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Ethics

The nation's ethics rules for screening and monitoring federal appointees' financial holdings and strategies have not kept pace with the ultra-complex investments common today, say authors Robert Rizzi and Dianna Mullis of Steptoe & Johnson. They describe key disconnects between the financial profiles of the highly successful private-sector individuals the government has called on to serve and ethics disclosure and conflicts regulations based on 1970s laws. Nominees to high office with cutting edge financial interests may face restrictions that can disrupt their efforts to take office or require costly divestitures. The authors advise those who anticipate possibly taking a high-level post in the next administration to review the ethics implications of their financial holdings.

Clearing the Hurdles: How 1970s Ethics Rules Can Trip Up Nominees With Cutting-Edge Financial Holdings

BY ROBERT RIZZI AND DIANNA MULLIS

The modern equivalent of the biblical admonition concerning a rich man hoping to enter the Kingdom of Heaven is that it is probably easier for a camel to pass through the eye of a needle than for a Wall Street banker to secure Senate confirmation. Since the days of the Founders, America has had a tradition of successful business executives leaving private industry to serve their country. In modern times, this tradition has flourished and many highly accomplished individuals with careers outside the federal government have heard the call to serve the public and have moved their families to Washington, often at significant personal, professional, and financial sacrifice. That tradition is now at risk.

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Experts from the private sector have provided critical skills in fields in which the permanent civil service, no matter how dedicated, simply cannot meet the needs of the nation. In the 21st century, information technology (now, especially cybersecurity), public finance, and international trade are all fields in which private industry has far outstripped government, and where the government must recruit talent if the country is to compete in global markets. The U.S. system of public administration, which is unique in the world, depends upon recruiting thousands of accomplished ''amateurs'' in government to maintain the nation's edge, and its security. Unfortunately, it is this exact set of individuals that face the most serious obstacles to successfully navigating the regulatory system called ''government ethics.'' If

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they cannot satisfy the requirements of this system, they cannot serve.

As the election approaches, it's not too soon for potential 2017 nominees to review the ethics implications of their financial holdings.

A principal source of the obstacles imposed by the government ethics system is, ironically, the assets that high-achieving individuals have accumulated while in the private sector. Many, if not most, financially successful individuals invest their wealth in a set of financial products that are increasingly complex and that the conflict of interest rules may not be able to evaluate adequately. These complex financial instruments are often commonplace and thoroughly understood in world financial centers, but fit uneasily, if at all, into the government ethics regime. The conflict of interest laws in that world are designed to prevent federal employees from ''serving two Masters'' (another biblical admonition that is also reflected in leading government ethics cases), that is, the public interest, on the one hand, and the personal financial interest of the employee, on the other. Navigating these rules is a challenge for both those individuals and their advisors.

As the election approaches and highly successful private-sector individuals anticipate possibly taking a high-level post in the next federal administration, it's not too soon for them to review the ethics implications of their financial holdings.

I. The Rise of Complex Assets

The basic problem with the current conflicts system is that it was designed for an era in which investment portfolios included only straightforward securities—stock, bonds and perhaps some real estate partnerships. Complex modern investments, on the other hand, can wreak havoc with the chances of a prospective nominee, despite the fact that these financial products that have become a normal part of the portfolios of successful investors.

These obstacles require careful analysis under government ethics rules that were adopted long before the development of some of these new products, and require careful and sometimes creative planning to balance economic and regulatory goals. Led by the Office of Government Ethics (OGE), and by designated ethics officials of the various agencies and departments (DAEOs), the regulatory system has had difficulty adapting to the steady stream of new products that financial services companies, institutions and advisers generate on a constant basis.

A prospective nominee's private counsel can be useful in explaining the unique features of complex instruments and aiding ethics officials in developing solutions within the regulatory framework.

Ethics regulators have only a limited set of tools for analyzing these products, and for determining whether and to what extent holding such products could create disqualifying conflicts. A prospective nominee's private counsel can be useful in explaining the unique features of complex instruments and aiding ethics officials in developing solutions within the regulatory framework.

If the financial interests of an individual turn out to be disqualifying, the prospective appointee will be frustrated in his or her ambitions, and will be either precluded from serving or required to divest the conflict assets, often at significant cost.

