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Client Alert

Current Issues Relevant to Our Clients

February 26, 2015

SEC Guidance on Gifts and Entertainment Received by Registered Fund Affiliates and Employees

The staff of the Securities and Exchange Commission ("SEC") recently issued guidance to remind affiliates of registered investment companies that the receipt of gifts or entertainment may violate Section 17(e)(1) of the Investment Company Act of 1940 (the "1940 Act"). Among others, registered investment company investment advisers, depositors and their officers, directors and employees are considered affiliates of a fund and therefore may trigger the prohibition in Section 17(e)(1). The SEC staff guidance also notes that fund compliance policies and procedures should include provisions to address this issue.

The Section 17(e)(1) Prohibition

Section 17(e)(1) generally prohibits affiliated persons of a registered investment company from accepting any compensation (other than salary or wages paid by the investment company) for the purchase or sale of any property to or for the fund if the affiliated person is acting as agent for the fund, except in the course of such person's business as an underwriter or broker. The SEC has previously found that gifts and entertainment meet the broad definition of "compensation" under Section 17(e)(1). The SEC staff also noted that the mere receipt of compensation for the purchase or sale of property to or for a fund is a violation of Section 17(e)(1); it is not necessary to show that the person receiving the compensation influenced the actions of the fund, or that the fund suffered economic injury in order to find a violation.

Who Can Trigger the Prohibition?

The Section 17(e)(1) prohibition applies to "affiliated persons" of a fund and to affiliated persons of such affiliated persons (*i.e.*, second-tier affiliates). An investment adviser of a fund is an affiliated person of the fund for this purpose. In addition, an investment adviser's officers, directors, partners and employees are affiliated persons of the investment adviser and are second-tier affiliates of a fund subject to the prohibition. Although the SEC staff did not specifically address unit investment trusts (*"UITs"*) in its guidance, the depositor of a UIT is an affiliated person of the UIT, and the depositor's officers, directors, partners and employees are second-tier affiliates of the UIT. As a result, acceptance of gifts or entertainment by these persons could also violate Section 17(e)(1).

When Does the Prohibition Apply?

The Section 17(e)(1) prohibition generally applies whenever an affiliated person or a second-tier affiliate is acting as agent for a registered investment company. This prohibition is very broad and the guidance notes that an affiliated person is deemed to be acting as agent for a fund in all cases when the person is not acting as broker for the fund. For example, if an employee of a fund's investment adviser receives any gift or entertainment from a broker-dealer for the purchase or sale of the fund's portfolio securities, the guidance provides that the employee has violated Section 17(e)(1).

Compliance Policies and Procedures

The SEC staff noted that the receipt of gifts or entertainment by fund affiliates should be addressed by the funds' compliance policies and procedures, which are required by Rule 38a-1 under the 1940 Act. The 1940 Act rule also requires fund boards, principal underwriters or depositors to approve the policies and procedures of fund service providers, including investment advisers, and requires that the fund's compliance policies and procedures include provisions for fund compliance oversight of its service providers. The content of a fund's policies and procedures concerning the receipt of gifts or entertainment will depend on the nature of the entity's business, among other considerations. The SEC staff suggested that some funds may adopt a blanket prohibition on gifts and entertainment, while others may wish to adopt a pre-clearance mechanism for assessing whether such gifts and entertainment would violate Section 17(e)(1).

Other Prohibitions

The SEC staff noted separately that the Investment Advisers Act of 1940 (the *"Advisers Act"*) requires SEC-registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser or any of its supervised persons. The Advisers Act also provides for the imposition of sanctions on an investment adviser or persons associated with the adviser for failing to reasonably supervise other persons under their supervision from violating the Advisers Act or the 1940 Act.

Firms registered with the Financial Industry Regulatory Authority, Inc. (*"FINRA"*) are also subject to rules similar to Section 17(e)(1), such as FINRA Rule 3220, NASD Rule 2830 and other FINRA rules. While certain FINRA rules could apply in the same situations as Section 17(e)(1), the SEC staff noted that the prohibition in Section 17(e)(1) is broader than the provisions in FINRA rules concerning gifts and gratuities and non-cash compensation for broker-dealers. Policies and procedures designed to address those rules may not address the complete scope of Section 17(e)(1).

For More Information

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