

Prudent Practices for Investment Support Services (U.S. Edition)

This document is derived from the publication: Prudent Practices for Investment Advisors (‘the Handbook’), published by Fi360, a division of Broadridge Retirement and Workplace, (fi360) with technical editing provided by the *American Institute of Certified Public Accountants* (AICPA). It is the basis for Investment Support Services assessments by the Centre for Fiduciary Excellence (CEFEX). The Handbook is available at www.fi360.com and www.cefex.org.

These Practices, and the CEFEX Investment Support Services certification program , are distinct and separate from the programs established for acknowledged fiduciaries (eg. Investment Advisors, Fiduciary Advisors, Investment Stewards and Investment Managers). They are also distinct from the program established for ASPPA Recordkeeper certification.

Substantiation

The Practices presented here align with the fiduciary responsibilities detailed in Prudent Practices for Investment Advisors and Prudent Practices for Investment Stewards which 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 and may impact foundations and endowments) [See Comments at the end of this section.]

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

MPERS—Uniform Management of Public Employee Retirement Systems Act (proposed legislation that may impact state, county, and municipal retirement plans) [See Comments at the end of this section.]

Investment Support Services Definition

For purposes of these Practices, Investment Support Service Providers(s) (“Support Provider(s)”) are organizations providing services to Investment Stewards or Advisors. The definition includes organizations providing services to ERISA plans (“parties in interest”) as well as those providing consulting, investment brokerage, or other similar services to investment fiduciaries.

Notes

This document is not intended to be used as a source of legal advice. The Support Provider should discuss legal aspects of the topics addressed in these Practices 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 derivative and/or synthetic financial instruments.

Step 1: Organize

Practice A-1.1 The Support Provider demonstrates an awareness of its own fiduciary duties and responsibilities, if any, and those of the clients it serves.

Support Providers may or may not act in a fiduciary capacity depending on the services they offer and how the services are delivered. All financial Support Providers should understand the circumstances that give rise to fiduciary status and have a firm grasp on whether they are, in fact, fiduciaries. They should also be aware of the fiduciary status of the clients they serve.

Criteria

- 1.1.1 The Practices and Procedures defined are applied by the Support Provider.***
- 1.1.2 Representatives of the Support Provider receive training and written policies and procedures regarding the fiduciary obligations of the Support Provider and the typical fiduciary duties of the client segments they serve.***

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

The Support Provider must collect, analyze, and review all of the documents pertaining to the Support Provider's role in the establishment and management of each client's investments. In addition, the Support Provider must be knowledgeable about the regulations and statutes governing the conduct of clients who are fiduciaries to the extent such laws and regulations impact the Support Provider's role. Proof that such a framework has been established presumes written documentation exists in some form.

Criteria

- 1.2.1 Investments are managed in accordance with all applicable laws.***
- 1.2.2 Investments are managed in accordance with client trust documents.***
- 1.2.3 Investments are managed in accordance with each client's written IPS.***
- 1.2.4 Documents pertaining to the investment management process are filed in a centralized location and records are retained according to legal, regulatory and written policy requirements.***

Practice A-1.3 The roles and responsibilities of the Support Provider (whether serving as a fiduciary or non-fiduciary) are defined, documented, and acknowledged.

There are numerous parties involved in the investment process, and all of them should have their specific duties and requirements documented in service agreements and contracts. This ensures continuity of the investment strategy when there is a change in any of the parties, prevents misunderstandings between parties, and prevents omission of critical fiduciary functions.

Criteria

- 1.3.1 The roles and responsibilities of the Support Provider are documented.*
- 1.3.2 The Support Provider demonstrates an awareness of, and an ability to effectively communicate, its duties and responsibilities.*
- 1.3.3 The Support Provider acknowledges its fiduciary (or non-fiduciary) status in writing.*

Practice A-1.4 *Potential conflicts of interest are appropriately managed.*

A fundamental duty of a fiduciary is to manage investment decisions for the exclusive benefit of the client. Support Providers acting in a fiduciary capacity must avoid conflicts of interest. All Support Providers, even those not acting in a fiduciary capacity, should have defined policies and procedures and designated senior staff tasked with the responsibility of overseeing and managing potential conflicts of interest.

