MEMORANDUM

State of Alaska
Department of Law

TO: David W. Marquez
Acting Deputy Attorney General

DATE: March 24, 2005

FILE NO: 663-05-0171

TEL. NO.: 465-2133

FROM: Barbara J. Ritchie
Chief Assistant Attorney General
Designated Ethics Supervisor

Paul R. Lyle
Sr. Assistant Attorney General
State Ethics Attorney

SUBJECT: Ethics Act Considerations: Personal Investments

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(AS 39.52.240)

Introduction

You requested a review of your personal investments in order to determine whether your official duties would be limited under the Ethics Act in the event Governor Murkowski were to appoint you to serve as Attorney General or Commissioner of Environmental Conservation. Based on your disclosures, we have examined whether you may be involved in negotiations on behalf of the state with oil companies concerning the construction of the proposed natural gas line.

Our advice is based upon your 2005 disclosure to the Alaska Public Offices Commission, a February 16, 2005 letter from your investment counselor, Roger Shaar, of AYCO, and a March 21, 2005 telephone conversation between Mr. Shaar and the authors of this memorandum.

You have investments in ten accounts. We have grouped the accounts into three types: (1) Discretionary managed brokerage accounts, (2) deferred compensation plans with ARCO/BP and ConocoPhillips from which you are currently receiving level (or near level) annual payments, (3) investments in mutual funds, and (4) cash accounts. We describe these accounts in more detail below and discuss the attendant ethics implications of each.

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Facts & Legal Analysis

A. Discretionary Managed Brokerage Accounts

You have two discretionary accounts with AYCO, a corporate bond account and a municipal bond account. Discretionary accounts allow a broker to make investments on your behalf without your prior knowledge or approval. However, you receive monthly reports of the investments made and, if you so choose, may review your account activity on a daily basis via the Internet. You have the authority to place prior restrictions on the types of investments in which the broker may invest, and you may withdraw money from or close the account at any time. Therefore, although your broker exercises wide discretion in investing the funds in these accounts, the assets in the accounts are not "blind" to you and you remain in ultimate control of the funds.

(i) Corporate Bond Account

Mr. Shaar reported to us the specific corporate bonds currently held in your corporate bond account. You do not own oil company bonds in your corporate bond account.

We have determined that it is unlikely that you would be required to have dealings as a state official with any of the companies in which you currently own bonds. Therefore, there are no present Ethics Act concerns with this account.

AS 39.52.120(b)(4) precludes a public official from taking or withholding official action in any matter in which the officer holds a "financial interest." An investment in a corporate bond is a "financial interest" under the Ethics Act. AS 39.52.960(9). Because your broker has broad discretion to invest in corporate bonds, it is possible that he could, without your knowledge, make an investment in a company that you are likely to deal with in your role as a public official.

In order to avoid the creation of an inadvertent conflict, and because it is possible you may be involved in negotiations with oil industry companies, we recommend that you restrict this account to non-oil industry investments. In the alternative, we recommend that you restrict the account to preclude your broker from investing in oil industry companies that do business in Alaska.

Furthermore, we recommend that you closely review your monthly statements to make sure that you are not invested in a company in litigation with the State of Alaska or concerning which you might take or withhold official

action. If you find that an investment has been made in a company with which you deal as a state official in a matter, you should withhold taking action until you have disclosed the potential conflict to your designated ethics supervisor. Your designated supervisor will review the matter under AS 39.52.210 and advise you of any preventive action that must be taken.

(ii) Municipal Bond Account

Mr. Shaar reported that your municipal bond account is not invested in any Alaska municipality or other Alaska government or public or quasi-public corporation bonds. Therefore, there is no possibility that your investments in this account create a conflict of interest with your public duties under the Ethics Act.

However, Alaska does have a gas line authority. The authority is comprised of Alaska municipalities. Because your official duties may require you to interact with this authority and its members, we recommend that you restrict investments in the municipal bond account to non-Alaska municipal bonds.

