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global fiduciary insights

PRUDENT PRACTICES *for* INVESTMENT

ADVISORS

Defining a Global Fiduciary Standard of Excellence

For professionals who provide investment advice, including financial advisors, broker-consultants, investment consultants, wealth managers, financial consultants, trust officers, financial planners, and fiduciary advisers.

WRITTEN BY
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AICPA EDITORIAL STATEMENT TO READERS

The Personal Financial Planning (PFP) Division of the American Institute of Certified Public Accountants (AICPA) has served as the technical editor for the "Prudent Practices for Investment Advisors (U.S. Edition)" handbook. The AICPA's participation in the development of the handbook is intended to promote and protect the interests of the consumer public and to perpetuate the delivery of competent and objective investment advice.

This handbook was developed specifically for Investment Advisors – those who provide personalized investment advice or exercise investment discretion – including financial advisors, broker - consultants, investment consultants, wealth managers, financial consultants, trust officers, financial planners, and all other fiduciary advisors.

This handbook will serve as a foundation for prudent investment fiduciary practices. It provides investment fiduciaries with an organized process for making informed and consistent decisions. Fiduciaries must, however, exercise professional judgment when applying these Practices, consulting legal counsel and other authorities when appropriate.

The investment practices and criteria contained within this handbook have been reviewed in detail by the Fiduciary Task Force of the AICPA's Personal Financial Planning Executive Committee. The Executive Committee has reviewed the work of the Task Force and approves their conclusions. Even with this level of review, this handbook is not authoritative literature for AICPA members or CPAs in practice. The AICPA's participation is solely in the capacity of technical editor.

Although this handbook primarily focuses on the many legal requirements of investment fiduciaries, which includes giving consideration to the Investment Advisers Act of 1940, Employee Retirement Income Securities Act (ERISA), Uniform Prudent Investor Act (UPIA), Uniform Prudent Management of Institutional Funds Act, and Uniform Management of Public Employee Retirement Systems Act (UMPERSA), Investment Advisors must become familiar, and comply, with all other federal and state laws applicable to the fiduciary's particular field of practice. This includes the rules and restrictions imposed by regulatory bodies such as the Securities and Exchange Commission, Department of Labor/ERISA, the Internal Revenue Service, etc.

We gratefully acknowledge the invaluable contributions of the many CPAs who were instrumental in the review of the handbook. The PFP Division would also like to acknowledge the special efforts of Clark M. Blackman II, CPA/PFS, CFA, AIF®, CIMA, CFP®, Ken A. Dodson, CPA/PFS, Joel Framson, CPA/PFS, CFP®, MBT, Stewart Frank, CPA/PFS, AIFA®, Charles R. Kowal, JD, CPA, and Scott K. Sprinkle, CPA/PFS, CGMA, CFP®.

The AICPA is the world's largest association representing the accounting profession, with nearly 377,000 members in 128 countries and a 125 year heritage. AICPA members represent many areas of practice, including business and industry, public practice, government, education and consulting.

FOR MORE INFORMATION ABOUT THE AICPA PFP DIVISION, VISIT ITS WEB SITE AT WWW.AICPA.ORG/PFP.

PRUDENT PRACTICES *for* INVESTMENT

ADVISORS

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STEP 1 : ORGANIZE

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The Investment Advisor demonstrates an awareness of fiduciary duties and responsibilities.

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Practice A-2.2 39
An appropriate risk level has been identified for each client.

Practice A-2.3 41
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Practice A-2.4 43
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Practice A-2.5 45
Selected asset classes are consistent with implementation and monitoring constraints.

Practice A-2.6 47
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Practice A-4.5 81
There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

LEGAL LIMITATIONS OF THE HANDBOOK

The fiduciary practices described in this handbook are intended to address many of the legal and ethical requirements applicable to Investment Advisors. In addition to these requirements, an Advisor also must become familiar, and comply, with all other laws and regulations applicable to the Advisor's particular field of practice in individual countries.

This handbook is not intended to be used as a compliance manual or as a source of legal advice. The Investment Advisor should discuss the topics with legal counsel knowledgeable in this specific area of the law in the country or countries involved. References to national laws and/or regulations are provided merely as a general guide. Nor is this handbook intended to represent specific investment advice.

This handbook will not address: (1) financial, actuarial, tax, or recordkeeping issues; (2) valuation issues, including the valuation of closely held stock, limited partnerships, hard assets, insurance contracts, blind investment pools, or alternative investments such as hedge funds; or (3) risk management issues, such as the use of derivative or synthetic financial instruments.

ABOUT THIS PUBLICATION

This publication is part of a series of fiduciary handbooks published by fi360 to define Global Fiduciary Standards of Excellence.

THE HANDBOOKS ARE DESIGNED TO BE REFERENCE GUIDES FOR KNOWLEDGEABLE INVESTMENT PROFESSIONALS AND INVESTORS WHO SERVE IN A FIDUCIARY CAPACITY, ALSO KNOWN AS "INVESTMENT FIDUCIARIES."

The handbooks are not "how to" manuals for beginners who are not familiar with basic investment management procedures.

To the right is a summary of the *Prudent Practices* handbook series.

The handbooks for Investment Stewards and Advisors are country specific and include full substantiation by local statutes, case law, regulations, and/or regulatory guidance, which are detailed in a corresponding *Legal Memoranda* handbook. fi360 has developed editions in the United States, Australia, Canada, and New Zealand. The Investment Managers handbook is a worldwide edition that is substantiated by professional best practices.

PRUDENT PRACTICES FOR INVESTMENT STEWARDS

Fiduciary practices for persons who have the legal responsibility for managing investment decisions, such as trustees and investment committee members.

PRUDENT PRACTICES FOR INVESTMENT ADVISORS

Fiduciary practices for professionals who provide investment advice, including wealth managers, financial advisors, trust officers, investment consultants, financial consultants, financial planners, and fiduciary advisers.

LEGAL MEMORANDA

Legal substantiation, based on statutes, case law, regulations and regulatory guidance, for all of the Practices defined for Investment Stewards and Investment Advisors.

PRUDENT PRACTICES FOR INVESTMENT MANAGERS

Fiduciary practices for professionals who have discretion to select specific securities for separate accounts, mutual or exchange-traded funds, commingled trusts, and unit trusts.

ABOUT fi360, THE CENTER FOR FIDUCIARY STUDIES, AND CEFEX

fi360

is the leading fiduciary training and resources organization in the United States. Its mission is to promote a culture of investment fiduciary responsibility and improve fiduciary decision-making through education, technology, knowledge, support, and leadership.

The Center for Fiduciary Studies

The Center for Fiduciary Studies is the standards-setting body for fi360 and is supported by a team of experienced investment practitioners, attorneys, educators, and other professionals. The Center for Fiduciary Studies develops and maintains the Prudent Practices defined in this handbook and awards the Accredited Investment Fiduciary® (AIF®) and Accredited Investment Fiduciary Analyst® (AIFA®) designations. The professional designations demonstrate a focus on all the components of a comprehensive investment process, the fiduciary standard of care, and a commitment to excellence.

Based on the work of the Center for Fiduciary Studies, fi360 offers the AIF and AIFA Designation Training programs and other fiduciary training programs. fi360 also develops sophisticated fiduciary management online tools for investment professionals that provide more efficient and effective implementation of the Prudent Practices. In addition to training, designations, and tools, fi360 offers a host of fiduciary resources including a blog, webinars, annual conference, and public advocacy for laws that promote greater transparency and accountability in the investment industry.

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CEFEX

fi360 is also a founding member of Centre for Fiduciary Excellence, LLC ("CEFEX"). CEFEX is an independent global assessment and certification organization dedicated to assisting investment stewards, advisors, investment managers, and financial service companies in applying the highest standards of fiduciary excellence in their investment management, governance, and operational processes. Many retirement plans, endowments, foundations, benefit plan administrators, investment managers, investment advisors, and trust companies engage AIFA Designees to help them earn CEFEX Certification, a formal, independent recognition demonstrating trustworthiness to plan participants, donors and the general investing public. In partnership with the American Society for Pension Professionals and Actuaries (ASPPA), CEFEX also offers assessments and certification of record-keeping and administrative organizations.

As an assessment and certification organization, CEFEX defines formal procedures to assess whether an investment fiduciary, or an organization providing services to an investment fiduciary, is in conformance with defined practices. An entry-level verification is a first-party assessment, referred to as a Self-Assessment of Fiduciary Excellence, or SAFE. The higher level of verification can be achieved through a review by a consultant, referred to as a Consultant's Review of Fiduciary Practices, or CRFP. And as discussed above, CEFEX offer a formal independent assessment that is performed by an AIFA Designee, referred to as the CEFEX Assessment of Fiduciary Excellence, or CAFE.

TO LEARN MORE ABOUT CEFEX,
VISIT WWW.CEFEX.ORG.

fi360 and CEFEX provide SAFE, CRFP, and CAFE working documents that correspond with each of the handbooks to assist with all of these levels of review and assessment.

THE ROLE OF INVESTMENT FIDUCIARIES

"Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."

Meinhard v. Salmon, 249 N.Y. 458, 464 (1928) (Cardozo).

The vast majority of the world's liquid investable wealth is in the hands of investment fiduciaries, and the success or failure of investment fiduciaries can have a material impact on the fiscal health of any country.

The timeless principles that underlie the fiduciary standard, such as loyalty and care, provide the basis for trustworthy conduct by those who are entrusted with other peoples' money. Fiduciary laws and regulations serve to define the details of prudent investment processes. Those prudent processes make adherence to the core fiduciary principles practical and reliable.

This handbook captures Practices to guide investment fiduciaries as they strive to fulfill their fiduciary obligations. By following a structured process based on the Practices, the fiduciary can be confident that critical components of an investment strategy are properly implemented and followed.

In this handbook, we define an investment fiduciary as someone who is providing investment advice or managing the assets of another person and stands in a special relationship of trust, confidence, and/or legal responsibility.

INVESTMENT FIDUCIARIES CAN BE DIVIDED GENERALLY INTO THREE GROUPS: INVESTMENT STEWARD, INVESTMENT ADVISOR, AND INVESTMENT MANAGER.

- An **Investment Steward** is a person who has the legal responsibility for managing investment decisions, including plan sponsors, trustees, and investment committee members.
- An **Investment Advisor** is a professional who is responsible for providing investment advice and/or managing investment decisions. Investment Advisors include wealth managers, financial advisors, trust officers, financial consultants, investment consultants, financial planners, and fiduciary advisers.
- An **Investment Manager** is a professional who has discretion to select specific securities for separate accounts, mutual and exchange-traded funds, commingled trusts, and unit trusts.

THE TERMS "ADVISER" AND "ADVISOR" ARE USED FOR DIFFERENT PURPOSES THROUGHOUT THIS PUBLICATION.

"Adviser," *as in "fiduciary adviser" or "investment adviser," is a reference to the legal terms defined by the 2006 Pension Protection Act and the Investment Advisers Act of 1940 and state securities laws. A "registered investment adviser" refers to a firm registered with the SEC or a state, even if it is a sole proprietor.*

"Advisor," *as used by fi360 throughout its materials, refers to the professional who is providing investment advice.*

THE NEED FOR A GLOBAL FIDUCIARY STANDARD OF EXCELLENCE

Investment Advisors are looking for universally accepted standards of practice to aid them in the performance of their fiduciary duties.

Adherence to a standard can be the foundation for the trust placed in Advisors by their clients, whether individuals or institutional investors.

Standards of excellence offer a consistency of interpretation and implementation, which facilitates the transfer of knowledge between the Advisor, clients, vendors, and regulators.

"We cannot say that [Defendant] was imprudent merely because the Balanced Fund lost money; such a pronouncement would convert the Balanced Fund into an account with a guaranteed return and would immunize plaintiffs from assuming any of the risk of loss associated with their investment. 'The fiduciary duty of care,' as the district court so cogently stated it, 'requires prudence, not prescience.'"

Debruyne v. Equitable Life Assurance Society of the United States, 920 F.2d 457, 465 (7th Cir. 1990) (Wood).

The legal and performance pressures endured by Investment Advisors are tremendous, and come from multiple directions and for various reasons. Complaints and/or lawsuits alleging fiduciary misconduct are likely to increase. However, contrary to widespread belief, fiduciary liability is not determined by investment performance, but in whether a prudent process was followed.

In that regard, a fiduciary often will confuse responsibility with liability. An Investment Advisor to a pension plan or trust, for example, can never delegate away fiduciary responsibility. Fiduciary duties can be shared with other "co-fiduciaries," such as Investment Managers, but can never be handed over completely to another party.

Although the Investment Advisor remains responsible as a fiduciary, the Advisor can substantially mitigate the risk of liability by following prudent investment practices.

Investment products and strategies are never inherently prudent or imprudent. The propriety of a fiduciary's actions is determined largely by evidence of procedural prudence—the extent to which the fiduciary assembled, evaluated, and acted upon pertinent information in a manner consistent with generally accepted investment theories. In fact, both case law and regulatory guidance suggest that fiduciaries are permitted considerable latitude in providing investment advice or making investment decisions when they can show they engaged in a prudent process. Thus, while even the most aggressive and unconventional investment can meet the standard if arrived at through a sound process, the most conservative and traditional product may be inappropriate if a sound process was not implemented.

"I know of no case in which a trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments ... has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand. Similarly, I know of no case in which a trustee who has made (or held) patently unsound investments has been excused from liability because his objectively imprudent action was preceded by careful investigation and evaluation. In short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently."

Fink v. National Savings and Trust Co., 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia concurring in part and dissenting in part).

It is important to note, however, that procedural prudence alone does not complete a fiduciary's obligations. Investments must be aligned with the cash flow requirements and investment objectives of the client. Thus, it would be objectively imprudent for a fiduciary to select or recommend investments or an investment strategy that would prevent the client's objectives and requirements from being achieved.

FOR THE ADVISOR, THE KEY BENEFITS ASSOCIATED WITH APPLYING THE PRUDENT PRACTICES OUTLINED IN THIS HANDBOOK INCLUDE:

① **Risk management:** Most investment litigation involves the alleged omission of certain fiduciary practices and/or prudent investment procedures, as opposed to the commission of certain acts. This handbook incorporates a "checklist" process to help the Investment Advisor ensure that investment decisions are prudently managed.

② **Distinction as a fiduciary specialist:** As much as 80 percent of the nation's liquid, investable wealth is managed by trustees and investment committees. Investment Advisors who desire to set themselves apart as leading professionals in their field should be able to demonstrate fiduciary skills, knowledge, and investment expertise as well as a sophisticated understanding of the law in order to attract and retain key clients.

③ **Competitive advantage:** "Fiduciary responsibility" has become the watchword with trustees, investment committee members, and even retail investors. Investment Advisors who can communicate clearly how they manage investment decisions to a defined fiduciary standard of excellence may enjoy a major advantage over competitors.

④ **Increased efficiency and effectiveness:** An Investment Advisor is expected to apply the skill, knowledge, diligence and good judgment of a professional. The Practices provide a consistent framework to help the Advisor not only achieve regulatory compliance but adopt best professional practices for sound portfolio management. By implementing a comprehensive process to fulfill fiduciary obligations the Advisor can establish a regimented business model that is specifically designed to serve the best interests of investors.

This handbook defines a Global Fiduciary Standard of Excellence for Investment Advisors as established by the Prudent Practices ("Practices"). The Practices provide the foundation and framework for a disciplined investment process and generally represent the minimum process prescribed by US law and legal precedent. The Practices are further supported by Criteria, which represent the details of the Global Fiduciary Standard of Excellence.

COMPONENTS OF A STANDARD

THE PRACTICES AND CRITERIA ARE ORGANIZED UNDER A FOUR-STEP FIDUCIARY QUALITY MANAGEMENT SYSTEM.

The steps are consistent with the global ISO 9000 Quality Management System standard, which emphasizes continual improvement to a decision-making process:

Step 1 : Organize

During the organize stage, the investment fiduciary identifies laws, governing documents, and other sources of guidance for fiduciary conduct.

Step 2 : Formalize

During the formalize stage, the investment fiduciary identifies the substantive investment objectives and constraints, formulates asset allocation strategies, and adopts an investment policy statement to guide the investment decision-making process.

Step 3 : Implement

The implement stage is when investment and service provider due diligence is performed and decisions about investment safe harbors are made.

Step 4 : Monitor

During the monitoring stage, the investment fiduciary engages in periodic reviews to ensure that the investment objectives and constraints are being met and that the Prudent Practices are consistently applied.

The Prudent Practices for Investment Advisors set forth in this handbook are similar to the Practices that have been defined for Investment Stewards, as one of the primary roles of the Advisor is to help their Steward clients manage their own fiduciary roles and responsibilities as investment fiduciaries.

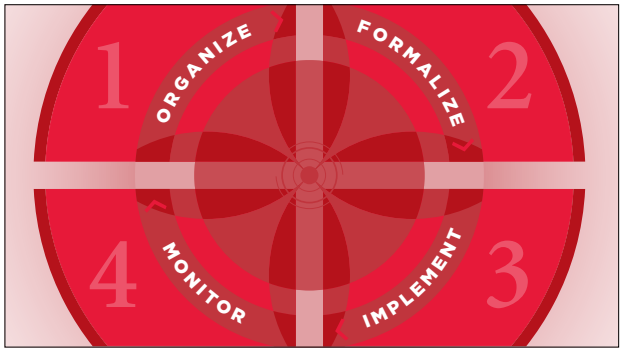
Investment Managers, on the other hand, have a unique role and an additional a separate set of Practices that have been defined for evaluating whether an Investment Manager is worthy of a fiduciary mandate.

THE PRACTICES ARE EASILY ADAPTABLE TO ALL TYPES OF PORTFOLIOS, REGARDLESS OF SIZE OR INTENDED USE, AND SHOULD HELP ACCOMPLISH THE FOLLOWING:

- Establish evidence that the Advisor is following a prudent investment process
- Serve all parties involved with investment decisions (Investment Stewards, Advisors, Managers, accountants, and attorneys), and provide an excellent educational outline of the duties and responsibilities of Investment Advisors
- Potentially increase long-term investment performance by identifying appropriate procedures for:
  - Diversifying the portfolio across multiple asset classes and peer groups
  - Controlling investment management fees and expenses
  - Selecting Investment Managers
  - Terminating Investment Managers who are no longer appropriate
- Uncover investment and/or procedural risks not previously identified, which may assist in prioritizing investment management activities
- Encourage Advisors to compare their practices and procedures with those of their peers
- Assist in establishing benchmarks to measure the performance of the Investment Advisor

FIDUCIARY QUALITY MANAGEMENT SYSTEM

(Analogous to the ISO 9000 QMS Continual Improvement Process)



LEGAL SUBSTANTIATION OF PRACTICES

Each Practice is backed by legal substantiation based on statutes, case law, regulations, and regulatory guidance. The major statutes and supporting law that are covered by the substantiation include:

- **ERISA** – The Employee Retirement Income Security Act of 1974, a federal law that impacts fiduciary responsibilities related to qualified retirement plans. Requirements under ERISA for qualified retirement plans are administered by the Department of Labor's Employee Benefits Security Administration, which issues regulations and regulatory guidance that further governs fiduciary obligations.
- **IAA** – The Investment Advisers Act of 1940, a federal securities law that governs the regulation of investment advisers and their fiduciary responsibilities. The IAA is administered by the Securities and Exchange Commission (SEC), which issues regulations and regulatory guidance affecting investment advisers and their fiduciary responsibilities. State statutes similar to the IAA are typically administered by individual state securities commissioners.

The following three laws are uniform acts developed and proposed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) for states to consider for adoption. To identify whether a state has adopted the model act, please visit NCCUSL's website (uniformlaws.org). If a particular state is not identified as having adopted the model act, then the Advisor should seek guidance from qualified legal counsel on the fiduciary standard of care that is applicable to that particular state, and whether any of the fiduciary practices covered in this handbook are not applicable.

- **UPIA** – Uniform Prudent Investor Act, a widely-adopted state law that covers fiduciary responsibilities related to private trusts. The UPIA was released in 1994 and subsequently endorsed by the American Bar Association and American Bankers Association. More than 40 states and the District of Columbia generally have adopted the model law, although differences may exist from state to state. The UPIA serves as a default standard for investment activities of private trusts. Typically, the provisions of a private trust prevail. However, if a trust document is silent regarding a particular fiduciary duty, such as the duty to diversify, then the provisions of the UPIA apply.
- **UPMIFA** – Uniform Prudent Management of Institutional Funds Act, a state law that impacts foundations, endowments, and government sponsored charitable organizations. UPMIFA was released in July 2006 and has been adopted by most states and the District of Columbia.
- **UMPERSA** – Uniform Management of Public Employee Retirement Systems Act, a model state law that impacts state, county, and municipal retirement plans. UMPERSA was released in 1997 and may apply to state, county, and municipal retirement plans. At the date of publishing, Maryland and Wyoming are the only states that have formally adopted the act.

GLOBAL FIDUCIARY PRECEPTS

If an Investment Advisor were to read all of the laws defining fiduciary obligations, the Advisor would discover seven common requirements.

WE HAVE ADOPTED THESE SEVEN REQUIREMENTS AS "GLOBAL FIDUCIARY PRECEPTS":

① Know standards, laws, and trust provisions
② Diversify assets to specific risk/return profile of client
③ Prepare investment policy statement
④ Use "prudent experts" (for example, an Investment Manager) and document due diligence
⑤ Control and account for investment expenses
⑥ Monitor the activities of "prudent experts"
⑦ Avoid prohibited transactions and avoid or manage other conflicts of interest in favor of the client

We suggest that the Investment Advisor utilize the seven Global Fiduciary Precepts, as these represent the best probing questions an Advisor could ask at the onset of a client engagement:

- What laws and governing documents apply to guide your decision-making processes?
- How was the portfolio's current asset allocation determined?
- Is there an IPS? When was the last time it was updated?
- What type of due diligence was performed on the investment allocations that currently exist in the portfolio, or other available investment options?
- Are you sure the fees and expenses paid pay to investment managers and other service providers are fair and reasonable?
- What type of periodic monitoring is applied to the portfolio?
- Does the client understand that not all service providers are required to serve its best interests? How are conflicts of interest being resolved in the client's favor?

This handbook will further explore the Advisor's fiduciary responsibilities under the Global Fiduciary Precepts and in the context of the Practices and Criteria.

PROMOTING A FIDUCIARY CULTURE

"An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care."