The difficulty of adapting 1970s - era ethics regulations to modern financial products was demonstrated early in the current administration, when a number of potential nominees held a relatively new financial instrument, ''equity-linked notes.'' These securities, which were widely available and generated attractive yields, provided holders with a fixed income stream (interest on the notes), together with an appreciation ''upside'' tied to an equity index, such as the S&P 500. Because of the ''link'' to equity, the notes, in theory, shared in the performance of every security that made up the index, although of course the holder could not affect the performance of the index by any official decision. However, because no existing exception applied, ethics officials determined that the holder owned an indirect interest in every stock in the index, a virtually insurmountable set of potential conflicts. Eventually, OGE determined to provide a standardized ''waiver'' of these miniscule conflicts for each individual who applied for one, a formal solution to a truly hypothetical problem.

II. Financial Disclosure of Investment Funds

Vetting for potential financial conflicts of interest is a major hurdle for executive branch appointees, and the completion of the dreaded OGE Form 278 is a rite of passage that for many prospective nominees generates more anxiety than the annual IRS Form 1040.

Under the Ethics in Government Act, the 1978 statute that imposes potential criminal liability for ethics violations, prospective nominees confront two hurdles: disclosure and potential conflicts. Public financial disclosure for most high-profile positions requires fully revealing the filer's, their spouse's and their dependents' entire portfolios, including all significant assets, their approximate value, and the approximate amounts of income generated during the reporting period. When the filer's assets include multi-tiered partnership interests in hedge funds, or ''short'' positions or securities ''straddles,'' or ''hybrid'' instruments that perform like stock as well as like indebtedness, disclosure on the

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face of the Form 278 often does not sufficiently describe the nature of the asset. Often, a detailed ''endnote'' description of underlying holdings or other aspects of the product must be attached to the Form. Thus, the 278 itself has, for certain instruments, become a limiting factor.

Additional aggravation occurs when the holdings of the prospective appointee include interests in private equity investments and similar ''funds,'' a type of vehicle that has grown increasingly complicated. The principal problem is that many such funds involve multiple layers—so-called ''funds of funds,'' or other tiered partnerships that have been formed for various purposes (primarily tax), but that have to be examined separately at each tier for conflicts purposes in light of the formal requirements of the disclosure rules. Multitier disclosure is both complicated and risky, because there is always a possibility of misinterpreting a particular structure, or of missing some chain or chains.

In the case of multi-tier holdings, it is generally only the ultimate portfolio investments—usually at the bottom tier—that create the potential for conflicts. On the other hand, public disclosure of the underlying portfolio holdings is often difficult, in light of confidentiality restrictions—the funds are called ''private'' equity for good reason—that limit the information available to investors. Thus, for example, a potential nominee invests in Fund X, which in turn owns a minority interest in Fund Y, which in turn owns a small interest in Company Z. This relatively simple structure is very rare in practice. Multi-tier funds are often vastly more complex. For disclosure purposes, the nominee must disclose the chain all the way down to Company Z. However, Fund Y has little or no interest in providing information to the public concerning its holdings and therefore, the nominee may not even have knowledge that Fund Y has a small interest in Company Z. Moreover, whatever information is provided to investors is often stale, because typical quarterly reports look backward, and portfolio holdings of the fund could easily have changed in the meantime.

a. Excepted Investment Funds

A special subset of investment vehicles is the so-called ''excepted investment fund,'' or EIF. Solely a creature of the regulations under title 5 of the Code of Federal Regulations, EIFs benefit from limited financial disclosure requirements and therefore qualification of a fund as an EIF streamlines the information that must be included in publicly filed documents (conflict analysis for such EIF investments is a separate question, discussed below). While no formal definition exists, guidance on OGE's website defines an EIF as an investment fund or other ''pooled investment vehicle'' that is independently managed, ''widely held,'' and either ''publicly traded or available'' or ''widely diversified.''

Once a particular investment fund qualifies as an EIF, nothing ''below'' that level in the typical investment fund structure needs to be revealed in the Form 278: for example, none of the underlying portfolio investments need be listed, and sales are not subject to periodic reporting on Form 278-T.

For many years, the definition of EIF was limited primarily to mutual funds. One of the key tests for qualification was that the interests in the pooled investment vehicle be ''widely held,'' defined as having more than 100 investors, a standard clearly tied to the securities law tests for private offerings where such offerings cannot involve more than 100 investors.

A key part of ethics planning for alternative investments in the form of interests in funds of various kinds (private equity, venture capital, hedge funds, etc.) is the set of OGE regulations and administrative guidance concerning pooled investment vehicles, and more specifically, excepted investment funds, or EIFs. Although originally designed primarily to address mutual funds and their underlying holdings—the filer who invested in a mutual fund that qualified as an EIF would not be required to disclose its portfolio—a number of evolutionary changes in the rules concerning such funds have created several opportunities for planning. Specifically, beginning around 2005, OGE ''liberalized'' the definitional standards for EIFs, thus permitting more and more funds—essentially any such fund with a pension plan as one of the investors– to qualify for EIF treatment. As noted, the result was that disclosure of the underlying portfolio holdings of the fund was not necessary.