B. Deferred Compensation Plans

(i) The Structure of the Plans

You participated in two deferred compensation plans while in private industry, a BP/ARCO plan and a ConocoPhillips plan. The combined value of these plans is between one and two million dollars. Because these plans are with oil companies involved in the gas line negotiations, and because you will be taking official action with respect to the gas line negotiations if you are appointed to serve as Attorney General or DEC Commissioner, we must analyze these financial interests under the Ethics Act.[1]

It is important to understand how these plans operate and whether you can do anything as a public official that may increase the value of the plans.

Both plans are "non-qualified" deferred compensation plans. It is our understanding from Mr. Shaar that, under a non-qualified plan, an employee's deferred compensation is not deposited into an account owned by the employee.

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[1] Although your compensation plans are now with BP and ConocoPhillips, you did not work for either of these companies. You were employed by ARCO before it was merged with BP. You worked for Phillips before it was merged with Conoco. Thus, you worked for competitors of BP and Conoco before the respective mergers occurred. As part of the merger agreements, BP and ConocoPhillips assumed the obligations of ARCO and Phillips under these plans.

Rather, the company owns the employee's plan contributions. Therefore, the contributions to non-qualified deferred compensation plans cannot be rolled over into independent Individual Retirement Accounts after an employee leaves the company.

At some point in time, an employee (or former employee) may begin to receive payments under the plan. In your plans, the amount paid each year equals a level portion of the total value of the account. The total value of the account, in turn, equals the total contributions to the plan plus the earned rate of return from year to year on those contributions while the account continues to exist. You are receiving level payments from both of your plans.

The method used for setting the rate of return is an important consideration in our analysis. Under the ARCO/BP plan, the rate of return (called a "fixed crediting rate") is set on an annual basis and is the highest of three independently set rates, such as a treasury rate. The contributions made to that plan earn the fixed crediting rate selected for each year. The fixed crediting rate applied in any year is completely out of the control of the plan participant.

The rate of return on the ConocoPhillips plan is figured differently. Contributions to the ConocoPhillips plan earn a return tied to the investment performance of a broadly diversified group of mutual funds. Employees choose the fund (or funds) in which to invest their contributions.[2] Mr. Shaar was unsure whether ConocoPhillips actually invests plan contributions into the mutual funds or holds the plan contributions in its own accounts and merely applies to the contributions the rate of return earned by the mutual fund or funds selected by the employee. Regardless, the rate of return on the mutual funds (and thus on the employee's contributions) is completely out of the control of the plan participant. The rate of return depends entirely on how the mutual funds selected by the employee perform in any year.

In both plans, the ability of the employee to receive payments due under the plan depend upon the company's continuing existence because the level payments are made out of operating revenue. Therefore, if the company becomes insolvent, the employee may lose the investment entirely. On the other hand, if the company is merged or acquired by another company, the acquiring firm assumes the deferred compensation debt of the acquired company.

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[2] In this regard, the ConocoPhillips plan appears similar to the State Deferred Compensation Plan, which allows state employees to invest some of their pre-tax income into one or more pre-selected mutual funds. The gain or loss on the contributions is dependent on how the mutual fund performs in any given period.

More importantly, however, neither the amount of the level payment received under either plan nor the rate of return on plan contributions is connected to the company's profitability in any year. In other words, so long as the company remains solvent, the pay out received by a plan participant does not depend upon either the profitability of the company in any given year or on the price of the company's stock.

(ii) Ethics Act Considerations of the Plans

As we stated above, the Ethics Act precludes a public official from taking or withholding official action "in order to affect a matter in which the public officer has a personal or financial interest." AS 39.52.120(b)(4). A "financial interest" is an "an interest in a business ... that is a source of income" to the public officer. AS 39.52.960(9). Furthermore, "in rendering opinions under AS 39.52, we assume generally that if the requisite interest in a matter is found, then participation by the interest holder is for his/her own benefit." 1989 *Inf. Op. Att'y Gen.* (663-89-0526; Jul. 1), 1989 WL 266908 at *2 (Alaska A.G. 1989).

Although it is not an equity interest, your financial interest in the BP/ARCO and ConocoPhillips deferred compensation plans is a "financial interest" in those companies. The deferred compensation plans are obligations that those companies owe to you and that are paid out of their operating revenue. Therefore, unless there is some exception in the Ethics Act for this type of interest, you would be precluded from being involved in any matter affecting these companies.

