
NOVEMBER 27, 2017

AGENDA ITEM 4
INFORMATION ITEM

CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD

*Federal Securities Law Treatment of Certain State-run Investment Programs (Follow-up to
Fiduciary Training)*

Background

At the October 23, 2017 California Secure Choice Retirement Savings Investment Board (“Board”) meeting, program consultants AFK Consulting provided the Board fiduciary training. During the presentation, there was some discussion about the federal securities law treatment of state-run investment programs. This presentation shall provide additional information and analysis on the topic.

Attachments

Presentation by AKF Consulting: *Federal Securities Law Treatment of Certain State-Run Investment Programs* (to be provided by the time of the meeting)

**California Secure Choice
Retirement Savings Investment Board**

**Federal Securities Law Treatment of Certain
State-Run Investment Programs**

November 27, 2017

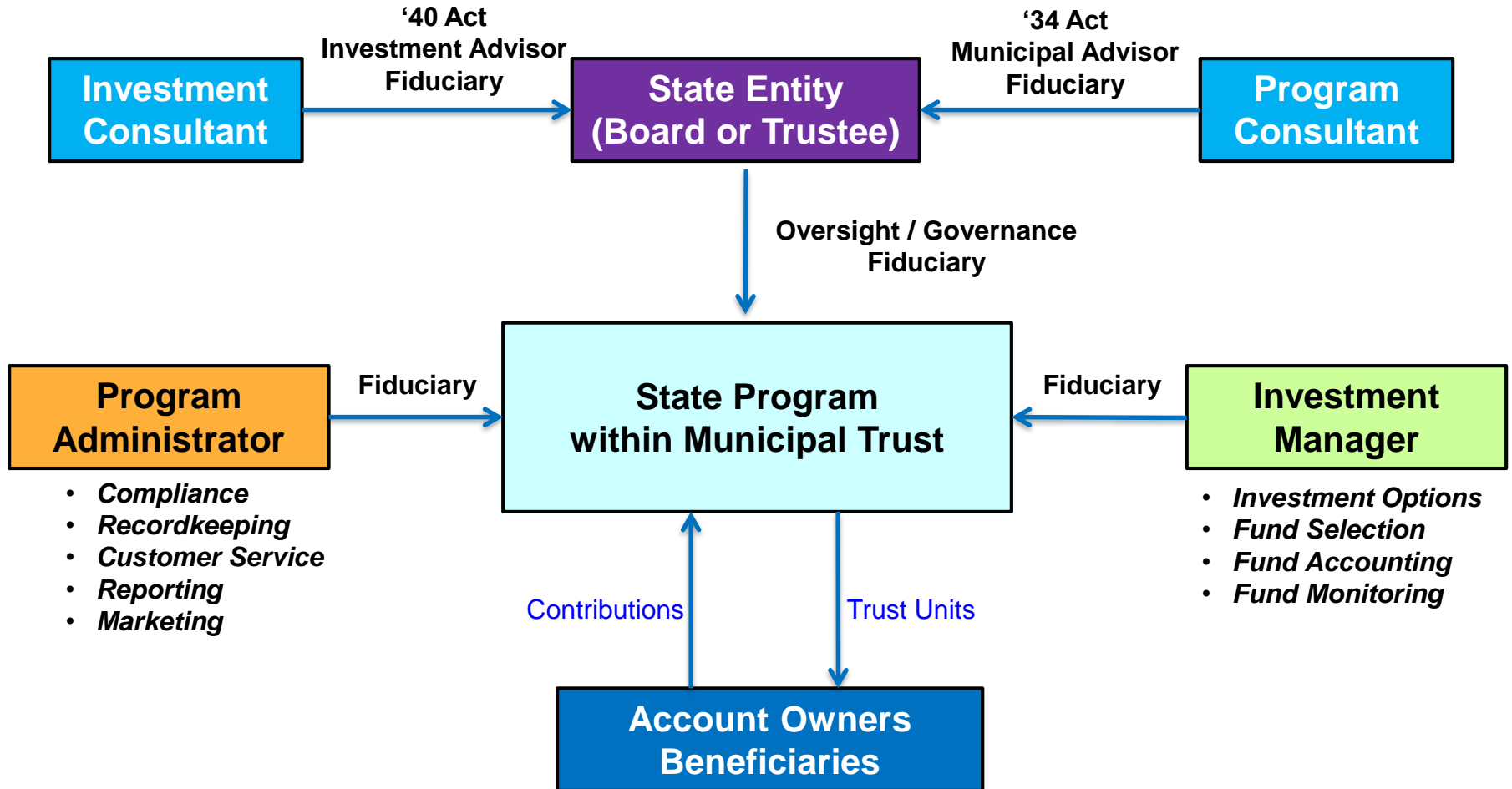
California Secure Choice Retirement Savings Trust Act (“Act”)

