

CONFLICTS OF INTEREST

Board of Administration
Federated City
Employees Retirement
System

January 17, 2019

Harvey L. Leiderman
Reed **Smith** LLP



THIS PRETTY MUCH SUMS IT UP

“[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, even if he attempts impartiality. ... 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**

WHAT WE ARE COVERING TODAY

- **Financial Conflicts of Interest**
 - Political Reform Act
 - Government Code section 1090
 - Government Code section 7513.95
 - San Jose Local 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 at all: 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.
- Code of Ethics: “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.”
- Open Government Resolution section 6.3.2: 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”

CONFLICT OF INTEREST LAWS AS APPLIED TO RETIREMENT BOARD MEMBERS

➤ To members of the system:

- Impacts all members: Usually no problem
- Impacts just the Board member: Usually a problem
- In between those extremes: Seek guidance

➤ To active City employees:

- Impacts the whole City: Usually no problem
- Impacts only the department that employs the Board member: Usually a problem
- In between those extremes: Seek guidance!

➤ To members in the investment industry:

- Conflicts can be a minefield; analyze each factual situation

➤ Quid pro quo: Don't do it!

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 about the decision)
- 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 identify and detail each financial interest that gives rise to the conflict of interest and why the decision might impact the 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 \$470 in gifts from a single source during a calendar year (this is the 2018 limit, which 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

➤ 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: Board members do not 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 indirect 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

Board member Sammy 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 \$500 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 business opportunities with several money managers who work with the system, including two finalists who are being interviewed that very week for new mandates.

Do you have any concerns with this?

SCENARIO #2

Strategic Liaison Asset Management (SLAM) is the system's longest serving emerging manager. Yours is SLAM's biggest account. SLAM's founder, Slim, is a renowned oenophile who spares no expense to impress his clients. Slim invites your fellow trustee (Chair of the IC) to a 4-star Michelin dinner and brings two bottles of Chateaux Lafitte Rothschild for the occasion. They enjoy a marvelous evening, reminiscing about their long relationship and vowing to work together forever, through thick and thin. Slim happily picks up the tab.

Meanwhile, your CIO has noted for some time significant style drift by SLAM. Their performance far lags their benchmark for 1, 3 and 5 years. At the next regular IC meeting the Chair regales all about the wonderful evening she enjoyed recently with Slim. When the CIO tells the Committee about the underperformance, the Chair takes him aside and warns, "cut Slim and SLAM some slack, that relationship is untouchable."

Any concerns here?

SCENARIO #3

In her spare time, Board member Gina has developed a simulator that helps predict the impact of currency fluctuations on global investments. One of your system's domestic equity managers (a subsidiary of a major Wall Street banking house) has a Belgian affiliate in fixed income that is interested in Gina's simulator, and she starts negotiating a personal licensing deal with the Belgian affiliate. The simulator will not be used by the domestic equity subsidiary 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 current domestic equity manager's contract to add \$150 million for a new mandate*
- *Negotiating a new investment contract with the Belgian affiliate*