

Office of Government Ethics

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**Memorandum Issued August 25, 2000,
from F. Gary Davis, Acting Director,
to Designated Agency Ethics Officials
Regarding Diversified and Sector Mutual Funds**

The Office of Government Ethics (OGE) is issuing this memorandum to provide guidance concerning the distinction between diversified mutual funds and sector mutual funds. This distinction is important for purposes of certain regulatory exemptions issued by OGE under the authority of 18 U.S.C. § 208(b)(2). OGE has received a number of requests from agency ethics officials for advice in this area. Moreover, OGE recently concluded a survey of agency experience and satisfaction with the regulatory exemptions, which are codified in subpart B of 5 C.F.R. part 2640. It was apparent from several of the responses that there was demand for legal and practical guidance concerning the application of the rules pertaining to diversified and sector mutual funds. The advice contained in this memorandum is an effort to meet that demand.

We note at the outset that this memorandum is intended only to provide general guidance. It is impossible not to take notice of the great number and variety of mutual funds on the market today. Moreover, one can easily imagine that new variations will continue to appear in the future, as fund managers respond to new investment opportunities and other developments in the economy. OGE's attempt in this memorandum to list representative types of sector and diversified funds is necessarily tentative and incomplete. Moreover, although OGE has been able to identify some common features of certain types of funds, we also have encountered occasional exceptions where, for example, the name of a fund would not be a conclusive indicator of the fund's investment concentration, for purposes of part 2640. Consequently, employees and ethics officials always will need to consider the characteristics of any given fund, including the nature and scope of any "sector" in which the fund manager may purport to specialize.

We also want to make clear that nothing in this memorandum is intended as an endorsement or disparagement of any particular mutual fund or type of mutual fund. For this reason, the discussion below generally omits specific fund names. Federal employees remain free to invest as they choose, subject to any

prohibited financial interest restrictions, as described in 5 C.F.R. § 2635.403, and any disqualification obligations, as described in 5 C.F.R. part 2640.

EXEMPTIONS UNDER 18 U.S.C. § 208(B) (2)

Section 208(a) of Title 18, United States Code, prohibits an employee from participating in any particular matter in which the employee, or any other person specified in the statute, has a financial interest. The prohibition has been interpreted as applying to financial interests in official matters affecting the underlying holdings of a mutual fund. See, e.g., OGE Informal Advisory Letter 93 x 27. OGE has authority, however, to promulgate regulations exempting certain types of financial interests from this prohibition, where OGE determines that the interest is too remote or inconsequential to affect the integrity of the services of the Government employees to whom the exemption applies. 18 U.S.C. § 208(b) (2). Subpart B of part 2640 contains a number of such exemptions, several of which are applicable to interests in mutual funds.¹ The distinction between diversified and sector mutual funds is particularly important for certain of these exemptions.

A. Exemption for Diversified Mutual Funds

Subpart B contains a relatively broad exemption for any disqualifying financial interest arising from the ownership of a "diversified mutual fund." 5 C.F.R. § 2640.201(a). Provided that the fund meets the definition of "diversified," set out in section 2640.102(a), an employee may participate in any matter affecting any of the underlying holdings of the mutual fund, without regard to the magnitude of the employee's interest in the fund. Such an expansive exemption was deemed justified because, among other reasons, diversified funds hold "securities of issuers who are engaged in a variety of businesses or industries." 60 Fed. Reg. 47207, 47211 (September 11, 1995) (preamble to proposed rule). Under such circumstances, it is likely that any Government action affecting a given issuer would have only a diffuse or negligible effect on the employee's financial interest in the overall fund.

¹ For purposes of part 2640, "mutual fund" is defined as "an entity which is registered as a management company under the Investment Company act of 1940, as amended (15 U.S.C. § 80a-1 et seq.)" 5 C.F.R. § 2640.102(k). This includes open-end, closed-end and exchange-traded mutual funds, and registered money market funds.

