Broadridge®

U.S. EDITION HANDBOOK

Prudent Practices for investment advisors

Defining a global fiduciary standard of excellence for professionals who provide investment advice, including financial advisors, broker-consultants, trust officers, financial planners, and fiduciary advisors

Ready for Next

Printed in the United States of America
Broadridge® is a registered trademark owned by Broadridge, Inc.

Library of Congress has catalogued the earlier printing as follows:
Centre for Fiduciary Excellence, Fiduciary360
Prudent Practices for Investment Advisors: Defining a global fiduciary standard of excellence for investment advisors, U.S. ed.

1. Investment advisors – legal status, laws, etc.
2. Investment advisor – client relationships KF
   1072.Z9 P78 2006 71496482

WRITTEN BY BROADRIDGE Fi360. Contributors and Task Force:
Blaine F. Aikin, AIFA®, CFA®, CFP®
John Faustino, AIFA®, PPC®
Michael Muirhead, AIF®, PPC®
Carlos Panksep
Duane Thompson, AIFA®
Aaron Drew, AIF®, AIFA®
Roger Levy, AIF®, AIFA®
David Vriesenga
Mark Mensack, AIF®, AIFA®
Mario Giganti, AIF®, AIFA®, PPC®
Keith (Sunny) Loveland, AIF®, AIFA®
Mary Kathryn Campion, Ph.D., CFA®, AIFA®
Carol E. Swanson

Technical reviewers from AICPA's Personal Financial Planning Executive Committee (Investment Advisory Task Force):
Clark M. Blackman II, Chair, MA, CPA/PFS, CFA, CFP, CGMA, AAMS, AIF®
Clark M. Blackman III, MS, CPA/PFS, CFA, CFP
Anish Chopra, MA, FCPA, FCA, FCBV, CFA, CAIA, FRM
Christopher R. Kowal, CFP
Thomas J. Trainor, CPA, CA, PFS, CFA, CFP, CLU

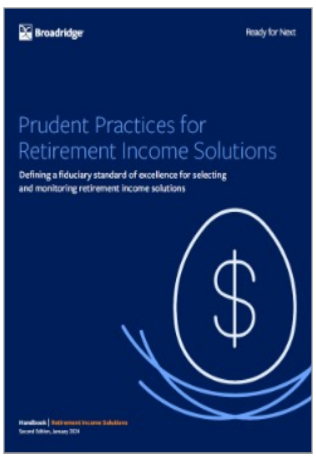
Legal review provided by:
Faegre Drinker Biddle & Reath

About this publication

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

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

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



This detailed handbook defines a prudent process for plan fiduciaries to introduce and manage retirement income solutions in a defined contribution plan.

Prudent Practices for investment stewards

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

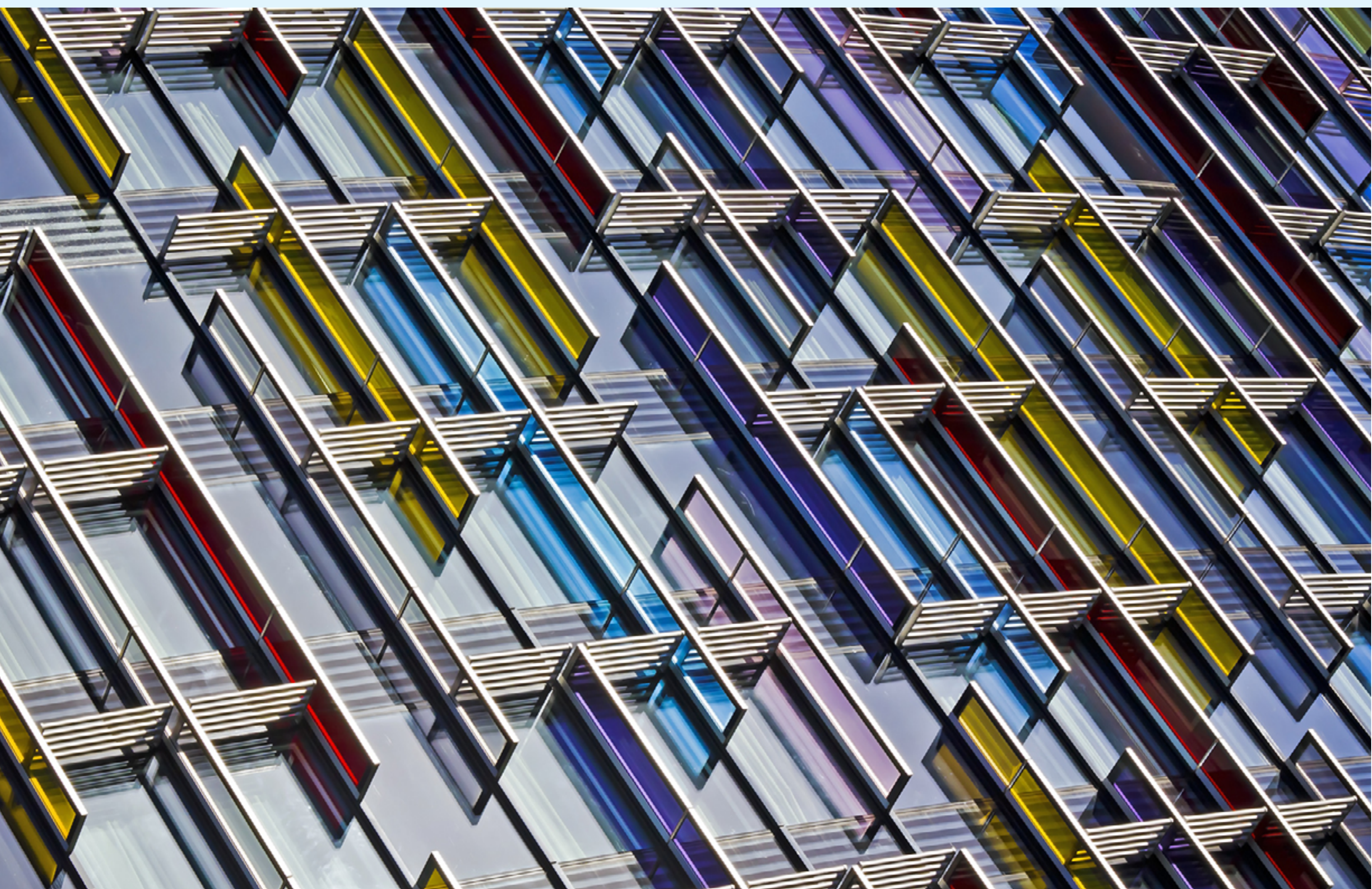
Prudent Practices for investment advisors

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

Prudent Practices for investment managers

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

Contents



Step 1: Organize

Step 2: Formalize

Step 3: Implement

Step 4: Monitor

2025 preface

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

What sets this review apart is our combined focus on the fiduciary standard and adherence to requirements of the ANSI National Accreditation Board (ANAB) under the ISO/IEC 17024 standard, a widely recognized standard for organizations that certify individuals. The Practices and Criteria found in this handbook serve as both a guide to investment fiduciary responsibility and as the standard to which candidates for the AIF® designation must demonstrate competence.

Following the ISO/IEC 17024 standard helps Broadridge ensure an objective process is followed with the involvement of appropriate subject matter experts and interested stakeholders.

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

For the second time, a full job task analysis, including a comprehensive survey distributed to all active AIF® and AIFA® Designees, was completed. More than 200 designees completed the survey, which measured the relative frequency and urgency each Practice and Criterion has in their day-to-day practices, and were asked to identify any gaps in the Practices. That exercise served to both validate the content of the Practices and to help Broadridge properly weight the AIF® exam to emphasize the most important tasks.

One of the encouraging aspects of this rigorous process is that it reinforced past review procedures and decisions. The twin duties of loyalty and care are constant, and as Broadridge has discovered when updating earlier editions, the reviews don't result in transformative changes to the Practices. Even still, the fiduciary standard is a dynamic process, and through statutory changes by legislative bodies, regulatory agencies, and the courts, it evolves in sometimes small but important ways that require fiduciaries to revise their policies and procedures accordingly. Thus, it is important to incorporate modifications as the legal environment changes for practicing fiduciaries. However, the Practices are rooted in basic precepts that define what it means to be a fiduciary and are not expected to change dramatically over time.

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

Moreover, the political environment in Washington, D.C., has resulted in partisan revisions to prevailing fiduciary requirements in regulation or law – only to have them reversed or substantially modified by a new administration or Congress. The dynamics of the ever-evolving fiduciary standard reflect the famous quote by Justice Frankfurter in SEC v. Chenery Corp., in which he observed, "To say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry." As such, this handbook and the accompanying substantiation that follows each Practice serve as a foundation for the reader.

The total number of Practices remains unchanged at 21, while the number of Criteria has slightly increased from 79 to 82. This change marks another step forward in refining the Prudent Practices and advancing the cause of fiduciary responsibility.

AICPA editorial statement to readers

The Personal Financial Planning (PFP) Division of the American Institute of Certified Public Accountants (AICPA) has served as the technical editor for the Prudent Practices for Investment Advisors (U.S. Edition) handbook since 2003.

The AICPA's participation in the development of the handbook is intended to promote and protect the interests of the consumer public and to perpetuate the delivery of competent and objective investment advice.

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

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

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

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

We gratefully acknowledge the invaluable contributions of the many CPAs who were instrumental in the review of the handbook. The PFP Division would also like to acknowledge the special efforts of:

- Clark M. Blackman II, Chair, MA, AIF, CPA/PFS, CFA, CFP, CGMA, AAMS
- Clark M. Blackman III, MS, CPA/PFS, CFA, CFP
- Anish Chopra, MA, FCPA, FCA, FCBV, CFA, CAIA, FRM
- Christopher R. Kowal, CFP
- Thomas J. Trainor, CPA, CA, PFS, CFA, CFP, CLU

The American Institute of CPAs® (AICPA®) is the world's largest member association representing the CPA profession, with 400,000 members in the United States and worldwide, and a history of serving the public interest since 1887. AICPA members represent many areas of practice, including business and industry, public practice, government, education, and consulting. AICPA sets ethical standards for its members and U.S. auditing standards for private companies, not-for-profit organizations, and federal, state, and local governments. It develops and grades the Uniform CPA Examination, offers specialized credentials, builds the pipeline of future talent, and drives continuing education to advance the vitality, relevance, and quality of the profession.

For more information about the AICPA PFP Division, visit the **AICPA Personal Financial Planning web page.**

About Broadridge

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

The Center for Fiduciary Studies

The Center for Fiduciary Studies oversees certain aspects of Broadridge's Accredited Investment Fiduciary® (AIF®), Accredited Investment Fiduciary Analyst® (AIFA®), and Professional Plan Consultant™ (PPC™) designations. The Center is the division of Fi360 that is responsible for the management of the certification program. It is composed of certain staff and the Certification Oversight Committee and its advisory commissions, which are tasked with making essential decisions related to standards, policies, and procedures of the certifications. They also make decisions regarding who is qualified to hold an Fi360 designation. One critical role the Center performs is validating the Prudent Practices as representative of the duties an advisor in a fiduciary role would be expected to perform.

> To learn more about Broadridge, visit **Broadridge.com**.

CEFEX

Broadridge is a founding member of the Centre for Fiduciary Excellence, LLC (CEFEX). CEFEX is an independent global assessment and certification organization dedicated to assisting investment stewards, advisors, managers, and financial service companies in applying the highest standards of fiduciary excellence in their investment management, governance, and operational processes. CEFEX also offers assessments and certification of recordkeeping and administrative organizations.

As an assessment and certification organization, CEFEX defines formal procedures to assess whether an investment fiduciary, or an organization providing services to an investment fiduciary, is in conformance with the Practices defined in this handbook and its companion handbooks.

> To learn more about CEFEX, visit **CEFEX.org**.

The Retirement Income Consortium

In 2022, Broadridge launched a Retirement Income Consortium to improve due diligence of retirement income offerings within retirement plans and facilitate adoption where they make prudent sense. The Consortium developed and released Prudent Practices for Retirement Income Solutions along with several other aids for advisors and plan sponsors considering retirement income solutions.

> To learn more about the Retirement Income Consortium, visit the **Broadridge Retirement Income Consortium web page**.

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 marketplace. 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)

Investment fiduciaries play a vital role in managing a significant amount of investments and wealth, impacting the fiscal health of nations globally. Their success or failure has serious consequences for millions of people around the world.

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. The prudent, objective processes that flow from those statutory requirements and case law make adherence to the core fiduciary principles practical and reliable.

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

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

Investment fiduciaries can be divided generally into three categories: Investment Steward, Investment Advisor, and Investment Manager.

- An Investment Steward is a person who has the legal responsibility for managing investment decisions (e.g., trustees and investment committee members).
- An Investment Advisor[1] is a professional who is responsible for providing investment advice and may also be managing investment decisions. Investment advisors include wealth managers, financial advisors, trust officers, financial consultants, investment consultants, financial planners, and fiduciary advisers.
- An Investment Manager is a professional who has discretion to select specific securities for separate accounts, mutual and exchange- traded funds, commingled trusts, and unit trusts.

[1] The terms "adviser" and "advisor" are used for different purposes throughout this publication.

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

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

The need for a global fiduciary standard of excellence

Recognized and substantiated standards of practice guide advisors in the performance of their fiduciary duties. Adherence to a standard can be the foundation for the trust placed in advisors by their clients, whether individuals or institutional investors.

Standards of excellence offer consistent interpretation and implementation, which facilitates the transfer of knowledge between the advisor, clients, vendors, and regulators.

> *"We cannot say that [Defendant] was imprudent merely because the Balanced Fund lost money; such a pronouncement would convert the Balanced Fund into an account with a guaranteed return and would immunize plaintiffs from assuming any of the risk of loss associated with their investment. 'The fiduciary duty of care,' as the district court so cogently stated it, 'requires prudence, not prescience.'"*
>
> *– U.S. Court of Appeals, 7th Circuit, 1990, in Debruyne v. Equitable Life Assurance Society, a suit filed by plan participants after the 1987 stock crash.*

The legal and performance pressures endured by investment advisors are tremendous and come from multiple directions and for various reasons. Complaints and/or lawsuits alleging fiduciary misconduct present real risk to fiduciaries. However, fiduciary liability is not determined by investment performance, but by whether a prudent process was followed.

In that regard, a fiduciary often will confuse responsibility with liability. An investment advisor to a pension plan or trust, for example, can never delegate away fiduciary responsibility. Fiduciary duties can be shared with other "co-fiduciaries," such as investment managers, but can never be handed over completely to another party. Although the investment advisor remains responsible as a fiduciary, the advisor can substantially mitigate the risk of liability by following prudent investment practices.

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

> *"I know of no case in which a trustee who has happened — through prayer, astrology or just blind luck — to make (or hold) objectively prudent investments ... has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand. Similarly, I know of no case in which a trustee who has made (or held) patently unsound investments has been excused from liability because his objectively imprudent action was preceded by careful investigation and evaluation. In short, there are two related, but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently."*
>
> *– Fink v. National Savings and Trust Co., 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia concurring in part and dissenting in part).*

The need for a global fiduciary standard of excellence

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

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

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

2. **Distinction as a fiduciary specialist:** Trillions of dollars in investable wealth are managed by trustees and investment committees. Investment advisors who want to distinguish themselves as leading professionals in their field should be able to demonstrate fiduciary skills, knowledge, and investment expertise as well as a sophisticated understanding of the law.

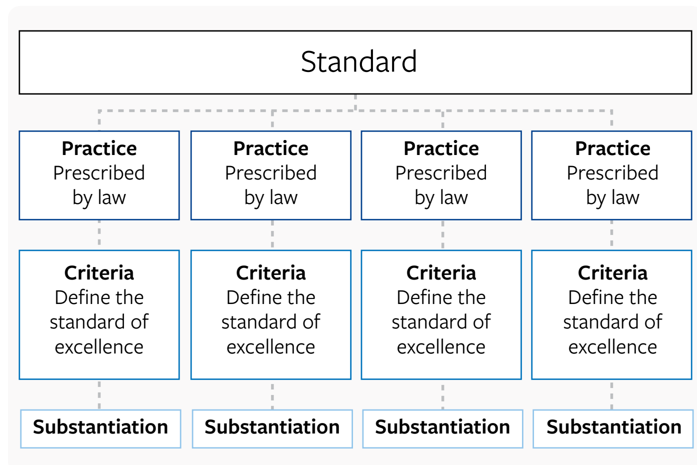
3. **Competitive advantage:** "Fiduciary responsibility" has become the watchword with trustees, investment committee members, and even retail investors. Investment advisors who can communicate clearly how they manage investment decisions to a defined fiduciary standard of excellence may enjoy an advantage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

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

Defining fiduciary excellence

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

Components of a standard of excellence
The practices and criteria are organized under a four-step fiduciary quality management system.



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

Step 1: Organize
During the organize stage, the investment fiduciary identifies laws, governing documents, and other sources of guidance for fiduciary conduct.

Step 2: Formalize
During the formalize stage, the investment fiduciary identifies the substantive investment objectives and constraints, formulates asset allocation strategies, and adopts an Investment Policy Statement to guide the investment decision-making process.

Step 3: Implement

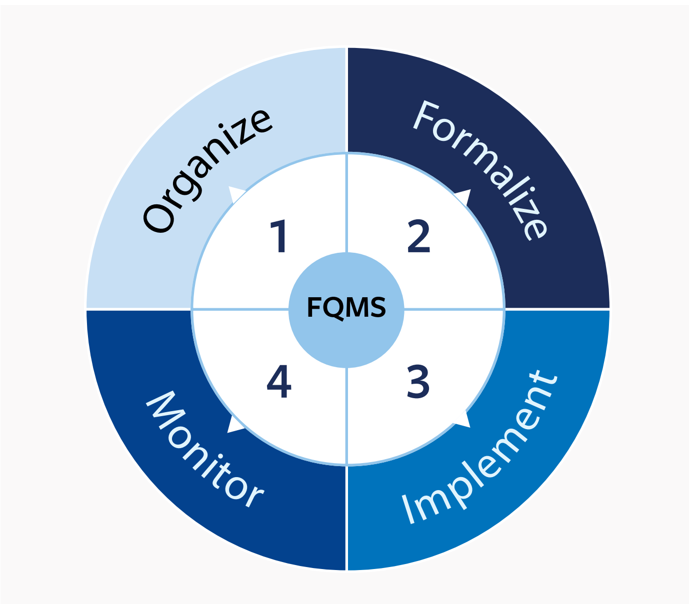
The implement stage is when investment and service provider due diligence is performed as part of the selection process, and decisions about investment safe harbors are made.

Step 4: Monitor

During the monitoring stage, the investment fiduciary engages in periodic reviews to ensure that the investment objectives and constraints are being met, service providers under the oversight of the advisor are performing necessary services at a reasonable cost, and the Prudent Practices are consistently applied.

Fiduciary Quality Management System (FQMS)

Analogous to the ISO 9000 QMS Continual Improvement Process



The Prudent Practices for investment advisors set forth in this handbook are similar to the Practices that have been defined for investment stewards, as one of the primary roles of the advisor is to help their steward clients manage their own fiduciary roles and responsibilities as investment fiduciaries.

