

PRUDENT PRACTICES *for* INVESTMENT
MANAGERS

Defining a Global Fiduciary Standard of Excellence

For organizations that manage separate accounts, mutual funds,
unit trusts, and commingled trusts.



Printed in the United States of America.

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Library of Congress has catalogued the earlier printing as follows:
Centre for Fiduciary Excellence, Fiduciary360

Prudent practices for investment managers: defining a global fiduciary standard of excellence for investment managers. Worldwide ed.

1. Investment advisors – Professional ethics.

HG4521.P865 2006

174/.933262-dc

WRITTEN BY CEFEX AND FI360. FIDUCIARY PRACTICES REFERENCED IN THIS HANDBOOK HAVE BEEN DEVELOPED BY CEFEX CENTRE FOR FIDUCIARY EXCELLENCE, LLC.

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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.

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

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

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

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



PRUDENT PRACTICES FOR INVESTMENT STEWARDS

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



PRUDENT PRACTICES FOR INVESTMENT ADVISORS

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



LEGAL MEMORANDA

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



PRUDENT PRACTICES FOR INVESTMENT MANAGERS

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

MANAGERS

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LEGAL LIMITATIONS OF THE HANDBOOK

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

This handbook is not intended to be used as a compliance manual or as a source of legal advice.

The Investment Manager should discuss the topics with legal counsel knowledgeable in this specific area of the law in the country or countries involved. References to national laws and/or regulations are provided merely as a general guide. Nor is this handbook intended to represent specific investment advice.

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

ABOUT fi360, THE CENTER FOR FIDUCIARY STUDIES, AND CEFEX

fi360

fi360 is the leading fiduciary training and resources organization in the United States. Its mission is to promote a culture of investment fiduciary responsibility and improve fiduciary decision-making through education, technology, knowledge, support, and leadership.

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

The Center for Fiduciary Studies

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

TO LEARN MORE ABOUT FI360 AND THE CENTER FOR FIDUCIARY STUDIES, VISIT WWW.FI360.COM.

CEFEX

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

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

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

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

THE ROLE OF INVESTMENT FIDUCIARIES

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

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

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

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

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

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

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

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

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

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

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

THE NEED FOR A GLOBAL FIDUCIARY STANDARD OF EXCELLENCE

Investment managers are responsible for the selection, purchase, and sale of individual securities for portfolios entrusted to their care, whether as separate accounts, mutual funds, commingled trusts or unit trusts. Managers generally act on a fully discretionary basis subject to guidelines established for each portfolio.

Manager selection is the final piece of the puzzle in constructing a well-diversified portfolio. In an environment where investors are constantly bombarded with new investment products, volatility, and regulatory uncertainty, the selection process has become increasingly more complex.

Though investors are constantly cautioned that past performance is no guarantee of future results, investors struggle to find alternative measures of evaluation upon which to base their selection. Earning investor trust, therefore, has become a more critical component of the selection process, to say nothing of an investment manager's ability to attract assets. That is particularly true in the case of institutional investors, who are themselves beholden as fiduciaries to others. Accordingly, earning trust is not simply a matter of recent, superior performance, dazzling presentations, or personal relationships; it is a matter of organizational integrity and process driven by prudent practices.

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

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

Recognizing that investment managers are fiduciaries immediately tells us that their performance will be judged, at least in part, by the prudence of the process they follow, not purely by investment results. 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 guidelines established for a portfolio and the requirements of a governing investment policy statement. Thus, it would be objectively imprudent for a fiduciary to select investments or an investment strategy that would prevent the client's objectives and requirements from being achieved. For example, including securities backed by sub-prime mortgages would be imprudent in a short term fixed income portfolio, the principal objective of which is preservation of capital.

Note, too, that it is not technically required to use managers for securities selection and purchase to implement an investment strategy. However, it would be foolish not to. The stewards and advisors who manage the investment process are held to a "prudent expert" standard, if under ERISA, or a "prudent investor" standard, if under UPIA or UPMIFA, basically meaning they would be expected to implement the strategy with the same competence as a professional investment manager. If they are unable to meet that standard, prudence dictates the appointment of such a manager. This would be particularly appropriate when dealing with complex investment strategies, such as those implemented by hedge funds and private equity funds.

The Prudent Practices for Investment Managers contained in this handbook are qualitative in nature and are designed as a practicum in aiding an investment manager to conform to the fiduciary standard. The Practices help to establish evidence that the investment manager is worthy of a fiduciary investment mandate.

OTHER KEY BENEFITS ASSOCIATED WITH APPLYING THE PRUDENT PRACTICES OUTLINED IN THIS HANDBOOK INCLUDE:

- ① **Risk management:** Most investment litigation involves the alleged omission of certain fiduciary practices and/or prudent investment procedures, as opposed to the commission of certain acts. This handbook incorporates a "checklist" process to help the Investment Manager ensure that the investment process is prudently managed.
- ② **Competitive advantage:** The number one challenge for investment managers is attracting assets. The reasons are many, but clearly the lingering effects of the 2008 capital markets crisis have caused institutional investors to set higher standards amidst a growth in investment products and an atmosphere of "fiduciary fatigue". Accordingly, investment managers are challenged to demonstrate how they meet higher standards while seeking to differentiate themselves from their competition. Indeed, "fiduciary responsibility" has become the watchword with trustees, investment committee members, and even retail investors. Investment Managers who can communicate clearly how they manage investments to a defined fiduciary standard of excellence may enjoy a major advantage over competitors.
- ③ **Increased efficiency and effectiveness:** An investment manager is expected to apply the skill, knowledge, diligence, and good judgment of a professional. The Practices provide a consistent framework to help the Manager not only achieve regulatory compliance but adopt best professional practices for sound portfolio management. By implementing a comprehensive process to fulfill fiduciary obligations the manager can establish a regimented business model that is specifically designed to serve the best interests of investors.

