

FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chair Ravel and Commissioners Eskovitz, Garrett, Montgomery, and Rotunda

From: Valentina Joyce, Commission Counsel, Legal Division
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Subject: Adoption of Proposed Regulation 18728.6 – Reporting of Investments

Date: September 12, 2011

I. Introduction

The Act requires public officials to disclose financial information concerning their investments. Section 82034 provides that the term “investment” does not include an interest in a diversified mutual fund registered with the Securities and Exchange Commission (“SEC”) under the Investment Company Act of 1940 (15 U.S.C. 80a). This means that such mutual funds need not be disclosed on a public official’s Statement of Economic Interests. Proposed Regulation 18728.6 provides that certain investments that share key characteristics with mutual funds will also be exempt from reporting.

II. Background and Current Law

The mutual fund exception was enacted in 1978 as an amendment to Section 82034, which defines “investment.” Commission advice prior to the amendment provided that mutual funds were not investments within the definition. The 1978 amendment codified this advice and added the limitation that the exception applies only to mutual funds that are diversified and are registered with the SEC. Since that amendment, the Commission has received many requests regarding the reporting requirements of various types of investments that are similar to mutual funds, but which either did not exist or were not commonly held in 1978. Of particular concern to requestors are investments in funds over which they have no control and that share other characteristics with mutual funds.

Although Section 82034 states that the exception applies only to mutual funds that are “diversified,” the term is not defined. Advice letters¹ interpreting “diversified” have used the definition in the Investment Company Act of 1940 (*supra*), but the complexity of that definition has caused it to be largely ignored. In addition, that definition only requires that a fund invest in a diversity of issuers of securities. It does not require a fund

¹ *Galiotto* Advice Letter, No. A-01-001; *Gillan* Advice Letter, No. I-98-216.

to invest in a diversity of industries even though a public official may be in a position to make governmental decisions that would affect a particular industry.

III. Proposed Regulation

Proposed Regulation 18728.6 seeks to interpret and clarify the mutual fund exception by providing that investments in funds that share key characteristics with mutual funds are exempt from reporting. Staff examined the key characteristics of diversified, registered mutual funds and is using those characteristics to establish criteria for determining whether a fund is exempt from reporting. The proposed regulation differs from the noticed regulation based, in part, on public comments received at the June 7, 2011 Interested Persons' meeting and thereafter. One of these changes removes what was previously the third criterion, discussed below. The purpose of this regulation is to treat these funds the same as mutual funds for reporting purposes. Investment in these funds would continue to be subject to the Act's conflict-of-interest rules.

The Three Criteria

(1) Diversified bona fide investment fund that pools money from more than 100 investors and invests the money in stocks, bonds, or other securities; and

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

The first criterion combines the basic definition of "mutual fund" with a requirement that the fund must have more than 100 investors.² The requirements that a fund must have more than 100 investors and invest in securities of more than 15 issuers are based on SEC registration requirements. Only funds that have more than 100 investors are required to register with the SEC. Once registered, a diversified mutual fund must invest in securities of more than 15 issuers. (15 U.S.C. 80a-5).

(3) The public official does not influence or control the selection of any specific investment purchased and sold by the fund, either on behalf of the fund or on behalf of any agency.

This provision differs from the noticed regulation by its narrowing of what was previously the third criterion: the public official who has an investment in the fund does not exercise responsibility for the management or investment of government funds. Staff

² Following are two relevant definitions of "mutual funds." (1) An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. (www.investopedia.com). (2) A company that pools money from investors and invests the money in stocks, bonds, short-term money-market instruments, or other securities. The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC. (www.sec.gov/answers/mutfund.htm).

continues to believe that it is useful and relevant to know where a public official who invests government funds invests his or her own funds. It has been suggested, however, that this criterion may be too broad as previously drafted. Staff considered the comments and reviewed the language and now believes that the concerns addressed by former (a)(3) may be more narrowly addressed in the context of former (a)(4) (previously fourth criterion): “the public official does not influence or control the selection of any specific investment purchased and sold by the fund.” The language “either on behalf of the fund or on behalf of any agency” is added to clarify the applicability of this exception to public officials who manage the investment of government funds.

By adding the more focused language we retain disclosure by persons who exercise responsibility for the management or investment of government funds, but only to the extent that they are the specific investments purchased and sold by the fund.