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

The Practices are easily adaptable to all types of portfolios and clients (e.g. institutional or individual) regardless of size or intended use and should help accomplish the following:

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

Legal substantiation of practices

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

ERISA: The Employee Retirement Income Security Act of 1974, a federal law that impacts fiduciary responsibilities related to qualified retirement plans. Requirements under ERISA for qualified retirement plans are administered by the Department of Labor's Employee Benefits Security Administration, which issues regulations and regulatory guidance that further governs fiduciary obligations.

IAA: The Investment Advisers Act of 1940, a federal securities law that governs the regulation of investment advisers and their fiduciary responsibilities. The IAA is administered by the Securities and Exchange Commission (SEC), which issues regulations and regulatory guidance affecting investment advisers and their fiduciary responsibilities. State statutes similar to the IAA are typically administered by individual state securities commissioners.

UPIA: The Uniform Prudent Investor Act, is a widely adopted, state-level uniform act that covers fiduciary responsibilities related to private trusts. The UPIA was released by the Uniform Law Commission (ULC) in 1994 and subsequently endorsed by the American Bar Association and American Bankers Association. Most states have adopted the act as law, although differences may exist from state to state. The UPIA serves as a default standard for investment activities of private trusts. Typically, the provisions of a private trust prevail. However, if a trust document is silent regarding a particular fiduciary duty, such as the duty to diversify, then the provisions of the UPIA apply.

UPMIFA: The Uniform Prudent Management of Institutional Funds Act is a widely adopted, state-level uniform act that impacts foundations, endowments, and government-sponsored charitable organizations. UPMIFA was released in July 2006 by the ULC and has been adopted by most states and the District of Columbia.

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

To identify whether a state has adopted a uniform or model act, please visit Uniform Law Commission web site. *The advisor should seek guidance from qualified legal counsel on the fiduciary standard of care that is applicable in a particular state and whether any of the fiduciary practices covered in this handbook are not applicable.*

Global fiduciary precepts

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

We have adopted these eight requirements as "Global Fiduciary Precepts":

1. Know standards, laws, and trust provisions.
2. Diversify assets to specific risk/return profile of client.
3. Prepare investment policy statement.
4. Prudently select fiduciary and non-fiduciary service providers and document due diligence.
5. Control and account for investment expenses and other costs.
6. Avoid or manage conflicts of interest in favor of the client.
7. Monitor service providers and prudently manage service provider relationships.
8. Monitor and ensure conformity to fiduciary obligations owed to clients and beneficiaries.

We suggest that the investment advisor utilize the eight Global Fiduciary Precepts to assess the fiduciary framework in place for each plan sponsor or retail client relationship. An advisor could ask the following probing questions at the outset of the engagement:

- What laws and governing documents apply to guide your decision-making processes?
- How was the portfolio's current asset allocation determined?
- Is there an IPS? How frequently is it reviewed? When was the last time it was updated?
- What type of due diligence was performed on the investments that were considered and selected for the portfolio?
- What process was used to select service providers supporting administration and management of the portfolio? Has each service provider divulged whether they are acting in a fiduciary or non-fiduciary capacity?
- Have all fees and expenses paid to investment managers and other service providers been identified and found to be fair and reasonable?
- Is a retirement income or other hybrid income solution being considered by the plan sponsor or in a retail client engagement? Is the decision to select a retirement income product compliant with existing federal or state law?
- What policies are in place to identify and avoid or manage material conflicts of interest in a manner that serves investors' best interests?
- What type of periodic monitoring is applied to the investments in the portfolio and service providers?
- Is there a process in place to monitor fiduciaries and assure conformity to fiduciary practices?

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

Promoting a fiduciary culture

> "The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship ... This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own."
>
> – SEC Interpretation Regarding Standard of Conduct for Investment Advisers, June 2019, at 7-8.

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

Historians have traced the roots of fiduciary principles back to Babylon and the Code of Hammurabi (ca. 1790 BC), which established one of the first written codes of law and set forth the rules governing the behavior of agents entrusted with property. In the Judeo-Christian tradition, fiduciary principles can be traced to the biblical principle that no person can serve two masters. Chinese historical texts also recognize fiduciary principles of trust and loyalty. One of the three basic questions of self- examination attributed to Confucius (551 BC - 479 BC) asks: "In acting on behalf of others, have I always been loyal to their interests?" Aristotle (384 BC - 322 BC) consistently recognized that in economics and business, people must be bound by high obligations of loyalty, honesty, and fairness, and that society suffers when such obligations are not required.

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

Fiduciary relationships also have appeared in Anglo-American law for more than 250 years. Courts of Equity were the first to grant relief in numerous circumstances involving one person's abuse of confidence and fiduciary principles developed over time. Under U.S. law, in the seminal opinion given in Meinhard v. Salmon, Justice Benjamin Cardozo eloquently articulated the fiduciary standard when he wrote: "Not honesty alone, but the punctilio

of an honor the most sensitive, is then the standard of behavior." And finally, as demonstrated throughout this handbook, although fiduciary principles were first applied in U.S. common law, many elements of the fiduciary standard have been codified in both federal and state statutes.

Fiduciary obligations represent the highest standard of care in law or equity. The importance attached by various societies' views to relationships of trust in certain business arrangements reveals that concepts of fiduciary responsibility were established in primitive law and have withstood the test of time.

That significant extensive history should speak to the timeless gravity of an investment fiduciary's responsibilities, as well as the strength of the ethical standards to which fiduciaries are held.

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

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

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

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

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

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

– Dr. Robert Kennedy, University of St. Thomas

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

Legal limitations of the handbook

The fiduciary practices described in this handbook are intended to address many of the legal and ethical requirements applicable to investment advisors. In addition to those requirements, an advisor must also become familiar, and comply, with all other laws and regulations applicable to the advisor's particular field of practice and locality.

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

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

Step 1

Organize

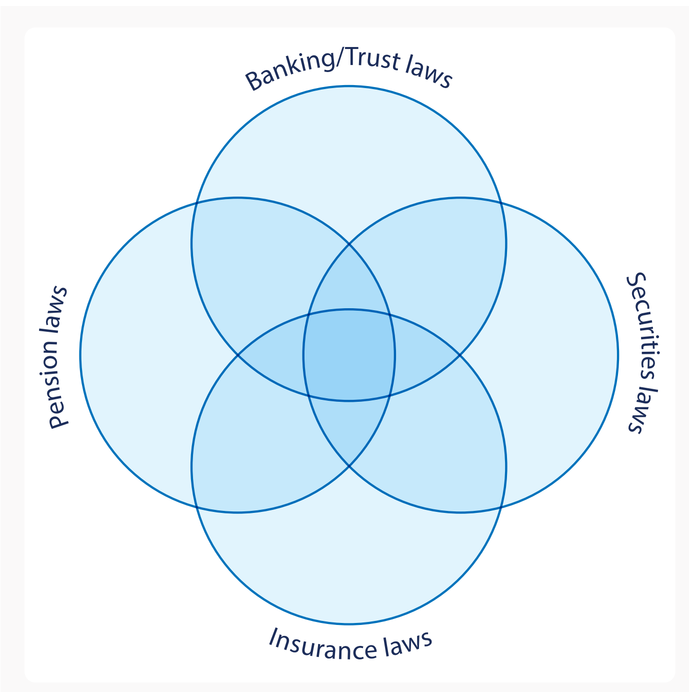
Step 1: Introduction

The first step of the Fiduciary Quality Management System is to organize your approach around the three potential types of "clients" referenced in this handbook — retail investor, retirement investor, and institutional client engagement.

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

The diagram below illustrates how, depending on the fiduciary services being offered by the advisor, various financial services laws may govern those activities.

Overlap of fiduciary services in financial laws



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

The overlap of fiduciary responsibilities is especially noteworthy when it comes to managing the assets in retirement plans or tax-advantaged accounts. Professionals registered under banking, securities, or insurance laws often provide advice to retirement accounts or sell related services or products to qualified plans, which aren't always subject to a fiduciary standard.

Similarly, securities brokers may be deemed fiduciaries for their investment advice to ERISA plans or individual retirement accounts as well as investment fiduciaries under securities law. More recently, the SEC and state insurance regulators have adopted "best interest" standards that are derived, in part, from the fiduciary standard in connection with retail securities or annuities transactions.

Investment adviser firms, in contrast, are always subject to a fiduciary duty under the Investment Advisers Act of 1940 (IAA), whether it involves retail investor, retirement investor, or institutional clients. In addition, many states also impose a fiduciary standard on investment advisers registered in those states.

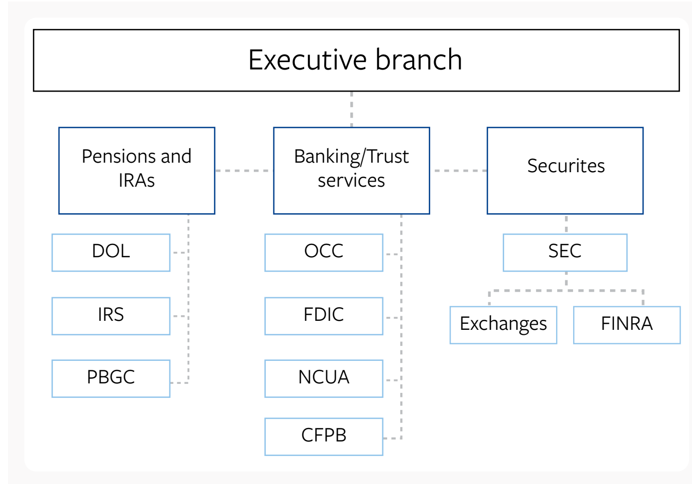
At first glance, the need to understand the scope of an investment advisor's fiduciary responsibilities may seem daunting, but with the increased regulatory focus on advice versus an arms-length transaction, the laws governing brokers, agents, and investment advisers are slowly beginning to merge under a fiduciary umbrella. As you apply the Prudent Practices in this handbook as a standard operating procedure, your awareness of your fiduciary role across different areas of federal and state regulation will come into greater focus.

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

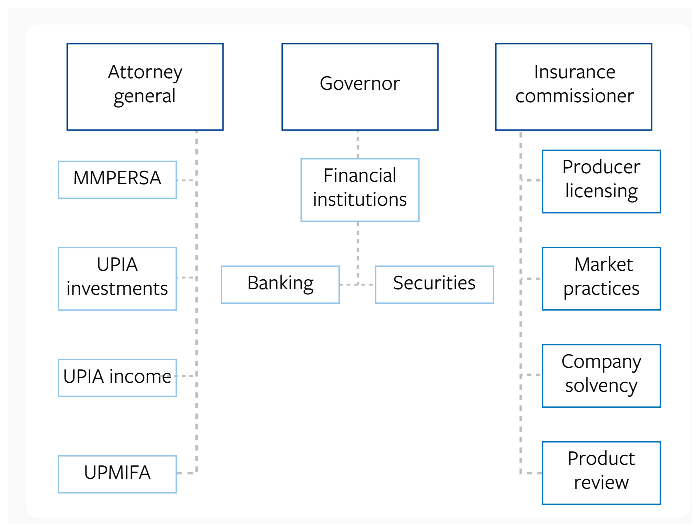
Note that federal oversight covers three of the four areas of law depicted in the illustration on page 18: namely, pensions and IRAs, banking and trust services, and securities statutes. State oversight typically covers state and local public employee pension plans, insurance companies doing business in a state, and small banks, trust companies, and investment advisers.

There is considerable variation in the oversight structure that exists across the 50 states, which is why the state-level chart is labeled as a "representative example." In all cases, it is best to consult with a lawyer to ensure you are aware of all levels of oversight that apply to your practice and services.

Federal oversight



State oversight – representative example



Practice 1.1

Demonstrate an awareness of fiduciary duties and responsibilities.

Criteria

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

1.1.2 The investment advisor complies with all applicable Practices and Procedures defined in this Prudent Practices handbook.

1.1.3 The investment advisor adheres to all applicable standards of conduct and code(s) of ethics required by law, regulation, employers, and professional organizations.

Fiduciary status under law

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

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

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

Robinhood Financial v. Sec'y of the Commonwealth (*Massachusetts*) is a recent example. In a case appealed to the state supreme court by Robinhood, a broker-dealer, on Aug. 25, 2023, the court held that the state had "expansive authority" to apply a fiduciary duty of care and loyalty to brokerage firms similar to the duty for investment advisers. Robinhood had sued the secretary of state, which oversees securities activities, for alleging that Robinhood violated the state's unethical and dishonest conduct rule by encouraging risky trading practices on its online investment platform.

With regard to insurance agents, Congress traditionally has deferred market regulation of insurance producers to the states. Historically, producers selling all lines of insurance have not been held to a fiduciary standard of care. However, the insurance marketplace has come under increasing scrutiny. In 2019, the National Association of Insurance Commissioners, the organization representing state insurance regulators, upgraded a model rule's suitability requirement for annuities transactions to a best interest standard, adopting provisions similar to those in the SEC's Regulation Best Interest rule covering securities brokers' advice to retail investors.

Advisors are obligated to determine if their professional activities entail fiduciary status and require registration with regulators. Fiduciary status under the IAA and similar state laws comes automatically with registration. Under ERISA the determinant is functional [most notably discretionary and nondiscretionary — Sections 3(38)and 3(21)].

Financial planners are generally required to register as investment advisers with either a state or the SEC, depending on the amount of assets under management.

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

Each of the following four circumstances generally gives rise to fiduciary status under federal and state laws and regulations:

1. Being named as a fiduciary in a trust document or similar legal instrument
2. Providing personalized advice about securities or other investment property for compensation
3. Exercising investment discretion
4. Having authority to name someone else as a fiduciary

Twin duties of loyalty and care

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

A fiduciary duty is also a "gap filler" when a client agreement, service contract, or the law is silent on a specific obligation of the advisor. The fiduciary duty of loyalty, for example, generally requires the advisor to avoid conflicts of interest or manage them in the best interest of the client.

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

Suggested procedure

Complying with all applicable standards related to your services requires assessing the scope of your advisory services, determining your fiduciary status under applicable laws and regulations, and understanding the obligations that apply to the specific client engagement. Fiduciary laws and regulations are intentionally principles-based. In contrast to rules-based regulations such as those administered by FINRA dealing with non-fiduciary sales practices, fiduciary laws and regulations are rarely highly prescriptive. They require professionals to serve clients' best interests by staying current with developments in their field and responding appropriately to changing economic, market, and social conditions, technology, and the body of knowledge in the profession.

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

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

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

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

Finally, to help retirement plan administrators and other institutional fiduciaries understand their fiduciary responsibilities to plan participants, many advisors regularly conduct fiduciary training. These fiduciary training sessions typically include content on fiduciary basics, updates on regulations, lessons learned from recent litigation, and insights on product trends.

In some recent class action settlements under ERISA, one of the conditions has been training for plan fiduciaries. For example, the settlement of the case of *Tracey v. Massachusetts Institute of Technology* required the plan fiduciaries to receive fiduciary training.

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)
Setting Every Community Up for Retirement Enhancement Act of 2019 §204

Regulations
29 C.F.R. §2550.404a-1

Final Rule – Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 1, 2022)
Final Rule – Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Workers & Retirees (Dec. 18, 2020)
Notice – Return of PTEs 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128 to pre-2016 Fiduciary Rule form, (July 7, 2020)

Case law
Hughes v. Northwestern University, 595 U.S. (2022); Tibble v. Edison, Int'l, 135 S. Ct. 1823, 59 E.B.C. 2461 (2015), on remand 843 F.3d 1187 (9th Cir. 2016) and 2017 WL 3523737 (C.D. Cal. 2017); Tussey v. ABB, Inc., 2012 WL 1113291 (W.D. Mo. 2012), aff'd in part 2014 WL 1044831 (8th Cir. 2014) and 2017 WL 929202 (8th Cir. 2017), Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009), 6:08-cv-03109-GAF (W.D. Mo. 2012); Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp.378 (D. Hawaii 1980); Katsaros v. Cody, 744 F.2d 270 (2d Cir. 1984), cert. denied, Cody v. Donovan, 469 U.S. 1072, 105 S. Ct. 565, 83 L. Ed. 2d 506 (1984); Donovan v. Mazzola, 716 F. 2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), cert. denied, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169

(1984); Fink v. National Savings and Trust Company, 772 F. 2d 951 (D.C. Cir. 1985); Metzler v. Graham, 112 F.3d 207 (5th Cir. 1997)

Robinhood Financial LLC v. Sec'y of the Commonwealth, 214 N.E. 3d 1058 (Mass. 2003)

Other

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

Investment Advisers Act of 1940 [IAA]

§202(a)(11) [Definition of an 'Investment Adviser']
§206(1), (2), (3), (4) [Anti-fraud provisions that apply to adviser's fiduciary obligations]
§203A(a)(1) [State authority over "small" RIAs]

Regulations

Investment Advisers Act Rule 203-1
[Application for Investment Adviser Registration]
Investment Advisers Act Rule 204-2
[Books and Records to Be Maintained by Investment Advisers]
Investment Advisers Act Rule 204-5
[Delivery of Form CRS]
Investment Advisers Act Rule 204A-1
[Investment Advisers Codes of Ethics]
Investment Advisers Act Rule 206(4)-1
[Investment Adviser Marketing]
Investment Advisers Act Rule 206(4)-6
[Proxy Voting by Investment Advisers]
Investment Advisers Act Rule 206(4)-7
[Compliance Procedures and Practices for Investment Advisers]

Case law

SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008); Scott E. DeSano, et al., SEC Adm Proc 3-12879A (Mar. 6, 2008); Strong Capital Management, Inc., et al., Investment Company Act Release No. 26448 (May 20, 2004); SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)

Other

Securities and Exchange Commission Interpretation Regarding Standard of Conduct for Investment Advisers (July 12, 2019)
SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (Apr. 20, 2023)
SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (last updated March 39, 2022)
Securities and Exchange Commission Risk Alert: Observations from Examinations of Newly-Registered Advisers (March 27, 2023).
Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers, NASAA Model Rule 102(a)(4)-1 (Adopted Apr. 27, 1997, Amended Apr. 18, 2004,
Sept. 11, 2005, Nov. 6, 2017, May 19, 2019, and May 16, 2022.)
Code of Ethics Guidance for Investment Advisers, i.e., personal securities transactions (June 26, 2015)

State Insurance Regulation

Suitability and Best Interests in Life Insurance and Annuity Transactions, New York Dep't. of Fin. Svcs. (11 NYCRR 224) (Adopted July 17, 2018; effective Aug. 1, 2019). The regulation, known as Insurance Regulation 187, was ultimately upheld by the highest court in New York State, the Court of Appeals. Matter of Independent Insurance Agents and Brokers of New York, Inc., et al. v. New York State Department of Financial Services, et al., 39 N.Y.3d 56 (2022).