DEFINING FIDUCIARY EXCELLENCE

This handbook defines a Global Standard of Fiduciary Excellence for Investment Managers as established by the Prudent Practices. The Practices provide the foundation and framework for a disciplined investment process and generally represent a minimum process. The Practices are further supported by Criteria, which represent the details of the Global Fiduciary Standard of Excellence.

COMPONENTS OF A STANDARD



THE PRACTICES ARE ORGANIZED WITHIN THE FRAMEWORK OF A FOUR-PART 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
- Step 2 : Formalize
- Step 3 : Implement
- Step 4 : Monitor

The Practices in Steps One and Two emphasize the importance of governance Structures. Using a sports analogy, Structure Practices (Steps One and Two) establish how a game is going to be played and the critical elements of a team’s strategy. Step One, “Organize,” outlines how legal, regulatory, fiduciary, and business requirements will shape the structure of the investment organization. Step Two, “Formalize,” focuses on the formulation of suitable policies to govern the operations of the organization.

The Practices in Step Three, “Implementation,” and Step Four, “Monitoring,” pertain to Systems in a flow-through approach—how the game plan is going to be executed and evaluated and how changes to the organization and strategy will be made.

For each Practice, one or more Criteria are provided to establish the scope of the Practice, and to help define the details of the Global Fiduciary Standard of Excellence.

FIDUCIARY QUALITY MANAGEMENT SYSTEM

(Analogous to the ISO 9000 Continual Improvement Process)



SUBSTANTIATION OF THE PRACTICES

Each Practice is principle-driven, and represents the investment industry's best practices, as proposed by various organizations including:

- **CFA Institute** – The Asset Manager Code of Professional Conduct adopted in 2005 by the CFA Institute (formerly Association for Investment Management and Research – AIMR, responsible for the Chartered Financial Analyst designation)
- **EFAMA** – The Code of Conduct for the European Investment Management Industry proposed in 2006 by the European Fund and Asset Management Association (EFAMA)
- **RSWG** – The Risk Standards for all Institutional Investment Managers and Institutional Investors adopted by the Risk Standards Working Group (RSWG), a private initiative set in 1996 by US investment professionals

OTHER SOURCES INCLUDE:

- **IMA** – Investment Management Association on the governance arrangements of United Kingdom authorized collective investment schemes
- **IOSCO** – The International Organization of Securities Commissions
- **BIS** – The Bank for International Settlements' (BIS) Risk Based Capital and Joint Forum

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 2011¹

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

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

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

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

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

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

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

PROMOTING A FIDUCIARY CULTURE

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

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

Dr. Robert Kennedy, University of St. Thomas]

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

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

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

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

⁴ Johnston, *supra* note 2.

⁵ Johnston, *supra* note 2.

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

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

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

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

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

¹¹ Aikin & Fausti, *supra* note 1.

ORGANIZE

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

PRUDENT PRACTICES *for* INVESTMENT MANAGERS

STEP 1

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.1

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

CRITERIA

- 1.1.1** The organization has the depth of experienced management to mitigate key person risk.
- 1.1.2** There is a defined succession plan for senior management to deal with sudden, unexpected disruption.
- 1.1.3** The recruiting process for senior management includes proper background checks and active involvement by external management.

The success of an organization is driven by the strength of those individuals running the company: the chief decision-makers. Investment management is a specialized industry. As such, it is essential that key decision-makers have experience with the financial services industry. They must understand and be able to plan for the risks of investing other people's money and have a competent team of qualified decision-makers.

The starting point is to review the biographies of the organization's key executives in terms of industry-related experience and professional designations and degrees. In addition, there needs to be a process for the recruitment of new executives. The process should include background checks and the role of the Board of Directors in the recruitment process.

Continuity and planning of leadership succession are essential factors for the long term success of an organization. The senior leadership of an investment management firm must be able to withstand disruption caused by internal and external factors and must also plan for its own eventual replacement. As such, a clear succession plan must be in place to achieve two major functions: (1) To reduce key man risk associated with sudden, unexpected disruptions in the leadership team and (2) to ensure the longer-term preparation, training, advancement, and selection of the next-generation of candidates for leadership roles.

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.2

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

CRITERIA

- 1.2.1 There is a well-defined mission statement for the organization as a whole that is communicated to all levels of personnel.
- 1.2.2 There is a focus and coherence to the organization.
- 1.2.3 Significant organizational changes are reported to clients on a timely basis.
- 1.2.4 There is a disciplined performance review process.

Although a team concept is conducive to effective management, good Managers must be aware of their individual accountability. Having clear designations of accountability at all levels of an organization ensures decisions are made with careful consideration of all possible outcomes.

Managerial decisions that appear to only affect specific departments or functions, may in fact affect operations throughout an organization. Therefore, the mission and operations of the company must be focused, so as to avoid the breakdowns in communications that lead to inefficiencies.

