

## INITIAL STATEMENT OF REASONS

The regulations being proposed by the Teachers' Retirement Board ("TRB" or "Board") reflect a one year effort on the part of the TRB to review and address ethical issues surrounding campaign gifts and contributions to public pension fund board members. In the course of this review, the Board examined the policies and practices of public pension funds around the country, past rule making efforts of the Securities and Exchange Commission ("SEC"), and the historic efforts of the California Public Employees' Retirement System ("CalPERS") to address what is referred to in the investment industry as "pay to play" practices. The Board heard from experts on ethics and public pension fund fiduciary standards. It also solicited the input of the investment community and the public.

The Board is granted plenary authority for administration of the Teachers' Retirement Fund by article XVI, section 17 of the California Constitution. This provision, also known as the "The California Pension Protection Act of 1992," (enacted by passage of Proposition 162) was intended to affirm the legal principle that a retirement board's duty to its participants and their beneficiaries takes precedence over any other duty. *Westly v. California Public Employees' Retirement System Board of Trustees* (2003) 105 Cal.App.4<sup>th</sup> 1095, 1102. Among the findings and declarations accompanying the enactment of Proposition 162 was, "To protect pension systems, retirement board trustees must be free from political meddling and intimidation." *Ibid.*

Similarly, the Teachers' Retirement Law (Education Code, §22000, et. seq.) requires that Board members, "shall discharge their duties with respect to the system and the plan solely in the interest of the members and beneficiaries..." Education Code section 22250.

The Board began a comprehensive review of its ethics policy in December 2005. During the April 2006 Board Governance Committee meeting, the Board heard from a panel of experts covering the topics of government ethics, current developments among state pension funds on the topic of restricting campaign contributions and gifts, and Department of Labor (the federal agency responsible for regulating private pension funds under the Employee Retirement Income Security Act – ERISA) activities addressing "pay to play" issues. As the focus of the Board turned toward the need for banning or restricting campaign contributions to Board members or their appointing authority, the Board also sought legal counsel on the implications of *Randall v. Sorrell* (2006) 126 S.Ct. 2479.

The Board found that when contributions are made to a public official or candidate for public office, the public often perceives that such contributors expect and receive reciprocal benefit for their contributions; in other words, "pay to play", or "quid pro quo". While there has been no occurrence of impropriety associated with California State Teachers' Retirement System (CalSTRS) investments or contracts, nor any allegations of improper investing based on campaign contributions, the Board recognized there was a potential for abuse, and that public perception of the possibility of potential abuse could undermine the credibility of CalSTRS' investing and contracting processes.

Ultimately, the Board unanimously concluded that the integrity of a public pension or retirement board and its individual members must not be compromised, nor perceived to be compromised, by the public perception that campaign contributions can buy influence over any board member. The board and its members must be safeguarded from the risk, and the appearance of risk, of improper influence. While considering various alternatives to address the potential campaign contribution abuses, the Board concluded that the only way to effectively protect the integrity of CalSTRS' investing and contracting processes was to set clear limits on contributions from those doing business with, and seeking to do business with, CalSTRS, and by providing for serious penalties for violating those limits.

In imposing limits on campaign contributions, and penalties for violating those limits, the Board also recognized the need to modify the existing CalSTRS' hearing process to provide hearings for contributors who disagree with a CalSTRS' finding of the limits' violation.

The proposed regulations do the following:

**1. Section 20520**

This provision is being amended to include disputes over campaign contribution limit violations within the hearing process presently afforded members dissatisfied with actions taken by the Chief Executive Officer. The regulation is being further amended to add subdivisions and move the portion relating to contracting to the same subdivision as the hearing process for violations of the campaign limit. Since the proposed regulations contain penalties, including possible termination of a business relationship, limits on future business, and monetary fines, the Board recognized a need to provide due process to entities alleged to have violated the regulations.

