U.S. EDITION

Handbook | Advisors

Fi360

Prudent Practices for Investment

ADVISORS

DEFINING A GLOBAL FIDUCIARY STANDARD OF EXCELLENCE

FOR PROFESSIONALS WHO PROVIDE INVESTMENT ADVICE, INCLUDING FINANCIAL ADVISORS, BROKER-CONSULTANTS, TRUST OFFICERS, FINANCIAL PLANNERS, AND FIDUCIARY ADVISORS

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About this Publication

This publication is part of a series of fiduciary handbooks published by Fi360 to define Global Fiduciary Standards of Excellence.

This publication is part of a series of fiduciary handbooks published by Fi360 to define Global Fiduciary Standards of Excellence.

The handbooks are reference guides for knowledgeable investment professionals, stewards, and investors who serve in a fiduciary capacity, also known as "investment fiduciaries."

The handbooks are not "how to" manuals for beginners. They assume some experience and familiarity with basic investment management concepts and procedures.

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.

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.

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2019 Preface

This handbook represents the third major revision to the Prudent Practices since their original publication in 2003. In each case, Fi360 works with outside technical experts, practitioners, lawyers, and others to ensure the Practices and handbooks continue to be the definitive guide to investment fiduciary responsibility.

What set this review apart is that we followed a methodology to meet the standards of the American National Standards Institute (ANSI) under the ISO 17024:2012 standard, which is a standard for organizations that certify individuals. The Practices and Criteria found in this handbook serve both as a guide to investment fiduciary responsibility and as the standard to which candidates for the AIF® designation must demonstrate competence. Following the 17024 standard helps Fi360 ensure an objective process is followed with the involvement of appropriate subject matter experts and interested stakeholders.

Among those involved in the review and approval of the Practices and handbook narrative include Fi360's own subject matter experts, Fi360's adjunct faculty, CEFEX Analysts, Drinker Biddle law firm, Hamburger Law Firm, the AIF® Scheme Commission (which represents outside stakeholders, including practicing advisors who hold the AIF® designation, employers of designees, institutions that benefit from designees, and the investing public), Fi360's Certification Oversight Committee, and the Personal Financial Planning (PFP) Division of the American Institute of Certified Public Accountants (AICPA).

The full job task analysis also included a comprehensive survey that was distributed to all active AIF® and AIFA® Designees. More than 1,100 designees completed the survey, which measured the relative frequency and urgency each Practice and Criteria has in their day-to-day practices, and asked to identify any gaps in the Practices. That exercise served both to validate the content of the Practices and to help Fi360 properly weight the AIF® exam to emphasize those tasks that are most important.

One of the encouraging aspects of going through that rigorous process was that it turned out to be not that different from the way we've done it in the past and didn't result in transformative changes to the Practices as we know them. While it is important for us to make changes as the environment changes for practicing fiduciaries, the Practices are rooted in principles that are at the heart of what it means to be a fiduciary and would not be expected to change much over time.

Specific points of emphasis that guided this review included simplifying language and eliminating unnecessary qualifiers, avoiding requirements that are not sufficiently substantiated in law, ensuring Practices and Criteria were focused on process and not application, and adding narrative to describe how each Practice is applied to specific segments of investors (individuals, retirement plans, institutions, and foundations and endowments).

In the end, the total number of Practices remained the same at 21. The number of Criteria decreased from 85 to 79. Three Practices received what could be described as substantial overhauls. Six Practices either did not change or were merely tweaked in non-substantive ways. The rest fell somewhere in the middle. The result is another step forward for the Prudent Practices and for advancing the cause of fiduciary responsibility.

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 whe n 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 Model Management of Public Employee Retirement Systems Act (MMPERSA), 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®, CGMA, CFP®, Ken A. Dodson, CPA/PFS, AIF®, Stewart Frank, CPA/PFS, AIFA®, Charles R. Kowal, JD, CPA (inactive), and Scott K. Sprinkle, CPA/PFS, CGMA, CFP®.

The AICPA is the world's largest association representing the accounting profession, with 431,000+ members in 137 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.

About Fi360

Fi360 is the leading fiduciary training and resources organization for the financial services industry in the United States. Its mission is to helps financial intermediaries use prudent fiduciary practices to profitably gather, grow, and protect investors' assets. Since 1999, Fi360 has been providing innovative solutions to financial services providers, including the AIF® and AIFA® **Designation programs, the Fi360 Toolkit™ software and the Fi360 Fiduciary Score®.**

The Center for Fiduciary Studies

The Center for Fiduciary Studies oversees certain aspects of Fi360's Accredited Investment Fiduciary® (AIF®), Accredited Investment Fiduciary Analyst® (AIFA®), and Professional Plan Consultant™ (PPC™) designations. The Center is comprised of Fi360's Certification Oversight Committee ("COC") and its various advisory commissions that are tasked with making essential decisions related to standards, policies, and procedures of the certifications, as well as decisions regarding who is qualified to hold an Fi360 designation. One critical role the Center performs is validating the Prudent Practices as being representative of the duties an advisor in a fiduciary role would be expected to perform.

To learn more about Fi360,
visit www.fi360.com.

CEFEX

Fi360 is 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. 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 the Practices defined in this handbook and its companion handbooks.

To learn more about CEFEX,
visit www.cefex.org.

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, substantiated in law and regulation, 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 (e.g., trustees and investment committee members).
- An **Investment Advisor**[1] 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.

[1] 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

Recognized and substantiated standards of practice aid advisors 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.'"

U.S. Court of Appeals, 7th Circuit, 1990, in *Debruyne v. Equitable Life Assurance Society, a suit filed by plan participants after the 1987 stock crash.*

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 present real risk to fiduciaries. However, 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).

The Need for a Global Fiduciary Standard of Excellence

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.

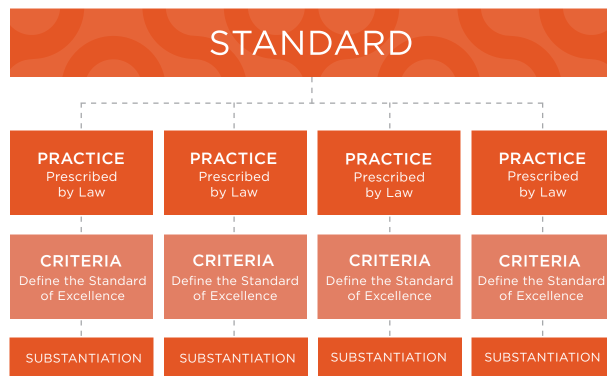
For the advisor, the key benefits associated with applying the Prudent Practices outlined in this han dbook include:

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 prudently manage investment decisions.
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 individual 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. By implementing a comprehensive process to fulfill fiduciary obligations, the advisor can establish a regimented business model that is designed to serve the best interests of investors.

Defining Fiduciary Excellence

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 U.S. 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 OF EXCELLENCE



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

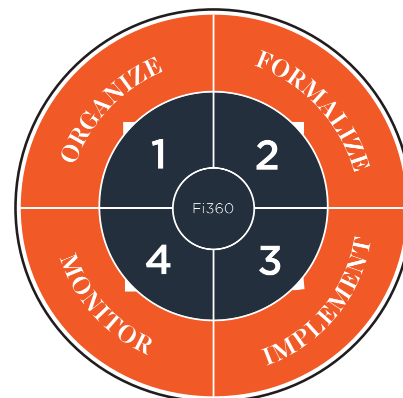
The implement stage is when investment and service provider due diligence is performed and decisions about investment safe harbors are made.

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.

FIDUCIARY QUALITY MANAGEMENT SYSTEM

(Analogous to the ISO 9000 QMS Continual Improvement Process)



Defining Fiduciary Excellence

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

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.

UPIA—Uniform Prudent Investor Act, is a widely-adopted, state-level uniform act that covers fiduciary responsibilities related to private trusts. The UPIA was released by the Uniform Law Commission (ULC) in 1994, and subsequently endorsed by the American Bar Association and American Bankers Association. Most states have adopted the act as 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, is a widely-adopted, state-level uniform act that impacts foundations, endowments, and government sponsored charitable organizations. UPMIFA was released in July 2006 by the ULC and has been adopted by most states and the District of Columbia.

MMPERSA—Model Management of Public Employee Retirement Systems Act, is a state-level model act that impacts state, county, and municipal retirement plans. MMPERSA was released in 1997 by the ULC and may apply to state, county, and municipal retirement plans.

To identify whether a state has adopted a uniform or model act, please visit ULC's website (http://www.uniformlaws.org). 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.

Global Fiduciary Precepts

If an investment advisor were to read all of the laws defining fiduciary obligations, the advisor would discover eight common requirements.

We have adopted these eight 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. Prudently select fiduciary and non-fiduciary service providers and document due diligence.
5. Control and account for investment expenses and other costs.
6. Avoid or manage conflicts of interest in favor of the client.
7. Monitor service providers and prudently manage service provider relationships.
8. Monitor and ensure conformity to fiduciary obligations owed to clients and beneficiaries.

We suggest that the investment advisor utilize the eight Global Fiduciary Precepts to assess the fiduciary framework in place for each client relationship. An advisor could ask the following probing questions 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? How frequently is it reviewed? When was the last time it was updated?
- What type of due diligence was performed on the investments that were considered and selected for the portfolio?
- What process was used to select service providers supporting administration and management of the portfolio? Has each service provider divulged whether they are acting in a fiduciary or non-fiduciary capacity?
- Have all fees and expenses paid to investment managers and other service providers been identified and found to be fair and reasonable?
- What policies are in place to identify and avoid or manage material conflicts of interest in a manner that serves investors' best interests?
- What type of periodic monitoring is applied to the investments in the portfolio and service providers?
- Is there a process in place to monitor fiduciaries and assure conformity to fiduciary practices?

This handbook will further explore the advisor's fiduciary responsibilities under the 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

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.

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. In the Judeo-Christian tradition, fiduciary principles can be traced to the biblical principle that no person can serve two masters. 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?" 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.

The Romans refined and formalized fiduciary principles and codified them further in law. Cicero (103 BC—46 BC) noted that we cannot do everything ourselves and therefore must rely on others (agents) having special expertise to act on our behalf. Cicero emphasized that the relationship between an agent and principal is necessarily one of high trust or confidence. An agent who shows carelessness or acts maliciously behaves dishonorably, undermines the basis of the social system, and must be held to account for breaking the bond of trust.

Fiduciary relationships also have appeared in Anglo-American law for over 250 years. 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. 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." 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.

Fiduciary obligations represent the highest standard of care in law or equity. 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. 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.

A primary reason that the fiduciary standard has survived and served society so well is that it is principles-based. Loyalty, care, prudence, diligence, and good faith are fiduciary duties that have stood the test of time and the expectations of competent and ethical professionals have evolved to reflect generally accepted theories and practices of the contemporary world.

Promoting a Fiduciary Culture

It is important to remember that laws and regulations set minimum expectations for fiduciary investment advisors. Employers set compliance rules that must be no less stringent than what is required by law. Standards setting bodies that grant professional certifications, such as CFP Board, CFA Institute, AICPA, and Fi360, promulgate codes of ethics and standards of conduct that may exceed certain legal and company compliance obligations based upon best practices for those with special expertise. Finally, individual practitioners may hold themselves to standards that surpass any of those standards. The illustration below represents that hierarchy of expectations for investment advisors.

In this handbook, we provide legal substantiation for each of the Practices. Legal substantiation provides readers references that shape the contours of how each practice and associated criteria may apply under various fiduciary laws. While fiduciary principles are consistent, the specific actions advisors may need to take to clear the minimum threshold of legal obligations necessarily depends on facts and circumstances and the specific laws and regulations that apply. In some circumstances, the Practices and Criteria in this handbook may directly reflect what is required by law. In other circumstances, they may rise above the minimum required by a particular law and regulation.

The Practices in this handbook are informed by law and regulations, intended to conform to fiduciary principles, and help assure that investors' best interests are served. As is evident from the rich history of the fiduciary standard, expectations of professionals evolve to stay current. As the profession advances, today's best practices may become tomorrow's minimum obligations. When in doubt about the minimum standard of conduct required, it is best to aim high.

In publishing the *Prudent Practices* handbooks, we strive to promote a culture of fiduciary responsibility among investment stewards, advisors, and managers.

"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 a nearly impossible task for lay persons who serve as trustees and investment committee members of retirement plans, foundations, endowments, and trusts. And because advisors, stewards, and 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.

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 those requirements, an advisor must also become familiar, and comply, with all other laws and regulations applicable to the advisor's particular field of practice and locality.

This handbook is not intended to be used as a compliance manual or as a source of legal advice. The advisor should discuss the topics with legal counsel knowledgeable in the specific areas of law and requirements in any states or countries where the services will be provided. References to federal or state laws or regulations are provided merely as a general guide and are not necessarily exhaustive of all requirements. Nor is this handbook intended to represent specific investment advice.

This handbook does 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, synthetic financial instruments, or the management of non-systematic risk.

STEP 1.