Criteria

- 1.4.1 Policies and procedures are in place to manage potential conflicts of interest.*
- 1.4.2 Designated senior staff is assigned the responsibility to oversee and manage potential conflicts of interest.*
- 1.4.3 Support Providers acting in a fiduciary capacity are not involved in self-dealing.*

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

The Support Provider should provide a written agreement that defines the scope of the parties' duties and responsibilities. This will ensure that the portfolio is managed in accordance with the written documents that govern the investment strategy, and to confirm that the parties have a clear, mutual understanding of their roles and responsibilities. The Support Provider should also provide clear and concise disclosure of all forms of direct and indirect compensation received and all affiliations with other Support Providers engaged in the relationship.

Criteria

- 1.5.1 Agreements and contracts are periodically reviewed to ensure they are consistent with the needs of the client.*
- 1.5.2 Agreements and contracts are periodically reviewed by legal counsel.*
- 1.5.3 Compensation arrangements and affiliations with other Support Providers are fully disclosed. (See the Service Agreement Disclosure Checklist available from fi360)*

Practice A-1.6 Assets are within the purview of the relevant judicial system, and are protected from theft and embezzlement.

Fiduciaries have a responsibility to safeguard entrusted assets, which also includes keeping the assets within the purview of the relevant judicial system. This gives the courts the ability to seize the assets when they, and/or a regulator, determine the best interests of the client are not being served.

If the client is an ERISA-qualified retirement plan, the Support Provider should ensure that the required surety bond is in place to reimburse the plan in case dishonest acts result in losses.

Criteria

- 1.6.1 Assets in the custody of the Support Provider are within the purview of a relevant and accessible judicial system.***

Step 2: Formalize

Practice A-2.1 Generally accepted investment principles are applied to identify an investment time horizon for each portfolio.

One of the most important decisions the investment fiduciary has to manage is the determination of the portfolio's time horizon. The time horizon is 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.

Based on the time horizon, the investment fiduciary then can determine which asset classes can be appropriately considered; what the allocation should be between the selected asset classes; whether there should be an allocation made among sub-asset classes; and, finally, which money managers or mutual funds should be retained to manage each asset class.

Criteria

- 2.1.1 Sources, timing, distribution, and uses of each portfolio's cash flows are documented for the coming five years.***
- 2.1.2 In the case of a retirement plan, the appropriate asset/liability study has been factored into the time horizon.***
- 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.***
- 2.1.4 Advisor: In the case of a retail investor, the appropriate needs-based analysis has been factored into the time horizon.***
- 2.1.5 Advisor: Sufficient liquid assets for contingency plans are maintained.***

Practice A-2.2 Generally accepted investment principles are applied to identify a risk level for each portfolio.

The term “risk” has different connotations, depending on an investment fiduciary’s and/or a client’s frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures such as standard deviation. However, these statistical measures may fail to adequately communicate the potential negative consequences an investment strategy can have on the client’s ability to meet investment objectives.

Simply stated, an investment strategy can fail by being too conservative or too aggressive. An investment fiduciary could adopt a safe investment strategy by keeping a portfolio in cash, but then see the portfolio’s purchasing power whither under inflation. 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.

Criteria

- 2.2.1 The level of risk the investor’s portfolio is exposed to is understood, and the quantitative and qualitative factors that were considered are documented.***
- 2.2.2 Advisor: The “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 Generally accepted investment principles are applied to identify a modeled return for each portfolio.

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

In this context, the term “model” means to replicate: to determine the probable returns of an investment strategy given current and historical information. There is no fiduciary requirement, or expectation, that the investment fiduciary be capable of forecasting future returns. Rather, they are required to demonstrate the process that was followed in developing the presumptions used to model the probable outcomes of a range of investment strategies.