The definition of diversified, obviously, is of critical importance. Basically, as OGE stated in the preamble to the final rule, "the exemption for diversified mutual funds applies to *all mutual funds except sector funds*." 61 Fed. Reg. 66829, 66833 (December 18, 1996) (emphasis added). Recognizing that sector and diversified might mean different things in different contexts, OGE specifically described the kind of sector/diversified distinction it had in mind: "Diversified means that the fund . . . does not have a stated policy of concentrating its investments in any industry, business, single country other than the United States, or bonds of a single State within the United States" 5 C.F.R. § 2640.102(a).

If a fund does have a stated policy of concentrating its investments in such a sector, OGE determined that the broad exemption of section 2640.201(a) would not apply because of heightened conflict of interest concerns. The possible effect of some particular matters on certain sector funds is much more focused and potentially substantial than would be the case with a diversified fund. Indeed, it is quite common for a sector fund prospectus to include some cautionary statement indicating the greater risk of volatility resulting from concentration in areas affected by Government regulation or spending. A Federal employee could participate in an important rulemaking proceeding that impacts many or all members of a given industry, thus affecting not only a number of the underlying holdings of a relevant sector fund but even the overall economic outlook for the sector in which the fund specializes. Employees whose duties affect companies in a discrete industry, business, etc., can have an appreciable conflict of interest if they invest heavily in mutual funds that specialize in that very sector.

B. Exemptions Applicable to Sector Mutual Funds

Nevertheless, OGE has promulgated certain other exemptions that may apply to interests in sector funds. For those mutual funds that do not meet the diversification standard, three exemptions are especially important.²

² Depending on the circumstances, other exemptions in subpart B may apply to certain interests in sector funds, but the three exemptions discussed here are the most commonly applicable. Note, however, that no regulatory exemption applies to any mutual fund that is a prohibited interest, pursuant to 5 C.F.R. § 2640.204, although many agency-specific prohibitions make some exception for the holding of funds not focused on a sector that is problematic for the particular agency. See, e.g., 5 C.F.R. § 3401.102(c)(1) (Federal Energy Regulatory Commission).

First, section 2640.201(b) expressly applies to certain interests in a sector mutual fund. For purposes of this exemption, sector mutual fund is defined essentially by contrast with the definition of diversified fund: "Sector mutual fund means a mutual fund that concentrates its investments in an industry, business, single country other than the United States, or bonds of a single State within the United States." 5 C.F.R. § 2640.102(q). With respect to such funds, section 2640.201(b) permits an employee to participate in any particular matter where the disqualifying interest arises solely from the "non-sector" holdings of the fund, i.e., those incidental holdings that are outside of the fund's express area of concentration. Thus, for example, an employee who owns a telecommunications sector fund may participate in certain energy matters, notwithstanding the fact that the fund may hold securities of an affected energy company.

Second, because part 2640 currently treats sector funds as "publicly traded securities," interests in such funds are covered by the \$5,000 de minimis exemption for particular matters involving specific parties. 5 C.F.R. §§ 2640.102(p) & (r); 2640.202(a). Thus, for example, an employee owning up to \$5,000 in a financial services sector fund may participate in the investigation of a bank whose stock is held by the fund. The \$5,000 limit would apply to the aggregated value of all affected sector funds held by the employee, the employee's spouse, and the employee's minor children. 5 C.F.R. § 2640.202(a)(2). Moreover, as with all of the de minimis exemptions discussed here, it should be noted that the value limit applies to the value of the person's interest in the fund as a whole, not the pro rata value of any underlying holding of the fund. See 61 *Fed. Reg.* at 66835-36.

Third, by the same token, the current de minimis exemption for particular matters of general applicability covers interests in sector mutual funds. 5 C.F.R. § 2640.202(b). An employee may participate in a matter of general applicability where the disqualifying interest arises from aggregated holdings of up to \$25,000 in any one affected sector fund and \$50,000 in all affected sector funds owned by the employee, the employee's spouse, and the employee's minor children. Thus, for example, an employee who owns \$10,000 in one health sector fund and \$20,000 in another health sector fund may participate in a Medicare policy decision affecting a certain class of healthcare providers, including issuers of securities held by the two funds.

