

Officials Must Note Financial Conflict Of Interest Law

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Earlier this year, Brenda Fitzgerald, the director of the U.S. Centers for Disease Control, was forced to resign because, shortly after taking the position, she had purchased stock in tobacco and pharmaceutical companies — transactions that created a glaring conflict of interest between her financial holdings and her official role.

According to public accounts, the director had not personally directed the purchases, which were instead made on her behalf by an investment manager. She also owned hundreds of other stocks, and there was no evidence that she took any official actions that were influenced by her financial interests. Nonetheless, the transactions cost the director her job.

This incident highlights how important it is for incoming federal officials to understand the financial conflict of interest statute, and structure their investment arrangements accordingly. In particular, federal officials must give clear instructions to anyone making investment decisions on their behalf, who may not otherwise appreciate how transactions can create legal or reputational risk.

The Federal Conflicts Statute

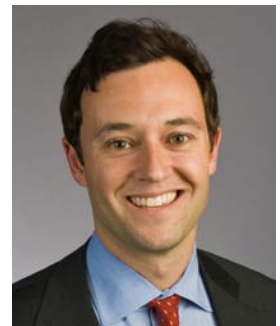
The federal financial conflict of interest statute, 18 U.S.C. § 208, provides that executive branch employees may not “participate” “personally and substantially” in any “particular matter” in which they, or certain others connected with them (such as close family members and business associates), have a “financial interest.” Implementing regulations, at 5 C.F.R. § 2640, add that participation is prohibited where the particular matter will have a “direct and predictable effect” on the interest.

The statute and regulations define “participation” broadly. In addition to the exercise of decision-making authority, making a recommendation concerning, advising on or investigating a matter can trigger potential liability. For example, a counselor to a cabinet secretary may lack authority to issue a policy directive affecting a discrete industry. But if she advises the secretary on such a directive while owning stock in a company that will be directly and predictably affected by the policy, she may face liability under the statute.

A “financial interest” can take a variety of forms. The most common is an equity stake in a business entity through stock or an ownership percentage, but there are other types as well. For example, owning bonds issued by a company or even a municipality can create a financial interest in the



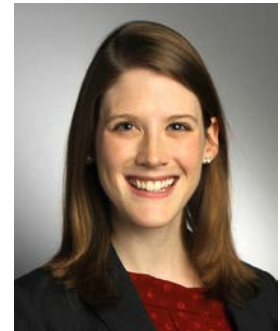
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debtor's ability and willingness to make payments. Likewise, entitlement to a defined-benefit pension from an ex-employer can create a conflict if a policy decision is likely to affect the company's ability to meet its obligations.

A "particular matter" under the statute covers both decisions targeting specific individuals or companies, such as regulatory enforcement actions and contract awards, and also policies and rules that are focused on the interests of a discrete and identifiable class of persons. More generally applicable policies are not "particular matters."

By way of example, the regulations cite a rule governing meatpacking plants as an example of a particular matter, but identify healthcare reform and workplace health and safety rules as general matters. The line between particular and general matters is not always clear, and employees with potentially conflicting financial interests should consult with ethics officials and err on the side of caution.

Importantly, it is not necessary under the statute to prove that an official's participation in the matter in question actually benefited her financially. Simply proving that she had a financial interest in the matter, whether or not her participation actually affected the value of that interest — or indeed, even if it hurt her interest — is all that is required.

The assets of certain other people are also imputed to an official when determining whether she has a financial conflict of interest. In addition to the financial interests of an official's spouse and dependent children, the statute extends to the financial interests of organizations and companies that the official is an employee, director or trustee of; companies with which the official is discussing possible future employment; general partners of the official; and any trusts that the official, the official's spouse and dependent children are beneficiaries of.

Ethics Agreements

High-level agency officials are typically required to sign an "ethics letter" addressed to the top ethics officer at their agency. In this letter, the official commits to comply with various ethical requirements, and in many cases to take concrete steps to divest assets that have been identified as posing a risk of creating financial conflicts given the official's responsibilities.