Model Insurance Rule

2020 Revisions to Model #275 Suitability in Annuity Transactions Model Regulation (Spring 2020); Adopted in 11 states as of 5/18/21; Annuity Suitability & Best Interest Standard (naic.org)

Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, SEC Interpretive Release No. IA-1092, (Oct. 8, 1987)

Uniform Prudent Investor Act [UPIA]

§1(a); §2(a); §2(d)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c)

Model Management of Public Employee Retirement Systems Act [MMPERSA]

§7

Case law

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

Practice 1.2

Provide investments and investment services consistent with governing documents.

Criteria

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

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

Governing documents

Governing documents provide direction to fiduciaries as to how they are to carry out their obligations. Provided that such documents are consistent with applicable laws and regulations, fiduciaries are expected to follow instructions provided by governing documents.

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

While individual investors generally have fewer, less complex governing documents, they are no less important. A client engagement agreement between the advisor and an individual investor typically sets parameters for the relationship, compensation, and how investments are to be managed. Moreover, an investment policy statement for an individual investor is a particularly important governing document that must be followed for purposes of sound portfolio management and fiduciary risk mitigation. (See Practice 2.6 for additional discussion of this point.)

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

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

- Cash flow considerations
- Current and expected future assets
- Investment experience, expertise, and aptitude
- Requirements and prohibitions about the use of certain types of investments or investment strategies and tactics
- Risk tolerance and capacity
- Directives or limitations on delegations of decision-making authority as permitted by law.

Documentation of investment-related activity is generally required under "books and records" rules established by the SEC and state securities administrators for registered investment advisers. SEC Advisers Act Rule 204-2 requires that those records be held for five years, the first two years in an easily accessible location. DOL and FINRA rules generally require similar records to be held for six years.

Special considerations under ERISA

ERISA §404(a)(1)(D) requires a fiduciary to discharge its duties in accordance with the terms of the plan's governing documents insofar as the documents are consistent with ERISA. This means an ERISA fiduciary may not discharge its duties in a manner that is inconsistent with ERISA. Thus, if the terms of a plan's governing document do not comply with ERISA, it is ERISA, not the plan document, that governs.

Special considerations under the UPIA

Unlike the more restrictive constraints of ERISA, such as the duty to offer diversified investment options to retirement investors, under the UPIA, the prudent investor rule is a default standard that can be expanded, restricted, or otherwise altered by the provisions of the trust. For example, in contrast to ERISA's duty to diversify to minimize the risk of large losses, if the trust restricted portfolio investments to a certain asset class, such as cash or cash equivalents, the trust would not violate the default duty to diversify.

Special considerations for in-plan retirement income solutions

In recent years, Congress has tried to encourage the use of retirement income solutions in 401(k)-type plans, including insured income solutions (guaranteed), investment-based income solutions (non-guaranteed), and hybrid solutions (which offer a combination of investment-based and insured solutions). For more information, see the Prudent Practices for Retirement Income Solutions handbook from Broadridge.

In 2019, under the Setting Every Community Up for Retirement Enhancement Act, known as "SECURE Act 1.0," Congress established a new safe harbor for ERISA fiduciaries in the selection of a guaranteed income provider, the ability for participants to take distributions if the plan no longer offered the option, and separately, a new disclosure requirement to give participants an annual projection of their retirement income.

In SECURE Act 2.0, signed into law in 2022, Congress removed other impediments to using annuities in retirement plans by removing required minimum distribution barriers for lifetime annuities in qualified plans and IRAs, and in making qualifying longevity annuity contracts (QLACs) more attractive by increasing the account limits. Finally, the law allows for the use of so-called 'insurance-dedicated' exchange-traded funds (ETFs) in retirement plans and IRAs, by allowing the use of ETFs inside variable annuity contracts.

There are several special considerations involved for in-plan retirement income solutions. Advisors to retirement plans are encouraged to consult and apply Broadridge's Prudent Practices for Retirement Income Solutions when advising investment committees and other ERISA fiduciaries selecting, implementing, and monitoring retirement income solutions in their plan lineup.

For example, plan sponsors should distinguish between fiduciary decisions and settlor decisions when introducing retirement income solutions to the plan. Settlor decisions, unlike fiduciary decisions, are not subject to ERISA. Instead, they relate to business judgments for the organization. The plan sponsor (as settlor) may make the business decision to include one or more retirement income solutions in the plan to help attract and retain talent for the business. Subsequently, plan fiduciaries may be tasked to perform due diligence to prudently select specific solutions to carry out the settlor's decision. Governing documents of the plan typically need to be amended to properly incorporate retirement income solutions.

Special considerations under UPMIFA

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

Suggested procedure — Fiduciary file

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

- Disclosure documents, such as Form ADV, Part 2, ERISA 408(b)(2) and FINRA Form U-4
- Marketing materials and advertisements, including references or links to the firm's website and commentary in social media
- Client agreements
- Investment policy statements
- Written minutes and/or files from investment committee meetings
- Applicable plan and trust documents or account opening documents (including amendments)
- Custodial and brokerage agreements
- Service agreements involved with investment management and other vendors (custodian, money managers, investment consultant, actuary, accountant, and attorney)
- Information on investment managers retained by the retail investor, retirement investor, or institutional client
- Information reviewed to formulate recommendations to clients
- Copies of current prospectuses for each mutual or exchange-traded fund, variable annuity and other investment products
- Investment performance reports
- Plan objectives or demographics relevant to election of plan investments and services.

- Documentation of analysis of lifetime or hybrid retirement income solution providers' ability to pay future income obligations.

- Various forms of material client communications, including newsletters, follow-up correspondence after client meetings, acceptance of meeting minutes, specific written (and email) responses to client questions, including those in which the client takes a different course of action from those recommended by the advisor.

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

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(C); §104(b)(4); §402(a)(1); §402(b)(1); §402(b)(2); §403(a); §404(a)(1)(D); §408(b)(2)

Regulations
Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73822 (Dec. 1, 2022) (codified at 29 C.F.R. pt. 2550)

Case law
LaRue v. DeWolff, Boberg & Associates, Inc., 552 U.S. 248 (2008); Tussey v. ABB Inc., 746 F.3d 327 (8th Cir. 2014); Liss v. Smith, 991 F. Supp. 278, 1998 (S.D.N.Y. 1998); Dardaganis v. Grace Capital, Inc., 664 F. Supp. 105 (S.D.N.Y. 1987) aff'd, 889 F.2d 1237 (2d Cir. 1989); White v. Martin, 286 F. Supp. 2d 1029 (D. Minn. 2003)

Other
DOL Field Assistance Bulletin (FAB) 2007-01

Investment Advisers Act of 1940 [IAA]
§204(a); §205

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

Case law
In the Matter of Blackstone Alternative Credit Advisors LP, Blackstone Management Partners L.L.C. and Blackstone Real Estate Advisors LP, Advisers Act Release No. 6812 (Jan. 13, 2025); In the Matter of Colony Capital Investment Advisors, LLC, Investment Advisers Act Release No. 6671 (Sep. 3, 2024); In the Matter of Covenant Financial Services, LLC and Stephen Shafer, Investment Advisers Act Release No. 4672 (Mar. 29, 2017); In the Matter of Calvert Investment Distributors, Inc. and Calvert Investment Management, Inc., Investment Advisers Act Release No. 4696 (May 2, 2017); In the Matter of Aisling Capital LLC, Investment Advisers Act Release No. 4951 (June 29, 2018)

Other
Twelve Firms to Pay More Than $63 million Combined to Settle SEC's Charges for Recordkeeping Failures, SEC Press Release 2025-6 (Jan. 13, 2025); Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. 4509 (August 25, 2016); Recordkeeping Requirements for Investment Advisers, NASAA Model Rule 203(a)-2, (Adopted Sept. 3, 1987, amended May 3, 1999, Apr. 18, 2004, and Sept. 11, 2005)

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

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

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

Practice 1.3

Document the roles and responsibilities of all parties, whether fiduciaries or non-fiduciaries.

Criteria

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

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

Defining roles

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

Clearly defining the scope and fiduciary status of the advisor's engagement is particularly important at a firm where the advisor may also work in a non-fiduciary capacity providing other client services. Many investors assume that their financial advisor is acting solely in the investor's interests.

However, while most advisors will act ethically, they may not always be required by law to act as a fiduciary and to serve their client's best interest. The full scope of engagement and fiduciary protections should be clear to the client from the outset.

Special considerations under ERISA

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

Under certain ERISA provisions, investment advisors are required to acknowledge their fiduciary status. In particular, ERISA §3(38) requires investment managers to acknowledge in writing that they are fiduciaries, and regulations under ERISA §408(b)(2) require service providers (including advisors) to acknowledge fiduciary status for the specific services they will perform as fiduciaries. Currently, Prohibited Transaction Exemption (PTE) 2020-02 requires financial institutions and their investment professionals to acknowledge in writing fiduciary status prior to engaging in a transaction. [See Practice 3.1]

Suggested procedure

The investment policy statement should address how the fiduciary process will be implemented and who is responsible for carrying out each component of that process. [See Practice 2.6] Potential roles to be included in the IPS are the client (retail investor, retirement investor, or institutional), the advisor, custodian, recordkeeper, investment managers, and any other consultant or service provider engaged to provide expertise. For certain institutional clients, such as philanthropic organizations, the roles of the client's board and executive staff may also be delineated.

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

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

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

Practice 1.3

Substantiation

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

Regulations
29 C.F.R. 2550.408(b)-2(c)(1)(iv)(B); Prohibited Transaction Exemption (PTE) 2020-02, Improving Investment Advice for Workers & Retirees, 85 Fed. Reg. 82798 (Dec. 18, 2020)

Case law
Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378

1 (D. Hawaii 1980); Katsaros v. Cody, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), cert. denied, Cody v.

Donovan, 469 U.S. 1072 (1984); Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y. 1977), aff'd,572 F.2d 894 (2d Cir. 1978); Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983), cert. denied, 464 U.S. 1040, 104 S. Ct. 704 (1984); Fink v. National Savings and Trust Company, 772 F. 2d 951 (D.C. Cir. 1985); Ellis v. Rycenga Homes, 484 F. Supp. 2d 694 (W.D. Mich. 2007); Jenkins v. Yager, 444 F.3d 916 (7th Cir. 2006)

Other
Department of Labor Field Assistance Bulletin (FAB) 2007-01
Meeting Your Fiduciary Responsibilities, EBSA, Date of publication unknown
Fiduciary Responsibilities, EBSA, Date of publication unknown

Investment Advisers Act of 1940 (IAA)
§205(a)(2)

Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)]; amended Aug. 23, 2023

Other
Risk Alert: Observations from Examinations of Newly-Registered Investment Advisers, prepared by the SEC Division of Examinations (Mar. 27, 2023)

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

Other
Restatement of Trusts 3d: Prudent Investor Rule §171 (1992)
Uniform Prudent Management of Institutional Funds Act [UPMIFA] §3(b); §3(c)

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

Case law
National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L. Ed. 2d 672 (1981)
Sacerdote v. N.Y. Univ., S.D.N.Y., No. 1:16-cv-06284-KBF (2018)

Practice 1.4

Identify, then avoid or manage, material conflicts of interest in a manner consistent with the duty of loyalty.

Criteria

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

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

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

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

Material Conflicts

The fundamental duty of the fiduciary advisor is to act in the best interest of their client or the client's beneficiaries in providing investment recommendations or portfolio management services. In addition, the advisor is obligated to be objective and diligent in the performance of duties conducted on behalf of the client. If a client is harmed by the advisor's conflict of interest, then a breach of the fiduciary duty of loyalty has occurred.

A good working definition of a material conflict of interest is any circumstance that brings fulfillment of the duty of loyalty into question. It is the circumstance itself that creates the conflict. There is no such thing as a "potential" conflict; the conflict either exists or it doesn't. Whether a conflicted party's conduct changes because of the conflict is a separate matter.

It is important to note that ERISA and the Internal Revenue Code prohibit fiduciary conflicts of interest (material or otherwise) absent an exemption. Management of the conflict by an investment fiduciary is satisfied only if a prohibited transaction exemption is available under ERISA, and if its conditions are met.

Fiduciaries are responsible for identifying conflicts in order to disclose them and manage them. The very suspicion of a material conflict of interest usually means that one does, in fact, exist. The best solution is to avoid situations or relationships that give rise to conflicts. However, no advisor is conflict-free, and it is sometimes preferable for a conflict to exist and be managed in the best interest of the client.

Compensation conflicts

It is not merely the receipt of compensation by an advisor that gives rise to a conflict; how the advisor is paid (specifically, financial incentives associated with the implementation of specific products or services) can compound the conflict. Financial services regulations frequently allow an advisor who acts in a fiduciary capacity to also hold licenses to sell related products or services in a non-fiduciary capacity. Therefore, managing conflicts in a client relationship can be a complex ethical and legal challenge. In an environment where cross-selling is legally permitted, or even encouraged, and a firm's compliance policies are structured to cover the activities of thousands of financial advisors, the advisor's ability to manage a conflict on his or her own may be limited. No matter the size or complexity of the firm's business model, however, material conflicts of interest that are not already addressed under its compliance procedures should be brought to the attention of management and addressed accordingly. Ideally, compliance procedures for addressing conflicts should focus on promoting a fiduciary culture within the firm.

The most serious and problematic conflict of interest involves self-dealing, when the fiduciary directly benefits from a transaction with the client (beyond receiving fully disclosed, reasonable compensation for the services provided). ERISA describes three fiduciary prohibited transactions, and the Internal Revenue Code identifies two fiduciary prohibited transactions for Individual Retirement Accounts, which are only allowed if certain conditions are met. The IAA also contains restrictions on self-dealing by a registered investment adviser, such as selling stocks or bonds out of a firm's own inventory (i.e., principal transactions).

Far subtler and challenging is managing conflicts when an adviser is providing fiduciary and non-fiduciary services to the same client. "Changing hats" from acting in a fiduciary capacity to a non-fiduciary capacity can be a source of confusion for clients as they are often unaware of the differences between the fiduciary and fair dealing (suitability) standards of conduct. That confusion is of concern to regulators and professional organizations; consequently, "hat changing" is under increasing scrutiny.

Existing rules are often not uniform across regulatory jurisdictions or among different advisory firms. Investment advisors who engage in "hat changing" should seek guidance from legal counsel and/or qualified compliance personnel to establish policies and procedures to conform to regulatory or company-imposed requirements.

As a best practice, advisors who engage in "hat changing" should provide clear written disclosure to, and receive informed written consent from, the client prior to switching between fiduciary and non-fiduciary roles. The disclosure and consent should directly address the differences in conflicts of interest that may arise and how they are handled when the advisor changes roles.

Fiduciary trends: "Best interest" standards

Fiduciary rulemaking has been a constantly evolving landscape since the Department of Labor's initial attempt at a revised definition of "fiduciary" in 2010. The rule was withdrawn and re-introduced in 2016. An industry legal challenge resulted in its vacatur two years later by a federal appeals court. In separate class-action complaints, federal courts have been actively addressing claims related to what constitutes fiduciary decisions related to specific advisory activities, such as rollover advice, selection of high-cost share classes, and certain plan investments. Some of the settlements have come at a high cost to plan sponsors. For example, between 2015 and 2023, plaintiffs garnered more than $470 million in settlements from financial institutions using affiliated funds in their 401(k) plans.

Ultimately, the goal for regulators is to cut down on the most damaging conflicts of interest. One of the substitutes to a fiduciary standard for commission-based brokers adopted in 2019 and 2020 is a quasi-fiduciary, or "best interest" standard. According to a June 5, 2019, SEC press release, Regulation Best Interest – or Reg BI – "imposes a new standard of conduct specifically for broker-dealers … The standard of conduct draws from key fiduciary principles and cannot be satisfied through disclosure alone." Reg BI requires brokerage firms to "act in the best interest of a retail customer" when recommending securities products or investment strategies, according to the press release.

A separate but parallel drafting process was undertaken at the same time by the National Association of Insurance Commissioners (NAIC), which upgraded its suitability requirements for annuity transactions by state-licensed insurance producers to include a "best interest" standard. However, both rulemakings disclaimed fiduciary status.

> To identify whether a state has adopted the 2020 Suitability in Annuity Transactions Rules, please visit the NAIC's website.

Special considerations under ERISA and MMPERSA

Investment advisors must not only be careful to avoid committing fiduciary breaches, they should also be alert to breaches of fiduciary duty committed by other fiduciaries. All fiduciaries to a retirement plan are obligated to act in the best interests of the participants and beneficiaries, without regard to which party pays the fees. If one plan fiduciary becomes aware of another co- fiduciary's breach, or undertakes to conceal it, both are personally liable under ERISA. No agreement can exonerate fiduciaries from liability, although special insurance coverage may be available to the sponsoring institution and advisory firm.

Like ERISA, MMPERSA borrows trust law in articulating "the well-recognized trust duty of loyalty" or, in other words, "not to be influenced by the interest of any third person." Fiduciaries to public employee retirement plans also should be aware of any additional stakeholders to whom a fiduciary duty is owed. In some states, the stakeholders could include the employer or taxpayers. Rules will vary from state to state, so advisors should seek legal opinion to understand the full extent of their fiduciary duties.

(For a more detailed discussion of disclosing and managing conflicts of interest under ERISA, please see Practice 3.1, including "Special Considerations Under ERISA.")

Special considerations under the IAA

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

- An investment manager or advisor is associated with a custodian, investment company, broker- dealer, insurance company, or bank where other services and products are cross- marketed and sold by the advisor or others
- An advisor is dually registered as a broker and executes principal trades on behalf of the client from the firm's own inventory
- An investment manager is acting as a sub- advisor to a separately managed account (wrap-fee account) and directs trades to a particular broker-dealer
- An advisor hires an investment manager or other service provider for a reason other than merit
- An advisor recommends that a new or prospective client roll over a 401(k) account into an IRA that he or she will manage
- An advisor compensated by asset management fees recommends that a client invest a portion of the portfolio in non-marketable, non-securities products, such as real estate, a private offering, or an annuity, and charges their AUM fee on the "market-value" of the asset

Suggested procedure

It is critical for the advisor to be aware of material conflicts of interest, recognize that the conflicts associated with each client may be unique, and evaluate how each conflict should be handled. The advisor should examine the nature and scope of each conflict, decide if it is a material conflict, and respond accordingly. A conflict is material when a reasonable client would consider the conflict important in making a decision about a recommendation from the advisor.

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

When a material conflict is not avoided, disclosure is required. It is important to keep in mind, however, that disclosure is not always satisfied through delivery and signed receipt of boilerplate language. The general instructions for Form ADV, Part 2 remind registered investment advisers that some of the information that must be disclosed by a fiduciary may not be specifically required by Part 2. If the advisor knows or should have known, or has reasonable grounds to believe, that the client is not sufficiently informed, then "sufficiently specific facts" are required so that the client can give informed consent to either accept the conflict and the advice or not approve the conflict and reject the conflicted advice. However, if the advice is demonstrably not in the client's interest, it is not reasonable to expect a client giving consent was sufficiently informed.

Disclosures of conflicts should inform clients of the scope and extent of any conflicts, so that clients can have the information needed to adequately evaluate the conflict. Disclosures should affirmatively state when a recommendation is conflicted and conditional language (such as there "may" be a conflict) should not be used.

