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through partnership

FIDUCIARY DUTIES, CONFLICTS OF INTEREST

ANNUAL BOARD EDUCATION

San Jose Police and Fire Department Retirement Plan

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FUNDAMENTAL FIDUCIARY DUTIES

1. *Primary Loyalty Rule* – Duty to act in the best interests of the members and beneficiaries; not to promote personal or others' interests (this duty takes precedence over all others).

2. *Exclusive Benefit Rule* – Duty to use plan assets solely for the purpose of paying the members' promised benefits and *reasonable* administrative expenses.

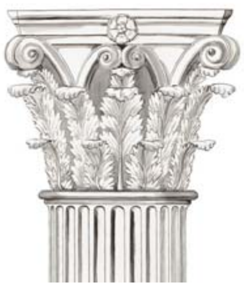
3. *Prudence Standard* – Duty to act with the "care , skill, prudence and diligence" "under the circumstances then prevailing" of a prudent person "in a like capacity and familiar with these matters…in the conduct of an enterprise of like character and with like aims." And to assure the competency of the assets of the system.

4. *Diversification* – Duty to diversify the investments so as to minimize risk and maximize return, unless clearly not prudent to do so (aka "Modern Portfolio Theory").

5. *Follow the Plan Documents* – Duty to administer the Plan in accordance with the Plan documents – including the Constitution, the City Charter and Municipal Code, state and federal law, IRC and regulations, Board's own charters and policies.

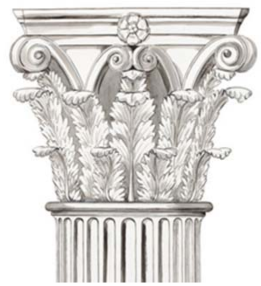
FIVE FIDUCIARY PILLARS

Primary Loyalty to Members



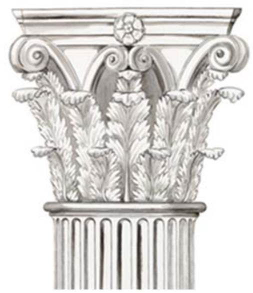
- Avoid conflicts of interest
- Attract/ retain capable staff
- Provide superior member service

Exclusive Benefit of Members



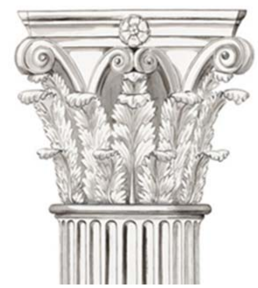
- Avoid using assets for others' purposes
- Avoid impacting plan for others' goals
- Pay only reasonable expenses

Prudent Care and Expertise



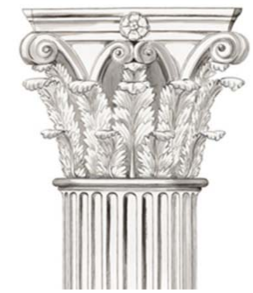
- Follow good governance policies
- Be independent
- Engage and delegate to expert staff/ consultants
- Monitor and adjust as needed

Diversify the Assets



- Establish risk tolerance
- Seek returns across all markets
- Weigh each investment in context of the whole program

Follow the Law



- Establish and comply with written plan documents
- Be mindful of your public official role

WHY ARE WE HELD TO SUCH HIGH STANDARDS?

Overcoming human foibles and situational ethics

- Doing something to advantage ourselves or others we like
- Doing something to disadvantage others we don't like
- Acting on our known and unknown biases when deciding
- Giving in to group pressure ("get along, go along")
- Personalizing decisions ("I could have kept working!")
- Making decisions for other reasons
- Making snap judgments
- Easier spending others' money, especially when there is a lot of it
- Easier making decisions in secret, out of the public eye

CONFLICTS OF INTEREST ARE THE MOST SERIOUS VIOLATIONS OF FIDUCIARY DUTY

- Breach of trust – the duty of absolute loyalty
- Undermines confidence in public officials, agencies
- Undermines confidence of colleagues
- Deprives all stakeholders of a “level playing field”
- The most unforgiven and penalized breach of fiduciary duty

THE CALIFORNIA SUPREME COURT:

"[A] person cannot serve two masters simultaneously. … If a public official is pulled in one direction by his financial interest and in another direction by his official duties, his judgment cannot and should not be trusted, <u>even if he attempts impartiality</u>.

"Where a prohibited interest is found, … the official … is subject to a host of civil and (if the violation was willful) criminal penalties, including imprisonment and disqualification from holding public office in perpetuity."