AN EXAMINATION OF THE ORGANIZATIONAL CHART SHOULD DEMONSTRATE THAT:

- There are clear lines of authority.
- There are clear separations of functions.
- The lines of authority are matched with lines of responsibility.
- The organization provides clients with timely reporting of changes to the organization.

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.3

The organization has the capacity to service its client base.

CRITERIA

- 1.3.1** The organization has a suitable distribution and support structure (physical locations and staff) for each type of client.
- 1.3.2** The organization provides timely and appropriate communications with clients.
- 1.3.3** The organization monitors and manages the concentration of individual clients and client types.

Each type of client—retail, high net worth, and institutional—has its own unique distribution and support requirements.

Retail clients are best accessed through intermediaries such as brokers, bankers, insurance agents, and Investment Advisors. Retail clients tend to be much more brand conscious than other types of clients, and the intermediaries tend to require greater sales support.

High net worth clients are best accessed through accountants and attorneys. They tend to require more servicing and contact from the portfolio manager than retail clients. Their decision-making process is driven more by reputation of the organization and service than performance.

Institutions (pension plans, foundations and endowments) are best accessed through direct contact with the institution and/or through investment consultants. Institutions tend to require more communications from the organization, sometimes daily.

THE ORGANIZATION'S INFRASTRUCTURE AND DISTRIBUTION CHANNELS SHOULD BE EVALUATED FROM THE CONTEXT OF CLIENT SERVICE:

- Does the organization's office locations provide appropriate support?
- Does the organization provide timely and appropriate communications with clients?
- Does it maintain a robust internet site that can provide clients with timely information about their accounts and the strategy of the portfolio managers?
- Is there a sufficient and experienced client-servicing staff?

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.4

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

CRITERIA

- 1.4.1 Each operational department has a procedures manual documenting flow and approvals.
- 1.4.2 Securities are priced in a timely, accurate, and independent manner.
- 1.4.3 Investment products are accounted for in an accurate and timely manner.
- 1.4.4 Securities lending procedures are well documented with communication to portfolio managers on lent assets.
- 1.4.5 Trade confirmations or periodic activity statements are sent to clients for all trading activities.
- 1.4.6 All client assets are adequately secured through a suitable custodian.

While the Investment Manager's job is to add value to performance through security selection, the back office's responsibility is to make sure the securities are settled, safeguarded, and accurately valued. In addition, operations are responsible for money movement, valuation of investment vehicles, and accounting for investors' ownership interests in funds or other investment vehicles. An operational error can be as damaging to investment performance as poor investment judgment.

The term "back-office" encompasses settlement, transfer-agent, custodial, accounting, and valuation activities. Sound operations ensure that trades settle on a timely basis, securities purchased in fund or

trust type vehicles are adequately secured through a reputable custodian from bankruptcy of the asset manager, income is collected in a timely manner, corporate actions are properly captured, securities are accurately priced, and investment vehicles are accounted for and properly valued.

In some cases, investment management companies outsource one or more of these activities. In such cases, it is important to determine that the vendor is adequately vetted and monitored.

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.5

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

CRITERIA

- 1.5.1** The organization has a well-documented technology plan addressing hardware and software maintenance and development needs.
- 1.5.2** Back-up procedures and disaster recovery plans are in place.
- 1.5.3** The organization has up-to-date technology that is supported by qualified staff.

Technology plays an increasingly important role in investment management. Systems to accurately and effectively account for client money, maximize the efficiencies of investment research and the investment process, manage the administration of assets under management, and automate risk management controls are all paramount to the success of an investment management organization.

Technology development needs to proceed at the same pace as the needs of the organization. Periodic reviews should be conducted on existing software to address

maintenance and modification issues. Back-up procedures and disaster recovery plans need to be defined before the need for them arises. Smaller investment management companies may outsource their technology requirements to third-party vendors, as long as procedures are in place to monitor and control their vendor. If an organization's technology is not up-to-date, they have put themselves at a disadvantage from the start of the investment process.

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.6

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

CRITERIA

- 1.6.1** Employees demonstrate an understanding of how their individual tasks and objectives fit with the organization's mission statement.
- 1.6.2** Formal systems are in place to foster open communications amongst employees at all levels, including questions, comments, and complaints.
- 1.6.3** Well-defined employee training programs are available.
- 1.6.4** Staff is actively supported in the pursuit of advanced degrees and professional designations.

An investment management organization produces an intangible product. As such, the success of the organization and the quality of its product is highly dependent upon the people it attracts, nourishes, and retains. An Investment Manager's greatest asset is its people, and the working atmosphere and corporate culture are key determinants to the organization's success.

To foster this culture and retain quality employees, there needs to be a strong team spirit. All employees should know the organization's mission statement and how their tasks and objectives help the organization achieve its mission.

Part of maximizing the potential of all employees is accessibility. Executive leaders must establish open channels of communication so that employees from all levels feel comfortable expressing their opinions and ideas.

In addition to pursuing quality employees, the organization should strive to cultivate the employees they have with a defined training program. By actively supporting staff in the pursuit of advanced degrees and professional designations, the organization is creating a more competent work force from within.

STEP 1 : ORGANIZE

ORGANIZE

PRACTICE

1.7

There is a formal structure supporting effective compliance.