Additionally, disclosure alone does not relieve the advisor from the duty of loyalty. Conflicted advice that is not reasonably formulated to serve the client's best interest is a fiduciary breach. Most client complaints relate to advice rendered at some time in the past and they are evaluated in hindsight during arbitration, litigation, or a regulatory action. The risk of mitigating a conflict rather than avoiding it is that facts and circumstances may change. Mitigation that may have been reasonably believed to be adequate at the time of the initial analysis may not be sufficient when the situation has evolved to make the conflict more problematic.

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

Suggested procedures under the IAA or state law

- Review compliance requirements under conflict-of-interest provisions of applicable law. Identify which conflicts are addressed in writing in standard documents, such as in Form ADV, Part 2, versus any other conflicts routinely encountered where clients may need to be furnished with additional, specific information on a timely basis.

- The SEC requires designation of a chief compliance officer by each registered investment adviser and adoption of a code of ethics for personal trades and for other activities by firm employees. As a best practice, the RIA may maintain a record of conflicts encountered by the firm on a regular basis, and how these conflicts are routinely addressed to fulfill the duty of loyalty to clients.

- In 2020, NASAA also approved a similar compliance rule for adoption by state securities regulators covering state-registered investment advisers. The model rule includes designating a chief compliance officer. As a general requirement, the adviser must adopt written compliance policies and procedures and review them at least once a year for their effectiveness.

- Although there is no single accepted method for adopting compliance procedures and fiduciary best practices, consider two complementary ones: a risk matrix, or inventory, that identifies material conflicts of interest encountered in your firm, and an action plan to prioritize and avoid or manage conflicts in the best interests of clients. Test conflict resolution procedures for effectiveness at least once a year.

- In a firm environment where procedures to address conflicts of interest are formulated and managed centrally by a CCO or compliance officer, establish a protocol for advisors to obtain guidance to handle conflicts not covered by established procedures.

Suggested procedures under ERISA and the Code

- Identify the prohibited transactions that you may encounter in your practice and available exemptions to manage them.

- Comply with prohibited transaction exemption (PTE) requirements, including required disclosures of compensation [see Practice 3.2].

- As best practices, inventory conflicts of interest in a risk matrix and develop an action plan to prioritize and avoid or properly manage conflicts in the best interest of plan participants and beneficiaries. In effect, the conditions in PTEs describe the proper management of conflicts of interest.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]
§4975(c)(1)(E) and (F); §4975(d)

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

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

Case law
Whitfield v. Tomasso, 682 F. Supp. 1287 (E.D.N.Y 1988); Tussey v. ABB, Inc., 746 F.327 (8th Cir. 2014).

Other
DOL ERISA Advisory Council, Outsourcing Employee Benefit Plan Services, U.S. Department of Labor (2014)
DOL ERISA Advisory Council, Mandated Disclosure for Retirement Plans – Enhancing Effectiveness for Participants and Sponsors, U.S. Department of Labor (2017)
DOL Advisory Council, Fiduciary Responsibilities and Revenue Sharing Practices, (Nov. 7, 2007)
DOL Prohibited Transaction Exemption 2020-02, 85 Fed. Reg. 82798 (Dec. 8, 2020)

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

Regulation
17 C.F.R. §275.204-3; 17 C.F.R. §275.204A-1; 17 C.F.R. §275.206(4)-7
Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationship with, Hedge Funds and Private Equity Funds, SEC Release BHCA-9 (June 25, 2020)
Form CRS Relationship Summary; Amendments to Form ADV, 34-86032, IA-5247 (June 5, 2019)

Case law
In the Matter of Credit Suisse Securities (USA) LLC, Investment Advisers Act Release No. 4678 (Apr. 4, 2017); In the Matter of Cadaret, Grant & Co., Inc. Investment Advisers Act Release No. 4736 (Aug. 1, 2017); In the Matter of Institutional Investors Advisory Company, Investment Advisers Act Release No. 4747 (Aug. 16, 2017); In the Matter of Envoy Advisory, Inc., SEC Investment Advisers Act Release No. 4764 (Sept. 8, 2017); In the Matter of Suntrust Investment Services, Inc., SEC Investment Advisers Act Release No. 4769 (Sept. 14, 2017); In the Matter of Financial Fiduciaries, LLC and Thomas Batterman, Investment Advisers Act Release No. 4863 (Mar. 5, 2018); In the Matter of Securities America Advisors, Investment Advisers Act Release No. 4876 (Apr. 6, 2018); In the Matter of WCAS Management Corporation, Investment Advisers Act Release No. 4896 (Apr. 24, 2018); In the Matter of Lyxor Asset Management, Inc., Investment Advisers Act Release No. 4932 (June 4, 2018); In the Matter of Michael Devlin, Investment Advisers Act Release No. 4973 (July 19, 2018); In the Matter of American Infrastructure Funds, LLC, Investments Advisers Act Release 6428 (Sep. 22, 2023); In the Matter of Closed Loop Partners, LLC, Investment Advisers Act Release No. 6712 (Sep. 20, 2024)

Other
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)
Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (FAQ) (Updated Mar. 30, 2022)
Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (FAQ) (Aug. 3, 2022)
Risk Alert: Division of Examinations Observations: Investment Advisers' Fee Calculations (Nov. 10, 2021)
Risk Alert: Observations from Examinations of Investment Advisers Managing Client Accounts That Participate in Wrap Fee Programs (July 21, 2021)
Risk Alert: OCIE Observations: Investment Adviser Compliance Programs (Nov. 19, 2020)
Risk Alert: Observations from OCIE's Examination of Investment Advisers: Supervision, Compliance and Multiple Branch Offices (Nov. 9, 2020)
Risk Alert: Observations from Examinations of Investment Advisers: Compliance, Supervisions, and Disclosure of Conflicts of Interest (July 23, 2019)
Risk Alert: Examinations that Focus on Compliance with Form CRS (Apr. 7, 2020)
Heitman Capital Management et al., SEC No-Action Letter (Feb. 12, 2007); NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, Model Rule 102(a)(4)-1
(Adopted April 27, 1997, Amended April 18, 2004 and Sept. 11, 2005)
SEC Share Class Selection Disclosure Initiative
(updated on May 1, 2018)

Securities Exchange Act of 1934

Regulation
Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, 33-10765, etc. (May 18, 2020)
Regulation Best Interest: The Broker-Dealer Standard of Conduct, 34-86031 (June 5, 2019)
Form CRS Relationship Summary; Amendments to Form ADV, 34-86032, IA-5247 (June 5, 2019)

Other
Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest (Jan. 30, 2023)
Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (FAQ) (Aug. 3, 2022)
Risk Alert: Examinations that Focus on Compliance with Regulation Best Interest (Apr. 7, 2020)
Risk Alert: Examinations that Focus on Compliance with Form CRS (Apr. 7, 2020)
Interpretative Rule: Commission Interpretation Regarding Standard of Conduct for Investment Advisers IA-5248 (June 5, 2019)

State Securities Laws

Regulation
NASAA Model Rule for Investment Adviser Written Policies and Procedures Under the Uniform Securities Acts of 1956 and 2002
(Adopted 11/24/2020)

Practice 1.4

State Insurance Laws

Regulation
Model #275: Suitability in Annuity Transactions Model Regulation (Spring 2020)

Other
MDL #275 Best Interest Standards Revisions (FAQs) (May 10, 2021)

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

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

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

Practice 1.5

Execute written agreements that are consistent with fiduciary obligations.

Criteria

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

1.5.2 The investment advisor provides a written description and scope of services to be provided in the service agreement.

1.5.3 If the investment advisor is responsible for oversight of other service providers, the advisor must evaluate all material compensation, affiliations, and the fiduciary status of each service provider.

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

1.5.5 Comparative reviews of service agreements for which the investment advisor is responsible are conducted and documented approximately every three years.

Written agreements

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

Many of the most critical disclosures are now mandated by law, such as Form ADV, Part 2 under the IAA and Department of Labor 408(b)(2) regulation under ERISA. Those laws may, however, require different types of disclosures.

Disclosures of affiliates are required by Form ADV. Under Rule 408(b)(2), both fiduciary and non-fiduciary services provided to a retirement plan must be fully disclosed.

Consistent with these obligations, if an investment advisor exercises discretion over the investment of assets of an ERISA plan, the advisor should be appointed by written agreement as an investment manager under ERISA §3(38), so that the plan fiduciaries are afforded relief from fiduciary liability for investment decisions made by the investment manager. Similarly, an investment advisor exercising discretion over retail client assets should disclose in the client agreement or IPS the frequency of ongoing monitoring and trading activities.

Consistent with the duty of care, investment fiduciaries who lack the requisite knowledge required to prudently manage certain investments or elements of the investment management process should seek assistance from outside professionals.

Construction and management of portfolios with complex investments or investment strategies may be delegated to qualified investment managers or consultants. For example, special expertise may be required to evaluate, select, and oversee retirement income solutions that are increasingly used in defined contribution plans to help manage the distribution phase of retirement. These solutions may involve special systematic withdrawal services or guaranteed lifetime income insurance products that are designed to manage longevity, legacy, liquidity, and other risks retirees face. (See Prudent Practices for Retirement Income Solutions for definitions.)

When hiring such professionals, any agreement of substance should be in writing and define the scope of the parties' duties and responsibilities. Written service agreements help ensure that the parties have a clear, mutual understanding of their roles and responsibilities, and that terms of the agreements can be readily checked for conformity to other governing documents. All such agreements should be prepared or reviewed and approved by knowledgeable legal counsel.

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

Suggested procedure

Advisory contracts and other service agreements should be reviewed at least annually as a best practice to ensure that the services being provided are consistent with agreements and that the investors' best interests continue to be served. (Note that governing documents may specify other circumstances that require a review to be conducted. In those cases, the governing documents should be followed.) Reviews should apply sound due diligence to evaluate relevant information about competitive providers in the marketplace.

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

- A change in the depth, breadth, or scale of services needed may make a different service provider better suited to the client's needs than the existing provider.
- The transition costs and administrative burdens placed on the advisor and clients resulting from a change in providers (e.g. the custodian).
- Rising competition and falling prices may change market-place dynamics.
- The scope of services offered by the existing service provider has changed.
- New technology offers the opportunity to secure improved services and/or lower costs elsewhere.
- New competitors have entered the marketplace and are seeking to expand market share through aggressive pricing and other incentives.

- Material and potentially adverse financial, qualitative, or organizational changes of a current retirement income solutions provider may threaten reliable payment of future insured income (e.g., financial strength rating downgrade) or the general performance of the solution.

- Changes in applicable laws or regulations require different services than the current vendor provides.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]
§4975(d)(2)

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

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

Regulations
29 C.F.R. §2550.408b-2 generally and specifically subsections (c) and (d)

Other
DOL Field Assistance Bulletin 2007-01; DOL Field Assistance Bulletin 2012-02R

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

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

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

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

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

Practice 1.6

Prudently protect sensitive personal identifying information and assets of clients from theft, embezzlement, business disruption, and cybersecurity risks.

Criteria

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

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

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

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

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

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

Safeguarding client assets

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

The advisor must ensure that assets entrusted to their firm or a third-party custodian are within the jurisdiction of a court of law where a viable claim can be brought. Well-established judicial authority gives courts the ability to exercise jurisdiction and take action when a judge and/or a regulator determines the best interests of the client are not being served.

Regulated U.S. investment companies, such as mutual funds, that hold assets outside the U.S. (for example, investments in foreign securities) are required to comply with SEC Rule 17f-5 (which contains many of the safeguards of Practice 1.6), so an advisor can reasonably rely on the fiduciary obligation having been fulfilled. If a client, however, is investing in foreign securities or has assets that are held in custody outside of the U.S. by an entity that is not a U.S. registered investment company, legal counsel should be consulted to ensure that the foreign laws impose appropriate requirements that protect portfolio assets.

Cybersecurity

Internet technology allows plan data and assets to be accessed from almost anywhere in the world. Cybercrime is a real threat and a growing problem. Fiduciary account information is a particularly attractive target because it often contains personal information, such as Social Security numbers, as well as financial data, such as balances and deposit information. The National Institute of Standards and Technology Cybersecurity Framework (CSF) 2.0 suggests a five-part framework for managing cybersecurity risk. Their publication is available free of charge.

1. **Identify** the organization's current cybersecurity risks

2. **Protect** assets and operations through appropriate safeguards at multiple levels

3. **Detect** possible cybersecurity attacks and compromises through ongoing monitoring

4. **Respond** to cybersecurity incidents by taking action to manage, analyze, and mitigate the incident and contain the impact, and through required or appropriate reporting and communication

5. **Recover** assets and operations compromised from a cybersecurity incident

In addition to this five-part framework for clients, in April 2021, the U.S. Department of Labor announced new guidance for plan sponsors, plan fiduciaries, record keepers and plan participants on best practices for maintaining cybersecurity, including tips on how to protect the retirement benefits of workers. This guidance includes three forms:

- **Tips for hiring a service provider:** Helps plan sponsors and fiduciaries prudently select a service provider with strong cybersecurity practices and monitor their activities, as ERISA requires.

- **Cybersecurity program best practices:** Assists plan fiduciaries and record-keepers in their responsibilities to manage cybersecurity risks.

- **Online security tips:** Offers plan participants and beneficiaries who check their retirement accounts online basic rules to reduce the risk of fraud and loss.

This additional cybersecurity guidance is focused on helping plan sponsors, fiduciaries, and participants safeguard their retirement benefits and personal information.

Finally, in May 2024, the SEC approved amendments to Regulation S-P (Privacy of Consumer Financial Information and Safeguarding Customer Information), which among other updates will require registered investment advisers and broker-dealers to adopt written policies and procedures to establish incident response programs for dealing with unauthorized access to customer information. The required policies and procedures will include procedures for notifying individuals whose "sensitive customer information" was or was likely to have been accessed improperly following a reasonable investigation of the incident. Notification will have to be given as soon as practicable, but not more than 30 days after the institution learns of the unauthorized access. These new requirements will apply to larger institutions beginning December 3, 2025, and smaller institutions beginning June 6, 2026.

Special consideration under ERISA

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

Suggested procedure

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

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

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

Substantiation

Internal Revenue Code of 1986, as amended [IRC], §6001

Other
IRS Revenue Procedures 97-22 and 98-25

Employee Retirement Income Security Act of 1974 [ERISA]
§107; §404(b); §405; §412(a)

Regulations
29 C.F.R. §2550.404b-1
29 C.F.R. § 2520.104b-1
29 C.F.R. §2520.107-1

Case law
Varity Corporation v. Howe, 516 U.S. 489, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996); Estate of Barton v. ADP Security Services Pension Plan, 820 F.3d 1060 (9th Cir. 2016)

Other
H.R. Report No. 931280 (93rd Congress, 2d Session, Aug. 12, 1974)
DOL Field Assistance Bulletin (FAB) 2008-04
ERISA Advisory Council on Employee Welfare and Pension Benefit Plans, Report on Cybersecurity Considerations for Benefit Plans, U.S. Department of Labor (November 2016)
ERISA Advisory Council on Employee Welfare and Pension Benefit Plans, Recordkeeping in the Electronic Age, U.S. Department of Labor (December 2023)
News Release: U.S. Department of Labor Announces New Cybersecurity Guidance for Plan Sponsors, Plan Fiduciaries, Recordkeepers, Plan Participants (Apr. 14, 2021)
EBSA Tips for Hiring a Service Provider With Strong Cybersecurity Practices (April 2021)
EBSA Cybersecurity Program Best Practices (April 2021)
EBSA Online Security Tips (April 2021)

Investment Advisers Act of 1940 (IAA)
15 U.S.C. 80b

Regulations
Investment Advisers Act Rule 204-2 [Books and Records to be Maintained by Investment Advisers] (reflecting updates to recordkeeping requirements under Regulation S-P)

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

Regulation S-P
17 C.F.R. § 248.1 et seq.

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

Other
SEC Risk Alert: Safeguarding Customer Records and Information at Branch Offices (Apr. 26, 2023)
SEC Risk Alert: Observations from Broker-Dealer and Investment Adviser Compliance Examinations Related to Prevention of Identity Theft Under Regulation S-ID (Dec. 5, 2022)
SEC Risk Alert: Safeguarding Client Accounts against Credential Compromise (Sept. 15, 2020)
SEC Risk Alert: Cybersecurity: Ransomware Alert (July 10, 2020)
SEC Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019)
SEC Cybersecurity Risk Alert: Observations From Cybersecurity Examinations (Aug. 2017)
SEC Cybersecurity Risk Alert: OCIE's 2015 Cybersecurity Examination Initiative (Sept. 2015)
The National Institute of Standards and Technology Cybersecurity Framework (CSF) 2.0 suggests a five-part framework for managing cybersecurity risk.

Investment Company Act
§17(f)

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

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

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

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

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

Best Practices on Cybersecurity
National Institute of Standards and Technology Cybersecurity Framework 2.0, Final (February 26, 2024.)

Step 2

Formalize

Step 2: Introduction

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

Formalizing the investment policy is not an isolated process, but rather builds upon the analysis conducted in the previous "Organize" step. At this stage, the fiduciary advisor must utilize their investment experience and investment theory to apply the principles of investment allocation, regardless of whether the IPS is designed for a retirement investor, retail investor, or institutional client. Based on current legal trends, a prudent expert is clearly expected to understand Modern Portfolio Theory (MPT) and apply generally accepted investment theories to the investment process. The first five Practices of this step pertain directly to asset allocation and MPT concepts.

The sixth Practice in Step 2 addresses the importance of having a well-drafted investment policy statement ("IPS") to guide investment fiduciaries and other investment service providers who are charged with managing or administering portfolio assets. In effect, the IPS serves as a business plan for the portfolio. As such, the IPS is a key governing document for advisors.

Finally, Practice 2.7 recognizes the use of environmental, social, and governance (ESG) factors in the investment decision-making process and stresses that, as is true for other factors used in investment decision-making, the process must conform to governing document provisions and fiduciary obligations. These obligations include care, prudence, diligence, loyalty, and the duty to follow lawful client instructions.

Practice 2.1

Identify an investment time horizon for each investment objective.

Criteria

2.1.1 Sources, timing, distribution, and uses of cash flows are documented.

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

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

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

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

Hierarchy of investment decisions

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

One of the most important determinations to be made for a portfolio is the time horizon of the investment strategy. Based on the time horizon, the fiduciary can determine: (1) the asset classes to be considered; (2) appropriate weighting among the asset classes; (3) the sub-asset classes to be considered; and, finally, (4) the money managers or mutual funds to be selected.

Most important

- Time horizon – Investment stratgy
- Appropriate level of risk/return
- Asset classes considered
- Mix among asset classes
- Sub-asset classes
- Managers/funds

Least important

Special considerations for individual investors

Prior to retirement, individuals strive to manage their resources to match income with expenses and saving objectives. Investment portfolios may be constructed to plan for anticipated major spending events, such as car or home purchases and education expenses. They also may be structured to produce investment income to supplement current earned income. A needs-based analysis informs portfolio construction and management, providing necessary liquidity when required.

