

I. Introduction

The purpose of this manual is to provide the Employees' Retirement System of the State of Hawaii (ERS) with a comprehensive set of guidelines for proper management of its investment decisions. The Board of Trustees, in its role as a fiduciary, is obligated to follow a procedurally prudent process when investing the plan's assets. Fiduciary prudence is based on the conduct of the Trustees in managing the plan's assets, and is evaluated by the *process* through which risk is managed, assets are allocated, managers are chosen, and results are supervised and monitored.

Evolving legal standards have made clear the legal responsibility of fiduciaries to manage a plan's assets in a prudent manner, and the guidelines contained in this manual are based on the relevant legislation and regulations confronted by public pension funds. However, the guidelines go beyond simply outlining legally prudent management of investment decisions—they are intended to assist the Trustees in achieving long-term success in investing the plan's assets.

Success in this context is defined as achieving a long-term return that is needed in conjunction with actuarial defined contributions to fund the plan over time and is reasonable through a fully diversified approach to the capital markets without being too aggressive or conservative as to run the risk of under-achieving a reasonable return.

Today's prudence emphasizes fiduciary responsibility regarding the portfolio and its purpose, rather than on the performance of the plan. Trustees as fiduciaries have the responsibility for the general management of the fund's assets. They are responsible for setting and overseeing the implementation of the fund's investment policy, but need not be investment managers or investment specialists and are not responsible for the results of any single investment. Although it is not possible to guarantee investment success, following the process outlined in this manual will significantly improve the odds of structuring an investment portfolio which will stand up to public scrutiny and benefit the plan's beneficiaries by providing an acceptable long-run return.

This manual, although comprehensive in its coverage, does not provide an in-depth analysis of all-important issues, which Trustees must deal with when investing the plan's assets. It therefore should not be viewed as the only "tool" required by the Trustees for prudent investment management, but rather as one component of the Trustees' "educational tool kit", to be used in conjunction with continuing education and the advice and services of investment consultants and investment managers.

II. ERS Plan Structure

II. 1. ERS Plan Summary

The Employees' Retirement System (ERS) of the State of Hawaii was established by the Legislature in 1925 to provide retirement, disability and survivor benefits for State employees, teachers, professors, county employees, police officers, firefighters, judiciary employees, judges and elected officials.

Administration of the ERS falls under the policy and executive direction of a Board of Trustees with certain areas of administrative control vested in the State Department of Budget and Finance. The Board of Trustees consists of eight members: the Director of Finance of the State, *ex officio*; four members of the ERS elected by the membership (two general employees, one teacher and a retiree); and three citizens of the State, one of whom is an officer of a bank authorized to do business in the State or a person of similar experience, who are not employees and are appointed by the Governor.

The ERS is a qualified pension plan under Section 401(a) of the Internal Revenue Code. As such, the ERS is exempt from federal income taxation on its investment earnings. Since January 1, 1988, member contributions have been tax deferred under Section 414(h) of the Internal Revenue Code.

Members are covered by the provisions of the contributory or noncontributory retirement plan. Those in the contributory plan are required to make contributions to the ERS and may also be covered by Social Security. Employees in the following occupational groups are required to be members of the contributory plan: police officers, firefighters, judges, elected officials, legislative officers, State and County department heads and deputies, administrative directors and deputy directors of the courts, attorney general investigators, narcotics enforcement investigators, public safety investigators, in addition to the chief clerk, assistant clerk, sergeant-at-arms and assistant sergeant-at-arms of the Legislature.

Members of the noncontributory plan do not make contributions to the ERS and must be covered by Social Security. The noncontributory plan covers most employees hired from July 1, 1984 as well as employees hired before that date who elected to join the plan. Since most new employees are required to become members of the noncontributory plan, these members will continue to increase.

II. 2. Mission Statement

The mission of the Employees' Retirement System of the State of Hawaii is to provide superior services to members in a cost-effective manner through qualified personnel while maintaining the highest ethical standards. The mission will be accomplished by ERS in cooperation with the Board of Trustees and the ERS staff through the following objectives:

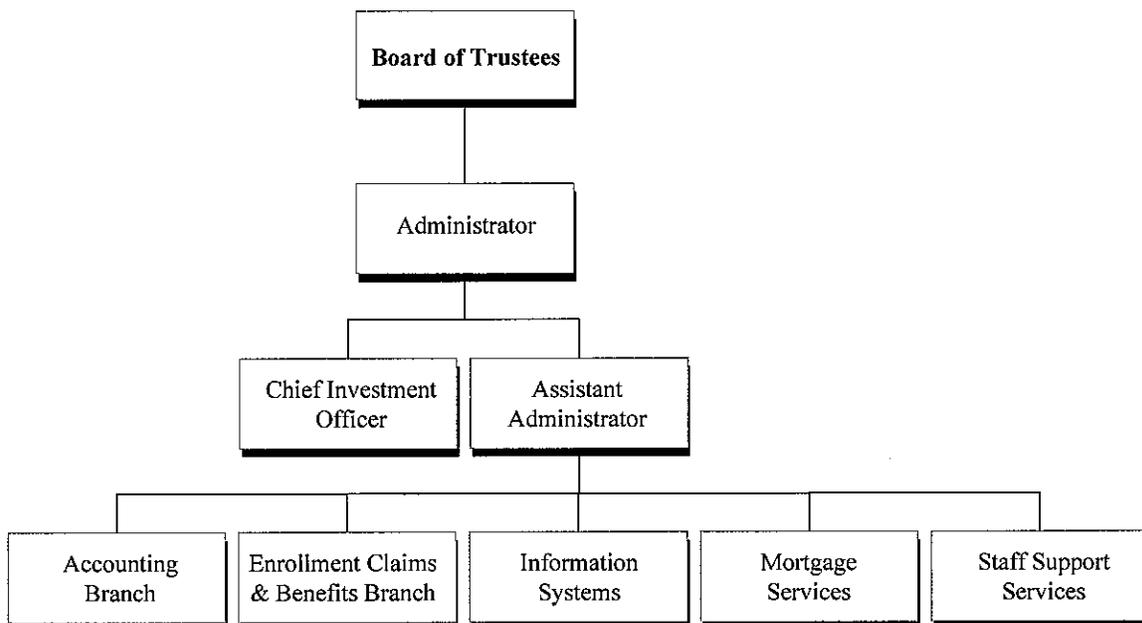
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| <i>Exemplary Service</i> | To provide accurate, courteous, and prompt service to members of ERS. |
| <i>Benefit Standards</i> | To provide retirement, disability, and survivor benefits for State and county employees. |
| <i>Funding Standards</i> | To provide for the long-term funding of ERS on an actuarial basis which will ensure that sufficient assets will be accumulated to pay the statutory benefits of current and future retirees. |
| <i>Staffing</i> | To attract and retain professional, highly trained staff in an atmosphere conducive to innovation, challenges, and a high level of performance. |
| <i>Research</i> | To continuously perform studies on pension issues and to compare the ERS plan with other public and private pension systems. |
| <i>Management</i> | To manage by leading, planning, organizing, and controlling the operation of ERS in a cost effective manner for the benefit of members and State of Hawaii taxpayers utilizing personnel, technology and capital efficiently, while providing the highest level of service. |
| <i>Ethical Standards</i> | To maintain the highest ethical standards. |
| <i>Investment Return</i> | To obtain a reasonable return on investments consistent with the preservation of principal, while maintaining sufficient liquidity to react to the changing environment and to pay benefits when due. |

II. 3. Statutes

The investment statutes relevant for the ERS are contained in section 88-119, Hawaii Revised Statutes, which is part of the ERS Investment Policy Statement.

II. 4. Administration

General provisions and administrative aspects of the ERS are contained in Chapter 88, Hawaii Revised Statutes, and Hawaii Administrative Rules, Title 6, Department of Budget and Finance, Employees' Retirement System." An organization chart of the ERS is shown below.



II. 5. General Responsibilities of the Various Parties

The principal entities include: Board of Trustees
Staff
Actuary
Auditor
Legal Counsel
Bank Custodians
Investment Consultants
Investment Managers

Board of Trustees

Main Responsibilities

- Pursuant to Chapter 88, HRS, the general administration of the retirement system is vested in Board of Trustees.
- The Board of Trustees' first responsibility is to the ERS Plan members.
- Responsible for setting policy and determining the asset allocation through the formulation of Investment Guidelines.
- Maintains overall responsibility for financial management of the plan.
- Appoints Administrator of ERS and Chief Investment Officer (CIO) of ERS.
- Selects the Actuary, Auditor, Custodians, Investment Managers and Investment Consultants and determines specific duties, authority, responsibilities, fiduciary status, and forms and amounts of compensation of each.
- Monitors and evaluates the Actuary, Custodians, Managers and Investment Consultant, as well as the results of the portfolio's investments.
- The Board of Trustees has formed an Investment Committee to review new investment proposals. The Investment Committee consists of three Trustees appointed by the Chair, the Administrator and the Chief Investment Officer as non-voting Ex Officio members. An alternate member is also selected by the Chair.
- Each Trustee is responsible for obtaining and maintaining the necessary training and education required to carry out their duties at the ERS. **It will be necessary for the Trustees to travel to industry conferences and participate in educational forums as opportunities arise.**

Staff

The Staff carries out the administration of the plan on behalf of the Board of Trustees and is directly responsible to the Board of Trustees.