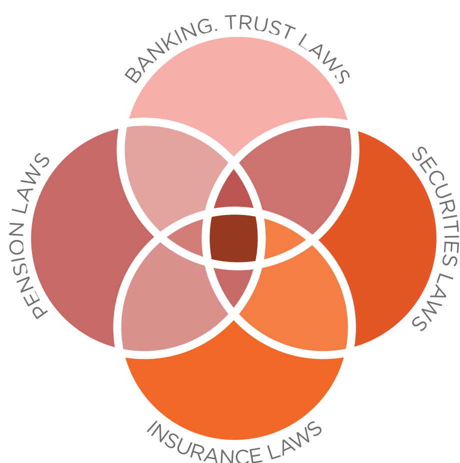
Step 1: Introduction

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

Organizing for a fiduciary engagement is analogous to running a business: you need to know your market, be familiar with the laws that apply to your services and relationships, know what resources are available (capital and people), and assess any other constraints.

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, bank 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. Professionals registered under banking, securities, or insurance laws often provide advice to retirement accounts, or sell related services or products to qualified plans, which aren't always subject to a fiduciary standard.

Similarly, securities brokers may be deemed fiduciaries for their investment advice under ERISA fiduciary standards for their advice to any retirement account as well as investment fiduciaries under securities law under certain conditions. 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.

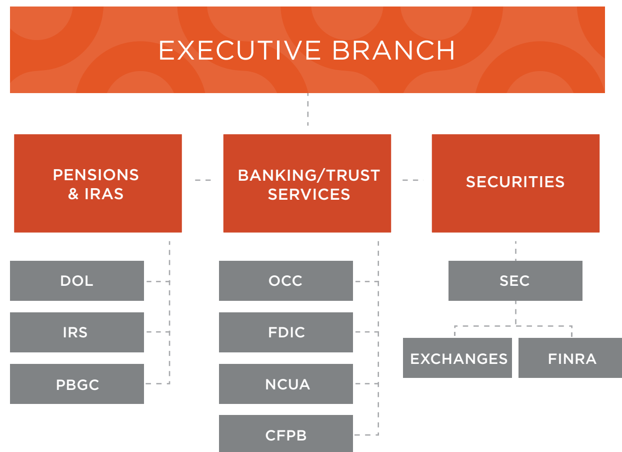
At first glance, then, the need to understand the scope of an investment advisor's fiduciary responsibilities may seem daunting, but with the increased regulatory focus on advice and not an arms-length transaction, the laws governing brokers, agents and investment advisers are slowly beginning to merge together under a fiduciary umbrella. As you apply the Prudent Practices in this handbook as a standard operating procedure, your awareness of your fiduciary role across different areas of federal and state regulation will come into greater focus.

Step 1: Introduction

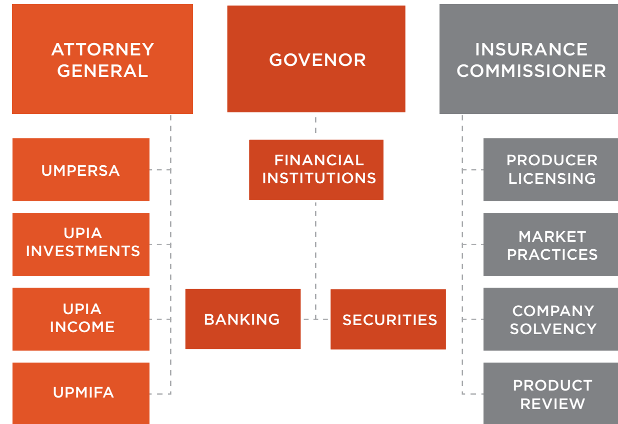
The organization charts below depict the structure of federal oversight of investment fiduciary activities and the typical state structure, respectively.

Note that federal oversight covers three of the four areas of law discussed above; namely, pension, banking law, and securities statutes. State oversight typically covers state and local public employee pension plans, insurance companies doing business in a state, and small banks, trust companies, and investment advisers. There is considerable variation in the oversight structure that exists across the 50 states, which is why the state-level chart is labeled as a "representative example." In all cases, it is best to consult with a lawyer to ensure you are aware of all levels of oversight that apply to your practice and services.

FEDERAL OVERSIGHT



STATE OVERSIGHT



PRACTICE 1.1

The investment advisor demonstrates an awareness of fiduciary duties and responsibilities.

CRITERIA

1.1.1 The investment advisor complies with all laws and rules that apply to the services the advisor is providing.

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 all applicable standards of conduct and code(s) of ethics required by law, regulation, employers, and professional organizations.

Fiduciary Status under Law

Recognizing who has fiduciary status under law is not always obvious. It may be stated explicitly in governing documents. It may be a function of the person's role with a given portfolio or how they are registered. Or It can be determined by facts and circumstances. However, being held accountable as a fiduciary is not dependent on the fiduciary being aware of their status. In order to meet their duties, a fiduciary must always be aware of what they are responsible for and which standards apply to their actions.

Registered investment advisers are fiduciaries under common law and in interpretive guidance provided by the Securities and Exchange Commission and state securities administrators.

Securities brokers are not presumed to have fiduciary status by their registration status. They may be ERISA fiduciaries if they meet the DOL's definition of a fiduciary by advising on plan assets. They are also fiduciaries under securities laws if they manage assets on a discretionary basis. Even if a broker disavows fiduciary accountability, they may be held accountable as a fiduciary in a proceeding against the broker if the broker is found to have assumed a position of trust or confidence on behalf of the client. Finally, state-licensed securities brokers may also be considered fiduciaries, or not, depending on the laws and regulations of the states in which they do business.

With regard to insurance agents, Congress traditionally has deferred market regulation of insurance producers to the states. Historically, producers selling all lines of insurance have not been held to a fiduciary standard of care. However, the insurance marketplace has come under increasing scrutiny and it would not be a surprise to see fiduciary accountability extend to insurance agents, particularly those who provide advice when selling annuity products to retirement investors.

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)). For advisers with less than $100 million in assets under advisement, state securities laws typically apply. Financial planners are generally required to register as investment advisers with either a state or the SEC, depending on the amount of assets under management.

Advisors may be deemed to be functional fiduciaries by virtue of their actions even if they fail to recognize their fiduciary status or register properly with regulators. Similarly, marketing materials may imply that fiduciary services will be provided, causing financial services representatives to unintentionally assume fiduciary status and compliance or litigation risks.

As a rule of thumb, each of the following four circumstances generally give rise to fiduciary status under federal and state laws and regulations:

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

Twin Duties of Loyalty and Care

A fiduciary standard generally establishes baseline obligations of loyalty and care to the client that provide an important overlay to the laws, regulations and legal agreements that govern a client relationship. These fiduciary duties are not nebulous concepts, they are obligations that are well established in common law and translate into practical and often specific requirements to be undertaken by the advisor. Many laws or regulations specifically prohibit contract provisions that waive fiduciary status.

A fiduciary duty is also a 'gap filler' when a client agreement, service contract, or the law is silent on a specific obligation of the advisor. The fiduciary duty of loyalty, for example, generally requires the advisor to avoid conflicts of interest or manage them in the best interest of the client. Compensation conflicts – situations when the compensation received by the advisor varies based upon the advice rendered – are particularly prevalent and the subject of the highest regulatory scrutiny.

The duty of care generally requires the advisor to "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This language is commonly known as the prudent person rule. Fiduciary investment advisors should think of this as the prudent "expert" rule because the phrase "acting in a like capacity and familiar with such matters" elevates the obligation to that expected of an expert in the field.

SUGGESTED PROCEDURE

Complying with all applicable standards related to your services requires assessing the scope of your advisory services, determining your fiduciary status under applicable laws and regulations, and understanding the obligations that apply to the specific client engagement. Fiduciary laws and regulations are intentionally principles-based. In contrast to rules-based regulations such as those administered by FINRA dealing with non-fiduciary sales practices, fiduciary laws and regulations are not highly prescriptive. They require professionals to always serve clients' best interests by staying current with developments in their field and responding appropriately to changing economic, market and social conditions, technology, and the body of knowledge in the profession.

Professional standards play a critical role in providing specific, practical, and timely guidance to advisors. This handbook addresses the reality that most advisors serve several client types: individuals, retirement plan sponsors, charitable organizations, trusts, and others. The fiduciary practices delineated here are substantiated in the various laws that apply to those audiences. Additionally, the practices are updated periodically to stay current with best investment management, business, and fiduciary practices. That is why Practice 1.1 requires adherence to all practices that apply to any given client engagement.

The ethical and competency standards established by professional associations also serve the important role of guiding the conduct of practitioners in their specific disciplines. Organizations such as the American Institute of CPAs, Certified Financial Planner Board of Standards, CFA Institute, and others set and enforce codes of conduct and ethics for their members or certified professionals. Practice 1.1 recognizes the importance of professional standards-setting bodies and the obligation of investment advisors to honor the commitments they have made to such organizations.

Organizations that confer professional designations and trade associations may promulgate professional standards of conduct or codes of ethics with more stringent requirements than apply under law or regulations; they cannot eliminate or lower legal or regulatory obligations. As a practical matter, advisors who are subject to varying levels of fiduciary accountability need to adhere to the highest one to avoid being out of compliance at some level.

The pursuit of fiduciary excellence by advisors serves the best interests of investors and enhances the reputation of the profession of investment advice. This involves going beyond mere compliance to adopt professional best practices.

Substantiation

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

Regulations
29 C.F.R. §2550.404a-1

Case Law
Tibble v. Edison, Int'l, 135 S. Ct. 1823, 59 E.B.C. 2461 (2015), *on remand* 843 F.3d 1187 (9th Cir. 2016) and 2017 WL 3523737 (C.D.Cal. 2017); *Tussey v. ABB, Inc.,* 52 E.B.C. 2826, 2012 WL 1113291 (W.D. Mo. 2012), *aff'd in part* 2014 WL 1044831 (8th Cir. 2014) and 2017 WL 929202 (8th Cir. 2017), *Braden v. Wal-Mart Stores, Inc*., 588 F.3d 585 (8th Cir. 2009), 6:08-cv-03109-GAF (W.D. Mo. 2012); *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* (Jan., 2011)

Investment Advisers Act of 1940 [IAA]

§202(a)(11) [Definition of an 'Investment Adviser']
§206(1), (2), (3) [Anti-fraud provisions that apply to adviser's fiduciary obligations]
§203A(b)(1) [State authority over 'small' RIAs]

Regulations

Investment Advisers Act Rule 203-1 [Application for Investment Adviser Registration]

Investment Advisers Act Rule 204-2 [Books and Records to be Maintained by Investment Advisers]

Investment Advisers Act Rule 204A-1 [Investment Advisers Codes of Ethics]

Investment Advisers Act Rule 206(4)-1 [Advertisements by Investment Advisers]

Case Law

Scott E. DeSano, et al., SEC Adm Proc 3-12879A (Mar. 6, 2008); *Strong Capital Management, Inc., et al.*, Investment Company Act Release No. 26448 (May 20, 2004); *SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); In re Arleen W. Hughes*, 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)

Code of Ethics Guidance for Investment Advisers (June 26, 2015) (im-guidance-2015-03.pdf).

State Insurance Regulation

Suitability and Best Interests in Life Insurance and Annuity Transactions, New York Dep't. of Fin. Svcs. (11 NYCRR 224). (Adopted July 17, 2018; effective Aug. 1, 2019.)

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 (Oct. 8, 1987)

Uniform Prudent Investor Act [UPIA]

§1(a); §2(a); §2(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c)

Model Management of Public Employee Retirement Systems Act [MMPERSA]

§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)

PRACTICE 1.2

Investments and investment services provided are consistent with governing documents.

CRITERIA

1.2.1 Investments are managed, and investment services are provided, in accordance with governing documents, including documents establishing the terms of an account or client engagement and the investment policy statement.

1.2.2 Documents pertaining to the investment management process, including records of decisions made by fiduciaries and clients, are secure and readily and reliably accessible by authorized persons.

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.

Institutional accounts (retirement plans, charitable organizations, etc.) generally involve multiple governing documents that define roles and responsibilities and direct how assets are to be managed. Certain documents may be required by law, such as a trust instrument or retirement plan document that contains provisions specifying obligations of investment fiduciaries. Other documents may be specific to certain types of institutional accounts. For example, the governing documents for public employee retirement plans often include references to state statutes and local ordinances that provide investment directives or limitations.

While individual investors generally have fewer, less complex governing documents, they are no less important. A client engagement agreement between the advisor and an individual investor typically sets parameters for the relationship and how investments are to be managed. Moreover, an investment policy statement for an individual investor is a particularly important governing document that must be followed for purposes of sound portfolio management and fiduciary risk mitigation.

While the documents that establish the terms of an account or engagement and the IPS are typically governing documents, special facts or circumstances may result in the creation of other governing documents that are unique to the specific client-advisor relationship. Consequently, the advisor must take care to collect, organize, and analyze all documents that are relevant to the management of the portfolio, the advisor's responsibilities, and that delineate investment-related responsibilities retained by the client.

Well-crafted governing documents often state client goals and objectives as well as key factors that are to be considered in, or that will impact, the decision-making process of the advisor. These factors may include, but are not limited to:

- cash flow considerations
- current and expected future assets
- investment experience, expertise, and aptitude
- limits and directives imposed to use or avoid certain types of investments or investment strategies and tactics
- risk tolerance and capacity

Documentation of investment-related activity is generally required under "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. DOL and FINRA rules generally require similar records to be held for six years.

Special Considerations under ERISA

ERISA §404(a)(1)(D) requires a fiduciary to discharge its duties in accordance with the terms of the plan's governing documents insofar as the documents are 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 a plan's governing 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 is a default standard that can be expanded, restricted, or otherwise altered by the provisions of the trust. Put another way, if the trust restricted portfolio investments to a certain asset class, such as cash, CDs and money market funds, the trust would not violate the default duty to diversify.