Assets held outside of defined contribution or defined benefit plans may also be devoted to saving for retirement. Decisions regarding the selection and management of assets held in taxable accounts, and intended for retirement, should be made with the same approach used with regard to assets held as a participant in a participant-directed retirement plan. Similarly, projected income from any defined benefit retirement plans should also be considered in tandem with the taxable portfolio's income stream.

Special attention also should be paid to tax planning during the accumulation phase. Consider a longer time horizon for Roth-type and non-retirement accounts that are eligible for continued growth, while the pretax retirement accounts that are subject to Required Minimum Distributions (RMDs) enter the distribution phase.

Consideration should also be given to management of longevity risk. The risk of outliving one's retirement savings is the greatest concern of most people approaching or entering retirement. Investment-based (non-guaranteed), insurance-based ("guaranteed"), or hybrid retirement income solutions (a combination of the two), together with Social Security retirement income, may play an important role in addressing this concern.

Individuals differ from Institutions in three materially significant categories: human capital, taxation, and the law of small numbers versus large numbers. Human capital is a unique asset class for individuals and encompasses the individual's ability to generate cashflow from their employment and labor. It can be equated primarily to fixed income securities.

Additionally, individuals' portfolios are generally taxable (with exceptions made for tax-deferred and tax-free investments) unlike institutional investments, which are typically tax-free. Investments for individuals are also impacted by mortality and morbidity issues associated with an individual, as opposed to large groups, such as pensions, where actuarial averages can be used and timelines and cashflows have a much higher level of certainty.

Similarly, risks for individuals can differ from institutional risks and are in addition to the risks that institutional investors must contend with.

These risks can include longevity, morbidity (including cognitive impairment), spending, taxation, legacy, sequence of return, and the risks identified through behavioral finance research, including emotional tolerance for risk.

Suggested procedure

The advisor, in collaboration with the client's advisory team (e.g., accountant, CFO), should prepare a schedule of anticipated cash flows so that an appropriate investment time horizon can be identified.

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

Clients may benefit from a "goals-based" approach to investment horizon identification and asset allocation optimization.

Special considerations for ERISA participant-directed defined contribution plans

ERISA section 404(c) provides a fiduciary safe harbor, where participant-directed plans offer a "broad range" of investment options which "in the aggregate enable the participant or beneficiary, by choosing among them, to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary." The options also should include "an income-producing, low risk, liquid fund, sub-fund, or account" for liquidity and risk management. The statute and its underlying regulation effectively promote providing those participants with an adequate lineup of investments to create a balanced portfolio in their accounts that is consistent with their risk tolerance and need for return on their retirement investments.

Traditionally, the investment menus of participant-directed defined contribution plans have focused on providing participants with the opportunity to properly diversify their holdings during the accumulation phase (pre-retirement). Increasing attention is being given to the distribution phase as the overall population ages. Without proper planning toward this phase, the defined contribution plan is only an accumulation vehicle.

As opposed to the out-of-plan retirement income solutions mentioned above, in-plan versions of these solutions offer advantages for participants in defined contribution plans. In particular, like other menu options, insured solutions are selected through a fiduciary due diligence process, and they are priced for the institutional market (i.e., less expensive than the retail, out-of-plan market).

In 2022, Broadridge published the Prudent Practices for Retirement Income Solutions handbook as a focused complement to the Prudent Practices handbook series (of which this handbook is a part). The handbook for retirement income solutions provides 10 practices that advisors should apply to prudently select and maintain retirement income solutions for participant-directed defined contribution plans.

Special considerations for ERISA defined benefit plans

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

Special considerations for UPMIFA

Unlike retirement planning for individuals, charitable and other nonprofit organizations' time horizons may be ongoing in order to carry out the foundation's mission. The focus is therefore on sustaining the appropriate Equilibrium Spending Rate (ESR) throughout the life of the organization and keeping in mind that endowments are allowed to sustain spending during a bear market as long as it meets UPMIFA's prudence standard. In response to severe economic conditions, UPMIFA established seven factors, or standards of prudence, that can be followed by the organization when carrying out its mission with an "underwater" portfolio. The seven factors are: (1) the duration and preservation of the endowment fund; (2) its purpose(s); (3) general economic conditions; (4) the possible effects of inflation or deflation; (5) expected total return from income and investments; (6) other resources; and (7) the investment policy statement.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]

Other
IRS Notice 2014-66

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

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2); 29 C.F.R. §2550.404c-5 (Preamble); 29 C.F.R. §2509.08-1; §2509.96-1; Pension Benefit Statements-Lifetime Income Illustrations, 85 F.R. 59132 (Sept. 18, 2020); Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 F.R. 73822 (Dec. 1, 2022)

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

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.961; H.R. Report No. 1280, 93d Congress, 2d Session (1974); ERISA Opinion Letter 2006-08A (Oct. 3, 2008); Target Date Retirement Date Funds – Tips for ERISA Plan Fiduciaries, US Department of Labor, Employee Benefit Security Administration (February 2013); DOL Information Letter to Mark Iwry (Oct. 23, 2014); DOL Advisory Council on Employee Welfare and Pension Benefit Plans Report on Participant Plan Transfers and Account Consolidation for the Advancement of Lifetime Plan Participation (November 2016); GAO Report on 401(k) Plans: DOL Could Take Steps to Improve Retirement Income Options for Plan Participants (Sept. 8, 2016); DOL Information Letter to Jon Breyfogle (June 3, 2020); U.S. Department of Labor Supplemental Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives (Dec. 21, 2021)

Investment Advisers Act of 1940
§206

Case Law
SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); In re George Sein Lin, Investment Advisers Act Release No. 1174 (June 19, 1989); In re David A. King and King Capital Corp., Investment Advisers Act Release No. 1391 (Nov. 9, 1993); In the Matter of One Oak Capital Management, LLC and Michael DeRosa, Investment Advisers Act Release No. 6855 (Feb. 14, 2025)

Other
SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (last updated March 30, 2022)
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)
Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994)
The Value of Goals-Based Financial Planning by David Blanchett, CFP®, CFA. Journal of Financial Planning 28(6): 42–50

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

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

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

Practice 2.2

Identify an appropriate risk level for the portfolio.

Criteria

2.2.1 The expected volatility of the portfolio is understood by the investment advisor and communicated to the client, and the quantitative and qualitative factors that were considered are documented.

2.2.2 "Large loss" scenarios have been identified and considered in establishing the portfolio's risk level.

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

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

Investment risk

Management of investment risk is among the most important aspects of a fiduciary's responsibility; it has many dimensions and impacts. One dimension of risk is the measurable possibility that the actual return of an investment will not match expectations. When formalizing the investment strategy, an advisor must determine how much risk and what types of risk the client is willing and able to assume to achieve investment goals.

Typically, investment professionals define risk in terms of statistical measures of volatility, such as standard deviation. However, these statistical measures may fail to adequately convey the potential consequences an investment strategy can have on the client's ability to meet investment goals and objectives. Additionally, volatility as the primary, measurable, risk is only appropriate if the portfolio has been adequately diversified, essentially eliminating all other types of idiosyncratic, or non-systematic risks from concentrated positions.

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

For individual investors, the real risk is not meeting clearly defined goals in the time frame hoped for. Volatility defines risk for short-term goals and for clients unable to withstand the stress of a falling market and selling out at the most inopportune time as a result.

Systematic and non-systematic risk

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

Systematic risk is the risk tied to overall economic conditions and cannot be avoided. Over time, investors are compensated for assuming more systematic risk via higher return expectations over longer-term time horizons; i.e., market risk.

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

The main exception is when governing documents or lawful client instructions direct that specific investments or types of assets should be held or avoided, potentially limiting diversification and increasing non-systematic risk, such as when concentrated positions are required to be held.

Planning for a "large loss" scenario

Large Loss Planning involves strategies to protect clients from significant financial setbacks due to market downturns or other adverse events. This includes:

1. **Risk Assessment:** Evaluating potential risks that could lead to large losses in the portfolio.

2. **Diversification:** Spreading investments across different asset classes to reduce the impact of a significant loss in any single area.

3. **Liquidity Management:** Ensuring there are enough liquid assets to meet withdrawal needs for extended periods while limiting the potential of having to sell investments at a loss.

4. **Downside Protection:** Utilizing investment strategies, such as hedging, to mitigate the impact of market declines.

The goal is to shield clients' portfolios from major losses while aligning the investments with their goals and risk tolerance.

Understanding "fat tails" in the distribution of returns

When we analyze the distribution of investment returns, we often notice that they do not perfectly follow a normal distribution. In a normal distribution, extreme events — or those that deviate significantly from the mean — are relatively rare. The bell curve shape of a normal distribution has "thin" tails because the likelihood of extreme returns diminishes rapidly as you move away from the mean.

However, financial returns more often exhibit what is known as "fat" tails. This means that extreme results — both extremely high and extremely low returns — occur more frequently than would be predicted by a normal distribution. The implications of "fat" tails are significant for investors because they suggest a higher probability of experiencing extreme price changes, leading to increased volatility and risk.

Sequence of returns risk

For investors, especially those with finite time horizons, understanding the sequence of returns risk is crucial. Sequence of returns risk refers to the risk that the order in which investment returns occur can impact the overall performance of a portfolio, particularly when withdrawals are being made. This can be a significant factor in retirement planning or any scenario where regular withdrawals from an investment portfolio are necessary.

Why is sequence of returns risk critical for finite time horizons?

1. **Retirement Income Planning:** For retirees, the early years of withdrawal are crucial. If significant market downturns occur during these initial years, the portfolio might not recover sufficiently to sustain future withdrawals, leading to the depletion of assets sooner than expected.

2. **Impact of Withdrawals:** When investors withdraw money during a market downturn, they are potentially locking in losses, which means that when the market recovers, they have a smaller base of capital to grow.

3. **Less Time to Recover:** Investors with finite investment time horizons do not have the luxury of waiting for extended periods for the market to recover. This is different from younger investors who can potentially wait out a bear market.

Mitigating sequence of returns risk

- **Diversification:** By diversifying across asset classes, investors can mitigate some of the risks associated with extreme events and their impact on the sequence of returns.

- **Strategic Asset Allocation:** Adjusting the mix of stocks, bonds, and other assets can help manage risk, especially as investors near the withdrawal phase of their investment plan.

- **Risk Management Tools:** Utilizing stop-loss strategies, options, or other financial instruments may help protect against downside risks associated with fat tails.

In summary, understanding the characteristics of return distributions and the implications of sequence of returns risk is vital for investors with finite time horizons. By taking proactive measures to account for these risks, investors can better protect their portfolios against extreme market events and ensure financial security during the withdrawal phase.

For multi-generational trust and endowment-type portfolios with effectively infinite investment periods, there is time for recovery from down markets. There may also be added flexibility provided by the ability to manage cash flows.

For example, where an endowment fund has regular annual withdrawals, the fund should be managed so that there are sufficient investments with low volatility to meet the anticipated withdrawals and minimize the risk of selling volatile investments in a down market.

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

Disbursement obligations

Near-term disbursement obligations also factor into a portfolio's ability to assume risk and in establishing liquidity requirements. Predictable disbursements from portfolios tailored to the needs of individual investors, and for pooled portfolios with established distribution patterns such as defined benefit plans, philanthropic organizations, and trusts, can dictate the allocations to fixed income asset classes. Specific allocations to cash can also be considered to avoid disruptive trading. For participant-directed defined contribution plans, the plan investment menu must provide options that consider a reasonable range of participant profiles corresponding to plan demographics.

Special considerations under ERISA

A recent trend for defined contribution retirement plans [e.g., 401(k) plans] is the use of a retirement income option in a qualified default investment alternative (QDIA) or otherwise in the menu of available options. Until recently, practical obstacles and regulatory uncertainty made the use of retirement income solutions in defined contribution retirement plan lineups relatively rare. However, marketplace developments have made in-plan, insurance-based retirement income solutions more practical, competitive, and compelling.

Moreover, Congress, the DOL, and Treasury have each clarified in recent years that these types of investments may have a place in the retirement portfolio if chosen prudently. The sharp and continuing decline in the number of companies offering defined benefits plans, along with concerns about the funding challenges of the Social Security Trust Fund, have heightened recognition of the need for stable and reliable retirement income solutions in participant-directed plans.

Longevity risk, the possibility for retirees to outlive the income and principal provided by accumulated retirement assets, is the number one fear of most people approaching retirement age, according a 2024 AARP article. Guaranteed income options leverage the power of pooling premium dollars to create a mortality credit that distributes resources accumulated from those who die prematurely to those who outlive their life expectancy.

While longevity risk is the primary concern of many retirees, there are many other risks that investors face in retirement. The table below outlines common risks retirees face and methods of mitigating them.

Risk	Description	Mitigation
Longevity	Exhausting retirement income prematurely	Guaranteed retirement income solutions
Legacy	Insufficient assets to fulfill goals to make bequests	Increase accumulation; maintain and exercise lifetime control of assets
Market	Losses due to adverse investment results	Reduce or eliminate market exposure; guaranteed lifetime income solutions
Sequence of returns	Impaired accumulation and income potential due to inopportune timing of withdrawals or deposits	Active liquidity management; guaranteed withdrawal benefits
Inflation	Erosion of income sufficiency due to cost-of-living increases	Inflation-aware asset allocation; provide inflation adjustment provision in RIS
Liquidity	Inability to freely access retirement assets	Maintain liquid assets
Counterparty	Probability of default on a contractual obligation	Due diligence; ratings; gov't guarantees
Cognitive or capability	Diminished cognitive ability or insufficient knowledge to manage or supervise assets	Outsource management/ administration in guaranteed or non-guaranteed RIS

* Note: RIS stands for Retirement Income Solution

There is an increasing awareness by plan sponsors of the need for guaranteed retirement income from plan benefits. As a result, an advisor can consider them as a means to mitigating risk for plan participants, as well as assisting plan sponsors in addressing the matter.

Suggested procedure

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

1. Will the investment results enable the client to cover short- and long- term liabilities and/or objectives?

2. Can the client tolerate the worst-case scenario? If not, the client will likely abandon a sound, long-term strategy during a market downturn, altering the investment strategy at precisely the wrong time and for the wrong reasons.

3. Are there additional or alternative investment strategies or products that may be used to mitigate risks or improve client outcomes? Careful consideration of stress test outcomes and potential modifications to the proposed strategy should help the advisor and client determine a course of action that is most likely to serve the client's best interests.

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§105(a)(2)(D); §402(b); §404(a)(1)(B); §404(a)(1)(C); §404(e)

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

Case Law
Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir.), reh'g and reh'g en banc denied, 184 F.3d 820 (5th Cir.), cert. denied, 528 U.S. 967, 120 S. Ct. 406, 145 L. Ed. 2d 316 (1999); Metzler v. Graham, 112 F.3d 207 (5th Cir. 1997); State Street Bank and Trust Co. ERISA Litigation, No. 7 Civ. 8488 (S.D.N.Y. 2012)

Other
DOL Advisory Council on Employee Welfare and Benefit Plans Report Hedge Funds and Private Equity Investments (November 2011); DOL Information Letter to Jon Breyfogle (June 3, 2020); U.S. Department of Labor Supplemental Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives (Dec. 21, 2021)

Investment Advisers Act of 1940

Case Law
In re Westmark Financial Services Corp., Investment Advisers Act Release No. 1117 (May 16, 1988); In re David A. King and King Capital Corp., Investment Advisers Act Release No. 1391 (Nov. 9, 1993); In re George E. Brooks & Assocs., Inc., Investment Advisers Act Release No. 1746 (Aug. 17, 1998); In the Matter of Philip A. Lehman, Investment Advisers Act Release No. 1831 (Sept. 22, 1999)

Practice 2.2

Other

Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations, (Apr. 20, 2023)
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)
Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994)

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

Case Law

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

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

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

Other

Renzulli, K. A. (Oct. 2, 2024), 5 Retirement Fears and How to Conquer Them

Practice 2.3

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

Criteria

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

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

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

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

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

Prudent return assumptions

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

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

Suggested procedure

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

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

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

The development of prudent optimizer inputs involves as much art and intuition as science and is well beyond the intended scope of this handbook. However, the advisor should be familiar with the input source and methodology used to develop any investment allocation strategy. Due to the great disparity between different models, careful research into the investment expertise of the source is required. Regulators are paying attention to the algorithms used to generate advice dispensed by both robo-advisors and human advisors. Fiduciaries should be confident that the data sources and technology they rely on are objective and effective. They should also be alert to any obvious misalignments between stated investment objectives and client portfolios.

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

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

Many investment professionals use "risk premium" adjusted inputs in an optimizer, as opposed to historical data. Developing the risk premium is quite involved, but simply stated, the process starts by calculating the premium each asset class has earned over the risk-free rate of return. The premium is then adjusted, or tweaked, based on possible economic scenarios that may impact the asset class over a specific time horizon, (e.g., the next five years). The adjusted premium is then added to the anticipated risk-free rate of return over that time horizon (the anticipated rate of inflation also could be used as a proxy) to come up with the final modeled return.

Such an approach can also be used for international asset classes, factoring in differences in domestic versus international interest rates and exchange rate hedging choices.

The advisor should consider carefully whether the risk premiums used are reasonable, as the asset allocation output can be quite sensitive to input values. If the advisor has reason to be skeptical of the projected returns, they should consider alternative sources.

The client's investment time horizon may impact the selection of capital market assumptions for a given asset class modeling or optimization exercise.

Those with an infinite time horizon, perhaps associated with an endowment, may select long- term asset class expected returns, risks, and correlations as the assumptions. Those with a shorter time horizon may be more inclined to use short-term forecasts driven more by current economic indicators and asset class valuation assessments.

Special considerations for foundations and endowments

Foundations and endowments are often treated as perpetual entities. Consequently, a central focus of portfolio management is to maintain the spending (or giving) power of contributed assets that are invested for the long term. This means that portfolio earnings and costs should be balanced. Doing so successfully prevents the corpus of the portfolio from being depleted. A mathematically simple formula for this balancing act is known as the Equilibrium Spending Rate.

The Equilibrium Spending Rate is an approximation of what the portfolio needs to earn over time in order to prevent the contribution of the investment portfolio from being eroded by the impacts of inflation and portfolio expenses. Thus, the formula for the Equilibrium Spending Rate (ESR) is as follows:

ESR = Expected Annual Portfolio Return – (Annual Inflation Rate + Annual Portfolio Expenses)

As discussed earlier, the probable return of a given asset class is difficult to predict, let alone the expected annual return for the entire portfolio and expenses that will be incurred in managing it. While the nonprofit's investment committee may be passionate about the organization's mission, and eager to weigh in on the big picture components of the investment strategy, it is often lacking the technical skills of determining how much can be safely distributed each year without invading the principal of the organization's invested assets.

The fiduciary advisor typically plays a key role by providing reasonable estimates for variables on the right side of the ESR equation. The critical phrase in the last sentence is "reasonable estimates for the variables on the right side of the equation." The equilibrium spending rate is a projected value that is only as accurate as the estimates for those variables.

