

## INITIAL STATEMENT OF REASONS

### Problem Statement

School district employers report member and pension contribution data and remit contributions to CalSTRS using a hierarchical reporting model wherein each community college or school district reports retirement information and remits contributions to its respective county office of education. The county then compiles and submits the information and remits the contributions to CalSTRS. Penalties and interest for late reporting and contributions are similarly coordinated through the county, adding a layer of complexity to an already complex business process. Beginning in 2014, the Governmental Accounting Standards Board Statements 67 and 68 require that CalSTRS record, track and report the contributions, service credit, penalties and interest paid and accounts receivable at the district level; however, the related transaction activities generally occur at the county level (as the direct report source).

Section 23004 of the Education Code was amended in 1999 (Chapter 939) to provide authority to the Teachers' Retirement Board to approve a school district or a community college district as a direct reporter. The Legislature enacted this change in law to reflect the preexisting practice of receiving data and contributions from a few large districts, bypassing the county office of education. Since the 2012–13 fiscal year, CalSTRS has piloted the direct reporting process with other districts. During that time, CalSTRS has refined its considerations in evaluating candidates for direct reporting.

Permitting these employers to directly report allows for direct communication between CalSTRS and the district and absolves the county of any reporting responsibility for its independent districts. When districts report directly to CalSTRS, process efficiencies (including the direct flow of data and contributions, elimination of potential introduction of errors at the county level, reduced time to receive deposits, improved ease of matching funds with report data, and ability to address issues directly with employers) result, benefiting all parties.

The primary objective in creating the evaluation criteria contained in these regulations is to establish permanent relationships with districts as direct reports that have the ability to report without undue intervention and instruction by CalSTRS staff. After it has begun, the relationship would be administratively complex to reverse. Through the standards laid out in these regulations, CalSTRS seeks to avoid circumstances that could lead to termination of the direct reporting relationship. These regulations would:

- Ensure districts accepted as direct reports are compliant with state and federal law.
- Require counties and districts to mutually agree to the division of responsibilities.
- Require districts to demonstrate that they have the authority to act independently and the tools and knowledge to report accurately.
- Validate a history of stable accreditation status, as loss of accreditation would affect a district's status as a CalSTRS-covered employer.

## Initial Statement of Reasons: Employer Direct Reporting

- Ensure potential direct reports are timely and responsive in reporting and responding to CalSTRS requests.

In addition, these regulations set limits as to when and how the direct reporting relationship may be terminated and subsequently reestablished. Administrative complexity would result if school employers were able to terminate and reinstate the direct reporting relationship at will with responsibility shifting between the district and county and back again. Once the direct reporting relationship is established, the district will be CalSTRS' sole point of contact for data and contributions, including data previously maintained by the county. In the event the relationship is subsequently terminated, responsibility for all reporting would return to the county. These regulations seek to ensure that there is a clear acceptance of that division of responsibilities on the part of the district and the county.

CalSTRS must also retain a degree of flexibility in order to balance workload. The application and approval process requires administration by staff. It is CalSTRS' intent to absorb this administration with existing resources. Having the flexibility to limit the number of direct reports who may be approved in a given time period and to limit reapplication from recently rejected applicants enables CalSTRS to manage that workload.

### **Benefits Anticipated**

Anticipated benefits of these regulations include improved process efficiencies for school districts, county offices of education and CalSTRS. These regulations ensure employers who have the minimum enabling technology and have demonstrated knowledge and ability to execute the laws and regulations related to reporting will be allowed to become direct reports. Further, these regulations set a high bar for compliance so that the direct report does not require the expenditure of additional staff time or other resources by CalSTRS, thereby promoting a stable and permanent direct reporting relationship. Restricting the ability to become a direct report to districts who have met the standards laid out in these regulations will maximize the likelihood that direct reporting employers will comply with reporting standards and governing laws and will not require an undue level of intervention by CalSTRS staff.

In addition, these regulations promote an efficient use of staff time in reviewing applications by encouraging a high rate of successful application submissions as opposed to repeat rejections of applicants following staff analysis. Initial training and support needs will be met using existing resources, providing a seamless transition for applicants.