EIF classification does not eliminate tension for conflicts of interest. Difficult as it is to believe, portfolio holdings of limited partnerships, over which a nominee may have no control and only limited knowledge, can create insurmountable conflicts of interest. Thus, for example, if a nominee holds an investment in a multibillion-dollar private equity fund (for example, one managed by Blackstone or KKR) representing a tiny fraction of a percentage interest in the fund's portfolio, and if the fund has an investment in 20 different portfolio companies, the nominee will have a potential conflict of interest with respect to each one of the 20 companies. Given that the investor generally cannot compel the fund to divest the fund's interest in any of the portfolio companies, the only choice for a nominee facing a likely conflict is to divest her interest in the entire fund. For a number of reasons, interests in such funds are highly illiquid, and divestiture will almost certainly require sale at a steep discount, if a sale is even possible. In some cases, nominees have been forced to abandon their interests in such funds, increasing the economic cost.

Of course, if the nominee only owns investments in publicly listed mutual funds, there is no disclosure risk, because such mutual funds by definition will be EIFs, and no conflict of interest risk exists because of an express regulatory exemption for diversified mutual funds under 5 CFR part 2640. However, as new products are developed, disclosure requirements and conflicts of interest can arise.

For example, when syndicated investments in mortgages and other indebtedness that was undervalued, because of the financial meltdown in 2008, were repackaged and sold as syndicated products, ethics officials began to require that each underlying debt obligation be tested independently, including the collateral supporting the debt instrument. If the nominee might eventually have jurisdiction over the auto industry, for example, notes issued by car companies as part of these syndications could pose a challenge, notwithstanding the fact that the notes themselves reflected dozens or even hundreds of such instruments, thus spreading the risk and also randomizing the connection between any government action and any particular underlying obligation.

b. Blind EIFs

As noted above, disclosure and conflict analysis of certain investment funds operate independently under government ethics rules, and qualification under the more flexible definitions of EIFs did not affect the conflict analysis with respect to underlying portfolio companies. However, beginning in 2009, coincidentally around the same time as a significant number of appointees in the new administration raised issues concerning investments in such funds, OGE first raised the possibility that EIFs as to which a filer had no actual knowledge concerning underlying investments could qualify for a de facto exemption from financial conflicts. Focusing on the statutory requirement that the filer must have ''knowledge'' of a financial interest in order to fall under the conflicts statute, section 208, OGE reasoned that, in the absence of such knowledge, no section 208 conflict could arise. Thus, a ''blind EIF'' provided the opportunity for filers to avoid potential conflicts of interest with respect to complex financial holdings involving investment funds of various kinds.

It has since become clear that many investment funds, especially hedge funds but including a number of private equity and debt-related funds as well, could qualify as blind EIFs, because of the limited amount of information that fund managers provide to investors, especially with respect to specific portfolio companies purchased by the fund (as opposed to overall performance). Because the investor has virtually nothing to say about investment strategy or the conduct of the manager (within some limited fiduciary obligations to investors), many funds have a policy providing little or no information concerning underlying investments, and therefore meet the test as established by OGE for a blind EIF.

In order to support the determination that a particular fund is a blind EIF, a standard form of documentation, commonly referred to as a ''manager's letter'', is required with respect to each fund for which blind EIF treatment is being claimed. The language of such documentation has become boilerplate, and some investment fund managers have become reasonably fluent in the terms required, and concerning the nuances of the required language. These managers have been able to provide the required letters, to the benefit of their investors who are facing the burden of conflicts analysis.

c. Blind Non-EIFs

A variation on the evolution of the treatment of certain investment funds as exempt from disclosure and conflicts analysis is the treatment of pooled investment vehicles that do not qualify as EIFs, even under the expanded interpretation by OGE described above. One common reason for failure to qualify as an EIF is that the fund interests are held by a limited group, for example friends and family, and thus fail to meet the ''publicly traded or available'' test. (The alternative test of ''widely diversified'' holdings is almost impossible to meet for a number of reasons.)

Under an advisory issued in 2008, OGE took the position that a pooled investment vehicle that did not satisfy the EIF tests had to meet both disclosure and conflicts requirements. Furthermore, OGE stated that, if such an investment vehicle could not disclose its underlying assets, the filer was required to divest the fund, often at a substantial discount. The basis for this opinion was that, because the filer did not meet the disclosure requirement of the Ethics in Government Act, the filer could not comply with the law and the fund interest had to be sold or otherwise disposed of. This harsh rule created a number of concerns and would, for example, have required Gov. [Mitt] Romney [(R-Mass.)], had he been elected president in 2012, to divest interests in funds which were held in blind trust (many of these funds were limited to executives at Bain and Company, and therefore did not qualify as EIFs).