**2. Section 24010, subdivision (a)**

This subdivision identifies the parties being regulated and specifies the campaign contribution limit (\$1000) being set by the TRB. While cognizant that the Political Reform Act ("Act") places general restrictions on campaign contributions, Government Code Section 81013 provides that nothing in the Act, "...prevents the Legislature or any other state or local agency from imposing additional requirements on any person if the requirements do not prevent the person from complying with this title." By placing campaign contribution restrictions only on those doing business with, or seeking to do business with, CalSTRS, the regulation is narrowly crafted to address the perceived harm caused by the perception of "pay to play" contributions. The \$1000 limit furthers the Act's purpose, and the Board carefully chose the amount to match the sufficiently important interest of preventing the appearance of harm from political contributions without infringing upon the First Amendment rights of those doing, or seeking to do business with CalSTRS.

3. **Section 24010, subdivision (b)**

This subdivision limits the application of the restrictions on campaign contributions by specifying the recipients to whom the restrictions apply. The restricted recipients are CalSTRS' officers and employees, TRB members, the Governor (the appointing authority for five TRB members as well as the Director of the Department of Finance, who is an *ex officio* TRB member) and gubernatorial candidates. The *ex officio* constitutional officer TRB member positions and candidates for these constitutional offices are also included in the restrictions. The regulation limits campaign contributions to CalSTRS' officers and employees, TRB members, and the appointing authority for TRB members, thereby narrowly focusing on preventing actual or perceived malfeasance in investment allocation and the award of contracts by CalSTRS. The Board felt it was necessary to include the Governor and candidates for Governor within the restrictions to insure against the perception that parties could circumvent the limits by contributing to those with the closest, most direct nexus to, and influence on, the TRB members: their appointing authority.

4. **Section 24010, subdivision (c)**

This subdivision identifies the business relationships with CalSTRS to be covered by the campaign contribution restriction. It identifies the key personnel of the covered business who would also be individually subject to the campaign contribution limit. The subdivision sets dollar thresholds for triggering the restrictions for entities that have, or are seeking a business relationship with CalSTRS.

In crafting this provision, the Board carefully weighed how to reach contributions from key personnel of a covered business, without placing restrictions on all employees of a firm or vendor doing business with CalSTRS. By limiting the restriction to vendors, firms and other non-governmental entities, their partners and executive officers, the Board sought to only limit contributions from the persons in control of the vendors or firms. Unless an owner, partner, or an executive officer of a business orders a non-covered employee to make a campaign contribution, non-covered employees' contributions are not restricted. The Board intends to eliminate even the perception of undue influence or "pay to play" in investments and contracts decision-making. The Board does not intend to place restrictions beyond the control level of a business entity. Nor is it the intent of these regulations to reach beyond the entity or vendor directly contracting with CalSTRS.

The Board recognizes that in a global economy, a business entity may be a subsidiary corporation, a parent corporation, a limited partner in a joint venture, or part of or involved in any number of other business relationships. Recognizing the myriad of potential relationships between business entities, as well as the futility of attempting to reach, monitor, or define the nexus or relationship between related entities that could or should trigger a campaign limit, these regulations are narrowly targeted to apply only to those entities in a direct business relationship with CalSTRS.

5. **Section 24010, subdivision (d)**

In the investment marketplace, there are third party placement agents who often act as intermediaries for entities seeking to do business with pension funds. The TRB recognized that failure to include these agency relationships within the ambit of this regulatory scheme could result in a perception that such placement agents could circumvent the regulations and accomplish what their principals could not.

6. **Section 24010, subdivision (e)**

The subdivision provides a clear time frame for when the campaign contribution restrictions attach to firms seeking to do business with CalSTRS. The Board recognized that failing to place restrictions on firms seeking to do business with CalSTRS as early as possible in the procurement process could create an opportunity to circumvent the restrictions. The Board therefore chose to time the restriction to coincide with the announcement of a particular procurement. The subdivision is tied to the subdivision (c) dollar threshold. The Board's decision also reflects its desire to ensure that no party interested in, or desirous of doing business with CalSTRS will erroneously conclude that there is a prohibition on contributions prior to participating in formal procurement with CalSTRS.

7. **Section 24011, subdivision (a)**

This subdivision places the responsibility for investigating violations of the regulations' restrictions with the CalSTRS' General Counsel.

