Note: The guidance in this advisory was updated in 2014 by Legal Advisory LA-14-05.

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July 22, 2008
DO-08-022

MEMORANDUM

TO: Designated Agency Ethics Officials

FROM: Robert I. Cusick
Director

SUBJECT: Financial Disclosure Requirements for Pooled Investment Funds

Section 102 of the Ethics in Government Act (EIGA) directs persons required to file public financial disclosure reports (SF 278) to report each source of income exceeding $200 and the identity of each property interest exceeding $1,000 in value, unless the source of income or the property interest falls into one of the exceptions enumerated in the Act. Unless a pooled investment fund, such as a hedge fund, meets the definition of an excepted investment fund, any of its underlying assets that meet these thresholds must be reported on the financial disclosure form. In some cases, an investor cannot obtain the identity of the assets from the fund manager. In other cases, a bona fide confidentiality agreement with the fund manager precludes disclosure of the fund's assets. The United States Office of Government Ethics (OGE), in this DAEOgram, explains what actions a nominee for a full-time Senate-confirmed position (PAS nominee) must take with regard to such pooled investment funds in order for the Director of OGE to certify the individual's financial disclosure report.

I. ANALYSIS OF THE REPORTING REQUIREMENT

OGE Certification

Under the EIGA, the Director of OGE reviews and certifies the reports of individuals appointed by the President and subject to confirmation by the Senate. 5 U.S.C. app. §§ 106(b)(1) and (b)(2). The Director's certification of the report means the Director has determined that, on the basis of the information contained in the report, the individual submitting the report is in compliance with applicable laws and regulations, including section 102 of the EIGA, which establishes the public financial disclosure requirements. If the filer has not complied with the financial disclosure requirements, the OGE Director does not have a basis to certify the report under section 106(b)(1).

The Requirement to Report the Assets of Pooled Investment Funds

Both the EIGA and executive branch regulations describe the assets that a PAS nominee must report on a financial disclosure form. Section 102(f)(1) of the EIGA reads as follows:

> Except as provided in paragraph (2) [the exception for certain trusts and excepted investment funds], each reporting individual shall report the information required to be reported pursuant to subsections (a), (b), and (c) of this section with respect to the holdings of and income from a trust or other financial arrangement from which income is received by, or with respect to which a beneficial interest in principal or income is held by, such individual, his spouse, or any dependent child.

5 C.F.R. section 2634.310(a)(1) implements this provision for public financial disclosure reports and states that:

> Except as otherwise provided in this section, each financial disclosure report shall include the information required by this subpart about the holdings of and income from the holdings of any trust, estate, investment fund or other financial arrangement from which income is received by, or with respect to which a beneficial interest in principal or income is held by, the filer, his spouse, or dependent child.

The terms "financial arrangement" and "investment fund" are broad enough to include pooled investment vehicles including hedge funds. Hedge funds invest the money they raise in order to return a profit to their investors, and, in this respect, they are similar to mutual funds. They are different from mutual funds in other respects. They are not regulated by the Securities and Exchange Commission. They generally accept only "accredited" investors--for example, those with a net worth of at least $1 million. The funds pursue sophisticated investment strategies as "hedges" against trends in broader financial markets in order to enhance the returns to their investors. In order to protect their strategy from exposure to their competitors, some hedge fund managers do not reveal the assets in the fund. The manner in which a particular fund manager employs certain strategies is unique to that fund. If a hedge fund manager were to reveal the underlying assets in the fund, he or she would expose the investment strategy to competitors, other hedge fund managers.

Exceptions to the Requirement to Report Underlying Assets

Because a hedge fund falls into the category of a "financial arrangement" or an "investment fund," a PAS nominee must report the assets in the fund unless an exception applies. Section 102(f)(2) of the EIGA provides the only three exceptions to the requirement to break out the assets. Section 102(f)(2) states that an individual is not required to report the holdings of or the source of income of the following financial arrangements:

- a qualified blind trust as defined by the EIGA;
- a trust not created by the individual, spouse, or any dependent child and the holdings of which they have no knowledge; or
- an excepted investment fund.

The fact that Congress specifically provides for three circumstances in which an individual is not required to report the holdings of a pooled investment fund indicates that, in all other circumstances, the underlying holdings must be reported. When it introduces the exceptions, Congress does not use the terms "for example" or "including but not limited to" or other similar language. OGE concludes that these are the exclusive exceptions to reporting underlying assets of a fund. If a pooled investment fund fits into one of these categories, the underlying assets do not have to be reported on a financial disclosure form. If the fund does not fit into one of these exceptions, the underlying assets must be reported.

The first two exceptions require that the "financial arrangement" be structured as a trust. The pooled investment funds that have caused the reporting issue to arise are not structured as trusts. The first exception applies to the qualified blind trust, one that is established for an Executive Branch employee in accordance with the EIGA and Federal regulations (5 C.F.R. §§ 2634.401-2634.409). Such qualified blind trusts must be certified by the Director of OGE, have an independent trustee approved by the Director, and a list of the initial assets placed in the trust at time of its creation must be provided to OGE. A pooled investment fund like a hedge fund cannot meet these requirements.