Special Considerations under UPMIFA

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

Suggested Procedure—Fiduciary File

An advisor should consider creating a fiduciary file to organize and serve as a repository for documents

that govern the client relationship and demonstrate faithful application of fiduciary best practices. Since investment firms are diverse in size, client demographics, and scope of services, there is no single recommended approach. The file should, however, be organized in a way that aligns with fiduciary best practices such as those addressed in this handbook and show that the practices are appropriately and consistently applied. The documents listed below are representative of the type that should be collected, reviewed, and analyzed for consistency with governing laws and regulations, professional conduct standards and codes of ethics, and the Practices in this handbook.

- disclosure documents, such as Form ADV, Part 2, ERISA 12b-1 and FINRA Form U-4
- marketing materials and advertisements, including references or links to the firm's website and commentary in social media
- client agreements
- investment policy statements
- written minutes and/or files from investment committee meetings
- applicable trust documents or account opening 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 individual or institutional client
- 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
- various forms of material client communications, including newsletters, follow-up correspondence after client meetings, specific written (and email) responses to client questions, including those in which the client takes a different course of action from those recommended by the advisor

The fiduciary file should be maintained in a manner that allows them to be readily and reliably accessed by authorized personnel only. Electronic files are generally preferred because they are typically more conducive to effective, efficient, and secure storage.

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
Interpretive Bulletin 2016-1 (reinstating the language of Interpretive Bulletin 94-2, with certain modifications), 81 Fed. Reg. 95879 (Dec. 29, 2016)

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 [IAA]
§204(a)

Regulations
SEC Advisers Act Rule 204-2 [Books and records to be maintained by investment advisers.]

Case law
In the Matter of Covenant Financial Services, LLC and Stephen Shafer, Investment Advisers Act Release No. 4672 (Mar. 29, 2017); *In the Matter of Calvert Investment Distributors, Inc. and Calvert Investment Management, Inc.*, Investment Advisers Act Release No. 4696 (May 2, 2017); *In the Matter of Aisling Capital LLC*, Investment Advisers Act Release No. 4951 (June 29, 2018)

Other
Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. 4509 (August 25, 2016)*; Recordkeeping Requirements For Investment Advisers*, NASAA Model Rule 203(a)-2, (Adopted Sept. 3, 1987, amended May 3, 1999, Apr. 18, 2004, and Sept. 11, 2005).

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)

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

PRACTICE 1.3

The roles and responsibilities of all involved parties, whether fiduciaries or non-fiduciaries, are defined and documented.

CRITERIA

1.3.1 All involved parties have acknowledged their roles and responsibilities and fiduciary or non-fiduciary status in writing.

1.3.2 Each investment committee formed, controlled, or required by the advisor has a defined set of by-laws or operating procedures to which the committee adheres.

For an investment program to be successful, all involved parties must work in coordination with one another. It cannot be taken for granted that everyone involved in the investment process has a complete, mutual understanding of where their respective duties begin and end. Defining and documenting the roles and responsibilities of all parties, whether fiduciary or non-fiduciary, prevents misunderstandings between parties, avoids omission of critical fiduciary functions, and ensures continuity of the investment strategy when there is a change to any of the parties.

Clearly defining the scope and fiduciary status of the advisor's engagement is particularly important at a firm where the advisor may also work in a non-fiduciary capacity providing other client services. Many investors assume that their financial advisor is acting solely in the investor's interests. However, while most advisors will act ethically, they may not always be required by law to act as a fiduciary and to serve their client's best interest. The full scope of engagement and fiduciary protections should be clear to the client from the outset.

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]

Under certain ERISA regulations, investment advisors are required to 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 3.1]

Suggested Procedure

The investment policy statement should address how the fiduciary process will be implemented and who is responsible for carrying out each component of that process. [See Practice 2.6] Potential roles to be included in the IPS include the client or other investment steward, the advisor, custodian, recordkeeper, investment managers, and any other consultant or service provider engaged to provide expertise.

All agreements with service providers should be in writing and contain sufficient information about the specific services the provider is performing. [See Practice 1.5]. A best practice is to have all service providers (not just those subject to ERISA) complete 408(b)(2)-like disclosure of the services they will be providing and their fiduciary or non-fiduciary status. A fiduciary acknowledgment letter can also be used to document the fiduciary status of anyone who has not otherwise disclosed their status.

Any investment committee, whether formed and operated by the steward or by an advisor should have documented operating procedures that explain their decision-making process. The operating procedures might include details such as the frequency of meetings, how it conducts due diligence and makes decisions on investments, who has final discretion to act on those decisions, and how those decisions are to be monitored. For example, the operating procedures of a steward's committee may state that the 3(21) advisor provides recommendations, but it is up to the investment committee to undertake its own due diligence by asking questions about the recommendation and that the final decision is ultimately up to the committee (all to be recorded in the minutes).

Finally, with regard to individual investors or charitable foundation clients, the fiduciary advisor subject to the Advisers Act or state securities laws should review Form ADV or the client agreement to determine whether sufficient disclosure has been provided, and whether supplemental disclosures documenting these procedures may be helpful.

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)
Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)]

Other

Adviser Business Continuity and Transition Plans (proposed rule), Investment Advisers Act Release No. 4439, https://www.sec.gov/rules/proposed/2016/ia-4439.pdf (June 28, 2016).

Information for Newly-Registered Investment Advisers, Prepared by the Staff of the U.S. Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations, http://sec.gov/divisions/investment/advoverview.htm (Oct. 8, 1987)

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)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§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)

Sacerdote v. N.Y. Univ., S.D.N.Y., No. 1:16-cv-06284-KBF (2018)

PRACTICE 1.4

The investment advisor identifies material conflicts of interest and avoids or manages conflicts in a manner consistent with the duty of loyalty.

CRITERIA

1.4.1 Policies and procedures for overseeing and managing conflicts of interest, including to avoid self-dealing and making false or misleading statements, are defined and followed.

1.4.2 Conflicts of interest are avoided when prohibited by law and/or governing documents.

1.4.3 Conflicts of interest that are not avoided must be managed in the client's best interest.

1.4.4 Conflicts of interest that are not avoided must be disclosed to the client and informed client consent must be obtained.

The fundamental duty of the fiduciary advisor is to act in the best interest of their client or beneficiaries of the portfolio, whether it is a financial planning client, retirement plan participant, or trust beneficiary. In addition, the advisor is obligated to be objective and diligent in the performance of the advisor's duties on behalf of the client. If a client is harmed by the advisor's self-interested decision or negligence, then a breach of the fiduciary duty of loyalty is likely to have occurred.

A good working definition of a material conflict of interest is a circumstance that makes fulfillment of the duty of loyalty less reliable. 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 because of the conflict is a separate matter.

The very suspicion of a material conflict of interest usually means that one does, in fact, exist. The best solution is to avoid situations or relationships that give rise to conflicts. However, no advisor is conflict-free, and it is sometimes preferable for a conflict to exist and be managed in the best interest of the client. For example, merely by receiving compensation, a conflict of interest exists – money changes hands from the client to the advisor. The conflict could be avoided if the advisor were to work for free, but presumably the advisor would be unwilling to do so and the client would therefore be denied the benefit of the advisor's professional advice. It is better for all parties that the conflict can exist and is managed by mutual agreement that the advisor will charge a fair and reasonable fee for the services provided.

Compensation Conflicts

It is not merely the receipt of compensation by an advisor that gives rise to a conflict; how the advisor is paid (specifically, non-level compensation) can compound the conflict. 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 an environment where cross-selling is legally permitted, or even encouraged, and a firm's compliance policies are structured to cover the activities of thousands of financial advisors, the 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, material 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 for addressing conflicts should focus upon promoting a fiduciary culture within the firm.

The most serious and problematic conflict of interest involves self-dealing, when the fiduciary directly benefits from a transaction with the client (beyond receiving reasonable compensation for the services provided). 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 only allowed 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 subtler and 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. That confusion is of concern to regulators and professional organizations; consequently, "hat changing" is under increasing scrutiny. 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.

Fiduciary Trends: “Best Interest” Standards

Fiduciary rulemaking has been a moving target since the Department of Labor’s first attempt at a revised definition of “fiduciary” in 2010. Regulators across the board have been looking both broadly at what constitutes fiduciary advice and more narrow questions regarding specific activities and products, such as rollovers, high-cost share classes, and annuities. Despite that attention, little to this point has stuck and we continue to be in a decidedly unsettled and disjointed environment for compliance.

Ultimately, the goal for regulators is to cut down on the most damaging conflicts of interest. At the time of writing, it appears that one of the most likely trends to take hold is for a “best interest” standard. “Regulation Best Interest,” as proposed by the Securities and Exchange Commission as part of their regulatory package to harmonize fiduciary standards for brokers and advisors, would require enhanced disclosures of conflicts of interests, for recommendations to be made with a reasonable basis to believe they are in the best interests of the client, and to have policies and procedures in place to identify and mitigate material conflicts of interest. Though we may still be a long way off from a more static regulatory environment, advisors should consider these as minimum principles for addressing conflicts of interest and should check with their compliance professional to ensure full compliance with the law.

Special Considerations under ERISA and MMPERSA

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. If one plan fiduciary becomes aware of another co-fiduciary’s breach, or undertakes to conceal it, both are personally liable under ERISA. No agreement can exonerate fiduciaries from liability, although special insurance coverage may be available to the sponsoring institution and advisory firm.

In the event an apparent breach is discovered, the advisor should notify the plan sponsor and consult legal counsel. Examples of possible 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

An advisor who provides services to a plan for compensation is technically committing a prohibited transaction and therefore must rely on an exemption provided under ERISA to avoid adverse consequences. Under ERISA, transactions between a “party in interest” and a plan are automatically considered self-dealing, and thus are defined as “prohibited transactions.” “Parties in interest” include the plan sponsor, plan fiduciaries, service providers, corporate officer, and just about anyone associated with making decisions on behalf of a qualified plan or who otherwise provide services to the plan. 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 for the benefit of, a party in interest, of any assets of the plan

- Acquisition, on behalf of the plan, any employer security or employer real property in violation of ERISA Section 407.

Most significantly, ERISA provides an exemption 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 disclosure rules, 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 A-3.1]

For public employee retirement plans, fiduciaries should also be aware of any additional stakeholders to whom a fiduciary duty is owed. In some states, that could include the employer or tax payers. Rules will vary from state to state, so advisors should seek legal opinion to understand the full extent of their fiduciary duties.

Special Considerations under the IAA

The 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 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 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 advisor hires an investment manager or other service provider for a reason other than merit
- an advisor recommends that a new or prospective client roll over a 401(k) account into an IRA that he or she will manage.
- an 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.

Suggested Procedure

It is critical for the advisor to be aware of material conflicts of interest, recognize that the conflicts associated with each client may be unique, and evaluate how each conflict should be handled. The advisor should examine the nature and scope of each conflict, decide if it is a material conflict, and respond accordingly. A conflict is material if awareness of the conflict would reasonably be expected to influence the client's decision-making.

The two basic remedies to a conflict are avoidance or mitigation. Avoidance is generally the preferred solution and is sometimes required, such as when a prohibited transaction would occur in an ERISA account with no available prohibited transaction exemption.

When a material conflict is not avoided, disclosure is required. 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 accept the conflict and the advice, or not approve the conflict and reject the conflicted advice.

Additionally, disclosure alone does not relieve the advisor from the duty of loyalty. Conflicted advice that is not reasonably formulated to serve the client's best interest is a fiduciary breach. Most client complaints relate to advice rendered at some time in the past and they are evaluated in hindsight during arbitration, litigation, or a regulatory action. The risk of mitigating a conflict rather than avoiding it is that mitigation may not be deemed adequate in an after the fact evaluation of the facts and circumstances giving rise to the conflicted advice at the point in time it was provided.

As a best practice, an advisor should discuss 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. As a best practice, the RIA may maintain a record of conflicts encountered by the firm on a regular basis, and how these conflicts are routinely addressed to fulfill the duty of loyalty to clients.
- 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 even if not required to do so. Also, identify practices specifically prohibited in state regulations or targeted by regulators and conduct annual reviews to promote regulatory compliance and fiduciary excellence.
- 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 encountered in your firm, and an action plan to prioritize and avoid or manage conflicts in the best interests of clients. Test conflict resolution procedures for effectiveness at least once a year.
- In a firm environment where procedures to address conflicts of interest are formulated and managed centrally by a CCO or compliance officer, establish a protocol for advisors to obtain guidance to handle conflicts not covered by established procedures.

Suggested Procedures under ERISA

- Identify the prohibited transactions that you may encounter in your practice and available exemptions to manage them.
- Comply with Prohibited Transaction Exemption requirements, including required disclosures of compensation [see Practice 3.1].
- As best practices, inventory conflicts of interest in a risk matrix and develop an action plan to prioritize and avoid or properly manage conflicts in the best interest of plan participants and beneficiaries.