Exchange Traded Funds

The proposed regulation also simplifies reporting by expressly stating that exchange traded funds (“ETFs”) and investments held in a plan qualified under Sections 401(k), 403(b) or 457 of the Internal Revenue Code are exempt, so long as they meet the four criteria. Although this provision adds nothing to the criteria-based exception, it will assist public officials by addressing a question often posed to staff.

An ETF is an investment fund traded on stock exchanges, much like stocks, that pools investor money to purchase stocks, bonds and other securities. ETFs are similar to mutual funds in the following ways: (1) they take money from the collective group and pool it together to invest in securities; (2) individual investors have no control over the choice of individual holdings that make up the fund; (3) funds are professionally managed by money managers; (4) shares have high liquidity; and (5) funds are diversified by investing in many stocks.

Closed-end Funds

Closed-end funds have been added to the other two examples (ETFs and qualified employee plans) of the types of funds that will qualify for the exception, provided all the criteria are met. Like an ETF, but unlike a mutual fund, a closed-end fund (1) does not continuously offer its shares for sale, rather, it sells a fixed number of shares at one time, after which the shares are traded on stock exchanges and (2) does not buy back its shares from investors. Closed-end funds are otherwise similar to mutual funds in the same ways as ETFs.

Qualified Employee Plans

Investments held in an employee plan qualified under Sections 401(k), 403(b) and 457 of the Internal Revenue Code are similar to mutual funds in the same ways as ETFs, except that interests in employee plans are not liquid.

Definition of “Diversified”

The proposed regulation interprets the term “diversified” which appears in Section 82034 but is not defined in the Act. Advice letters interpreting “diversified” have used the definition in the Investment Company Act of 1940 (*supra*),³ but the complexity of that definition has caused it to be largely ignored. The definition in the proposed regulation is simplified in that it does not require complex calculations based on information that is not readily available to an investor.

The proposed regulation also deviates from the Investment Company Act’s definition by requiring that a fund must not only invest in a diversity of individual issuers, but also in a diversity of industries. The narrower definition looks only to holdings in *a single corporation’s stocks*. The regulation’s broader definition requires that holdings cannot be concentrated in *a single industry*. (These funds are commonly called “sector funds.”)

Staff does not recommend adding a definition of “industry or business” in the regulation, as has been suggested by some commentators. We believe that any attempt to define these terms in the regulation would be problematic because the question of whether two or more stocks are in the same industry is necessarily fact specific. Thus, the question is best addressed in advice letters. This approach mirrors the federal laws governing conflicts of interest for certain federal employees. The U.S. Office of Government Ethics has provided guidance for determining whether a group of companies are in the same industry by articulating factors to be considered on a case-by-case basis. These factors are: whether the industry is narrowly described, whether the companies share a common regulatory environment and are affected by governmental decisions in the same or similar fashion given their interdependence or competition with each other, and the degree of similarity in their operations and interests.⁴

In addition, the narrow definition we propose serves a primary purpose of the Act as stated in Section 81002(c): “Assets and income of public officials which may be materially affected by their official actions should be disclosed and in appropriate circumstances the officials should be disqualified from acting in order that conflicts of interest may be avoided.” This purpose is not served if a public official may avoid reporting investments in businesses that can be affected by the official’s decisions, simply because the official’s investment fund spreads its holdings in those businesses over many companies. For example, the offshore oil and gas drilling industry could be affected by decisions of the California Coastal Commission, Air Resources Board,

³ “A diversified company means a management company which meets the following requirements: At least 75 per centum of the value of total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.” (31 U.S.C. --Section 5.(b)(1).)

⁴ Office of Government Ethics, Memorandum Issued August 25, 2000, from F. Gary Davis, Acting Director, to Designated Agency Ethics Officials Regarding Diversified and Sector Mutual Funds.

Environmental Protection Agency, the Senate's Transportation and Housing Committee, or the Senate's Energy, Utilities and Communications Committee. As is the case with all the Act's disclosure rules, disclosure of investments in sector funds will alert public officials and the public to potential conflicts of interest.

Other Changes to the Noticed Regulation

Based on public comment, minor changes have been made to clarify and make consistent several provisions of the regulation. The list of examples of funds that qualify for the exception has been moved from previous subdivision (c) to subdivision (a). Also, qualified employee plans and closed-end funds have been added to the presumption in subdivision (b).

IV. Staff Recommendation

Staff recommends adoption of proposed Regulation 18728.6.

Attachments

1. Section 82034.
2. Proposed Regulation 18728.6.