SEC Study on Investment Advisers and Broker-Dealers, January 2011[1]

The concept of serving as a fiduciary is not new. In fact, centuries of law and business demonstrate that the concepts of trust and expert service underlying fiduciary relationships have a long history within many different societies.[2]

Historians have traced the roots of fiduciary principles back to Babylon and the Code of Hammurabi (ca. 1790 BC), which established one of the first written codes of law and set forth the rules governing the behavior of agents entrusted with property.[3] In the Judeo-Christian tradition, fiduciary principles can be traced to the biblical principle that no person can serve two masters.[4]

Chinese historical texts also recognize fiduciary principles of trust and loyalty. One of the three basic questions of self-examination attributed to Confucius (551 BC—479 BC) asks: "In acting on behalf of others, have I always been loyal to their interests?"[5] Aristotle (384 BC—322 BC) consistently recognized that in economics and business, people must be bound by high obligations of loyalty, honesty, and fairness and that society suffers when such obligations are not required.[6]

The Romans refined and formalized fiduciary law even further. Cicero (103 BC—46 BC) noted the relationship of trust between an agent and principal, and emphasized that an agent who shows carelessness behaves very dishonorably and undermines the basis of the social system.[7]

Fiduciary relationships also have appeared in Anglo-American law for over 250 years.[8] Courts of Equity were the first to grant relief in numerous circumstances involving one person's abuse of confidence and fiduciary principles developed over time.[9]

Under U.S. law, in the seminal opinion given in *Meinhard v. Salmon*, Justice Benjamin Cardozo eloquently articulated the fiduciary standard when he wrote: "Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[10] And finally, as demonstrated throughout this handbook, although fiduciary principles were first applied in U.S. common law, many elements of the fiduciary standard have been codified in both federal and state statutes.

The importance attached by various societies' views to relationships of trust in certain business arrangements reveals that concepts of fiduciary responsibility were established in primitive law and have withstood the test of time.[11] That significant extensive history should speak to the timeless gravity of an investment fiduciary's responsibilities, as well as the strength of the ethical standards to which fiduciaries are held.

PROMOTING A FIDUCIARY CULTURE

Investment Stewards, Investment Advisors and Investment Managers who do not foster and promote a culture of fiduciary responsibility are going to lack the sensitivity and awareness to identify the fiduciary breaches of others. When a fiduciary fails to address his or her conflicts of interest, then that fiduciary will be marginalized at best; corrupted at worst.

"Society depends upon professionals to provide reliable, fixed standards in situations where the facts are murky or the temptations too strong. Their principal contribution is an ability to bring sound judgment to bear on these situations. They represent the best a particular community is able to muster in response to new challenges."

Dr. Robert Kennedy, University of St. Thomas

Investment fiduciaries are challenged by the need to foster a culture of fiduciary responsibility and professionalism that is defined by reliable principles established in law. The management of investment decisions is not an easy task, even for trained investment professionals; and it is a nearly impossible task for lay persons who serve as trustees and investment committee members of retirement plans, foundations, endowments, and trusts. And because Investment Advisors, Investment Stewards, and Investment Managers rely on various service providers for assistance in managing their diverse roles and responsibilities, it is important to foster and promote a culture of fiduciary responsibility with all involved parties.

[1] Study Regarding Obligations of Brokers, Dealer and Investment Advisers, Exchange Act Release No. 62, 577, 75 Fed. Reg. 44,996 (July 30, 2010).

[2] Blaine F. Aikin & Kristina A. Fausti, *Fiduciary: A Historically Significant Standard*, Review of Banking and Financial Law, Boston University School of Law, Vol. 30, 155 (2010-2011)

[3] Joseph F. Johnston, Jr., *Natural Law and the Fiduciary Duties of Business Managers*, 8 J. MKTS & MORALITY 27, 29 (2005).

[4] Johnston, supra note 2.

[5] Johnston, supra note 2.

[6] James O'Toole, *Advice from Aristotle*, http://www.scu.edu/ethics/publications/submitted/otoole/business-ethics-aristotle.html.

[7] Johnson, supra; Marcus Tullius Cicero, THE ORATION FOR SEXTUS ROSCIUS OF AMERIA (Charles Duke Yonge, trans., London, G. Bell and Sons, 1916), *available at* http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=570&chapter=87171&layout=html&Itemid=27.

[8] Robert Cooter & Bradley Freeman, *An Economic Model of the Fiduciary's Duty of Loyalty*, 297 Tel AVIV UNIV. STUD. L. 297, 298 (1990) (citing Keech v. Sanford (1726), Sel. Cas T. King 61; 25 E.R. 223), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1055&context=robert_cooter).

[9] Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880 (Nov. 1988) (citing Sealy, Fiduciary Relationships, 1962 CAMBRIDGE L.J. 69, 69-72).

[10] Meinhard v. Salmon, 164 N.E. 545, at 546 (N.Y. 1928) (citation omitted).

[11] Aikin & Fausti, supra note 1.

Step 1 is the First of Four Steps Employed in the Global Fiduciary Standard of Excellence for Investment Advisors

PRUDENT PRACTICES *for* INVESTMENT ADVISORS

STEP 1

STEP 1 : INTRODUCTION

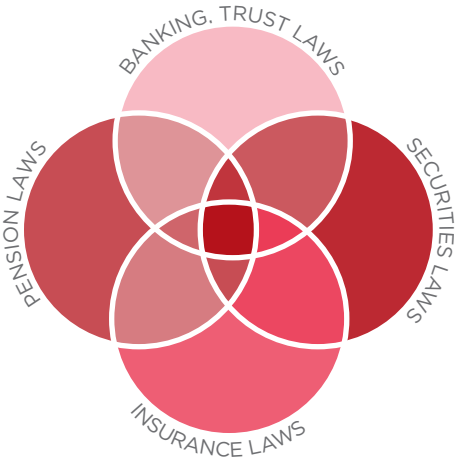
The first step in the Global Fiduciary Standard of Excellence for Investment Advisors is to organize your approach to each client engagement.

The starting point is not too dissimilar to running a business: You need to identify your market, be familiar with the laws affecting your industry, know what resources will be available – capital and people, and assess what constraints will affect your business. That last part – more specifically, the legal and compliance requirements underlying a fiduciary environment within your business – is the focus of this step.

One way of looking at the fiduciary space is by examining the major federal and state financial services laws governing the activities of investment fiduciaries. Although the various financial service providers engage in distinct activities are regulated by different government authorities, they all engage in some services that are subject to the fiduciary standard.

THE DIAGRAM BELOW ILLUSTRATES HOW, DEPENDING ON THE FIDUCIARY SERVICES BEING OFFERED BY THE ADVISOR, VARIOUS FINANCIAL SERVICES LAWS MAY GOVERN THOSE ACTIVITIES.

Overlap of fiduciary services in financial laws



Although banking laws are beyond the scope of this handbook, their regulators typically maintain strict guidelines for investment fiduciaries in the trust departments. SEC and state securities rules have fewer specific guidelines, but generally more robust requirements for disclosure of conflicts. Trust services are typically provided by banks, credit unions, and independent trust companies, although asset management services to a trust may be delegated outside of the bank's trust department to broker-dealers or investment advisors. Credit unions, however, must use a 'shared employee' of an investment advisor or broker-dealer to provide investment advice, or outsource that activity.

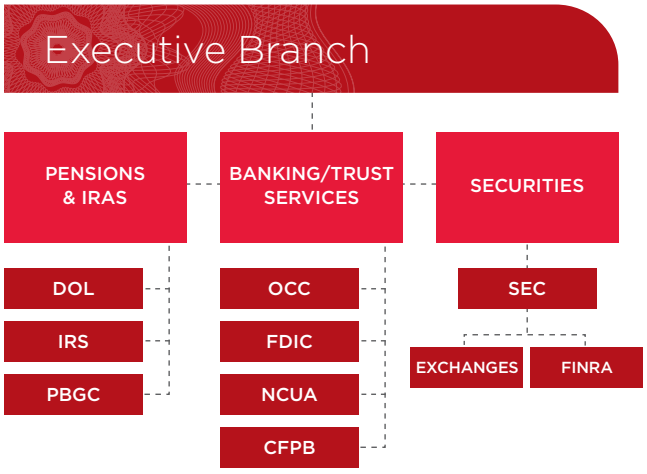
The overlap of fiduciary responsibilities is especially noteworthy when it comes to managing the assets in retirement plans. By law, professionals registered under banking, securities, or insurance laws may provide advice on retirement accounts, or sell related services or products to qualified plans. Insurance agents may be deemed fiduciaries under ERISA for certain activities, although they otherwise are not subject to a fiduciary duty in selling products such as life insurance and annuities to individuals outside of the pension plan. Similarly, securities brokers may be deemed ERISA fiduciaries for their investment advice and, depending on the scope of the individual client relationship, investment fiduciaries under securities law. Investment adviser firms, in contrast, are always subject to a fiduciary duty under the IAA, whether it involves an ERISA plan or individual retail clients.

At first glance, then, the need to understand the scope of an Investment Advisor's fiduciary responsibilities may seem daunting, but as you apply the Prudent Practices in this handbook as standard operating procedures, your awareness of your fiduciary roles will come into greater focus.

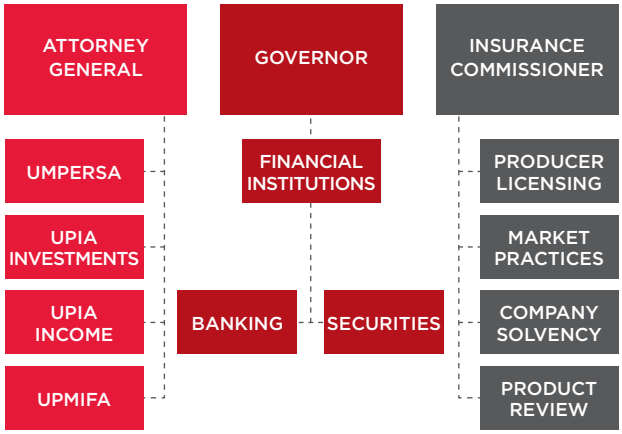
THE ORGANIZATION CHARTS BELOW DEPICT, FIRST, THE STRUCTURE OF FEDERAL OVERSIGHT OF INVESTMENT FIDUCIARY ACTIVITIES AND, SECOND, THE TYPICAL STATE OVERSIGHT STRUCTURE.

Note that federal oversight covers three of the four areas of law discussed above; namely, pension law, banking and trust law, and securities law. State oversight covers insurance law as well as aspects of the other three areas of law when the states have jurisdiction as a result of state law or, as in the case of the regulation of smaller investment advisers, when oversight has been delegated by Congress. There is considerable variation in the oversight structure that exists across the 50 states, which is why the stat- level chart is labeled as a "representative example."

FEDERAL OVERSIGHT



STATE OVERSIGHT



STEP 1 : ORGANIZE

ORGANIZE

PRACTICE 1.1

The Investment Advisor demonstrates an awareness of fiduciary duties and responsibilities.

CRITERIA

1.1.1 The Investment Advisor complies with all fiduciary laws and rules that apply to the Advisor's services.

1.1.2 The Investment Advisor complies with all applicable Practices and procedures defined in this Prudent Practices handbook.

1.1.3 The Investment Advisor adheres to the professional standards of conduct and codes(s) of ethics required by law, regulation, their firm and all applicable organizations in which they are a member.

Twin Duties of Loyalty and Care

A fiduciary standard generally establishes baseline obligations of loyalty and care to the client that provides an important overlay to the laws, regulations, and legal agreements that govern a client relationship. These fiduciary obligations are not just nebulous concepts, but broad duties that translate into practical and often specific requirements to be undertaken by the Investment Advisor.

A fiduciary duty, by virtue of being a broad standard of conduct under the law, is also a 'gap filler' when a client agreement, service contract, or the law is silent on a specific conflict or issue. The fiduciary duty of loyalty, for example, generally requires the Investment Advisor to avoid or manage conflicts in the best interest of the client, particularly if compensation received by the Advisor varies based upon different recommendations the Advisor may make.

A duty of care generally requires the Advisor, among other duties, to implement investment recommendations and diligently manage assets in the best interest of the client, including prudent selection and monitoring of investments and service providers.

Fiduciary Status under Law

Fiduciary status is sometimes difficult to determine, but not in the case of registered investment advisers—they are fiduciaries under common law and in interpretive guidance provided by the Securities and Exchange Commission and state securities administrators.

Securities brokers may be held to a fiduciary standard under case law when clearly acting in a position of trust or confidence on behalf of the client, or managing assets on a discretionary basis. However, when Congress enacted sweeping changes to financial services laws in 2010, in a reform law commonly known as the Dodd-Frank Act, the SEC was given the authority to impose a fiduciary standard on securities brokers providing personalized investment advice.[1]

With regard to insurance agents, Congress traditionally has deferred market regulation of insurance producers to the states. Producers selling all lines of insurance are generally not held to a fiduciary standard of care in the sale of 'pure' insurance products, although hybrid securities products such as variable annuities may eventually come under an SEC fiduciary standard.

Unfortunately, as critical a role as Investment Advisors play in managing the liquid assets of the nation, little has been done to prepare them for their awesome responsibility compared to other professions. There are few regulatory requirements for minimum competency standards in providing investment advice and nothing in the way of advanced education and training or experience. There is also a lack of unified guidance from regulators on what constitutes an Advisor's investment fiduciary standard of care.

AS INVESTMENT FIDUCIARIES, ADVISORS HAVE THE FOLLOWING OBLIGATIONS:

- Be aware of fiduciary requirements established by law, rule, and legal precedent that underlie the client relationship, keeping in mind that regulation will focus mostly on the duty of loyalty and care.
- Review and determine how to apply the Practices in this handbook consistent with requirements under the law and professional codes of ethics.
- Be aware of limitations of their knowledge and expertise and limit the scope of an engagement or delegate to other professionals to conform to the duty of care.
- Always place the client's best interest ahead of all others' interests.

PRACTICAL APPLICATION

Practically applying Practice 1.1 entails assessing the scope of your advisory services and whether you are required to register or are exempt under financial services laws. Also, with respect to performance of your duties, you should consider obligations you may have under standards of conduct and codes of ethics associated with your firm or professional credentials you hold.

GENERALLY SPEAKING, THE FOLLOWING FOUR CIRCUMSTANCES GIVE RISE TO FIDUCIARY STATUS:

1. being named as a fiduciary in a trust document or similar legal instrument
2. providing personalized advice about securities for compensation
3. exercising investment discretion
4. having authority to name someone else a fiduciary

Advisors are obligated to determine if their professional activities entail fiduciary status and require registration with regulators. There are specific determinants of fiduciary status under the Investment Advisers Act of 1940 and ERISA (most notably Sections 3(21) and 3(38)) at the federal level. For advisers with less than $100 million in assets under management, state securities laws typically apply.

Advisors who perform fiduciary activities are deemed to be functional fiduciaries even if they fail to recognize their fiduciary status or register properly with regulators. Similarly, the marketing materials of advisors or advisory firms may imply that they provide fiduciary services and trigger fiduciary status or registration requirements.

Organizations that confer professional designations or practitioners associations may promulgate professional standards of conduct or codes of ethics with more stringent requirements than apply under law or regulations. Advisors who are subject to varying levels of fiduciary accountability need to adhere to the highest level to avoid being out of compliance.

It is self-evident that the pursuit of fiduciary excellence by advisors serves the best interests of investors and enhances the reputation of the discipline of investment advice. That involves going beyond mere compliance to adopt professional best practices such as avoiding conflicts of interests when disclosure may be all that is legally required.

[1] At the time of publication of this handbook, the SEC had not yet proposed a rule.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a) (1)

Regulations

29 C.F.R.§2550.404a-1

Case Law

Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 2 E.B.C. 1006 (D.Hawaii 1980); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984); *Marshall v. Snyder*, 1 E.B.C. 1878 (E.D.N.Y. 1979); *Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169 (1984); *Fink v. National Savings and Trust Company*, 772 F. 2d 951, 6 E.B.C. 2269 (D.C. Cir. 1985); *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997)

Other

Joint Committee on Taxation, *Overview of the Enforcement and Administration of the Employee Retirement and Income Security Act of 1974* (JCX1690, June 6, 1990)

Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker Dealers, As Required by Section 913 of the Dodd-Frank Act* (January, 2011)

Investment Advisers Act of 1940

§202(a)(11); §206(1), (2), and (3); §203A(b)(1)

Regulations

17 C.F.R. §275.203-1; 17 C.F.R. §275.204-2; 17 C.F.R. §275.206(4)-1

Case Law

Scott E. DeSano, et al., SEC Adm Proc 3-12879A (March 6, 2008); *Strong Capital Management, Inc., et al.*, IC Rel. No. 26448 (May 20, 2004); *In Re Atlantic Financial Management, Inc.*, '34 Act Rel. No. 19898, IA Rel. No. 867, (June 21, 1983); *SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); In re Arleen W. Hughes*, '34 Act Release No. 34-4048 (Feb 18, 1948)

Other

Information for Newly-Registered Investment Advisers, Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations, http://sec.gov/divisions/investment/advoverview.htm (July 2011)

Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers, NASAA Model Rule 102(a)(4)-1 (Adopted Apr. 27, 1997, Amended Apr. 18, 2004 and Sept. 11, 2005)

Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, SEC Interpretive Release No. IA-1092, http://www.sec.gov/rules/interp/1987/ia-1092.pdf (July 2011)

Uniform Prudent Investor Act [UPIA]

§1(a); §2(a); §2(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§7

Case Law

Harvard College v. Amory, 26 Mass. 446, 9 Pick. 454 (1830); Davoue v . Fanning, 2 Johns. Ch. 252 (N.Y. 1816); Fulton v. Whitney, 66 N.Y. 548 (1876); and National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981)

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE 1.2

Investment products and investment services provided are consistent with applicable governing documents.

CRITERIA

1.2.1 Investments held in trust are managed in accordance with the documents governing the trust.

1.2.2 Investments are managed and investment services are provided in accordance with governing documents, including the investment policy statement.

1.2.3 Documents pertaining to the investment management process, including records of decisions made by fiduciaries, are organized and retained in a centralized location.

Governing Documents

Governing documents provide direction to fiduciaries as to how they are to carry out their obligations. Provided that such documents are consistent with applicable laws and regulations, fiduciaries are expected to follow instructions provided by governing documents. For example, an investment policy statement is a governing document and its provisions must be followed. Often, the governing documents for public plans include state statutes and local ordinances.

The starting points for the Investment Advisor is to collect, analyze, and review relevant documents pertaining to the establishment and management of each client's investments. Well-crafted governing documents should reveal definitive client goals and objectives as well as key factors that will impact investment management recommendations and actions of the Investment Advisor.

THESE FACTORS GENERALLY INCLUDE, BUT ARE NOT LIMITED TO, THE FOLLOWING:

- cash flow
- current and future assets
- investment experience, expertise, and aptitude
- limits and constraints imposed by trust documents (if applicable)
- risk tolerance

In addition, if a client is a trust, foundation, endowment, or pension plan, the Investment Advisor should be familiar with all regulations and statutes that define the conduct of the client as they relate to the provision of investment products and services. Proof that such a framework has been established presumes written documentation exists in some form. Moreover, documentation is generally required under the so-called "books and records" rules established by the SEC and state securities administrators for registered investment advisers. SEC Advisers Act Rule 204-2 requires that those records be held for five years, the first two years in an easily accessible location.

Special Considerations Under ERISA

ERISA §404(a)(1)(D) requires a fiduciary to discharge its duties in accordance with the terms of the plan document insofar as the document is consistent with ERISA. This means an ERISA fiduciary may not discharge its duties in a manner that is inconsistent with

ERISA. Thus, if the terms of the plan document do not comply with ERISA, it is ERISA, not the plan document, that governs. In contrast, for example, under the UPIA the prudent investor rule can be expanded, restricted, or otherwise altered by the provisions of the trust.

Special Considerations Under UPMIFA

Under UPMIFA, subject to the intent of a donor expressed in a gift instrument, an institution, in managing an institutional fund, must consider the charitable purposes of the institution and the purposes of the institutional fund.

Fiduciary File

An Investment Advisor should consider creating a fiduciary file to organize and integrate fiduciary best practices into their existing compliance requirements and other documents that govern the client relationship. Because investment firms are diverse in size, client base, and scope of services, there is no single recommended approach. Best practices, however, should incorporate consistent processes for all clients of a firm and include careful documentation of how these processes are applied. The following documents, at a minimum, should be collected, reviewed, and analyzed for consistency with governing laws, codes of ethics, and the Practices in this handbook:

- Disclosure documents, such as Form ADV, Part 2 and FINRA Form U-4
- Marketing materials and advertisements, including the firm website
- Client agreements
- A copy of the investment policy statement
- Written minutes and/or files from investment committee meetings
- Applicable trust documents (including amendments)
- Custodial and brokerage agreements
- Service agreements with investment management and other vendors (custodian, money managers, investment consultant, actuary, accountant, and attorney)
- Information on Investment Managers retained by the client or pension plan
- Copies of current prospectuses for each mutual or exchange-traded fund, variable annuity and other investment products
- Performance reports distributed by Investment Manager(s) and/or custodian(s) that are retained by the client or plan
- A quality 'spot' check of various forms of client communications, including newsletters, follow-up correspondence after client meetings, specific written (and email) responses to client questions, etc.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(C); §104(b)(4); §402(a)(1); §402(b)(1); §402(b)(2); §403(a); §404(a)(1)(D); §404(b)(2)

Regulations
29 C.F.R. §2509.08-2(2); Interpretive Bulletin 08-02(2), 73 Fed. Reg. 61,731 (Oct. 17, 2008)

Case Law
Morse v. New York State Teamsters Conference Pension and Retirement Fund, 580 F. Supp. 180 (W.D.N.Y. 1983), aff'd, 761 F.2d 115 (2d Cir. 1985); *Winpisinger v. Aurora Corp. of Illinois*, 456 F. Supp. 559 (N.D. Ohio 1978); *Liss v. Smith*, 991 F. Supp. 278, 1998 (S.D.N.Y. 1998); *Dardaganis v. Grace Capital, Inc.*, 664 F. Supp. 105 (S.D.N.Y. 1987) aff'd, 889 F.2d 1237 (2d Cir. 1989)); *White v. Martin*, 286 F.Supp.2d 1029, 1039-41 (D. Minn. 2003); *Kirshbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008)

Investment Advisers Act of 1940
§204(a)

Regulations
17 C.F.R. §275.204-2; 17 C.F.R. §275.204-3; 17 C.F.R. §279.1

Other
Amendments to Form ADV, IA Rel. No. 3060, http://www.sec.gov/rules/final/2010/ia-3060.pdf (July 28, 2010); *Recordkeeping Requirements For Investment Advisers*, NASAA Model Rule 203(a)-2, (Adopted 9/3/87, amended 5/3/99, 4/18/04, 9/11/05) ; 64 PA Code §404.011(a)

Case Law
In the Matter of Financial Design Associates, Inc. and Albert L. Coles, Jr., Investment Advisers Act Release No. 2654 (Sept. 25, 2007); *Colley Asset Management, Inc., and John E. Colley*, Investment Advisers Act Release No. 2363 (Feb. 25, 2005); *In the Matter of Fleet Investment Advisors, Inc.*, Investment Advisers Act Release No. 1821 (Sept. 9, 1999).

Uniform Prudent Investor Act [UPIA]
§1(b); §2(a)–(d); §4

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(a); §3(b); §3(c); §3(e); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§4(a)–(d); §7(6); §8(b)

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.3

The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined and documented.