Finally, in connection with the subject of de minimis interests, we note that OGE anticipates proposing a new de minimis exemption in the near future specifically for sector funds. The exemption, if adopted, would create a higher limit of \$50,000 for all particular matters. The \$50,000 de minimis level would apply

to all interests in affected funds focused on the same sector, whether owned by the employee, the employee's spouse, or the employee's minor children. OGE believes that such an exemption would be justified because interests in the underlying holdings of a sector fund are more remote and inconsequential than direct ownership by the employee of securities in an affected issuer. Nevertheless, the basic distinction between diversified and sector funds will remain, since OGE does not intend to propose an unlimited exemption of the type that currently exists for diversified funds.

DISTINGUISHING SECTOR AND DIVERSIFIED FUNDS

As indicated above, the distinction between sector and diversified funds turns on whether the fund has an express policy of "concentrating its investments in *any industry, business, single country other than the United States, or bonds of a single State* within the United States." 5 C.F.R. § 2640.102(a) (emphasis added). This standard differs somewhat from other rules that establish the requisite degree of diversification for different purposes, and any guidance herein should not be confused with guidance pertaining to those other standards of diversification. Compare 5 C.F.R. § 2634.1003(c)(1) (permitted rollover property for certificates of divestiture); § 2634.310(c)(3) (excepted investment funds); § 2634.404(b)(2) (diversified trusts). Unlike some of these other standards, the focus of part 2640 is not whether a fund concentrates on a broadly defined "economic," "geographic" or "regional" sector, but rather a somewhat narrower "industry," "business," "single country" or "bonds of a single State."

A. Industry or Business Sector

Agencies occasionally have questions about whether a particular fund really concentrates on an "industry" or "business," as opposed to a broader economic sector that includes a significant variety of independent industries or businesses. Determining what is an industry or business sector, therefore, is crucial for purposes of the relevant exemptions. Moreover, such determinations necessarily involve the exercise of some judgment, taking into account the stated policies of the fund and any common features of the companies in which it specializes.

OGE is aware of no universally accepted criterion for what constitutes an "industry" or "business" that would be useful for this purpose. Any conceivable classification of the economy by industry groupings would involve numerous judgments about what degree of similarity in operations or interests among firms would be sufficient to place them within a single industry. One can distinguish among companies on so many different levels, and with

such varying degrees of detail, that it is possible to describe a virtually infinite number of classes and subclasses. For example, the North American Industry Classification (NAIC) system, used by the United States for a variety of statistical and other purposes, now divides the economy into twenty broad "sectors," whereas the Standard Industrial Classification (SIC) system, which was used until recently, had only ten sectors. Even under NAIC, some sectors are defined very broadly (e.g., "Manufacturing," which includes a great diversity of manufacturing operations), whereas other sectors are seemingly more narrow (e.g., "Health Care and Social Assistance"). Moreover, under both systems, there are several levels of subdivision within each sector, thus indicating the possibility of ever more refined distinctions among industries and sub-industries³. More important, some ways of grouping industries and businesses, while relevant for certain statistical and other purposes, may be wholly inadequate for conflict of interest purposes. For example, according to NAIC, medical equipment and pharmaceuticals are not only separate "industries," but also they are in different "industry groups" and even different manufacturing "sub-sectors" altogether; from a Federal conflict of interest perspective, however, drugs and medical devices are not only regulated by the same agency (the Department of Health and Human Services) and subject to many related regulatory requirements, but also it has been recognized that certain medical devices and drugs may be complementary or even competing products for the same medical condition.

Therefore, in addressing the question of what constitutes an industry or business, for purposes of identifying a sector fund, OGE has attempted to take a pragmatic approach. In doing so, OGE has taken into account both the need for clarity and the need for criteria that are relevant to the purposes of the executive branch ethics program. In some respects, the best guidance in this area would be examples of decisions OGE has already made in applying the standard, rather than abstract statements of general principle. Nevertheless, before setting out a list of examples of representative types of sector and diversified funds (see below), we believe there is at least some utility in articulating the general approach that governs OGE's application of the diversification standard.

³ NAIC uses six-digit codes breaking the economy down according to sector, subsector, industry group, industry, and U.S. industry. SIC used a four-digit system indicating division, major group, industry group, and industry code.