There are no specific exceptions to the Ethics Act's definition of "financial interest." However, AS 39.52.110 provides general, mandatory guidelines for interpreting the Ethics Act. Section .110(a)(3) provides that the Act's ethical conduct standards must distinguish between "minor and inconsequential" conflicts and those conflicts that are "substantial and material."

AS 39.52.110(b) provides that there is no substantial impropriety where a public officer's "financial interest in the matter is insignificant" or the public officer's action or influence would have an "insignificant or conjectural effect on the matter." Here, the "matter" is a possible gas line contract between the State and BP and ConocoPhillips and that contract's effect, if any, on your deferred compensation plans with these companies. AS 39.52.110(c) requires the attorney general and designated ethics supervisors to be guided by these principles when rendering opinions under the Ethics Act. Therefore, we must determine whether

your interest in the BP/ARCO or ConocoPhillips deferred compensation plans creates a significant financial interest in BP and ConocoPhillips that would preclude you from being involved in the gas line contract negotiations on behalf of the state.

In determining whether a public officer's financial interest in a matter crosses section .110's "significance threshold," this office focuses, not on the bare market value of the interest, but on whether the public officer may take or withhold official action in the matter that will likely **affect the value** of the official's interest. In other words, we look to see whether the officer's actions in the matter would likely increase or decrease the value of the officer's financial interest. If so, we may preclude the officer from being involved in the matter, depending on the value of the officer's financial interest and the degree of the change in its value. If the public officer cannot affect the value of his financial interest in a matter through the exercise of official action, then the officer's financial interest does not create a conflict of interest under the Act.

For example, we permitted a permanent fund trustee to vote on an investment in a building partly owned by an ANCSA village corporation in which his children owned shares. We found that "[t]he impact on his children's shares ... if the ... Permanent Fund actually invested in the property is *de minimis*." 1989 *Inf. Op. Att'y Gen.*, 1989 WL 266908 at *3.[3]

In another case, we determined that a commission member could vote on a petition creating a new borough that would encompass property owned by the member because it was not likely that "the property **value** of the cabin **would change** as a result of action taken on the petition. . . ." 1996 *Inf. Op. Att'y Gen.* (663-97-0074; Sep. 6), 1996 WL 913884 at *2 (Alaska A.G. 1996)(emphasis added). Thus, in determining whether the official's financial interest in the petition was significant, we looked at whether official action on the petition would likely increase or decrease the value of the cabin. We did not consider the bare market value of the cabin itself.

Where a Fish Board member owned a commercial fishing permit on a certain river, we advised the board chair that, in deciding whether the board member could vote on an allocation issue affecting that river's fishery, the chair "should focus on how the proposal will **affect** the financial interests of the Board member as a permit holder and fisher in the particular fishery in question." 1994

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[3] In that case, we also considered the percentage of the company that the children owned. *Id.* at *1 n. 1. That factor is not relevant in your situation since your interest in the deferred compensation plans is not an ownership interest in the companies.

Inf. Op. Att'y Gen. (661-95-0214; Nov. 29), 1994 WL 1029333 at *3 (Alaska A.G. 1994)(emphasis added). As to a fish processing business owned by the same board member, we concluded that the board member would be precluded from voting only on issues that "**significantly affect** Mr. X's financial interests as a fish processor." *Id.* at *4 (emphasis added).

In each of these opinions, our determination of whether a financial interest in a matter was "significant" turned, in the first instance, not on the value of the interest, but on whether the public officer could take official action in the matter that would be likely to increase or decrease the value of that interest. Therefore, we must determine whether you could take official action in gas line negotiations that would likely increase or decrease the value of your deferred compensation plans.

In our opinion, your involvement in gas line negotiations – whether or not they result in a contract between the state and BP and ConocoPhillips for construction of a gas line – would not likely increase the value of your interest in either the BP/ARCO or ConocoPhillips deferred compensation plans. First, the level payments you receive under the plans are not tied to company profits or the price of the company stock. Thus, if the gas line contract (or the companies failure to obtain a contract) were to move the price of BP or ConocoPhillips stock or affect the profitability of the companies over a given period, the value of your deferred compensation plans (and the level payments) would be unaffected.