Substantiation

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

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(A) and (B); §404(a)(1)(A); §405(a); §406(a) and (b); and §408

Regulation

29 C.F.R. §2550.408(b)-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*, 135 S. Ct. 1823, 59 E.B.C. 2461 (2015), *on remand* 843 F.3d 1187 (9th Cir. 2016) and 2017 WL 3523737 (C.D.Cal. 2017); *People v. Martz*, 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, Nov. 7, 2007

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

DOL Prohibited Transaction Exemption 77-4, 42 Fed. Reg. 18732 (Apr. 8, 1977)

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

Case Law

In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C., Investment Advisers Act Release No. 4219 (Oct. 7, 2015); In the Matter of Centre Partners Management, Investment Advisers Act Release No. 4604 (Jan. 10, 2017); *In the Matter of Credit Suisse Securities (USA) LLC*, Investment Advisers Act Release No. 4678 (Apr. 4, 2017); *In the Matter of Institutional Investors Advisory Company*, Investment Advisers Act Release No. 4747 (Aug. 16, 2017); *In the Matter of Envoy Advisory, Inc.*, SEC Investment Advisers Act Release No. 4764 (Sept. 8, 2017*); In the Matter of Suntrust Investment Services, Inc.*, SEC Investment Advisers Act Release No. 4769 (Sept. 14, 2017); *In the Matter of Financial Fiduciaries, LLC and Thomas Batterman*, Investment Advisers Act Release No. 4863 (Mar. 5, 2018); *In the Matter of Securities America Advisors*, Investment Advisers Act Release No. 4876 (Apr. 6, 2018); *In the Matter of WCAS Management Corporation,* Investment Advisers Act Release No. 4896 (Apr. 24, 2018); *In the Matter of Lyxor Asset Management, Inc.*, Investment Advisers Act Release No. 4932 (June 4, 2018); *In the Matter of Michael Devlin*, Investment Advisers Act Release No. 4973 (July 19, 2018)

Other

Heitman Capital Management et al., SEC No-Action Letter (Feb. 12, 2007); *NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, Model Rule 201(a)(4)-1* (Adopted April 27, 1997, Amended April 18, 2004 and Sept. 11, 2005), http://www.nasaa.org/wp-content/uploads/2011/07/6-IAUnethical091105.pdf; *SEC Share Class Selection Disclosure Initiative* (announced on Feb. 12, 2018), https://www.sec.gov/enforce/announcement/scsd-initiative.

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

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

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

PRACTICE 1.5

Agreements under the supervision of the investment advisor are in writing and do not contain provisions that conflict with fiduciary obligations.

CRITERIA

1.5.1 The investment advisor fully discloses in writing all compensation arrangements and affiliations associated with the service agreement.

1.5.2 If the investment advisor is responsible for oversight of other service providers, the advisor must evaluate all material compensation, affiliations, and the fiduciary status of each 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 reasonable agreements with service providers. That requires performing 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 Investment Advisers Act and Department of Labor Rule 408b-2 under ERISA. Those 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 management 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 in writing and define the scope of the parties' duties and responsibilities. Written service agreements help ensure that the parties have a clear, mutual understanding of their roles and responsibilities and that terms of the agreements can be readily checked for conformity to other governing documents. All such agreements should be prepared or reviewed and approved by knowledgeable legal counsel.

A prudent and appropriately documented process to hire a service provider must be followed by diligent monitoring of the relationship and periodic assessments of whether the service provider should be retained. 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. (Note that governing documents may specify more frequent reviews or other circumstances that require a review to be conducted. In those cases, the governing documents should be followed.) Reviews should apply sound due diligence to evaluate relevant information about competitive providers in the marketplace.

The timing of reviews may be more or less frequent than every three years based upon facts and circumstances impacting the likelihood that a change in service providers would justify the time and money cost of evaluating alternatives and making a change. Factors that may influence the frequency of reviews include the following:

- A change in the depth, breadth, or scale of services needed may make a different service provider better suited to the client's needs that the existing provider.
- Rising competition and falling prices may change marketplace dynamics.
- The scope of services offered by the existing service provider has changed.
- New technology offers the opportunity to secure improved services and/or lower costs elsewhere.
- New competitors have entered the marketplace and are seeking to expand market share through aggressive pricing and other incentives.
- Changes in applicable laws or regulations, require different services than the current vendor provides.

Substantiation

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

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)

Regulations

29 C.F.R. §2550.408b-2; 29 C.F.R. § 2550.408b-2(c).

Investment Advisers Act of 1940
§*206(1) and (2)*

Case Law

In the Matter of Central States Capital Markets, LLC, et. al, Investment Advisers Act Release No. 4352 (Mar. 16, 2016); *In the Matter of Potomac Asset Management Co., Inc., et al.*, Investment Advisers Act Release No. 4766 (Sept. 11, 2017); *In the Matter of Platinum Equity Advisors, LLC*, Investment Advisers Act Release No. 4772 (Sept. 21, 2017); *In the Matter of TPG Capital Advisors, LLC*, Investment Advisers Act Release No. 4830 (Dec. 21, 2017); In the Matter of Aberon Capital Management, LLC & Joseph Krigsfield, Investment Advisers Act Release No. 4914 (May 24, 2018).

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)

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

PRACTICE 1.6

Sensitive personal identifying information and assets of clients are prudently protected from theft, embezzlement, and business disruption risks.

CRITERIA

1.6.1 The investment advisor has a reasonable basis to believe assets are within the jurisdiction of a viable judicial system.

1.6.2 Appropriate procedures are in place to secure and prudently protect the privacy of client or plan data.

1.6.3 Appropriate procedures are in place to assure that sensitive personal identifying information and assets of clients are prudently protected from physical, operational, virtual, and other material risks associated with business disruptions.

1.6.4 The investment advisor has a reasonable basis to believe assets are protected by appropriate insurance, bonding, internal controls, and security measures taken by fiduciaries and other service providers, including the investment advisor's own firm.

1.6.5 The investment advisor has procedures in place to manage situations where the advisor reasonably believes that a client's assets are at risk due to suspicious behavior by service providers, the client, or others with access to or influence over the client's assets.

1.6.6 The investment advisor has documented a succession plan and a business continuity plan that is reviewed and tested periodically.

An investor's confidence in their advisor must extend beyond that the advisor will provide impartial and expert advice. The investor will expect that the advisor and the advisor's firm will protect both information and assets of the client from external threats, whether operational, physical, or virtual. One of the most fundamental risk management precautions an advisor can take is to have procedures in place to detect, prevent, and mitigate the threat of theft of client assets and data.

Safeguarding Client Assets

In their position of trust, advisors must take reasonable precautions to protect client assets from theft and embezzlement. Certain measures are required by law, others are established by the scope of the engagement, and some may be implemented as best practices in the pursuit of fiduciary excellence.

The advisor must 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 U.S. investment companies, such as mutual funds, that invest in foreign securities are fiduciaries and required to comply with SEC Rule 17f-5 (which contains many of the safeguards of Practice 1.6), so an advisor can reasonably rely on the fiduciary obligation having been fulfilled. If a client, however, 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 U.S. registered investment company, legal counsel should be consulted to ensure that the foreign laws impose appropriate requirements that protect portfolio assets.

Cyber Security

Internet technology allows plan data and assets to be accessed from almost anywhere in the world. Cybercrime is a viable threat, and the problem is growing. Fiduciary account information is a particularly attractive target because it often contains personal information, such as social security numbers, as well as financial data, such as balances and deposit information. The National Institute of Standards and Technology suggests a five-part framework for managing cybersecurity risk across an organization:

1. Identify the assets at risk
2. Protect assets from compromise
3. Detect possible breaches through ongoing monitoring
4. Respond to breaches by taking action and containing the impact
5. Recover from a breach by understanding what happened, restoring capabilities, and making improvements

Special Consideration under ERISA

With respect to ERISA, if the client is a qualified plan sponsor, 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.

Suggested Procedure

If the advisor's firm custodies client assets, the firm should have appropriate insurance, internal controls, and physical security measures to protect against theft and embezzlement. Similarly, if it is within the scope of the advisor's engagement, the advisor must verify that service providers that custody client assets have appropriate insurance and internal controls.

Finally, as a best practice, it is recommended that the advisor put in place procedures to manage situations where the advisor reasonably believes that a client's assets are at risk due to suspicious behavior by service providers, the client, or others with access to or influence over the client's assets. For example, an advisor typically has a uniquely intimate perspective of an individual client's

financial affairs. The advisor may note signs of an elderly client's diminishing capacity and potential financial exploitation by friends, family, or others. The well prepared advisory firm will establish procedures to escalate these types of concerns to a person/position in the organization who has responsibility to understand the legal implications of the issue and follow protocols to handle the situation in the best interest of the client.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]

Other

Revenue Procedures 97-22 and 98-25

Employee Retirement Income Security Act of 1974 [ERISA]

§107; §404(b); §405; §412(a)

Regulations

29 C.F.R. §2550.404b1

29 C.F.R. § 2520.104b-1

29 C.F.R. §2520.107-1

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, Aug. 12, 1974)

ERISA Advisory Council on Employee Welfare and Pension Benefit Plans Report on Cybersecurity Considerations for Benefit Plans (November 2016).

Investment Advisers Act of 1940

15 U.S.C. 80b

Case Law

In the Matter of R.T. Jones Capital Equities Management, Inc., Investment Advisers Act Release No. 4204 (Sept. 22, 2015).

Regulations

Regulation S-P, 17 CFR Part 248 Subpart A; Regulation S-AM, 17 CFR Part 248, Subpart B; Regulation S-ID, 17 CFR Part 248, Subpart C

Other

SEC Cybersecurity Risk Alert (Aug. 2017) (https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf); SEC Cybersecurity Risk Alert (Sept. 2015) (https://www.sec.gov/files/ocie-2015-cybersecurity-examination-initiative.pdf)

Investment Company Act

§17(f)

Regulations

Investment Company Act Rule 17f-5 [Custody of investment company assets outside the United States].

Uniform Prudent Investor Act [UPIA]

§2(a); §5; §9(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §5(d)

Model Management of Public Employee Retirement Systems Act [MMPERSA]

§2(21); §6(e); §7; §11(c) and Comments

State Law

State privacy laws will also often apply and sometimes are much stricter than the laws and regulations outlined above.

Best Practices on Cybersecurity

National Institute of Standards and Technology Cybersecurity Framework V1.1 (Apr. 2018) (https://www.nist.gov/cyberframework)

STEP 2.

Step 2: Introduction

The second step of the Fiduciary Quality Management System is to formalize the investment strategy. Broadly speaking, Step 2 focuses upon establishing proper portfolio diversification and preparing an effective investment policy statement.

Formalizing the investment policy is not an isolated process, 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 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, consideration should be given to whether and how environmental, social, and governance factors ("ESG") will be used in constructing the portfolio.

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 cash flows are documented.

2.1.2 In the case of an individual investor, an appropriate needs-based analysis has been factored into the time horizon.

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

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

2.1.5 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..

"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 fiduciary to ensure there are sufficient liquid assets (cash and cash equivalents) on hand to cover known or expected liabilities when they come due.

One of the most important determinations to be made for a portfolio is the time horizon of the investment strategy. Based on the time horizon, the fiduciary 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.

Special Considerations for Individual Investors

In the context of retirement planning, sufficient liquidity should be retained during the accumulation phase for re-balancing purposes and to dampen volatility, depending upon the client's risk tolerance. During the distribution phase, sufficient cash reserves should be maintained to fund withdrawal schedules during a down market in order to avoid selling other, more volatile asset classes at an inopportune time. Similar cash-flow schedules should be maintained to address other goals and objectives of the high-net worth client.

Special Considerations for ERISA Defined Benefit Plans

Defined benefit plans represent unique challenges since the investment time horizon typically lasts as long as the corporate entity is obligated to pay distributions to plan beneficiaries. The advisor should be well-informed about funding status, employee and beneficiary demographics, and the overall financial health of the company and industry sector in order to periodically assess the appropriate weighting of different asset classes.

Special Considerations for UPMIFA

Unlike retirement planning for individuals, charitable and other nonprofit organizations' time horizons may be ongoing in order to carry out the foundation's mission. The focus is therefore on sustaining the appropriate Equilibrium Spending Rate (ESR) throughout the life of the organization and keeping in mind that endowments are allowed to sustain spending during a bear market as long as it meets UPMIFA's prudence standard. In response to severe economic conditions, UPMIFA established seven factors, or standards of prudence, that can be followed by the organization when carrying out its mission with an 'underwater' portfolio. The seven factors are the duration and preservation of the endowment fund, its purpose(s), general economic conditions, the possible effects of inflation or deflation, expected total return from income and investments, other resources, and the IPS.

Suggested Procedure

The advisor should prepare a schedule of each client's anticipated cash flows so that an appropriate investment time horizon can be identified.

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

Those clients with larger accounts and several well-defined goals may benefit from a 'goals-based' approach to investment horizon identification and asset allocation optimization. The application of MPT is still relevant in these instances, it just needs to be applied in multiple iterations through examination of each specific goal and available funding sources.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]

Other

IRS Notice 2014-66

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

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2); 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, 20 E.B.C. 2857 (5th Cir. 1997)

Other

Interpretive Bulletin 961, 29 C.F.R. §2509.961; H.R. Report No. 1280, 93d Congress, 2d Session (1974); ERISA Opinion Letter 2006-08A (Oct. 3, 2008); Preamble to 29 C.F.R. §§2509, 2510, and 2550, 81 Fed. Reg. 20945 (Apr. 8, 2016); but see *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018) (vacating final regulations) ;DOL Information Letter to Mark Iwry (October 23, 2014); DOL Advisory Council on Employee Welfare and Pension Benefit Plans Report on Participant Plan Transfers and Account Consolidation for the Advancement of Lifetime Plan Participation (November 2016).