The second exception has in the past been applied to certain trusts created in accordance with a state's trust law. An example of one of these trusts is one created by a family member (such as a parent or grandparent of the nominee) with the PAS nominee as a beneficiary. OGE has not reviewed any pooled investment funds that are organized as trusts. These funds are usually organized as limited liability corporations or limited partnerships. If a fund manager were able to organize a hedge fund as a trust, OGE would consider whether this exception could apply to that fund.

The only remaining exception is that of the excepted investment fund. This provision exempts a filer of a financial disclosure form from reporting the underlying assets of an investment fund if the following conditions are met: (a) the fund is widely held; (b) the filer neither exercises control over nor has the ability to exercise control over the financial interests held by the fund; and (c) the fund is publicly traded/available or widely diversified. 5 C.F.R. § 2634.310(c)(2).

Can a pooled investment fund qualify as an excepted investment fund? Yes. For example, many hedge funds do qualify as excepted investment funds. First, hedge funds often meet the "widely held" requirement. Generally, OGE's practice is to consider funds with more than 100 investors to be widely held. Second, the individual investors do not have control over nor have the ability to control the financial interests held by the fund. Finally, many such funds meet the "publicly available" prong of the last requirement listed above. As long as a pooled

investment fund meets the criteria of an excepted investment fund, a full-time PAS nominee who is invested in such a fund is not required to report the underlying holdings of the fund. Sometimes, however, pooled investment funds do not meet the criteria of an excepted investment fund.

If a pooled investment fund is not an excepted investment fund, a full-time PAS nominee who has an investment in one of these funds is faced with the task of reporting the underlying assets of the fund. As stated at the beginning of this DAEOgram, managers of pooled investment funds often do not reveal the underlying assets in the funds to their investors. The lack of knowledge of the underlying assets of a pooled investment fund does not excuse a filer from the statutory requirement.

The fact that the EIGA already contains exceptions for no-knowledge situations indicates that Congress knows how to provide for such exceptions when it intends to do so. For example, section 102(f)(2)(A) excuses a full-time PAS nominee from reporting assets that are held in a qualified blind trust created under the EIGA. A key feature of the qualified blind trust is that the full-time PAS nominee who creates the trust is prohibited from gaining knowledge of the assets which the independent trustee adds to the trust. In addition, section 102(f)(2)(B) excuses the nominee from reporting assets of a trust if neither he nor his spouse nor his dependent child created the trust and if they have no knowledge of the holdings or sources of income of the trust. If Congress had intended to provide an exception for the situation in which a manager of an investment fund does not disclose the underlying assets in the fund to investors, it could have done so.

II. QUALIFIED CERTIFICATION OF A REPORT

OGE recognizes that there may be situations involving investment vehicles like hedge funds where a full-time PAS nominee not only lacks knowledge of the underlying assets, but cannot obtain that information because fund mangers will not share it with any investors. A variation on this theme is where fund managers provide investors with only annual or quarterly statements. An annual or quarterly statement may not be a reliable indication of the assets in the fund at any times other than the time periods covered by the statements. Finally, OGE is aware of pooled investment funds that do disclose fund assets to each investor but require each investor to enter into a legally binding confidentiality agreement.

In short, these are situations either where it is impossible for a full-time PAS nominee to make the full disclosure required by section 102 or where disclosing the information required would breach a bona fide pre-existing confidentiality agreement and potentially subject the nominee to legal liability from fund managers or investors. While section 102 does not excuse the nominee of his or her obligation to disclose in any of these circumstances, the certification provisions of the EIGA in section 106 provide OGE with the ability to prescribe corrective action for the failure to disclose and to fashion remedies that, if implemented, will enable the Director to certify that a nominee is in compliance with applicable laws and regulations. The remedy in most cases will be divestiture of the undisclosed assets because the Director cannot

certify that the full-time PAS nominee has complied with the financial disclosure laws and regulations. Divestiture of the undisclosed assets must be accomplished within 90 days of confirmation or, if the terms and conditions of the investments do not permit divestiture within that period, during the first window provided by the terms of the fund following confirmation. In such circumstances, OGE can grant extensions to divest the interest. See 5 C.F.R. § 2634.802(b). It is imperative, however, that any known inability to divest within 90 days be identified before confirmation and incorporated into the nominee's ethics agreement. Providing this information prior to confirmation will help OGE ensure that the ethics agreement contains a realistic timeframe for divestiture.

In the case where the full-time PAS nominee does not know the identity of the assets in the fund, he or she must demonstrate, to OGE's satisfaction, the inability to obtain the required information. This requirement may be satisfied by submitting a letter from the fund manager stating that the fund does not disclose its underlying assets to investors and that the fund will not make an exception for the nominee. Where the nominee has signed a confidentiality agreement that bars him or her from disclosing the assets in the fund, OGE requires the nominee to establish that the confidentiality agreement was entered into before the nominee knew that he or she was being considered for a position in the executive branch and that the confidentiality agreement is applicable to a class of investors that includes the nominee. In both of these cases, OGE issues a qualified certification of the form. In its letter to the appropriate Senate committee, OGE notes that the report does not fully disclose all financial interests and that certification is contingent upon the full-time PAS nominee's divesting his or her interest in the fund. In addition, the form will reflect that the nominee did not disclose the underlying assets of a pooled investment fund and the reason for the non-disclosure.

OGE hopes that this DAEOgram answers any questions you may have had about reporting pooled investment funds on the public financial disclosure form. You should direct questions about a particular nominee's report to the OGE employee who has been assigned to review that report.