CRITERIA

- 1.7.1 The organization has compliance policies and procedures manuals that are kept current.
- 1.7.2 The organization has a designated Chief Compliance Officer CCO who is an experienced, senior-level executive.
- 1.7.3 All compliance issues are reported directly to the office of the CCO, regardless of where they originate.
- 1.7.4 The CCO has direct access to the CEO and external management.
- 1.7.5 There is compliance training for all new employees and ongoing training to emphasize changes in both regulations and internal policies.
- 1.7.6 Compliance breaches are documented and reported to the board and appropriate regulators and procedures are put into place to reduce the risk of future noncompliance.

The success of an investment management business depends upon the investors' trust in the organization. It is therefore important that compliance, both regulatory and from client mandates, be a major emphasis of the organization. The company should support a strong compliance culture and have appropriate resources dedicated to monitoring adherence to those policies. It is important that compliance issues be well documented—typically through a compliance manual.

Some indications of effective compliance are that the firm should not have had a regulatory or compliance breach, nor have been involved in litigation, in the past five years. In cases where there has been a breach, the firm must be able to demonstrate that substantial steps have been taken to ensure similar lapses do not occur again in the future.

Even quality compliance policies and procedures lack effectiveness if there is not centralized enforcement. The organization needs to have an experienced

industry executive to serve as Chief Compliance Officer (CCO). The CCO should report directly to the CEO, and have independent access to external management.

THE CCO HAS FOUR MAJOR ROLES:

1. Be the primary watchdog to ensure that the firm complies with all applicable rules and regulations.
2. Stress-test the firm's policies and procedures in order to determine whether the firm is at risk of violating any rules and regulations.
3. Serve as the firm's expert on compliance.
4. Ensure that the firm's operations are conducted in the best interest of the investing public.

In addition to in-house compliance, there should be a system of legal review for interpreting regulation and compliance. All compliance issues should be communicated throughout all levels of an organization.

FORMALIZE

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PRUDENT PRACTICES *for* INVESTMENT MANAGERS

STEP 2

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.1

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

CRITERIA

- 2.1.1 Standard financial statements or executive disclosures provide evidence of adequate resources to sustain operations.
- 2.1.2 There is adequate insurance to protect the organization from serious breaches.

Transparency and capital adequacy can be subjective terms, as a management firm generally needs little capital to provide a bare-bone investment service. Unlike the credit world, where clear benchmarks exist against liabilities, the investment fiduciary industry is not constrained by any financial commitment to develop, maintain, improve, and/or expand its infrastructure and fiduciary systems to serve investors.

All things being equal, an organization with a more diversified client base has lower business risk. Excessive client-concentration carries downside risks, including volatility of financial performance, proportionately larger redemptions, and being blind-sided by industry or macro trends. However, a wider, less concentrated client base imposes its own demands on the organization.

The sole liability of an investment management organization towards a client is expressed in terms of services. This is why no regulations can compel them to disclose their financial statements publicly. Furthermore, regulations vary considerably around the world on the amount of equity or shareholders' funds that an asset management company must maintain permanently to ensure adequate resources and sustainable service. Whereas some regulators will set no minimum absolute balance, others will require the equivalent of six months worth of annual expenses.

Traditional accounting statistics are to be examined to ensure that the organization is a viable going concern. In addition, the organization's product and client base are to be evaluated to ascertain that it can withstand both cyclical trends in the market and the loss of large clients.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.2

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

CRITERIA

- 2.2.1** The organization has a discernible business plan for development.
- 2.2.2** The organization demonstrates an effective process for fostering service and product innovations.

No organization should be standing still; it always should be able to demonstrate a commitment to innovation.

For organizations that are still in a growth mode, a vision and a plan should be evident for: (1) the development of new products, (2) the acquisition of other organizations, and/or (3) growth into a new market.

If the organization and/or its product(s) has reached a saturation point (zero growth), the organization still needs to have a plan to improve the servicing of its clients, in order to remain relevant.

If the organization hopes to separate itself from its competition, it needs to be offering unique services in addition to performance.

AN INVESTMENT MANAGER'S COMPETITIVE ADVANTAGES CAN COME IN MANY SHAPES AND SIZES, SUCH AS:

diversity – The organization operates from a wide base in terms of geographic locations, types of clients, and lines of business. Diversity is the competitive advantage mentioned most by Investment Managers themselves.

niche – The opposite of diversity; the organization has chosen to become the market “expert,” and/or the “benchmark,” specializing in a particular strategy, product, type of client, and/or geographic location.

client services – Certain organizations thrive on client servicing, while others view it as a necessary evil. There are clients that value and demand high-touch, while others are indifferent as long as the investment organization performs.

marketing brand – The organization has a recognizable brand as a result of advertising, marketing, and/or effective press and public relations.

strategic alliances and partnerships – The organization itself may not have a discernible competitive advantage, but it serves as a sub-advisor and/or strategic partner to a firm that does.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.3

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

CRITERIA

- 2.3.1 The organization has a competitive evaluation process for selecting third-party service providers.
- 2.3.2 The organization has a review process in place to assess the performance of internal and external service providers.
- 2.3.3 There is effective communication between administration and portfolio management functions to ensure that both parties' needs are being met.

The success of an investment management organization is often dependent on its ability to manage its resources and effectively determine when to outsource activities. Although many Investment Managers maintain their own back office responsible for trade execution, valuation, and accounting of investment products, it is not unusual to see one or all of these functions handled outside of the organizations.