Criteria

- 2.3.1 The “expected” or “modeled” return assumptions for each asset class are based on reasonable risk-premium assumptions, as opposed to recent short-term performance.***
- 2.3.2 The “expected” or “modeled” return for each portfolio is consistent with the investor’s investment goals and objectives.***

Practice A-2.4 Generally accepted investment principles are applied to select asset classes that are consistent with the identified risk, return, and time horizon of the portfolio.

The investment fiduciary's role is to choose the appropriate combination of asset classes that optimizes each investor's identified risk and return objectives, consistent with the investor's time horizon. The investment fiduciary's choice of asset classes and subsequent allocation typically will have more impact on the long-term performance of the portfolio than the selection of money managers.

Criteria

- 2.4.1 Assets are efficiently diversified to conform to the time horizon and risk/return profile specified for the portfolio.***
- 2.4.2 Provider: For participant directed plans, selected asset classes provide each participant the ability to diversify their portfolio appropriately given their time horizon and risk/return profile.***
- 2.4.3 Provider: The methodology and tools used to establish appropriate portfolio diversification for each portfolio are effective and consistently applied.***

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

The number of asset classes should be consistent with the investment fiduciary's implementation and monitoring constraints. No formula can determine the best number of asset classes—the appropriate number is determined by facts and circumstances. How many asset classes should be considered? Or in the case of participant-directed retirement plans, how many investment options should be offered? The answer depends on:

- Size of the portfolio
- Investment expertise of the investor
- Ability of the investment fiduciary to properly monitor the strategies and/or investment options
- Sensitivity to investment expenses—more asset classes and/or options may mean higher portfolio expenses. The additional costs of added diversification should be evaluated in light of the price the client may save in investment expenses by being less diversified.

Criteria

- 2.5.1 The Support Provider has the time, inclination, and knowledge to effectively implement and monitor investments in the selected asset classes.***
- 2.5.2 The process and tools used to implement and monitor investments in the selected asset classes are effective.***
- 2.5.3 Consideration has been given of the ability to access suitable investment products within all selected asset classes.***

Practice A-2.6 There is an IPS which contains the detail to define, implement, and monitor the investment strategy of the portfolio.

The preparation and maintenance of an appropriate Investment Policy Statement (“IPS”) is one of the most critical functions performed by the investment fiduciary. The IPS should be viewed as the business plan and the essential management tool for directing and communicating the activities of the portfolio. It should be a formal, long-range, strategic plan that allows the investment fiduciary to coordinate the management of the investment program in a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

The investment fiduciary is required to manage investment decisions with a reasonable level of detail. By reducing the details to writing and preparing a written IPS, the investment fiduciary can: (1) avoid unnecessary differences of opinion and the resulting conflicts among fiduciaries, Support Providers, and investors, (2) minimize the possibility of missteps due to a lack of clear guidelines, and (3) establish a reasoned basis for measuring success.

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

Criteria

- 2.6.1 The IPS defines the duties and responsibilities of all parties involved.***
- 2.6.2 The IPS defines diversification and rebalancing guidelines consistent with specified risk, return, time horizon, and cash flow parameters.***
- 2.6.3 The IPS defines the due diligence criteria for selecting investment options.***
- 2.6.4 The IPS defines the monitoring criteria for investment options and service vendors.***
- 2.6.5 The 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).

There is increasing interest by some investors to incorporate social, ethical, moral, and/or religious criteria into their investment strategy. Generally speaking, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a socially responsible investing (SRI) strategy. Of course, the retail investor has no such constraints.

In the case of portfolios that fall under the UPIA (personal trusts, foundations, and endowments), failure to consider an SRI could be a breach if:

- The trust documents establishing the private trust, foundation, or endowment state that SRI is permitted.
- A donor directs the use of an SRI strategy as a condition for making a donation.