- The Staff needs to receive the necessary training and education required to carry out their duties at the ERS. **It will be necessary for the Staff to travel to industry conferences and participate in educational forums as opportunities arise.**

Administrator

- Under the policy and executive direction of the Board of Trustees, the Administrator is responsible for the operations of the ERS.
- Subject to the approval of the Chair, prepares the agenda, arranges and attends the monthly meetings of the Board of Trustees and special committees thereof, submits and explains reports, presents matters requiring Board actions together with recommendations for such action.
- Interprets the laws and policies governing the ERS, proposes rules or amendments thereof for adoption by the Board.
- Sets procedures to effectively carry out provision of, and changes in, laws as enacted by Legislature. Prepares legislation for the Board's consideration, submits Board's legislative proposals to the Legislature, and testifies before the various committees of the Legislature to explain any proposed changes in benefits, and the cost implications of such changes.
- Represents the ERS as its titular head in all matters concerning the ERS as it involves State and county governments and departments and divisions thereof, the custodian, actuary, legal counsel investment advisors, medical board, the press, and the public.
- Responsible to the Director of Finance for all phases of administration of the ERS that are subject to the administrative control or supervision of the Department of Budget and Finance in accordance with the provisions of Section 26-35, Hawaii Revised Statutes.

Chief Investment Officer (CIO)

- Responsible for the oversight of ERS' investment portfolio. Monitors and oversees the ERS' external investment management firms and the internal investment portfolio.
- Meets with investment managers to review performance and to monitor compliance with investment policies and procedures, and contractual guidelines.
- Develops search criteria for new investment managers; participates in the evaluation and selection of investment managers; negotiates fees and contracts; and recommends the termination of investment managers if necessary.
- Develops search criteria for investment consultant; participates in the evaluation and selection of investment consultant; and recommends termination of investment consultant if necessary.
- Oversees security lending and commission recapture programs.
- Formulates, evaluates, recommends and implements investment policies and procedures for all asset classes. Conducts ongoing review and maintains the Board of Trustees Investment Policy Manual.
- Monitors performance benchmarks, risk characteristics and performance attribution analysis for the fund, asset classes and individual investment managers.
- Implements long and short-term asset allocation strategic plans. Develops programs to efficiently implement asset allocation decisions, including securities trading and cash management.
- Develops search criteria, evaluates and participates in the selection of asset transition management firms.
- Advises the Board on a quarterly basis of cash flow requirements and the availability of funds for investment.
- Develops and implements investment education and training programs for Board and ERS staff.
- Reviews proposed legislation on matters dealing with the ERS' investment programs. Drafts legislative proposals, testimonies and administrative rules.

Assistant Administrator

- Reviews and recommends changes to the Vision and Mission Statement of the ERS.
- Works with the Administrator to develop and implement strategic plans in meeting the mission of the ERS.
- Develops and/or reviews recommendations for improvements in policies, practices and procedures.
- Provides general direction and guidance in handling the unusual or more complex problems relative to determination of members' retirement benefit, creditable service, purchasable service, taxability of benefits, etc.
- Directs procurement and contracting activities for the system in accordance with policies issued by the Department of Budget and Finance and statutory requirements of Chapter 103D, HRS.
- Provides general direction to ERS staff in budgeting, fiscal, personnel, information technology, and records management activities, and approves purchase orders and payments for the ERS.
- In concert with the Administrator, reviews proposed legislation, including estimating costs thereof and implementation after enactment of legislation. Participates in drafting legislative proposals, testimonies, and administrative rules and procedures. Works with the Administrator on matters dealing with legislative hearings.
- Assumes responsibilities of the Administrator during the Administrator's absence.
- Represents the ERS at membership and other meetings for the purpose of discussing retirement benefits and Federal income taxes.
- Appoints the hearing officer and court reporter and arranges for hearings of appeals from adverse decisions of the Medical Board in connection with members' applications for disability retirement.
- Plans, organizes, coordinates and directs the implementation of new statewide programs resulting from changes in Federal and State laws affecting retirement benefits, income taxes on retirement benefits, and social security taxes.
- Serves as the Project Director for major computer system and other project initiatives.

Retirement Benefits Manager

This position is responsible for administering, directing, and managing the work performed by the subordinate Retirement Claims Examiners and Clerical Staff in the Enrollment, Claims and Benefits Branch. The operations and activities of this Branch include the following:

- Training of employer's staff on the eligibility requirements and enrolling of members in the contributory and noncontributory plans.
- Oversees counseling services and information regarding retirement, disability and death benefits, taxes, and contributions.
- Directs the enrollment of State and County members into the appropriate retirement plan and membership enrollment changes.
- Oversees the computation and processing of claims and applications for retirement, disability and death benefits, as well as refunds of contributions to members who terminate employment.
- Directs the examination, authorization, and calculation of members' claims to purchase past membership service.
- Plans sessions for new and mid-career members on retirement planning.
- Plans, develops, and conducts pre-retirement and informational sessions throughout the State.
- Plans, organizes, and directs the implementation of new statewide programs resulting from changes in Federal and State laws affecting retirement benefits.