Lexin v. Superior Court (2010) 47 Cal.4th 1050

THE CONFLICT RULES ARE MANY AND COMPLEX

- Financial Conflicts of Interest
  - Political Reform Act
  - Government Code section 1090
  - Government Code section 7513.95
  - San Jose City Rules
- Restrictions on Gifts and Honoraria
- Non-Financial Conflicts of Interest
  - Common Law
  - Board Governance Issues
- Special Rules for Investment Advisors

POLITICAL REFORM ACT:
THE PROHIBITION

Government Code section 87100:

No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.

POLITICAL REFORM ACT: "FINANCIAL INTEREST"

Government Code section 87103: … reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally, on the official, a member of his or her immediate family, or on any of the following:

(a) Any business entity in which the public official has a direct or indirect investment worth [$2,000] or more.

(b) Any real property in which the public official has a direct or indirect interest worth [$2,000] or more.

(c) Any source of income … aggregating [$500] or more in value provided or promised to, received by, the public official within 12 months prior to the time when the decision is made.

(d) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management.

(e) Any donor of, or any intermediary or agent for a donor of, a gift or gifts aggregating [$470] or more in value provided to, received by, or promised to the public official within 12 months prior to the time when the decision is made. …"

FPPC REGULATIONS

The regulations provide clarification on:

- “Material”
- “Reasonably foreseeable”
- “Public generally”
- Parent/subsidy issues
- Exception if participation legally required
- Other less common circumstances and exceptions

2 C.C.R. 18700 et seq.

GOVERNMENT CODE SECTION 1090

Similar to the Political Reform Act, but only applies to making contracts, not all decisions

- The prohibited financial interest may be direct or very indirect:

  "We must disregard the technical relationship of the parties and look behind the veil which enshrouds their activities in order to discern the vital facts. However devious and winding the trail may be which connects the officer with the forbidden contract, if it can be followed and the connection made, a conflict of interest is established."

  People v. Honig (1996) 48 Cal.App.4th 289, 315.

- If a direct conflict, the Board cannot enter into the contract <u>at all</u>: recusal by the affected member is not sufficient to cure
- If a remote or non-interest, recusal will cure the problem
- There are many technical distinctions triggered in particular circumstances – seek guidance!

GOVERNMENT CODE SECTION 7513.95

- A complete prohibition

  A member or employee of the board shall not,

  directly or indirectly,

  by himself or herself,

  or as an agent, partner, or employee of a person or entity other than the board,

  sell or provide any investment product that would be considered an asset of the fund to any public retirement system in California.

CITY OF SAN JOSE RULES

- Generally consistent with state laws.
- <u>Code of Ethics</u>: "City employees and officials are expected to avoid any conflicts of interest. Further, employees [and officials] should *avoid the appearance* of conflicts of interest in order to ensure that City decisions are made in an independent and impartial manner."
- <u>Open Government Resolution section 6.3.2</u>: Recusing official must submit a "declaration of a conflict of interest" to City Clerk and City Attorney "at least 24 hours in advance of the meeting at which the agenda item will be discussed or heard"

CONFLICTS AND TRUSTEES FROM VARIED BACKGROUNDS

- Trustees who are members of the system:
  - Decisions impacting members: Usually no problem
  - Decisions impacting active trustees' departments: Often a problem!
- Trustees who are investment professionals:
  - Conflicts can be a minefield; analyze each factual situation
- All trustees:
  - Decisions impacting self: Always a problem!

IF YOU HAVE TO RECUSE YOURSELF…

- Acknowledge it and withdraw at the earliest possible moment
- Do not try to exert influence behind the scenes (*e.g.*, talking to staff or other Board members)
- Timely file a recusal declaration with the City Clerk and City Attorney
- After the announcement of the agenda item but before the discussion begins:
  - Publicly disclose each financial interest that gives rise to the conflict and how the decision might impact that interest
  - Recuse, leave the room and ask that the minutes reflect both
- *See* 2 C.C.R. 18707 for more details

GIFT AND HONORARIA RESTRICTIONS

- You may accept no more than $500 in gifts from a single source during a calendar year (this is the 2020 limit, which usually increases bi-annually)

- You must report gift value of $50 or more from a single source during a calendar year to the FPPC

- What is a "gift"? *Anything of value* that provides a benefit to the official (or family members) for which the donor has not received equal or greater consideration from the official.
  - Examples: Meals, transportation, accommodations, tickets, flowers, items for home, office or recreational use, and discounts in the cost of products or services