8. **Section 24011, subdivision (b)**

This subdivision provides for the possibility of a sanction for parties seeking to do business with CalSTRS. A business which violates the regulations could be disqualified from doing business with CalSTRS for two years. This penalty provision was considered necessary by the TRB in order to ensure compliance with the campaign contribution restrictions.

9. **Section 24011, subdivision (c)**

This subdivision allows for the imposition of a sanction upon those parties already engaged in doing business with CalSTRS. It provides for disqualification from future or additional business for a period of two years, or a fine payable to CalSTRS in the greater of the amount of the impermissible contribution or \$10,000. This very serious penalty provision was considered necessary by the TRB to ensure compliance with the restrictions on campaign contributions. The Board also felt it necessary to provide alternative penalties for violation to make sure that a necessary existing business relationship is not terminated to the detriment of CalSTRS or the Teachers' Retirement Fund.

**10. Section 24011, subdivision (d)**

This subdivision provides access to an administrative hearing process for any entity wishing to dispute a disqualification or penalty decision.

**11. Section 24012**

This section adopts, by reference, relevant definitions for interpreting these proposed regulations.

**12. Section 24013**

This section clarifies that these regulations are to become effective on the date of final adoption.

**TECHNICAL STUDY**

The Board conducted hearings over a twelve month period on the topic of public pension fund ethics. In drafting these regulations the Board relied upon findings of the SEC, education and reports on ethical considerations for governmental entities, the testimony of experts and the public. The minutes, including the material considered by the Board in its deliberations on the promulgation of these regulations, are available on CalSTRS' website at [www.calstrs.com](http://www.calstrs.com), CalSTRS, Teachers' Retirement Board, Meeting Agenda, April 5, 2006, Board Governance Committee meeting. More background information will be found in Meeting Agenda, Board Governance Committee, for 2006 meetings. This material includes policies of other state pension systems, reports, briefings, and summaries prepared by counsel to the Board Governance Committee. Persons having difficulty accessing the Board Agenda materials may contact the parties listed in the notice of proposed rulemaking for assistance.

**RULEMAKING AUTHORITY**

Education Code section 22305 provides that any rule or regulation adopted by the Board for the purpose of the administration of the Teachers' Retirement Law shall have the force and effect of law. Further, Education Code section 22207 grants the Board authority to perform any necessary acts for carrying into effect the provisions of the Teachers' Retirement Law. By resolution, duly adopted at the December 7, 2006 meeting, the Board authorized this rulemaking activity and delegated to the Chief Executive Officer the duty of conducting a public hearing for the purpose of public comment.

**ALTERNATIVES CONSIDERED**

The Board weighed the options of either restricting campaign contributions or merely increasing transparency of campaign contributions to clearly remove any perception of "pay to play"

transactions. The Board engaged in extensive hearing and discussion, including study of the attempts of other states' pension funds to limit or outlaw campaign contributions to board members and staff. The Board concluded that the only effective prophylactic measure was a hard limit on campaign contributions and accompanying penalties for its violation.

The Board also studied, discussed and debated who to include in the restriction on contributions and concluded that such restrictions would be ineffective if they did not constrain contributions to all Board members, as well as the appointing authority for Board members, and CalSTRS' staff. The Board also recognized a need to include entities seeking to do business with CalSTRS and third party agents in order to avoid any perceived or actual possible circumvention of the restrictions.

The Board concluded the only viable alternative to adopting restrictions by regulation was to seek legislation. Since the Board has clear authority to adopt these regulations, the regulatory alternative was chosen.

### **ECONOMIC IMPACT ON BUSINESS**

These regulations do not place any economic burden on business. The threshold requirements for being subject to these regulations require either a business relationship with CalSTRS, or to be actively seeking a business relationship with CalSTRS. To the extent a business is not seeking CalSTRS as a client, there is no economic impact. To the extent a business meets the threshold requirements, the regulations place dollar limits on political contributions but do not place any direct or indirect economic burden on business. These regulations do not place any additional licensing, record keeping, or compliance efforts on businesses.