- Assists in the preparation of legislative testimonies and reviews legislative measures affecting retirement benefits.

Accounting Manager

This position is responsible for administering, directing, and managing the work performed by the subordinate Accountants and Account Clerks in the Accounting Branch. The operations and activities of this Branch include the following:

- Accounts for the ERS domestic and foreign equity investments and fixed income investments, and ensures that all interest, dividends and other investment earnings are properly accounted for, computed, and received on a timely basis.
- Reviews, analyzes, and reconciles the bank custodians' and investment managers' records.
- Reviews monthly financial statements and other financial reports, and recommends courses of action which includes proposing adjustments.
- Accounts for all incoming cash receipts (such as employer and employee contributions), outgoing cash disbursements, and transactions processed through ERS' bank accounts.
- Manages the ERS cash to maximize earnings while maintaining sufficient resources to satisfy retirement benefit payments and operating expenses.
- Directs the implementation of internal control systems and procedures to insure that all assets are safeguarded.
- Audits benefit claims and refunds, and processes all retirement, disability and death benefit payments.
- Processes purchase orders and payments to vendors.
- Prepares the ERS annual budget, expenditure plans, variance reports, and various financial reports to legislative committees.
- Implements provisions of the Social Security tax laws that apply to State and County employees under the agreement between the State of Hawaii and the Social Security Administration.
- Accounts for the ERS Member Home Loan Program, real estate, alternative investments and other in-house investments.
- Reviews and interprets federal income tax laws affecting pension benefits, and provides/solicits expertise in the taxability of those benefits.
- Generates tax information returns (1099-R) to benefits recipients.

IS Branch Manager

This position is responsible for the development, enhancement and maintenance of the ERS computer systems.

Applications

- Develops and maintains ERS' website.
- Develops, implements and maintains the accounting, enrollment, annuity savings, retirement benefit computations, pension payroll, refunds, bank reconciliation, retirement application tracking, disability application tracking, inquiry tracking and other computer programs.
- Develops legislative and administrative inquiry programs.

Systems Management

- Plans, installs, operates and maintains computer hardware and software.
- Manages the database files and responsible for system security.
- Designs, implements and maintains the internal network and telecommunications linkage between ERS and other State and County payroll and personnel systems, the Hawaii Employer-Union Health Benefit Trust Fund, bank custodians, public employees, unions and other organizations.

Staff Support Services Supervisor

This position is responsible for the administrative housekeeping and office services functions of the ERS. The operations and activities of this Branch include the following:

- Disseminates general information and assists members in filing claims for refund of contributions, changes in beneficiary, changes in address and bank assignments, federal tax changes, requests for retirement benefit estimates, etc.
- Provides support for personnel functions, inventory control and maintenance, typing, and other office functions.
- Processes and mails pension checks and statements on a semimonthly basis.
- Maintains the membership records of all active, inactive, and retired members.

Actuary

Main Responsibilities

- Measures and evaluates the actuarial soundness of the plan on an annual basis.
- Provides actuarial values for the asset/liability study.
- Performs actuarial studies as requested by the Board of Trustees.
- The actuary is hired by, and responsible to, the Board of Trustees. However, the Board of Trustees does not have direct control over the work of the actuary, since the studies do not involve any discretion but rather are based on the "facts" of the plan and standard actuarial procedures.
- Reviews proposed legislation and estimates cost.
- Performs actuarial evaluations to determine the annual State and county contributions to fund the ERS.

Auditor

Main Responsibilities

- Performs an independent audit of the ERS' financial statements in accordance with generally accepted government and other related accounting standards.
- The auditor is selected by the Audit Committee and recommended to the Board of Trustees. The final decision in the selection of the auditor is the responsibility of the Board of Trustees.

Legal Counsel

- The State Attorney General serves as the legal adviser to the Board of Trustees.

Bank Custodians

Main Responsibilities

- Provides a monthly reconciliation of ERS assets from the Custodian Bank's reports with each investment manager's statement.
- Provides safekeeping and custody of all securities purchased by managers on behalf of the plan.
- Provides for timely settlement of securities transactions.
- Maintains short-term investment vehicles for investment of cash not invested by managers.
- Checks all manager accounts daily to make sure that all available cash is invested.
- Collects interest, dividend and principal payments on a timely basis.
- Processes corporate actions.
- Files and Monitors class action settlements on behalf of ERS.
- Prices all securities at least on a monthly basis, preferably on a daily basis contingent on asset class and types of securities.
- Manages a securities lending program.
- The Custodian generally is asked to provide data and reports directly to the ERS and service providers on a regular basis.
- Provides monthly, quarterly and annual reports.
- Values and monitors derivatives and the trades from which they emanate.
- The Custodian is hired by, and responsible to, the Board of Trustees.
- Provides continuing education programs for the Board of Trustees and ERS staff.

