



Prudent Practices for Investment Advisors (U.S. Edition)

This document is an excerpt from the publication *Prudent Practices for Investment Advisors* by Fiduciary360. The excerpt is intended for use with Web-based certificates issued by the Centre for Fiduciary Excellence (CEFEX), as a means of outlining the basis for CEFEX Certification. To download a PDF version of the handbook, visit www.fi360.com. For more information regarding certifications, please visit www.cefex.org.

About the *Prudent Practices for Investment Advisors* handbook:

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Several of the handbook's themes are from *The Management of Investment Decisions* (New York: McGraw-Hill, 1996) by Donald B. Trone, William R. Albright, and Philip R. Taylor.

Substantiation

All twenty-three Practices are substantiated by legislation, case law and/or regulatory opinion letters from:

ERISA – Employee Retirement Income Security Act (impacts qualified retirement plans)

UPIA – Uniform Prudent Investor Act (impacts private trusts)

MPERS – Uniform Management of Public Employee Retirement Systems Act (impacts state, county and municipal retirement plans)

UPMIFA – Uniform Prudent Management of Institutional Funds Act (impacts foundations, endowments and government-sponsored charitable institutions)

Investment Advisor Definition

A fiduciary who is responsible for *managing* a client's overall investment strategy: deciding on the client's asset allocation, developing the client's investment strategy, implementing the strategy with appropriate Investment Managers, and monitoring the strategy on an ongoing basis. The Investment Advisor has the most important, yet most misunderstood, role in the investment process: to manage the investment Practices, without which the other components of a client's investment strategy cannot be defined, implemented or evaluated. The term refers to those who provide comprehensive and continuous investment advice including financial advisors, broker-consultants, investment consultants, wealth managers, financial consultants trust officers, financial planners and fiduciary advisers.

Notes

The fiduciary practices described address many of the ethical and professional requirements of Investment Advisors. In addition, the Investment Advisor must become familiar, and comply, with all other laws applicable to the Advisor's particular field of practice.

This document is not intended to be used as a source of legal advice. The Investment Advisor should discuss the topics with legal counsel knowledgeable in this specific area of the law. This document is not intended to represent specific investment advice.

The scope of these practices do not include: (1) financial, actuarial and/or recordkeeping issues; (2) valuations of closely held stock, limited partnerships, hard assets, insurance contracts, hedge funds, or blind investment pools; and/or (3) risk management issues such as the use of derivatives and/or synthetic financial instruments.

Step 1: Organize

Practice A-1.1: The Advisor demonstrates an awareness of fiduciary duties and responsibilities.

Criterion 1.1.1 The fiduciary Practices and Procedures defined in the *Prudent Practices for Investment Advisors* handbook are applied.

Practice A-1.2: Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements (IPS).

Criterion 1.2.1 Investments are managed in accordance with all applicable laws.

Criterion 1.2.2 Investments held in trust are managed in accordance with client trust documents.

Criterion 1.2.3 Investments are managed in accordance with each client's written IPS.

Criterion 1.2.4 Documents pertaining to the investment management process are filed in a centralized location.

Practice A-1.3: The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined, documented, and acknowledged.

Criterion 1.3.1 The roles and responsibilities of all parties are documented in the IPS.

Criterion 1.3.2 All parties demonstrate an awareness of their duties and responsibilities.

Criterion 1.3.3 All parties have acknowledged their status in writing.

Criterion 1.3.4 Investment committees have and follow a defined set of by-laws.

Practice A-1.4: The Investment Advisor is not involved in self-dealing and has policies and procedures to address self-dealing of co-fiduciaries.

Criterion 1.4.1 Policies and procedures for overseeing and managing potential conflicts of interests are defined.

Criterion 1.4.2 All employees annually acknowledge the ethics policies of the Investment Advisor's organization and agree to disclose any potential conflicts of interest.

Practice A-1.5: Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

Criterion 1.5.1 Agreements and contracts are periodically reviewed to ensure consistency with the needs of the client.

Criterion 1.5.2 Agreements and contracts are periodically reviewed by legal counsel.

Criterion 1.5.3 Consideration is given to putting vendor contracts back out for bid every three years.

Practice A-1.6: Assets are within the jurisdiction of appropriate courts, and are protected from theft and embezzlement.

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

Criterion 1.6.2 ERISA fiduciaries have the required surety bond.

Step 2: Formalize

Practice A-2.1: An investment time horizon has been identified for each client.

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

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

Criterion 2.1.3 In the case of a foundation or endowment, the receipt and disbursement of gifts and grants has been factored into the time horizon.

Criterion 2.1.4 In the case of a retail investor, the appropriate needs based analysis has been factored into the time horizon.

Criterion 2.1.5 Sufficient liquid assets for contingency plans are maintained.

Practice A-2.2: A risk level has been identified for each client.

Criterion 2.2.1 The level of risk the client's portfolio is exposed to is understood, and the quantitative and qualitative factors that were considered are documented.

Criterion 2.2.2 A "worst-case" scenario has been considered, and it has been determined that the portfolio has sufficient liquidity to meet short-term (less than five years) obligations.

Practice A-2.3: An expected, modeled return to meet investment objectives has been identified.

Criterion 2.3.1 The "expected" or "modeled" return for each client is consistent with the client's investment goals and objectives.

Criterion 2.3.2 The "expected" or "modeled" return assumptions for each asset class are based on risk-premium assumptions, as opposed to recent short-term performance.

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

Practice A-2.4: Selected asset classes are consistent with the risk, return, and time horizon.

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

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

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

Practice A-2.5: Selected asset classes are consistent with implementation and monitoring constraints.