B. Basic Approach

Basically, OGE approaches such questions by examining the degree of relatedness and overlapping interests and operations among the types of companies in which a given mutual fund specializes. As suggested above, this inquiry also is performed in the context of realistic conflict of interest considerations, as well as the need for some measure of common sense. Given the latter considerations, OGE will deem certain arguably discrete types of companies to be part of one industry or business sector if, for example, they share a common regulatory environment or if Government decisions affecting one type of company would be expected to affect the other, given their interdependence or competition with each other.

This approach is embodied in part 2640 itself. In example 2 following section 2640.202(b), OGE indicates that a particular fund is not diversified because "it is invested in health-related companies such as pharmaceuticals, developers of medical instruments and devices, managed care health organizations, and acute care hospitals." See also 61 Fed. Reg. at 66833 (preamble to final rule cites "Vanguard Specialized Portfolios: Healthcare" as example of sector fund). OGE acknowledges that, for certain economic and other purposes, one could argue that this fund does not describe a single sector but rather a cluster of discrete types of businesses, each occupying an identifiable niche within the multifaceted sphere of health care and health science. Primarily for conflict of interest reasons, however, OGE has chosen to focus rather on the common denominator of health to describe the relevant sector. Despite their differences, the types of companies in which this fund specializes are significantly interdependent, and Government decisions affecting one type often will affect the others. For example, Government decisions concerning the reimbursement of health care providers (e.g., hospitals) for certain services can have an impact on the manufacturers of the medical products (e.g., drugs and medical devices) specifically used in connection with those services.

In a similar vein, example 2 following section 2640.201(a) indicates that a fund "that expressly concentrates its holdings in the stock of utilities companies" is not diversified. OGE is aware that utility funds may define their concentration as including companies involved in such areas as electricity, gas, water, sanitation systems, telecommunications (mainly telephone service), and cable television. As diverse as these areas may be for some purposes, OGE generally believes that utility funds are properly treated as sector funds. Many of these types of utility companies have common interests in the use of rights of way for transmission and distribution, are sensitive to energy prices, and may even

compete with each other in some respects. Moreover, according to one prospectus OGE reviewed, "telephone and electric companies dominate the utility stock market," thus indicating a further degree of potential concentration within the sector. (See the discussions below concerning "dual industry" funds and "real focus" vs. miscellaneous sectors.) OGE also recognizes the practical need to draw a line that can be easily understood and applied in various situations; utility funds are fairly common, and OGE believes that historically they have been regarded as sector funds within the ethics community.

We want to emphasize, however, that a fund will not be deemed a sector fund where the manager describes essentially generic categories of concentration. Relatively general or superficial similarities among a group of disparate industries or businesses will not be sufficient to trigger the stricter treatment OGE has reserved for sector funds. Several examples would be "entertainment," "leisure," "consumer products," "cyclicals," and "venture capital" funds. Another common example would be generic "science" or "technology" funds. Most of the science and technology funds we have reviewed do not focus on any particular scientific or technological industry, but rather a variety of industries, including biotechnology, computers, telecommunications, environmental services, aerospace, etc., which have little in common except a commitment of resources to research and development in scientific fields.⁴

In some cases, of course, the distinction between a sector and a diversified fund can be difficult to draw because the distinctions among certain industries may be blurred. The case of "financial services funds" illustrates this problem. On the one hand, there is little question that "banking funds" should be treated as sector rather than diversified funds; prospectuses for such funds often indicate a fairly specific focus, such as companies engaged in accepting deposits and making commercial and principally non-mortgage consumer loans, including state chartered banks, savings and loan institutions, and banks that are members of the Federal Reserve System. On the other hand, the question is somewhat closer with respect to the broader category of financial services funds. Some of the prospectuses for these funds define the financial services sector as including, in addition to the

⁴ We should caution, however, that we have reviewed the prospectus for at least one self-described "technology" fund that expressly focused on computers and electronics, and another prospectus for a "high technology" fund that expressly focused on computer and related companies; we believe such funds are not diversified, despite their names.