Investment Consultant

The role of the investment consultant is to provide objective, independent third-party advice to the Board of Trustees. An investment consultant does not have discretionary decision-making authority on behalf of the Board of Trustees. The investment consultant functions in a research, evaluation, education, and due diligence capacity for the Board of Trustees and maintains a fiduciary responsibility for the quality of the service delivered.

Main Responsibilities

- Recommends strategic procedures and process.
- Upon the request of the Board of Trustees, prepares an asset allocation study together with alternatives.
- Assists with manager structure, selection, monitoring and evaluation.
- Measures and evaluates the overall performance of the portfolio.
- Carries out special projects at the request of the Board of Trustees and ERS staff.
- Provides continuing education to the Board of Trustees and ERS staff.

Investment Consultants are identified and hired by, and provide advice and services to, the Board of Trustees. However, the investment consultants make no decisions on behalf of the Board of Trustees.

Investment Managers

Main Responsibilities

- Acts as a “prudent expert” on behalf of the Board of Trustees.
- Develops a portfolio strategy within the specific mandate and asset size determined by the Board of Trustees.
- Manages, purchases and sells assets for the portfolio in accordance with their assigned portfolio mandate.
- The specific relationship (including, for example, fees, investment restriction, etc.) between each Manager and the Board of Trustees is outlined in the agreement between the specific Manager and the Board of Trustees.
- The Investment Manager is a fiduciary for assets under its management.

Potential Conflicts of Interest

The Trustees require that ERS' investment consultant and investment managers adopt policy to avoid actual or even perceived conflicts of interest by disclosing any potential conflicts. Failure of investment managers to disclose a conflict of interest in managing assets is grounds for watchlist status and eventual termination according to this policies and procedures manual. Similarly, the Trustees require that the ERS' investment consultant disclose all business activities and relationships that could be perceived as potential conflicts of interest on an annual basis. Specifically, the investment consultant shall disclose annually any business relationships with current ERS investment managers, the services provided in these relationships, and the compensation earned from the investment manager for these services. Additionally, at the time of an investment manager search any business relationships with the advisors being considered must be disclosed. ERS also expects that both its managers and consultant adhere to a firm-wide ethical code that explicitly seeks to avoid any conflicts of interest in order to ensure the highest possible honesty and integrity in the services that these firms provide to the fund.

II. 6. Fiduciary Responsibilities of the Various Parties

Fiduciary Responsibilities of the Board of Trustees

As outlined by the Third Restatement, Trusts, the fiduciary responsibilities of the ERS Board of Trustees are the following:

1. All actions are for the sole benefit of the plan participants.
2. Prepare written investment policies and document the process. In doing so the Trustees must:
 - Determine the fund's missions and objectives.
 - Choose an appropriate asset allocation strategy.
 - Establish specific investment policies consistent with the fund's objectives.
 - Select investment managers to implement the investment policy.
3. Diversify assets with regard to specific risk/return objectives for the participants/beneficiaries.
4. Use “prudent experts” to make investment decisions.
5. Control investment expenses.
6. Monitor the activities of all investment managers and investment consultants.
7. Avoid conflicts of interest.

The Board of Trustees and ERS staff should regularly undertake continuing education relevant for their duties. Specifically, all Trustees and key ERS staff should participate in an educational program, which provides basic instruction on the four primary components of the investment management process:

- Fiduciary responsibility and procedural process
- Developing investment policy guidelines and designing investment manager structures
- Implementing investment policy
- Evaluating and controlling an investment program.

General guidelines concerning fiduciary responsibilities and prudent investment decision making, are contained in Appendix A, and a contemporary "Fiduciary Code of Conduct" is contained in Appendix B.

Statutory Protection for Trustees

Section 26-35.5, Haw. Rev. Stat., is applicable to members of boards and commissions, and generally provides that a board or commission member, including the trustees of the Employees' Retirement System will not be personally liable for damages or loss resulting from their acts or omissions in their capacity as a trustee unless the individual acts with a malicious or improper purpose.

The liability of trustees with respect to investments will be decided on a case-by-case basis. The Restatement (Third) of Trusts § 227 contains a revised "prudent person" standard for trustees who deal with investments. According to this standard:

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purpose, terms, distribution requirements, and other circumstances of the trust.

- a) This standard requires the exercise of reasonable care, skill, and caution and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
- b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
- c) In addition, the trustee must:
 - (1) Conform to fundamental fiduciary duties of loyalty and impartiality;
 - (2) Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
 - (3) Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

In addition, § 26-35.5, Haw. Rev. Stat., provides in subsection (b) as follows:

Notwithstanding any law to the contrary, no member shall be liable in any civil action founded upon a statute or the case law of this State, for damage, injury, or loss caused by or resulting from the member's performing or failing to perform any duty which is required or authorized to

be performed by a person holding the position to which the member was appointed, unless the member acted with a malicious or improper purpose, except when the plaintiff in a civil action is the State.