CRITERIA

1.3.1 The roles and responsibilities of all involved parties are documented in the investment policy statement.

1.3.2 All involved parties have acknowledged their fiduciary or non-fiduciary status in writing.

1.3.3 Investment committees have a defined set of by-laws or operating procedures to which they adhere.

1.3.4 The Investment Advisor has a documented disaster recovery plan that is reviewed and tested periodically.

Scope of Engagement

Whether an ERISA plan, an endowment or foundation, a private trust, or an individual investor, all of the various parties that are involved in the investment process must work in coordination with each other and have a clear understanding of where their individual roles and responsibilities begin and end. For example, each service provider to an ERISA plan, some of whom may be co-fiduciaries, should have their specific duties and requirements documented, preferably in the plan's IPS [See Practice 2.6]. Documentation ensures continuity of the investment strategy when there is a change to any of the parties, prevents misunderstandings between them, and avoids omission of critical fiduciary functions.

Clearly defining the scope of the Investment Advisor's engagement is particularly important at a large firm where the Advisor may also work in a non-fiduciary capacity providing other client services. Most investors assume that their financial advisor always acts solely in their interests. However, while many Advisors may act in an ethical manner, from a legal standpoint they may not always be required to act as a fiduciary and to serve their client's best interest.

Under certain ERISA regulations, Investment Advisors must acknowledge their fiduciary status. In particular, ERISA §3(38) requires investment managers to acknowledge in writing that they are fiduciaries, and regulations under ERISA §408(b)(2) require service providers (including advisors) to acknowledge fiduciary status for the specific services they will perform as fiduciaries. See Practice A-3.1.

Roles and Responsibilities in the Investment Policy Statement

The investment policy statement serves as the business plan for how a portfolio is to be managed. As such, it should include information about the roles and responsibilities of the parties involved in the portfolio, including:

- The responsibilities of the client and, in the case of an institutional client, the role of the investment committee or other parties acting in a fiduciary capacity for the Investment Steward

- The role of the Investment Advisor
- The role of the custodian [See also Practice 3.1]
- The role of the separate account or alternative investment (e.g., hedge fund) manager(s), if any
- Instructions for each money manager, including: (a) securities guidelines, (b) responsibility to seek best price and execution on trading the securities, (c) responsibility to account for soft dollars, and (d) responsibility to vote all proxies [See Practice 4.3]
- The role of the recordkeeper
- The role of the investment consultant

Business Continuity Plans

Finally, consistent with the fiduciary duty of care, Investment Advisors should maintain a disaster recovery plan for the investment firm.

Special Considerations Under ERISA

Under ERISA § 402(a)(1), a plan covered by ERISA is required to identify one or more named fiduciaries who jointly or severally control and manage the plan. ERISA § 403(a) generally requires plan assets to be held in trust by a trustee. Unless (1) the trustee is a directed trustee, (2) an investment manager is appointed, or (3) the plan allows for participant-directed investments, the trustee has exclusive authority and discretion to manage and control the assets of the plan. Under ERISA §405, if a plan provides a procedure for allocating fiduciary responsibilities, a named fiduciary may delegate authority to another fiduciary. In such a case, the named fiduciary's liability for the acts of the delegated fiduciary can be limited. [See Practice 3.2]

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(c); §402(a)(1); §402(b)(2) and (3); §403(a)(2); §404(a)(1)(B); §404(c); §405(c)

Regulation
29 C.F.R. §2550.408b-2(c)(1)(iv)(B).

Case Law
Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F.Supp. 378 2 E.B.C. 1006 (D.Hawaii 1980); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984); *Marshall v. Snyder*, 1 E.B.C. 1878 (E.D.N.Y. 1979); *Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169 (1984); *Fink v. National Savings and Trust Company*, 772 F. 2d 951, 6 E.B.C. 2269 (D.C. Cir. 1985); *Ellis v. Rycenga Homes*, 484 F.Supp.2d 694 (W.D. Mich. 2007) ; *Jenkins v. Yager*, 444 F.3d 916 (7th Cir. 2006).

Other
Joint Committee on Taxation, Overview of the Enforcement and Administration of the Employee Retirement and Income Security Act of 1974 (JCX1690, June 6, 1990)

Investment Advisers Act of 1940
§205(a)(2); §206(3)

Other
Information for Newly-Registered Investment Advisers, Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations, http://sec.gov/divisions/investment/advoverview.htm (July 2011); *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, SEC Rel No IA-1732, http://www.sec.gov/rules/interp/ia-1732.html#foot1 (July 17, 1998).

Uniform Prudent Investor Act [UPIA]
§1(a); §2(a); §2(d); §9(a)(1) and (2)

Other
Restatement of Trusts 3d: Prudent Investor Rule §171 (1992)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(b); §3(c)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§6(a) and (b); §7; §8(b)

Case Law
National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981)

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE 1.4

The Investment Advisor identifies conflicts of interest and addresses conflicts in a manner consistent with the duty of loyalty.

CRITERIA

1.4.1 Policies and procedures for overseeing and managing potential conflicts of interest, including self-dealing, are defined.

1.4.2 Conflicts of interest are avoided when possible and always when required by law, regulation, and/or governing documents.

1.4.3 Unavoidable conflicts of interest are disclosed in writing to the client and are managed in the best interest of the client.

1.4.4 When an unavoidable conflict of interest exists, the conflict is explained and informed written consent is obtained from the client.

Dealing With Conflicts

The fundamental duty of the Investment Advisor is to act solely in the best interest of another party, such as a financial planning client, retirement plan participant, or trust beneficiary. In addition, the Advisor has a responsibility to employ an objective due diligence process at all times. If a client is harmed by a decision not conducted at arm's length, then a breach of the fiduciary duty of loyalty is likely to have occurred.

A good working definition of a conflict of interest is a circumstance that makes fulfillment of the duty of loyalty less reliable. It is important to understand that it is the circumstance itself that creates a conflict; there is no such thing as a "potential" conflict. The conflict either exists or it doesn't; whether a conflicted party's conduct changes as a result of the conflict is a separate matter. The very suspicion of a conflict of interest usually means that one does, in fact, exist. Whenever possible, the best solution is to avoid situations or relationships that give rise to conflicts.

However, financial services regulations frequently allow an advisor who acts in a fiduciary capacity to also hold licenses to sell related products or services in a non-fiduciary capacity. Therefore, managing conflicts in a client relationship can be a complex ethical and legal challenge. In a large firm environment where cross-selling is legally permitted, or even encouraged, and compliance policies are structured to cover the activities of thousands of financial advisors, the Investment Advisor's ability to manage a conflict on his or her own may be limited. No matter the size or complexity of the firm's business model, however, conflicts of interest that are not already addressed under its compliance procedures should be brought to the attention of management and addressed accordingly. Ideally, compliance procedures addressing conflicts should be established with a singular focus on promoting a fiduciary culture within the firm.

The most serious and problematic conflict of interest involves self-dealing, when the fiduciary materially

benefits from a transaction with the client (beyond receiving a reasonable fee for services). ERISA rules outline most of the self-dealing restrictions or prohibitions to be avoided or managed by fiduciaries. Those are called "prohibited transactions" under ERISA, and are allowed only under a limited number of exemptions. The IAA also contains restrictions on self-dealing by a registered investment adviser, such as selling stocks or bonds out of a firm's own inventory (i.e., principal transactions).

Far more subtle and equally challenging is managing conflicts after the advisor acting in a fiduciary capacity "changes hats" and acts in a non-fiduciary capacity when providing other services or products to the same client. "Hat changing" can be a source of confusion for clients as they are often unaware of the differences between the fiduciary and fair dealing standards of conduct and may not know when a change in roles is taking place. This confusion is of concern to regulators and professional organizations; consequently, rules pertaining to "hat changing" are likely to change. As it is, existing rules are often not uniform across regulatory jurisdictions or among different advisory firms. Investment Advisors who engage in "hat changing" should seek guidance from legal counsel and/or qualified compliance personnel to establish policies and procedures to conform to regulatory or company-imposed requirements. As a best practice, advisors who engage in "hat changing" should provide clear written disclosure to, and receive informed written consent from, the client prior to switching between fiduciary and non-fiduciary roles. The disclosure and consent should directly address the differences in conflicts of interest that may arise and how they are handled when the Advisor changes roles.

Special Considerations under ERISA and UMPERSA

Investment Advisors must not only be careful to avoid committing fiduciary breaches, they should also be alert to breaches of fiduciary duty committed by other fiduciaries. All fiduciaries to a retirement plan are obligated to act in the best interests of the participants and beneficiaries, without regard to which party pays the fees.

In the event an apparent breach is discovered, the Advisor should notify the plan sponsor and also consult legal counsel. **Examples of possible client fiduciary breaches include:**

- Using retirement plan assets to buy real estate for corporate use
- Using the assets of a public retirement plan to invest in local, high-risk business ventures
- Using the assets of a private trust to provide unsecured loans to related parties and/or entities of the trustee
- Using a company retirement plan as collateral for a line of credit
- Buying artwork and/or other collectibles with retirement plan assets and putting the collectibles on display
- Selecting investments with higher fees for the express purpose of capturing revenue sharing to reduce the plan's recordkeeping fees that the sponsor is required to pay
- A public retirement plan's use of a placement agent who may have inappropriate influence with the plan's fiduciaries
- For charitable organizations, selecting an unqualified service provider simply because the provider contributes a lot of money to the charity

In addition, under ERISA, transactions between a "party in interest" and a plan are automatically considered self-dealing, and thus are defined as "prohibited transactions." **The following are examples of specific prohibited transactions:**

- A sale or exchange, or leasing of any property between the plan and a party-in-interest
- Lending of money or other extension of credit between the plan and a party-in-interest
- Furnishing of goods, services, or facilities between the plan and a party-in-interest
- Transfer to, or use by or the benefit of, a party-in-interest of any assets of the plan
- Acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA §407

The term "party-in-interest" includes a service provider. Accordingly, an Advisor who provides services to a plan covered by ERISA automatically commits a prohibited transaction. However, the Advisor may be able to rely on an exemption provided under ERISA to avoid the adverse consequences that could arise from a technically-prohibited transaction that serves the best interests of plan participants and beneficiaries.

One significant exemption in ERISA provides that a plan contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of a plan is not a prohibited transaction if no more than reasonable compensation is paid therefor. Under the Department of Labor's disclosures rules effective July 1, 2012, no service provider to a plan covered by ERISA, including Advisors, will be eligible for this exemption unless the service provider discloses its direct and indirect compensation in writing to the plan's fiduciary. See Practice 3.1 for more details.

Special Considerations under the IAA

The Investment Advisor should have defined policies and procedures to manage conflicts of interest that may arise in specific situations. **Additional scrutiny may be required under securities laws when:**

- An Investment Manager or Investment Advisor is associated with a custodian, investment company, broker-dealer, insurance company, or bank where other services and products are cross-marketed and sold by the Advisor or others
- An Investment Advisor is dually registered as a broker and executes principal trades on behalf of the client from the firm's own inventory
- An Investment Manager is acting as a sub-advisor to a separately-managed account (wrap-fee account) and directs trades to a particular broker-dealer
- An Investment Advisor hires an Investment Manager or other service provider for a reason other than merit
- An Investment Advisor compensated by asset management fees recommends that a client invest a portion of the portfolio in non-securities products, such as real estate, a private offering, or a fixed annuity

PRACTICAL APPLICATION

In summary, it is critical that the Investment Advisor recognize that the conflicts associated with each client may be unique. The Investment Advisor should examine the scope of the conflict, decide if it is material to the client relationship, and respond accordingly. The two basic remedies to a conflict are avoidance or mitigation, with avoidance being the preferred solution. The risk of mitigation is that it may not be deemed adequate in an after-the-fact evaluation of the facts and circumstances.

Where a conflict cannot be avoided, the most common form of mitigation is through disclosure. It is important to keep in mind, however, that disclosure is not always satisfied through delivery and signed receipt of boilerplate language. The general instructions for Form ADV, Part 2 remind registered investment advisers that some of the information that must be disclosed by a fiduciary may not be specifically required by Part 2. If the Advisor knows or should have known, or has reasonable grounds to believe, that the client is not sufficiently informed, then "sufficiently specific facts" are required so that the client can give informed consent to a recommendation, or reject it.

As a best practice, it is recommended that the Advisor discuss all material conflicts verbally with the client and not merely rely on previously delivered written or electronic disclosures. A summary of the discussion and ultimate decision by the client should be put in writing by the Advisor and sent to the client for a signature, with a copy retained by the Advisor.

SUGGESTED PROCEDURES UNDER THE IAA OR STATE LAW

- Review compliance requirements under conflict of interest provisions of applicable law. Identify which conflicts are addressed in writing in standard documents, such as in Form ADV, Part 2, versus any other conflicts routinely encountered where clients may need to be furnished with additional, specific information on a timely basis.
- The SEC requires designation of a chief compliance officer by each registered investment adviser and adoption of a code of ethics for personal trades and for other activities by firm employees. Consider maintaining an additional central file with a list

of other conflicts encountered by the firm on a regular basis, and how these conflicts are addressed consistent with a duty of loyalty to the client.

- Although most state registered investment advisers do not have a chief compliance officer requirement, consider establishing a similar position within the firm to oversee compliance and fiduciary best practices. Also, identify any prohibited unethical practices in state regulations that would be considered a breach of fiduciary conduct and conduct annual reviews for overall compliance.
- Although there is no single accepted method for adopting compliance procedures and fiduciary best practices, consider two complementary ones: a risk matrix, or inventory, that identifies material conflicts of interest that are commonly encountered in your firm's practice, and a central file for documenting all others. For each material conflict routinely encountered, develop a procedure that is enforceable (meaning practical to implement) and addresses the conflict in the best interest of the client. Test the procedure for effectiveness at least once a year. For other unique conflicts, document how each is handled, cross-referencing each to a client file.
- In a large firm environment where discretion in managing conflicts by the Investment Advisor is limited, bring any problems not addressed by compliance procedures to the attention of your CCO or compliance officer for guidance. Document how it was addressed.
- If you document non-systemic conflicts that eventually become a pattern, consider adding to the risk matrix and draft a new, enforceable policy to address that specific problem.

SUGGESTED PROCEDURES UNDER ERISA

- Identify the plan's parties-in-interest and disqualified persons.
- Identify the prohibited transactions that you may encounter in your practice.
- Identify available exemptions and comply with their requirements, including required disclosures of compensation in writing (see Practice 3.1).
- Draft policies in response to these conflicts and review them for overall effectiveness at least once a year.
- Create a master file for unanticipated conflicts and manage the file and conflicts similar to the procedures suggested above for registered investment advisers under the IAA.

SUBSTANTIATION

Internal Revenue Code of 1986, as amended [IRC]
§4975

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(A) and (B); §404(a)(1)(A); §406(a) and (b); and §408

Regulation
29 C.F.R. §2550.408b-2(b), (c), and (e)

Case Law
Whitfield v. Tomasso, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y 1988); *Tibble v. Edison Int'l*, No. CV 07-5359-SVW, 2010 WL 2757153 (C.D. Cal. Jul. 8, 2010) (appeal pending); *People v. Morris*, 28 Misc.3d 1215A, No. 0025/09, 2010 WL 2977151 (N.Y. Sup. July 29, 2010)

Other
DOL Advisory Council on Employee Welfare and Benefit Plans Report of the Working Group on Fiduciary Responsibilities and Revenue Sharing Practices, November 7, 2007

DOL Advisory Council on Employee Welfare and Benefit Plans Report of the Working Group on Soft Dollars and Commission Recapture November 13, 1997

Investment Advisers Act of 1940 [IAA]
§205(a); §206(1) and (2)

Regulation
17 C.F.R. §275.204-3; 17 C.F.R. §275.204A-1; 17 C.F.R. §275.206(3)-3T; 17 C.F.R. §275.206(4)-6; 17 C.F.R. §275.206(4)-7

No-Action Letters
Heitman Capital Management et al., SEC Staff No-Action Letter (Feb. 12, 2007).

Uniform Prudent Investor Act [UPIA]
§2; §5

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
Prefatory Note

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§7(1) and (2); §17(c)(12) and (13)

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE 1.5

Agreements, including service agreements under the supervision of the Investment Advisor, are in writing and do not contain provisions that conflict with fiduciary standards of care.

CRITERIA

1.5.1 The Investment Advisor fully discloses in writing all compensation arrangements and affiliations involved in the service agreement between the client and Advisor, as well as the Advisor's services and fiduciary status.

1.5.2 If the Investment Advisor is responsible for oversight of other service provider agreements, those service agreements disclose all compensation, affiliations, and fiduciary status if it is assumed by the service provider.

1.5.3 Agreements are periodically reviewed to ensure consistency with the needs of the client.

1.5.4 Comparative reviews of service agreements for which the Investment Advisor is responsible are conducted and documented approximately every three years.

Fiduciaries are expected to only enter into reasonable agreements with service providers. This requires them to perform sufficient due diligence to establish that needed services will be delivered at a reasonable cost and with appropriate accountability. Service agreements should directly disclose the information needed by fiduciaries to perform appropriate due diligence or should include references to specific disclosure documents that provide the information.

Many of the most critical disclosures are now mandated by law, such as Form ADV, Part 2 under the IAA and DOL Rule 408b-2 under ERISA. These laws may, however, require different types of disclosures. Disclosures of affiliates are required by Form ADV; under Rule 408b-2, non-fiduciary services provided to a retirement plan must be fully disclosed.

Consistent with the duty of care, investment fiduciaries who lack the requisite knowledge required to manage certain investments prudently, or elements of the investment manage process, should seek assistance from outside professionals. For example, construction and management of portfolios with complex investments or investment strategies may be delegated to qualified Investment Managers.

When hiring such professionals, any agreement of substance should be reduced to writing in order to define the scope of the parties' duties and responsibilities. That will help ensure that the portfolio will be managed in accordance with the written documents that govern the investment strategy, and to confirm that the parties have a clear, mutual understanding of their roles and responsibilities. All such agreements should be prepared (and periodically reviewed) by knowledgeable legal counsel.

A prudent and appropriately documented hiring decision must be followed by diligent monitoring of the relationship and periodic assessments of whether service providers should be retained as circumstances change. A decision to replace a service provider should be based upon careful consideration of changes in client needs, service provider capabilities, and competing alternatives available in the marketplace.

SUGGESTED PROCEDURE

Advisory contracts and other service agreements should be reviewed approximately every three years to ensure that investors' best interests continue to be served. The review process necessarily involves gathering information about competitive providers in the marketplace so appropriate due diligence can be performed. (Such a review may be advisable sooner if there is a material change in factors such as the value of account assets or the demographics of participants.) The investment industry is constantly evolving, and, in fulfilling the duty of care, Investment Advisors may discover:

- There is an opportunity to take advantage of price breaks because the client's portfolio has grown in size.
- The vendor's fees have been reduced because of competitive pressures or other changes in the industry.
- The scope of services required by the client has changed.
- Technology has improved, resulting in lower costs.
- The service provider's product offering has expanded and the client can benefit from more services without an increase in fees.
- A more appropriate vendor has entered the market.
- There has been a change in applicable law or regulations, requiring additional review by counsel.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B); §3(38)(C); §402(c)(2); §403(a)(2); §404(a)(1); §408(b)(2)

Case Law
Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998); *Whitfield v. Tomasso*, 682 F.Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y. 1988); *Kraft Foods Global, Inc.*, 641 F.3d 786 (7th Cir. 2011)

Investment Advisers Act of 1940
§206(4)

Regulations
17 C.F.R. §275.206(4)-2

Case Law
In the Matter of Commonwealth Equity Services, LLP d/b/a Commonwealth Financial Network, S.E.C. Rel. No. IA 2929 (Sept. 29, 2009).

Other
MA 201 CMR 17.00

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §7; §9(a)(2)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(b); §3(c); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§5(a)(2); §6(b)(2); §7

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE 1.6

Client assets are protected from theft and embezzlement.

CRITERIA

1.6.1 The Investment Advisor has a reasonable basis to believe assets are within the purview of a viable judicial system.

1.6.2 ERISA fiduciaries have the required fidelity bond, if applicable.

1.6.3 If the Investment Advisor's firm custodies client assets , the firm has appropriate insurance, internal controls, and physical security measures to protect against theft and embezzlement.

1.6.4 If within the scope of the Investment Advisor's engagement, the Investment Advisor verifies that service providers that custody client assets have appropriate insurance.

1.6.5 Appropriate procedures are in place to secure client or plan data.

Safeguarding Client Assets

The Investment Advisor has the responsibility to ensure that assets entrusted to their firm or a third-party custodian are within the jurisdiction of a court of law where a viable claim can be brought. Well-established judicial authority gives courts the ability to seize the assets when a judge and/or a regulator determines the best interests of the client are not being served. Regulated US investment companies, such as mutual funds, that invest in foreign securities are fiduciaries and are required to comply with SEC Rule 17f-5 (which contains many of the safeguards of Practice 1.6), so an Investment Advisor could rely on the fiduciary obligation having been fulfilled. However, if a client is investing in foreign securities or has assets that are held in custody outside of the United States by an entity that is not a US-registered investment company, legal counsel should be consulted to ensure that the foreign laws impose appropriate requirements that protect portfolio assets.

With respect to ERISA, if the client is a qualified plan sponsor, Investment Advisors should ensure that a fidelity bond is in place to reimburse the plan in the event that fraud or other dishonest acts result in losses. If managing assets on a discretionary basis, the Advisor should verify that the custodian also has adequate insurance to cover losses from theft or fraud.

Internet technology allows plan assets to be accessed from almost anywhere in the world. Cyber crime is a viable threat, and the problem is growing. Advisors and fiduciaries should ensure that plan assets are protected by commercially reasonable security practices. What is commercially reasonable will vary based on the particular facts and circumstances of the plan.

Finally, financial services regulators are placing greater emphasis on protection of customers' privacy data, which is consistent with a duty of care. Advisors should review the appropriate laws affecting their practice and security, and address any deficiencies.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§ 404(b); § 412(a)

Regulations
29 C.F.R. §2550.404b1

Case Law
Varity Corporation v. Howe, 516 U.S. 489, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996)

Other
H.R. Report No. 931280 (93rd Congress, 2d Session, August 12, 1974)

Investment Company Act of 1940
§17(f)

Regulations
SEC ICA Rule 17f-5

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §9(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(b); §5(d)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§2(21); §6(e); §7; §11(c) and Comments

FORMALIZE

Step 2 is the Second of Four Steps Employed in the Global Fiduciary Standard of Excellence for Investment Advisors

PRUDENT PRACTICES *for* INVESTMENT ADVISORS

STEP 2

STEP 2 : INTRODUCTION

"Formalize" is the second of four steps that comprise the Fiduciary Quality Management System. Broadly speaking, Step 2 focuses upon establishing proper portfolio diversification and preparing an effective investment policy statement.

However, this next process is not isolated, but rather builds upon the analysis conducted in the previous "Organize" step. At this stage, the fiduciary advisor must utilize their investment experience and investment theory in order to apply the principles of investment allocation. Based on current legal trends, a prudent expert is clearly expected to understand Modern Portfolio Theory (MPT) and apply generally accepted investment theories to the investment process. The first five Practices of this step pertain directly to asset allocation and MPT concepts.

