



Consent

Agenda Item 4c

February 19, 2013

ITEM NAME: Proposed Regulation Relating to the External Investment Resource Conflict of Interest Policy

PROGRAM: Total Fund

ITEM TYPE: Policy & Delegation – Consent Action

RECOMMENDATION

Grant approval for staff to initiate the rule making process to adopt a regulation regarding External Investment Resource Conflicts of Interest pursuant to the Administrative Procedures Act (APA).

EXECUTIVE SUMMARY

On August 13, 2012, the Investment Committee (the Committee) adopted revisions to the External Investment Resource Conflict of Interest Policy (the Policy). On August 20, 2012, the Office of Administrative Law (OAL) received a petition alleging that by adopting the Policy, CalPERS had issued, used, enforced, or attempted to enforce an underground regulation. Once the petition was accepted by OAL for consideration, CalPERS, by letter dated October 31, 2012, notified OAL that it would not enforce the previously adopted policy. Staff now seeks to adopt the Policy as a regulation pursuant to the APA rulemaking procedure. Until the rulemaking process is complete, CalPERS will continue to include, in our contracts with external investment resources, specific terms and conditions related to conflicts of interest. CalPERS will also continue to review and take appropriate action regarding all conflicts of interest involving external resources of which it becomes aware.

STRATEGIC PLAN

This agenda supports the CalPERS Strategic Plan goal to cultivate a high-performing, risk-intelligent and innovative organization. The adoption of the External Investment Resource Conflict of Interest Regulation enhances CalPERS ability to mitigate investment and reputational risks.

BACKGROUND

The APA requires, with few exceptions, that state agencies adopt regulations following the procedures laid out in the APA with the OAL. California Government Code section 11342.600 defines a regulation as:

"Regulation means every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure."

A rule is called an "underground regulation" if a state agency issues or attempts to enforce a rule without following the guidelines in the APA. State agencies are not allowed to issue or enforce underground regulations.

ANALYSIS

To ensure that the Policy can be enforced going forward, staff recommends that the Policy be adopted as a regulation following the guidelines of the APA. The proposed regulation is provided as Attachment 1. A copy of the August 13, 2012 "Revision of the Consultant Conflict of Interest Policy" marked to show changes made in the regulation to clarify certain defined terms and add specific timeframes, where appropriate, is provided as Attachment 2. Upon approval by the Committee, the regulation adoption process will begin in February 2013.

BENEFITS/RISKS

The original Policy was developed to improve INVO's processes regarding identifying and evaluating conflicts of interests. During the period it will take to finalize the regulation, CalPERS is prohibited from implementing the policy and supporting processes. Accordingly, there is a risk that conflicts of interest will neither be identified nor evaluated.

ATTACHMENTS

Attachment 1 – Proposed Regulatory Action by CalPERS

Attachment 2 – August 13, 2012 "Revision of the Consultant Conflict of Interest Policy" with Changes Marked

Attachment 3 – Wilshire Opinion Letter

CAROL MOODY
Senior Portfolio Manager
Investment Compliance and Operational Risk

JANINE GUILLOT
Chief Operating Investment Officer

PROPOSED REGULATORY ACTION BY CALPERS

Add 2. Cal. Code Regs. Section 557. External Investment Resource Conflict of Interest

(a) Definitions:

1. *Conflict of Interest.* Conflict of Interest or Conflict means those circumstances that create the significant likelihood for the External Investment Resource to be unable to provide unbiased information, advice, or services to CalPERS. A Conflict may arise from activities and interests of the External Investment Resource, the Key Personnel of the External Investment Resource, or the Key Personnel's spouse, domestic partner, child or sibling.
2. *Consultant.* Consultant refers to individuals or firms, and includes Key Personnel of Consultant firms, who are contractually retained by CalPERS to provide investment advice to CalPERS but who do not exercise investment discretion.
3. *Disclosable Interest.* Disclosable Interest is any interest or circumstance that may give rise to an actual, potential or perceived Conflict.
4. *External Investment Resource.* Any Consultant, External Manager or other entity which provides any investment management or investment advisory services related to the administration of CalPERS investment programs. An External Investment Resource does not include a general consultant who provides strategic planning, project management or general administrative or operational services unrelated to specific investment transactions or decisions.
5. *External Manager.* External Manager means either of the following:
 - (A) A Person who is seeking to be, or is, retained by CalPERS to manage a portfolio of securities or other assets for compensation, or
 - (B) A Person who manages an Investment Fund and who offers or sells, or has offered or sold an ownership interest in the Investment Fund to CalPERS.