Subsection (c) of § 26-35.5 describes the situations when trustees will be indemnified by the State in civil actions. Section 26-35.5 also contains subsections describing when indemnification is not available and when the Attorney General will provide representation.

Subsection 26-35.5(e) provides that if a board or commission member is sued in his/her official capacity, the member may request that the attorney general represent and defend the individual. The individual may retain counsel of the individual's own choosing.

A copy of § 26-35.5 is attached in Appendix D.

Fiduciary Responsibilities of the Investment Managers

Investment Managers have a fiduciary responsibility for the assets placed under their discretion.

Fiduciary Responsibilities of Consultants (Actuary, Auditor, Investment Consultants, and other Service Providers)

The ERS' consultants have a fiduciary responsibility for the services they are contracted to provide the ERS. Consultants are not plan fiduciaries because they have no discretion over the assets or any decision-making authority. They do, however, have fiduciary responsibility for the quality and accuracy of any service, report information, or recommendations made to the Trustees or staff.

Fiduciary Responsibility of Custodian Banks

A master custodian's fiduciary responsibility shall involve the proper safekeeping, valuation, pricing, accounting and reporting of plan assets across multiple investment manager portfolios and asset classes. As co-fiduciary to the plan, investment prudence shall be applied to short term cash management and securities lending functions.

II. 7. Delegation of Authority

The Department of the Attorney General State of Hawaii, in a letter to Mr. Kenneth Matsuura dated April 28, 1993 (contained in Appendix D), has indicated that the Third Restatement is the appropriate standard by which to gauge the delegation of authority by the Board of Trustees. This letter pointed out that "while administration of a trust may not be delegated in full, Trustees may, and for many purposes do, delegate authority to properly selected and supervised agents. Furthermore, the board has statutory authority to hire investment advisors." Consistent with the accepted fiduciary standards outlined in this manual, the Department of the Attorney General has indicated that while the Board of Trustees is able to delegate authority concerning the buying and selling of individual securities, they "may not abdicate their fiduciary responsibility. The Trustees' duty of prudence to the trust compels establishing the parameters and guidelines for investment, setting controls to be maintained, and monitoring the performance of the investment advisors."

II. 8. Code of Ethics and Conflicts of Interest

The Board of Trustees is bound by an Oath of Office. In addition, the Board of Trustees and staff are bound by the standards contained in Chapter 84, Hawaii Revised Statutes, the State Ethics Code. The State of Hawaii Ethics Commission has issued the "Ethics Guide for Elected Officials, Employees, Members of Boards and Commissions. The main points from this Guide are:

1. In recognition of the fiduciary duties of the ERS, all Trustees must act in good faith and not allow their personal interests to prevail over the interest of the ERS.
2. Trustees shall conduct themselves so as to avoid even the appearance of any illegal or unethical conduct, and shall at all times do their utmost to carry out their duties with courtesy and in a professional manner.
3. Trustees are required to file an annual financial disclosure to the Ethics Commission.
4. Annually the Board should review Chapter 84, Hawaii Revised Statutes and any rulings by the Ethics Commission.
5. Trustees should exclude themselves from discussions and/or votes the results of which would or could affect that person's immediate family, or any other entity in which that person has an ownership or other financial interest.
6. If a Trustee is not sure whether his/her interest constitutes a conflict, such Trustee shall fully disclose his/her interest and the Board shall refer the matter to the Attorney General or Ethics Commission for advice. Until an advisory is issued, the Trustee shall exclude himself/herself from discussions and/or votes.
7. Trustees are to disclose before the discussion of the issue any conflict or possible conflicts of interest. The Trustee shall reclude himself/herself from participating in any discussion, votes, or other decision making on the matter. The recording secretary shall note for the minutes the Trustee's disclosure.
8. Chapter 84, HRS, is the standard of conduct to be followed by all State employees. For the purposes of Chapter 84, HRS, in their official capacities all Trustees whether elected or appointed are considered State employees.
9. The Conflicts of Interest Law of Chapter 84, HRS, is summarized as follows:
 - a) The law applies to ERS Trustees and staff.
 - b) Employees may not accept gifts that will influence the performance of their duties.
 - c) Employees may not disclose confidential ERS information that may benefit them or others.
 - d) Employees may not use their ERS position to secure unwarranted privileges for themselves or others.
 - e) Employees must disqualify themselves from making any decision or recommendation on a matter where you have financial interest.

- f) Employees may not, within twelve months after leaving an ERS position, represent a person or organization for compensation on ERS matters or engage in items (c) through (e).

A Memorandum from the Deputy Attorney General dealing with the Code of Ethics follows.