Criterion 2.5.1 The Advisor has the time, inclination, and knowledge to effectively implement and monitor all selected asset classes for each client.

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

Criterion 2.5.3 The ability to access suitable investment products within all selected asset classes has been considered.

Practice A-2.6: There is an IPS which contains the detail to define, implement, and monitor the client's investment strategy.

Criterion 2.6.1 Each client's IPS defines the duties and responsibilities of all parties involved.

Criterion 2.6.2 Each client's IPS defines diversification and rebalancing guidelines consistent with specified risk, return, time horizon, and cash flow parameters.

Criterion 2.6.3 Each client's IPS defines the due diligence criteria for selecting investment options.

Criterion 2.6.4 Each client's IPS defines the monitoring criteria for investment options and service vendors.

Criterion 2.6.5 Each client's IPS defines procedures for controlling and accounting for investment expenses.

Practice A-2.7: The IPS defines appropriately structured, socially responsible investment (SRI) strategies (where applicable).

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

Criterion 2.7.2 If a client has elected to implement a socially responsible investment strategy, the client's IPS is appropriately structured, implemented, and monitored.

Step 3: Implement

Practice A-3.1: Each client's investment strategy is implemented in compliance with the required level of prudence.

Criterion 3.1.1 A due diligence procedure for selecting investment options exists.

Criterion 3.1.2 The due diligence process is consistently applied.

Practice A-3.2: When safe harbors are elected, each client's investment strategy is implemented in compliance with the applicable provisions.

Criterion 3.2.1 Applicable safe harbor requirements pertaining to the delegation of investment responsibility are implemented properly, when elected.

Criterion 3.2.2 Applicable 404(c) safe harbor requirements are implemented properly, when elected.

Criterion 3.2.3 Applicable fiduciary adviser safe harbor requirements are implemented properly, when elected

Criterion 3.2.4 Applicable qualified default investment alternative (QDIA) requirements are implemented properly, when elected.

Practice A-3.3: Investment vehicles are appropriate for the portfolio size.

Criterion 3.3.1 Decisions regarding passive and active investment strategies are documented and appropriately implemented.

Criterion 3.3.2 Decisions regarding the use of separately managed and commingled accounts, such as mutual funds and unit trusts, are documented and appropriately implemented.

Criterion 3.3.3 Regulated investment options are selected over unregulated options when comparable risk and return characteristics are projected.

Criterion 3.3.4 Investment options that are covered by readily available data sources are selected over similar alternatives for which limited coverage is available.

Criterion 3.3.5 In the case of wrap or sub-accounts, the portfolio's return is comparable to the returns received by institutional clients in the same investment strategy.

Practice A-3.4: A due diligence process is followed in selecting service providers, including the custodian.

Criterion 3.4.1 A documented due diligence process is applied to select the custodian and all other service providers.

Criterion 3.4.2 Each custodian has appropriate and adequate insurance to cover each client's portfolio amount.

Criterion 3.4.3 An appropriate sweep money market fund is selected.

Criterion 3.4.4 An inquiry has been made as to whether each custodian can facilitate performance reporting and year-end tax statements.

Step 4: Monitor

Practice A-4.1: Periodic reports compare investment performance against an appropriate index, peer group, and IPS objectives.

Criterion 4.1.1 The performance of each investment option is periodically compared against an appropriate index, peer group, and due diligence procedures defined in each client's IPS.

Criterion 4.1.2 The information that is provided in performance reports is relevant to each client's circumstances.

Criterion 4.1.3 "Watch list" procedures for underperforming Investment Managers are followed.

Criterion 4.1.4 Rebalancing procedures are followed.

Practice A-4.2: Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.

Criterion 4.2.1 Periodic evaluations of the qualitative factors which may impact Investment Managers are performed.

Criterion 4.2.2 Unsatisfactory news regarding an Investment Manager is documented and acted on in a timely manner.

Practice A-4.3: Control procedures are in place to periodically review policies for best execution, “soft dollars,” and proxy voting.

Criterion 4.3.1 Control procedures are in place to periodically review each separate account manager’s policies for best execution.

Criterion 4.3.2 Control procedures are in place to periodically review each separate account manager’s policies for “soft dollars.”

Criterion 4.3.3 Control procedures are in place to periodically review each separate account manager’s policies for proxy voting.

Practice A-4.4: Fees for investment management are consistent with agreements and with all applicable laws.

Criterion 4.4.1 A summary of all parties being compensated from each client’s portfolio has been documented and the fees are reasonable given the level of services rendered.

Criterion 4.4.2 The fees paid to each party are periodically examined to determine whether they are consistent with service agreements.

Criterion 4.4.3 The fees being paid for various services are periodically evaluated for reasonableness.

Practice A-4.5: “Finder’s fees” or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.

Criterion 4.5.1 All parties compensated from portfolio assets have been identified, along with the amount (or schedule) of their compensation.

Criterion 4.5.2 Compensation paid from portfolio assets has been determined to be fair and reasonable for the services rendered.

Practice A-4.6: There is a process to periodically review the organization’s effectiveness in meeting its fiduciary responsibilities.

Criterion 4.6.1 Operational effectiveness is periodically reviewed to foster continued improvement.

Criterion 4.6.2 Assessments are conducted at planned intervals to determine whether (a) appropriate policies and procedures are in place to address all fiduciary obligations, and (b) such policies and procedures are effectively implemented and maintained, and (c) the IPS is up-to-date.

Criterion 4.6.3 Assessments are documented, conducted in a manner that ensures objectivity and impartiality, and results are reviewed for reasonableness.