The External Manager usually has full discretion to manage CalPERS assets, consistent with investment management guidelines provided by CalPERS and fiduciary responsibility.

6. *Investment Fund.* Investment fund means a private equity fund, public equity fund, venture capital fund, hedge fund, fixed income fund, real estate fund, infrastructure fund, or similar pooled investment entity that is, or holds itself out as being, engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, owning, holding, or trading securities or other assets.
7. *Key Personnel.* Persons who will exercise a significant role in providing to CalPERS the services required under an assignment or contract.
8. *Staff.* Staff refers to CalPERS Investment Office staff.

(b) The disclosure responsibilities of External Investment Resources are:

1. Identify in writing the circumstances and nature of all Disclosable Interests and respond to any follow-up requests by Staff within 15 business days. In the event that the External Investment Resource is required to file a Form ADV, the External Investment Resource may provide the Form ADV to CalPERS as its initial disclosure document required by this regulation.
2. Provide sufficiently specific facts relating to its business practices so that Staff, and if appropriate the CalPERS Legal Office, can analyze each Disclosable Interest as set forth below in subsection (c)6, including but not limited to:
 - a. The circumstances and nature of all Disclosable Interests that exist pertinent to the specific assignment, recommendation, advice or other service.
 - b. Whether and under what circumstances the Disclosable Interest is likely to give rise to a Conflict.
 - c. A description of how the External Investment Resource has or intends to manage the circumstances of the Disclosable Interest in order to prevent the Disclosable Interest from resulting in a Conflict.

The disclosures required under this subsection must be made prior to the time the External Investment Resource provides the services that give rise to the Disclosable Interest, and annually, thereafter.

3. Once a Disclosable Interest has been made, the External Investment Resource shall update CalPERS within 15 business days in writing of any changes in circumstances that affect the Disclosable Interest.
4. In following this regulation, External Investment Resources are to consider the spirit as well as the literal expression of this regulation, by taking ongoing responsibility for scrutinizing their activities and transactions for Disclosable Interests and making appropriate disclosures. In cases where the External Investment Resource is unsure whether a Disclosable Interest exists, the situation or circumstances should be disclosed.

(c) Staff is responsible for the following:

1. Review all Disclosable Interests provided by External Investment Resources as set forth in Section (b) above.
2. Provide to the Committee no less than annually a summary of any actions taken by Staff to address the Disclosable Interests (including decisions not to take any actions).
3. Incorporating and including a copy of this regulation as an attachment to all Requests for Proposals and State of California Standard Agreements (“STD 213 Agreements”) between CalPERS and each External Investment Resource.
4. To the extent that the agreement outlining the services to be provided by the External Investment Resource is not a STD 213 Agreement, notifying the External Investment Resource of its obligation to provide these disclosures as set forth in Section (b) above.
5. Staff shall review all information presented by each External Investment Resource in accordance with Section (b) above and may request additional information.
6. Staff, and if appropriate the CalPERS Legal Office, will analyze each Disclosable Interest to determine:
 - a. Whether a Conflict currently exists, in which case, the assignment will be precluded;

- b. If a Conflict does not currently exist, how likely it is that the Disclosable Interest will in the future give rise to a Conflict; and,
- c. If a Conflict does not currently exist, whether there are any ways of handling or managing the circumstances of the Disclosable Interest in order to prevent the Disclosable Interest from resulting in a Conflict in the future. In addition, Staff will analyze on a case-by-case basis whether the Disclosable Interest is of a level of severity (either by itself or in combination with other Disclosable Interests) which warrants consideration or action by the Committee. Otherwise, Staff will instruct the External Investment Resource of any additional action it deems necessary or appropriate to mitigate or manage the Disclosable Interest so that it does not give rise to a Conflict.

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
EXTERNAL INVESTMENT RESOURCE CONFLICT OF INTEREST**

August 13, 2012

This policy is effective immediately upon adoption and supersedes all previous Consultant Conflict of Interest policies and protocols. However, this policy does not supersede and is meant to supplement any applicable provisions of state or federal law, including the Political Reform Act (Cal. Gov. Code sec. 87200 et seq.) and Government Code sections 20152.5 and 20153.

