Office of Government Ethics
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Letter to a Deputy DAEO dated April 3, 1986

This is in response to your letter of March 19, 1986. By your letter, you ask for advice concerning the situation of an official who is a member of a private investment club. The club's portfolio, which is determined by a majority vote of the members, includes a small proportionate holding of the securities of an entity which the official would not be permitted to hold directly. This fact pattern is not expressly provided for by applicable regulations; however, you are considering an amendment to your regulations which would permit such a derivative interest to be retained.

We anticipate that the reporting aspect of the issue you raise will soon be subject to the principles of section 202(f)(1) of the Ethics in Government Act (relating to the reporting of derivative interests). As you are aware, there will be an amendment to Executive Order 11222 under the authority granted by recent legislation which will lead, pursuant to regulations to be promulgated by this Office, to a new confidential financial reporting system which will complement the present public financial disclosure system established pursuant to title II of the Ethics Act. Even though title II rules regarding the quantification of asset valuations and income items might not be applied in the case of confidential filers, we presume that the basic scheme of that title will be adopted so as to require, pursuant to section 202(f)(1), a listing of assets attributable to a confidential filer through a trust or other financial arrangement, such as an investment club. Accordingly, it is anticipated that the new confidential system would not include a provision equivalent to 5 C.F.R. § 735.404(a) (relating to interests not required to be reported). You should assume that interests, such as those which are the subject of your inquiry, held through an investment club, will be required to be reported.

The substantive issue you raise is a matter within the scope of 18 U.S.C. § 208, as well as the standards of conduct. Under well settled precedent, section 208(a) has no de minimis aspect. The operation of that provision may only be ameliorated through the procedures provided for by subsections (b)(1) and (b)(2) of section 208. We feel that a regulatory provision which properly

invokes the exemption of subsection (b)(2) should specifically refer to that provision and repeat the statutory formulation of the wording for the determination which that provision requires. The broad effect of the general waiver available under subsection (b)(2) necessitates that it should be used only when there is confidence that the Government's interests will be protected in the array of cases it will apply to because the substantive facts and circumstances in all of the cases will be essentially equivalent. Thus, such a general waiver is appropriate in the case of diversified mutual funds. Mutual funds exist pursuant to an elaborate statutory scheme under the Investment Company Act of 1940. The scheme entails a formal separation between the ordinary shareholder and the managers of the funds. The relationship is completely impersonal and defined by statute. The standards for a portfolio which is maintained by a diversified fund, as opposed to the concentration permitted a sector fund, are also defined by statute. The portfolios are publicly reported in standard reference materials such as Moody's and announced periodically, not on a trade-by-trade basis. On the other hand, there are no generally accepted or imposed standards with respect to investment clubs. The clubs, in actuality and appearance, present a situation where, although the objectives might be quite serious, the setting may be perceived as social or congenial. The facts and circumstances encountered in the management and portfolio policies of investment clubs vary widely and, therefore, there is no essential equivalency between clubs. Our view is that investment clubs are not an appropriate subject for general waivers under subsection (b)(2) of section 208.

Conversely, we feel as a general matter that it could be appropriate for an agency to announce in its regulations that waivers will be granted under subsection (b)(1) on a case-by-case basis when it is demonstrated to the satisfaction of the appropriate agency official that certain types of specified conditions exist -- for example, in the case of an investment club that: (i) the portion of the club's equity which is attributable to agency personnel is insignificant, (ii) the club's security portfolio is independently managed by a licensed broker, and (iii) the portfolio is diversified. The regulation should specifically refer to subsection (b)(1) of section 208 and repeat the statutory formulation of the wording for the determination that the agency official would have to make in each case in which the waiver is granted. The situation of self-managed clubs does not seem appropriately amenable to this announcement approach as the Government's interests are more

exposed. The opportunity for subsection (b)(1) waivers to be granted pursuant to generally applicable procedures as appropriate situations are encountered and examined would seem sufficient.

While you will realize that the necessity for a consistent approach within the executive branch to the type of fact pattern which you have brought to our attention mandates the outcome indicated herein, we do appreciate the individualized impact of this type of solution upon an agency such as yours which is subject to particularized statutory restrictions in addition to those which are generally applicable. It would seem appropriate and consistent with your present treatment of the particularized restrictions to deem any derivative interest, such as those attributable through an investment club, for which a waiver is obtained under section 208(b)(1) or for which an exemption exists by regulation under section 208(b)(2) to not constitute an indirect interest for the purposes of those particularized restrictions.

Sincerely,

David H. Martin
Director