The ESR is used as the benchmark to guide or control distributions from the portfolio. The most important and most difficult to estimate variable in the ESR equation (and the focus of Practice 2.3) is the Expected Portfolio Return. Inflation estimates are readily available from economic data provided by reputable sources, such as the U.S. Department of Labor's Bureau of Labor Statistics. Portfolio expenses can be relatively easily and accurately estimated based upon current portfolio holdings, trading activity, and service provider agreements. They are largely controlled through prudent due diligence and monitoring.

Ultimately, it is the bottom line that matters – for the portfolio to be sustainable, only net (after fees and expenses) real (after inflation) portfolio earnings should be withdrawn. In any given year, the ESR established at the start of a year and the total of the actual values for the variables on the right side of the equation at the end of the year will rarely match; but, in the long run, they need to be close. If all goes as expected, fiduciaries overseeing the portfolio should be able to make distributions using the ESR as a guide and observe long-term appreciation in the portfolio at approximately the rate of inflation (in addition to growth from new deposits to the investment portfolio).

Always remember that the ESR is intended to be used as a guide for making sustainable withdrawals from the portfolio, not as a mandated limit. The Expected Portfolio Return variable is an average return projection. Actual annual returns can, and will, depart from this projection, sometimes dramatically. It is disruptive and generally detrimental for an organization to change the ESR radically from year-to-year. For that reason, using muti-year (e.g., three- or five-year) averaging of the gap between expected and actual returns to adjust and smooth distribution rates from one year to the next (up or down) is suggested. During periods of extremely volatile returns, longer averaging periods may be used to reduce the variation in annual spending amounts.

Finally, note that the equilibrium spending rate concept is useful as a guide for any long-term portfolio that is to be managed sustainably. For example, multi-generational trusts often use this approach to manage distributions to beneficiaries.

Substantiation

Internal Revenue Code of 1986, as amended [IRC]
§412(c)(3); §430(h)(3)

Other
IRS Notice 2014-66

Practice 2.3

Employee Retirement Income Security Act of 1974 [ERISA]
§3(34); §302(c)(3); §304(c)(3); §404(a)(1); §404(c)

Regulations
29 C.F.R. 2520.105-3; 29 C.F.R. §2550.404a-1(b)(1); 29 C.F.R. §2550.404a-1(b)(2); 29 C.F.R. § 2550.404c-1; 29 C.F.R. §2550.404c-5(e)(4)(iii) and Preamble

Case Law
Leigh v. Engle, 858 F.2d 361 (7th Cir. 1988); Jones v. O'Higgins, 11 EBC 1660 (N.D.N.Y. 1989); GIW Industries, Inc. v. Trevor, Stewart, Burton, & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990); Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992); Mertens v. Hewitt Associates, 508 U.S. 248 (1993); Usenko ex rel. SunEdison Semiconductor Ltd. V. MEMC LLC, 926 F.3d 468 (8th Cir. 2019)

Other
H.R. Rep. No. 1280, 93rd Cong., 2d Sess. 304 (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038; Elton, Edwin J. and Gruber, Martin J., Modern Portfolio Theory and Investment Analysis (1995); DOL Interpretive Bulletin 96-1, Participant Investment Education (29 C.F.R. §2509.96-1); U.S. Gov't Accountability Off., GAO-12-565, Defined Benefit Pension Plans: Recent Developments Highlight Challenges of Ensuring Pension Plan Funding (2012); DOL Information Letter to Mark Iwry (Oct. 23, 2014); U.S. Gov't Accountability Off., GAO-23-105813, 401(k) Retirement Plans: DOL Could Better Inform Participants About Risks in Selecting Target Date Funds with Inappropriate Asset Allocations (2023)

Investment Advisers Act of 1940

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

Other
Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (SEC, Jan. 21, 2011)
Guidance Update: Robo-Advisers (SEC's Division of Investment Management, Feb. 2017)
Investor Alert: Automated Investment Tools, (SEC and FINRA, May 8, 2015)
Recommendation of the SEC Investor Advisory Committee's Disclosure Subcommittee Regarding Digital Engagement Practices [Draft] SEC Investor Advisory Committee, Nov. 17, 2023

Uniform Prudent Investor Act [UPIA]
§2(a), (b), and (c); §2(c) comments; §3(b); §5

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

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

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

Practice 2.4

Ensure that selected asset classes are consistent with the time horizon and risk and return objectives for the portfolio.

Criteria

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

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

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

Strategic asset allocation and investment menu design

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

Special considerations under ERISA

ERISA §404(a)(1)(C) requires fiduciaries of an ERISA-covered plan to discharge their duties by diversifying the investments of the plan to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

Thus, an ERISA fiduciary should not "normally invest all or an unduly large portion of funds in a single security, or in any one type of security, or even in various types of securities that depend on the success of one enterprise." (Liss v. Smith) Before investing a substantial portion of plan assets in one investment, the fiduciary should investigate and document the reasons why the investment is prudent and how the risk of large loss resulting from non-diversification will be mitigated.

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

Special considerations under UPMIFA

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

Special considerations under MMPERSA

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

Alternative investments

Alternative investments are asset classes that fall outside the standard or traditional broad asset classes: stocks, bonds, and cash. There is no universally accepted list of all asset classes that appropriately fall under the heading of alternative investments; however, most investment experts would agree that, at a minimum, alternative investment asset classes include private capital (equity and debt), hedge funds, real estate, and commodities.

A good working definition of "asset class" is a set of investments that exhibit similar characteristics, are subject to the same laws and regulations, and are influenced in a similar way by fundamental market forces. From a portfolio management perspective, an asset class should be represented by a relevant benchmark with risk, return, and correlation statistics that make portfolio optimization calculations practical and meaningful.

From a fiduciary perspective, two fundamental questions that an advisor must answer when considering a recommendation to add an alternative investment to a portfolio are: (1) what role will the investment play in the portfolio (e.g., improved diversification, risk reduction, return enhancement, etc.) and (2) will the addition of the investment be in the best interest of the client (i.e., will it withstand a rigorous due diligence process that meets the fiduciary duties of prudence, care, and loyalty)?

To answer those questions, specialized expertise may be required along with accessible and reliable data for the due diligence process. Nevertheless, for established alternative investment asset classes, such as those mentioned above, sufficient information is generally available to determine if there is a clear role for the investment in a client's portfolio and if a convincing due diligence case can be made for including it.

However, in other situations, especially when information about a purported alternative asset class is sparse or inconsistent, those two fundamental questions can be difficult to answer satisfactorily. For example, the case for cryptocurrencies as an investable asset class and having a role in a diversified portfolio is still under debate within the financial services industry, and for regulators and Congress. In March 2022, the DOL issued Compliance Assistance Release No. 2022-01 warning 401(k) plan fiduciaries "to exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants."

Until regulators provide further guidance, or Congress establishes a regulatory framework for crypto, it is unlikely that many prudent investment fiduciaries will consider cryptocurrency to be anything more than a speculative form of investment.

Suggested procedure

Asset allocation models and portfolio optimization tools can assist the advisor in assessing the risk and projected return profiles of different asset mixes. Outputs of those tools are dependent upon the inputs they require — specifically, the assumed risk and projected return characteristics of each asset class under consideration and assumed correlations among those asset classes. These risk, projected return, and correlation inputs, known as Capital Market Assumptions (CMAs), can vary over time based upon a variety of factors, including changing economic and market conditions, shifting characteristics of industries and asset classes, as well as other unknown or unpredictable factors.

Computer optimization models typically use index risk-and-return assumptions. That means they presume that non-systematic risk for each asset class is not material. Diversification across asset classes serves to reduce non-systematic risk in the context of a broad, multi-asset class market.

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

Fiduciary advisors must take care to evaluate asset allocation models and portfolio optimization tools and underlying CMA assumptions to make sure that they are academically sound and objective.

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

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

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

Practice 2.4

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B); §404(a)(1)(C); §404(c)(1); §404(c)(5)

Regulations
29 C.F.R. §2550.404a-1(b); 29 C.F.R. §2550.404c-1; 29 C.F.R. §2550.404c-5; Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73822 (Dec. 1, 2022) (to be codified at 29 C.F.R. pt. 2550)

Case Law
GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990); Leigh v. Engle, 858 F.2d 361 (7th Cir. 1988); Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992); Liss v. Smith, 991 F. Supp. 278, 301 (S.D.N.Y. 1998); Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Haw. 1980); Anderson v. Intel Corp. Inv. Policy Comm., 579 F. Supp. 3d 1133 (N.D. Cal. 2022); Lauderdale v. NFP Retirement, Inc., No. 8:21-cv-00301-JVS-KES (C.D. Cal. Feb. 23, 2024)

Other
Interpretive Bulletin 96-1(d)(3), 29 C.F.R. §2509.961(d)(3); Joint Committee on Taxation, Overview of the Enforcement and Administration of the Employee Retirement Income Security Act of 1974, at 12 (JCX-16- 90, June 6, 1990); Advisory Council on Employee Welfare & Pension Benefit Plans, Report of the Working Group on Prudent Investment Process (2006); DOL Information Letter to Jon Breyfogle (June 3, 2020); DOL Supplemental Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives (Dec. 21, 2021)

US Department of Labor Cautions 401(k) Plan Fiduciaries to Exercise Extreme Care as They Consider Cryptocurrencies, DOL news release. (Mar. 10, 2022)

Investment Advisers Act of 1940

Case Law
In re George Sein Lin, Investment Advisers Act Release No. 1174 (June 19, 1989); In re David A. King and King Capital Corp., Investment Advisers Act Release No. 1391 (Nov. 9, 1993)

Other
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)
Brinson, G.P., Hood, L.R., & Beebower, G.L. (1986), Determinants of Portfolio Performance, Financial Analysts Journal, 42(4), pp. 39-44
SEC Office of Investor Education and Advocacy, Investor Alert: Exercise Caution with Crypto Asset Securities, March 23, 2023

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

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

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

Practice 2.5

Ensure that selected asset classes are consistent with implementation and monitoring constraints.

Criteria

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

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

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

Asset class considerations

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

Variables that should generally be considered include the following:

- Size of client's portfolio relative to goals
- Investment expertise and experience of the client and/or advisor
- Availability of data required to perform prudent due diligence analysis, including a representative benchmark for the asset class
- Ability of the advisor to properly monitor the strategies and investment options
- Cost considerations — investing in specialized/niche asset classes and investing smaller amounts across more asset classes may mean higher portfolio expenses (the benefit of added diversification must be weighed against the drawback of added costs)
- Asset class attributes (complexity, limited marketability, etc.) that may not be suitable for the client
- Liquidity needs to accommodate anticipated disbursements, rebalancing needs, and tactical asset allocation flexibility

Suggested procedure

Ordinarily, the most appropriate asset classes to be used as a starting point are the traditional broad market asset classes: stocks, bonds, and cash. From that starting point, sub-asset classes within the traditional asset classes (e.g., domestic and international equities, government and corporate bonds) and additional (alternative) asset classes may be added to assess whether they may provide meaningful risk and return benefits to the overall investment strategy and offer tactical allocation opportunities, consistent with the client's investment time horizon.

Alternative asset classes may be quite complex, requiring special skills to perform proper due diligence. They may also require analysis of intricate legal documents associated with acquiring or exiting the investment.

The advisor should keep in mind that even though the risk-return characteristics of a non-traditional investment may be appealing, it would be imprudent to make an allocation to an asset class that cannot be effectively and efficiently implemented and monitored at a reasonable cost.

Substantiation

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

Regulation
29 C.F.R. §2550.404a-1(b)

Case Law
Fink v. National Savings and Trust Company, 772 F.2d 951, 957 (DC Cir. 1985); Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982); Harley v. Minnesota Mining and Manufacturing Company, 284 F,3d 901 (8th Cir. 2002); Howard v. Shay, 100 F.3d 1484 (9th Cir. 1996); Katsaros v. Cody, 744 F.2d 270 (2d Cir.), cert. denied, 469 U.S. 1072 (1984); Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984); Laborers Nat'l. Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir. 1999); Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess.304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974); U.S. Government Accountability Office, Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors, GAO-08-774 (July 2008); Congressional Research Service, Department of Labor's 2016 Fiduciary Rule: Background and Issues, R44884 (June 22, 2017)

Investment Advisers Act of 1940

Case Law
In Re Westmark Financial Services Corp., Investment Advisers Act Release No. 1117 (May 16, 1988)

Other
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)

Uniform Prudent Investor Act [UPIA]
§2; §2(a) comments; §2(f) comments; §4; §9(a)(1-3)

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

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

Model Management of Public Employee Retirement Systems Act [MMPERSA]
§6(a) and (b); §7(3); §7(3) comments; §8(a); §8(b); §10(2)

Practice 2.6

Confirm that the investment policy statement contains sufficient detail to define, implement, and monitor the portfolio's investment and distribution strategies.

Criteria

2.6.1 The investment policy statement identifies the bodies of law governing the portfolio.

2.6.2 The investment policy statement defines the duties and responsibilities of all parties involved.

2.6.3 The investment policy statement specifies risk, return, and time horizon parameters.

2.6.4 The investment policy statement defines asset weighting and rebalancing guidelines consistent with risk, return, and time horizon parameters.

2.6.5 The investment policy statement defines due diligence criteria for selecting investment options.

2.6.6 The investment policy statement defines procedures for controlling and accounting for investment expenses.

2.6.7 The investment policy statement defines monitoring criteria.

Investment policy guidance

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

Although the IPS is not required by law, it can be an effective management tool, commonly used by investment professionals for directing and communicating the activities of each client's portfolio. It should be a formal, long-range strategic plan that allows the advisor to coordinate the management of the client's investment program in a logical and consistent framework. Material facts, assumptions, and objectives necessary to guide investment decision-making should be included and agreed upon with the client.

Benefits of a well-written IPS

- Avoids misunderstandings about the goals, roles, strategies, limitations, and expectations of the investment management process.

- Excludes responsibility for services that are carved out from what would otherwise be considered normal responsibilities of the client, advisor, or other service providers. For example, if the advisor is not expected to monitor certain assets, the IPS should explicitly state that fact.

- Minimizes the possibility of missteps by providing clear guidelines.

- Establishes a reasoned basis for measuring success, both in terms of meeting the client's objectives and assessing the advisor's efforts.

- Clarifies foundational understandings between the client, advisor, and other parties whose responsibilities are identified in the IPS. One of the first documents a litigator or regulator is likely to review is the IPS, because it should provide an outline of the client's overall investment strategy and the roles of parties involved in implementing it.

- Insulates the advisor and client from "market noise" and can keep the client focused on their long-term goals and objectives in times of unusual and distressing downturns in the capital markets

- Provides implementation guidance and rationale, which is particularly useful in the case of a disruption in the continuity of decision-makers. Similarly, it can help to ensure a smooth transition if there is a change in investment advisors.

Special considerations for retirement income solutions in defined contribution plans

If a retirement income solution is to be offered in a defined contribution plan, the IPS should include a section that provides policy guidance that pertains to that solution. Recommended provisions should:

- Define the duties and responsibilities of all parties involved in the selection of retirement income solutions;

- Address the due diligence process for selecting retirement income solutions;

- Address procedures for controlling and accounting for expenses; and,

- Outline monitoring criteria.

Additionally, if inclusion of the retirement income solution in the plan was a business (settlor) decision, this fact should be noted in the IPS and will necessarily be reflected in plan documents. (See Practice 1.2.)

Suggested procedure

The IPS should have sufficient detail so that a competent third party could implement the investment strategy. It should be flexible enough that it can be implemented in a complex and dynamic financial environment. It should not, however, be so detailed as to require constant revisions and updates.

Here are some tips to make an IPS effective and manageable:

- Use the Criteria of this Practice as an outline of provisions to include when drafting new investment policy statements or amending existing IPS documents.

- Attach addendums to capture information that may change frequently, such as the capital markets assumptions used to develop the client's asset allocation and the names of involved parties (e.g., board members, accountants, attorneys, actuaries, money managers, and custodians).

- Include an addendum to capture key terms used in the IPS. This will help to educate clients and avoid misunderstandings.
- Emphasize core duties, concepts, and policies; don't dive into directives about how things are to be done. For example, acknowledge that investments and service providers are to be prudently selected with careful attention to, and management of, costs and conflicts. Don't specify how responsible parties are to accomplish that. The processes that carefully selected responsible parties use should be vetted when those parties are entrusted with their duties.
- Review the IPS at regular intervals as determined necessary during the course of the relationship. A "best practice" is for a fiduciary investment advisor to review the IPS with the client annually (and on an ad hoc basis if special circumstances arise that necessitate changes in the IPS); consider using a brief "due diligence" questionnaire to determine if a comprehensive review of the IPS is warranted.
- Use IPS reviews as an opportunity to assure alignment between the advisor and client of the purposes of the portfolio and educating on and reinforcing the goals and practices governing management of the portfolio. This is also an important part of meeting monitoring obligations.

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(a)(1); §402(b)(2); §402(c)(3); §403(a)(2); §404(a); §404(c); §405(c)(1); §405(d)(1); §408(g)(10)-(11)

DOL Guidance
Field Assistance Bulletin 2006-01; Field Assistance Bulletin 2015-02; Field Assistance Bulletin 2016-01

Regulations
29 C.F.R. §2550.404a-1(b)(1); §2550.404a-1(b)(2) Interpretive Bulletin 95-1; 29 CFR § 2509.95-1. (July 1, 2022)

Case Law
Falberg v. Goldman Sachs Grp., Inc., No. 22-2689 (2d Cir.) unpublished decision, Feb. 14, 2024 (i.e., "In fact, experts for both sides agreed that although adoption of an IPS may represent a 'best practice' for fiduciaries, it is 'not required' that fiduciaries adopt one in order to be found to have acted prudently."); In re Omnicom Group, Inc. ERISA Litigation, No. 20-CV-4141 (LJL), 2021 WL 3292487 (S.D.N.Y. Aug. 2, 2021); Snyder v. UnitedHealth Group Inc., No. 0:21-cv-01049 (D. Minn. 2021); Brotherston v. Putnam Investments, LLC, 907 F.3d 17 (1st Cir. 2018), cert. denied, 140 S.Ct, 911 (2020); Morrissey v. Curran, 567 F.2d 546 (2nd Cir. 1977); Harley v. Minnesota Mining and Manufacturing Company, 42 F. Supp. 2d 898 (D. Minn. 1999), aff'd, 284 F.3d 901 (8th Cir. 2002); Whitfield v. Cohen, 682 F. Supp. 188
1739 (S.D.N.Y. 1988); Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1988); Laborers Nat'l. Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir. 1999); Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992); Katsaros v. Cody, 744 F. 2d 270, 279 (2d Cir. 1984)

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

Investment Advisers Act of 1940

Other
Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994)
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)

Uniform Prudent Investor Act [UPIA]
§2 and Comments; §3 and Comments; §4; §7; §9(a)(1), (2), and (3)

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

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

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

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

Other Resources
Prudent Practices for Retirement Income Solutions; Defining a fiduciary standard of excellence for selecting and monitoring retirement income solutions (Broadridge, Jan. 2024)

Practice 2.7

Apply environmental, social, governance (ESG) factors to investment due diligence in conformity to law, regulations, governing documents and the fiduciary obligations of investment decision-makers.