Some functions, such as custody, must be outsourced, but can remain within the “family” of the organization’s companies.

OTHER FUNCTIONS THAT MAY BE OUTSOURCED INCLUDE:

- legal
- audit
- shareholder services
- fund administration
- prime brokerage
- soft dollar arrangements
- specialized investment research
- technology

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.4

There are effective and appropriate external management controls.

CRITERIA

ORGANIZATION LEVEL

- 2.4.1** External management is comprised of knowledgeable, experienced, and independent individuals.
- 2.4.2** External management exercises authority and provides the organization with a system of checks and balances.

PRODUCT LEVEL

- 2.4.3** There is external governance for mutual funds or similar investment vehicles comprised of knowledgeable, experienced, and independent individuals.
- 2.4.4** External governance has sufficient authority to ensure that the investment vehicle is managed within its guidelines and that risk management controls are being adhered to.

The evaluation of the organization's management now shifts from key internal decisions-makers to external controls—be it in the form of a Board of Directors, an external management committee, and/or influential outside shareholders.

External management should be comprised of knowledgeable, experienced, and independent individuals who have sufficient authority (formal and/or financial) to provide a system of checks and balances to the organization's internal management.

The attributes and roles of an effective Board has been well-documented by other governance experts. A less obvious source of external control is the role of outside shareholders who can provide intellectual and/or financial capital in times of difficulty. Also, certain significant shareholders have the opportunity to “flex their muscles” and affect change when they are less than pleased with internal decision-makers.

In the case of an investment organization that is overseen by a Board of Directors and also offers a mutual fund or similar investment vehicle, the Board should show evidence that it meets at least quarterly to review:

1. The investment strategy of each fund; whether the portfolio manager is following the assigned mandate and whether the underlying securities are consistent with the assigned mandate.
2. How the fund compared to its peer group and appropriate benchmark for the most recent quarter, and the fund's performance on a rolling one-, three-, and five-year basis.
3. How the risk-adjusted performance of the fund compared to its peer group.
4. Whether the organization's risk management policies are being followed.
5. Whether all investment-related fees and expenses are appropriate and reasonable.
6. Whether there has been a material increase or decrease in the fund's assets, and whether the change is having an impact on the portfolio manager's ability to follow the assigned mandate.
7. Whether sales and marketing activities are consistent with the organization's policies.
8. Whether there is any pending litigation or regulatory enforcement action against the fund or the organization.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.5

The organization has a defined process to control its flow of funds and asset variation.

CRITERIA

- 2.5.1 The organization has a defined approach to plan and control assets under management.
- 2.5.2 Systems are in place to monitor and manage short-term investor cash movement.

Unexpected redemptions or sudden growth in assets under management can seriously test the capacity of an investment management organization to serve its clients properly or to execute its investment system in an effective way. Furthermore, these uncertainties can challenge the organization's management and infrastructure in a significant way.

The organization should have a well-defined plan for growing assets to achieve economies of scale, along with a plan to limit growth when the limits of manageability are reached. For example, new products

may provide suitable alternatives to investors that will induce them to stay with the organization rather than redeem. To keep growth controlled, marketing programs can be scaled back or client hurdles such as minimum account size can be raised when asset intake is surging. Additionally, policies and procedures may be implemented to deter institutional investors from engaging in arbitrage or timing schemes that involve investing and redeeming large sums of money in short time periods.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.6

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

CRITERIA

REMUNERATION

2.6.1 The organization can demonstrate a policy outlining how it aligns remuneration with investors' interests.

COMPENSATION

2.6.2 Compensation of executive leadership (CEO, CFO, COO) is tied to well-defined financial targets, in contrast to being solely linked to asset growth or investment performance.

2.6.3 Investment management professionals earn incentives from the performance of their portfolio on a risk-adjusted basis and on asset retention and/or growth.

2.6.4 Investment management professionals are encouraged to invest in the portfolios they manage, subject to compliance procedures and conflict of interest guidelines.

An examination of the organization's compensation structure should be divided into two parts: (1) remuneration for the firm and (2) the compensation of key decision-makers.

Remuneration of the investment management organization includes all gross revenues earned from advising and managing assets on behalf of third parties. It is reasonable for the investment management team's compensation to be based on a formula that includes both investment performance and asset growth, subject to strict controls.

However, key decision-makers in the front office should have an equity stake in the organization, with incentives tied to "business" performance, as opposed

to investment performance and/or asset growth. Such incentives can have considerable influence on the execution of fiduciary duties by key decision-makers. When incentives are tied to performance, there is temptation to do whatever it takes to make the numbers. Invariably, such a policy will clash with good business principles, causing a detrimental impact on the long-term performance of the organization.

Likewise, the investment management team should be encouraged to invest in the portfolios they manage. Aligning the organization's interests with those of its investors helps ensure that decisions are made to maximize potential for the long-term health of a portfolio.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.7

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

CRITERIA

- 2.7.1 Documented guidelines are applied for sales and marketing practices.
- 2.7.2 There is a legal and compliance review of all marketing communications.
- 2.7.3 There is a clear and defined policy for remuneration of third-party representatives or fund distributors.

The investment management industry is built upon trust. If an activity by the organization raises even the question and/or specter of an ethical breach, the activity should be eliminated. This includes company marketing.