- A reasonable person would deduce from the foundation's/endowment's mission that SRI would be considered (e.g., it is reasonable to assume that the American Cancer Society would not be investing in tobacco companies).

In the case of portfolios subject to ERISA, the key to successfully incorporating an SRI strategy is to demonstrate that prospective investment results are not negatively impacted. It has become a generally accepted practice to permit the inclusion of an SRI strategy as a secondary screen to a normal (unrestricted) investment process. If there are equally attractive investment options, then social factors may be considered.

If the client is a participant-directed defined contribution plan, the most prudent way to implement an SRI investment option is to present the SRI investment option alongside a general purpose fund of the same peer group. This way, each participant can choose whether or not to elect SRI.

Criteria

- 2.7.1** *Investor's goals and objectives have been evaluated to determine whether socially responsible investing is appropriate and/or desirable.*
- 2.7.2** *If an investor has elected to implement a socially responsible investment strategy, the investor's IPS is appropriately structured, implemented, and monitored.*

Step 3: Implement

Practice A-3.1 *The due diligence process used to select investments is implemented in conformity with generally accepted investment principles.*

When investments 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 investment fiduciary to hear, and not necessarily what the fiduciary needs to know.

As a general rule, a fiduciary should develop due diligence criteria that can serve a dual purpose—apply to searches as well as to monitoring.

Criteria

- 3.1.1** *A due diligence procedure for selecting investment options exists.*
- 3.1.2** *The due diligence process is consistently applied.*

Practice A-3.2 The Support Provider provides fiduciary clients services to assist them in meeting “Safe Harbor” provisions (when elected).

Regulatory “safe harbor” rules typically are voluntary and, when adopted, may insulate a party from certain liabilities. Support Providers may offer services that enable investment fiduciaries to adhere to safe harbor rules and mitigate some level of fiduciary liability.

Criteria

- 3.2.1 Fiduciary clients are provided agreed upon services that are intended to help them gain the protection of “Safe Harbor” provisions.***

Practice A-3.3 Generally accepted investment principles are applied to select the investment vehicles offered to fiduciary clients.

The primary focus of this Practice is the implementation of the investment strategy with appropriate investment vehicles. This includes the proper use of mutual funds, separate account managers, alternative investments, or other types of investments. It also addresses thoughtful consideration of active versus passive investment strategies.

Criteria

- 3.3.1 Decisions regarding passive and active investment strategies are documented and appropriately implemented.***
- 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.***
- 3.3.3 Regulated investment options are selected over unregulated options when comparable risk and return characteristics are projected.***
- 3.3.4 Investment options that are covered by readily available data sources are selected over similar alternatives for which limited coverage is available.***
- 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.***

Step 4: Monitor

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

In keeping with the duty of prudence, an investment fiduciary must determine the frequency of reviews, taking into account such factors as: (1) prevailing general economic conditions, (2) the size of the portfolio, (3) the investment strategies employed, (4) the investment objectives sought, (5) the volatility of the investments selected, and (6) the fiduciary status of the client.

The investment fiduciary should establish performance objectives for each investment option, and record the same in the IPS. Investment performance should be evaluated in terms of an appropriate market index, and the relevant peer group. The IPS also should describe the actions to be taken when an investment decision-maker fails to meet the established criteria.

Oftentimes, a money manager may begin to exhibit shortfalls in the defined performance objectives but, in the opinion of the investment fiduciary, does not warrant termination. In such situations, the fiduciary should establish in the IPS specific “watch list” procedures.

The decision to retain or terminate a manager cannot be made by a formula. It is the investment fiduciary’s confidence in the money manager’s ability to perform in the future that ultimately determines the retention of a money manager.

The monitoring procedures also should include an examination as to whether the portfolio requires rebalancing.

Criteria

- 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.*
- 4.1.2 The information that is provided in performance reports is relevant to each client’s circumstances and consistent with service agreements and contracts.*
- 4.1.3 “Watch list” procedures are followed for underperforming investment options.*
- 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.

