

UNITED STATES OFFICE OF
GOVERNMENT ETHICS



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LEGAL ADVISORY

TO: Designated Agency Ethics Officials

FROM: David J. Apol
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SUBJECT: Diversified and Sector Real Estate Funds (Exemption under 5 C.F.R. § 2640.201)

This Legal Advisory clarifies the applicability of certain regulatory exemptions issued by the U.S. Office of Government Ethics (OGE) under the authority of 18 U.S.C. § 208(b)(2) as applied to real estate investment funds. Specifically, this Legal Advisory addresses the distinctions between a diversified real estate fund and a sector real estate fund. In a 2000 legal advisory, OGE addressed the issue of how to determine whether a mutual fund is a diversified fund or a sector fund for purposes of the exemption at 5 C.F.R. § 2640.201. DO-00-030. The 2000 legal advisory did not draw a distinction that OGE now finds meaningful between funds focusing on real estate generally and funds focusing on real estate in a particular industry or country. DO-00-030. This Legal Advisory clarifies the 2000 guidance by identifying the circumstances in which real estate funds qualify as diversified funds that are eligible for the exemption at 5 C.F.R. § 2640.201(a) and those circumstances in which they qualify as sector funds eligible only for the narrower exemption at 5 C.F.R. § 2640.201(b).

I. Diversified and Sector Fund Exemptions under 18 U.S.C. § 208(b)(2)

Under 18 U.S.C. § 208(a), an employee is prohibited from participating in any particular matter in which the employee knows that the employee, or anyone whose interests are imputed to the employee, has a financial interest. Pursuant to its statutory authority under 18 U.S.C. § 208(b)(2), OGE has promulgated regulations exempting certain types of financial interests from the prohibition because OGE has determined that the interest is too remote or inconsequential to affect the integrity of services provided by federal government employees. Two of the exemptions apply to an employee's interest in funds registered under the Investment Company Act of 1940 and turn on the distinction between diversified and sector funds, as defined by 5 C.F.R. § 2640.102(a) and (q). *See* 5 C.F.R. § 2640.201.

In 2000, OGE issued guidance discussing the exemptions for diversified and sector funds contained in subpart B of part 2640. DO-00-030. That guidance noted that section 2640.201(a) provides a broad exemption for disqualifying financial interests that arise from the ownership of a diversified mutual fund. As defined in part 2640, "(d)iversified 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). Subpart B contains a more limited exemption for sector mutual funds. 5 C.F.R. § 2640.201(b).

The 2000 legal advisory acknowledged that it is sometimes difficult to distinguish between sector and diversified funds and provided guidance to agency officials on distinguishing between them. The distinction is made “by examining the degree of relatedness and overlapping interests and operations among the types of companies” in which a fund is invested. DO-00-030. OGE considers factors such as whether the companies share a common regulatory environment or whether a government decision affecting one type of company would also affect other companies in the fund. DO-00-030. The 2000 guidance also encouraged ethics officials to make “realistic conflict of interest” determinations and with a bit of common sense. DO-00-030.

II. Distinguishing Diversified Real Estate Funds and Sector Real Estate Funds

In 2000, the Legal Advisory contained a list of “Sector Fund Examples” based on OGE’s general experience. Real estate funds were included as sector funds. Since 2000, OGE has considered the conflicts issues associated with a wide variety of real estate funds held by employees of agencies across the executive branch. OGE has found that, although the funds often have a policy of investing in real estate, many of them invest in the real estate and the real estate companies located in a variety of geographic locations and serving a variety of industries. As is true with the holdings of diversified mutual funds, the real estate companies and the properties in many of these funds do not share a regulatory environment, and a single government decision is unlikely to impact most of the holdings of the fund, unless they are focused in a particular industry or country other than the United States. Consequently, even if an employee participates in a matter that affects a holding in a general real estate fund, it is likely that any such action would have only a diffuse or negligible effect on the employee’s interest in the fund as a whole.

Based on this understanding, OGE is refining its guidance regarding real estate funds because it has determined that without a focus on a particular industry or country, an employee’s financial interest in a general real estate mutual fund is too remote or inconsequential to affect the integrity of services provided by the employee. For example, a general real estate fund with a stated policy to track the MSCI US REIT Index, to be principally engaged in the real estate industry, or to pursue commercial real estate opportunities, without focusing on a specific industry or single country other than the United States, would be considered to be a diversified fund. However, if a real estate mutual fund’s stated policy is to focus on real estate in an industry such as “Healthcare” or “Hotels and Resorts,” or to focus on real estate in an individual country other than the United States, OGE would consider the fund to be a sector mutual fund. In that case, the fund would be eligible for the sector mutual fund exemptions, but would be ineligible for the diversified mutual fund exemption. 5 C.F.R. § 2640.201(a) and (b).

DAEOs should contact their OGE Desk Officers if they have any questions about whether a particular mutual fund would constitute a diversified or sector fund.