### **Purpose and Rationale**

#### Section 27700

This section defines terms that are used in the regulations to provide clarity for the purpose of streamlining the regulations text.

## Initial Statement of Reasons: Employer Direct Reporting

### Section 27701

This section specifies that the regulations are effective for existing direct reports as well as those who apply going forward. While those who are already approved as direct reports need not reapply, since the direct reporting relationship is intended as a permanent arrangement, these regulations also include the permissive criteria for terminating the direct report relationship, which are relevant to existing direct reports.

This section also sets an effective date of July 1 for newly approved applicants to begin reporting following approval. This practice allows for a clear margin of responsibility from one fiscal year to the next, rather than allowing a midyear change in reporting responsibility that could reasonably cause confusion at all levels of reporting (the district, the county and CalSTRS).

### Section 27702

This section describes prerequisites districts must meet in order to apply to be a direct report as well as permissive standards by which CalSTRS may reject an application.

Subdivision (b) lists five specific requirements; these requirements, if not met, will result in denial of the application. The purpose and rationale of each is summarized below.

- (1) **Submission of the documentation required under Section 27703 with no change to the correctness of each of the declarations therein.** See “Section 27703” for an explanation of the purpose of each declaration in the required documentation. This paragraph specifies that each of those declarations must remain current to avoid a situation wherein a resolution is adopted and some change in eligibility occurs during the application process.
- (2) **Demonstrated ability to successfully transmit specified files and information to the system.** Fulfillment of this requirement demonstrates that the employer has the capacity to create and upload a test file that CalSTRS can successfully receive. The specific files listed are encrypted files that districts may be granted access to by the county.
- (3) **If the district was previously terminated as a direct report, more than five fiscal years have elapsed.** A waiting period between termination and reapplication is included to encourage employers to maintain good standing in the areas of initial eligibility, and to avoid interchanging reporting responsibility between the county and the district due to transient issues such as administrative changes, while still allowing an employer to eventually reapply as a direct report should circumstances change in the future. Five years was deemed a sufficient length of time because it is lengthy enough to promote employers’ ongoing compliance without completely prohibiting the possibility of reestablishing the direct reporting relationship in the future.
- (4) **An audit by the system that demonstrates full compliance with reporting mandatory membership, one-time or limited-term payments and outgrowth activities and providing information regarding the compensation to be paid to employees.** This prerequisite ensures the district is compliant with key formatting and reporting standards

## Initial Statement of Reasons: Employer Direct Reporting

and is compliant with the Teachers' Retirement Law. This condition is required because each of the items specified in the audit may be submitted electronically to CalSTRS but must be audited manually to validate that the reporting was done correctly. Thirty-six months was determined to be a sufficient timeframe to adequately demonstrate current compliance while balancing the CalSTRS Audit Division's workload priorities with the length of time CalSTRS expects the processing of an application to take. Consequently, once an audit is performed, it will not need to be redone prior to approval of an application.

- (5) **Sustained compliance with responding to requests for adjustments, providing acceptable annotations to employer-approved edits, reporting full-time minimum standards and timely reporting of information regarding compensation.** The items listed relate to legal requirements; if these requirements are not met, CalSTRS may be required to assess penalties or request that the employer submit corrected data. Sustained historical compliance with these legal requirements adequately demonstrates that the district is a reliable reporter and can be expected to submit data in accordance with the law. The rationale behind each standard used is described below.
- (A) A timeframe of 60 days to respond to a request for adjustment is specified to mirror the legal threshold before penalties are assessed under section 23008 of the Education Code.
  - (B) Acceptable annotations are provided to CalSTRS by direct report sources; this requirement ensures the district is able to use the functionality to provide annotations that clearly communicate the reasoning behind employer-provided edits.
  - (C) Reporting full-time minimum standards that are consistent with the written employment agreement demonstrates compliance with sections 22115 and 22138.5 of the Education Code.
  - (D) The district's provision of information related to compensation is required annually under law. Thirty days was selected to demonstrate ample time for a district to demonstrate its ability to comply with section 22458 of the Education Code.

