:

- "proprietary" accounts and/or separately managed accounts (model portfolios)
- Publicly-traded stocks and bonds.
- Shares of SEC-registered mutual funds and ETFs
- SEC-registered variable annuity contracts with insurance companies
- Interests in unregistered vehicles (e.g., stable value accounts) that qualify as "insurance" under Federal securities laws
- "Secure Choice Reserve Fund" bonds issued by "SCRF"

Employees will be auto-enrolled, subject to opt-out, employee election.

Percentage of compensation will be allocated to IRA established for each employee.

It is expected that approximately 6.3 million employees will be eligible for Secure Choice Program.

Each IRA to qualify for Federal tax-favored treatment under IRC 408.

Amounts allocated to IRAs will be transferred to Trustee of Secure Choice Trust.

The Secure Choice Trust should be considered an "instrumentality" of the State of California. If so:

(1) the Trust should not be considered an "investment company" under the Investment Company Act.

(2) Board members should not be considered "investment advisers" subject to registration under the Investment Advisers Act.

(3) Interests in the Trust, if they are considered to be "securities," should not subject to registration under the Securities Act, Securities Exchange Act, or Trust Indenture Act.

SEC confirmation of the above (by no-action letter or otherwise) is recommended.