Memorandum from Deputy Attorney General Concerning the Code of Ethics

July 27, 1992

MEMORANDUM

TO: Kenneth Matsuura, Trustee
Employees' Retirement System

FROM: Celia L. Jacoby
Deputy Attorney General

RE: Inquiry Regarding Application of Chapter 84, H.R.S.

While the ethics commission is the definitive voice regarding issues under chapter 84 of the Hawaii Revised Statutes, the following was gleaned from a review of all ethical opinions published through June 1992. Particularly of concern were three areas: conflicts, contracts, and post-employment issues.

Section 84-14(a) requires State employees to disqualify themselves from taking official action directly affecting businesses or undertakings in which they have substantial financial interests. State board and commission members are "employees" for purposes of the ethics code. Section 84-3, H.R.S. An "official action" is defined in the ethics code as a decision, recommendation, approval, disapproval, or other action, including inaction, which involves the use of discretionary authority. Section 84-3, H.R.S.

A public officer is a public Trustee. However, this principle should be carefully balanced with the expressed legislative desire that the State be able to attract competent and qualified individuals to public service. "The public interest is best served by attracting and retaining in our State government and the legislature men and women of high caliber and attainment. A code of ethics that is unnecessarily rigid and restrictive will defeat its purpose. It would discourage qualified persons from entering government and may have a detrimental effect on incumbents." Stand. Comm. Rpt. No. 367, Haw. H.J. (1967).

The ethics commission has acknowledged that many employees come into their positions with outside interests, and noted that these interests are generally taken into account before the person is hired or appointed. In those cases, chapter 84 usually requires that the employee abstain from actions affecting such interests. Divestment of that interest (or presumably resignation from appointment) would be required only where the employee's interests were so extensive as to require his constant abstention. Advisory Op. No. 300 (1977).

Further, the ethics commission has recognized "that in a community of this size, it is not unusual for a State employee to take action affecting a business in which an acquaintance holds an employment or ownership interest. Unless that relationship was of such a nature that the employee's judgment would be affected, there should be no need for disqualification. For an employee to [disqualify] himself in [such] matter would [deprive] the Board of assistance that would be helpful to it in making an important judgment." Advisory Op. Bo. 325 (1977).

The ethics commission has generally determined that official action directly affecting an industry or profession as a whole also directly affects individual businesses within that industry or profession. Therefore, a State employee with private financial interests in a business may not usually take official action directly affecting either the employee's own business in particular or the employee's industry or profession in general.¹

There is, however, a limited exception to the general disqualification requirement for board and commission members who are mandated by statute, resolution or executive order to possess particular qualifications. The ethics commission has referred to such board or commission members as "mandated" board members. Mandated board members are allowed to take official action affecting their industries or professions as a whole, and are only prohibited from taking official action that directly and specifically affects businesses in which they have substantial financial interests. "Specifically" has been interpreted to mean "individually" or "as opposed to another business." Thus, mandated board members are only prohibited from taking official action that directly affects their own business as opposed to other businesses in the same industry or profession.

However, if the financial interests in the business or undertaking are not related to the particular mandated qualifications, the general conflict of interests requirement may be applied. In that case, the member is prohibited from taking official action that directly affects that specific business or undertaking as well as the industry or profession of which the personal business or undertaking is a part.²

Further, the ethics commission has held that the exception to the general conflicts of interest requirement should only be applied if it clearly appears that a mandated member's financial interests are in fact related to his or her mandated qualifications.

¹ Arguably, such member is only disqualified in rule-making or declaratory functions which might affect the whole industry, or if his own business is affected. Action on loan applications of third parties should then be permissible. Presumably, action on an individual loan would only affect that particular applicant, not the industry or profession as a whole.

But one could argue that any loan would so diminish the funds available for further investment that the member should be deemed to have an interest to "preserve the pot" for proposals by his own company, and so, a taint would possibly exist.

² There seems to be a split on how rigorous that match must be. The expertise and perspective of a person involved in land development, financing and investment is invaluable to the ERS board in its investment decisions as well as in formulating policies and guidelines for investments. By the appointment, the governor indicated that an individual with such expertise and experience was desirable. It is also likely that the legislature desired persons with an expertise in finance, realty, etc., to serve on the board and that such professional affiliation relates to that member's expertise in the area and "mandated qualifications," even if those qualifications were not explicitly specified in the statute.

A strong argument, therefore, can be made that Trustee need only disqualify himself in those instances of conflict which may result in State action directly affecting a business or undertaking in which he has a substantial interest, particularly since Trustee would still be able to make a significant contribution to the board.

Other issues arising under chapter 84 concern contracting and post-employment activities. Section 84-18 would apply when a member leaves the board. Employees may not assist or represent businesses on matters in which they participated as an employee, or on matters requiring official action by the board on which they sat. These restrictions continue for 12 months after termination of service, and are apparently personal to the former employee, rather than extending to his post-employment affiliation.

