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**PUBLIC UTILITIES COMMISSION**

505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3298



September 15, 2011

**BY E-MAIL AND  
REGULAR MAIL**

Ms. Valentina Joyce  
Commission Counsel  
California Fair Political Practices Commission  
428 J Street, Suite 800  
Sacramento, CA 95814

**Re: Notice to Adopt Regulation 18728.6**

Dear Ms. Joyce,

We are writing to comment on the Fair Political Practices Commission ("FPPC") staff's proposed regulation §18728.6, Reporting of Investments. This proposed regulation, most recently revised on 8/1/2011, excludes from the *reporting* requirement in Section 82005, funds that are substantially similar to a "diversified mutual fund registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940." Although we agree with the FPPC staff that these kinds of funds should no longer be reportable, we also strongly believe they should not be subject to the Political Reform Act's ("PRA") conflict of interest provisions. Therefore, we recommend that the FPPC instead adopt the regulation initially proposed by its staff, which was emailed on 6/6/2011, Regulation §18237, Definition of "Investment", with certain changes, discussed below and shown in the attachment. The initially proposed Regulation §18237 would interpret Section 82034 which defines "investment" for purposes of the reporting *and* conflict-of-interest provisions of the PRA. Under this proposed regulation, funds which had certain characteristics would neither be reportable nor disqualifying.

We agree with the FPPC staff that there are various types of investments which either did not exist, or were not commonly held, at the time the mutual fund exception was adopted in Section 82034. Since that time, many new kinds of investments have come into common use, such as ETFs, that are in many ways like mutual funds, even though they are not "mutual funds" under the Investment Company Act of 1940. These funds, however, share several important characteristics with true "mutual funds". In particular: (1) there are numerous investors in these funds; (2) the investors have no control over what investments the funds make; and (3) the funds are invested in a sizeable number of different stocks and/or bonds. The general public, including public officials, often use these funds as investment vehicles where, in the past, they would have invested in mutual funds. Oftentimes, public officials use such investment vehicles in their 401(k) and

similar retirement plans. Indeed, of the 19 funds offered to California State employees by the DPA's Savings Plus program, only one is a mutual fund.

Originally, to deal with the issues raised by these funds, the FPPC staff proposed Regulation §18237. Definition of "Investment." As the FPPC staff stated, Section 82034 provides that the term "investment" does not include an interest in a diversified mutual fund registered with the SEC under the Investment Company Act of 1940. The proposed Regulation §18237 sought to clarify this exemption by stating that it includes funds sharing certain characteristics with mutual funds. The FPPC proposal stated, "[t]he purpose of the regulation is to permit public officials who hold investments in these funds to treat those investments the same as mutual funds so that they would not need to be reported on statements of economic interests and would not give rise to a conflict of interest." We strongly agree that these funds should be excluded from the definition of "investment" in Section 82034, for reporting *and* conflict of interest purposes. The originally proposed Regulation §18237, would avoid the unduly complicated analysis required to determine when and whether a public official needs to disqualify himself due to the ownership of funds that are like mutual funds.

However, the FPPC staff then proposed Regulation §18728.6, Reporting of Investments. Instead of defining the term "investment" to exclude funds sharing certain characteristics with mutual funds, this regulation seeks to interpret and clarify the mutual fund exception in Section 82034 by providing that investments in funds that share key characteristics with mutual funds are exempt from the *reporting* requirement only. Proposed Regulation §18728.6 thus greatly narrowed the nature of the exception that would be granted to funds that are like, but are not, mutual funds. We believe this is a mistake.

Proposed Regulation §18728.6 would reintroduce all the difficulties presented to a public official who owns shares in such a fund who is trying to determine whether he must disqualify himself from participating in a governmental decision that may affect one of the component entities held by such a fund. For example, if a state employee holds in his 401(k) an investment in a closed-end fund, exchange-traded fund, or similar vehicle, and that fund in turn owns stock in a company regulated by the agency he works for, it would appear that under the currently proposed regulation, §18728.6, the employee would need, as to each action affecting that company in which he participates, to determine whether there would be a reasonably foreseeable material financial effect on that fund. It is unclear how to perform this kind of disqualification analysis, which in any event would appear to be extremely burdensome and require complex calculations and would likely require the official to project potential changes in stock price of the company held by the fund. Furthermore, this would require complex calculations as to how a change in stock price for one company would financially affect a fund which invests in that stock. If these funds are not excepted from both the disclosure and reporting requirements of the PRA, public officials may not be able to determine when or whether they are required to disqualify themselves from a governmental decision that may impact one of the companies held by the fund. The previously proposed regulation, §18237 which defined "investments", would avoid all such difficulties. Similarly, while the proposed regulation §18728.6 would help avoid inquiries to the FPPC about what is reportable, it would not

simplify the FPPC's task in responding to when disqualification is required, which as discussed above, is very complex.

