



# Performance, Compensation & Talent Management Committee

## Agenda Item 7a

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**November 18, 2020**

**Item Name:** Financial Interest Separation Requirements for Chief Investment Officer Position

**Program:** Administration

**Item Type:** Information

### **Executive Summary**

At the direction of the Performance, Compensation, and Talent Management (PCTM) Committee, CalPERS team has gathered information regarding financial separation requirements collected from various entities and has outlined planned next steps. CalPERS has connected with multiple entities, both in the private and public sectors, to gain a better understanding of the controls and separation requirements at various institutions. There is a wide range of policy and legislative controls that apply to various industries. Within the public pension space, our current policies and practices are largely consistent with other entities, however, as the largest public pension fund in the nation, CalPERS has an opportunity to lead in this field. CalPERS intends to mandate additional requirements for the Chief Investment Officer (CIO) position, which is in the recruitment process, and is exploring additional requirements that may require the selected incumbent to sell certain securities prior to assuming the position or to dispose of those securities and place the resulting assets into a blind trust.

### **Strategic Plan**

This agenda item supports CalPERS' Strategic Goals to cultivate a risk-intelligent organization and promote a high-performing and diverse workforce as outlined in the 2017-22 Strategic Plan.

### **Background**

The CalPERS investment office has a diversified and far reaching portfolio; it is possible that the CIO may have personal investments that could potentially be affected by investment decisions which may conflict with the full exercise of their job duties. Requiring an incumbent to sell securities that could potentially give rise to a conflict under the Political Reform Act or to do so and place their assets into a blind trust, removes perceived or real conflicts originating from the assets.

Government code 87100 clearly prohibits all public officials at any level of state or local government from making, participating in making, or in any way attempting to use their official position to influence a governmental decision in which they have a financial interest.

Additionally, the Political Reform Act and regulations adopted by the Fair Political Practices Commission (FPPC) contain various requirements designed to ensure that employees act impartially. These regulations include the option for a public official to maintain a qualified blind trust, subject to certain requirements.

With a qualified blind trust, control over the trust and its assets is given to an independent trustee, who has complete discretion to buy and sell assets without the knowledge or consent of the beneficiary. A public official with a qualified blind trust is further detached from potential conflicts originating from the assets held in trust because the beneficiary would have no knowledge of the impact of official actions on their personal financial interests. Properly structured, a blind trust severs any link between a person and control over his or her assets to avoid potential conflicts of interest.

CalPERS received information from many different institutions, consulting firms, public agencies, and companies regarding policies and controls these entities have in place to ensure conflicts of interest are mitigated. Institutions or entities consulted include Deloitte, Federal Retirement Thrift Investment Board, International Public Management Association for Human Resources membership, National Association of State Retirement Administrators membership, Korn Ferry, State Street, Grant Thornton, Olson Remcho LLP, and other state of California entities.

## **Analysis**

The most significant determinant for the types of controls in place was the industry and regulatory environment; for the consulting industry, we discovered highly comprehensive and deep controls that were tied to regulation; for public pensions we discovered controls similar to our current policies; for other state agencies we saw a high dependence on state regulation including the statement of economic interest requirement (form 700); for the private sector we saw a large dependency on federal regulatory controls; and for other large independent government organizations we discovered policies that prohibited board members from influencing investments for which the members may have a financial interest. Our current practices are consistent with other public pension funds; however, it is of note that CalPERS is the largest public pension fund and uniquely situated in some respects.

The large multinational consulting firm we connected with shared their practices and industry knowledge regarding the expansive and deep controls that they utilize. Consulting firms are a regulated industry with practices that are based on applicable federal and state law. To prevent any potential conflicts, perceived or otherwise, they require all employees to eliminate any interests for themselves and their families. Examples include requiring employees to remortgage their home through a different lender, if the existing lender should become a client; requiring employees to move assets from one bank to another, if the existing bank should become a client; and requiring employees to change their car insurance if the existing insurer should become a client. This highly comprehensive approach is appropriate for the consulting industry as their degree of exposure and access to an individual company is considerably deeper, as they typically have a higher degree of operational influence and access to non-publicly available accounting knowledge and other inside information.

The various public pension systems we connected with shared familiar policies and controls. A large AUM fund responded with questions regarding the recruitment challenges we would face

from forcing divestment and the tax consequences from such a divestment. Another large AUM fund responded with similar policies and controls we have in place today. A medium AUM fund responded with similar technological and policy controls, along with similar state financial disclosure requirements. Another medium AUM fund responded that they were not planning on instituting such controls.

The compensation and recruitment consultants shared their belief that adding such a requirement could have a marginal impact on our candidate pool but may have unintended impacts with respect to salary. They also added they have not seen such a requirement at other public pension funds.

In the course of our research, we learned that the blind trust would not relieve individuals from a duty to report investments owned upon entrance into the blind trust on their Annual Statement of Economic Interests (Form 700). Despite the assets being managed by the trust, the individual would have a duty to report the assets originally placed in the blind trust on their Form 700 until their trustee notified them of the sale of the asset/investment holding. Thus, until the originally owned assets were replaced there would still be a potential conflict of interest. Only once the asset is disposed of can the conflict be removed. Based on this and other aspects of our research, we are pivoting from pursuit of a blind trust to a more focused elimination of specific conflicts.

CalPERS is continuing our research on this topic with other public pension plans, state agencies, and industry partners. The Board's new executive compensation consultant will be starting in December 2020, and we plan to engage them in our research as well. We plan to return to the Board in February with a detailed analysis and recommendation.

Requiring the incumbent Chief Investment Officer to sell any securities that could potentially give rise to a conflict under the Political Reform Act, or to do so and place the resulting assets in a blind trust, will significantly diminish any perceived or real conflicts of interests originating from such assets. This prohibition would cover most securities that would be reportable on the Form 700 (e.g., investment securities, targeted ETF's, and real estate investments). CalPERS would allow for diversified mutual funds registered under the Investment Company Act of 1940 and broad-based ETF and index fund ownership. Since the position is currently vacant, this is an ideal opportunity to add such a requirement to the position. CalPERS may explore the addition of such provisions to other positions in the future following a role-based analytical approach.

### **Budget and Fiscal Impacts**

Not applicable.

### **Benefits and Risks**

Benefits include increased public trust, increased transparency, and reduced sanctions. This item also seeks to reduce risk by enhancing compliance.

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