Second, the rate of return earned on your plan contributions is not dependent upon the profitability of the companies in any given period. Rather, in the case of BP/ARCO, the rate of return is dependent upon pre-determined rates (such as treasury rates) which vary depending upon general economic conditions and actions taken by the Federal Reserve. For the ConocoPhillips plan, the rate of return is tied to the overall performance of the mutual funds in which your contributions are invested. The rates of return are not tied to company performance. Therefore, it is highly unlikely that you could take official action in the gas line negotiations that would change the value of your interest in the deferred compensation plans or their rates of return, even if the result of the gas negotiations affected the overall profitability of BP or ConocoPhillips for some period of time.

Your ability to continue receiving level payments under these plans is tied to the continuing solvency of these companies. Whether or not the gas line negotiations result in a contract between these companies and the state, there is no evidence to suggest that these companies risk insolvency in the foreseeable future,

and certainly not within the likely period of your state service. Furthermore, even if one the companies were to encounter severe financial difficulties while you remained in state service, the fact that the company owns valuable assets, leases and natural resources indicates that the company and its obligations under its deferred compensation plan would be acquired by another corporation, as has been the case with past mergers affecting your compensation plans.

Successful gas line negotiations with these companies will require them to commit substantial resources to the project. However, given the considerable resources and experience of these companies, it is highly conjectural that the gas line negotiations will lead to the companies' insolvency, thus threatening the viability of your deferred compensation plan payments. AS 39.52.110(b)(2). Moreover, if these companies do not invest their resources into an Alaska gas line, those resources will be invested elsewhere in projects that may have equally attendant investment risk for the companies. In either case, it does not appear the companies risk insolvency in the foreseeable future.

Thus, we find that, given the structure of these deferred compensation plans, your ability to take official action in the gas line negotiations that would affect the value of your plan payments is conjectural. You may be involved in gas line negotiations with these companies while retaining your interest in the deferred compensation plans.

C. Mutual Funds

You have invested in mutual fund companies. These companies, in turn, invest in a broadly diversified portfolio of stocks, bonds and other investment vehicles. At any given time, some of these mutual funds may invest in BP, ConocoPhillips, or other companies with which you will deal as a state official. You have asked whether your financial interests in mutual funds that may own stock in oil companies with which you must deal creates a conflict of interest under the Ethics Act. We conclude that they do not.

The Act's definition of "financial interest" includes "an interest held by a public officer ... in a business ... that is a source of income, or from which [the officer] expects to receive a financial benefit." AS 39.52.960(9)(A). You also have a "financial interest" in a business if you are an officer, director or manager of that business. AS 39.52.960(9)(B). To our knowledge, the issue of whether ownership of mutual fund shares constitutes a "financial interest" in the companies in which the mutual fund invests is an issue of first impression under Alaska's Ethics Act.

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When an individual invests in a mutual fund, the individual does not purchase fractional shares of the stocks of companies contained within the mutual fund's portfolio. Rather, the individual purchases shares in the mutual fund itself. The manager of the fund company then invests the money in a variety of stocks and bonds. A purchaser of a mutual fund does not own stock in the companies in which the fund invests. Rather, the purchaser owns shares in the mutual fund.

Therefore, if a public officer invests in a mutual fund that owns BP stock, for example, the officer does not own an interest in BP's business. The interest held is an interest in a separate mutual fund company. Thus, unless the officer is a board member, officer or manager of BP, the officer does not have a "financial interest" in BP by virtue of his ownership of shares in a mutual fund that, in turn, owns BP stock.

Moreover, even if ownership of mutual fund shares constitutes an interest in the stock of the companies in which the fund is invested, we find that it is a *de minimis* interest where, as in your case, the money is invested in large, broadly diversified mutual funds. As stated above, mutual fund shareholders have no control over the investment decisions of the fund. Professional money managers who are employed by the fund make all investment decisions. In accordance with pre-set rules, limitations and investment objectives contained in the fund's prospectus, the fund manager (not the mutual fund shareholder) determines whether, and when, to buy and sell individual stocks and how much of the stock to acquire or divest.