The organization should be able to demonstrate a responsible approach to marketing. Over-aggressive marketing can dilute the credibility of a firm, but under-marketing can impact its ability to grow.

Investment Managers should be directly involved in marketing planning so as to ensure there is adequate availability and support for the services and products being offered.

The same goes for sales practices. Client needs vary and investment decisions should be backed up with documentation on the nature and background of each individual client. The client deserves to be kept up-to-date on the performance of their portfolio with timely and accurate reporting processes. If a client feels their needs are not being met, procedures should be in place to address and/or correct those deficiencies.

Sales and marketing are key components to an organization's success and these areas should be staffed with experienced industry professionals, and all pertinent decisions should be subject to legal review.

STEP 2 : FORMALIZE

FORMALIZE

PRACTICE

2.8

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

CRITERIA

BUSINESS RISK

- 2.8.1 There is an effective process for evaluating business risk and ensuring business continuity.
- 2.8.2 The organization has defined policies and procedures and designated senior staff tasked with the responsibility of overseeing and managing the organization's conflicts of interest policies.

INVESTMENT RISK

- 2.8.3 Credit and investment research is adequately documented and subjected to review procedures.
- 2.8.4 There is a dedicated investment risk management oversight committee that regularly reviews the activities and investment risk of the investment management groups.
- 2.8.5 Investment products have clear and defined risk management parameters that are reviewed by senior management on a regular basis.
- 2.8.6 Breaches of maximum investment risk parameters are communicated to the investment risk management oversight committee.
- 2.8.7 Risk-management tools are used to assess overall portfolio risk and the risk within major asset classes.
- 2.8.8 Broker-dealer relationships are structured to minimize counterparty risk.

Risk assessment has become an increasingly crucial area in the investment management industry. Risk includes both the risk to the organization (business risk) and risk to the success of a portfolio (investment risk). The organization should have defined procedures and designated senior-level staff responsible for evaluating the organization's business and investment risks.

There are many types of business risk. Regulatory risk is the threat that a company's activities will be scrutinized or penalized by industry overseers. There are financial and reputation risks that come with conflicts of interest, the issuance of specific

products, and customer reporting and communication. Prevention should include having an infrastructure that meets organizational needs and making sure no one (employee or client) is able to profit at the expense of a client.

The monitoring of investment risk is driven by clear and concise procedures for credit analysis and research as well as trading and execution. The organization's risk assessment procedures should be tailored to its investment process and products. Ordinarily, risk assessment procedures should include an examination of the organization's liquidity, credit, counterparty, and execution risks.

IMPLEMENT

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PRUDENT PRACTICES *for* INVESTMENT MANAGERS

STEP 3

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE

3.1

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

CRITERIA

- 3.1.1** There is a defined succession plan for key investment professionals to deal with sudden, unexpected disruption.
- 3.1.2** The organization has the depth of experienced managers, traders, and research staff to negate key person risk.
- 3.1.3** Key employees demonstrate expertise in their respective fields.
- 3.1.4** Training courses and continuing education is offered to employees to develop their skill sets.
- 3.1.5** Investment professionals should have a clear understanding of how their tasks and objectives fit with the organization's mission.
- 3.1.6** Procedures for employee review and evaluation are performed regularly.

As with senior management at the executive level, cohesiveness is equally important to an asset management team. There should be strong communication between research staff, Investment Managers, and traders. Individuals should be groomed to move into key management positions when the need arises. In addition, there should be guidance given through an investment committee to assure the objectives of each investment product are being met. These steps ensure smooth transitions and continuance when faced with the prospect of personnel changes.

Even more important than continuity are quality and knowledge. Research staff and Investment Managers should have sufficient experience and tenure in the disciplines they are responsible for. Regular meetings should take place to discuss market conditions and the effect on managed products. Regular training courses should be held for staff development along with an ongoing assessment and evaluation process for all employees.

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE

3.2

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

CRITERIA

- 3.2.1 The investment team can demonstrate that there is a defined process that is applied consistently over time and market cycles.
- 3.2.2 The investment team can demonstrate that there is a defined process that adds value relative to the benchmark.

An investment system is the entire investment chain from strategy to execution. It is essential for any investor to understand the edge of a Manager, the way his system works to add value in a consistent manner. The key focus is on the organization's ability to apply a strategic approach to management and to demonstrate their abilities to add value to the process.

The team should demonstrate that a defined process has been applied over a period of time. Each component should be assembled in a way that

coheres with the system; from initial research, through portfolio construction, to trade execution. The process should be applicable during bull or bear markets.

Objectives and processes should be well documented and testable. Each rung in the investment ladder should be able to demonstrate their contribution and a measurement process should be in place to evaluate each member of the team.

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE

3.3

The investment research process is defined, focused, and documented.

CRITERIA

- 3.3.1** There is a documented research process and a mechanism to capture and track recommendations given by research analysts.
- 3.3.2** The research team has access to appropriate databases and external research and is supported with adequate technology and communications tools.

The research department is responsible for evaluating and giving recommendations on the markets, sectors, and individual securities purchased by the Investment Manager. This process has a different focus depending on the discipline. For fixed income securities the focus is on credit risk, with an emphasis on finding value in the long-term market. For equity securities, the emphasis is on finding value in industries and specific securities.