Subdivision (c) provides permissive reasons CalSTRS may deny an application. If there are outstanding amounts receivable to the system attributable to the district or outstanding or unresolved audit findings at any point during the application process, CalSTRS may deny the application. The purpose of these provisions is to demonstrate the employer's ability to make timely deposits and be responsive to CalSTRS' requests for correction. If an account receivable or audit correction is delinquent, it is reasonable that the district is in jeopardy of future delinquencies with respect to remittances, deposits and corrections. These provisions are permissive because there are conceivable situations in which a receivable balance due or an audit finding would not necessarily translate to the district's unsuitability as a direct report. Similarly, a previous denial of an application to be a direct report could be due to an easily correctible issue that was resolved promptly and satisfactorily. Under these regulations, CalSTRS would retain the flexibility to deny or allow an application to proceed on the merits of the individual application without applying a blanket standard, while still providing clarity that these conditions are grounds for denial.

## Initial Statement of Reasons: Employer Direct Reporting

Subdivision (d) provides that CalSTRS may, at its discretion, defer consideration of an application until a future fiscal year. Even if an employer meets the prerequisites and submits all required documentation, this provision allows workload and other resource considerations at CalSTRS to be factored into whether or not a district is accepted as a direct report during a given year.

### Section 27703

Subdivision (a) requires that an applicant submit specified documentation. Paragraph (1) provides that, if the employer “picks up” employee contributions pursuant to section 22903 or 22904 of the Education Code, the applicant provide the district’s resolution to do so. This is necessary to demonstrate that the employer meets the legal requisites to take formal action evidenced in writing before being allowed to “pick up” employee contributions under Internal Revenue Code § 414(h)(2). Written documentation of the formal arrangement provides CalSTRS with evidence that the direct deposits of contribution on behalf of the member comply with IRS requirements.

Broadly, paragraphs (2) and (3) describe required content for a resolution by the governing authorities of both the district and the county. Written documentation via a formal resolution is necessary to provide adequate evidence that the direct reporting arrangement has been agreed upon by the district and county.

Paragraph (2) contains 14 subparagraphs of required language (A through N) for the district resolution. The purpose and rationale of each is summarized below.

- (A) This subparagraph provides for an effective date of the intent to become a direct report of July 1 and is included to ensure that the resolution will clearly declare the intended date of transfer of responsibility between the county and the district. This mirrors language in the resolution required from the county under subparagraph (A) of paragraph (3) and demonstrates that the district and county have mutually agreed as to accountability for the data.
- (B) The district must certify that it has an independent payroll system. The payroll system is the primary system needed to report directly to CalSTRS. If the district relies on the county’s system, then it does not have the technical capacity to be a direct report.
- (C) The district must be fiscally accountable, fiscally independent or both. The purpose of this requirement is to demonstrate that the employer has authority to directly take on financial obligations. Fulfillment of this requirement demonstrates that the employer has the independence to bypass the county as an intermediary in the reporting and billing process.
- (D) and (E) These subparagraphs refer to existing legal and regulatory requirements. The purpose is to provide an explicit declaration of responsibility for all aspects of reporting by districts that were not previously subject to those provisions. This is necessary to provide a clear delineation of responsibility, not just for the mechanics of reporting but also for adherence to the legal provisions that underlie reporting. The language in subparagraph (E) mirrors language in the resolution required from the county under subparagraph (C) of

## Initial Statement of Reasons: Employer Direct Reporting

paragraph (3) and is included to ensure the district and county have mutually agreed as to accountability for the data.