The sixth Practice in Step 2 addresses the importance of having a well-drafted investment policy statement ("IPS") to guide investment fiduciaries and other investment service providers who are charged with managing or administering portfolio assets. In effect, the IPS serves as a business plan for the portfolio. As such, the IPS is a key governing document for advisors. Finally, at this stage consideration should be given to whether socially responsible investing will be used in constructing the portfolio.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.1

An investment time horizon has been identified for each investment objective of the client.

CRITERIA

2.1.1 Sources, timing, distribution, and uses of each client's cash flows are documented.

2.1.2 In the case of a defined benefit retirement plan client, an appropriate asset/liability study has been factored into the time horizon.

2.1.3 In the case of a defined contribution retirement plan client, the investment options provide for a reasonable range of participant time horizons.

2.1.4 In the case of a foundation or endowment, a schedule of expected receipts and disbursements of gifts and grants has been factored into the time horizon to the extent possible and an estimated equilibrium spending rate has been established.

2.1.5 In the case of a retail investor, the appropriate needs-based analysis has been factored into the time horizon.

"Time horizon" can be defined as that point in time when more money is flowing out of the portfolio than is coming in from contributions and/or from portfolio growth. It is a fundamental duty of the Investment Advisor to ensure there are sufficient liquid assets (cash and cash equivalents) on hand to cover known or expected liabilities when they come due.

SUGGESTED PROCEDURE

One of the most important decisions the Investment Advisor has to make is the time horizon of the investment strategy. Based on the time horizon, the Investment Advisor can determine: (1) the asset classes to be considered, (2) appropriate weighting among the asset classes, (3) the sub-asset classes to be considered, and, finally, (4) the money managers or mutual funds to be selected.

It is important that the Investment Advisor prepare a schedule of each client's anticipated cash flows so that an appropriate investment time horizon can be identified.

HIERARCHY OF DECISIONS

A cash flow schedule provides the Investment Advisor with information needed to rebalance a client's asset allocation strategy. For example, if a particular asset class drifts outside the range of the IPS's strategic limit, the Investment Advisor should generally use cash flows to rebalance the client's portfolio effectively, taking withdrawals from over-allocated asset classes and directing deposits to asset classes where balances have fallen below their target allocations.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§3(34); §401(b)(1); §404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A); 29 C.F.R. §2550.404c-5 (Preamble); 29 C.F.R. §2509.08-1; §2509.96-1.

Case Law
Metzler v. Graham, 112 F.3d 207, E.B.C. 2857 (5th Cir. 1997)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; H.R. Report No. 1280, 93d Congress, 2d Session (1974); ERISA Opinion Letter 2006-08A (October 3, 2008)

Investment Advisers Act of 1940
§206

Case Law
SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); *In re David A. King and King Capital Corp.*, IA Rel. No. 1391 (November 9, 1933); *In re George Sein Lin*, IA Rel. No. 1174 (June 19, 1989).

Other
Suitability of Investment Advice Provided by Investment Advisers, IA Rel. No. 1406 (March 16, 1994).

Uniform Prudent Investor Act [UPIA]
§2(a), (b), and (c); §4; §6

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§7; §7(4) (Comments); §8; §10(b)

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.2

An appropriate risk level has been identified for each client.

CRITERIA

2.2.1 The level of volatility the client's portfolio is exposed to is understood by the Investment Advisor and communicated to the client, and the quantitative and qualitative factors that were considered are documented.

2.2.2 "Large loss" scenarios have been identified and considered in establishing each client's risk tolerance level.

2.2.3 Expected disbursement obligations and contingency plans have been considered in order to establish liquidity requirements for the portfolio.

2.2.4 In the case of a defined contribution retirement plan client, the investment options provide for a reasonable range of participant risk tolerance levels.

The term "risk" has different connotations, depending on an Investment Advisor's and/or client's frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures of volatility such as standard deviation. However, these statistical measures may fail to adequately convey the potential consequences an investment strategy can have on the client's ability to meet investment objectives.

An investment strategy can fail by being too conservative or too aggressive. An Investment Advisor could adopt a "safe" investment strategy by keeping a portfolio in cash, but then see the portfolio's purchasing power erode through inflation, and thereby fall short of the inflation adjusted goal established by the client. Or a long-term growth strategy could be implemented that overexposes a portfolio to equities, when a more conservative fixed-income strategy would be sufficient to cover the identified goals and objectives.

Many investment advisors and their clients are acutely aware of the risks of a "large loss" scenario, having experienced the historic market correction in the fall of 2008, the most severe since the Great Depression. Yet if clients nearing retirement had their portfolios balanced appropriately in early 2008 to include sufficient financial reserves to carry them through a rolling five-year period in retirement – the recommended contingency period for a "large loss" scenario – then the significant market rebound in 2009 and 2010 would have righted the financial ship as the storm subsided.

Effective dialogue with the client involves discussion of both the theoretical and practical dimensions of risk. Ultimately, the advisor and client must achieve a mutual understanding of the client's investment objectives and establish the client's tolerance for risk consistent with the investment time horizon.

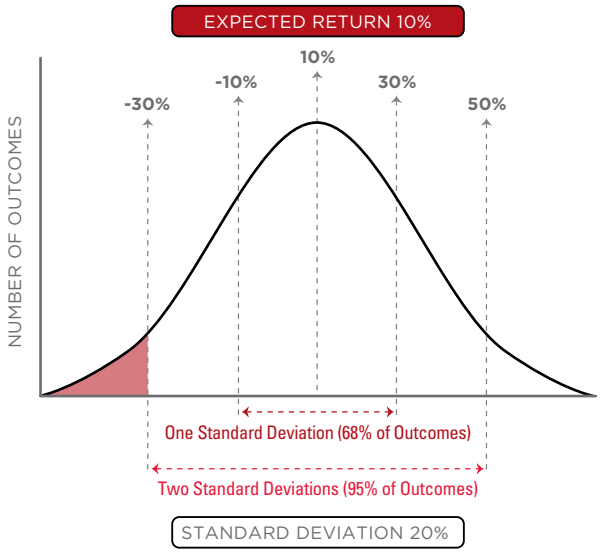
SUGGESTED PROCEDURE

One suggested approach is to stress test a client's proposed investment strategy by analyzing possible outcomes (worst case, most likely, and best case) over one, three, and five- year (or longer) periods. The Investment Advisor should then consider the possible consequences of each outcome:

1. Will the investment results enable the client to cover short and long- term liabilities and/or objectives?
2. Can the client stomach the worst-case scenario? If not, the client will likely abandon a sound, long-term strategy during a market downturn; altering the investment strategy at precisely the wrong time and for the wrong reasons.

MODELED LARGE LOSS SCENARIO

A modeled large loss scenario can be represented visually in a number of different ways, a simple illustration of which is shown here:



Special ERISA Issues

See Special ERISA Issues under Practice A-2.4 below for guidance on diversifying ERISA plan assets to minimize the risk of large losses.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§402(b); §404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2509.75-5, FR-20; 29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii); 29 C.F.R. 2550.404c-1 (Preamble)

Case Law
Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 23 E.B.C. 1001 (5th Cir.), *reh'g and reh'g en banc denied*, 184 F.3d 820 (5th Cir.), *cert. denied*, 528 U.S. 967, 120 S.Ct. 406, 145 L.Ed.2d 316 (1999); *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997); *Chase v. Pevear*, 383 Mass. 350, 419 N.E.2d 1358 (1981)

Investment Advisers Act of 1940

Case Law
In re Westmark Financial Services Corp.,IA Rel. No. 1117 (May 16, 1988); *In re George E. Brooks & Assocs., Inc.*, IA Rel. No. 1746 (Aug. 17, 1998)

Other
Suitability of Investment Advice Provided by Investment Advisers, IA Rel. No. 1406 (March 16, 1994).

Uniform Prudent Investor Act [UPIA]
§2(a), (b), and (c); §2 Comments

Case Law
In the Matter of the Judicial Settlement of the Final Account of E. Barker, 801 N.Y.S. 2d 778 (2005), citing Matter of Rothko, 43 N.Y.2d 305 320 (1977)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§7; §8; §8 Comments

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.3

An expected return to meet each investment objective has been identified.

CRITERIA

2.3.1 The expected return for each portfolio is consistent with the client's risk level and investment goals and objectives.

2.3.2 The expected return assumptions for each asset class are based on reasonable risk premium assumptions.

2.3.3 For defined benefit plans, the expected return values used for modeling are reasonable and are also used for actuarial calculations.

2.3.4 For defined contribution plans, the expected return assumptions for pre-diversified options, such as target date funds or model portfolios, are based on reasonable risk/premium assumptions.

2.3.5 For endowments and foundations, the expected return values used for modeling are reasonable and are consistent with distribution requirements or the projected equilibrium spending rate.

The Investment Advisor should determine whether trust documents, spending policies for endowments, and/or actuarial reports (for defined benefit retirement plans) establish a minimum investment return expectation or requirement. In all cases, the Investment Advisor should determine the expected return a given investment strategy is likely to produce, and whether it meets the client's stated investment goals and objectives.

In this context, the expected return is the probable return of an investment strategy given current and historical information. There is no fiduciary requirement, or expectation, that the Investment Advisor be capable of forecasting future returns. Rather, they are required to demonstrate the prudent process that was followed in developing the assumptions used to model the probable outcomes of a range of investment strategies.

SUGGESTED PROCEDURE

Several tools exist that an Investment Advisor may use in structuring a diversified portfolio; these include mean-variance optimization, Monte Carlo simulation, and portfolio optimizers—particularly those applying the re-sampled efficiency optimization approach. An asset allocation modeling tool requires at least three inputs:

- **expected return**—the ***modeled*** return assumption that will be used for each asset class.
- **standard deviation**—the ***probable*** level of variability each asset class will exhibit.
- **correlation coefficient**—the ***estimate*** of the degree to which each asset class will perform relative to another. (Historically, equities and fixed income asset returns have not been similar over the same periods of time; therefore, they would have a relatively low correlation to one another.)

SUGGESTED PROCEDURE

Note that all three variables are nothing more than estimates, models, or probable outcomes. The asset allocation strategy must be built upon carefully developed expectations for the capital markets and the way in which individual asset classes are expected to perform in relation to, and in combination with, each other. Further constraints on asset classes may be required to comply with the client's investment policy statement and to generate meaningful allocations.

The development of prudent inputs involves as much art and intuition as science, and is well beyond the intended scope of this handbook. However, the Investment Advisor is advised to be familiar with the source and methodology used to develop any asset allocation strategy. Due to the great disparity between different models, careful research into the investment expertise of the source is required.

The outputs of the computerized modeling tools are only as good as the inputs. The old adage "garbage in—garbage out" has never been more applicable.

The modeling of a probable return for a given asset allocation strategy is very difficult to develop. Simple extrapolations of recent historical data may be poor estimates of future performance; they also may cause the Investment Advisor to overweight an asset class that has had recent superior performance and underweight the laggards, setting the stage for the Investment Advisor to make the classic investment mistake— buying high and selling low.

Many investment professionals use "risk premium" adjusted inputs in an modeling tool, as opposed to historical data. Developing the risk premium is quite involved but, simply stated, the process starts by calculating the premium each asset class has earned over the risk-free rate of return. The premium is then adjusted, or tweaked, based on possible economic scenarios that may impact the asset class over the next five years. The adjusted premium is then added to the anticipated risk-free rate of return over the next five years (the anticipated rate of inflation also could be used as a proxy) to come up with the final modeled return. The Investment Advisor should consider carefully whether the risk premiums used are reasonable, as the asset allocation output can be quite sensitive to input values.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§3(34); §404(a)(1)

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A); 29 C.F.R. §2550.404c-5 (Preamble)

Case Law

Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Communications Satellite Corporation v. Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977); *Katsaros v.Cody*, 744 F. 2d 270, 279 (2d Cir. 1984) (*citing Marshall v. Glass/Metal Association*, 507 F. Supp. 378, 384 (D. Haw. 1980)); *Leigh v. Engle*, 858 F.2d 361 (7th Cir. 1988); *Jones v. O'Higgins*, 11 EBC 1660 (N.D.N.Y. 1989); *GIW Industries, Inc. v. Trevor, Stewart, Burton, & Jacobsen, Inc.*, 895 F.2d 729 (11th Cir. 1990); *Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 926 F.2d 1206 (D.C. Cir. 1991); *Lanka v. O'Higgins*, 810 F. Supp. 379 (N.D.N.Y. 1992)

Other

H.R. Rep. No. 1280, 93rd Cong., 2d Sess. 304 (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038; Elton, Edwin J. and Gruber, Martin J., *Modern Portfolio Theory and Investment Analysis* (1995); DOL Interpretive Bulletin 96-1, *Participant Investment Education*. [29 C.F.R. §2509.96-1]

Investment Advisers Act of 1940

Case Law

Jones Memorial Trust v. Tsai Inv. Services, Inc., 367 F. Supp. 491 (S.D.N.Y 1973); *In the Matter of Alfred C. Rizzo*, IA Release No. 897 (Jan. 11, 1984).

Other

Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (SEC, Jan. 21, 2011).

Uniform Prudent Investor Act [UPIA]

§2(a), (b), and (c); §2(c) comments; §3(b); §5

Case Law

Donahue v. Donahue, 2010 WL 481226 (Cap. App. 4 Dist.)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b) and (e)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§8(a)(1) and (3); §8(b)

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.4

Selected asset classes are consistent with the client's time horizon and risk and return objectives.

CRITERIA

2.4.1 Assets are appropriately diversified to conform to each client's specified time horizon and risk/return profile and to reduce non-systemic risk.

2.4.2 For participant-directed plans, selected asset classes provide each participant the ability to diversify their portfolio appropriately given their time horizon and risk/return profile.

2.4.3 The methodology and tools used to establish appropriate portfolio diversification for each client are prudent and consistently applied.

Computer optimization models can mathematically assist the Investment Advisor in determining alternative optimal asset mixes. Yet these technological tools and comprehensive databases have not reduced the asset allocation decision to a computerized, mathematical solution.

The scope of an Investment Advisor's engagement often includes the responsibility to choose an appropriate combination of asset classes to optimize the client's portfolio. This involves structuring the portfolio to achieve maximum portfolio returns consistent with the client's investment objectives, risk tolerance and time horizon. The Investment Advisor's choice of asset classes and subsequent allocation typically will have more impact on the long term performance of the client's investment strategy than the selection of money managers.

THE ACRONYM "TREAT"

Helps to define the key inputs to a client's asset allocation strategy.

- **T** — **TIME HORIZON** of the client (Practice A-2.1)
- **R** — **RISK LEVEL** of the client (Practice A-2.2)
- **E** — **EXPECTED RETURN** necessary to meet client's goals and objectives (Practice A-2.3)
- **A** — **ASSET CLASS** preferences of the client
- **T** — **TAX STATUS** of the client

Special Considerations Under ERISA

ERISA § 404(a)(1)(C) requires fiduciaries of an ERISA-covered plan to discharge their duties by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. Thus, an ERISA fiduciary should not "normally invest all or an unduly large portion of funds in a single security, or in any one type of security, or even in various types of securities that

depend on the success of one enterprise." (*Liss v. Smith*) Before investing a substantial portion of plan assets in one investment, the fiduciary should document its investigation and the reasons why it believes the investment is prudent and why there is no risk of large loss resulting from non-diversification.

Special Considerations Under UPMIFA

A decision to rely on the exception for diversification under exceptional circumstances – found in §3(e)(4) of the UPMIFA – must be based on the needs of the charity and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances.

Special Considerations Under UMPERSA

Under §8(a)(2) of UMPERSA, a trustee is required to diversify the investments of each retirement program or appropriate grouping of programs unless the trustee reasonably determines that, because of special circumstances, it is clearly prudent not do so. According to the comment under §8(a)(2), special circumstances that justify non-diversification are less likely to be present for public retirement systems than for private trusts. Thus, in "only very rare circumstances, if ever, will it be prudent for the trustee of a public pension fund to under diversify." (UMPERSA §8(a)(2) comment)

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B) ; § 404(a)(1)(C)

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law
GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361 (7th Cir. 1988); *Liss v. Smith*, 991 F.Supp. 278, 301 (S.D.N.Y. 1998); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F.Supp. 378, 384 (D. Haw. 1980).

Other
Interpretive Bulletin 96-1(d)(3); 29 C.F.R. §2509.96-1(d)(3); Joint Committee on Taxation, *Overview of the Enforcement and Administration of the Employee Retirement Income Security Act of 1974*, at 12 (JCX-16-90, June 6, 1990)

Investment Advisers Act of 1940
Case Law
People v. Goldsmith, 86 N.Y.S.2d 12 (1948)

Uniform Prudent Investor Act [UPIA]
§1(a); §2(a) and (b); §3

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3 ; §3(e)(4) comment

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§8(a)(2); §8(a)(2) comment; §7(1-3); §8 (b)

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.5

Selected asset classes are consistent with implementation and monitoring constraints.

CRITERIA

2.5.1 The Investment Advisor has the time, resources, and requisite knowledge and skills to implement and monitor all selected asset classes for each client.

2.5.2 The process and tools used to implement and monitor investments in the selected asset classes are appropriate.

2.5.3 Appropriate investment products are accessible within each selected asset class.

The number of asset classes should be consistent with the Investment Advisor's (in some cases, the client's) implementation and monitoring constraints. No formula can determine the best number of asset classes—the appropriate number is determined by facts and circumstances. How many asset classes should be considered? Or in the case of participant-directed retirement plans, how many investment options should be offered? The answer depends on variables that will generally include the following:

- size of client's portfolio
- investment expertise of the client and/or Investment Advisor
- ability of the Investment Advisor to monitor the strategies and investment options properly
- sensitivity to investment expenses—more asset classes and/or options may mean higher portfolio expenses. The additional costs of added diversification should be evaluated in light of the price the client pays for being less diversified
- suitability of the asset class to the client

SUGGESTED PROCEDURE

Ordinarily, the most appropriate asset classes to be used as a starting point are the broad market classes representing the full range of investment opportunities, namely: stocks, bonds, and cash. From this starting point, additional asset classes, sub-asset classes and/or peer groups should be added to provide meaningful risk and return benefits to the overall investment strategy. This is based on the premise that the client's time horizon is greater than five years.

The Investment Advisor should keep in mind that the allocation also must be implemented and monitored. It makes no sense to make an allocation to an asset class that cannot be effectively and efficiently implemented and/or monitored on an ongoing basis.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)

Regulation

29 C.F.R. §2550.404a-1(b);

Case Law

Fink v. National Savings and Trust Company, 772 F.2d 951, 957, 6 E.B.C. 2269 (DC Cir. 1985); *Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983); *Morrissey v. Curran*, 567 F.2d 546, 548-49 (2d Cir. 1977); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp. 2d 898 (D.Minn. 1999); *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996); *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F. Supp. 882, 886 (S.D.N.Y. 1995); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F. Supp. 1509, 1516 (S.D.N.Y. 1988); *Katsaros v. Cody*, 744 F.2d 270 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040 (1984); *Leigh v. Engle*, 727 F.2d 113, 125-6 (7th Cir. 1984); *Beck v. Pace International Union*, 427 F.3d 668, 677 (9th Cir. 2005); *In the Matter of the Judicial Settlement of the Intermediate and Supplemental Account of the JP Morgan Chase Bank, as Trustee of the Trust under Eighth (B) of the Last Will and Testament of Blanche D. Hunter, Deceased*, 910 N.Y.S. 2d 405(2010); *Laborers Nat'l. Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999); *Lanka v. O'Higgins*, 810 F. Supp. 379 (N.D.N.Y. 1992); *Jones v. O'Higgins*, 11 EBC 1660 (N.D.N.Y. 1989); *Katsaros v.Cody*, 744 F. 2d 270, 279 (2d Cir. 1984) (*citing Marshall v. Glass/Metal Association*, 507 F. Supp. 378, 384 (D. Haw. 1980))

Other

H.R. Report No. 1280, 93rd Congress, 2d Sess.304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Investment Advisers Act of 1940

Case Law

In the Matter of Kidder Peabody & Co., Inc., IA Release No. 232 (October 16, 1968).

Other

Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, '34 Act Rel. No. 23170 (April 23, 1986).

Uniform Prudent Investor Act [UPIA]

§2; §2(a) comments; §2(f) comments; §4; §9(a)(1-3);

Other

Restatement of Trusts 3d: Prudent Investor Rule §227, comment

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b) and (e); §5(a)(1)-(3)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(a) and (b); §7(3); §7(3) comments; §8(a) and (b); §10(2)

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE 2.6

The investment policy statement contains sufficient detail to define, implement, and monitor the client's investment strategy.

CRITERIA

- **2.6.1** The investment policy statement identifies the bodies of law governing the portfolio.
- **2.6.2** The investment policy statement defines the duties and responsibilities of all parties involved.
- **2.6.3** The investment policy statement specifies risk, return, and time horizon parameters.
- **2.6.4** The investment policy statement defines diversification and rebalancing guidelines consistent with risk, return, and time horizon parameters.
- **2.6.5** The investment policy statement defines due diligence criteria for selecting investment options.
- **2.6.6** The investment policy statement defines procedures for controlling and accounting for investment expenses.
- **2.6.7** The investment policy statement defines monitoring criteria for investment options and service vendors.

The preparation and maintenance of each client's IPS is one of the most critical functions performed by the Investment Advisor. The IPS should be viewed as the business plan for managing an investment portfolio, and should be consistent with the terms of the plan document and trust. It should also be aligned with, and make reference to, legislation governing investment activities of the plan or portfolio; e.g., ERISA, IAA, UPIA, UPMIFA, and UMPERSA. It is the essential management tool for directing and communicating the activities of each client's portfolio. The IPS should be a formal, long- range strategic plan that allows the Investment Advisor to coordinate the management of each client's investment program in a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

The Investment Advisor is required to manage investment decisions with a reasonable level of documentation. By memorializing the details to writing in a mutually agreed-upon IPS, the Investment Advisor can: (1) avoid unnecessary differences of opinion and the resulting conflicts with clients, (2) minimize the possibility of missteps due to a lack of clear guidelines, (3) establish a reasoned basis for measuring success, both in terms of meeting the client's objectives and the Investment Advisor's efforts, and (4) establish and communicate reasonable and clear expectations with clients.

THERE ARE A NUMBER OF BENEFITS FROM HAVING A WELL-WRITTEN IPS:

- The IPS supports the "paper trail" in the event of an audit, litigation, or a dispute. One of the first documents a litigator or auditor is likely to review is the IPS, because it should provide an outline of the client's overall investment strategy.
- The IPS helps insulate the Investment Advisor and the client from "market noise." During periods of unusual volatility in the capital markets, the IPS helps to keep the client focused on the long- term goals and objectives.
- The IPS helps to provide implementation guidance during estate planning, particularly when one spouse is still actively managing all or a significant portion of the investable assets. Often, it's the "investing spouse" who is the first to become incapacitated, leaving the surviving spouse and/or executor with the near impossible task of maintaining the former investment strategy. An IPS thoughtfully prepared in advance and integrated within the overall estate plan helps to ensure smooth transition of the investment management decisions, particularly if there is a change in investment advisors.