In 2014, OGE modified its position on blind non-EIFs significantly, ruling that, under most circumstances, OGE will certify the financial disclosure report of a Senate-confirmed nominee who is unable to disclose the holdings of a non-excepted investment fund, reasoning that in the case of a nominee who has no information about fund holdings because fund managers do not provide such information to investors ''there is little if any potential for conflicts of interest because knowledge is a critical element of a conflict of interest.''

The evolution in the treatment of pooled investment vehicles has taken place entirely independently of the regulations governing such instruments, which have not been significantly changed since 2002. Further evolution might be anticipated, perhaps, for example, limiting the extent to which a management role with respect to the fund would disqualify the pooled investment vehicle (especially where the filer's management role is limited or part of an investment committee, as to which the filer has only one vote). Each such evolution may help to align the expectations of prospective appointees, who often do not understand why a merely passive investor role should create potential conflicts of interest.

III. Conflict Analysis for Complex Assets

Once a nominee's financial holdings have been properly disclosed on Form 278, they are individually evaluated to determine whether a conflict of interest exists with respect to that asset. While this evaluation is relatively simply with respect to an individual stock holding, it is extremely complex with respect to sophisticated financial assets.

a. Debt vs. Equity vs. Hybrid Instruments

As noted above, in an earlier time, investments could generally be categorized as either equity or debt. These two categories had different income and appreciation expectations, as well as different positions in the hierarchy of corporate capital. The distinction between these two categories has an impact on the terms of analysis under the rules concerning potential financial conflicts of interest.

In general, the ethics analysis applied to most debt instruments and other obligations that provide for fixed payments was limited to whether the holder as a prospective employee of the federal government could, in a particular matter, affect the ''ability or willingness'' of the issuer to make the payment under the obligation. Although the holding of the obligation was a ''financial interest'' requiring conflicts scrutiny, in practice, the analysis was limited to decisions the nominee might make in office that could affect the solvency of the issuer, a relatively unusual situation (although, during the financial collapse in 2008, not unheard of).

In contrast, ethics analysis of ''equity'' instruments provides a completely different set of concerns. Securities that represent an ownership interest in the issuer,

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and that move depending upon the valuation of that interest, create a potential financial conflict of interest at any time that an activity with respect to a particular matter could impact that valuation, whether up or down. (Perversely, if a government employee could make a decision that would result in a financial loss in a holding, there is still a potential conflict as the loss could be used to the benefit of the nominee for tax purposes.) For these purposes, there is no ''de minimis,'' much less ''material,'' threshold for financial conflicts of interest, therefore *any* impact on the equity interest is deemed prohibited. Thus, for example, an interest of a tiny fraction of 1 percent of a large private equity or hedge fund would create a potential conflict of interest, even though, as a practical matter, the holder of the interest in the fund, while in government, could only affect the interest in the fund by, at most, a few pennies.

This dichotomy, however, does not take into account a number of real-world investment realities. Thus, for example, debt that is publicly traded or is otherwise available in the ever-increasing range of securities markets (including ''pink sheets'' and other nontraditional exchanges) can fluctuate in value based on a number of factors, in addition to the obvious impact of market interest rates. Moreover, corporate debt that is ''subordinated'' (that is, positioned lower in the pecking order of the capital structure than more senior debt, although higher than preferred stock) often fluctuates in value because of perceptions concerning the credit worthiness of the issuer. Similarly, preferred stock issued by major corporations may resemble fixed income debt securities in many ways, but is issued in part because payments on the instrument—dividends—may be eligible for a reduced rate of tax as a result of tax reforms first made in 2003 and carried over into the current tax code, as compared to interest on corporate bonds. Preferred stock is almost always analyzed for ethics purposes as equity.

The bifurcation of securities into either debt or equity has also become more difficult as a result of active efforts in the private sector to create additional investment vehicles for investors. There are number of reasons for this creativity, many tax-driven and others driven by market appetites for higher yields, in an era of historically low interest and inflation rates. Instruments that have characteristics of both debt and equity, therefore, have been created in great numbers and ranges by the alchemists on Wall Street. Such ''hybrid'' instruments create special problems for purposes of government ethics analysis.