In addition, during and after one's tenure as a board member, certain limitations on contracting between the business in which the board member has a controlling interest and the State agency which has jurisdiction over the particular board are imposed by Section 84-15.

The ethics commission has opined that the "ethics law exists to separate the activities of State employees in the performance of their State duties from activities connected to their personal and private business." Advisory Op. No. 560 (1985). Also the "standards of conduct provide employees with guidelines that clearly differentiate between State responsibilities and private business interests." Id.

Further, the ethics commission often noted that "it is unwise for a State official or employee to make assumptions about the interpretation or application of the State Ethics Code. The Commission employees a staff of attorneys who are available to advise State employees and officials." See, Advisory Op. No. 88-2 (1988).

Generally, the ethics commission has held that disqualification, not resignation, is appropriate when the financial interest in question was acquired before the State employment began. Therefore, in situations where conflicts may be present, these remedial actions are advisable:

1. self-disqualification from board action;
2. disclosure of actions and interest to board (and possibly to the ethics commission);
3. reporting promptly any possible conflict so that the action may be subject to review by a disinterested person; or
4. such other steps as may be deemed appropriate.

The ethics commission has also advised that "when disqualifying oneself at a board meeting with respect to the private organization's request for support or other official action, the Commission recommend[s] that the board member leave the meeting room so that the fact that he did not participate in the matter was clear and thus could not be challenged." Furthermore, the commission [has] advised the board member refrain from informally expressing his views to the other board members on the private organization's request for support so that it is clear that he had not been involved in any official action the board took with respect to the private organization. Advisory Op. No. 86-4 (1986).

Nothing herein is meant to suggest that resignation from State service is appropriate in such conflict instances, rather, by selective disqualification, one may avoid ethical violations, yet still significantly contribute to the board's work.

Selected ethical advisory opinions are attached for your information.

ATTACHMENT
ADVISORY OPINIONS

Opinion No. 91 (1-26-71)

Opinion No. 348 (8-21-78)

Opinion No. 392 (9-17-79)

Opinion No. 449 (11-16-81)

Opinion No. 470 (7-16-82)

Opinion No. 484 (2-07-83)

Opinion No. 534 (7-09-84)

Opinion No. 544 (10-24-84)

Opinion No. 562 (7-15-85)

Opinion No. 565 (10-09-85)

Opinion No. 86-11 (12-24-86)

Opinion No. 88-1 (3-29-88)

Opinion No. 88-5 (4-12-88)

Opinion No. 88-6 (5-11-88)

Opinion No. 88-7 (5-11-88)

Opinion No. 88-9 (7-20-88)

II. 9. Operating Procedures

Meetings

1. All regular meetings shall be held on the second Monday of each month unless otherwise agreed upon by the trustees. The schedule for the regular meetings shall be reviewed by the Trustees each January.
2. All special meetings shall be on days agreed upon by the Trustees.

Agenda

1. Deadline for requesting matters to be placed on the agenda for regular meetings by a Trustee, Deputy Attorney General, and/or Administrator shall be by 12:00 noon, seven (7) calendar days prior to the meeting date. Should the seventh day fall on a holiday, the last working day preceding the holiday shall be the deadline.
2. Deadline for requesting matters to be placed on the agenda for special meetings by a Trustee, Deputy Attorney General, and/or Administrator shall be 12:00 noon, seven (7) calendar days prior to the meeting date. Should the seventh day fall on a holiday, the last working day preceding the holiday shall be the deadline.
3. The final composition of the agenda shall have the approval of the Chair of the Board of Trustees.
4. A Trustee, Deputy Attorney General, and/or Administrator wishing to place matters on the agenda after the deadline has passed, must have copies of the subject material available to the Trustees when the meeting convenes with a note indicating that he or she will be requesting that this matter be placed on the agenda. (A minimum of six (6) Trustees must be present to put matters on the agenda - Chapter 92, Section 7(b) HRS.)

Material

1. All regular meeting material shall be in the hands of the Trustees no later than Wednesday prior to the meeting date.
2. All special meeting material shall be in the hands of the Trustees no later than four (4) calendar days prior to the meeting date.
3. All Trustees who will not be on the island to receive their material will inform the Administrator as soon as possible so other arrangements can be made.

III. Specific Policies and Procedures of the ERS

The ERS has adopted specific policies and procedures regarding the investment of assets under its control. This section includes the following ERS policies and procedures, which have been approved by the Board of Trustees:

- Investment Policy Statement
- Asset Allocation Rebalancing Guidelines
- Local Manager Policy
- New Investment Proposals
- Asset Transition Guidelines
- Securities Litigation policy
- Proxy Voting Policy
- Real Estate Policies and Procedures
- Private Equity and Timberland Policies and Procedures