types of banks described above, such companies as: "brokerage and advisory firms;" "leasing companies;" "insurance firms;" "publicly traded, government-sponsored financial enterprises;" "home, auto, and other specialty finance companies;" "electronic trading networks;" "electronic transaction processors for financial services companies;" and "diversified financial companies." Nevertheless, OGE has determined that financial services funds generally should be viewed as sector funds. See 60 *Fed. Reg.* at 47213. As one fund prospectus notes, "the financial services industries . . . can be subject to relatively rapid change due to increasingly blurred distinctions between service segments," and all can be "significantly affected by availability and cost of capital funds, changes in interest rates, and price competition." OGE believes that there is enough potential for competition among the types of companies within the sector, as well as potential for certain particular matters to affect more than one type, that funds focused on financial services companies should not be treated as being diversified, for purposes of part 2640.

Along the same lines, OGE generally considers "dual industry" funds to be nondiversified. These funds are expressly marketed as being concentrated in two industry or business sectors, such as "defense and aerospace," "telecommunications and utilities," or "media and telecommunications." OGE usually treats such dual industry funds as being sector funds, under part 2640, for essentially two reasons. First, rarely would two unrelated industries be yoked together arbitrarily. Usually, one would assume that the fund manager perceives that the two sectors are related in some significant way. Indeed, in many instances, one could argue that the prospectus really describes only two aspects of a single industrial sector. Second, we believe that a fund that is expressly focused on two sectors is still sufficiently concentrated in each sector to pose the kinds of risks associated with sector funds.

DETERMINING A FUND'S INVESTMENT POLICY

Before providing a list of examples of how OGE has applied this general approach to several types of sector and diversified funds, it is necessary to address one last issue that has generated some confusion. Agency ethics officials commonly ask what it means for a fund to have a "stated policy" of concentrating its investments in a sector. In other words, where and how can one find the concentration policy of a particular fund?

On one level, this involves the very practical question of where to look for such a policy. The rule notes that whether a mutual fund meets the diversification standard "may be determined by checking the fund's prospectus or by calling a broker or the

manager of the fund." 5 C.F.R. § 2640.102(a) (Note). Many fund prospectuses are readily available to employees and ethics officials through various means, including the Internet. Typically, such prospectuses have statements indicating the "principal investment strategy," "fund objective," or other provisions that make reference to any sector concentration policy. Moreover, as we have advised in the past, "[o]ften, it is possible to learn whether a fund is a sector fund simply from the fund's name (i.e., Vanguard Specialized Portfolios: Healthcare)." 61 Fed. Reg. at 66833. OGE also has found that other convenient resources, such as publications and certain online mutual fund guides, can provide quick and understandable descriptions of many fund concentration policies, although such aids may not be as current or reliable as the fund prospectus in some instances.

We must emphasize that OGE's focus is on the *stated* policy of the fund manager, not on the actual breakdown of fund holdings at any given point in time.⁵ The actual portfolio of investments in a particular fund is subject to change, including the relative concentrations in certain sectors. Therefore, OGE has determined that a more reliable and consistent measure of concentration, for purposes of the exemptions in part 2640 anyway, is the fund's express statement of overall concentration philosophy. The relevant starting point, therefore, is not a printout of a fund's recent holdings or even a list of the fund's top five or ten holdings, but rather the fund's statement of basic concentration policy.

OGE is aware that ethics officials sometimes may note an apparent "disconnect" between the level of diversification espoused in a fund's policy statement and the level of concentration reflected in the fund's actual holdings at a given time. For example, OGE recently reviewed the prospectus of a particular "science and technology fund," whose statement of concentration policy described a significant diversity of businesses and industries: "electronics; communications; e-commerce; information services; media; life sciences and health care; chemicals and synthetic materials; and defense and aerospace." At the same time, the fund's top ten holdings seemed disproportionately weighted in computer and computer-related industries. The ethics official who brought this to our attention asked whether computer procurement specialists at her agency could own such a fund without risking

⁵ This approach differs, for example, from the financial disclosure rule applicable to excepted investment funds, which defines "widely diversified" according to the actual portfolio composition at a specific time in the reporting period. See 5 C.F.R. §2634.310(C)(3).

problems under 18 U.S.C. § 208; we advised that this fund was covered by the exemption for diversified mutual funds. In such cases, the definitions of "diversified" and "sector mutual fund," in part 2640, require that the focus remain on the stated policy in the prospectus, not the actual fund portfolio at any historical point. Not only is this result compelled by the rule, but it is consistent with the reality that relative sector concentrations may change frequently and with little or no notice, within the limits of the stated fund policy.