I. ~~PURPOSE~~

~~The California Public Employees' Retirement System ("CalPERS") Total Fund Statement of Investment Policy, adopted by the CalPERS Investment Committee ("Committee"), sets forth CalPERS overarching investment purposes and objectives with respect to all its investment programs.~~

~~This document sets forth the investment policy ("Policy") for External Investment Resource Conflict of Interest. The design of this Policy ensures that investors, managers, consultants and other participants selected by CalPERS take prudent and careful action while managing the investment programs. In administering its investment programs, CalPERS has determined it is appropriate to retain External Investment Resources to facilitate the implementation of its investment programs.~~

~~These External Investment Resources provide CalPERS with technical expertise and advice in specialized areas. In addition to serving CalPERS, External Investment Resources may have economic or personal interests that may not be fully aligned with CalPERS interests.~~

II. ~~STRATEGIC OBJECTIVE~~

~~The strategic objective of this Policy is to~~

- ~~A. Assure that the information and advice CalPERS receives from its External Investment Resources is impartial;~~
- ~~B. Outline a system whereby External Investment Resources disclose to CalPERS those circumstances that may create actual, potential or perceived Conflicts of Interest; and~~

~~C. Set forth a process for CalPERS to evaluate the disclosures to determine whether assignments should be precluded.~~

III. RESPONSIBILITIES

~~A. CalPERS Investment Staff (“Staff”) is responsible for the following:~~

- ~~1. Review all Disclosable Interests provided by External Investment Resources as set forth in Section III B. below.~~
- ~~2. Provide to the Committee annually or, as needed, a summary of any actions taken by Staff to address the Disclosable Interests.~~
- ~~3. This policy shall be incorporated and included as an attachment to all Requests for Proposals and State of California Standard Agreements (“STD 213 Agreements”) between CalPERS and each External Investment Resource.~~
- ~~4. To the extent that the agreement outlining the services to be provided by the External Investment Resource is not a STD 213 Agreement, Staff will notify the External Investment Resource of its obligation to provide these disclosures as set forth in Section III B. below.~~

~~A. The disclosure responsibilities of External Investment Resources are:~~

- ~~1. Identify in writing the circumstances and nature of all Disclosable Interests and respond to any follow-up requests by Staff within 15 business days. In the event that the External Investment Resource is required to file a Form ADV, the External Investment Resource may provide the Form ADV to CalPERS as its initial disclosure document required by this regulation. The following examples illustrate Disclosable Interests that an External Investment Resource should disclose to CalPERS. This list is not exhaustive of the situations that may constitute a Disclosable Interest.~~
 - ~~a. Fees and Compensation arrangements that any person employed or used by the External Investment Resource has that could create a Conflict of Interest.~~
 - ~~b. Any relationship or arrangement that the External Investment Resource or anyone employed or used by the External Investment Resource has with any related person listed below.~~

- ~~(1) Broker dealer, municipal securities dealer or government securities dealer or broker;~~
- ~~(2) Investment company or other pooled investment vehicle (including a mutual fund, closed end investment company, unit investment trust, private investment company or "hedge fund," and offshore fund);~~
- ~~(3) Other investment adviser or financial planner;~~
- ~~(4) Futures commission merchant, commodity pool operator, or commodity trading advisor;~~
- ~~(5) Banking or thrift institution;~~
- ~~(6) Accountant or accounting firm;~~
- ~~(7) Lawyer or law firm;~~
- ~~(8) Insurance company or agency;~~
- ~~(9) Pension consultant;~~
- ~~(10) Real estate broker or dealer; and~~
- ~~(11) Sponsor or syndicator of limited partnerships.~~

2. ~~The External Investment Resource must p~~Provide sufficiently specific facts relating to its business practices so that ~~CalPERS s~~Staff, and if appropriate the CalPERS Legal Office, can analyze each Disclosable Interest as set forth below in ~~Section III.C.2~~subsection (c)6, including but not limited to:
- a. The circumstances and nature of all Disclosable Interests that exist pertinent to the specific assignment, recommendation, advice or other service.
 - b. Whether and under what circumstances the Disclosable Interest is likely to give rise to an ~~actual~~ Conflict.
 - c. A description of how the External Investment Resource has or intends to manage the circumstances of the Disclosable Interest in order to prevent the Disclosable Interest from resulting in an ~~actual~~ eConflict.