- (F) , (G) and (H) The district must accept responsibility to submit adjustments to historical data and all contributions and remittances prior to and after the effective date of becoming a direct report. Direct reports are responsible to research and correct historical accounts such that there is no need for CalSTRS to coordinate separately with the county. This language is necessary to provide a clear delineation of that responsibility. The language in subparagraph (G) mirrors language in the resolution required from the county under subparagraph (D) of paragraph (3) and is included to ensure the district and county have mutually agreed as to accountability for the data.
- (I) The district must meet specified standards for the last five fiscal years' annual financial audits. These standards demonstrate the financial soundness of the employer and reliability of the internal controls in place. This specific standard is necessary to provide a benchmark that is readily available from all employers and adequately demonstrates well-defined criteria of overall soundness of finances and internal controls that can be applied to any employer statewide. If an employer has demonstrated insufficiency in these areas, it indicates systemic challenges that are reasonably likely to be relevant to its reliability as a direct report.
- (J) The district must meet specified standards in its accreditation status. These standards demonstrate that the employer is in good standing with its accrediting body and is, therefore, not in imminent danger of losing its status as a CalSTRS-covered employer. This specific standard is necessary to provide a benchmark that is readily available from all employers, and a history of acceptable standing in accreditation is the best measure CalSTRS has identified that reasonably can be expected to provide some assurance of continued good standing.
- (K) The district must certify that it will notify CalSTRS of specified changes that would affect its ability to direct report. The subparagraph also specifies circumstances in which the county is responsible for resuming reporting responsibility. This mirrors language in the resolution required from the county under subparagraph (E) of paragraph (3) and is included to ensure the district and county have mutually agreed as to accountability for the data. Prompt notification to CalSTRS is necessary because of the administrative challenges that would be associated with restoring reporting responsibility to the county. In the case of fiscal independence, the county has the legal authority to rescind the status with immediate effect, meaning the district, county and CalSTRS would need to coordinate a transfer of responsibility back to the county promptly. Although loss of fiscal accountability would take place at the start of the next fiscal year, a prompt notification allows for adequate planning of the transition and remains essential. Three days was determined to be an adequate timeframe within which to notify CalSTRS of either determination.
- (L) The district must certify that it will notify CalSTRS of specified changes in its accreditation status. This provision is necessary because a loss of accreditation could affect the district's

## Initial Statement of Reasons: Employer Direct Reporting

continued standing as a CalSTRS-covered employer and because the accreditation status specified would trigger the permissive ability for CalSTRS to terminate the direct reporting relationship and restore reporting responsibility to the county. Three business days was determined as an adequate timeframe within which to notify CalSTRS of such a determination.

- (M) The district asserts that if the direct report relationship is terminated, the county's responsibility for reporting will resume. This mirrors language in the resolution required from the county under subparagraph (F) of paragraph (3) and is included to ensure the district and county have mutually agreed as to accountability for the data.
- (N) This paragraph specifies that all parties must agree to a voluntary termination by the district as a direct report. This is necessary to address a theoretical situation wherein a district wishes to discontinue direct reporting but has not lost the capacity to do so or been terminated by CalSTRS as a direct report. In such a case, only with agreement from CalSTRS and the county, the district would be permitted to discontinue as a direct report, and the county would resume reporting.

Paragraph (3) contains six subparagraphs of required language (A through F) for the county resolution. With the exception of subparagraph (B), each mirrors language as described under paragraph (2) as noted above. Subparagraph (B) asserts that the district has completed a resolution pursuant to paragraph (2), and the subparagraph is necessary to confirm for CalSTRS that the county has validated the district's declaration of its intent.

### Section 27704

This section describes the criteria for permissive termination of the direct reporting relationship. The purpose of these provisions is to clarify the circumstances under which the board could rescind its approval of a district as a direct report.

Under subdivision (a), CalSTRS may initiate termination if any of the initial qualifying criteria are not met. The purpose of this discretionary provision is to allow CalSTRS flexibility to continue to work with an employer who has a lapse in meeting the initial qualifying criteria or, alternatively, to terminate the direct reporting relationship if, in CalSTRS' judgment, that would be the more cost-effective or otherwise appropriate action. This provision is necessary to promote the district's accountability to maintain the same standards of quality that initially qualified it as a direct report.

Under subdivision (b), CalSTRS retains similar flexibility in terminating a district that does not respond to an audit finding within a specified period. This serves the additional purpose of encouraging direct reports' timely response to audit findings and promotes the district's maintenance of the same standards of quality that initially qualified it as a direct report. The audit determination will dictate deadlines for response, depending upon the specific audit finding. Those deadlines may be less than the 90-day window currently provided by section 27102;

## Initial Statement of Reasons: Employer Direct Reporting

therefore, CalSTRS' permissive option to terminate the direct reporting relationship applies after all deadlines for response, through compliance or appeal, have passed.