In each case, there should be well documented procedures for the evaluation of markets and securities. A formal documentation process should be in place to substantiate each of its recommendations. Because an Investment Manager is not obligated to accept recommendations, research analysts should be evaluated based on the strength of their recommendations rather than portfolio performance.

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE

3.4

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

CRITERIA

- 3.4.1 An investment committee is in place to set strategy and boundary constraints on the Investment Manager.
- 3.4.2 There is a formal portfolio review process to ensure adherence to investment policies and mandates.
- 3.4.3 The portfolio management process for each distinct investment strategy is clearly defined, focused, and documented.
- 3.4.4 The portfolio manager has adequate technical support to plan investment actions and monitor portfolio constraints.
- 3.4.5 The Manager has a defined portfolio turnover strategy that adds value over time.
- 3.4.6 Tactical asset allocation is consistent with the investment team's stated long-term goals of strategy, client mandate, and risk parameters.

The portfolio construction and balancing process produces buy and sell decisions.

THERE SHOULD BE RULES-BASED TECHNOLOGY TO CHECK:

- **investable cash levels** (new cash which requires investment as a result of interim contributions or securities income)
- **holdings constraints by:** (a) type of security (socially-responsive mandate screens, low-basis or restricted stock) and (b) percentage in a particular security and/or industry
- **manager-defined risk metrics** with supporting systems (value at risk, style analysis, market event simulation, integration of the order book with risk measurement indicators, and trade simulation)

A tactical style allocation should be consistent with the investment team's stated strategy, and there should be documented evidence that it adds value to the strategic long-term strategy.

The Manager should have a defined time horizon policy that affects its portfolio turnover, and demonstrate that it has been applied in a consistent way.

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE

3.5

The trade execution process is defined, focused, and documented.

CRITERIA

- 3.5.1 Trade allocation policies are well defined, fair, and reviewed on a regular basis.
- 3.5.2 Broker-dealer relationships and activity are closely monitored to verify that they are providing value-added services.
- 3.5.3 Trade execution systems provide timely and accurate trading.
- 3.5.4 Tactical trading generates measurable added value, and is consistent with the investment team's stated strategy and risk parameters.

Traders can play a critical role in eking out additional basis points in performance. These basis points can mean the difference between an investment team meeting, or not, their performance targets.

But, traders can also be the source of inappropriate conduct. They have the potential to do more damage to an investment team than poor investment performance.

TO ENSURE PROPER TRADE EXECUTION PROCESSES, THE INVESTMENT TEAM SHOULD ACTIVELY MONITOR TRADING ACTIVITIES AND DEMONSTRATE THE FOLLOWING:

- impact on performance
- value added by the services of each broker-dealer
- appropriate allocation of trades across client portfolios, particularly in the case of initial public offerings
- utilization of the latest trade technology

MONITOR

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PRUDENT PRACTICES *for* INVESTMENT MANAGERS

STEP 4

STEP 4 : MONITOR

MONITOR

PRACTICE

4.1

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

CRITERIA

- 4.1.1 The organization conducts comprehensive performance attribution analysis.
- 4.1.2 The organization accurately calculates and verifies portfolio performance.

To make informed investment decisions, investors must have easy-to-understand, comparable information. This information includes gross return information, as well as the costing structure of the vehicle they are investing in. Therefore, the investment management team should be in compliance with the CFA Institute's Global Investment Performance Standards (GIPS), which assures comparability of information between investment management companies.

Attribution analysis is central to understanding how an investment system can add value in a consistent way. Although analysis can be applied all the way down to the level of each security held, the traditional

approach of risk and return attribution was restricted to investment selection and still applies poorly to fixed-income investments. Technology has improved to a point where cost, integrating transaction cost analysis (TCA), and structural factors (such as sales and marketing strategies and fund flow volatility impacting on cash reserves and rebalancing requirements) are now part of a more general discipline of attribution.

The investment management team should conduct performance attribution analysis and demonstrate that it understands and is actively managing every component which impacts investment risk and return.

STEP 4 : MONITOR

MONITOR

PRACTICE

4.2

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

CRITERIA

- 4.2.1** There is a system in place to capture required mandates and any changes to mandates, whether those changes come from clients, regulators, or from internal sources.

Investment management is a complicated activity that requires a delicate sense of balance between a wide range of constraints, risks, and skills.

Investment mandates are dictated by three primary sources: regulation, client documentation, and internal requirements. There should be ongoing monitoring and a formal reporting system of trading activity and portfolio make-up to check if the Investment Manager is in compliance with all mandates.

STEP 4 : MONITOR

MONITOR

PRACTICE

4.3

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

CRITERIA

- 4.3.1 The organization has a process to ensure “best execution.”
- 4.3.2 The investment team is: (a) monitoring the generation and use of “soft dollars,” (b) is in compliance with regulatory requirements regarding the generation and use of soft dollars, and (c) maintaining a “soft dollar” log.
- 4.3.3 The organization is appropriately accepting and monitoring directed brokerage and commission recapture mandates.
- 4.3.4 The organization is tracking, voting, and accounting for proxies.

The investment team has a fiduciary responsibility to control and account for investment expenses: to see that the expenses are prudent and are applied in the best interests of the investor, participant (in the case of a retirement plan), or beneficiary (in the case of a private trust, foundation, or endowment).

The investment team, therefore, must demonstrate that best execution practices are followed in securities transactions. In seeking best execution, the investment team demonstrates that it takes into consideration: (1) commission costs, (2) the actual execution price of the security, and (3) quality and reliability (timing) of the trade.