A basic example is convertible debt. Issued as a standard debt instrument with a fixed term and coupon (interest) rate, convertible debt has as a core feature the ability to exchange the instrument for equity in the issuer, that is, a full stock interest. The conversion feature provides optionality and a possibility of sharing in corporate appreciation, and also provides the holder with downside protection, since the conversion feature will not be exercised if the conversion right is into a security with a value less than the debt obligation itself. However, until conversion occurs, the instrument continues to act like pure debt.

Similar issues are raised in connection with ''mezzanine debt,'' that is, indebtedness that has a repayment priority subordinated to various classes of senior indebtedness (for example, bank debt, mortgage debt, etc.), but that is to be repaid before equity. Although mezzanine debt takes many forms, and is sometimes (inaccurately) referred to as ''junk bonds,'' mezzanine debt is treated as indebtedness for tax and other purposes, therefore such payments during the term are deductible as interest. Moreover, mezzanine debt does not generally include a conversion feature, although non-compensatory options, or warrants, may be bundled with mezzanine debt as part of a financing transaction.

Despite this treatment in the Tax Code, the OGE approach to mezzanine debt is more like the conflicts analysis for equity than for indebtedness. This approach is based upon the understanding that such indebtedness ''is secured only by an entity's future earnings.'' While that characterization is true of any indebtedness that is not secured by specific collateral, the ethics concern that OGE embraces is, once again, focused on the connection between the success of the security issuer, and the decision-making by the security holder while in government service.

b. Equity Compensation

Equity-based incentives constitute one of the most problematic categories under government ethics rules. Executive equity compensation, such as options, restricted stock units, shared appreciation rights, or other similar kinds of products developed by consultants to incentivize corporate executives are becoming increasingly common. Equity compensation arrangements are especially common in the technology sector, the area in which talented private-sector individuals are most needed for national security and other positions in government.

Equity compensation arrangements are often problematic for nominees for several reasons. First, the information on the face of the Form 278 is almost always insufficient to properly evaluate the potential conflict of interest and further information is requested, including the details of exercise requirements, vesting conditions and other customized terms. Second, the types of assets typically involved may not have a readily ascertainable value at the time Form 278 is filed. Stock appreciation rights may even be underwater, in that the value of the stock decreased after the appreciation right was granted, however there is still value to holding the stock appreciation right. In this case, OGE permits the nominee to employ an alternate form of reporting. Lastly, equity compensation can be very difficult to divest as there is often only a very limited pool of potential buyers and nominees are often forced to take a steep discount in order to clear themselves of conflicts.

The dichotomy between debt and equity interests in the analysis of potential conflicts of interest described above often creates substantial incentives to modify an executive compensation arrangement from ''floating to fixed.'' This change could disconnect the financial interest of the nominee from potential value fluctuations in the company. The benefit of doing so is that the asset now falls under the much more limited ''ability or willingness'' standard described above.

c. Managed Accounts

An increasing part of investment strategy of high net worth individuals is the allocation of assets to ''managed accounts.'' These accounts, created at financial institutions and managed with little or no input by individual investors, have raised a number of conflict of interest and similar issues. Especially with respect to

managed accounts where trading is frequent, keeping track of new acquisitions, both for purposes of conflict analysis and in order to comply with periodic transaction reporting (the relatively recent OGE Form 278-T) creates a number of challenges.

As an initial matter, it is important to understand that the conflict of interest rules view such accounts in accordance with their legal form – as direct interests held by the filer in each of the securities in the account—rather than as the effective equivalent of an interest in a fund or other pooled vehicle. Thus, even though in many financial institutions, a managed account for a particular account holder is invested in identical securities with other account holders using the same program, an account holder who is being considered for an executive branch appointment is viewed as if those securities were his or her unique interest.

Because under such programs, the account holders' managed accounts are invested collectively, the appointee is not able to direct the manager to make specific investments or to avoid financial conflicts of interest; as result, a managed account can be the worst of both worlds from an ethics standpoint—full attribution of direct ownership, but an inability to avoid the consequences of such ownership. Finally, managed accounts can sometimes involve some of the relatively sophisticated and complicated financial positions described above, including hybrid instruments and short sales. As a result, managed accounts create a number of serious obstacles, as a matter of disclosure, initial conflicts analysis, and ongoing monitoring once the individual enters the government.

IV. Conclusion

Although complex financial instruments pose serious challenges to nominations and reforms in the treatment of such holdings are long overdue, ethics regulators have proven adept at addressing some of the challenges of regulating such holdings, given the constraints they are under because of the existing statutory authority. At some point, however, these rules must be updated and brought into line with the evolution of financial instruments and the related investment postures of the individuals that the government would like to encourage to serve in the government.

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