- **The Act creates an investment program offered by the California Secure Choice Retirement Savings Trust (the “Program” or “California Secure Choice”)**
- **The Program is structured like qualified tuition programs and ABLE programs created under Sections 529 and 529A of the Internal Revenue Code of 1986, as amended (“529 programs” and “ABLE programs”, respectively)**
- **Importantly, the Act is substantially similar to the authorizing legislation for the ScholarShare Investment Board and the ScholarShare 529 Plan, and the California ABLE Act Board and the California ABLE Plan**

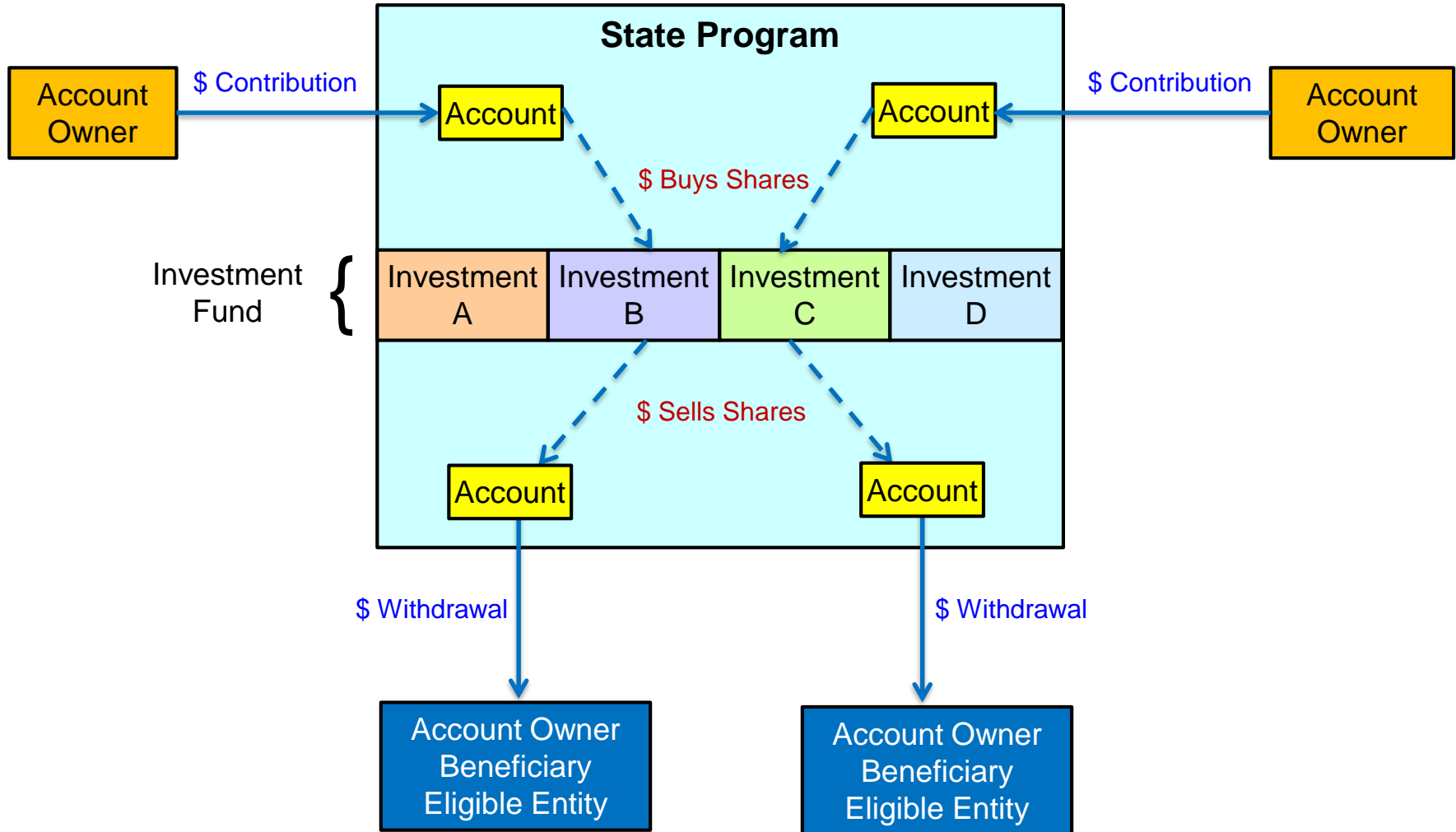
Key Structural Elements

- **Structural Program elements common to 529 and ABLE programs include:**
 - **A trust created and overseen by a state instrumentality in a fiduciary capacity**
 - **Contributions made by participants will be deposited into the Trust and invested in underlying investments approved by the Board**
 - **The Trust will own the underlying investments**
 - **Investments by participants (i.e., eligible employees) will be evidenced by ownership of units in the Trust**
 - **A participant will not directly own shares of the underlying investments**
 - **Asset-based fees will be charged against each participant's account to pay the administrative costs of the Program**

Typical 529 and ABL Structure



Typical 529 and ABLF Flow-of-Funds



Source: Ernesto Lanza, Clark Hill PLC, with modifications

Federal Regulatory Framework for State-Run Investment Programs

- **529 programs operate in accordance with opinions of counsel and prior SEC no-action letter guidance in reliance on various exemptions for political subdivisions or public instrumentalities of a state:**
 - ***Division of Corporate Finance will not recommend enforcement action for the sale of 529 plan interests as non-registered securities***
 - ***Division of Investment Management will not recommend enforcement action if the municipal fund is not registered***
 - ***Division of Market Regulation will not recommend enforcement action if state employees offer or sell units in the 529 plan without being registered***
- **ABLE programs also rely upon the 529 SEC no-action letters since:**
 - **529 and ABLE programs have an almost identical product structure**
 - **There are not any novel issues of fact or law that would distinguish ABLE programs from 529 programs**

Federal Securities Laws Exemptions for Municipal Issuers

- In summary, 529 and ABLE programs are not registered under:
 - Securities Act of 1933 in reliance upon the exemption provided by Section 3(a)(2)
 - Trust Indenture Act of 1939 in reliance upon the exemption provided by Section 304(a)(4)(A)
 - Investment Company Act of 1940 in reliance upon the exemption provided under Section 2(b)
 - Investment Advisors Act of 1940 in reliance upon the exemption provided under Section 202(b)