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.,* Investment Advisers Act Release No. 1391 (Nov. 9, 1933); *In re George Sein Lin*, Investment Advisers Act Release No. 1174 (June 19, 1989).

Other

Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994).

The Value of Goals-Based Financial Planning by David Blanchett, CFP®, CFA. Journal of Financial Planning 28 (6): 42–50.

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

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

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

PRACTICE 2.2

An appropriate risk level has been identified for the portfolio.

CRITERIA

2.2.1 The expected volatility of the portfolio 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 the portfolio's risk level.

2.2.3 Expected disbursement obligations and contingency plans have been considered when establishing liquidity requirements for the portfolio and assessing the capacity to assume portfolio risk.

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

Risk

Management of investment risk is among the most important aspects of a fiduciary's responsibility. Risk is the measurable possibility that the actual return of an investment will not match expectations. When formalizing the investment strategy, an advisor must determine how much risk the client is willing and able to assume to achieve investment goals. Typically, investment professionals define 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 goals and objectives.

An investment strategy can fail by being too conservative or too aggressive. An 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.

Systematic & Non-Systematic Risk

There are two major components of investment risk: systematic and non-systematic.

Systematic risk is the risk that is tied to overall economic conditions and cannot be avoided. Investors are compensated for assuming more systematic risk via higher return expectations over longer-term time horizons.

Non-systematic risk is the risk that is specific to each asset held and generally can be lessened by increasing the number of diverse assets whose returns would not be expected to closely correlate to each other or to the assets already held in the portfolio. Generally speaking, fiduciaries are obligated to diversify to reduce non-systematic risk.

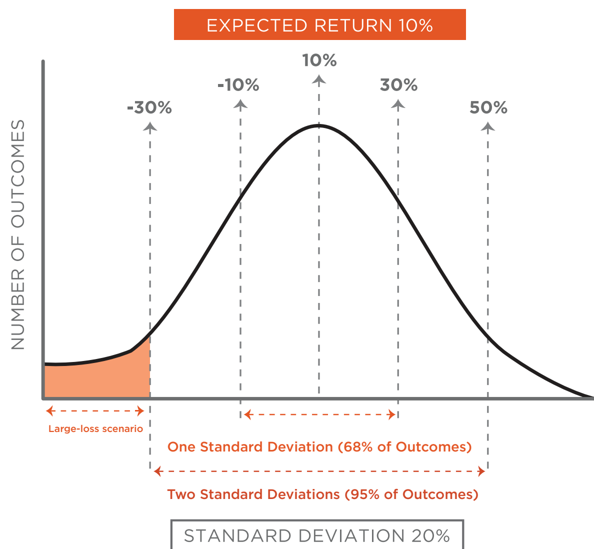
Planning for a "Large Loss" Scenario

One only needs to look back as far as the 2007-2008 Financial Crisis for a lesson on the risks of a "large loss" scenario. With market losses of over 50%, many investors and portfolios were devastated during the period. 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.

Return distributions tend to have 'fat' tails (more frequent extreme results) relative to a normal distribution. For clients with finite time-horizons, sequence of returns risk is particularly critical. For other portfolios with effectively infinite time horizons, there is time for recovery from down markets. Fiduciary advisors have a responsibility to construct investment allocations to account for, and mitigate, exposures in the context of each investor's time-horizon and ability to absorb a large loss.

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.

A modeled large loss scenario can be represented visually in a number of different ways. The illustration on the following page shows both a normal distribution of returns and a "fat tail" illustration that may more accurately reflect that a "large loss" scenario is very much in the realm of expected outcomes.



Disbursement Obligations

Short-term disbursement obligations also factor into a portfolio's ability to assume risk and in establishing liquidity requirements. For single portfolios, such as individual investors, defined benefit plans, and foundations, disbursement obligations can dictate the allocations to fixed income asset classes. Specific allocations to cash can also be considered to avoid disruptive trading. For pooled accounts, such as a defined contribution plan, the portfolio must provide options that consider a reasonable range of participant profiles using the demographics of the plan.

Special Considerations Under ERISA

A recent trend for retirement plans is the use of a lifetime income option in a qualified default investment alternative (QDIA) or otherwise in the menu of available options. Given concerns about their liquidity, transferability, and costs, annuities had long been considered a taboo for retirement plan lineups. The DOL and Treasury have each clarified in recent years that those types of investments do have a place if chosen prudently.

Annuities are increasingly seen as a viable option for a guaranteed retirement income stream now that the prevalence of defined benefit plans has drastically declined in the private sector and amidst growing concern that Social Security benefits will be reduced in the future. Facts and circumstances still prevail when determining whether guaranteed income options should be made available, but an advisor would be remiss to not consider them as a means to mitigating risk, especially when considering whether an investor will outlive their assets in retirement.

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 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 scenar-io? 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.

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); 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)

Other

DOL Advisory Council on Employee Welfare and Benefit Plans Report Hedge Funds and Private Equity Investments (November 2011)

Investment Advisers Act of 1940

Case Law

In re Westmark Financial Services Corp., Investment Advisers Act Release No. 1117 (May 16, 1988); *In re George E. Brooks & Assocs., Inc.,* Investment Advisers Act Release No. 1746 (Aug. 17, 1998)

Other

Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 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

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§7; §8; §8 Comments

PRACTICE 2.3

The distribution of projected portfolio returns is evaluated in the context of the client's risk and return objectives.

CRITERIA

2.3.1 The projected portfolio return is consistent with the client's tolerance and capacity to assume volatility risk and investment goals and objectives.

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

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

2.3.4 For defined contribution plans, the projected returns for pre-allocated options, such as target date funds or model portfolios, are based on reasonable risk premium assumptions.

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

Advisors are neither expected nor required to predict future returns. Rather, they are required to demonstrate that a prudent process and reasonable assumptions are used to model the probable outcomes of a range of investment strategies.

It's critical to differentiate between required and projected returns. The required return is the minimum return that would result in all goals and objectives being met. The projected return varies based on investment allocation and associated expected risk, return, and correlation assumptions. The advisor should determine the projected return a given investment strategy is likely to produce and evaluate whether it meets the client's stated investment goals and objectives. If there is a mismatch between the required and projected returns, the discrepancy must be reconciled.

SUGGESTED PROCEDURE

There are several reasonable approaches that an advisor may use to structure a prudently allocated portfolio. Those can include mean-variance optimization, Monte Carlo simulation, and various other asset allocation modeling tools. An asset allocation modeling tool requires at least three inputs:

- **projected 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.)

Note that all three optimizer variables are nothing more than estimates 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 optimizer inputs involves as much art and intuition as science and is well beyond the intended scope of this handbook. However, the advisor should be familiar with the input source and methodology used to develop any investment allocation strategy. Due to the great disparity between different models, careful research into the investment expertise of the source is required. Regulators are paying attention to the algorithms used to generate advice dispensed by both robo-advisors and human advisors. Fiduciaries should be confident that the technology they rely upon is objective and effective. They should also be alert to any obvious misalignments between stated investment objectives and client portfolios

The outputs of the computerized optimization models 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 advisor to overweight an asset class that has had recent superior performance and underweight the laggards, setting the stage for the advisor to make the classic investment mistake—buying high and selling low.

Many investment professionals use "risk premium" adjusted inputs in an optimizer, 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 a specific time horizon, (e.g., the next five years). The adjusted premium is then added to the anticipated risk-free rate of return over that time horizon (the anticipated rate of inflation also could be used as a proxy) to come up with the final modeled return. The advisor should consider carefully whether the risk premiums used are reasonable, as the asset allocation output can be quite sensitive to input values. If the advisor has reason to be skeptical of the projected returns, they should consider alternative sources.

The client's investment time horizon may impact the selection of capital market assumptions for a given asset class modeling or optimization exercise. Those with an infinite time horizon, perhaps associated with an endowment, may select long-term asset class average returns, risks, and correlations as the assumptions, while those with a shorter horizon may be more inclined to use forecasts driven by current economic indicators.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]

Other

IRS Notice 2014-66

Employee Retirement Income Security Act of 1974 [ERISA]
§3(34); §404(a)(1); §404(c)

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2); 29 C.F.R. § 2550.404c-1; 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. Hawaii 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); *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]

Preamble to 29 C.F.R. §§2509, 2510, and 2550, 81 Fed. Reg. 20945 (Apr. 8, 2016); but see *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018) (vacating final regulations).

DOL Information Letter to Mark Iwry (Oct. 23, 2014)

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).

Guidance Update: Robo-Advisers (SEC's Division of Investment Management, Feb. 2017).

Investor Alert: Automated Investment Tools, (SEC and FINRA, May 8, 2015).

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)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§7; §7(4) (Comments); §8(a)(1) and (3); §8(b)

PRACTICE 2.4

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

CRITERIA

2.4.1 Asset classes are appropriately weighted to conform to the portfolio's specified time horizon and risk/return profile.

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

2.4.3 The methodology and tools used to establish appropriate portfolio allocation are prudent and consistently applied.

The scope of an advisor's engagement often includes the responsibility to recommend or choose an appropriate combination of asset classes and their weightings to optimize the client's portfolio. That involves structuring the portfolio to achieve the client's investment objectives, in the context of their risk tolerance and time horizon, while maximizing projected return for a given risk undertaken or minimizing risk for a given projected return targeted. Asset class and allocation decisions typically have greater impacts on the long term performance of the client's investment strategy than the selection of money managers or individual investments.

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 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 investigate and document the reasons why the investment is prudent and how the risk of large loss resulting from non-diversification will be mitigated.

In the case of participant-directed plans, participant demographics and behavioral issues also play a part in asset class selection. The plan must provide each participant the ability to allocate their portfolio appropriately given their individual time horizon and risk and return parameters, whether that be a younger worker with a long-term time horizon or someone who is nearing retirement. That said, participant behavior is often a function of the options presented to them. To mitigate the risk of participants equally allocating assets across all available asset classes or concentrating their assets into a single asset class, the advisor should consider making available age-based or target-risk funds or models for participants who are unable or disinterested in formulating an appropriate asset allocation strategy on their own.

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 MMPERSA

Under §8(a)(2) of MMPERSA, 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." (MMPERSA §8(a)(2) comment)

SUGGESTED PROCEDURE

Asset allocation models and portfolio optimization tools can assist the advisor in assessing the risk-projected return profiles of alternative asset mixes. Outputs of those tools are dependent upon the inputs they require; specifically, the assumed risk and projected return characteristics of each asset class under consideration and assumed correlations among those asset classes. These risk, projected return, and correlation inputs, known as Capital Market Assumptions (CMAs), can vary over time based upon a variety of factors including changing economic and market conditions, shifting characteristics of industries and asset classes, as well as other unknown or unpredictable factors. Computer optimization models typically use index risk and return assumptions. That means they presume that non-systematic risk for each asset class is not material. Diversification across asset classes serves to reduce non-systematic risk in the context of a broad, multi-asset class market.

To project risk-return expectations of portfolios with very long term or infinite time horizons, such as multi-generation trust funds, most foundations and endowments, and retirement plans, it may be appropriate to use historic averages for CMA values. However, using long-term historic averages for portfolios with shorter time horizons, such as those intended to meet future spending objectives of individual investors, may yield risk-return expectations that seem unrealistic or unreasonable. It may be more appropriate to use recent, shorter-term averages in these cases, or to make other adjustments to CMA values. Another option would be to use consensus estimates of CMA values from reputable independent sources that are appropriate for the investment time horizon of the subject portfolio.

Fiduciary advisors must take care to evaluate asset allocation models and portfolio optimization tools and underlying CMA assumptions to make sure that they are academically sound and objective. CMA statistics drive asset allocation outcomes, which can in turn drive investment selections. Thus, potential conflicts of interest should be considered when evaluating those tools and assumptions. For example, a tool provider that stands to gain from having more funds invested in a particular asset class (e.g., they offer a proprietary mutual fund in that asset class) could use CMA assumptions that use unreasonably high return estimates or unreasonably low risk and correlation assumptions to drive assets to that asset class and their proprietary investment.

It is also important to remember that there is more to making sound asset allocation recommendations than using valid CMA values. A more complete set of key factors should be considered in formulating a client's asset allocation strategy:

- Time horizon of the client (Practice 2.1)
- Risk tolerance and capacity of the client (Practice 2.2)
- Projected portfolio returns modeled to align with client's goals and objectives (Practice 2.3)
- Asset class preferences of the client
- Tax status of the client

Substantiation

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

Regulations

29 C.F.R. §2550.404a1; 29 C.F.R. §2550.404a1(b)(1)(A); 29 C.F.R. §2550.404a1(b)(2)(B)(iiii)

Case Law

Fifth Third Bank v. Dudenhoeffer, 134 S.Ct. 2459, 58 E.B.C. 1405 (2014); 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. §2509.961(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

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

PRACTICE 2.5

Selected asset classes are consistent with implementation and monitoring constraints.

CRITERIA

2.5.1 The investment advisor has the time, resources, knowledge, and skills to implement and monitor all selected asset classes.