The disclosures required under this ~~paragraph~~ subsection must be made prior to the time the External Investment Resource provides the services that give rise to the Disclosable Interest, and annually, thereafter.

~~3. For all External Investment Resources which are required to file SEC Form ADV, the Form ADV, Part 2A (“Form ADV”) shall be the document to identify Disclosable Interests and the policies and procedures in place to prevent a Disclosable Interest from resulting in an actual Conflict unless Staff determines that additional information is required pertinent to the specific assignment, recommendation, advice, or other services as set forth in Section III.C. below. For any External Investment Resource that is not required to file the Form ADV, Staff shall send the relevant questions from the Form ADV to the External Investment Resource to determine whether additional information is required.~~

4.3. Once a Disclosable Interest has been ~~disclosed~~ made, the External Investment Resource ~~will promptly~~ shall update CalPERS within 15 business days in writing of any changes in circumstances that affect the Disclosable Interest.

5.4. In following this ~~Policy~~ regulation, External Investment Resources are to consider the spirit as well as the literal expression of this ~~policy~~ regulation, by taking ongoing responsibility for scrutinizing their activities and transactions for Disclosable Interests and making appropriate disclosures. In cases where the External Investment Resource is unsure whether a Disclosable Interest exists, the situation or circumstances should be disclosed.

B. ~~Staff responsibilities following disclosures are~~ is responsible for the following:

1. Review all Disclosable Interests provided by External Investment Resources as set forth in Section ~~III.B. below~~ (b) above.

2. Provide to the Committee no less than annually or, as needed, a summary of any actions taken by Staff to address the Disclosable Interests (including decisions not to take any actions).

3. ~~This policy shall be i~~ ncorporatinged and includinged a copy of this regulation as an attachment to all Requests for Proposals and State of California Standard Agreements (“STD 213 Agreements”) between CalPERS and each External Investment Resource.

~~4.~~ 4. To the extent that the agreement outlining the services to be provided by the External Investment Resource is not a STD 213 Agreement, ~~Staff will notifying~~ the External Investment Resource of its obligation to provide these disclosures as set forth in Section ~~III B. below~~ (b) above.

~~3.5.~~ 3.5. Staff shall review all information presented by each External Investment Resource in accordance with Section ~~III.B.(b)~~ (b) above and may request additional information, ~~if warranted. If upon review of the information provided, Staff desires additional information, the External Investment Resource will promptly provide the additional information requested.~~

~~4.6.~~ 4.6. Staff, and if appropriate the CalPERS Legal Office, will analyze each Disclosable Interest to determine:

- a. Whether an ~~actual~~ Conflict currently exists, in which case, the assignment will be precluded;
- b. If an ~~actual~~ Conflict does not currently exist, how likely it is that the Disclosable Interest will in the future give rise to an ~~actual~~ Conflict; and,
- c. If an ~~actual~~ Conflict does not currently exist, whether there are any ways of handling or managing the circumstances of the Disclosable Interest in order to prevent the Disclosable Interest from resulting in an ~~actual~~ Conflict in the future. In addition, Staff will analyze on a case-by-case basis whether the Disclosable Interest is of a level of severity (either by itself or in combination with other Disclosable Interests) which warrants consideration or action by the Committee. Otherwise, Staff will instruct the External Investment Resource of any additional action it deems necessary or appropriate to ~~handle~~ mitigate or manage the Disclosable Interest so that it does not give rise to an ~~actual~~ Conflict.

~~3.~~ 3. ~~In all instances, Staff shall document its conclusions made in Section III.C.2., above.~~

IV. GLOSSARY OF TERMS

Key words used in the policy are defined in CalPERS Master Glossary of Terms.

Approved by the Policy Subcommittee:

June 10, 2005

Adopted by the Investment Committee:

June 13, 2005

Revised by the Policy Subcommittee:

December 15, 2008

Approved by the Investment Committee: February 17, 2009
Administrative changes made due to Policy Review Project: June 16, 2009
Approved by the Investment Committee: August 13, 2012