The IPS should have sufficient enough detail that a competent third party could implement the investment strategy. It should be flexible enough that it can be implemented in a complex and dynamic financial environment. It should not, however, be so detailed as to require constant revisions and updates. Addendums may be used to identify client information that will change on a more frequent basis, such as the capital markets assumptions used to develop the client's asset allocation and the names of board members, accountants, attorneys, actuaries, money managers, and custodians.

One of the challenges of writing an IPS is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet flexible enough so as not to create an oversight burden. This is particularly true when establishing the client's asset allocation and rebalancing limits.

Rebalancing is required to maintain proper diversification, where the goal is to ensure the client's portfolio avoids 'allocation drift' by not straying far from its targeted levels of risk and return. Once the target allocation is established, periodic rebalancing is necessary to maintain the intended risk-return profile of the portfolio.

By establishing specific asset allocation parameters and money manager (or mutual/exchange-traded fund) selection criteria, it is much easier to determine whether a prospective manager fits into the approved investment program. The Investment Advisor should investigate the qualities, characteristics, and merits of each money manager, and identify the role each plays in the implementation of the client's investment strategy. However, such an investigation and the related analysis cannot be conducted in a vacuum—it must be within the context of the needs of the overall investment strategy. Once the needs have been defined, and the general strategies developed, specific money managers should be chosen within the context of this strategy.

The Investment Advisor's duty to monitor the performance of Investment Managers and other service providers is inherent in the obligations of fiduciaries to act prudently in carrying out their duties. Specific performance criteria and objectives should be identified for each money manager and/or fund.

Investment Advisors also must establish procedures for controlling and accounting for investment expenses. An Investment Advisor has a duty to ensure that their client incurs only reasonable and necessary expenses.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§402(a)(1); §402(b)(2); §402(c)(3); §403(a)(2); §404(a); §405(c)(1); §406(a)(1)(C); §408(b)(2)

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); §2550.404a-1(b)(2)(i); 29 C.F.R. §2550.404a-1(b)(408b-2)

Case Law

In re Unisys Savings Plan Litigation, 74 F.3d 420, 19 E.B.C. 2393 (3rd Cir.), *cert. denied*, 510 U.S. 810, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996); *Morrissey v. Curran*, 567 F.2d 546, 1 E.B.C. 1659 (2nd Cir. 1977); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp.2d 898 (D.Minn. 1999), aff'd, 284 F.3d 901 (8th Cir. 2002); *Whitfield v. Cohen*, 682 F. Supp. 188, 9 E.B.C. 1739 (S.D.N.Y. 1988); *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y. 1988); *Leigh v. Engle*, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989); *GIW Industries, Inc. v. Trevor, Stewart, Burton, & Jacobsen, Inc.*, 895 F.2d 729 (11th Cir. 1990); *Laborers Nat'l. Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999); *Lanka v. O'Higgins*, 810 F. Supp. 379 (N.D.N.Y. 1992); *Jones v. O'Higgins*, 11 EBC 1660 (N.D.N.Y. 1989); *Katsaros v.Cody*, 744 F. 2d 270, 279 (2d Cir. 1984)

Other

Interpretive Bulletin 94-2, 29 C.F.R. §08-2; 29 C.F.R. §2509.94-2; §2509.08-2; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1(e); 75-8; H.R. Report No. 1280, 93rd Cong. 2d Sess. 304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974); Interpretive Bulletin 96-1, *Participant Investment Education*. 29 C.F.R. §2509.96-1; Elton, Edwin J. and Gruber, Martin J., *Modern Portfolio Theory and Investment Analysis* (1995)

Investment Advisers Act of 1940

Other

Suitability of Investment Advice Provided by Investment Advisers, IA Rel. No. 1406 (March 16, 1994).

Uniform Prudent Investor Act [UPIA]

§2 and Comments; §3 and Comments; §4; §7; §9(a)(1), (2) and (3)

Other

Restatement of Trusts 3d: Prudent Investor Rule §227(a) and §277; OCC Interpretive Letter No. 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m (1992)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c); §3(e); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(a); §6(b)(2) and (3); §7(2), (3) and (5); §7(5) and Comments; §8 and Comments

Other

Restatement of Trusts 3d: Prudent Investor Rule§171 and §227, comment g

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.7

When socially responsible investment strategies are elected, the strategies are structured appropriately.

CRITERIA

2.7.1 Each client's goals and objectives are evaluated to determine whether socially responsible investing is appropriate and/or desirable.

2.7.2 If a client has elected a socially responsible investment strategy, the client's investment policy statement documents the strategy, including appropriate implementation and monitoring procedures.

There is increasing interest by some clients to incorporate social, ethical, moral, religious, or political criteria into their investment strategy to align investment decisions with their core values. There are two terms that are used interchangeably by the industry: mission-based investing and socially responsible investing (SRI).

If the client desires to employ a socially responsible investment strategy, one might assume the Advisor's general fiduciary duties of care and loyalty would work in this situation. However, an SRI strategy must be implemented within the confines of the overriding fiduciary duty to act prudently in the client's best financial interests, not for the greater good of society.

Special Considerations under ERISA

The exclusive purpose doctrine under ERISA focuses upon the need to align the investment options with the central purpose of an ERISA-covered plan, which is saving for retirement or health and welfare benefits. Thus, fiduciary standards of care cannot be abrogated to accommodate the pursuit of an SRI strategy, not even where the sole reason for the plan sponsor's existence is to further specific social goals.

Before selecting an SRI opportunity for an ERISA-covered plan, the responsible fiduciary must first conclude that the value to the plan offered by the SRI opportunity is equal to or greater than the value of other investment opportunities available to the plan – truly equal or greater, taking into account a quantitative and qualitative analysis of the economic impact to the plan. This does not mean that an investment option that is mission-based or socially responsible must be given special consideration if in fact it has more value than competing investments. Rather, it means that non-economic factors may be considered only if the two investment options are truly equal.

These rules apply to plan investments, proxy voting, shareholder activism, and activities that further policy or political issues. For example, using plan assets to solicit proxy votes to require corporate directors and officers to disclose their political contributions, or to organize union campaigns, would not likely enhance the value of plan assets and would therefore

raise compliance issues under ERISA §§404(a)(1)(A) and (B). The Department of Labor has stated, in official guidance, that it believes fiduciaries who select SRI options over available alternative investments "will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value."

Special Considerations under UPMIFA

In stark contrast to ERISA, UPMIFA requires a plan fiduciary, subject to the intent of a donor expressed in a gift instrument, to consider the charitable purposes of the institution and the purposes of the institutional fund. In addition, the commentary to §3(e)(3) expressly states that a donor may impose SRI restrictions on a gift. Nothing, however, in the UPMIFA sanctions SRI options that are unrelated to the charitable purpose of the institution, the purposes of the institutional fund, or the intent of a donor.

Special Considerations under the UPIA

The comment to §5 of the UPIA provides that "[n]o form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries–for example, by accepting below-market returns–in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause." Under § 1(b), however, the terms of the trust could conceivably override the duty of loyalty in favor of SRI options.

Other Considerations

In addition, with respect to personal trusts, foundations, and endowments, failure to consider an SRI strategy could be a breach of state trust law under certain circumstances:

- The trust documents establishing the private trust, foundation, or endowment state that SRI is preferred.
- A donor directs the use of an SRI strategy as a condition for making a donation.
- A reasonable person would deduce from the foundation's/endowment's mission that SRI would be considered (e.g., it is reasonable to assume that the American Cancer Society would avoid investing in tobacco companies).

SAMPLE LANGUAGE FOR THE IPS

The following sample IPS language could be utilized for any client where the above "Other Considerations" do not apply. If they do apply, the following language should be modified accordingly:

The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.

SUGGESTED PROCEDURE

There are a number of different approaches the client can employ to execute mission-based and SRI strategies. Some strategies may not be legally suitable for all clients and certain fiduciary clients should consult legal counsel before adopting an SRI approach.

THE FOLLOWING IS A BRIEF SYNOPSIS:

① The client may wish to direct the Investment Advisor to find money managers or funds that incorporate particular SRI screens. The screens may be either inclusionary or exclusionary. **Inclusionary qualitative screens might include companies that emphasize the following qualities and initiatives:**

- product quality/consumer relations
- environmental performance
- community relations
- diversity
- employee relations

Exclusionary screens might include companies in the following sectors:

- "sin" stocks—alcohol, tobacco, firearms
- nuclear power
- military weapons
- life ethics

② The client may wish to pursue a strategy of shareholder activism—actually purchasing shares of stock in a targeted company so that the client can participate in corporate governance activities.

③ The client may wish to pursue economically targeted investing (ETI). ETI is the use of portfolio assets to produce collateral benefits such as jobs, housing loans, and venture capital.

④ The client may wish to direct the Investment Advisor to find money managers that are minority and/or women-owned business enterprises.

In the case of ERISA clients, the key to incorporating an SRI strategy successfully is first to document a written policy that articulates why the SRI opportunities are just as likely (or more likely) than any other available alternative investment option with commensurate degrees of risk and return to enhance the economic value of the plan, taking into account the role the investment plays with respect to the applicable portion of the plan's investment portfolio within the scope of the fiduciary's responsibilities. For example, an SRI option with a rate of return that is equal to a competing investment would not be appropriate if the SRI option were more risky than the alternative. The factors to be considered include, but are not limited to, diversification, liquidity, and risk/return characteristics of the SRI opportunity and the competing investment opportunities. Social factors may be considered only if there are equally attractive investment options – an SRI option included in the plan must be economically indistinguishable (or better) than competing investment options - and only after the responsible fiduciary has duly investigated the alternatives and documented in writing the reasons for selecting the SRI option over competing investments.

If the client is a participant-directed defined contribution plan, the most prudent way to implement an SRI investment option is to present the SRI investment options that have been duly investigated and documented as provided above alongside a general purpose fund of the same peer group. This way, each participant can choose whether or not to elect the SRI opportunity.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§403(c)(1); §404(a)(1)

Regulations
29 C.F.R. §2550.404a-1

Case Law
In re Unisys Savings Plan Litigation, 74 F.3d 420, 435 (3d Cir.), *cert. denied*, 510 U.S. 810 (1996); *Leigh v. Engle*, 727 F.2d 113, 125-6 (7th Cir. 1984); *Beck v. Pace International Union*, 427 F.3d 668, 677 (9th Cir. 2005); *Morrissey v. Curran*, 567 F.2d 546, 548-49 (2d Cir. 1977); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp. 2d 898 (D.Minn. 1999), *citing Whitfield v. Cohen*, 682 F. Supp. 188, 196 (S.D.N.Y. 1988)

Other
ERISA Opinion Letter No. 98-04A (May 29, 1998); ERISA Opinion Letter 2007-7A (Dec. 21, 2007); ERISA Opinion Letter 2008-05A (June 27, 2008); Interpretive Bulletin 08-1, 29 C.F.R. §2509.08-1

Investment Advisers Act of 1940

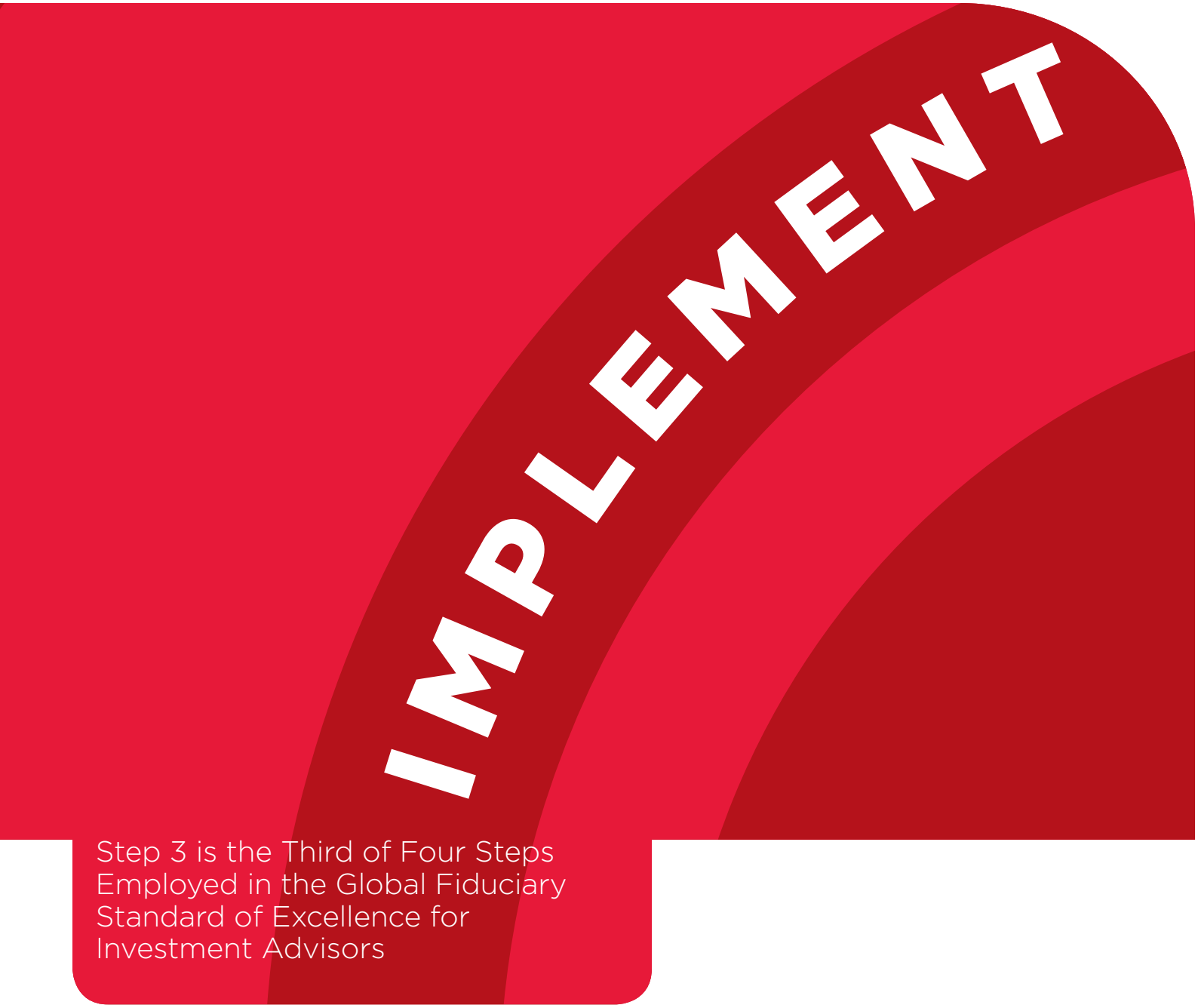
Case Law
In re ND Money Mgmt., Inc., Inv. Adv. Act Rel. No. 2027 (Apr. 12, 2002)

Other
Status of Investment Advisory Programs under the Investment Company Act of 1940, IC Rel. No. 22579 (March 24, 1997);

Uniform Prudent Investor Act [UPIA]
§2(a); §2(c); §4; §5 and comment

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(a); §3(a) comment; §3(b); §3(e) and comment

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§7(1), (2) and (3); §8(a) (1) and (2); §8(a)(5) and comment; §8(b)



Step 3 is the Third of Four Steps Employed in the Global Fiduciary Standard of Excellence for Investment Advisors

PRUDENT PRACTICES *for* INVESTMENT ADVISORS

STEP 3

STEP 3 : INTRODUCTION

If one were to sum up Step 3 of the Fiduciary Quality Management System in two words, they would be "due diligence." This Step is where all of the planning, organizing, and formalizing that was involved in the initial stages of the client engagement are executed with utmost good faith. In fact, all areas of fiduciary duty come into play in this Step: the duty of loyalty, of care, and utmost good faith.

At this point, you should ask yourself a range of process-related questions: Do I have a sound process for selecting the service providers that will assist with implementing the investment process, as well as the specific investments? Is the process objective? Is it applied consistently and with appropriate care and due diligence? If the portfolio will involve alternative investments or strategies, how will I appropriately measure and benchmark risk and return, and will I monitor these positions effectively? What protocols will I use to properly document the decisions of fiduciaries and the reasons for the decisions?

Along with the selection of service providers and investments, Step 3 also includes the optional safe harbor Practice. The general and fiduciary adviser safe harbors protect the fiduciary from liability for the actions of those experts to whom they have delegated responsibility. The general safe harbor extends beyond ERISA to endowments, foundations, and private trusts, as there is language similar to ERISA Section 404(a) in UPIA and UPMIFA. The 404(c) safe harbor protects the fiduciary from liability for the actions of the participants. The QDIA safe harbo" protects the plan sponsor from liability for defaulting the participant into the QDIA. Also, there are two limited safe harbors associated with IAA.

As always, the roles and responsibilities of all parties, consistent with Step 1, should continue to be clearly identified and documented. These will vary, of course, depending upon the scope of the engagement. When setting up a new ERISA plan, for example, the adviser may be directly involved in coordinating the work of the plan sponsor and various service providers, including investment managers. In contrast, the same advisor may face different challenges if he or she is advising a private client group and coordinating the needs of a high net worth client, such as establishing and funding multiple trusts, setting up 529 accounts for college savings, and perhaps rolling over a 401(k) account into an IRA.

Finally, it is important to communicate any change of fiduciary status during Step 3, where the Investment Advisor may change roles during implementation. Ideally, fiduciary status does not change during an engagement, but it may. For example, a financial planner dually registered as a broker may develop financial planning recommendations under the RIA, and if the engagement provides for implementation of some or all of the recommendations, it may require him or her to inform the client of a change in fiduciary status when executing trades as a registered representative. In situations such as this, the Advisor should be sure to comply not only with laws and regulations, but also professional codes of conduct (such as the AICPA Code of Professional Conduct) that may set higher obligations than may be required by law.

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE 3.1

A reasonable due diligence process is followed to select each service provider in a manner consistent with obligations of care.

CRITERIA

3.1.1 Reasonable criteria are identified for each due diligence process used to select service providers.

3.1.2 The due diligence process used to select each service provider is documented.

3.1.3 Each due diligence process used to select service providers is consistently applied.

Investment Advisors will be held to an "expert standard of care" and their activities and conduct will be measured accordingly. If the Advisor is involved with ERISA plans as the 3(38) investment manager, the role of selecting other service providers will likely be more complex and involved than when working with individual clients. Nevertheless, the primary role of the Investment Advisor is almost always to guide the client's investment process. The Advisor may act with discretion, as in the case of the 3(38) role, or may make recommendations for an institutional fiduciary or individual investor client to act upon. In either situation, the Advisor is expected to apply sound due diligence to select or recommend investment strategies; individual stocks, bonds, or other securities; and outside money managers or other service providers.

With respect to qualified plans, the Advisor will need to carefully document the investment process. Service providers are required under ERISA Section 408(b)(2) to disclose their services, compensation arrangements, and fiduciary status (if assumed). These disclosure requirements took effect under DOL rules imposed in mid-2012 and make the documentation process significantly easier, albeit with heightened expectations by the DOL for plans to obtain and use this information in the due diligence used to select service providers.

Custodial selection is also a very important fiduciary function. As with other prudent practices, there are a number of important decisions that need to be managed. The role of the custodian, whether acting as custodian of a qualified plan or for an individual client, is to: (1) hold securities for safekeeping, (2) report on holdings and transactions, (3) collect interest and dividends, and, if required, (4) effect trades.

At the retail level, the custodian typically is a brokerage firm. Most securities are held in street name, with the assets commingled with those of the brokerage firm. To protect the assets, brokerage firms obtain adequate and appropriate insurance. Most institutional investors use trust companies as custodians and pay an additional custody fee. The primary benefit is that the assets are held in a separate account, and are not commingled with other assets of the institution.

Keeping all these factors in mind, there is a great emphasis on the due diligence process. Whether investment decisions are delegated to other investment professionals or retained by the Investment Advisor, the Advisor should demonstrate that a due diligence process was followed in the selection process.

Special Considerations Under ERISA

With respect to plans covered by ERISA, the Advisor will need to carefully document the process. As mentioned in the section above, DOL rules relating to ERISA section 408(b)(2)require specific disclosures by service providers in order to avoid a prohibited transaction. These rules apply to the following providers if they reasonably expect $1,000 or more in direct or indirect compensation to be received in connection with the identified services (Covered Service Providers):

- ERISA fiduciary service providers to an investment product, contract, or entity that is a plan asset vehicle in which a plan invests
- investment advisers registered under federal or state law
- record-keepers or brokers who make designated investment alternatives available to the covered plan (e.g., a platform provider)
- providers of one or more of the following services to the covered plan who also receive "indirect compensation" in connection with such services: accounting, auditing, actuarial, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities brokerage, third party administration, or valuation services

COVERED SERVICE PROVIDERS MUST FULFILL THE FOLLOWING REQUIREMENTS:

1. Disclose that they provide services as a fiduciary under ERISA or the IAA, to the extent applicable
2. Describe the services to be provided and all direct and indirect compensation to be received by a Covered Service Provider, its affiliates, or subcontractors. Direct compensation is compensation received directly from the covered plan. Indirect compensation generally is compensation received from any source other than the plan sponsor, the Covered Service Provider, an affiliate, or subcontractor. Covered Service Providers that disclose indirect compensation also must describe the arrangement between the payer and Covered Service Provider pursuant to which indirect compensation is paid. Covered Service Providers must identify the sources for indirect compensation, plus services to which such compensation relates. Compensation disclosures by Covered Service Providers must include allocations of compensation made among related parties (i.e., among a Covered Service Provider's affiliates or subcontractors) when such allocations occur as a result of charges made against a plan's investment or are set on a transaction basis.
3. Covered Service Providers must disclose compensation they, an affiliate, or subcontractor expects to receive if the contract is terminated.
4. Covered Service Providers must disclose whether they are providing recordkeeping services and the compensation attributable to such services, even when no explicit charge for recordkeeping is identified as part of the service package or contract, an estimate of the cost to the plan of the recordkeeping services, and an explanation of how that estimate is calculated.
5. Some Covered Service Providers must disclose charges against an investment (e.g., commissions and sales loads) and an investment's annual operating expenses (e.g., expense ratio) and any ongoing operating expenses in addition to annual operating expenses. For participant-directed individual account plans, such disclosures must include total annual operating expenses as required under the participant disclosure regulations at 29 CFR §2550.404a-5.