“Soft dollars” must be expended only for brokerage and research for the benefit of the investment program. The amount must be reasonable in relation to the value of such services and a log must be maintained of expenditures. 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 investment team to monitor soft dollars may subject the investment program to expenditures which yield no benefit, itself a fiduciary breach.

Proxies need to be voted in a manner most likely to preserve or enhance the value of the subject stock, and a log maintained on how each proxy was voted.

STEP 4 : MONITOR

MONITOR

PRACTICE

4.4

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

CRITERIA

- 4.4.1** Reviews 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.
- 4.4.2** Reviews are conducted in a manner that ensures objectivity and impartiality.

Fiduciary duties are generally 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 audits provides such a framework.

Assessment of fulfillment of fiduciary practices necessarily requires an objective evaluation of evidence pertaining specifically to the requirements (i.e. audit criteria) of the practices. An investment fiduciary would be hard pressed to demonstrate a genuine commitment to fulfill fiduciary obligations without a program of regular and comprehensive review.

The trend in law and regulation is towards greater formality in: (1) policies and procedures, and (2) processes that ensure that the policies and procedures are effective. Given that internal and external audits are well recognized tools to evaluate risks and assure effectiveness of policies and procedures, this adds further weight to the need to establish a formal overall review process, such as is provided by an audit program.

CONCLUSION

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

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

GLOSSARY OF TERMS

THIS GLOSSARY WAS COMPILED FROM THE FOLLOWING SOURCES:

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

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

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

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

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

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

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

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

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

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

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

CFA Institute (formerly AIMR) Performance Presentation Standards – These standards, effective January 1, 1993, are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing Manager results. These standards include ethical principles, and apply to all organizations serving investment management functions.

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.

GLOSSARY OF TERMS

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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

risk tolerance – Investors ability to deal with the potential of losing money without abandoning investment process.

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.

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.

GLOSSARY OF TERMS

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 in excess of the actual cost of executing the trade provided by the broker dealer.

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



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

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

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

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

PERIODIC TABLE OF GLOBAL FIDUCIARY PRACTICES

for INVESTMENT MANAGERS

PRACTICE 2.1

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

PRACTICE 1.1

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

PRACTICE 1.2

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

PRACTICE 2.2

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

PRACTICE 2.3

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

PRACTICE 1.3

The organization has the capacity to service its client base.

PRACTICE 1.4

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

PRACTICE 2.4

There are effective and appropriate external management controls.

PRACTICE 2.5

The organization has a defined process to control its flow of funds and asset variation.

PRACTICE 1.5

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

PRACTICE 1.6

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

PRACTICE 2.6

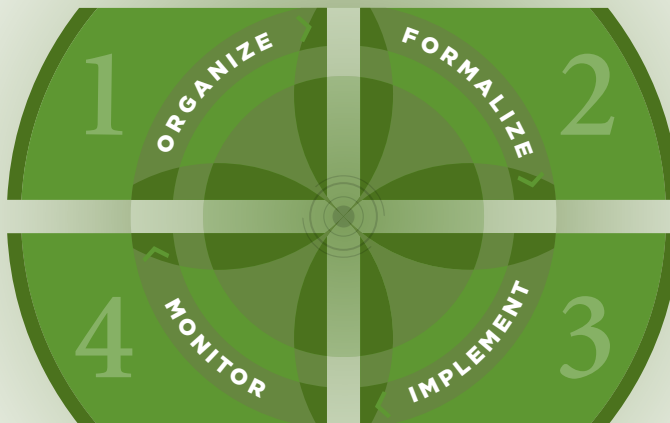
Remuneration of the company and compensation of key decision-makers is aligned with client interests.

PRACTICE 2.7

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

PRACTICE 1.7

There is a formal structure supporting effective compliance.



PRACTICE 2.8

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

PRACTICE 4.1

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

PRACTICE 3.1

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

PRACTICE 4.2

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

PRACTICE 4.3

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

PRACTICE 3.2

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

PRACTICE 3.3

The investment research process is defined, focused, and documented.

PRACTICE 4.4

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

PRACTICE 3.4

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

PRACTICE 3.5

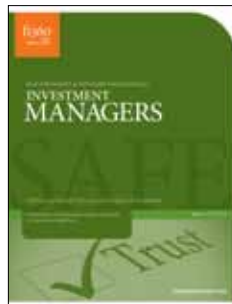
The trade execution process is defined, focused, and documented.

ASSESSMENT LEVELS

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

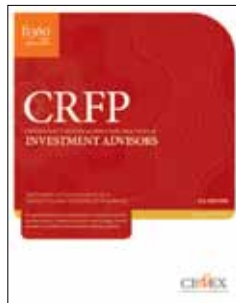
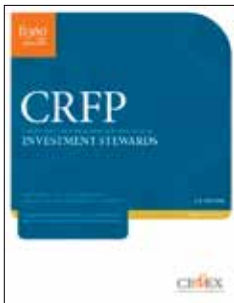
LEVEL 1: SAFE

Self-Assessment of Fiduciary Excellence



LEVEL 2: CRFP

Consultant's Review of Fiduciary Practices



LEVEL 3: CAFE

CEFEX-Assessment of Fiduciary Excellence



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RRD4M04_13