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 and types of asset classes in a portfolio should be consistent with the advisor's and client's implementation and monitoring constraints. No formula can consistently determine how many and which asset classes are ideal in every situation—facts and circumstances drive those decisions. Variables that should generally be considered include the following:

- size of client's portfolio
- investment expertise of the client and/or advisor
- ability of the advisor to monitor the strategies and investment options properly
- cost considerations—investing in specialized/niche asset classes and investing smaller amounts across more asset classes may mean higher portfolio expenses (the benefit of added diversification must be weighed against the drawback of added costs)
- asset class attributes (complexity, limited marketability, etc.) that may not be suitable for some clients

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. Simply stated: stocks, bonds, and cash. From that starting point, additional asset classes and sub-asset classes should be added to provide meaningful risk and return benefits to the overall investment strategy, consistent with the client's investment time horizon.

The advisor should keep in mind that the allocation also must be implemented and monitored. It would be imprudent 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); DOL Advisory Council on Employee Welfare and Benefit Plans Report on Outsourcing Employee Benefit Plan Services, November 2014.

Investment Advisers Act of 1940

Case Law

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

Other

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

Model Management of Public Employee Retirement Systems Act [MMPERSA]

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

PRACTICE 2.6

The investment policy statement contains sufficient detail to define, implement, and monitor the portfolio'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 asset weighting 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.

The preparation and maintenance of each client's investment policy statement (IPS) is one of the most critical functions performed by the advisor. The IPS should be viewed as the business plan for managing an investment portfolio. For an individual investor, it should reflect the goals, directives, resources, and unique circumstances of the client. In the case of an institutional client, like a retirement plan or charitable organization, it should be consistent with the terms of governing documents and the entity's purpose. It should also be aligned with, and reference, legislation governing investment activities of the portfolio or plan, e.g., ERISA, IAA, UPIA, UPMIFA, and **MMPERSA**.

The IPS is the essential management tool for directing and communicating the activities of each client's portfolio. It should be a formal, long- range strategic plan that allows the advisor to coordinate the management of each client's investment program in a logical and consistent framework. All material facts, assumptions, and objectives necessary to guide investment decision-making should be included.

The 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 advisor can: (1) avoid unnecessary differences of opinion and 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 advisor's efforts, and (4) establish and communicate reasonable and clear expectations with clients.

THERE ARE MANY BENEFITS OF 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 can insulate the 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 provides implementation guidance, which can be particularly useful in the case of a disruption in the continuity of decision-makers. Similarly, it can help to ensure a smooth transition if there is a change in investment advisors.
- Finally, the IPS serves the important role of delineating roles and responsibilities among the parties involved. It is particularly important for the IPS to specifically exclude responsibility for services that are carved-out from what would otherwise be considered normal responsibilities of the client, advisor, or other service providers. For example, if the advisor is not expected to monitor certain assets, the IPS should explicitly state that fact.

SUGGESTED PROCEDURE

The IPS should have sufficient 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 allocation, where the goal is to ensure the client's portfolio avoids 'allocation drift' by not straying far from its targeted levels of systematic risk and return. Once the target allocation is established, periodic rebalancing is necessary to maintain the intended systematic risk-return profile of the portfolio.

By establishing specific asset allocation parameters and money manager (or investment) selection criteria, it is much easier to determine whether a prospective security (pooled or individual) fits into the approved investment program. The 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 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, fund, or individual security.

Advisors also must establish procedures for controlling and accounting for investment expenses. An 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); §2550.404a-1(b)(2); 29 C.F.R. §2550.408b-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 942, 29 C.F.R. §08-2; 29 C.F.R. § 2509-08(2); Interpretive Bulletin 758, 29 C.F.R. §2509.75-8; 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, Investment Advisers Act Release No. 1406 (Mar. 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)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§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

PRACTICE 2.7

Investment due diligence using environmental, social, and governance (ESG) factors conforms to governing documents and the fiduciary obligations of investment decision-makers.

CRITERIA

2.7.1 The client's goals, objectives, and investment parameters are evaluated to determine whether ESG investing is necessary and/or desirable.

2.7.2 Provisions regarding ESG investing in governing documents are aligned with fiduciary obligations.

There is growing interest in research regarding the relative performance of, what has historically been known as "socially responsible investing." Until recently, fiduciaries have struggled with how to "balance" their fiduciary obligation to serve the economic interests of investors with non-economic interests the client may have. Contemporary research shows that consideration of SRI information is less a balancing act than it is an opportunity to enhance investment due diligence with additional, relevant data. Companies or managers that are not taking environmental or social impact into consideration or that do not demonstrate good corporate governance can be viewed as riskier long-term investments. Today, a substantial majority of institutional investors use environmental, social, and corporate governance (ESG) factors in their investment analysis. Moreover, regulators are becoming more comfortable with, and supportive of, the use of those factors in the fulfillment of fiduciary obligations.

Special Considerations under ERISA

The Department of Labor considers SRI investing to fall within the broader heading of "economically targeted investments" (ETIs). It defines ETIs as "investments that are selected for the economic benefits they create in addition to the investment return to the employee benefit plan investor."

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. The Department of Labor has expressed a consistent position that sections 403 and 404 of ERISA do not permit fiduciaries to sacrifice the economic interests of plan participants in receiving their promised benefits in order to promote collateral goals. By walking through the various guidance the DOL has provided on ESG investing, we can see the broader trends of acknowledging that ESG considerations can be a valuable data point while also being cautious about not letting "other" considerations be put ahead of optimizing outcomes for the investors and beneficiaries.

In Interpretive Bulletin 2008-01, the DOL stated that "fiduciary consideration to collateral, non-economic factors in selecting plan investments should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards. Seven years later, IB 2008-01 was replaced by Interpretive Bulletin 2015-01 to make clear that "[t]he fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally." The Department took this action out of concern that the 2008 guidance was dissuading fiduciaries from "pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments."

IB 2015-01 explicitly allows ERISA fiduciaries to incorporate ESG factors in due diligence procedures and in investment policy statements. It also makes clear that SRI investing and consideration of ESG factors does not presumptively require additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.

Similarly, Interpretative Bulletin 2016-01 updates guidance on fiduciary obligations associated with proxy voting and statements of investment policy relating to SRI investing. The Bulletin affirms that fiduciary duties of prudence and loyalty require the responsible fiduciary to vote proxies on issues that may impact the value of a plan's investments. It also affirms that authority to vote proxies may be delegated to others, particularly investment managers, and that the IPS is often the governing document used to delegate proxy voting authority. Further, the IPS may also establish policies regarding SRI investing, including policies about the role SRI Investing is to play in deciding how proxies are to be voted.

IB 2016-01 reminds fiduciaries that policies established in governing documents, including the IPS, are to be followed, unless it would be imprudent or disloyal to do so. The Bulletin notes, as an example, that an investment manager would not be shielded from liability for imprudent actions taken in compliance with a statement of investment policy.

The most recent guidance from the DOL, from Field Assistance Bulletin 2018-01, didn't make any substantive changes to standing policy on ESG investing, but warned that, "fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision."

What does that mean for plan fiduciaries navigating ESG factors? DOL Interpretive Bulletin 2015-01 said it best: "The fiduciary standards applicable to Economically Targeted Investments are no different than the standards applicable to plan investments generally." Essentially, this means that the fiduciary must (1) act solely in the interest of plan participants and beneficiaries (2) with the care, skill, prudence, and diligence of a prudent expert, (3) incur only reasonable plan expenses, and (4) act in accordance with plan documents.

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 restrictions on a gift, citing as an example a gift instrument that precludes the healthcare-related institution from investing in tobacco stocks. However, UPMIFA makes clear that "giving effect to donor intent does not mean that the donor can or should control the management of the institution." Thus, financial returns must not be sacrificed to achieve non-financial outcomes that are unrelated to the charitable purpose of the institution or the purposes of the institutional fund.

Special Considerations under the UPIA

UPIA obligates trustees to comply with the prudent investor rule and adhere to a duty of loyalty. A 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." However, § 1(b), provides that the "prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." It goes on to state that a "trustee shall not be liable to a beneficiary to the extent the trustee acted in reasonable reliance upon the provisions of the trust."

Other Considerations

With respect to personal trusts, foundations, and endowments, failure to consider an SRI investing strategy could be a breach of state trust law if:

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

Investment advisors with clients in other countries should be aware that, internationally, SRI investing is commonplace and strongly encouraged. Quoting from the *Fiduciary Duty in the 21st Century* published by the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI), UNEP Inquiry and UN Global Compact in September 2015, "Failing to consider long-term investment value drivers, which include ESG issues, in investment practice is a failure of fiduciary duty." While this conclusion was reached based upon an "in-depth assessment in eight countries (US, Canada, Germany, UK, Japan, Australia, South Africa and Brazil)", fiduciary laws in the US are more nuanced than this blanket statement implies, as discussed above.

Suggested Procedures

1. Stay abreast of the rapidly evolving SRI Investing body of knowledge and develop the requisite skills to properly apply SRI Investing methodologies. Research has confirmed that applying credible ESG factors in a robust due diligence process is highly unlikely to result in inferior investment choices as compared to what would result from due diligence performed without those factors. Research also suggests that consideration of ESG factors may improve the efficacy of investment due diligence.
2. Evaluate clients' goals, objectives, and investment parameters (e.g., risk capacity and tolerance, return requirements, investment time horizon, and investment preferences) to determine if SRI Investing may be necessary or appropriate.
3. Evaluate governing documents and applicable laws to determine if SRI Investing is required or prohibited.
4. With respect to the investment policy statement, three courses of action are suggested, depending upon the situation involved:
   a. If SRI Investing is restricted or required by other governing documents, legal or regulatory obligations, or explicit client direction, the IPS should properly reflect the restrictions or requirements;
   b. If the client prefers, but does not require, SRI Investing, the IPS should note the preference but not make the use of SRI Investing a requirement. This will allow flexibility to handle situations that may make SRI Investing imprudent or impractical (e.g., certain asset classes and investment types may lack satisfactory data to perform adequate due diligence); and
   c. If the client is indifferent about or disinclined to pursue SRI Investing, it is generally best to not include reference to SRI Investing in the IPS, thereby allowing maximum flexibility to use or not use SRI-related factors in due diligence based upon prudence considerations.
5. When it is practical to do so, apply due diligence consistently across similar investment types. For example, ESG data is increasingly becoming available for many types of mutual funds, even those that are not marketed as "SRI" funds. This allows due diligence to be performed using ESG factors across the full spectrum of funds rather than just those labeled as SRI-focused.

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; *Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted* Investments, EBSA IB 2015-01, reinstating IB 94-01 and withdrawing IB 08-01 (Oct. 22, 2015); *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, including Proxy Voting Policies or Guidelines*, reinstating IB 94-2 with certain modifications and replacing IB 2008-2 (Dec. 29, 2016); and DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018).

Investment Advisers Act of 1940

Case Law
In re ND Money Mgmt., Inc., Investment Advisers Act Release No. 2027 (Apr. 12, 2002)

Other
Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release 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

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

STEP 3.

Step 3: Introduction

The third step of Fiduciary Quality Management System is to implement the investment strategy that was formalized in step 2. To summarize step 3 in two words is "due diligence." This is the critical point where the planning, organizing, and formalizing that was involved in the initial stages of the client engagement are executed. 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, the advisor should ask themself 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? If the engagement involves consideration of a rollover, transfer, or distribution, do I follow a consistent process that objectively compares the status quo to reasonable alternatives? Is the process 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 Practice to adopt safe harbors and limit liability.

As always, the roles and responsibilities of all parties, consistent with Step 1, should continue to be clearly identified and documented. Those will vary, of course, depending upon the scope of the engagement. When setting up a new ERISA plan, for example, the advisor 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 they are 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 advisor may change roles during implementation.

Ideally, fiduciary status does not change during an engagement, but in some instances fiduciary coverage depends on function or registration status. For example, a pension advisor may provide advice to a plan sponsor about other aspects of plan administration, which would not be a fiduciary activity. Or 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 them 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 that may set higher obligations than required by law.

PRACTICE 3.1

A prudent due diligence process is followed to select each service provider.

CRITERIA

3.1.1 Prudent 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.

When delegating responsibilities to service providers, fiduciaries are expected to act prudently and in the best interests of those they serve. Advisors will be held to an "expert standard of care" and their activities and conduct will be measured accordingly. That standard can be relative though. For an advisor working 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 advisor is almost always to guide the client's investment process, whether it is a wealth management client or a plan or foundation's investment committee. Regardless of situation, the advisor is expected to define, document, and consistently apply sound due diligence to select or recommend investment strategies, individual stocks, bonds, or other securities, and outside money managers or other service providers.

Custodial Selection

Custodial selection is a very important fiduciary function. As with other prudent practices, there are several 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 broker-dealer or investment management firm. Most securities are held in street name, with the assets commingled with those of the firm. To protect the assets, 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 investment and account selection process.

Special Considerations Under ERISA – 408(b)(2) Disclosures

ERISA requires that the selection of service providers be made in the best interests of plan participants and that no more than reasonable compensation is paid for those services. To meet that standard, the Department of Labor requires services providers to disclose their services, compensation, and fiduciary status (if assumed). Plans, in turn, are expected to obtain that information and use it to make informed decisions regarding the selection of service providers. The disclosure rule applies 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):

1. ERISA fiduciary service providers to an investment product, contract, or entity that is a plan asset vehicle in which a plan invests;
2. investment advisers registered under federal or state law;
3. record-keepers or brokers who make designated investment alternatives available to the covered plan (e.g., a platform provider);
4. 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.

The requirements are:

1. Covered Service Providers must disclose that they provide services as a fiduciary under ERISA or the IAA, to the extent applicable.
2. Covered Service Providers must 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 who 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 which is 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 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.