However, the fact that a particular company's stock is not on an official's required divestiture list — or the fact that the official never had to sign a letter at all — does not give the official carte blanche to participate in particular matters that have a direct and predictable effect on the company.

Exemptions and Waivers to the Conflict Rule

The U.S. Office of Government Ethics has promulgated certain regulatory exceptions to the federal conflict of interest statute. In particular, it has implemented de minimis exceptions for certain financial holdings.

Someone who owns \$15,000 or less of a company's publicly traded securities can participate in particular matters involving specific parties where the company is a party. Someone who owns \$25,000 or less of a company's publicly traded security can still work on particular matters of general applicability that will affect the company. Likewise, ownership of a sector mutual fund amounting to \$50,000 or less will not prevent an official from participating in a matter that affects the holdings of the fund.

Anyone who relies on these de minimis exceptions should take care to monitor the value of their investments, as appreciation and reinvestment of proceeds can bring them over the threshold. The exceptions do not inoculate officials against reputational risk — for example, a senior agency official may face criticism for owning any amount of stock in a company he or she directly regulates. These exceptions also apply only to publicly traded securities — they do not apply to privately held stock, real estate or investment funds.

Agency ethics officials can also legally waive a conflict such that an official can participate in a matter notwithstanding his interest in an affected company. These waivers have been subject to a great deal of public scrutiny, and may not be granted in every case. The Office of Government Ethics has issued comprehensive guidance to agency ethics officers regarding when granting a waiver is appropriate. Even if a waiver is possible, an official seeking to avoid controversy may look for other ways to address a potential financial conflict, such as through recusal or by selling the asset.

Manage Your Managers

Particular risks can arise for individuals whose investments are in “managed accounts.” These accounts are managed by professionals who are authorized to buy and sell assets on the account owner's behalf, often without the client's advance knowledge or approval. Having a managed account can lead to a federal employee's inadvertently owning securities she should avoid because of her official duties.

This is apparently how the former CDC director came to own the problematic stocks that led to her resignation. Accordingly, people who enter government would be well-advised to freeze trading on their managed accounts until they establish a clear process of preapproval for asset purchases, or to instruct their investment manager to invest only in assets that do not create conflicts, such as widely diversified mutual funds.

Solutions

An official faced with a potential conflict of interest arising out of her holdings has a number of ways to comply with the rules. In many cases, the best option will be to divest the conflicting assets. The proceeds from divestment may be reinvested in assets that do not generate conflicts, most often “diversified” mutual funds, which the Office of Government Ethics has defined to include funds that do not focus on a single sector or a single non-U.S. country.

There is a blanket regulatory exemption for conflicts that arise out of interests held through such funds. However, note that this exemption applies only to publicly traded mutual funds and unit investment trusts, not to personal portfolios of individual stocks or private investment funds. Accordingly, a diverse mix of individual stocks, created as a kind of bespoke diversified fund, would not qualify for this exemption.

An official who is required to sell an asset because of financial conflicts may be eligible to receive a certificate of divestiture, which carries important tax benefits relating to the sale. A certificate of divestiture is issued by the Office of Government Ethics after being requested by the official's agency. After it is issued, the official can sell the asset and roll over the proceeds into diversified funds or U.S. treasuries. The official can then defer taxation on gains from the sale until she sells the new, rolled-over asset — even if that sale takes place long after she leaves government.

However, not all assets can be quickly or easily sold on the open market. If an official cannot easily sell a conflicting asset, giving the asset to adult children or other nondependent relatives can be another way to effectively divest conflicting assets. These relatives' interests are not imputed to the official under the financial conflict of interest statute.

Depending on the nature of the conflicts and the duties of the official, recusal can also be an effective vehicle for addressing potential conflicts, and numerous officials have carried out their responsibilities while maintaining recusals from particular matters where they have potential conflicts. As a last resort, an official can seek a waiver from their agency ethics official.

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