Occasionally, there also may be issues concerning the central focus of a fund, as described in the prospectus. For example, agencies sometimes may question whether references in a prospectus to "other" or miscellaneous sectors are sufficient to render a fund diversified when it would otherwise appear to be a sector fund. In this connection, OGE recently reviewed the prospectus of a self-described "internet fund" that included a fairly typical description of an Internet sector concentration policy: "companies . . . engaged in the research, design, development or manufacturing, or engaged to a significant extent in the business of distributing products, processes or services for use with Internet or Intranet related businesses." However, the prospectus then went on to state that the fund "may also invest in other 'high tech' companies," which it defined as "firms in the computer, communications, video, electronics, office and factory automation and robotics sectors." OGE determined that the main thrust of the stated concentration policy of this fund remained Internet-related companies, notwithstanding the discretion of the fund manager to "minor" in other areas of technology that are more or less tangential to the core Internet focus. Obviously, such questions are matters of degree, and a fund should be regarded in light of the overarching investment strategy articulated in the prospectus and any other statements from the fund manager. Moreover, as a practical matter, the name by which a fund is marketed (e.g., "ABC Internet Fund") sometimes may help to settle close questions as to the core focus.

EXAMPLES OF SECTOR AND DIVERSIFIED FUNDS

As stated above, the best guidance in this area probably is OGE's experience with specific types of mutual funds. Subject to the caveats expressed earlier, particularly the need to consider any peculiarities of a given fund and its prospectus where appropriate, the following lists provide examples of common types of funds with respect to which OGE generally has been able to discern a policy of sector concentration or diversification. Please note that these lists are not intended to be comprehensive or static.

A. Sector Fund Examples

OGE's general experience has been that mutual funds promoted as having the following areas of concentration are likely to be sector funds:

- Utilities
- Telecommunications
- Energy
- Health Care/Health Sciences
- Life Sciences
- Financial Services
- Banking
- Brokerage & Investment Management
- Precious Metals
- Gold
- Biotechnology
- Food & Agricultural Products
- Media
- Automotive
- Chemicals
- Computers
- Electronics
- Internet
- Japan/Mexico/etc.
- California/Maryland/etc. Bonds
- GNMA
- Real Estate
- REIT
- Defense & Aerospace
- Transportation
- Housing & Construction

Note that some of the above sectors are not mutually exclusive but may overlap to a significant degree or even subsume others, depending on how the fund manager defines the concentration policy. For example, depending on the focus described in the prospectus, a

biotechnology fund might significantly overlap with the health sciences or life sciences sector, or a utilities fund might significantly overlap with either the energy or telecommunications sector. In some cases, therefore, ethics officials and employees still may need to look beyond the fund name to the prospectus, in order to determine whether there is a conflict between the sector fund's actual focus and an employee's expected duties.

B. Diversified Fund Examples

The following types of funds generally have been found by OGE to be diversified for purposes of the exemptions in part 2640:

Leisure/Entertainment
Research
Generic "Science"/"Technology"⁶
Venture Capital
Pacific/European/South Asian/etc.
Generic "Index"/"S&P"/etc.
Generic "Growth"/"Income"/"Capital Appreciation"/"High Yield"/"Value"/etc.
Generic "Equity"/"Bond"
Generic "Municipal"
Generic "Tax-Free"
Emerging Markets
Cyclicals
Small Cap/Mid Cap/Large Cap
Balanced
Consumer Products/Services
Natural Resources
Basic Materials/Industrial Materials
Money Market⁷
U.S. Treasury

⁶ But note the caution at footnote 4 above.

⁷ This includes only money market mutual funds, not bank deposit money market accounts, which are not mutual funds. See 60 Fed. Reg. at 47213.