Under subdivision (c), the district may voluntarily terminate the direct reporting relationship only when CalSTRS, the district's governing body and the county governing authority have mutually agreed to terminate the relationship. The purpose of this provision is to provide a mechanism and prescribed language for all parties to agree upon the effective date of any transition of responsibility for reporting associated with the termination. This is necessary to ensure that there is understanding and agreement among affected parties if the direct reporting relationship is voluntarily terminated.

### Section 27705

This section provides the deadline for districts to request a review of CalSTRS' decision to terminate the direct reporting relationship. This provision is necessary because review or appeal rights under existing regulations do not address CalSTRS decisions affecting employers other than those made as the result of an employer audit. These regulations provide that the resulting decision after such a review shall be final. This is necessary to clarify and distinguish that employers may not request an administrative hearing in the event CalSTRS terminates the direct reporting relationship.

### **Studies, Reports or Other Documents Relied Upon**

None.

### **Economic Impact Analysis**

CalSTRS has considered the proposal's impact on business, with consideration of industries affected and information supplied by interested parties, including the ability of California businesses to compete with businesses in other states.

CalSTRS has determined that the regulations proposed do not constitute a major regulation as they are not expected to have any economic impact beyond streamlining the reporting process, which is not expected to result in monetary savings to school districts, community college districts, their respective county offices of education or the state. These regulations are not anticipated to have any effect on California businesses. Specifically:

- The action will not affect the creation or elimination of jobs within the state.
- The action will not affect the creation of new businesses or the elimination of existing businesses within the state.
- The action will not affect the expansion of businesses currently doing business within the state.
- The action will have no effect on the health and welfare of California residents, worker safety and the state's environment.

### **Conferring with Interested Persons**

Pursuant to Government Code section 11346.45, CalSTRS staff provided early drafts and met with stakeholder groups, including representatives of the California Teachers Association, the Faculty Association of California Community Colleges, the California Federation of Teachers, the Small School Districts' Association, the Association of California School Administrators and other representative groups, and provided presentations to the CalSTRS Employer Advisory Committee to solicit feedback regarding these proposed regulations. Early drafts of the proposed concepts have been provided to interested persons, and revisions have been made based upon the feedback received.

CalSTRS staff has consulted with the Department of Finance, and Finance has affirmed that it has no concerns regarding the proposed regulations.

### **Alternatives Considered**

CalSTRS weighed the option of continuing to approve district-level employers as direct reports on a case-by-case basis. CalSTRS determined that well-defined standards for acceptance and removal, established through regulation, would create a streamlined and clear application process, permitting CalSTRS to more effectively implement its authority to allow district-level employers to directly report and enabling employers to understand prior to application what is required to become a direct report.

CalSTRS considered more stringent standards in allowing districts to direct report. For example, CalSTRS examined using stricter standards of accreditation maintenance. After consulting with stakeholders and investigating how the use of stricter standards would affect the eligible pool of employers, the use of more stringent standards was found to exclude a significant portion of community college district employers that were unlikely to be in imminent jeopardy of loss of accreditation, in CalSTRS' judgment.

CalSTRS considered the use of less stringent standards. The direct reporting relationship is desirable as a procedural efficiency, and CalSTRS does not aim to unduly exclude employers from participation. The standards contained in these regulations were determined to strike an appropriate balance between setting a high bar and allowing those highly qualified employers to participate without imposing a burdensome application process on school districts, community college districts, county offices of education or CalSTRS.

CalSTRS has not identified any alternative that would lessen any adverse impact on small businesses. No alternative has been proposed that would be less burdensome and equally effective in achieving the purposes of the regulation in a manner that accomplishes the purposes of the statute being implemented.

### **Economic Impact on Business**

These regulations do not place any economic burden on business as they do not place any additional licensing, record keeping or compliance requirements on businesses. These regulations primarily affect school districts, community college districts, county offices of education and other employing agencies, and no direct or indirect effect on businesses is anticipated.