6. A Covered Service Provider that is a plan asset vehicle offered as an investment option under the plan must disclose data and information about the investment option that is within the control of, or reasonably available to, the Covered Service Provider and that is required for the plan's administrator to comply with the participant disclosure obligations of 29 C.F.R. §2550.404a-5.
7. A Covered Service Provider may provide current disclosure materials of an unaffiliated issuer of a designated investment alternative, or information replicated from such materials, provided that the issuer is a registered investment company (i.e., mutual fund), an insurance company qualified to do business in a state, an issuer of a publicly-traded security, or a financial institution supervised by a state or federal agency.
8. Covered Service Providers should provide plan fiduciaries with a guide, summary, or similar tool to assist fiduciaries in identifying all of the disclosures required under these rules, particularly when service arrangements and related compensation are complex and information is disclosed in multiple documents.
9. Covered service providers must update this information within 60 days after the Covered Service Provider learns of the change.
10. Covered Service Providers must disclose compensation or other information related to their service arrangements upon the request of the responsible plan fiduciary or plan administrator, reasonably in advance of the date upon which such person states that they must comply with ERISA's reporting and disclosure requirements.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§402(a)(1); §402(b)(2); §404(a)(1)(B);§405(c); §406(a); §408(b)(2)

Regulations

29 C.F.R. §2550.404a-1(b)(1) and (2); 29 C.F.R. §2550.408b-2(c); 29 C.F.R. §2509.96-1

Other

DOL Field Assistance Bulletin 2007-01 (2/2/2007); DOL Information Letter, Qualified Plan Services (7/28/98); DOL Information Letter, Service Employees International Union (2/19/98)

Case Law

Howard v. Shay, 100 F.3d 1484, 20 E.B.C. 2097 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237, 117 S.Ct. 1838, 137 L.Ed.2d 1042 (1997); *Fink v. National Savings and Trust Co.*, 772 F.2d 951 (D.C. Cir. 1985); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2nd Cir.), *cert. denied*, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S.Ct. 704, 79 L.Ed.2d 169 (1984); *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F.Supp. 882, 19 E.B.C. 1467 (S.D.N.Y. 1995); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F.Supp. 1509 (S.D.N.Y. 1988); *George v. Kraft Foods Global, Inc.*, 641 F.3d 786 (7th Cir. 2011); *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585 (8th Cir. 2009); *In the Matter of Rivas*, 30 Misc. 3d 1207 (N.Y. Sur. 2011)

Investment Advisers Act of 1940

§206(1)-(2)

Case Law

In the Matter of Eugene Bilotti, SEC Rel. No. IA-1689 (Dec. 23, 1997); *SEC v. Greenberg*, Civ. Act. No. 1:11-cv-00313-JLK (D. Co. Feb. 11, 2011); *In the Matter of Alfred C. Rizzo*, SEC Rel. No. IA-897 (Jan. 11, 1984); I*n the Matter of Hennessee Group LLC and Charles J. Gradante*, SEC Rel. No. IA-2871 (Apr. 22 2009)

Uniform Prudent Investor Act [UPIA]

§2(a); §2(c); §2(f); §7 and Comments; §9(a) (1), (2) and (3);

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c); §3(e); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(a); §6(b)(1) and (2); §7; §8(a)(1)

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE 3.2

When statutory or regulatory investment safe harbors are elected, each client's investment strategy is implemented in compliance with the applicable provisions.

CRITERIA

3.2.1 Applicable ERISA safe harbor requirements pertaining to the delegation of investment responsibility are implemented in compliance with regulatory requirements, when elected.

3.2.2 For participant-directed qualified retirement plans, applicable 404(c) safe harbor requirements are implemented in compliance with ERISA requirements, when elected.

3.2.3 For participant-directed qualified retirement plans, applicable fiduciary adviser safe harbor requirements are implemented in compliance with ERISA requirements, when elected.

3.2.4 For participant-directed qualified retirement plans, qualified default investment alternatives (QDIA) are implemented in compliance with ERISA requirements, when elected.

3.2.5 Applicable safe harbors for automatic rollovers to individual retirement plans are implemented properly, when elected.

3.2.6 For non-ERISA services, safe harbors and exemptions are implemented in compliance with regulatory requirements, when elected.

The first five criteria pertain to ERISA-related safe harbors and the first two were enacted when ERISA was originally passed in 1974. The fiduciary adviser and QDIA safe harbors were established in the Pension Protection Act of 2006 (PPA) and provide amendments to, or exemptions from, certain ERISA provisions in the spirit of encouraging plan sponsors to provide more assistance to their participants. Criteria 3.2.6 addresses safe harbors that derive from the Investment Advisors Act of 1940 (IAA).

Safe harbors are highly desired by fiduciaries because they mitigate fiduciary risk. They provide prescriptive formulas for taking certain actions in ways that are deemed to be consistent with fiduciary obligations. Thus, while there may be alternative approaches that would not constitute breaches of fiduciary duties, the safe harbors provide clear and certain methods of avoiding liability.

THERE ARE THREE IMPORTANT CONCEPTS ASSOCIATED WITH ALL OF THE SAFE HARBOR PROCEDURES SUMMARIZED IN THIS PRACTICE:

1. They are voluntary – the procedures are not compulsory for the Steward under ERISA or for the Investment Advisor to a qualified plan or executing principal transactions under the IAA. Under ERISA, a Steward choosing not to rely on available safe harbors bears the associated risk and consequences, but with risk often comes rewards. The requirements of safe harbors are deemed to be prudent even when the short term result of applying a safe harbor may

be damaging to the end investor For example, in 2008 and 2009, the QDIA safe harbor, combined with automatic enrollment, arguably contributed to the most precipitous decline ever of asset values held in individual account plans covered by ERISA. The unfortunate timing of when this safe harbor was introduced (just prior to the financial crisis of 2008) resulted in many 401(k) plan participants being more heavily invested at the time of steep market declines than might have otherwise have been the case. A judicious fiduciary should thoughtfully consider and weight the protection that comes with a safe harbor versus potential costs or risks for participants or beneficiaries of the trust. At a minimum, an Advisor who serves as a consultant to a retirement plan should clearly advise the plan Stewards of safe harbor opportunities so that they can make informed decisions.

2. ERISA safe harbors may insulate the Steward (and possibly the Advisor/consultant) from liability associated with certain investment-related decisions and acts. The Steward should think of safe harbor procedures as a form of "insurance." IAA safe harbors under §206 provide a basic means for managing conflicts inherent in principal transactions (known as self-dealing under ERISA).
3. ERISA safe harbors require the Steward to demonstrate compliance with the applicable defined requirements. IAA safe harbors also require specific documentation. Applicable, in both instances, means those provisions directly affecting the investment decision-making process.

THE FIVE DISTINCT SAFE HARBORS AVAILABLE TO INVESTMENT FIDUCIARIES UNDER ERISA ARE:

① The 405(c) Safe Harbor, or general safe harbor provisions related to delegation of investment decisions

② The 404(c) Safe Harbor (applicable only to ERISA Investment Stewards or other ERISA fiduciaries)

③ The Fiduciary Adviser Safe Harbor

④ The Qualified Default Investment Alternative (QDIA) Safe Harbor (applicable only to ERISA Investment Stewards)

⑤ The Automatic Rollover Safe Harbor

405(c) Delegation of Investment Decisions: Requirements

When investment decisions are delegated (regardless of being in a participant-directed or committee-directed plan), there are seven generally-recognized safe harbor requirements that should reduce, but not completely eliminate, the Steward's liability:

1. The ERISA plan must provide a procedure for allocating fiduciary responsibility for investment decisions, and the Investment Steward must act pursuant to that procedure when delegating such responsibilities.
2. The plan's procedures for allocating fiduciary responsibilities must be established or implemented in a prudent fashion.
3. Investment decisions must be delegated to a "prudent expert" (i.e., registered investment adviser, a bank, or an insurance company).
4. The Investment Steward must demonstrate the prudent expert was selected by following a prudent, due diligence process.
5. The prudent expert must be given discretion over the assets.
6. If the prudent expert is a registered investment adviser, it must acknowledge its fiduciary status in writing (advisers to registered mutual funds are exempted from this requirement as the mutual fund's assets are not assets of an ERISA plan, and the prospectus is deemed to serve as the fund's fiduciary acknowledgment under the IAA).
7. The Investment Steward must monitor the activities of the prudent expert(s) to ensure that the expert is properly performing the agreed upon tasks using the agreed-upon criteria.

[Note: UPIA, UPMIFA, and UMPERSA also include language that provides a certain degree of protection for fiduciaries – usually the trustees – who properly delegate investment responsibility, though many states have declined to adopt such a provision. It is therefore important to check applicable state law.]

404(c) Safe Harbor Requirements

THE 404(C) SAFE HARBOR IS COMMONLY USED BY SPONSORS OF PLANS WITH PARTICIPANT-DIRECTED INVESTMENTS AS A MEANS OF REDUCING FIDUCIARY LIABILITY.

In essence, this safe harbor shields plan fiduciaries from liability for the investment selections made by plan participants so long as the requirements of the safe harbor are met. The 404(c) and 405(c) safe harbors work in tandem. The plan sponsor applies sound due diligence to select investment managers (generally, mutual funds) that will be available in the plan's menu of investment options. This general delegation of investment management responsibilities is in compliance with the 405(c) safe harbor requirements described above. But there is more to it.

In addition to requirements for the general safe harbor, 404(c) has eight additional requirements:

1. Plan participants must be notified in writing that the plan sponsor intends for the plan to constitute a 404(c) plan and seek that the fiduciaries may be relieved of liability through these safe harbor procedures.
2. Participants must be offered at least three investment options, each of which is diversified, with materially different risk/return profiles. The investment options must provide the participant with a reasonable opportunity to materially affect the potential return on amounts in the participant's account with respect to which he is permitted to control and the degree of risk to which such amounts are subject. Also, in the aggregate, the options must enable the participant, by choosing among them, to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant. When combined with other alternatives, the investments should minimize through diversification the overall risk of the participant's portfolio.
3. Participants must have the opportunity to give investment directions to a fiduciary who is generally obligated to comply with the instructions, and the opportunity to receive a written confirmation of such instructions.
4. If any investment alternative permits changes more frequently than once every three months, at least one of the three investments described above must permit the same frequency of change, and the investment into which participants can transfer must be income producing, low risk, and liquid.
5. Participants must have the right to diversify their investments so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' accounts.
6. Participants must receive information and education on the different investment options.
7. Participants must be provided the opportunity to change their investment strategy/ allocation with a frequency that is appropriate in light of market volatility, but no less frequently than once within any three-month period.
8. The plan administrator must comply with the participant disclosure requirements of 29 C.F.R. §2550.404a-5.

With respect to the information plan sponsors provide the participants, the final rule to improve transparency of fees and expenses to participants in 401(k)-type retirement plans [often referred to as the 404(a)(5) or Participant Disclosure Rule] takes this disclosure to a new level. It is a significant step by the DOL meant to ensure that participants receive information that is complete and understandable.

Fiduciary Adviser Safe Harbor Requirements

THE PROHIBITED TRANSACTION PROVISIONS OF ERISA AND THE INTERNAL REVENUE CODE PROHIBIT A FIDUCIARY FROM GIVING ADVICE TO PARTICIPANTS THAT RESULT IN THE PAYMENT OF ADDITIONAL ADVISORY OR OTHER FEES TO THE FIDUCIARY OR ITS AFFILIATES.

The Pension Protection Act of 2006 ("PPA") provides a statutory exemption for such prohibited transactions provided certain requirements are met. The PPA also codifies existing guidance that relieves plan sponsors from potential fiduciary liability that may arise from the investment advice provided by the advisor to the participant.

THE PPA EXEMPTION FOR ELIGIBLE INVESTMENT ADVICE ARRANGEMENTS

PPA established a safe harbor for Investment Advisors who want to provide specific investment advice to 401(k) plan participants, and defines two terms that are related to the safe harbor requirements: "fiduciary adviser" and "eligible investment advice arrangement."

A "fiduciary adviser" is a person who provides investment advice to plan participants or beneficiaries. The "fiduciary adviser" must be a registered investment adviser, a bank or similar financial institution, an insurance company, a registered broker/dealer, an affiliate of the foregoing, or an employee, agent, or registered representative of any of the foregoing.

An "eligible investment advice arrangement," is an arrangement between a qualified plan sponsor and a fiduciary adviser in order for the plan sponsor to avoid liability for the fiduciary advisor's investment advice. Under the arrangement, the fiduciary adviser can be fee neutral (i.e., fees do not vary based on investments selected by the participant) and/or use a computer model certified as unbiased and as applying generally accepted investment theories.

The final rule shows advisors how to comply with other conditions and safeguards in this statutory exemption, including:

- requires that a plan fiduciary (independent of the investment adviser or its affiliates) authorize the advice arrangement
- imposing recordkeeping requirements for investment advisers relying on the exemption
- requiring that computer models must be certified in advance as unbiased and meeting the exemption's requirements by an independent expert
- establishing qualifications and a selection process for the investment expert who must perform the above certification
- clarifying that the fee neutral or level-fee requirement does not permit investment advisers (including their employees) to receive compensation from any party (including affiliates) that vary on the basis of the investments participants select
- establishing an annual audit of both computer model and level-fee advice arrangements, including the requirement that the auditor be independent from the investment advice provider
- requiring disclosures by advisers to plan participants

CODIFICATION OF FIDUCIARY RELIEF

If an eligible investment advice arrangement complies with the requirements above for an exemption, then a plan sponsor (or other fiduciary) shall not be liable under ERISA's fiduciary provisions solely by reason of the investment advice provided by a fiduciary adviser to participants or beneficiaries if (1) the terms of the eligible investment advice arrangement require the fiduciary adviser to comply with the terms of the exemption, (2) the terms of the eligible investment advice arrangement acknowledge that the fiduciary adviser is a fiduciary of the plan with respect to the investment advice, and (3) the authorizing fiduciary prudently selects and monitors the fiduciary advisor. Similar relief may be available even if the arrangement does not satisfy the exemption, provided the authorizing fiduciary prudently selects and monitors the fiduciary adviser.

Qualified Default Investment Alternative Safe Harbor Requirements

Under the QDIA safe harbor, a plan sponsor can have 404(c) protection for default investment options in which, absent a participant's election after proper notice, the participant's accounts are invested in accordance with the QDIA requirements.

A "qualified default investment alternative," is defined as an investment that is available to participants and beneficiaries that is:

a. age-based lifecycle or targeted-retirement-date funds or accounts;

b. risk- based, balanced funds; or

c. a professionally-managed account.

A capital preservation product may be utilized for the first 120 days of participation.

Participants must be provided with the following:

1. details of default investment arrangement, including any automatic contribution arrangement in the plan, if applicable
2. an explanation that the participant or beneficiary has the right to direct investments
3. a description of the QDIA, including fees and expenses
4. a description of the right of participants and beneficiaries to switch investments, including related restrictions, fees, or expenses
5. an explanation of where participants or beneficiaries can get more information
6. the participant disclosures required by 29 C.F.R. §2550.404a-5

Notice is due 30 days in advance of plan eligibility or the date of any first investment in the QDIA. If the plan allows withdrawals of automatic contributions under Internal Revenue Code Section 414(w), notice is due on or before the date of plan eligibility. Notice is also due 30 days in advance of each subsequent year.

Employer stock is generally not permissible unless either:

a. stock is held or acquired by a registered investment company or pooled investment vehicle that is independent of the employer; or

b. stock is acquired as a matching contribution from the employer and the stock is held at the direction of the participant

Automatic Rollover Safe Harbor

Under Internal Revenue Code §401(a)(31)(B), if a plan forces out a distribution (generally, distributions of more than $1,000 to $5,000) and the participant does not elect a rollover or a direct distribution, then the plan is required to rollover the distribution to an individual retirement plan, e.g., an IRA. Under the automatic rollover safe harbor, an ERISA fiduciary is deemed to satisfy its duties under ERISA §404 with respect to both the selection of the IRA and the investment of the funds in connection with the automatic rollover. The safe harbor also applies to automatic rollovers of $1,000 or less.

The automatic rollover safe harbor has the following requirements:

1. The value of the automatic rollover may not exceed $5,000 (not counting rollovers disregarded by the plan for mandatory distributions).
2. The rollover is made to an individual retirement plan described in Internal Revenue Code §7701(a)(37), e.g., an IRA established by a bank or insurance company.
3. There must be a written agreement between the plan fiduciary and the IRA provider that includes the requirements below.
4. The rolled over funds must be invested in a product designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, consistent with liquidity.
5. The investment product must seek to maintain, over the term of the investment, the dollar value of the principal investment.
6. The investment product must be offered by a bank or savings association insured by FDIC, a credit union insured under the Federal Credit Union Act, an insurance company protected by state guaranty associations, or a registered investment company under the Investment Company Act.
7. Fees and expenses charged for the IRA cannot exceed the fees and expenses charged for other IRAs.
8. The participant must have the right to enforce the contract establishing the IRA.
9. The participant must have received a summary plan description or summary of material modifications that describes the automatic rollover provisions, including an explanation that the funds will be invested in a product designed to preserve principal and provide a reasonable rate of return and liquidity; how the fees and expenses will be allocated; and a name, address, and phone number of a plan contact who can provide more details.
10. The selection of the IRA and the investment of the funds cannot be a non-exempt prohibited transaction.

Note that these ERISA safe harbor rules are in addition to the rules under the Internal Revenue Code that relate to automatic rollovers, including the Special Tax Notice required under Internal Revenue Code §402(f).

Other Safe Harbors

IAA offers two limited safe harbors for principal transactions, one of which is rarely used, the other of which is a temporary rule for broker-dealers that are dually registered as investment advisers.

The first safe harbor, which was written into the law passed by Congress in 1940, requires investment advisers to provide written notice and receive consent from the client prior to each principal transaction. In 2007, the SEC adopted a Temporary Rule 3T for broker-dealers acting as investment advisers to provide a blanket notice and consent to advisory clients, subject to certain limitations, under an expanded safe harbor. This temporary rule has been extended through the end of 2014.

In addition, ERISA provides a safe harbor for distributions from terminated orphan plans and a safe harbor for selecting an annuity provider and an annuity contract for distributions from individual account plans. The safe harbor provided for annuities under § 2510.3-2(f) issued by the DOL in 1979 allows for the purchase of annuity contracts or custodial accounts in accordance with provisions set forth in Section 403(b) of the Internal Revenue Code and which are funded solely through salary reduction agreements or agreements to forego an increase in salary. Annuities are not considered as being "established or maintained" by an employer under section 3(2) of ERISA, and, consequently, are not employee pension benefit plans subject to ERISA's Title I, when: (1) participation of employees is completely voluntary, (2) all rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary, (3) the involvement of the employer is limited to certain optional specified activities, and (4) the employer receive no direct or indirect consideration or compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §404(a)(1)(B); §404(c); §405(c)(2); §405(d)(1); §408(b)(14); §408(g)(10)-(11)

Regulations
29 C.F.R.§2510.3-2f; 29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404-2; 29 C.F.R. §2550.404-3; 29 C.F.R. §2550.404-4; 29 C.F.R. §2550.404a-5; 29 C.F.R. §2550.404c-1; 29 C.F.R. §2550.404c-5; 29 C.F.R. §2550.408g-1

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR13-15, FR17Q); Interpretive Bulletin 08-02, 29 C.F.R. §2509.08-2; DOL Miscellaneous Document, 4/13/98 – Study of 401(k) Plan Fees and Expenses; Preamble to Investment Duties Regulation, 44 Fed. Reg. 37,255 (June 26, 1979); Interpretative Bulletin 96-1(e), 29 C.F.R. § 2509.96-1(e); Department of Labor Field Assistance Bulletin 2007-1 (February 2, 2007); DOL Advisory Opinion Letter 97-15A (May 22, 1997); DOL Advisory Opinion Letter 97-16A (May 23, 1997)

Case Law
Tittle v. Enron Corp., 284 F.Supp.2d 511, 578 (S.D. Texas 2003)

Investment Advisers Act of 1940
§203(e)(6); §206(3) (principal transactions)

Securities Exchange Act of 1934
§28(e)

Regulations
17 C.F.R. §275.202(a)(25); 17 C.F.R. §275.203(3)(6); 17 C.F.R. §275.206(4)-7; 17 C.F.R. §270.38a-1; 17 C.F.R. §275.206(3)-3T (Temporary Rule 206(3)-3(T))

Case Law
Tittle v. Enron Corp., 284 F.Supp.2d 511, 578 (S.D. Texas 2003); *In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc.*, SEC Rel. IA-1980 (Sep. 28, 2001); *In the Matter of Morgan Stanley Investment Management, Inc.*, SEC Rel. IA-3315 (Nov. 16, 2011)

Other
Uniform Application for Investment Adviser Registration (Form ADV), Glossary, Item 42; Disclosure by Investment Advisers Regarding Soft Dollar Practices, SEC Rel. IA-1469 (Feb. 14, 1995); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, SEC. Rel. No. 34-52635 (Oct. 19, 2005)

Uniform Prudent Investor Act [UPIA]
§9(a); §9(c)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§5(a); 5(c)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§6(a); §6(b); §6(d)

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE 3.3

Decisions regarding investment strategies and types of investments are documented and made in accordance with fiduciary obligations of care.

CRITERIA

- **3.3.1** A documented due diligence process, consistent with prudent practices and generally accepted investment theories, is used to select investments and third-party Investment Managers.
- **3.3.2** Decisions regarding the selection of investments consider both qualitative and quantitative criteria.
- **3.3.3** The documented due diligence process used to select investments and third-party Investment Managers is consistently applied.
- **3.3.4** Regulated investments are preferred over unregulated investments when all other characteristics are comparable.
- **3.3.5** Investments that are covered by readily available data sources are preferred over similar investments for which limited coverage is available when all other characteristics are comparable.
- **3.3.6** Decisions regarding passive and active investment strategies are documented and made in accordance with obligations of care.
- **3.3.7** Decisions regarding the use of separately managed and commingled accounts, such as mutual funds, unit trusts, exchange-traded products, and limited partnerships, are documented and made in accordance with obligations of care.
- **3.3.8** Decisions to use complex investments or strategies, such as alternative investments or strategies involving derivatives, are supported by documentation of specialized due diligence conducted by professionals who possess knowledge and skills needed to satisfy the heightened obligations of care.
- **3.3.9** When socially responsible investment strategies are elected, the strategies are implemented appropriately.

The primary focus of this Practice is the implementation of the investment strategy with appropriate investment vehicles. By appropriate, we mean the strategies and products are suitable for the specific client and in line with generally accepted investment theories. The term "generally accepted investment theories" refers to practices considered to be effective in producing the desired outcomes by academics and the community of professionals in the investment field. Given that the state of the art and science of investing evolves over time, generally accepted theories also change to reflect advances in the field. As an investment fiduciary, suitability is also implied under a duty of care.

It is important for the Investment Advisor to be familiar with the universe of investment options (i.e., mutual funds, exchange-traded products, separately managed accounts, and alternative investments), prudently select them, and document the process, for no one implementation structure is right for all occasions. ERISA's prudence requirement is generally comprised of two components – "procedural prudence" and "substantive prudence." The former refers to the process involved in making decisions for a plan, whereas the latter refers to the merits of the decision made by the fiduciary. The prudence requirement focuses on the fiduciary's conduct in arriving at the decision, not on its results, and asks whether a fiduciary employed appropriate methods to investigate and determine the merits of a particular decision. However, the failure to investigate alone may withstand scrutiny where the investment decision nonetheless was objectively prudent. This means that even if a fiduciary failed to conduct a sufficient investigation before making a decision (procedural prudence), he or she probably avoids a fiduciary breach if a "hypothetical prudent fiduciary" would have made the same decision anyway (substantive prudence).

