The Asset Management Industry
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Clarification of the SEC's Recent Guidance on Gifts and Entertainment Paid to Advisory Personnel

[29073]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 26-15
COMPLIANCE MEMBERS No. 21-15
INVESTMENT ADVISER MEMBERS No. 15-15
OPERATIONS MEMBERS No. 22-15
SEC RULES MEMBERS No. 38-15
SMALL FUNDS MEMBERS No. 26-15
TRANSFER AGENT ADVISORY COMMITTEE No. 28-15 RE: CLARIFICATION OF THE SEC'S RECENT GUIDANCE ON GIFTS AND ENTERTAINMENT PAID TO ADVISORY PERSONNEL

As you may recall, earlier this year the staff of the SEC's Division of Investment Management (the "Division") published a Guidance Update on Acceptance of Gifts and Entertainment by Fund Advisory Personnel – Section 17(e) of the Investment Company Act. [1] While the Guidance was intended to better clarify the application of Section 17(e) to gifts and entertainment provided to fund advisory personnel, its publication has raised concerns regarding whether 17(e) is to be read as a strict prohibition on the receipt by advisory personnel of any and all compensation paid by a service provider or, instead, whether a violation of Section 17(e) will be determined based on the facts and circumstances presented. This memorandum explains our understanding of this issue based on our conversation with the staff of the Division.

As noted by the staff, the Guidance never expresses the view that Section 17(e) imposes a "zero tolerance" policy. Instead, as explained by the U.S. Court of Appeals in the Decker case cited in the Guidance,

> Petitioner argues that the Commission has misinterpreted § 17(e)(1) as a flat prohibition against conflicts of interest. . . . We agree with petitioner that such an interpretation of § 17(e)(1) is too expansive. The Investment Company Act and the Investment Advisers Act were designed, in part, to prevent conflicts of interest from affecting the judgment of investment advisers. [Citations omitted.] The statute prohibits the receipt of compensation in exchange for the purchase or sale of property to or for an investment company. Thus, some

> nexus must be established between the compensation received and the property bought or sold. Although it need not be shown that there was any 'intent to influence,' [citations omitted] it must be shown, or properly inferable, that compensation was received 'for' the sale or purchase of property." [2]

Consistent with Decker, in comments before the Mutual Funds Directors Forum in 2005, then Division Director Paul F. Roye touched on the issue of gifts and entertainment provided to fund advisory personnel. According to Roye,

> There is no doubt that the receipt of lavish gifts and entertainment can influence fund personnel's actions, and even tempt fund personnel to take actions that may not be in the best interest of fund investors. Consequently, it is essential for advisers-and fund directors- to consider whether there are appropriate controls in place addressing the receipt of gifts and entertainment. A code of ethics is an appropriate place to outline a firm's philosophy regarding the receipt of gifts and entertainment as well as establish the controls the firm puts in place to limit the corrupting influence of such gifts. [3] (Emphasis added)

The Division's Guidance, too, attempts to impress upon registrants the importance of having compliance policies and procedures that are reasonably designed to prevent a violation of Section 17(e). As expressed in the Guidance:

> The receipt of entertainment by fund advisory personnel, among others, may violate section 17(e)(1) of the 1940 Act and, in the staff's view, should be addressed by funds' compliance policies and procedures under rule 38a-1. The particular policies and procedures, concerning the receipt of gifts or entertainment that might be appropriate would depend on the nature of the adviser's business, among other considerations. 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 acceptance 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) [4].

As fund advisers either adopt new compliance policies and procedures relating to Section 17(e) or review their existing policies and procedures, they may want to keep in mind a few points:

- As noted in the SEC's release adopting Rules 206(4)-7 and 38a-1, these rules require "only that the policies and procedures be reasonably designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser." [5] [Emphasis in original.]
- In designing its policies and procedures, an adviser "should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." [6] This approach to the adviser's compliance policies and procedures is consistent with the above excerpt from the Guidance.

- In order for the Commission to prove a violation of Section 17(e), it "must show that some form of compensation was received in exchange for the purchase and sale of investment company property." However, "'once a conflict of interest is proven, the burden shifts to the party in conflict to prove that he has been faithful to his trust.'" [7]
- According to the Decker case, "the ultimate burden of proof remains on [the SEC's] Enforcement Division to prove each element of the alleged violation by a preponderance of the evidence. When the Enforcement Division introduces prima facie evidence of a conflict of interest in the allocation of brokerage business, the burden is properly shifted to petitioner to come forward with evidence sufficient to justify a finding that no money was received as compensation for the sale or purchase of Fund property. If petitioner produces such evidence, the presumption is no longer operative and the Commission must consider all relevant evidence and determine whether the Enforcement Division established its case by a preponderance of the evidence." [8]

We hope you find this additional information relating to the Commission's Guidance to be helpful.

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endnotes

[1] See IM Guidance No. 2015-01(February 2015) (the "Guidance"), which is available at: http://www.sec.gov/investment/im-guidance-2015-01.pdf.

[2] Decker v. SEC, 631 F2d 1380 (10th Cir. Aug. 18, 1980) at pp. 13-14.

[3] See Remarks before the Mutual Fund Directors Forum Fifth Annual Policy Conference: Critical Issues for Investment Company Directors, by Paul E Roye (February 17, 2005), which are available at https://www.sec.gov/news/speech/spch021705pfr.htm

[4] Guidance at p. 2.

[5] See Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IA-2204 and IC-26299 (Dec. 17, 2003) (the "38a-1 Release") at p. 47.

[6] See 38a-1 Release at p. 5. Included in the list of issues that the adviser's policies and procedures should address is "Trading practices, including procedures by which the adviser satisfies its best execution obligation." Id.

[7] Decker at p. 16.

[8] Decker at p. 7.