The net asset value of the mutual fund's shares (and thus the value of any particular shareholder's investment) is determined on a daily basis. It reflects the per-share market value of the fund's total assets for that day (as determined by the activity of the markets in which the stock is traded) less the fund's liabilities and expenses.[4] In any given trading day, changes in the value of one of the fund's stocks may be offset by changes in other holdings.

So, for example, a fund that owns BP stock may see the net asset value of the fund increase over a quarter even though the value of its BP stock may have decreased during the same quarter. A public officer has little ability to affect the value of his mutual fund shares through his official dealings with any particular company in which the fund is invested. Thus, in the words of the statute, the official's "action or influence [on the gas line contract] would have insignificant or

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[4] *See* definition of "net asset value" at www. mutualfunds.about.com.

conjectural effect on the matter" of the official's mutual fund value. AS 39.52.110(b)(2).

This conclusion is supported by at least two opinions from other states. In *Opinion of the Justices No. 368*, 716 So.2d 1149 (Alabama 1998), the Alabama Supreme Court was asked whether legislators could vote on a bill that would benefit companies owned by mutual funds in which the legislators had invested. The Alabama Constitution prohibits legislators from voting on any bill in which they have a "personal or private interest." The court ruled that legislators owning shares in mutual funds could vote on bills affecting companies in which their mutual funds were invested. The court held:

> Mutual funds differ in kind from many other investment opportunities. Because of these differences, they have been singled out for special consideration in the context of ethics. Although mutual funds are not expressly addressed in the Ethics Act, they *are* addressed in the Alabama Canons of Judicial Ethics.
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> Canon 3C.(1)(c), requires a judge to "disqualify himself in a proceeding in which ... [h]e knows that he ... has a financial interest in ... a party to the proceeding." "Financial interest" is defined as "ownership of a legal or equitable interest, however small, or a relationship as director, advisor, or other active participant in the affairs of a party." Canon 3C.(3)(c). But Canon 3C.(3)(c)(i) *excepts* mutual funds from this definition, stating that "[o]wnership in a mutual or common investment fund that holds securities *is not a 'financial interest'* in such securities unless the judge participates in the management of the fund." (Emphasis added.)
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> Some of the reasons for the mutual-fund exception were set out in *New York City Housing Development Corp. v. Hart,* 796 F.2d 976 (7th Cir. 1986) (per curiam)(discussing 28 U.S.C. ("Judiciary and Judicial Procedure") § 455(d)(4)(i), the federal counterpart to Alabama Canon 3C.(3)(c)(i)):
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> > "A judge may hold a mutual fund that contains AT & T stock. Yet the judge is expressly authorized by § 455(d)(4)(i) to sit in a case involving AT & T, in part because the fund may sell the stock before the judge decides the case, in part because a change in the value of AT & T stock will have a small effect on the fund as

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> a whole, and in part because a decision that helps or hurts AT & T may have the opposite effect on MCI, GTE, or other securities in the fund, washing out the effect on the judge's portfolio. When Congress amended § 455 in 1974, it designed § 455(d)(4)(i) as a *safe harbor,* a way for judges to hold securities without needing to make fine calculations of the effect of a given suit on their wealth."
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> 796 F.2d at 980 (emphasis added). Moreover, because ownership in a mutual fund--by definition--does not constitute a "financial interest," the *quantity* of this type of investment held by the judge is immaterial. *Id.*

716 So.2d at 1154 (italics in original).

The court went on to hold that the reasoning concerning mutual funds under the Canons of Judicial Ethics applied with equal force to other public officials, observing that

> it would be anomalous to hold that [Section 82 of the Alabama Constitution] imposes a higher standard in this respect on legislators than the Canons of Judicial Ethics impose on judges. It would seem especially anomalous in view of the fact that Canon 3C.(3)(c) disqualifies a judge who owns even a *de minimis* financial interest in a party, while [the Ethics Act] prohibits legislative action only if the legislator owns more than 5%. In other words, if the standards of the Canons are higher than those of the Ethics Act, and if the Canons expressly exempt mutual fund investment, then, *a fortiori,* mutual fund investment should be excluded from the prohibitions of the Ethics Act, and, by extension, from § 82. Thus, § 82 does not "prohibit a legislator from voting ... on [legislation], if ... [t]he legislator participates in a mutual fund or similar type investment venture in which the legislator has no control over the investments made."