There are numerous factors that should be considered in the selection of an investment vehicle, including:

- liquidity
- marketability
- minimum required investment
- contribution to the diversification strategy
- ease in meeting asset allocation and rebalancing guidelines
- accessibility of information needed to perform the appropriate due diligence
- ability to fund with assets-in-kind
- built in (phantom) tax issues
- tax efficiency – ability to manage the tax consequences of low basis and/or restricted stock
- degree of portfolio transparency
- whether portfolio and performance information is audited
- degree of regulatory oversight
- ability to give investment direction to the portfolio manager
- deductibility of management fees
- cost

An annuity is an insurance product that offers investment and retirement features and benefits. As such, the special characteristics of annuities should be considered when deciding whether to use them in a particular client situation. The mortality and expense (M&E) charges associated with annuities usually make them more expensive than analogous investment products. However, the added expense may be justified if the client has maxed out their contributions to other types of retirement plans. They also may be beneficial if there is a need to shelter investments from a bankruptcy, avoid probate, or a client places a high priority on a lifetime income guarantee.

Selection of appropriate investment vehicles also necessarily involves consideration of the relative merits of passive versus active management. There is a tradeoff between the potential of active management to achieve extra returns (alpha) versus the lower cost of index-investing. In keeping with the fiduciary duty of care, Investment Advisors should be able to demonstrate that they thoughtfully considered whether to implement passive versus active investment strategies, or a core and satellite strategy that contains both.

Fiduciaries who invest in alternative investments or complex strategies involving derivatives must possess and apply special analytical skills to fulfill their obligation of care because these investments are generally not regulated, transparent, easily valued, or marketable.

The compensation structure of most alternatives is very profitable for investment managers. Performance-based compensation structures can encourage managers to swing for the fences by taking on high risk. Similarly, the potential for high returns may induce advisors to promote these investments to grow asset-based fee revenue. These situations can create conflicts of interest that jeopardize the fiduciary duty of loyalty. Fiduciaries may reasonably find that alternative investments offer sufficiently unique and attractive diversification or return opportunities that justify taking on the heightened due diligence challenges involved; the key is for them to make sure they faithfully execute their obligations of care to make that determination.

Finally, when socially responsible investment strategies are elected they need to be properly implemented; refer to Practice 2.7 for implementation guidance and suggested procedures.

SUGGESTED PROCEDURES

As a general rule, a fiduciary should develop investment due diligence criteria with the following in mind:

- Develop a process that can be applied to both funds and separately managed accounts, so that the Advisor can easily migrate from one universe to another.
- Develop a process that can be applied to any of the readily available databases on funds and/or separately managed accounts.
- Develop a simple process that can easily be understood by clients and replicated outside of the office.
- Develop screens that can serve a dual purpose—apply to searches as well as to monitoring.

When managers or funds are selected without following a due diligence process, there are potential problems:

- Important search criteria can be omitted.
- Performance may be compared to inappropriate indexes or peer groups.
- Information provided by the manager or fund may focus on what the manager or fund wants the Advisor to hear, and not necessarily what the Advisor needs to know.

The matrix below is an example of a basic check list for performing due diligence. The first column lists broad due diligence areas that should routinely be examined. The second column provides specific threshold expectations suggested by fi360 based upon the organization's academic research. Each "criterion" not met, constitutes a deficiency deserving of special consideration or the assessment of "demerits" in the analysis. The third column provides the opportunity for the fiduciary to enter their own criteria that, based upon their own research, may be more appropriate to a particular fiduciary relationship involved. The final two columns provide the opportunity to verify whether the due diligence criteria identified in the second or third column are also identified in the IPS (as described in Practice 2.6) and used in the monitoring process (as described in Practice 4.1). Verification can be demonstrated by check marks or annotations in the final two columns.

Please note that the "Sample Criteria Suggested by fi360" shown in this matrix are not intended to apply to alternative investments or strategies involving derivatives that may be included in a client's portfolio. These investments typically must be addressed with criteria unique to those investments.

DUE DILIGENCE PROCESS

SUGGESTED FIELDS OF DUE DILIGENCE	SAMPLE CRITERIA SUGGESTED BY FI360	CRITERIA ESTABLISHED BY FIDUCIARY	IPS (PRACTICE 2.6)	MONITOR (PRACTICE 4.1)
Regulatory oversight	Each investment option is managed by: (a) a bank, (b) an insurance company, (c) a registered investment company (mutual fund), or (d) a registered investment adviser.			
Minimum track record	Each investment option has at least three years of history.			
Stability of the organization	The same portfolio management team has been in place for at least two years.			
Assets in the investment	The investment has at least $75 million under management (For mutual funds: Across all share classes.)			
Composition consistent with asset class	At least 80% of the underlying securities are consistent with the broad asset class.			
Style consistency	The investment is highly correlated to the asset class of the investment option.			
Expense ratios/fees relative to peers	The investment's fees are not in the bottom quartile (most expensive) of their peer group.			
Risk-adjusted performance relative to peers	The investment's risk-adjusted performance (e.g., Alpha and Sharpe Ratio) is above the peer group median manager's risk-adjusted performance.			
Performance relative to peers	The investment's performance is above the peer group's median manager return for 1-, 3- and 5-year cumulative periods.			

The table below indicates whether commingled accounts (such as mutual funds, exchange traded products, collective trusts, etc.) or separately managed accounts have a relative advantage with respect to various factors commonly used to determine the most appropriate investment vehicle.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2550.404c1(b)(3)(i)(C)

Case Law
Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F. Supp. 378 (D.Haw. 1980); *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 10 E.B.C. 2290 (S.D.Ga. 1989); *aff'd*, 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §3; §3 Comments

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(e)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§7(3); §8(a)(1)

RELATIVE ADVANTAGE OF ACCOUT TYPES

FACTOR	COMMINGLED ACCOUNTS	SEPARATE ACCOUNTS
Ability to provide direction to the investment manager		✓
Minimum required investment	✓	
Degree of portfolio diversification	✓	
Ease in managing asset allocation and rebalancing		✓
Availability of data for due diligence	✓	
Fee schedules scaled to portfolio size		✓
Ability to fund the portfolio with assets-in-kind		✓
Avoidance of phantom tax issues (built-in taxable gains)		✓
Ability to manage restricted and low-basis stock issues		✓
Degree of portfolio transparency		✓
Availability of performance reports at the investor level		✓
Degree of regulatory oversight	✓	
Ability to provide direction to the investment manager		✓
Tax deductibility of management fees		✓
Cost		✓
Flexibility to use various active investment strategies		✓

MONITOR

Step 4 is the Fourth of Four Steps Employed in the Global Fiduciary Standard of Excellence for Investment Advisors

PRUDENT PRACTICES *for* INVESTMENT ADVISORS

STEP 4

STEP 4 : INTRODUCTION

Step 4, Monitor, presumes the scope of the client engagement is ongoing, whether the Advisor holds discretion over client assets or not. For most investment fiduciaries, monitoring can be labor-intensive, because it may involve a need to respond to changes in the economic or market cycle, the pricing of investment services, retirement plan arrangements, and the circumstances directly impacting the client's financial situation or outlook. No one should be lulled into thinking that the 'heavy lifting' was done in the previous three steps and the client portfolio is now on 'auto pilot,' marked only by periodic re-balancing, quarterly performance reports, and routine client meetings.

For the investment fiduciary, the starting point of monitoring is working backwards through the four-step Fiduciary Quality Management System. The logic is simple: activities involved in monitoring are dependent upon what was done in the first three Steps. As you work your way back through the process, you will typically analyze what you did in the first three steps.

You will recall that the focus of Step 3, Implement, involves a due diligence process used to select Investment Managers and service providers. Generally speaking, the criteria used to select managers and service providers are the same criteria used in monitoring.

In the Formalize step, we focused on establishing an appropriate asset allocation strategy and preparing the investment policy statement. The asset allocation strategy is the cornerstone of the IPS, which is the business plan for management of the plan or portfolio.

It may be necessary to go back to the Organize step to review the laws, regulations, and documents used to establish the governing principles for the portfolio.

Reviewing the process in this way should allow the Advisor at some point to step back and self-assess his or her own effectiveness in adhering to established best practices and ultimately establishing a strong fiduciary culture in the firm.

Step 4 is where many fiduciary breaches occur, and the cause may be inadequate preparation and execution in the earlier parts of the investment process, resulting in errors of omission, which are more common than acts of commission. For example, a poorly written investment policy statement undermines effective monitoring. Another common form of an omission is failure to follow through on established policies and procedures.

Monitoring requires the Investment Advisor to conduct quantitative and qualitative reviews. Quantitative reviews, among other things, involve a comparison of investment performance to appropriate benchmarks and client objectives in the IPS. Qualitative reviews of Investment Managers and service providers include the need to be aware of and consider things such as: 1) trade press or news reports on turnover in management, 2) repeated enforcement actions taken against the investment organization or its parent, and 3) the quality of responses to requests for information. Policies and procedures governing trading practices and proxy voting of separate account managers also need to be periodically reviewed.

One of the seven global fiduciary precepts is to control and account for investment expenses. This is a critical part of monitoring that is getting more and more scrutiny from regulators and the courts. The Investment Advisor needs to ensure, or help the Steward ensure, that all paid participants in the investment process are identified, along with their compensation amounts, and that a determination is made that the amounts paid are reasonable in light of the services provided.

Finally, Step 4 is where the fiduciary duty of care takes on special meaning with respect to assessing the Advisor's overall effectiveness in meeting his or her fiduciary obligations. Planned fiduciary assessments conducted at regular intervals provide for this needed review.

STEP 4 : MONITOR

MONITOR

PRACTICE 4.1

Periodic reports compare investment performance to appropriate index, peer group, and investment policy statement objectives.

CRITERIA

4.1.1 The performance of each investment option is periodically compared to an appropriate index, peer group, and any other performance-related due diligence criteria defined in the investment policy statement.

4.1.2 "Watch list" procedures for underperforming Investment Managers are documented, and consistently applied.

4.1.3 Rebalancing procedures are reasonable, documented, and consistently applied.

The Investment Advisor's monitoring function extends beyond a strict examination of performance. By definition, monitoring occurs across all policy and procedural issues previously addressed in this handbook. The ongoing review, analysis, and monitoring of relevant decision-makers and/or money managers is just as important as the due diligence implemented during the manager selection process.

In keeping with the duty of care, an Investment Advisor must determine the frequency of reviews, taking into account such factors as: (1) prevailing general economic conditions, (2) the size of a client's portfolio, (3) the investment strategies employed, (4) the investment objectives sought, (5) the volatility of the investments selected, and (6) the fiduciary or other regulatory obligations to the client. The Investment Advisor should monitor every investment option implemented at least quarterly, or more frequently as required by the facts and circumstances.

The Investment Advisor should establish performance expectations for each investment option, and record the same in the IPS. Investment performance should be evaluated in terms of an appropriate market index, and the relevant peer group. By relevant peer group, we mean, for example, sub-asset class or style, such as large cap value to large cap value, rather than using the S&P 500 or other total market index for every equity position. As a best practice, established "watch list" procedures to be taken when an investment fails to meet the due diligence criteria may also be described in the IPS. The IPS should acknowledge that fluctuating rates of return characterize the securities markets, and may cause variations in performance.

The Advisor should evaluate performance from a long-term perspective, meaning an investment time horizon of at least five years. The decision to retain or terminate a manager requires judgment and cannot be made by a formula. It is the Investment Advisor's confidence in the money manager's ability to perform in the future that ultimately determines selection and retention.

Reasonable Standard

In referring to "reasonable" rebalancing procedures, and other references throughout the handbook to a "reasonable" standard of conduct, the legal standard of care is generally one that a reasonably prudent person would observe under a given set of circumstances. An investment fiduciary who subscribes to such a standard, as imprecise as the term may seem, can more likely avoid liability for negligence by following a consistent process.

SUGGESTED PROCEDURES

The monitoring procedures should include an examination of the client's contribution or distribution schedule in determining portfolio rebalancing. In this way, the Investment Advisor can more cost effectively rebalance the portfolio, given tax and transaction cost considerations. Otherwise, rebalancing should be implemented as required by the IPS.

In the absence of any pressing issues of the client, performance reports should be prepared at least quarterly and Advisors should review these reports as they are prepared. Performance reports should be provided to the client and discussed as necessary to keep the portfolio current with the client's objectives, changes in economic and market conditions, and changes in the outlook for investment positions held. Advisors should conduct portfolio performance reviews with clients no less frequently than annually. However, risk and diversification issues may require reporting at unscheduled and far more frequent intervals.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a); §405(c)(2)(A)(iii)

Case Law
Leigh v. Engle, 727 F.2d 113 , 4 E.B.C. 2702(7th Cir. 1984); *Atwood v. Burlington Indus. Equity, Inc.*, 18 E.B.C. 2009 (M.D.N.C. 1994)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17); Interpretive Bulletin 08-2, 29 C.F.R. §2509.08-2

Investment Advisers Act of 1940

Case Law
SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)

Other
Study on Investment Advisers and Broker-Dealers (SEC Staff, January 21, 2011); Compliance Alert (June, 2007)

Uniform Prudent Investor Act [UPIA]
§2(a);§2(c); §9(a)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(b); §3(e); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§6(a); §6 (b)(1-3); §6(d); §6 Comments; §8(b)

STEP 4 : MONITOR

MONITOR

PRACTICE 4.2

Periodic reviews are made of qualitative and/or organizational changes of Investment Managers and other service providers.

CRITERIA

4.2.1 Periodic evaluations of the qualitative factors that may impact the results or reliability of Investment Managers are performed.

4.2.2 Negative news and other material information regarding an Investment Manager or other service provider are considered and acted on in a timely manner.

4.2.3 Deliberations and decisions regarding the retention or dismissal of Investment Managers and other service providers are documented.

4.2.4 Qualitative factors that may impact service providers are considered in the contract review process.

The Investment Advisor has a continuing duty to exercise reasonable care, skill, and caution when it delegates the investment management function to others, including separately managed accounts, mutual and exchange-traded funds, hedge funds, and other third parties.

The Investment Advisor's review of an Investment Manager must be based on more than recent investment performance results, for all professional money managers will experience periods of poor performance. Conversely, Advisors should not replace their manager lineup simply because of the reported success of other managers.

In addition to the quantitative reviews of Investment Managers, periodic reviews of the qualitative performance and/or organizational changes to the Managers should be made at reasonable intervals. On a periodic basis (e.g., quarterly) the Advisor should review whether each Investment Manager continues to meet specified objectives, such as the following example criteria:

- the Investment Manager's adherence to the guidelines established by the IPS
- material changes in the Manager's organization, investment philosophy, and/or personnel
- any legal or regulatory agency proceedings that may affect the Manager

Materiality Standard

The materiality of an occurrence, event, or information under the law is generally defined as something that is sufficiently significant to influence a client into acting in a certain way, such as entering into an agreement with an Advisor or deciding whether to take an Advisor's recommendation after disclosure of a conflict of interest. The SEC states "facts are 'material' if a reasonable investor would consider them to be important."

Compensation arrangements, such as those with service providers that may have a significant long-term effect on investment returns, would likely be considered a material factor to be examined by the decision-maker in terms of a reasonable standard. In other words, the Advisor should consider whether the costs are reasonable in light of services rendered and in comparison to market rates.

THIS HANDBOOK IS ABOUT THE PRACTICES THAT DEFINE A FIDUCIARY STANDARD OF CARE FOR INVESTMENT ADVISORS. A COMPANION HANDBOOK, PRUDENT PRACTICES FOR INVESTMENT MANAGERS, COVERS A FIDUCIARY STANDARD OF CARE FOR INVESTMENT MANAGERS.

Advisors should be familiar with these practices to help guide reviews of the qualitative and organizational issues that may affect the quality of Investment Manager performance.

SHOWN BELOW IS A LIST OF THE PRACTICES ADDRESSED IN THE PRUDENT PRACTICES FOR INVESTMENT MANAGERS HANDBOOK.

Practice M-1.1 Senior management demonstrates expertise in their field, and there is a clear succession plan in place.

Practice M-1.2 There are clear lines of authority and accountability, and the mission, operations, and resources operate in a coherent manner.

Practice M-1.3 The organization has the capacity to service its client base.

Practice M-1.4 Administrative operations are structured to provide accurate and timely support services and are conducted in an independent manner.

Practice M-1.5 Information systems and technology are sufficient to support administration, trading, and risk management needs.

Practice M-1.6 The organization has developed programs to attract, retain, and motivate key employees.

Practice M-1.7 There is a formal structure which supports effective compliance.

Practice M-2.1 The organization provides disclosures that demonstrate adequate resources to sustain operations.

Practice M-2.2 The organization has a defined business strategy that supports competitive positioning.

Practice M-2.3 There is an effective process for allocating and managing both internal and external resources and vendors.

Practice M-2.4 There are effective and appropriate external management controls.

Practice M-2.5 The organization has a defined process to control the flow of funds and asset variation.

Practice M-2.6 Remuneration of the company and compensation of key decision-makers is aligned with client interests.

Practice M-2.7 The organization has responsible and ethical reporting, marketing, and sales practices.

Practice M-2.8 There is an effective risk-management process to evaluate both the organization's business and investment risk.

Practice M-3.1 The asset management team operates in a sustainable, balanced, and cohesive manner.

Practice M-3.2 The investment system is defined, focused, and adds value in a consistent manner.

Practice M-3.3 The investment research process is defined, focused, and documented.

Practice M-3.4 The portfolio management process for each distinct strategy is clearly defined, focused, and documented.

Practice M-3.5 The trade execution process is defined, focused, and documented.

Practice M-4.1 There is a defined process for the attribution and reporting of costs, performance, and risk.

Practice M-4.2 All aspects of the investment system are monitored and are consistent with assigned mandates.

Practice M-4.3 Control procedures are in place to periodically review policies for best execution, "soft dollars," and proxy voting.

Practice M-4.4 There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§3(38); §402(c)(3); §404(a)(1)(B)

Regulations

29 C.F.R. §2550.408b2(d); 29 C.F.R. §2550.408c2

Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17); Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration

Investment Advisers Act of 1940

Regulations

17 C.F.R. §275.206(4)-7

Other

Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. IA-2204 (Dec. 18, 2003)

Uniform Prudent Investor Act [UPIA]

§2(a); §7; §9(a)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(a) and (b)(13); §7(5)

STEP 4 : MONITOR

MONITOR

PRACTICE 4.3

Control procedures are in place to periodically review policies for trading practices and proxy voting.

CRITERIA

4.3.1 Control procedures are in place to periodically review each Investment Manager's policies for best execution.

4.3.2 Control procedures are in place to periodically review each Investment Manager's policies for special trading practices such as "soft dollars", directed brokerage, and commission recapture.

4.3.3 Control procedures are in place to periodically review each Investment Manager's policies for proxy voting.

The Investment Advisor has a responsibility to control and account for investment expenses and to assess whether the expenses incurred are consistent with the fiduciary obligation to serve the best interests of the client. Monitoring and controlling expenses is consistent with a fiduciary duty of care and even more so when the Advisor applies an active trading strategy, uses directed brokerage or soft dollars, and other expenses that, over time, can significantly impair portfolio performance. Even seemingly minor, but recurring, expenses need to be documented and justified.

Similarly, the Advisor should ensure that each client relationship has an established policy in place for proxy voting, consistent with the duties of loyalty and care. Proxies should be voted in a manner that preserves or enhances the value of the security. The proxy policy and responsibility for who is to vote proxies should be in the IPS, especially for ERISA plans. In the case of institutional clients, responsibility for voting proxies normally rests with the Steward or is delegated by the Steward to Investment Managers. Retail investors normally retain proxy voting responsibility unless the Investment Advisor has been delegated investment discretion and proxy voting authority. When voting on behalf of clients, or using a third party proxy voting service, the SEC-registered adviser must establish procedures for voting in the client's best interests, disclose the policies to them, and provide access to proxy voting records.

Although state securities administrators do not have a model proxy voting rule, it is advisable to maintain a similar policy if your firm is state-registered.

Whether the Advisor is utilizing a separate account manager, or managing assets directly, the Advisor needs to monitor trading policies and procedures that ensure the following:

- Best execution policies are applied in securities transactions. The Advisor has a responsibility to seek confirmation that he or she, or the third party

Investment Manager, is seeking best execution in trading the portfolio's securities. In seeking best execution, Investment Managers are required to shop their trades with various brokerage firms, taking into consideration: (1) commission costs, (2) an analysis of the actual execution price of the security, and (3) the quality and reliability (timing) of the trade.

- "Soft dollars" are expended only for brokerage and research for the benefit of the investment program, and the amount must be reasonable in relation to the value of such services. Soft dollars represent the excess in commission costs: the difference between what a brokerage firm charges for a trade versus the brokerage firm's actual costs. The failure of the Advisor to monitor soft dollars may subject the investment program to expenditures that yield insufficient investor benefit to justify the cost, itself a fiduciary breach.

SUGGESTED PROCEDURES

Practice 1.5 requires a regular review of all service provider agreements. The separate account manager's agreement should be specifically evaluated to determine if it addresses (as appropriate) trading practices, including best execution, soft dollars, directed brokerage, and commission recapture, as well as proxy voting.

One of the easiest ways for an Investment Advisor to monitor a separate account manager's practices for best execution and soft dollars (to some extent) is to watch where the manager is trading the client's account. When the same brokerage firm keeps popping up, additional scrutiny may be required, unless the client has agreed to "directed brokerage," where the client instructs the money manager to trade a percentage of the client's account with a specific broker. This often is the case when a client agrees to a wrap-fee arrangement or managed account platform.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§3(38); §402(c)(3); §403(a)(1) and (2); §404(a)(1)(A) and (B)

Case Law

Herman v. NationsBank Trust Co., (Georgia), 126 F.3d 1354, 21 E.B.C. 2061 (11th Cir. 1997), reh'g denied, 135 F.3d 1409 (11th Cir.), cert. denied, 525 U.S. 816, 19 S.Ct. 54, 142 L.Ed.2d 42 (1998)

Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17Q); Interpretive Bulletin 08-2, 29 C.F.R. §2509.08-2; DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975); DOL Information Letter, Prescott Asset Management (1/17/92) (fn. 1); DOL Information Letter, Refco, Inc. (2/13/89); ERISA Technical Release 86-1 (May 22, 1986)

Investment Advisers Act of 1940

§206(4); Securities Exchange Act of 1934 §28(e)

Regulation

17 C.F.R. §275.206(4)-6; 17 C.F.R. §275.206(4)-7

Case Law

In re Arleen W. Hughes, Act Rel. No. 4073, (Feb. 20, 1948)

Other

Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986); IAA Rel. No. 232 (Oct. 16, 1968); *Charles Lerner, Esq.*, SEC No-Action Letter (July 25, 1990); IAA Rel. No. 2106 (Jan. 31, 2003); Investment Company Act Rel. No. 25922 (Jan. 31, 2003); *Salomon Bros.*, SEC No-Action Letter (May 23, 1972)

Uniform Prudent Investor Act [UPIA]

§2(a) and (d); §7; §9(a)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b), (c), and (e)(5); §5(a)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(2) and (3); § 7(2), (3), and (5); §8(a)(3)

STEP 4 : MONITOR

MONITOR

PRACTICE 4.4

Periodic reviews are conducted to ensure that investment-related fees, compensation and expenses are fair and reasonable for the services provided.