Because these kinds of funds share certain characteristics with mutual funds, e.g., the fund has more than 100 investors, the fund holds securities of more than 15 issuers, and the public official/investor has no control over what securities the fund invests in, it makes sense to also except them from the disqualification requirements of the PRA. Since the public official does not control the decisions about what to invest in, and since the fund is diversified and invests in the securities of a number of issuers, the public official is not likely to participate in governmental decisions for the purpose of influencing the price of a particular stock so that the impact on the fund will benefit him or herself. In short, the ways in which these funds are like mutual funds, support the conclusion that an exception from disqualification, as well as reporting requirements, is justified for these funds, just as for mutual funds.

To summarize, the FPPC's proposed regulation should be a regulation which clarifies the exemption in Section 82034, which defines "investment", for purposes of the reporting *and* conflict of interest provisions of the Political Reform Act. We would agree, however, that some of the wording changes included in the more recently proposed regulation, 18728.6, should be included in a regulation defining the term "investment". These are the wording changes included in 18728.6, in subparts (1)-(4) of subdivision (a) and in subdivisions (b) and (d), which should be included in a revised Regulation 18237. A revised proposal for Regulation 18237 including these further changes is attached.

If, however, the FPPC decides to adopt regulation 18728.6, we believe that subdivision (c) will require re-wording. We have no objection to the FPPC clarifying that ETFs, closed-end funds and investments held in a plan qualified under Sections 401(k), 403(b) or 457 or similar provision of the Internal Revenue Code will be exempt from reporting requirements so long as they meet the four conditions spelled out in subdivision (a), (as modified by the presumptions set forth in subdivision (b)). However, as currently written, subdivision (c) appears to be a separate exception, even though the exception it grants is a subset of what has already been granted under subdivision (a). Thus, subdivision (c) does not add anything, making it superfluous and confusing. Moreover, the fact that ETFs (and closed-end funds) may qualify for the exception contained in subdivision (a) is already made clear by the reference to them in subdivision (b). Accordingly, subdivision (c) could easily be eliminated. However, if it is retained, it should be re-written to clarify that it just provides some examples of the kinds of investments that may qualify for exemption under subdivision (a). We suggest the following wording: "(c) The following are examples of the kinds of funds that need not be reported, if they meet all the requirements contained in subdivision (a) of this regulation: (i) an exchange traded fund, (ii) a closed-end fund; or (iii) a fund that is held in an employee plan qualified under Section 401(k), 403(b), 457 or similar provision of the Internal Revenue Code."

For the reasons stated above, we believe the FPPC should exempt these funds that are like, but are not, mutual funds from both the reporting *and* conflict of interest provisions of the Political Reform Act by adopting a revised Regulation 18237, as shown in the attachment. However, if the FPPC chooses to adopt its proposed Regulation 18728.6, the FPPC should at least eliminate or modify subdivision (c), as stated above, to avoid confusion.

This letter is being sent to you by e-mail, so you will receive this information as soon as possible, as well as by regular mail.

Yours truly,

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Lionel B. Wilson  
Deputy General Counsel

## **Attachment**

### **CPUC Staff's Proposed Regulation § 18237. Definition of "Investment."**

#### **§ 18237. Definition of "Investment."**

(a) For purposes of Section 82034, the term "investment" does not include an investment fund that is substantially similar to a "diversified mutual fund registered with the Securities and Exchange Commission under the Investment Company Act of 1940" because it meets all the following criteria:

(1) The fund is a diversified bona fide investment fund that pools money from more than 100 investors and invests the money in stocks, bonds, or other securities.

(2) The fund holds securities of more than 15 issuers.

(3) The public official who has an investment in the fund does not exercise responsibility for the management or investment of government funds.

(4) The public official does not influence or control the selection of any specific investment purchased and sold by the fund.

(b) For purposes of subdivision (a)(1) and (a)(2), an exchange traded fund (ETF) or a closed-end fund is presumed to have more than 100 investors and hold securities of more than 15 issuers.

(c) For purposes of Section 82034 and this regulation, a diversified fund means a fund that does not have a stated policy of concentrating its holdings in the same industry or business.