Id.[5]

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[5] The definition of "financial interest" in Alaska's Judicial Canons and in Alaska's Ethics Act are similar to the definition of "financial interest" construed by the Alabama Supreme Court. *Compare* Alabama Canon 3C.(3)(c)(i) (quoted above) *with* 2005 Alaska Rules of Court, Code of Judicial Conduct, at p. 983 *and* AS 39.52.960(9).

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In the second opinion, the Attorney General for the State of Illinois held that state officials invested in mutual funds through the state's deferred compensation plan could take official action affecting companies with which they deal without violating a state law prohibiting officials from holding stock or bonds in such companies. 1998 *Ill. Att'y Gen. Op. 021*, (98-021; Sep. 29), 1998 WL 986001 (Ill. A.G. 1998). In concluding ownership of mutual funds shares does not create a conflict of interest, the attorney general cited, *inter alia*: (1) the inability of mutual fund shareholders to control the acquisition or divestment of particular stocks, (2) the *de minimis* interest in any one company an official possesses through the ownership of mutual fund shares, and (3) the "virtually nonexistent" likelihood that a state official could take official action affecting the return on an investment in mutual fund shares. *Id.* at *2, *4.

Consistent with these authorities that construe ethics provisions similar to Alaska's, we find that where a public official has a financial interest in a company through the ownership of shares in a broadly diversified mutual fund, the interest of the official in the company in which the mutual fund is invested is *de minimis*. Therefore, if your mutual funds own shares in companies with which you must deal as a state official, your interest is *de minimus* under AS 39.52.110 and you are not disqualified from taking official action with respect to those companies.

However, there may be circumstances where ownership of mutual funds would create a conflict of interest. For example, if you own shares in a mutual fund company that itself has a matter pending before you (as may be the case for officials sitting on the Permanent Fund Corporation), you may not be able to take official action affecting the mutual fund company itself. If you are a board member, officer, or manager of **any** company you are precluded from taking official action with respect to that company regardless of whether or how you own shares in that company. AS 39.52.960(9)(B).

If you own shares in a mutual fund that is heavily invested in one company or class of companies, you may be able to affect the value of those shares if you are dealing with the company or class of companies in which the fund is invested. If that were the case, you should disclose the matter to your designated ethics supervisor and withhold taking official action until the matter has been analyzed.

D. Cash Accounts

Your cash accounts and depository bank accounts do not implicate any concerns under the Ethics Act unless you are taking or withholding official action that affects the company in which the cash is deposited and there is a possibility

that your account value could be reduced. Since bank accounts are federally insured, it is unlikely a conflict of interest would arise unless your account exceeds the insured amount provided by the federal government.[6]

However, if your depository accounts exceed the insured maximum under federal law, you should take no official action in any matter affecting the institutions holding your funds until you have received advice from your designated ethics supervisor.

You have one cash account that is not federally insured. If you must take official action in a matter involving that company, you should advise your designated ethics supervisor of the situation before acting on the matter.

Conclusion

Your current investments and your interest in the deferred compensation plans described above do not constitute conflicts of interest that would preclude you from taking official action under the Ethics Act affecting BP, ConocoPhillips or other oil companies.

Direct ownership by you of stocks or bonds in those companies or of Alaska municipalities may create a conflict. You should avoid making those investments and should place restrictions on discretionary brokerage accounts to avoid the creation of a conflict.

If you have any questions concerning this advice, please do not hesitate to contact us.

cc: James F. Clark, Chief of Staff

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[6] The Alaska Judicial Canons except from the term "economic interest" depository accounts in financial institutions unless a proceeding pending before the judge "could substantially affect the value of the interest." Alaska Rules of Court, Code of Judicial Conduct, at p. 983. This rule is similar to the analysis we conduct under AS 39.52.110 in determining whether a financial interest is significant. Again, where the value of an official's financial interest is unlikely to be affected by official action, we find no significant conflict precluding the exercise of official action in the matter by the owner of the interest.