Criteria

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

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

ESG considerations

In most respects, a decision to use environmental, social, and/or governance (ESG) factors in the process of making investment decisions is no different from using other factors, such as investment management styles, sector or industry focus, domestic versus international market, etc. From a fiduciary perspective, two key obligations may frame or limit decision-making flexibility about what factors to consider. First, legal and regulatory obligations. Second, client preferences that may involve lawful client instructions to include or exclude certain factors in the decision-making process.

The chart below illustrates a range of situations when ESG factors may be used in the investment management process.

ESG investing guided by client or regulatory directives

Philanthropy	Address specific societal challenges that do not generate financial returns	Social return only
Impact investing	Address specific societal challenges that require below market returns	Expectation of below market returns
Socially responsible investing	Seek investments with both social and financial returns	Willingness to accept below market returns
ESG integration	Pursue ESG opportunities to enhance risk-adjusted returns	Apply ESG factors to enhance value and returns
Sustainable investing	Incorporate ESG factors to traditional investing to mitigate ESG-related risks	Mitigate ESG risks to protect value and achieve competitive returns

Note: This chart is based upon the Spectrum of Capital published by the OECD and other sources.

The first categories of this chart give consideration to environmental, social, or governance factors as directed by the client. These columns involve varying degrees of willingness to sacrifice financial returns, if necessary, to meet philanthropic, impact, or personal satisfaction objectives. The fiduciary advisor is generally obligated to follow lawful client instructions to make investments in these situations if doing so is within the scope of the engagement and it is practicable to do so.

The fourth category, labeled ESG Integration, involves using ESG factors to enhance risk-adjusted returns in the portfolio. This approach involves selecting investments that are competitive with comparable investments in a specific asset class (or subclass) when subjected to due diligence processes that are generally recognized as prudent. (See the discussion below under Special Considerations for ERISA plans.)

The last category, labeled Sustainable Investing, is similar to ESG integration but places greater emphasis on risk management. It often tends to focus on long-term ESG considerations and how they may impact the risk-return relationships of long-term holdings in a large and broadly diversified portfolio (e.g., climate change impacts on energy companies and insurance companies).

Special considerations under ERISA

On December 1, 2022, The Department of Labor published a rule titled “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,” which sets forth regulations that address ESG factors in the context of fiduciary duties. In the relevant part, the regulation states that “A fiduciary’s determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, using appropriate investment horizons consistent with the plan’s investment objectives and taking into account the funding policy of the plan established pursuant to section 402(b)(1) of ERISA. **Risk and return factors may include the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.** Whether any particular consideration is a risk- return factor depends on the individual facts and circumstances. The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return.”

The regulation goes on to state: “A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.”

Thus, ERISA permits using ESG factors in a manner consistent with the approaches described in the chart as ESG Integration and Sustainable Investing, but not to the detriment of financial returns.

Traditional Financial Only Investing is also permissible; however, under the heading “Investment prudence duties” the regulation states that prudence duties may be satisfied if the fiduciary:

1. “ … has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary’s investment duties the fiduciary knows, or should know, are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s portfolio or menu with respect to which the fiduciary has investment duties” and

2. “ … has acted accordingly.” The approaches described in the chart as Philanthropy, Impact Investing, and Socially Responsible Investing would not conform to the ERISA regulations described above.

Special considerations under UPMIFA

In stark contrast to ERISA, UPMIFA requires a plan fiduciary, subject to the intent of a donor expressed in a gift instrument, to consider the charitable purposes of the institution and the purposes of the institutional fund. In addition, the commentary to §3(e)(3) expressly states that a donor may impose restrictions on a gift, citing as an example a gift instrument that precludes the healthcare-related institution from investing in tobacco stocks.

However, UPMIFA makes clear that “giving effect to donor intent does not mean that the donor can or should control the management of the institution.” Thus, financial returns must not be sacrificed to achieve non-financial outcomes that are unrelated to the charitable purpose of the institution or the purposes of the institutional fund.

Special considerations under UPIA

UPIA obligates trustees to comply with the prudent investor rule and adhere to a duty of loyalty. A comment to §5 of the UPIA provides that “[n]o form of so-called ‘social investing’ is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries — for example, by accepting below-market returns — in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.” However, §1(b), provides that the “prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust.” It goes on to state that a “trustee shall not be liable to a beneficiary to the extent the trustee acted in reasonable reliance upon the provisions of the trust.”

Other considerations

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

- The trust documents establishing the private trust, foundation, or endowment state that investments that consider ESG factors are preferred.

- A donor directs that the use of an investment strategy that considers ESG factors is a condition for making a donation.

- A reasonable person would deduce from the foundation’s/endowment’s mission that ESG factors should be considered (e.g., it is reasonable to assume that the American Cancer Society would avoid investing in tobacco companies).

Investment advisors with clients in other countries should be aware that, internationally, ESG investing is commonplace and more strongly encouraged than in the U.S. — it may even be required. Advisors should gain an understanding of regulations, professional practices, and typical client expectations with respect to ESG investing in countries where they will be doing business.

Suggested procedures

1. Stay abreast of the rapidly evolving ESG investing body of knowledge and develop the requisite skills to properly apply ESG investing methodologies. Research has confirmed that applying credible ESG factors in a robust due diligence process is unlikely to result in inferior investment choices compared to what would result from due diligence performed without those factors. Research also suggests that consideration of ESG factors may improve the efficacy of investment due diligence.

2. Evaluate clients’ goals, objectives, and investment parameters (e.g., risk capacity and tolerance, return requirements, investment time horizon, and investment preferences) to determine if ESG Investing may be necessary or appropriate.

3. Evaluate governing documents and applicable laws to determine if ESG Investing is required or prohibited.

4. With respect to the investment policy statement, three courses of action are suggested, depending upon the situation involved:

   — If ESG Investing is restricted or required by governing documents, legal or regulatory obligations, or explicit client direction, the IPS should properly reflect the restrictions or requirements;

   — If the client prefers, but does not require, ESG Investing, the IPS should note the preference but not make the use of ESG Investing a requirement. This will allow flexibility to handle situations that may make ESG Investing imprudent or impractical (e.g., certain asset classes and investment types may lack satisfactory data to perform adequate due diligence); and

   — If the client is indifferent about or disinclined to pursue ESG Investing, it is generally best to not include reference to ESG Investing in the IPS, thereby allowing maximum flexibility to use or not use ESG-related factors in due diligence based upon prudence considerations.

5. When it is practical to do so, apply due diligence consistently across similar investment types. For example, ESG data is increasingly becoming available for many types of mutual funds, even those that are not marketed as "ESG" funds. This allows due diligence to be performed using ESG factors across the full spectrum of funds rather than just those labeled as ESG-focused.

6. Advisors should be aware that "greenwashing" (labeling a fund as green or socially responsible without having a robust methodology in place to do so) for marketing purposes or to justify charging higher fees is known to occur in the marketplace. Responsible fiduciaries must ascertain the ESG-related objectives for the portfolio and verify that the subject investment aligns to those objectives. Consistent with point 5 above, fiduciaries should perform robust due diligence without being influenced by a fund's name to confirm that the investment manager has implemented a credible ESG investing protocol.

Substantiation

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

Regulations
29 C.F.R. §2550.404a-1
Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, DOL (Nov. 22, 2022)

Case Law
Spence v. American Airlines, Inc., No. 4:23-CV-00552-0, 2025 WL 225127 (N.D. Tex. Jan. 10, 2025); Beck v. Pace International Union, 427 F.3d 668, 677 (9th Cir. 2005); Morrissey v. Curran, 567 F.2d 546, 548-49 (2d Cir. 1977)

Other
ERISA Opinion Letter No. 98-04A (May 29, 1998) (superseded); ERISA Opinion Letter 2008-05A (June 27, 2008); Interpretive Bulletin 08-1, 29 C.F.R. §2509.08-1 (superseded); Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments, EBSA IB 2015-01, reinstating IB 94-01 and withdrawing IB 08-01 (Oct. 22, 2015) (superseded by 2024 regulation); Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, including Proxy Voting Policies or Guidelines, reinstating IB 94-2 with certain modifications and replacing IB 2008-2 (Dec. 29, 2016); and DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018)

Investment Advisers Act of 1940

Case Law
In the Matter of ND Money Mgmt., Inc., RansonCapital Corporation, Robert E. Walstad and Monte E. Avery, Investment Advisers Act Release No. 2027 (Apr. 12, 2002)

Regulation
[Proposed Rule] SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices, SEC (May 25, 2022)
SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 6, 2024)

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

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

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

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

Practice 2.7

International Regulation and Resources

Squire Patton Boggs, Update: ESG Laws Across the World (October 2023)

Harvard Law School Forum on Corporate Governance, The Rise of International ESG Disclosure Standards (June 29, 2023)

Principles for Responsible Investment, What are the Principles for Responsible Investment?

CFS Institute, What is ESG investing? (Mar. 4, 2024)

European Securities and Markets Authority

Final Report on MiFID II [ESG] Product Governance Requirements (Mar. 27, 2023)

Australia

Australia's Climate, Sustainability & ESG Reporting Requirements in 2023 – Key laws, Rules & Regulations (June 27, 2023)

Step 3

Implement

Step 3: Introduction

The third step of the Fiduciary Quality Management System is to implement the investment strategy that was formalized in Step 2. Step 3 can be summarized in two words: due diligence. This is the critical point where the planning, organizing, and formalizing that was involved in the initial stages of the client engagement are executed. In fact, all areas of fiduciary duty come into play in Step 3: loyalty, care, prudence, diligence, and good faith.

At this point, the advisor should consider a range of process-related questions:

- Do I have a sound process for selecting the service providers that will assist with implementing the investment process, as well as the specific investments?

- If the engagement involves consideration of a rollover, transfer, or distribution, do I follow a consistent process that objectively compares the status quo to reasonable alternatives?

- Is the process applied consistently and in accordance with all areas of fiduciary duty?

If the portfolio involves alternatives or other, less-conventional investments, a higher level of competency is required from the advisor. Do they have the experience, knowledge, and skills to evaluate these complex and unique investments?

Along with the selection of service providers and investments, Step 3 also includes a Practice option to adopt safe harbors or meet prohibited transaction exemption (PTE) requirements to limit liability.

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

Finally, it is important to communicate changes of fiduciary status during Step 3, when the advisor changes roles during implementation.

Ideally, fiduciary status does not change during an engagement, but in some instances, fiduciary coverage depends on function or registration status. For example, a pension advisor may provide advice to a plan sponsor about other aspects of plan administration, which would not be a fiduciary activity. Or a financial planner dually registered as a broker may develop financial planning recommendations under the RIA, and if the engagement provides for implementation of some or all of the recommendations, it requires them to inform the client of a change in fiduciary status when executing trades as a registered representative. In situations such as this, the advisor should be sure to comply not only with laws and regulations, but also professional codes of conduct that could set higher obligations than those required by law.

Practice 3.1

Follow a prudent due diligence process to select each service provider and specific products and services.

Criteria

3.1.1 Define service provider requirements.

3.1.2 Conduct research and establish a shortlist of suitable candidates.

3.1.3 Conduct due diligence on shortlist candidates.

3.1.4 Verify references and conduct interviews.

3.1.5 Complete negotiations and contract terms.

3.1.6 Ensure the service provider due diligence process is consistently applied and documented.

Service provider due diligence

When delegating responsibilities to service providers, fiduciaries are expected to act prudently and in the best interests of those they serve.

Advisors will be held to an “expert standard of care” — that is, the standard of a person who is knowledgeable about the matter at hand — and their activities and conduct will be measured accordingly. The primary role of the advisor is almost always to guide the client’s investment process, whether it is a retail investor, a retirement investor, or an institutional client.

Regardless of the situation, the advisor is expected to define, document, and consistently apply sound due diligence to select or recommend service providers, products, and services.

Keeping these factors in mind, there is a great emphasis on the due diligence process (see substantiation section for details). Regardless of the services to be delegated, the advisor must demonstrate that a due diligence process was followed.

Suggested procedure

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

Whether you are using a database to benchmark, a survey, or a request for proposal (RFP) to support your due diligence process, there are several key stages to ensure that the provider is reliable and capable of meeting the required services. These stages can be summarized as follows:

1. **Define Requirements:** Clearly define the specific objectives, services, evaluation criteria, timeline, and expectations. This includes the ability to monitor service provider capabilities and performance in the future.

2. **Evaluate and Create Shortlist:** Assess potential providers based on their capabilities, reputation, and alignment with defined requirements. Shortlist the most suitable candidates.

3. **Conduct Due Diligence:** Perform a comprehensive assessment of shortlisted providers’ services, experience, expertise, legal compliance, financial stability, and costs.

4. **Verify References and Conduct Interviews:** Collect and verify references provided by the service provider, contacting their existing and/or previous clients for insights into their performance and reliability. Conduct interviews with key personnel to evaluate their expertise and commitment.

5. **Finalize Contract Provisions:** Negotiate terms and conditions, including pricing, service level agreements, confidentiality, and termination clauses.

By following these five steps, you can ensure a well-structured and streamlined due diligence process when selecting and engaging with service providers.

Importance of requests for proposals (RFPs)

Over the last few years, litigation and settlements in the United States have reinforced the importance of conducting a formal request for proposal process to document your due diligence efforts. The benefits of using RFPs include: (1) effectively comparing and evaluating service provider capabilities; (2) determining reasonableness of fees; and (3) documenting a consistent and transparent process.

Custodial selection

Custodial selection is an important fiduciary function. The role of the custodian, whether acting as custodian of a qualified plan or for an individual client, is to: (1) hold securities for safekeeping; (2) report on holdings and transactions; (3) collect interest and dividends, if required; (4) effect trades; and (5) administer anti-money laundering controls.

At the individual investor level, it is common for the custodian to be a broker-dealer or a trust company. In such cases, the majority of securities are held in street name, meaning they are registered under the name of the broker-dealer or trust company, and the client’s assets are commingled with those of other investors. This arrangement allows for efficient management and administration of client assets.

To protect the assets, custodians are regulated entities. Most institutional investors use trust companies as custodians and pay an additional custody fee. The primary benefit is that the assets are held in a separate account.

Special considerations under ERISA – §408(b)(2)

ERISA requires that the selection of service providers be made in the best interests of plan participants, and that no more than reasonable compensation is paid for those services. To meet that standard, the Department of Labor requires service providers to disclose their services, compensation, and fiduciary status (if applicable). Plan fiduciaries, in turn, are expected to obtain that disclosure information and use it to make informed decisions regarding the selection and monitoring of service providers. The disclosure rule applies to the following providers if they reasonably expect to receive $1,000 or more in direct or indirect compensation in connection with the identified services (i.e., Covered Service Providers):

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

The §408(b)(2) requirements are:

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

Special considerations for individual investors, foundations, or public retirement funds

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

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]

§3(38); §402(a)(1); §402(b)(2); §404(a)(1)(B); §405(c); §406(a)(1)(C); §408(b)(2)

Regulations

29 C.F.R. §2550.408b-2(c and Preamble); 29 C.F.R. §2509.96-1; 29 C.F.R. §2509.75-8

Case Law

Howard v. Shay, 100 F.3d 1484 (9th Cir. 1996), cert. denied, 520 U.S. 1237, 117 S.Ct. 1838, 137 L. Ed. 2d 1042 (1997); Katsaros v. Cody, 744 F.2d 270 (2nd Cir.), cert. denied, 469 U.S. 1072, 105 S. Ct. 565 (1984); Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984); George v. Kraft Foods Global, Inc., 641 F. 3d 786 (7th Cir. 2011); Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009); Ramos v. Banner Health, 461 F.Supp. 3d 1067 (D. Colo. 2020); Huang v. TriNet HR III, Inc., No. 8:20-cv-2293, 2023 WL 3092626 (M.D. Fla. Apr. 26, 2023); Moore v. Humana, Inc., No. 3:22-cv-93, 2024 WL 497125 (W.D. Ky. Feb. 8, 2024)

Other

DOL Field Assistance Bulletin 2007-01 (Feb. 2, 2007); DOL Information Letter, Qualified Plan Services (July 28, 1998); DOL Information Letter, Service Employees International Union (Feb. 19, 1998); DOL Advisory Opinion 2003-09A; U.S. Department of Labor, Employee Benefits Security Administration, Tips for Hiring a Service Provider with Strong Cybersecurity Practices (April 2021); U.S. Department of Labor, Employee Benefits Security Administration, Meeting Your Fiduciary Responsibilities (September 2021)

Investment Advisers Act of 1940

§206(1)-(2)

Case Law

In the Matter of Eugene Bilotti, Investment Advisers Act Release No. 1689 (Dec. 23, 1997); SEC v. Greenberg, Civ. Act. No. 1:11-cv-00313-JLK (D. Co. Feb. 11, 2011); In the Matter of Baskin Planning Consultants, Ltd., Investment Advisers Act Release 1297 (Dec. 19, 1991); In the Matter of Alfred C. Rizzo, Investment Advisers Act Release No. 897 (Jan. 11, 1984); In the Matter of Hennessee Group LLC and Charles J. Gradante, Investment Advisers Act Release No. 2871 (Apr. 22, 2009)

Other

Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)

Uniform Prudent Investor Act [UPIA]

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

Uniform Prudent Management of Institutional Funds Act [UPMIFA]

§3(b); §3(c); §3(e); §5(a)

Model Management of Public Employee Retirement Systems Act [MMPERSA]

§6(a); §6(b)(1) and (2); §7; §8(a)(1)

Practice 3.2

Implement statutory or regulatory investment safe harbors in compliance with the applicable provisions.

Criteria

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

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

Safe harbors and PTEs

Each of the major fiduciary laws below offers various safe harbor provisions. For example, the following statutory provisions address safe harbors for the delegation of investment management:

- §5 of the Uniform Prudent Management of Institutional Funds Act (UPMIFA)
- §9 of the Uniform Prudent Investor Act (UPIA)
- §6 of the Model Management of Public Employee Retirement Systems Act (MMPERSA)
- §405(d)(1) of the Employee Retirement Income Security Act (ERISA)

Safe harbors are essentially sets of rules or requirements that, if followed, offer legal protections to fiduciaries against potential liabilities.

Safe harbors aim to provide clarity and guidance to fiduciaries, and by complying with the prescribed rules, fiduciaries can feel more confident about meeting fiduciary requirements and minimizing legal risks. However, fiduciaries should ensure that the conditions for obtaining the protection are satisfied.

Similar to safe harbors, ERISA and the Internal Revenue Code include provisions related to prohibited transaction exemptions (PTEs) for retirement investors. These exemptions are designed to provide relief or exceptions to certain transactions that would typically be considered prohibited under ERISA's and the Code's fiduciary rules.

Normally, ERISA prohibits certain transactions between retirement plans or IRAs and parties with a fiduciary role, as they may create conflicts of interest or result in self-dealing. However, there are circumstances where exemptions are granted to allow these transactions under specific conditions.