The investment fiduciary’s review of a money manager must be based on more than recent investment performance results, for all professional money managers will experience periods of poor performance. Qualitative factors to be considered may include:

1. Staff turnover
2. Organization structure
3. Level of service provided
4. Quality of reports
5. Quality of responses to requests for information
6. Investment education

Criteria

- 4.2.1 Periodic evaluations of the qualitative factors which may impact selected money managers are periodically evaluated.*
- 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.

The investment fiduciary has a responsibility to control and account for investment expenses. When the fiduciary is utilizing a separate account manager, managers need to be monitored for:

Best Execution Practices: The investment fiduciary has an ongoing responsibility to determine that money managers are seeking best execution in trading the client’s portfolio. In seeking best execution, money managers are required to shop their trades to 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 Dollar” Practices: 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 fiduciary must confirm that soft dollar arrangements are specifically authorized by the client and that the costs involved are reasonable in relation to the value of services received.

Proxy Voting Policy: A client has the right to vote their own proxies, but the vast majority of sub-institutional clients delegate the responsibility to the money manager. The investment fiduciary should periodically (at least once a year) confirm that the money manager is fulfilling their proxy voting responsibilities.

Criteria

- 4.3.1 Control procedures are in place to periodically review each separate account manager’s policies for best execution.***
- 4.3.2 Control procedures are in place to periodically review each separate account manager’s policies for “soft dollars.”***
- 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.

The investment fiduciary’s responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from portfolio assets [See also Practice 1.2.] and (2) whether the fees are reasonable in light of the services to be provided. [See also Practice 1.5.] Accordingly, the investment fiduciary must negotiate all forms of compensation to be paid for investment management to ensure that the aggregate (and individual components) is reasonable compensation for the services rendered.

Criteria

- 4.4.1 A summary of all parties being compensated from each portfolio has been documented, and the fees are reasonable given the level of services rendered.***
- 4.4.2 The fees paid to each party are periodically examined to determine whether they are consistent with service agreements.***
- 4.4.3 The fees being paid for various services are periodically compared with industry benchmarks.***

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.

The investment fiduciary has a duty to 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 fiduciary has the responsibility for identifying those parties that have been compensated from the fees and applying a reasonableness test to the amount of compensation received by any party.

In the case of an all-inclusive fee (sometimes referred to as a “bundled” or “wrap” fee) investment product, the investment fiduciary 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, and to compare the costs of the same services on an *à la carte* basis.

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. Normally, for a new plan with few assets, such an arrangement is beneficial to the participants. However, as the assets grow, the fiduciary should periodically determine whether it is more advantageous to pay for the recordkeeping and administrative costs on an *à la carte* basis, switching to mutual funds that have a lower expense ratio, and reducing the overall expenses of the investment program.

Criteria

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

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.

Verification of fulfillment of fiduciary practices necessarily requires an objective evaluation of evidence pertaining specifically to the requirements (i.e., review criteria) of the practices. While there is no legal or regulatory requirement for regular documented fiduciary reviews, an investment fiduciary would be hard pressed to demonstrate a genuine commitment to fulfill fiduciary obligations without a program of regular and comprehensive reviews.

This certainly would be consistent with the well-established fiduciary principle of documented procedural due diligence. Moreover, the prudent expert standard is one that benchmarks the performance of the investment fiduciary against experts. Given that internal and external reviews 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 process of reviews.

Finally, it is important to recognize that the trend in law and regulation is towards greater formality in: (1) policies and procedures and (2) processes to ensure that the policies and procedures are effective.

Criteria

- 4.6.1 Operational effectiveness is periodically reviewed to foster continued improvement.*
- 4.6.2 Each client's IPS is reviewed at least once a year.*
- 4.6.3 Reviews 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.*
- 4.6.4 Reviews are conducted in a manner that ensures objectivity and impartiality.*