Special Considerations for Individual Investors, Foundations or Public Retirement Funds

While there is less prescriptive guidance for non-ERISA portfolios, these areas place similar emphasis on prudence, loyalty, and fee reasonableness. Court decisions and regulatory guidance have stressed the necessity to properly consider the relative merits of the investments or service providers being considered. Advisors and fiduciaries have been found liable for failing to investigate relevant factors before making a decision or recommendation.

Suggested Procedure

A fiduciary must be able to demonstrate that a process was followed in selecting service providers. Going through a formal process of requesting, receiving, and evaluating proposals is certainly the best way to demonstrate due diligence in making a service provider selection. However, simply requesting information, such as by using a market survey, is also permissible. The key is to gather sufficient information from an adequate number of service providers that addresses their capabilities, costs, and ability to address security requirements. That information can be evaluated before making an initial selection, or when deciding whether the relationship with a service provider should continue. At all times, documenting the process and the evidence gathered is essential.

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; 29 C.F.R. §2509.75-8.

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); 6:08-cv-03109-GAF (W.D. Mo. 2012); *In the Matter of Rivas*, 30 Misc. 3d 1207 (N.Y. Sur. 2011)

Other

DOL Field Assistance Bulletin 2007-01 (Feb. 2, 2007); DOL Information Letter, Qualified Plan Services (July 28, 1998); DOL Information Letter, Service Employees International Union (Feb. 19, 1998)

Investment Advisers Act of 1940
§206(1)-(2)

Case Law

In the Matter of Eugene Bilotti, Investment Advisers Act Release No. 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*, Investment Advisers Act Release No. 897 (Jan. 11, 1984); *In the Matter of Hennessee Group LLC and Charles J. Gradante*, Investment Advisers Act Release No. 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)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§6(a); §6(b)(1) and (2); §7; §8(a)(1)

PRACTICE 3.2

Statutory or regulatory investment safe harbors that are elected are implemented in compliance with the applicable provisions.

CRITERIA

3.2.1 Available safe harbors are evaluated to determine if any advance the best interests of the investors and/or beneficiaries.

3.2.2 When elected, safe harbor provisions are implemented in compliance with requirements.

"Safe harbors" are provisions within a law or regulation that carve out specific activities – generally conflicted investment advice or transactions – as being permitted under specific circumstances even though those activities would otherwise be a violation if the provision did not exist. Also referred to as prohibited transaction exemptions under ERISA, safe harbors are highly desired by fiduciaries because they mitigate fiduciary risk. These exemptions provide prescriptive formulas for taking certain actions, such as ensuring compensation is reasonable or disclosing conflicts in ways that are consistent with fiduciary obligations. Thus, while there may be alternative approaches that would not constitute breaches of fiduciary duties, such as avoidance, safe harbors provide clear and certain methods for reducing legal or civil liability.

There are three important concepts associated with safe harbor procedures:

1. Safe harbors are voluntary. A fiduciary 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 in the rare event when applying a safe harbor may cause losses for the end investor. For example, in 2008 and 2009, the Qualified Default Investment Alternative (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 the effective date for this safe harbor (just prior to the financial crisis of 2008) resulted in greater equities exposure for many 401(k) plan participants at a time of steep market declines when the previous default safe harbor restricting contributions to cash equivalents would have mitigated those losses. A judicious fiduciary should thoughtfully consider and weigh 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 retirement plans should clearly advise the plan stewards of safe harbor opportunities so they can make informed decisions.
2. Safe harbors **may** insulate the fiduciary from liability associated with certain investment-related decisions and acts. The fiduciary should think of safe harbor procedures as a form of "insurance."
3. The fiduciary **must** demonstrate compliance with the applicable defined requirements to take advantage of the safe harbor. Safe harbor provisions are prescriptive and any missteps or deviations from its conditions would likely invalidate any protection from liability. From a fiduciary perspective, it is highly encouraged to investigate what safe harbors may be available and to adopt ones that are consistent with the interests of the investors/beneficiaries.

ERISA Safe Harbors

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
3. The Fiduciary Adviser Safe Harbor
4. The Qualified Default Investment Alternative (QDIA) Safe Harbor
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 do 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" (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 MMPERSA 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, the 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 in selecting investment managers (i.e., the managers of mutual funds) that will be available in the plan's menu of investment options. The general delegation of investment management responsibilities is consistent with the §405(c) safe harbor requirements described above. But there is more to it than that: in addition to requirements for the general safe harbor, §404(c) requires the following:

1. Plan participants must be notified in writing that the plan sponsor intends for the plan to constitute a 404(c) plan and that the fiduciary 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 risk and return. Stated another way, in the aggregate the investment options must enable the participant to create 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 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 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 considering 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. (see Practice 3.1 for more information)

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 Stewards 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 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 that:

- Require a plan fiduciary (independent of the investment adviser or its affiliates) to authorize the advice arrangement.
- Impose recordkeeping requirements for fiduciary advisers relying on the exemption.
- Require computer models to be certified in advance by independent experts as unbiased and meeting the exemption’s requirements.
- Establish qualifications and a selection process for the investment expert who must perform the above certification.
- Clarify 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 based on the investments participants select.
- Establish 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.
- Require disclosures by advisers to plan participants.

Note that so-called “ robo advisers” in today’s marketplace did not exist when the PPA was enacted, but are likely subject to the same requirements for the computer model exemption listed above.

Codification of Fiduciary Relief

If an eligible investment 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:

1. Age-based lifecycle or targeted-retirement-date funds or accounts;
2. Risk- based, balanced funds; or
3. A professionally-managed account

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

Participants must be provided:

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:

1. The stock is held or acquired by a registered investment company or pooled investment vehicle that is independent of the employer; or
2. The 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 $1,000-$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, although in those cases a direct payment (e.g., direct deposit or check) is generally the most common distribution method.

The automatic rollover safe harbor requirements are:

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 the 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 a limited safe harbor for principal transactions, although it is rarely used. Written into the law passed by Congress in 1940, Section 206(3) requires investment advisers to provide written notice and receive consent from the client prior to each principal transaction, including when it acts as broker in connection with the transaction.

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 receives 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]
§3(38); §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, Apr. 13, 1998 – 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 (Feb. 2, 2007); DOL Advisory Opinion Letter 97-15A (May 22, 1997); DOL Advisory Opinion Letter 97-16A (May 23, 1997); TIAA Information Letter, Dec. 22, 2016.

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;

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*., Investment Advisers Act Release IA-1980 (Sep. 28, 2001); *In the Matter of Morgan Stanley Investment Management, Inc.*, Investment Advisers Act Release No. 3315 (Nov. 16, 2011)

Other

Uniform Application for Investment Adviser Registration (Form ADV), Glossary, Item 42; Disclosure by Investment Advisers Regarding Soft Dollar Practices, Investment Advisers Act Release 1469 (Feb. 14, 1995); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*,* Investment Advisers Act Release No. 54165 (July 18, 2006)

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

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

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

PRACTICE 3.3

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

CRITERIA

3.3.1 A prudent due diligence process is used to select investment strategies, investment managers, and investments.

3.3.2 Decisions regarding the selection of investments consider both qualitative and quantitative criteria.

3.3.3 The due diligence process used to select investment strategies, investment managers, and investments is documented and 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 A prudent due diligence process is used to make decisions regarding the use of proprietary versus non-proprietary products, and separately managed versus commingled accounts.

3.3.7 Decisions regarding rollover advice are made in accordance with fiduciary duties of loyalty and care.

A fiduciary must be able to demonstrate that the strategies and products implemented 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 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. That 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

Variable and Indexed Annuities

Variable and indexed annuities are retirement savings and income vehicles that include an investment component within the framework of an insurance contract. As such, due diligence performed on these products involves not only investment analysis, but also of costs and characteristics of the insurance contract and the financial strength of the insurance company.

It's worth noting that there are a variety of charges associated with annuities beyond the costs of the investment component. Accordingly, they tend to be more expensive than investments that do not have insurance features that may be of particular benefit to certain clients. There are many possible features and riders that may be associated with the insurance. The added expense of each needs to be evaluated based on the needs and circumstances of the client.

Passive vs. Active

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, 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.

Alternative Investments

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, nor 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:

DUE DILIGENCE PROCESS

SUGGESTED FIELDS OF DUE DILIFENCE	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.			

1. 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.
2. Develop a process that can be applied to any of the readily available databases on funds and/or separately managed accounts.
3. Develop a simple process that can easily be understood by clients and replicated outside of the office.
4. 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:

1. Important search criteria can be omitted.
2. Performance may be compared to inappropriate indexes or peer groups.
3. 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 on page 78 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 which, based upon their own research,

RELATIVE ADVANTAGE OF ACCOUNT TYPES

FACTOR	COMINGLED 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		✓

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.

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. Hawaii 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); DOL Prohibited Transaction Exemption 77-4, 42 Fed. Reg. 18732 (Apr. 8, 1977); DOL Advisory Opinion 1998-06A (July 30, 1998); DOL Advisory Opinion 2003-09A (June 25, 2003); DOL Advisory Opinion 2005-23A (December 7, 2005); DOL Advisory Opinion 2006-06A (July 26, 2006).

Investment Advisers Act of 1940

Other
Risk Alert: Investment Adviser Due Diligence Processes for Selecting Alternative Investments (*https://www.sec.gov/about/offices/.../adviser-due-diligence-alternative-investments.pdf)*

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

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

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

STEP 4.

Step 4: Introduction

Step 4, Monitor, presumes the scope of the client engagement is ongoing, and not a limited engagement. 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 investments 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 their 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 investments 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 eight 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 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.

PRACTICE 4.1

Periodic reviews compare investment performance against appropriate market and peer group benchmarks and overall portfolio objectives.

CRITERIA

4.1.1 Investment performance of the overall portfolio is compared against an appropriate benchmark and evaluated in the context of portfolio objectives.

4.1.2 The performance of each investment option is periodically compared against an appropriate market and peer group benchmark and any other performance-related due diligence criteria defined in the investment policy statement.

4.1.3 Underperforming investments are monitored and decisions to retain or replace investments are documented.

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

4.1.5 Investment performance is periodically reported to the client.

The ongoing review and analysis of portfolio and investment performance is just as important as the initial decision making that lead to those strategies and tactics to be implemented. The advisor's role is to ensure that the client remains best positioned to meet their objectives even as circumstances change over time. The advisor should establish performance expectations relative to appropriate benchmarks for both the overall portfolio and each investment option and record the same in the IPS. The advisor should then use that information to make informed decisions, using a consistent process, about the efficacy of the current strategy and specific investments. When considering the overall portfolio, an appropriate benchmark, such as a market index, can be used to compare the performance of the portfolio in the context of the overall market conditions. Portfolio performance should be further evaluated in the context of the portfolio objectives and the strategy employed. For example, in the case of a portfolio with a shorter time horizon, you might very well see returns that lag behind overall market conditions, but which are better protected from downside risk.

For investment-level performance monitoring, each investment should be compared to appropriate index and peer group benchmarks and other due diligence criteria that are defined in the investment policy statement. Relevant peer group can include 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. The IPS should acknowledge that fluctuating rates of return characterize the securities markets and may cause variations in performance.

Retain or Replace Decision-making

When an investment fails to meet established performance expectations and due diligence criteria, fiduciaries must decide whether it is best to retain or replace that investment. The decision should not be made based solely on prior performance. What matters is having confidence that the investment will meet expectations going forward. One way to manage those decisions is by having established "watch list" procedures. When an investment fails to meet defined criteria, it is then placed on a watch list for closer scrutiny. There are no established mandates for when an investment should be added to the watch list or removed from a portfolio or plan line-up. Like so many other areas of fiduciary responsibility, the most important phrase to remember is "sound process, consistently applied." To demonstrate that a sound watch list process is being consistently applied, the fiduciaries overseeing the portfolio should:

- First, meet regularly to review the current situation.
- Second, collect and carefully evaluate the evidence of whether the investments are serving their intended purposes.
- Third, act appropriately based upon the evidence and precedents established through previous deliberations and actions.
- And fourth, document the evidence gathered, the substance of deliberations held, and the decisions that were made. Apparent inconsistencies among watch list decisions, although permissible, should be specifically discussed and well documented to reflect the line of reasoning applied.

In the end, the decision to retain or terminate a manager requires judgment and cannot be made by a formula. It is the advisor's confidence in the money manager's ability to perform in the future that ultimately determines selection and retention.

Rebalancing

The monitoring procedures should include an examination of the client's contribution or distribution schedule in determining portfolio rebalancing. In this way, the advisor can more cost effectively rebalance the portfolio to strategic allocation targets, given tax and transaction cost considerations.

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

In keeping with the duty of care, an advisor must determine the frequency of reviews, considering 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 advisor should monitor every investment option implemented at least quarterly, or more frequently as required by the facts and circumstances.

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 clients' 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); §408(g)

Case Law

Tibble v. Edison, Int'l, 135 S. Ct. 1823, 59 E.B.C. 2461 (2015), on remand 843 F.3d 1187 (9th Cir. 2016) and 2017 WL 3523737 (C.D.Cal. 2017); Tussey v. ABB, Inc., 52 E.B.C. 2826, 2012 WL 1113291 (W.D. Mo. 2012), aff'd in part 2014 WL 1044831 (8th Cir. 2014) and 2017 WL 929202 (8th Cir. 2017); 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; Interpretive Bulletin 2016-01, 29 C.F.R. §2509.2016-01; and DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018); DOL Tips for Selecting and Monitoring Service Providers (2005).