- You may not receive payments for making speeches, writing articles, attending conferences, or similar activities not part of normal work or Board requirements

- There are many exceptions and technical rules that can impact these prohibitions and reporting requirements

- Prepare Form 700s with care and read the instructions

NON-FINANCIAL CONFLICTS OF INTEREST

- Common Law
  - Interests of extended family and friends
  - Other biases that compromise a trustee's ability to be fair, impartial and prudent and put the plan's interests above the trustees' personal interests (duty of loyalty)
- Board Governance
  - Engaging in activities inconsistent with Board duties, positions
  - Speaking on behalf of the Board without authorization
  - Failing to maintain the Board's confidentiality
  - NOTE: Trustees do <u>not</u> lose their free speech rights as individuals by virtue of their Board positions

PENALTIES FOR VIOLATIONS

- Vacating the Board decision or voiding the contract
- Disgorging any profits
- Administrative penalties of up to $5,000 per violation
- Damages and attorneys' fees in a civil action
- Up to three times the value of a gift or honorarium
- Criminal sanctions for willful violations, including:
  - Up to $10,000 fine per violation
  - Limitations on ability to run for elected office or be a lobbyist
  - Felony for willful violations of Government Code section 1090
  - Potential forfeiture of retirement benefits

SPECIAL RULES FOR REGISTERED INVESTMENT ADVISORS

- SEC "Pay to Play" rules and the Investment Advisers Act of 1940 generally prohibit investment advisors from:
  - Providing investment advisory services for compensation to a governmental entity within two years after making a prohibited contribution to an official of the entity
  - Making payments or contributions to officials when the investment advisor is seeking to provide investment services to that official's governmental entity
  - Paying third parties ("bundlers") to solicit governmental entities or officials on their behalf
- Covers direct and <u>indirect</u> activities
- *See* 17 CFR 275.206(4)-5

PRACTICAL TIPS

- Review all Board agendas and materials with an eye for potential conflicts
- When in doubt, seek guidance
  - From counsel
  - From FPPC Hotline
- The 2010 Publication by the California Attorney General found at https://oag.ca.gov/conflict-interest provides good general guidance (but should not be relied upon as the final authority)

SCENARIO #1

A retirement board wants its plan sponsor City to issue a POB to improve funding of the plan, and is looking for support from the City Council.

Meanwhile: The Investment Committee has decided to reduce the number of Opportunistic Fund managers from 7 to 3. Under the IPS, Staff is responsible for recommending to the IC which managers should remain and which should be cut.

An influential Councilperson contacts the IC Chair and tells her an Opportunistic Fund manager who is a big contributor to his reelection fears being cut…can't the Chair find a way to keep the manager in the program?

What should the IC Chair do?

- Politely decline?
- Agree, but secretly do nothing?
- Consider the fate of the POB?
- Consider reputational risk?
- Direct staff to retain the manager?

SCENARIO #1 CONT'D.

Suppose the IC Chair goes to Investment Staff and directs them to recommend the manager be retained.

What should Staff do?

- Obey?
- Refuse to discuss?
- Explain the process they are employing to make the cuts?
- Ignore the Chair?
- Be offended that the Chair has put her thumb on the scale?
- Complain to the CEO? Board Chair?
- Comment on social media?

SCENARIO #2

Trustee Sam is a financial analyst. He is invited as a guest to a charitable fundraiser for disadvantaged high school youth that raises funds for financial literacy education. The gala is sponsored by two dozen prominent institutional investment management firms who have been promised the opportunity to socialize with trustees and CIOs from several western states' pension funds. The general admission to the event is $600 per person, which includes a meal, beverages and a raffle ticket for the big door prize, a Tesla. The admission has been waived for guests like Sammy.

Sammy is flattered to be invited, and readily accepts. At the event, he meets and discusses employment opportunities with several money managers who work with his fund, including two finalists who are being interviewed that very week for new mandates.

Any concerns?

SCENARIO #3

In her private business, Trustee Gina has developed a simulator that helps predict the impact of pandemics on global investments. One of the fund's domestic equity managers (a major Wall Street Bank) has a European affiliate that is interested in Gina's simulator, and she starts negotiating a personal licensing deal with the affiliate.   The simulator will not be used by the Wall Street Bank in connection with any of the system's investments.

Is it OK for Gina to participate in the following investment activities of the Board:

- *Setting asset class and sub-class allocations*
- *Selecting domestic equity managers*
- *Expanding the Wall Street Bank's contract to add $150 million for a new mandate*
- *Negotiating a new investment contract with the Belgian affiliate*

QUESTIONS?