- Finally, 529 board members, officers and employees may participate in the sale of interests in 529 and ABLE programs without registering as broker-dealers under the 1934 Act if they comply with safe harbor under Rule 3a4-1

MSRB Definition of Municipal Fund Security

- The Municipal Securities Rulemaking (“MSRB”) has defined 529 and ABLE programs distributed by SEC-registered broker-dealers or municipal securities dealers as “municipal fund securities” under Rule D-12:

“The term “municipal fund security” shall mean a municipal security issued by an issuer that, but for the application of Section 2(b) of the Investment Company Act of 1940, would constitute an investment company within the meaning of Section 3 of the Investment Company Act of 1940.”

- 529 and ABLE programs that are sold directly to the public without the assistance of a broker-dealer or municipal securities dealer are not subject to MSRB jurisdiction
- However, it is prudent for state-run investment programs to operate pursuant to an exemption from the relevant provisions of the federal securities laws

Definition of Investment Company

- If the Section 2(b) exemption for political subdivisions and instrumentalities of a state were not available, in the absence of SEC no-action relief, it is highly likely that 529 programs, ABLE programs, and other state-run investment programs, such as California Secure Choice, would be deemed to fall within the Section 3(a)(1)(A) definition of Investment Company:

“When used in this title, “investment company” means any issuer which— (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities”

- Securities are defined as all securities other than government securities

Importance of the Investment Company Act Exemption

- **The exemption from the Investment Company Act is critical because the Act would otherwise subject the Program to all the disclosure and corporate governance provisions applicable to mutual funds**
- **By contrast, the SEC is prohibited by law from regulating the content of disclosure of municipal issuers, and the governance of state-run investment programs is a matter of state law**

Secure Choice and the Anti-Fraud Provisions of the 1934 Act

- **Securities law exemptions available to municipal issuers do not provide exemptions from anti-fraud provisions of the Securities Exchange Act of 1934 Act**
- **At the heart of the anti-fraud provisions is an affirmative obligation not to:**
 - **Omit any statements of material fact regarding the investment, or**
 - **Make any untrue or misleading statements of material fact regarding the investment**
- **This is the single most important concept in the federal securities laws relating to disclosure and would apply to Secure Choice Program disclosure materials**
- **AKF would be pleased work with staff and external counsel to assist the Board in complying with this requirement**
- **Questions?**