CONFLICTS OF INTEREST: WHEN YOU'RE HAVING TOO MUCH FUN AT THAT BUSINESS LUNCH

Fund directors face challenging new hurdles to comply with the 1940 Act's gifts and entertainment prohibition

BY JAY G. BARIS

How should fund directors monitor gifts and entertainment received by investment adviser personnel?

This question moved to the forefront in February, when the Securities and Exchange Commission's Division of Investment Management published guidance about conflicts of interest that arise when a fund's investment adviser personnel are presented with gifts, favors or other forms of consideration from people doing business, or hoping to do business, with a fund.

The guidance created a minor stir, as funds and advisers scrambled to ensure that their compliance policies and procedures satisfy the SEC's standards. This article discusses the challenge of addressing gifts and entertainment in compliance policies and procedures and summarizes certain actions a fund board can take to ensure that funds and their investment advisers comply with the gifts and entertainment rules.

BACKGROUND

The statutory prohibition. Section 17(e) of the Investment Company of 1940, as amended, generally prohibits any affiliated person of a registered investment company or fund (including, among others, its officers, directors and employees), or any affiliated person of an affiliated person (a second-tier affiliate) from acting as agent "to accept from any source any compensation," other than salary and wages

from a fund "for the purchase or sale of any property" to or for the fund, except in the course of the person's business as an underwriter or a broker. A fund's investment adviser is an affiliated person of the fund. The adviser's officers, directors and employees are "affiliated persons" of the investment adviser. Thus, as second-tier affiliates of the fund, they are subject to the prohibitions of Section 17(e).

By enacting Section 17(e), Congress sought to ensure that investment advisers manage funds for the benefit of fund shareholders and not to further their own interests. For example, a broker-dealer that pays money or gives something of value to an employee of an investment adviser as an incentive to buy and sell portfolio securities from the broker creates a conflict that the statute was designed to prevent.

The compliance rule. Rule 38a-1 under the 1940 Act, requires funds to adopt and implement, and for directors to approve, written compliance policies "reasonably designed to prevent violation of the Federal Securities Laws by the fund." Rule 38a-1 also requires fund directors to approve the compliance policies and procedures of certain fund services providers, including the fund's investment adviser, principal underwriter, administrator and transfer agent. A fund's compliance policies and procedures must provide for compliance oversight of these service providers.

Rules under the 1940 Act also require investment advisers to adopt and implement written policies reasonably designed to prevent violations of the law. Recent enforcement actions suggest that the SEC believes that receipt of gifts and entertainment by portfolio managers and traders may create incentive to pay the higher trading execution costs, in violation of their fiduciary duty to the funds.

Given the possibility for conflicts of interest, a fund's compliance policies and procedures should ensure that any gifts or entertainment are not in connection with the purchase or sale of a fund's portfolio securities.

THE COMPLIANCE CHALLENGE

Two principal issues bubbled to the surface in February:

- How far does the statutory prohibition of Section 17(e) extend?
- How should a fund and its compliance policies address this issue?

In practice, these issues have proven more challenging than initially anticipated by many industry participants.

The egregious cases are easy to identify. For example, it is easy to take the position that a fund's portfolio manager may violate Section 17(e) if the portfolio manager were to accept tickets to the Super Bowl or a new BMW from a broker-dealer who trades with the fund, whether or not the investment adviser's compliance department approves or signs off on receipt of the gift. But would the portfolio manager violate Section 17(e) if a broker-dealer treats a portfolio manager to a modest lunch at the Olive Garden or gives the portfolio manager a bottle of Benchmark Bourbon during the holiday season?

"THE CHALLENGE IS THAT THE 1940 ACT DOES NOT DISTINGUISH BETWEEN SUPER BOWL TICKETS AND THE BOTTLE OF INEXPENSIVE (YET TASTY) BOURBON."
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The challenge is that the 1940 Act does not distinguish between Super Bowl tickets and the bottle of inexpensive (yet tasty) bourbon. Rather, Section 17(e) contains an absolute prohibition as noted in the guidance:

> *For example, if a fund's portfolio manager accepts any gifts or entertainment from a broker-dealer for the purchase or sale of the fund's portfolio securities, the portfolio manager has violated Section 17(e)(1).*

The guidance noted that the SEC has found that gifts or entertainment meets the broad definition of compensation in the context of Section 17(e)(1). An equity trader, for example, would be deemed to be willfully violating the statute "by accepting gifts from brokerage firms to which he transmitted orders to buy and sell securities on behalf of certain of the investment adviser's mutual fund clients." Moreover, the mere receipt of compensation for the purchase or sale of property to or for a fund violates Section 17(e)(1). Notably, the prohibition does not require proof of the broker-dealer's intent to influence the trader, nor is it necessary to show that the recipient of the compensation influenced the actions of the fund or that the fund suffered economic injury.