CRITERIA

4.4.1 A summary of all parties being compensated from client portfolios or from plan or trust assets and the amount of compensation has been documented.

4.4.2 Fees, compensation, and expenses paid from client portfolios or from plan or trust assets are periodically reviewed to ensure consistency with all applicable laws, regulations, and service agreements.

4.4.3 Fees, compensation, and expenses paid from client portfolios or from plan or trust assets are periodically reviewed to ensure such costs are fair and reasonable based upon the services rendered and the size and complexity of the portfolio or plan.

The Investment Advisor has a duty to control and account for all dollars spent for investment management services, whether the dollars are paid directly from the account or in the form of soft dollars and other fee-sharing arrangements. In addition, the Advisor has the responsibility to identify those parties that have been compensated from the fees, and apply a reasonableness test to the amount of compensation received by any party. If you are using funds or managers with higher than average fees, then you should document the reasons why.

Finder's Fees

If the Advisor pays finder's (and solicitor's) fees, they must be disclosed and approved in writing. Under the IAA and some state laws, a 'cash solicitation rule' requires special disclosures by the person referring prospective clients to the RIA, and may also trigger registration of that person as an investment adviser representative under state law. For public retirement plans, some states, such as California and New York, may regulate or prohibit placement agents.

Individual Client Fees

With regard to individual clients, fees charged directly by the Advisor should be in line with the marketplace, and consistent with the Advisor's qualifications, experience, and scope of services. Benchmarking organizations provide this information for a fee to advisors and plans. Of course, Advisors should also periodically review the cost of funds and other investment products that they place in a client's portfolio, since numerous studies have demonstrated that, over time, slight variations in fund expense ratios can nonetheless make a significant difference in a portfolio's long-term investment performance.

Retirement Plan Fees

The Investment Advisor's responsibility in connection with the payment of fees is to determine: 1) whether the fees can be paid from ERISA plan assets [see also Practice 1.2] and 2) whether the fees are reasonable in light of the services being provided [see also Practice 1.5]. Accordingly, the Investment Advisor should ensure all forms of compensation are reasonable for the services rendered.

In the case of defined contribution plans, it is customary to offer investment options that carry fees that often are used to offset the plan's recordkeeping and administrative costs. Particularly for a new plan with few assets, such an arrangement can be beneficial to the participants. Fiduciaries should not, however, use the availability of revenue sharing that can offset any administrative plan expenses as a critical factor in making investment selections. The fiduciary should determine whether it is more advantageous to pay for the recordkeeping and administrative costs on an à la carte basis using funds that forego revenue sharing and have lower expense ratios.

Also, see Practice 3.1's Special Considerations Under ERISA for a discussion of the Department of Labor requirements for disclosures that are required in order for a plan's fees to be reasonable for purposes of ERISA §408(b)(2).

Wrap Fees

In the case of an all-inclusive fee (sometimes referred to as a "bundled" or "wrap" fee) investment product, the Investment Advisor should investigate how the various parties associated with each component of the all-inclusive fee are compensated to ensure that no one vendor is receiving unreasonable compensation.

SUGGESTED PROCEDURE FOR BUNDLED PRODUCTS

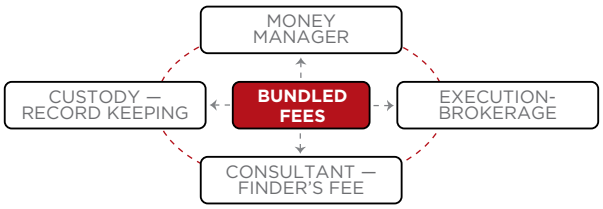
Basically, there are five cost components in a bundled, wrap, or all-inclusive fee investment product. The Investment Advisor should investigate the reasonableness of compensation for each of the various service vendors involved, and to compare the costs of the same services on an à la carte basis.

The following are the five service providers generally included in a bundled product:

1. money manager who is selecting the stocks and bonds for the portfolio
2. brokerage firm that is executing the trades
3. directed trustee/custodian that is holding and safeguarding the securities
4. Investment Advisor, or broker, who is servicing the account
5. recordkeeper who maintains records of individual account balances

UNBUNDLING FEES AND EXPENSES

"Bundled fees" should be broken down into four categories so that a proper evaluation can be made – various costs can be obscured or moved to create apparent savings.



SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]

§3(14)(B); §404(a)(1)(A), (B) and (D); §406(a); §408(b)(2)

Regulations

29 C.F.R. §2550.408(b)(2)

Case Law

Brock v. Robbins, 830 F.2d 640, 8 E.B.C. 2489 (7th Cir. 1987)

Other

Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 2001-01A (1/18/01); DOL Advisory Opinion Letter (7/28/98) 1998 WL 1638072; DOL Advisory Opinion Letter 89-28A (9/25/89) 1989 WL 435076; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17Q); California Assembly Bill No. 1743 (Chapter 668, Statutes of 2010), codified in scattered sections of the California Government Code; 11 CRR-NY 136-2.4(d); DOL Advisory Opinion 97-15A (May 22, 1997); DOL Advisory Opinion 97-16A (May 22, 1997)

Investment Advisers Act of 1940

§205(a)(1)

Regulations

17 C.F.R. §275.205-3; 17 C.F.R. § 275.206(4)-3

Case Law

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)

Other

Bisys Fund Servs., Inc., SEC No-Action Letter (Sept. 2, 1999); SEC Investment Adviser Examination Manual (1980); Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2017 (Feb. 5, 2003); *Don P. Matheson & Co.*, SEC No-Action Letter (May 15, 1976)

State Securities Regulations

NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers, Model Rule 102(a)(4)-1 *Adopted 4/27/97, amended 4/18/04, 9/11/05* http://www.nasaa.org/content/Files/IAUnethical091105.pdf (August 2011)

NASAA Investment Adviser Representative Definition, Model Rule USA 2002 102(16), adopted by NASAA on Sept. 17, 2008, http://www.nasaa.org/content/Files/IA_Model_Rules_Under_2002%20Act_091708.pdf (August 2011)

Uniform Prudent Investor Act [UPIA]

§2(a); §7 and Comments; §9, Comments

Case Law

Matter of Derek W. Bryant, 188 Misc. 2d 462, 729 NYS 2d 309 (6/21/01)

Other

McKinneys EPTL112.3(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(a)(, (b), and (c); §5(a) and (c)(1)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]

§6(b)(2) and (3); §7(2) and (5); §7, Comments

STEP 4 : MONITOR

PRACTICE 4.5

There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

CRITERIA

4.5.1 Fiduciary assessments are conducted at planned intervals to determine whether (a) appropriate policies and procedures are in place to address all fiduciary obligations, (b) such policies and procedures are effectively implemented and maintained, and (c) the investment policy statement is reviewed at least annually.

4.5.2 Fiduciary assessments are conducted in a manner that promotes objective analysis and results are documented and reviewed for reasonableness.

Fiduciary duties generally are presented as distinct obligations substantiated through law and regulation. Many of the duties are accompanied by documentation and review obligations. As a practical matter, a comprehensive framework is needed to ensure that all applicable fiduciary practices are fully and effectively addressed on an ongoing basis. A planned approach to conduct periodic reviews provides such a framework. The SEC requires designation of a Chief Compliance Officer for each RIA to ensure that the firm meets its fundamental fiduciary obligations. The CCO's principal duty is to administer policies and procedures for compliance with SEC rules and fiduciary principles, and to review those procedures at least annually for their adequacy and effectiveness.

Under the Pension Protection Act of 2006 (PPA), the practices of plan sponsors and fiduciary advisers who are party to eligible investment advice arrangements (EIAAs) must be examined as part of the required annual independent audit of the EIAA. Advisors who provide services to ERISA plans and who serve as fiduciary advisers should take special note of this audit requirement in the PPA. For more information, see Practice 3.2.

Given that internal and external reviews and assessments are well-recognized tools to evaluate risks and ensure the effectiveness of policies and procedures, further weight is added to the need to establish a formal overall review process (as provided by an assessment program).

SUGGESTED PROCEDURES FOR ASSESSMENTS

There are three levels of fiduciary reviews or assessments. These levels are analogous to the levels used in auditing for conformity to accounting and ISO standards.

LEVEL 1 IS A SELF-ASSESSMENT.

This is analogous to an internal audit. Every fiduciary organization (including the Advisor's firm) should periodically conduct a formal review of its own policies, procedures, and activities to determine the extent to which they fulfill the Practices presented in this handbook.

LEVEL 2 IS A CONSULTANT'S (RELATED PARTY) REVIEW OR ASSESSMENT.

It is conducted by an outside analyst engaged to systematically evaluate a fiduciary organization's fiduciary practices. The analyst will also generally provide consulting assistance to the assessed entity in correcting any shortfalls. An Advisor with training and experience in the areas of fiduciary responsibility and assessments may choose to provide Level 2 reviews or assessments for other fiduciary organizations.

LEVEL 3 IS AN INDEPENDENT ASSESSMENT.

Analysts who conduct independent assessments must not be affiliated or have other business relationships with the assessed entity. Like independent financial audits, Level 3 fiduciary assessments may be conducted to demonstrate that an organization has undergone a rigorous and objective process to determine its conformity to set standards.

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Case Law

Fink v. National Savings & Trust Co., 772 F.2d 951, 957 (D.C. Cir. 1985); *Liss v. Smith*, 991 F.Supp. 278, 299300 (S.D.N.Y.,1998); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F.Supp. 2d 898, 906 (D. Minn. 1999)

Other

Department of Labor Employee Benefits Security Administration, "Meeting Your Fiduciary Responsibilities" (May 2004); 29 C.F.R. 2509.75-8; 29 C.F.R. 2509.08-2; 17 C.F.R. § 275.206(4)7; DOL Field Assistance Bulletin 2007-01.

Investment Advisers Act of 1940

Regulation

17 C.F.R. §275.206(4)-7)

Uniform Prudent Investor Act [UPIA]
§2(a); §2(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(b) and (c)

Uniform Management of Public Employee Retirement Systems Act [UMPERSA]
§8(b); §7

The approach used to structure the Practices in this handbook is modeled after that used by the International Organization for Standardization (ISO). Recently, the financial services community has begun to recognize the value of certification of conformity to standards. There is now an ISO standard for financial planning (ISO 22222) and investment performance reporting practices can be certified to Global Investment Performance Standards (GIPS). In 2006, the Centre for Fiduciary Excellence (CEFEX) was formed to certify conformity with the practices covered in the Prudent Practices for Investment Fiduciaries handbook series. fi360 is a founding member of CEFEX.

CONCLUSION

The Practices identified in this handbook prescribe a process that strives for excellence in the management of investment decisions. The Practices will help fiduciaries understand which new investment strategies, products, and techniques fit into their operations, and which do not.

The intelligent and prudent management of investment decisions requires the fiduciary to maintain a rational, disciplined investment program. The mind¬boggling array of investment choices, coupled with market noise from stock markets around the world, understandably can result in financial paralysis from information overload. Fiduciaries clearly need a framework for managing investment decisions that allows them to consider developing investment trends, and to thoughtfully navigate the possibilities.

GLOSSARY OF TERMS

THIS GLOSSARY WAS COMPILED FROM THE FOLLOWING SOURCES:

Eugene B. Burroughs, CFA, *Investment Terminology* (Revised Edition), International Foundation of Employee Benefit Plans, Inc., 1993.

John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* (Fifth Edition), Barron's Educational Series, Inc., 1998.

John W. Guy, *How to Invest Someone Else's Money*, Irwin Professional Publishing, Burr Ridge, Illinois, 1994.

Joshua P. Itzoe, CFP®, AIF®, *Fixing the 401(k), What Fiduciaries Must Know (And Do) To Help Employees Retire Successfully*, Mill City Press, Minneapolis, MN, 2008.

Ken Ziesenheim, CFP®, JD, LL.M, *Understanding ERISA*, Ken Ziesenheim and Marketplace Books, 2002.

Accredited Investment Fiduciary® (AIF®) – Professional designation signifying knowledge and competency in fiduciary responsibility.

Accredited Investment Fiduciary Analyst® (AIFA®) – Professional designation for those who wish to conduct ISO-like assessments of a global fiduciary standard of excellence.

alpha – Statistic that measures a portfolio's return in excess of the market return adjusted for risk. It is a measure of the Manager's contribution to performance with reference to security selection. A positive alpha indicates that a portfolio was positively rewarded for the residual risk, which was taken for that level of market exposure.

assessment – The process of determining whether a fiduciary conforms with defined Practices and Criteria.

asset allocation – The process of determining the optimal allocation of a fund's portfolio among broad asset classes in order to increase expected risk-adjusted return.

basis point – One hundredth of a percent (100 Basis Points = 1%). Basis points are often used to express changes or differences in yields, returns or interest rates.

best execution – Formally defined as the difference between the execution price (the price at which a security is actually bought or sold) and the "fair market price," which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost; for example, when there is no increase in the price of a security shortly after it is sold.

cash sweep accounts – A money market fund or cash account into which all new contributions, stock dividend income, and bond interest income is placed ("swept") for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the asset allocation stipulated in the IPS.

CEFEX™, Centre for Fiduciary Excellence – An independent global assessment and certification organization. CEFEX works closely with investment fiduciaries and industry experts to provide comprehensive assessment programs to improve risk management for institutional and retail investors. CEFEX certification helps determine trustworthiness of investment fiduciaries.

CEFEX Analyst – A person approved by CEFEX to conduct an assessment of a firm's fiduciary practices for CEFEX Certification.

CEFEX Certification – Independent recognition of a firm's conformity to Practices and Criteria within the Standard of Excellence. It implies that a firm can demonstrate adherence to the industry's best practices, and is positioned to earn the public's trust.

commingled fund – An investment fund, similar to a mutual fund, in which investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds usually are offered through a bank-administered plan allowing for lower cost, diversification, and professional money management.

commission recapture – An agreement by which a retirement plan fiduciary earns credits based upon the amount of brokerage commissions paid. These credits can be used for services that will benefit a retirement plan, such as consulting services, custodian fees, or hardware and software expenses.

correlation coefficient – Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed income assets represents a diversified portfolio that attempts to take advantage of the low correlation between the two asset classes.

Criteria – Define the scope and details of a Practice and provide a standard by which a Practice can be evaluated.

directed brokerage – Circumstances in which a board of trustees or other fiduciary requests that the Investment Manager direct trades to a particular broker so that the commissions generated can be used for specific services and/or resources. See soft dollars.

GLOSSARY OF TERMS

economically targeted investment (ETI) – Investments where the goal is to target a certain economic activity, sector, or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk adjusted rate of return.

expected return – The expected return, expected value or mean of all likely returns of investments comprising a portfolio. It is the mean or expected return that an investor attempts to maximize at a given level of risk.

fi360 – An organization that promotes a culture of investment fiduciary responsibility and improves the decision making processes of investment fiduciaries.

fiduciary – From the Latin word fiducia, meaning "trust." Someone who stands in a special relation of trust, confidence, and/or legal responsibility. A fiduciary is held to a standard of conduct and trust above that of a stranger or of a casual business person due to the superior knowledge and/or training of the fiduciary.

fiduciary excellence – A function of how well Investment Stewards, Investment Advisors, and Investment Managers follow defined fiduciary Practices and Criteria.

Investment Advisor – A professional who is responsible for providing investment advice and/or managing investment decisions. Investment Advisors include wealth managers, financial advisors, trust officers, financial consultants, investment consultants, financial planners, and fiduciary advisers. See Registered Investment Adviser.

Investment Manager – A professional who has discretion to select specific securities for separate accounts, mutual funds and exchange traded funds commingled trusts, and unit trusts.

> Note: An ERISA §3(38) Investment Manager is any fiduciary (other than a trustee or named fiduciary) who has the power to manage, acquire, or dispose of plan assets; is either a registered investment adviser under the Investment Advisers Act of 1940, a bank or an insurance company; and has acknowledged its fiduciary status in writing to the plan.

Investment Steward – A person who has the legal responsibility for managing investment decisions on behalf of others, including plan sponsors, trustees, and investment committee members.

liquidity – The ease with which assets can be converted into cash with little risk of loss of principal. Any asset other than cash has some liquidity risk, though money market funds and the instruments that they typically hold are generally considered adequately liquid to meet short term spending requirements without exposing a portfolio to undue risk of loss.

liquidity risk – The risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

Practice – The details of a prudent process that provide the foundation and framework for a disciplined investment process.

proxy voting – A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders' annual or special meeting called to elect directors or for some other corporate purpose.

Risk-adjusted return – The return on an asset, or portfolio, modified to explicitly account for the risk of the asset or portfolio.

risk-free rate of return – The return on 90-day U.S. Treasury Bills. This is used as a proxy for no risk due to its zero default risk issuance, minimal "interest rate" risk and high marketability. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk free" point of departure. See sharpe ratio.

risk tolerance – The degree to which an investor is comfortable with the potential of losing money without abandoning a defined investment strategy.

R-squared (R^2 or R2) – Formally called the coefficient of determination, this measures the overall strength or "explanatory power" of a statistical relationship. In general, a higher R2 means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision making. Primarily used to determine the appropriateness of a given index in evaluating an Investment Manager's performance.

safe harbor – A legal or regulatory provision that may limit a fiduciary's liabilities as long as certain guidelines are fully adhered to.

Sharpe Ratio – This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the risk free rate of return (usually 3-Month U.S. Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe Ratio can be used to compare the relative performance of managers. If two managers have the same level of risk but different levels of excess return, the manager with the higher Sharpe Ratio would be preferable.

socially responsible investment (SRI) – An investment that is undertaken based upon social, rather than purely financial, guidelines. See also economically targeted investment.

GLOSSARY OF TERMS

soft dollars – The payment for brokerage services through commission revenue rather than direct payments. For example, a portion of a commission expense may be used to pay for research or other services in excess of the actual cost of executing the trade provided by the broker dealer.

Standard of Excellence – The Practices and Criteria that detail a prudent process and the attributes of a trustworthy fiduciary.

standard deviation – A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measures how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns were normally distributed (i.e., has a bell shaped curve distribution) then approximately two thirds of the returns would occur within plus or minus one standard deviation from the sample mean.

strategic asset allocation – Rebalancing back to the normal mix at specified time intervals (quarterly) or when established risk tolerance levels are violated.

tactical asset allocation – The "first cousin" to Market Timing which involves the use of certain "indicators" to make adjustments in the proportions of portfolio invested in three asset classes – stocks, bonds, and cash.

trading costs – Behind investment management fees, trading accounts for the second highest cost of plan administration. Trading costs are usually quoted in cents per share.

variance – A statistical measure that indicates the spread of values within a set of outcomes around a calculated average. For example, the range of daily prices for a stock will have a variance over a time period that reflects the amount that the stock price varies from the average, or mean, price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of the portfolio might fluctuate up or down from the average value over a given time.

PERIODIC TABLE OF GLOBAL FIDUCIARY PRACTICES

for INVESTMENT ADVISORS

PRACTICE 1.1
The Investment Advisor demonstrates an awareness of fiduciary duties and responsibilities.

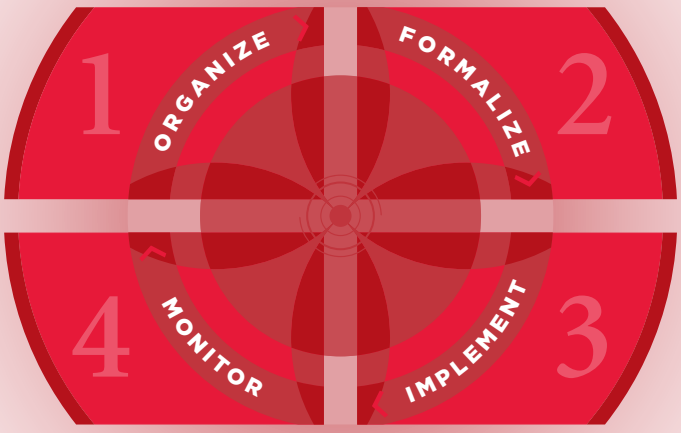
PRACTICE 1.2
Investments and investment services provided are consistent with applicable governing documents.

PRACTICE 1.3
The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined and documented.

PRACTICE 1.4
The Investment Advisor identifies conflicts of interest and addresses conflicts in a manner consistent with the duty of loyalty.

PRACTICE 1.5
Agreements, including service provider agreements under the supervision of the Investment Advisor, are in writing and do not contain provisions that conflict with fiduciary standards of care.

PRACTICE 1.6
Client assets are protected from theft and embezzlement.



PRACTICE 2.1
An investment time horizon has been identified for each investment objective of the client.

PRACTICE 2.2
An appropriate risk level has been identified for each client.

PRACTICE 2.3
An expected return to meet each investment objective has been identified.

PRACTICE 2.4
Selected asset classes are consistent with the client's time horizon and risk and return objectives.

PRACTICE 2.5
Selected asset classes are consistent with implementation and monitoring constraints.

PRACTICE 2.6
The investment policy statement contains sufficient detail to define, implement, and monitor the client's investment strategy.

PRACTICE 2.7
When socially responsible investment strategies are elected, the strategies are structured appropriately.

PRACTICE 4.1
Periodic reports compare investment performance against appropriate index, peer group, and investment policy statement objectives.

PRACTICE 4.2
Periodic reviews are made of qualitative and/or organizational changes of Investment Managers and other service providers.

PRACTICE 4.3
Control procedures are in place to periodically review policies for trading practices and proxy voting.

PRACTICE 4.4
Periodic reviews are conducted to ensure that investment-related fees, compensation, and expenses are fair and reasonable for the services provided.

PRACTICE 4.5
There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

PRACTICE 3.1
A reasonable due diligence process is followed to select each service provider in a manner consistent with obligations of care.

PRACTICE 3.2
When statutory or regulatory investment safe harbors are elected, each client's investment strategy is implemented in compliance with the applicable provisions.

PRACTICE 3.3
Decisions regarding investment strategies and types of investments are documented and made in accordance with fiduciary obligations of care.

ASSESSMENT LEVELS

fi360 and CEFEX provide SAFE, CRFP, and CAFE working documents that correspond with each of the handbooks to assist with all of these levels of review and assessment.

LEVEL 1: SAFE

Self-Assessment of Fiduciary Excellence

LEVEL 2: CRFP

Consultant's Review of Fiduciary Practices

LEVEL 3: CAFE

CEFEX-Assessment of Fiduciary Excellence

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