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, Jan. 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)

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

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 advisor's monitoring function extends beyond a strict examination of performance. Qualitative reviews should be used to detect warning signs about an investment manager. The 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, collective investment trusts, hedge funds, and other 3rd parties.

The 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. Likewise, advisors should not replace their manager lineup simply because of the reported success of other managers.

Periodic reviews of qualitative factors 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. For example:

- 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 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 the decision-making of a reasonable person acting in a like capacity and familiar with such matters. For example, turnover of an investment manager's key portfolio management personnel would usually be considered material to an advisor's decision about whether to recommend that investment manager's fund to clients. 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 other words, the advisor should consider whether the costs are reasonable in light of services rendered and compared to market rates.

Prudent Practices for Investment Managers

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 M1.1 Senior management demonstrates expertise in their field, and there is a clear succession plan in place.

Practice M1.2 There are clear lines of authority and accountability, and the mission, operations, and resources operate in a coherent manner.

Practice M1.3 The organization has the capacity to service its client base.

Practice M1.4 Administrative operations are structured to provide accurate and timely support services and are conducted in an independent manner.

Practice M1.5 Information systems and technology are sufficient to support administration, trading, and risk management needs.

Practice M1.6 The organization has developed programs to attract, retain, and motivate key employees.

Practice M1.7 There is a formal structure which supports effective compliance.

Practice M2.1 The organization provides disclosures that demonstrate adequate resources to sustain operations.

Practice M2.2 The organization has a defined business strategy that supports competitive positioning.

Practice M2.3 There is an effective process for allocating and managing both internal and external resources and vendors.

Practice M2.4 There are effective and appropriate external management controls.

Practice M2.5 The organization has a defined process to control the flow of funds and asset variation.

Practice M2.6 Remuneration of the company and compensation of key decision-makers is aligned with client interests.

Practice M2.7 The organization has responsible and ethical reporting, marketing, and sales practices.

Practice M2.8 There is an effective risk-management process to evaluate both the organization's business and investment risk.

Practice M3.1 The asset management team operates in a sustainable, balanced, and cohesive manner.

Practice M3.2 The investment system is defined, focused, and adds value in a consistent manner.

Practice M3.3 The investment research process is defined, focused, and documented.

Practice M3.4 The portfolio management process for each distinct strategy is clearly defined, focused, and documented.

Practice M3.5 The trade execution process is defined, focused, and documented.

Practice M4.1 There is a defined process for the attribution and reporting of costs, performance, and risk.

Practice M4.2 All aspects of the investment system are monitored and are consistent with assigned mandates.

Practice M4.3 Control procedures are in place to periodically review policies for best execution, "soft dollars," and proxy voting.

Practice M4.4 There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

Suggested Procedure

Examples of factors to include in a periodic qualitative review include:

- staff turnover
- organizational structure
- level of service provided
- quality of reports
- quality of responses to requests for information
- investment education
- media coverage of that organization

Often, the information uncovered in a qualitative review can add context to the quantitative review. In the face of a run of poor performance, it may provide reassurance that the manager remains competently managed and that there is little reason to doubt that the manager can meet expectations going forward. Alternatively, a qualitative review may uncover signs of an overall decline in quality that should be acted on sooner than later.

No matter what is decided, the decision and its rationale should be documented. Precedent is important, and the record can help assure that actions taken in one situation are consistent with actions taken in similar situations over time.

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

Case Law
In the Matter of Horter Investment Management, LLC Investment Advisers Act Release No. 4823 (December 8, 2017)

Other
Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 18, 2003)

Regulation of Investment Advisers, SEC Division of Investment Management (Mar. 2013), Discussion of material disclosure, p. 23. Available at https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

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

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

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§6(a) and (b)(13); §7(5)

PRACTICE 4.3

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

CRITERIA

4.3.1 Procedures are in place to periodically review each investment manager's policies for best execution.

4.3.2 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 Procedures are in place to periodically review each investment manager's policies for proxy voting.

The 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 investment policy statement, 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. Individual investors normally retain proxy voting responsibility unless the 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 clients' 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 to ensure that:

- *best execution* policies are applied in securities transactions. The advisor has a responsibility to seek confirmation that he or she, or the third-party manager is seeking best execution in trading the portfolio's securities. In seeking best execution, 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", which are utilized less frequently than in the past, 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. For example, a separate account manager's agreement should address (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 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. That is often 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 (Jan. 17, 1992) (fn. 1); DOL Information Letter, Refco, Inc. (Feb. 13, 1989); 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 Release No. 4073, (Feb. 20, 1948)*; In the Matter of Laurence I. Balter d/b/a Oracle Investment Research*, SEC Investment Advisers Act Release No. 4545 (Oct. 4, 2016)*; In the Matter of Focus Point Solutions, Inc.*, Advisers Act Release No. 30196 (Sept. 6, 2012); *In the Matter of KMS Fin. Servs., Inc.*, Advisers Act Release No. 4730 (July 19, 2017)*; In the Matter of Valor Capital Asset Management, LLC*, SEC Investment Advisers Act Release No. 4864 (Mar. 6, 2018); *In the Matter of John B. Engebretson*, SEC Investment Advisers Act Release No. 4967 (July 12, 2018)

Other

Securities Exchange Act Release No. 23170 (Apr. 23, 1986); Investment Advisers Act Release No. 232 (Oct. 16, 1968); SMC Capital, Inc. SEC No-Action Letter (Sept. 5, 1995); *Charles Lerner, Esq.*, SEC No-Action Letter (July 25, 1990); SMC Capital, Inc. No-Action Letter (Sept. 5, 1995); Pretzel & Stouffer No-Action Letter (December 1, 1995); Investment Advisers Act Release No. 2106 (Jan. 31, 2003); Investment Company Act Release No. 25922 (Jan. 31, 2003); *Salomon Bros.*, SEC No-Action Letter (May 23, 1972)); Risk Alert: Most Frequent Best Execution Issues Cited in Adviser Exams (https://www.sec.gov/ocie/announcement/risk-alert-most-frequent-best-execution-issues-cited-adviser-exams-1)

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)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§6(2) and (3); § 7(2), (3), and (5); §8(a)(3)

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, policies and procedures, and service agreements.

4.4.3 Procedures are in place to avoid or identify and appropriately address unreasonable fees.

The 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, these must be disclosed and approved in writing. Under the Investment Advisers Act 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 or other investment product expenses can make a significant difference in a portfolio's long-term investment performance.

Retirement Plan Fees

The 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 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. As a best practice, revenue sharing dollars that are rebated back to the plan should be allocated to those participants invested in the funds that included revenue sharing fees.

Also, see *Special Considerations Under ERISA, Practice A-3.1*, 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 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.

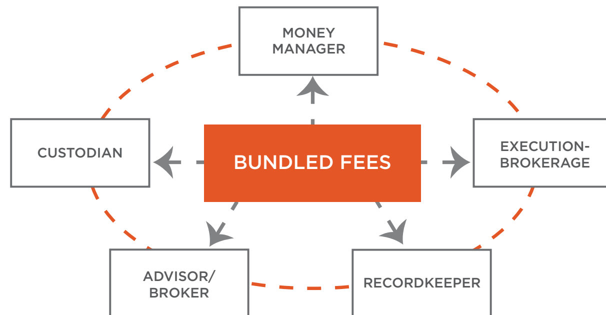
SUGGESTED PROCEDURE FOR BUNDLED PRODUCTS

There are five basic cost components in a *bundled, wrap,* or *all-inclusive fee* investment product. The 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 five components are:

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

UNBUNDLING FEES AND EXPENSES



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 (Jan. 18, 2001); DOL Advisory Opinion Letter (July 28, 1998) 1998 WL 1638072; DOL Advisory Opinion Letter 89-28A (Sept. 9, 1989) 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), Section 206(1) and Section 206(2)

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); *In the Matter of Barclays Capital Inc.*, Investment Advisers Act Release No. 4705 (May 10, 2017); *In the Matter of Morgan Stanley Smith Barney, LLC*, Investment Advisers Act Release No. 4607 (Jan. 13, 2017); *In the Matter of Capital Dynamics, Inc.*, Investment Advisers Act Release No. 4746 (Aug. 16, 2017); *In the Matter of Beverly Hills Wealth Management, LLC and Margaret Mulligan Black, aka Margaret Mulligan Scott*, Investment Advisers Act Release No. 4975 (July 20, 2018).

Other

BISYS Fund Services, Inc., SEC No-Action Letter (Sept. 2, 1999); SEC Investment Adviser Examination Manual (1980); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2017 (Feb. 5, 2003); Don P. Matheson & Co., SEC No-Action Letter (May 15, 1976); Risk Alert: Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf)

Other

NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers, Model Rule 102(a)(4)-1 (Adopted April 27, 1997, Amended April 18, 2004 and September 11, 2005), http://www.nasaa.org/content/Files/IAUnethical091105.pdf.

NASAA Investment Adviser Representative Definition, Model Rule USA 2002 102(16), (Adopted Sept. 17, 2008), http://www.nasaa.org/wp-content/uploads/2011/08/33-IA-Rules_General_USA2002.pdf

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 (June 21, 2001)

Other

McKinneys EPTL112.3(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(a), (b), and (c); §5(a) and (c)(1)

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§6(b)(2) and (3); §7(2) and (5); §7, Comments

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 appropriate policies and procedures are in place to address all fiduciary obligations and that such policies and procedures are effectively implemented and maintained.

4.5.2 The investment policy statement is reviewed at least annually to ensure it is aligned with current facts and circumstances.

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 these 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 A-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 assessments.

Level 1 Every fiduciary organization should periodically conduct a formal review of its policies, procedures, and activities to determine the extent to which they adhere to the practices presented in this handbook. A level 1 assessment is a gap analysis and may be conducted by trained internal staff or by external fiduciary experts.

Level 2 If deficiencies are identified, then a level 2 remediation assessment should be conducted. Typically, an objective and competent assessor is best positioned to conduct remediation.

Level 3 When all deficiencies are remediated, an organization may choose to pursue formal recognition from a competent and independent assessor. A level 3 certification assessment is a rigorous and objective determination of conformity to set standards. The assessor must not be affiliated or have other business relationships with the assessed entity.

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

Case Law

In the Matter of Trust & Investment Advisors, Inc., Larry K. Pitts, and George M. Prugh, Investment Advisers Act Release No. 4087 (May 18, 2015); In the Matter of Institutional Investor Advisers, Inc. Investment Advisers Act Release No. 4824 (Dec. 8, 2017**).**

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

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

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§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. An ISO standard for financial planning (ISO 22222) was promulgated in [year] 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.

Glossary of Terms

This glossary was compiled from the following sources:

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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.

ash 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.

Glossary of Terms

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.

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.

Equilibrium Spending Rate. – ESR is used by foundations and other nonprofits to calculate the modeled return of the portfolio less inflation and investment expenses. ESR represents the amount that a foundation or endowment can prudently spend while maintaining a sustainable, inflation-adjusted asset base.

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.

Glossary of Terms

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.

R-squared (R2 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.

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

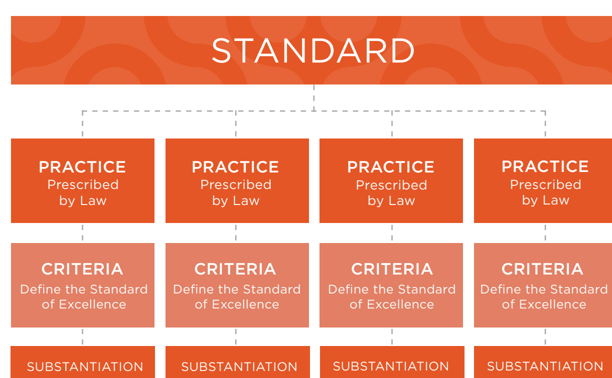
safe harbor – A legal or regulatory provision that may limit a fiduciary's liabilities if adheres it to certain requirements.

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.

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 more than 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

PRACTICE 1.1
The investment advisor demonstrates an awareness of fiduciary duties and responsibilities.

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 the portfolio.

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

PRACTICE 1.3
The roles and responsibilities of all involved parties, whether fiduciaries or non-fiduciaries, are defined and documented.

PRACTICE 2.3
The distribution of projected portfolio returns is evaluated in the context of the client's risk and return objectives.

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

PRACTICE 1.4
The investment advisor identifies material conflicts of interest and avoids or manages conflicts in a manner consistent with the duty of loyalty.

PRACTICE 1.5
Agreements under the supervision of the investment advisor are in writing and do not contain provisions that conflict with fiduciary obligations.

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 portfolio's investment strategy.

PRACTICE 1.6
Sensitive personal identifying information and assets of clients are prudently protected from theft, embezzlement, and business disruption risks.

ORGANIZE 1 · FORMALIZE 2 · IMPLEMENT 3 · MONITOR 4 · Fi360

PRACTICE 2.7
Investment due diligence using environmental, social, and governance (ESG) factors conforms to governing documents and the fiduciary obligations of investment decision-makers.

PRACTICE 4.1
Periodic reviews compare investment performance against appropriate market and peer group benchmarks and overall portfolio objectives.

PRACTICE 3.1
A prudent due diligence process is followed to select each service provider.

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

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

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

PRACTICE 3.2
Statutory or regulatory investment safe harbors that are elected are implemented in compliance with the applicable provisions.

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.

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