Thus, it would seem, that receipt of a mere cup of coffee proffered by a broker-dealer to an investment adviser's trader who transmits buy and sell orders to the broker-dealer with respect to a fund would violate the statute.

The guidance raised concerns in the industry that the SEC staff reads Section 17(e) to strictly prohibit advisory personnel from receiving any and all compensation from a service provider. This interpretation was fueled by the staff's suggestion that a blanket prohibition on gifts and entertainment may be appropriate:

Some funds and advisers might find a blanket prohibition on the receipt of gifts or entertainment by fund advisory personnel to be appropriate. Other funds and advisers might find other measures to be more appropriate, such as some type of a pre-clearance mechanism for acceptances of gifts or entertainment to assess whether they would be for the purchase or sale of any property to or for the fund and therefore prohibited under section 17(e)(1).

Does this mean that the days of business lunches for fund portfolio managers and traders are over? Not necessarily.

In a memorandum to its members, dated June 9, the Investment Company Institute attempted to clarify the guidance by reporting on its conversations with the staff of the division. According to the ICI, the staff noted that the guidance does not express the view that Section 17(e) imposes a zero tolerance policy. Rather, the ICI suggested that the purpose of the guidance was to impress upon funds and investment advisers the importance of having compliance policies and procedures that are reasonably designed to prevent a violation of Section 17(e).

While not dispositive, the dialogue between the ICI and the SEC staff, as reported by the ICI, was helpful in putting the guidance in its proper perspective.

PRACTICAL SUGGESTIONS FOR FUND DIRECTORS

While all of this regulatory controversy swirls around them, fund directors must monitor investment advisers' compliance policies and procedures with respect to gifts and entertainment in a way that is consistent with their fiduciary duties.

Indeed, practices among investment advisers and fund complexes vary. Some fund complexes prefer a program that approaches a tight ban, while others take a less strict approach. In any event, fund directors must take seriously their responsibility to ensure that the compliance programs they oversee are "reasonably designed" to prevent violations of federal securities laws and, specifically, Section 17(e) of the 1940 Act. The challenge for fund directors is how to accomplish this goal.

Here are some practical suggestions for fund directors for consideration:

- Understand how the adviser's compliance policies address gifts and entertainment. For example, do the policies and procedures:
  - o Contain an outright ban, and if so, is the ban effective?
  - o Contain a procedure to pre-approve gifts and entertainment?
  - o Include a "de minimus" exception for gifts and entertainment?
  - o Require a substantive review by the chief compliance officer of receipt of gifts and entertainment on a case-by-case basis?
  - o Distinguish between advisory personnel responsible for funds and those responsible for non-fund accounts of the adviser?
  - o Require reporting by advisory personnel of any and all gifts and entertainment?
  - o Require the adviser's chief compliance officer to report to the board how the adviser monitors compliance?
  - o Require the adviser's chief compliance officer to report violations to the board?
- Understand how the adviser's policies and procedures compare with those of the fund the board oversees.
  - o Are the fund's policies and the adviser's policies consistent?
  - o Do the fund's policies cover affiliated persons of the fund other than advisory personnel (including the directors themselves)?
- Gather market information about how other fund complexes address gifts and entertainment.
- Be aware of SEC guidance and recent enforcement cases as an aid to understanding the effectiveness of the compliance policies and procedures of the fund and the adviser.

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CONCLUSION

To be sure, recent regulatory developments have reminded fund directors that they should be aware of how funds and their investment advisers comply with the gifts and entertainment prohibition of the 1940 Act. As a starting point, fund directors must ensure that compliance policies and procedures are reasonably designed to prevent violations of Section 17(e) of the 1940 Act, among other things. Directors should review compliance with the fund's chief compliance officer, fund counsel and counsel to the independent directors to ensure that their oversight of this important area remains adequate.

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