PTEs outline the criteria and conditions for exempting certain transactions from ERISA and Code prohibitions. These exemptions must be granted by the Department of Labor (DOL) and typically involve demonstrating that the transaction is in the best interests of the plan and its participants, or that it meets specific requirements outlined in the exemption.

There are three important concepts associated with safe harbor procedures:

1. Safe harbors are voluntary. A fiduciary choosing not to rely on available safe harbors bears the associated risk and consequences. But with risk often comes rewards. The requirements of safe harbors are deemed to be prudent even in the rare event when applying a safe harbor may cause losses for the end investor. A judicious fiduciary should thoughtfully consider and weigh the protection that comes with a safe harbor versus potential costs or risks for participants or beneficiaries of the trust. At a minimum, an advisor who serves as a consultant to retirement plans should clearly advise the plan stewards of safe harbor opportunities so they can make informed decisions.
2. Safe harbors insulate the fiduciary from liability associated with certain investment-related decisions and acts. The fiduciary should think of safe harbor procedures as a form of "insurance."
3. The fiduciary must demonstrate compliance with the applicable defined requirements to take advantage of the safe harbor. Safe harbor provisions are prescriptive and any missteps or deviations from their conditions would likely invalidate any protection from liability. Fiduciaries are strongly encouraged to investigate what safe harbors may be available and to adopt ones that are consistent with the interests of the investors/beneficiaries.

ERISA safe harbors

Here are six common safe harbors available to investment fiduciaries under ERISA:

1. The §405(c) safe harbor, or general safe harbor provisions related to delegation of investment decisions
2. The §404(c) regulations (safe harbor)
3. The Qualified Default Investment Alternative (QDIA) Safe Harbor
4. §3(38) Investment Manager Safe Harbor
5. The Automatic Rollover Safe Harbor
6. The Annuity Selection Safe Harbor

§405(c) Delegation of investment decisions requirements

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

1. The ERISA plan must provide a procedure for allocating fiduciary responsibility for investment decisions, and the investment steward must act pursuant to that procedure when delegating such responsibilities.

2. The plan's procedures for allocating fiduciary responsibilities must be established or implemented in a prudent fashion.

3. Investment decisions must be delegated to a "prudent expert" (registered investment adviser, a bank, or an insurance company).

4. The investment steward must demonstrate the prudent expert was selected by following a prudent due diligence process.

5. The prudent expert must be given discretion over the assets.

6. If the prudent expert is a registered investment adviser, it must acknowledge its fiduciary status in writing (advisers to registered mutual funds are exempted from this requirement as the mutual fund's assets are not assets of an ERISA plan, and the prospectus is deemed to serve as the fund's fiduciary acknowledgment under the IAA).

7. The investment steward must monitor the activities of the prudent expert(s) to ensure that the expert is properly performing the agreed-upon tasks using the agreed-upon criteria. If the tasks are not being met, the investment steward has the obligation to request corrective action, including removal.

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

§404(c) Safe harbor requirements

The §404(c) safe harbor is commonly used by sponsors of plans with participant-directed investments as a means of reducing fiduciary liability. In essence, the safe harbor shields plan fiduciaries from liability for the investment selections made by plan participants as long as the requirements of the safe harbor are met. The §404(c) and §405(c) safe harbors work in tandem. The plan sponsor applies sound due diligence in selecting investment managers (i.e., the managers of mutual funds) that will be available in the plan's menu of investment options. The general delegation of investment management responsibilities is consistent with the §405(c) safe harbor requirements described above. But there is more to it than that: in addition to requirements for the general safe harbor, §404(c) requires the following:

1. Plan participants must be notified in writing that the plan sponsor intends for the plan to constitute a 404(c) plan and that the fiduciary may be relieved of liability through these safe harbor procedures.

2. Participants must be offered at least three investment options, each of which is diversified, with materially different risk/return profiles. The investment options must provide the participant with a reasonable opportunity to materially affect the potential risk and return of the portfolio. Stated another way, in the aggregate, the investment options must enable the participant to create a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant. When combined with other alternatives, the investments should minimize the overall risk of the participant's portfolio.

3. Participants must have the opportunity to give investment directions to a fiduciary who is generally obligated to comply with the instructions, as well as the opportunity to receive a written confirmation of such instructions.

4. If any investment alternative permits changes more frequently than once every three months, at least one of the three investments described above must permit the same frequency of change, and the investment into which participants can transfer must be income producing, low risk, and liquid (e.g., a money market fund).

5. Participants must have the right to diversify their investments to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' accounts.

6. Participants must receive information on the different investment options.

7. Participants must be provided the opportunity to change their investment strategy/ allocation with a frequency that is appropriate considering market volatility, but no less frequently than once within any three-month period.

Qualified Default Investment Alternative (QDIA) Safe Harbor requirements

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

A QDIA is defined as an investment that is available to participants and beneficiaries that is:

1. Age-based lifecycle or target-date retirement funds or accounts;

2. Risk-based or balanced funds;

3. A professionally managed account that uses the plan's designated investment options and that is age-based.

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

Participants must be provided:

1. Details of the default investment arrangement, including any automatic contribution arrangement in the plan, if applicable;

2. An explanation that the participant or beneficiary has the right to direct investments;

3. A description of the QDIA, including fees and expenses;

4. A description of the right of participants and beneficiaries to switch investments, including related restrictions, fees, or expenses;

5. An explanation of where participants or beneficiaries can get more information; and

6. The participant disclosures required by 29 C.F.R. §2550.404a-5.

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

Employer stock is generally not permissible unless:

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

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

§3(38) Investment Manager Safe Harbor

ERISA §405(d) creates a fiduciary safe harbor where an investment steward (for example, the plan sponsor) appoints a discretionary investment manager [sometimes referred to as a 3(38) investment manager].

In order for an individual or entity to be considered an ERISA 3(38) investment manager, the person or entity must:

1. Be formally appointed and monitored by a named fiduciary of the plan;

2. Have the power to manage, acquire, or dispose of any asset of the plan (i.e., have discretion);

3. Be a registered investment adviser (RIA) under federal or state law, a bank as defined under the Investment Advisers Act of 1940, or an insurance company that is qualified to perform investment services under the laws of more than one state; and

4. Acknowledge in writing that it is a fiduciary with respect to the plan.

If a plan uses the services of a person who does not satisfy all the above criteria, then the appointing fiduciary is not relieved of fiduciary responsibility and will remain liable for the acts or omissions of the investment manager.

If the investment steward prudently selects and monitors the investment manager, the steward will be relieved of any liability for the acts or omissions of the discretionary investment manager.

Automatic Rollover Safe Harbor

Under Internal Revenue Code §401(a)(31)(B), if a plan forces out a distribution (generally, distributions of up to $7,000) and the participant does not elect a rollover or a direct distribution, then the plan is required to roll over the distribution to an individual retirement plan, e.g., an IRA. Under the Automatic Rollover Safe Harbor, an ERISA fiduciary is deemed to satisfy its duties under ERISA §404 with respect to both the selection of the IRA and the investment of the funds in connection with the automatic rollover. The safe harbor also applies to automatic rollovers of $1,000 or less, although in those cases a direct payment (e.g., direct deposit or check) is generally the most common distribution method.

Under the SECURE 2.0 Act, plan sponsors can transfer those assets into safe harbor IRAs with providers that will search for and, with consent, transfer the assets to the plan of a new employer of the individual.

The Automatic Rollover Safe Harbor requirements are:

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

Annuity Selection Safe Harbor

In 2019, Congress passed the SECURE Act, which included a new safe harbor to provide protections that was not clear under earlier DOL guidance. The main feature in the new safe harbor is a provision to eliminate the plan's fiduciary liability if the insurance company offering the lifetime benefits becomes insolvent.

In order to comply with the conditions of the safe harbor, plan fiduciaries must obtain a statement from the insurance company that:

1. The insurance company is licensed to offer guaranteed retirement income contracts;
2. At the time of selection and for the preceding seven plan years, the insurer:
    - Operates under a certificate of authority from the state insurance commissioner where the company is domiciled – and such registration has not been revoked or suspended;
    - Has filed audited financial statements in accordance with state requirements;
    - Maintains reserves which satisfy all of the states' requirements where it does business; and
    - Is not operating under an order of supervision, rehabilitation, or liquidation.
3. The insurer undergoes a financial examination by its home state insurance commissioner at least once every five years.
4. The insurer will notify the plan fiduciary of any changes in status inconsistent with the previous provisions.
5. The plan fiduciary cannot have information that conflicts with the insurance company's representations.

Important prohibited transaction exemptions (PTEs) for fiduciary advisors

PTEs are instructions for managing conflicts of interest of fiduciaries.

Rollover Advice

For the last decade, regulators have focused on rollover advice, in particular, from 401(k)-type plans to IRAs. The concern has been that rollover recommendations are being made without considering the typically higher costs incurred in a rollover IRA —

in other words, a possible failure to act in the participant's best interest. Regulators have stressed the importance of thoroughly examining the costs and documenting the potential increase in services and value from advisors.

Given the amount of money transferred from qualified plans to IRAs, the DOL, SEC, and FINRA have all made rollover advice an examination priority.

The DOL has undertaken a special effort to curb biased rollover advice in the form of a prohibited transaction exemption (PTE 2020-02), which acts much like a safe harbor for fiduciary advisors who make rollover recommendations and who satisfy the conditions of the exemption.

A suggested process for meeting the conditions of PTE 2020-02 and acting in the best interest of the participant or retail client is detailed below.

Suggested procedure for providing rollover advice under ERISA

1. When providing rollover advice, the fiduciary advisor acknowledges fiduciary status and complies with the Impartial Conduct Standards. The advisor must describe in writing the services to be provided after the rollover and disclose material conflicts of interest.

2. The services to be provided include a comparative analysis of current retirement accounts, including investment options, the services provided, and costs.

3. The fiduciary advisor will evaluate reasonable alternatives to staying in the current plan, including:

   — Rolling over to a new plan, if available to the worker;

   — Rolling over to an IRA;

   — Taking a taxable distribution; or

   — Leaving the benefits in the plan, if permitted.

4. The advisor will conduct an analysis of the current retirement account, comparing it to the new plan or IRA services. Review of the plan investment options should include:

   — Brokerage window

   — Company stock

   — Asset classes that would benefit the participant that are not in the plan

5. Fees and expenses that need to be considered include:

   — Expense ratios (including money market and stable value funds)

   — Trading costs (i.e., reviewing fund's turnover ratio)

   — Commission costs in the brokerage window

   — Administrative costs paid by the plan sponsor and the participants

6. Services available under the current plan and alternatives should also be considered, including:

   — Personalized investment advice

   — Educational seminars and materials

   — Interactive investment tools

   — Loans

   — Other services

7. Differences in asset protection as the result of a legal judgment should be assessed.

8. The advisor should review the tax consequences of a rollover, including consideration of penalty-free withdrawals and distribution penalties.

9. Compliance with the Impartial Conduct Standards means that:

   — The advisor will act prudently and loyally by considering the investor's investment objectives, risk tolerance, financial circumstances, and needs.

   — Compensation received for the services is reasonable.

   — The advisor seeks to obtain best execution.

   — Statements made in connection with the recommendation, fees, and conflicts of interest are not misleading.

   — The firm/advisor does not place their interests ahead of the participant.

— The fiduciary advisor must document and provide in writing to the participant the specific reasons that the recommendation to roll over assets is in the participant's best interest.

Note that PTE 2020-02 requires that the firm have policies and procedures to ensure compliance with the Impartial Conduct Standards and the disclosure requirements and conduct an annual retrospective review that is designed to detect and prevent violations. A written report of the review must be prepared and certified by a senior executive officer at the firm within six months after the end of each year.

The Pension Protection Act (PPA) exemption for eligible investment advice arrangements

The PPA established a PTE that acts similar to a safe harbor for investment stewards who want to provide specific investment advice to 401(k) plan participants. It defines two terms that are related to the requirements — "fiduciary adviser" and "eligible investment advice arrangement."

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

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

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

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

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

Codification of fiduciary relief

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

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a)(1)(B); §404(c); §404(c)(5); §404(e); §405(d)(1); §408(b)(14); §408(g)(10)-(11)

SECURE 2.0 Act of 2022

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-2; 29 C.F.R. §2550.404a-3; 29 C.F.R. §2550.404a-4 29 C.F.R. §2550.404a-5; 29 C.F.R. §2550.404c-1; 29 C.F.R. §2550.404c-5; 29 C.F.R. §2550.408g-1
PTE 2020-02, Improving Investment Advice for Workers & Retirees (Dec. 18, 2020)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR13-15, FR17Q); Interpretive Bulletin 08-02, 29 C.F.R. §2509.08-2; DOL Miscellaneous Document, Apr. 13, 1998 – Study of 401(k) Plan Fees and Expenses; Interpretative Bulletin 96-1(e), 29 C.F.R. § 2509.96-1(e); Department

of Labor Field Assistance Bulletin 2007-01 (Feb. 2, 2007); DOL Advisory Opinion Letter 97-15A (May 22, 1997); DOL Advisory Opinion Letter 97-16A (May 23, 1997); TIAA Information Letter, Dec. 22, 2016; U.S. Department of Labor, Employee Benefits Security Administration, New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers and Retirees Frequently Asked Questions, (April 2021)

Case Law
Whitfield v. Cohen, 682 F. Supp. 188 (S.D.N.Y. 1988); DeFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007); Tibble v. Edison Int'l, 729 F.3d 1110 (9th Cir. 2013); Tussey v. ABB, Inc., 746 F.3d 327 (8th Cir. 2014)

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

Securities Exchange Act of 1934
§28(e)

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

Case Law
In Re Enron Corp. Securities, Derivative & ERISA Lit., 284 F.Supp.2d 511, 578 (S.D. Texas 2003); In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Investment Advisers Act Release No.1980 (Sep. 28, 2001); In the Matter of Morgan Stanley Investment Management, Inc., Investment Advisers Act Release No. 3315 (Nov. 16, 2011)

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

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

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

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

Practice 3.3

Make and document decisions regarding investment strategies and types of investments in accordance with fiduciary obligations.

Criteria

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

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

3.3.3 The due diligence process used to select investment strategies, investment managers, and investments is documented and consistently applied.

3.3.4 Regulated investments are preferred over unregulated investments when all other characteristics are comparable.

3.3.5 Investments that are covered by readily available data sources are preferred over similar investments for which limited coverage is available when all other characteristics are comparable.

3.3.6 A prudent due diligence process is used to make decisions regarding the use of proprietary versus non-proprietary products, and separately managed versus commingled accounts.

Investment due diligence

A fiduciary must be able to demonstrate that the strategies and products implemented are suitable for the specific client and in line with generally accepted investment theories. The term "generally accepted investment theories" refers to practices considered to be effective in producing the desired outcomes by academics and the community of professionals in the investment field. Given that the state of the art and science of investing evolves over time, generally accepted theories also change to reflect advances in the field. As an investment fiduciary, suitability is also implied under the fiduciary duty of care.

It is important for the advisor to be familiar with the universe of investment options (e.g., stocks, bonds, cash, mutual funds, exchange-traded products, separately managed accounts, and alternative investments), prudently select them, and document the process, for no one implementation structure is right for all situations or client types.

Procedural vs. substantive prudence

There is an important distinction (grounded in ERISA, but broadly applicable) between procedural and substantive prudence. The former refers to the process involved in making decisions, whereas the latter refers to the merits of the decision made by the fiduciary.

Procedural prudence focuses on the fiduciary's conduct in arriving at the decision, rather than the result, and asks whether a fiduciary employed appropriate methods to investigate and determine the merits of a particular decision.

Substantive prudence recognizes that the failure to be procedurally prudent may withstand actionable accountability if the investment decision nonetheless was objectively prudent. That means that even if a fiduciary failed to conduct a sufficient investigation before making a decision (procedural prudence), the fiduciary probably avoids a fiduciary breach if a "hypothetical prudent fiduciary" would have made the same decision anyway (substantive prudence).

Our focus in this handbook is on procedural prudence. Procedural prudence is the most certain path to achieving a substantively prudent decision; far better than relying on luck, intuition, or an educated guess.

Considerations in selecting investment vehicles

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

- Liquidity
- Marketability
- Minimum required investment
- Contribution to the diversification strategy
- Ease in meeting asset allocation and rebalancing guidelines
- Appropriate benchmark
- Accessibility of information needed to perform the appropriate due diligence
- Ability to fund with assets-in-kind
- Built-in (phantom) tax issues
- Tax efficiency – ability to manage the tax consequences of low basis and/or restricted stock
- Degree of portfolio transparency
- Whether portfolio and performance information is audited
- Degree of regulatory oversight
- Ability to give investment direction to the portfolio manager
- Deductibility of management fees for taxable accounts
- Cost

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

Suggested procedures

The following matrix is an example of a basic checklist for performing due diligence. The first column lists broad due diligence areas that routinely should be examined. The second column provides specific threshold expectations suggested by Broadridge Fi360 based upon the organization's academic research. Each criterion not met constitutes a deficiency deserving of special consideration or the assessment of "demerits" in the analysis. The third column provides the opportunity for the fiduciary to enter their own criteria which, based upon their own research, may be more appropriate to the particular fiduciary relationship involved. The final two columns provide the opportunity to verify whether the due diligence criteria identified in the second or third column are also identified in the IPS (as described in Practice 2.6) and used in the monitoring process (as described in Practice 4.1). Verification can be demonstrated by check marks or annotations in the final two columns.

Please note that the "Sample Criteria Suggested by Broadridge Fi360" shown in this matrix may not all be directly applicable or sufficient for specialized due diligence. For example, non-traditional assets such as retirement income solutions, alternative investments, or strategies involving derivatives typically must be addressed with criteria unique to those investments.

In summary, and as a general rule, a fiduciary should develop due diligence criteria for any investment with the following criteria listed in the table below.

The investment due diligence process

Suggested fields of due diligence	Sample criteria suggested by Broadridge Fi360	Criteria established by fiduciary	IPS (Practice 2.6)	Monitor (Practice 4.1)
Regulatory oversight	Each investment option is managed by: (a) a bank, (b) an insurance company, (c) a registered investment company (mutual fund), or (d) a registered investment adviser.	☐	☐	☐
Minimum track record	Each investment option has at least three years of history.	☐	☐	☐
Stability of the organization	The same portfolio management team has been in place for at least two years.	☐	☐	☐
Assets in the investment	The investment has at least $75 million under management (for mutual funds, across all share classes).	☐	☐	☐
Composition consistent with asset class	At least 80% of the underlying securities are consistent with the broad asset class.	☐	☐	☐
Style consistency	The investment is highly correlated to the asset class of the investment option.	☐	☐	☐
Expense ratios/ fees relative to peers	The investment's fees are not in the bottom quartile (most expensive) of their peer group.	☐	☐	☐
Risk-adjusted performance relative to peers	The investment's risk-adjusted performance (e.g., alpha and Sharpe Ratio) is above the peer group median manager's risk-adjusted performance.	☐	☐	☐
Performance relative to peers	The investment's performance is above the peer group's median manager return for 1-, 3-, and 5-year cumulative periods.	☐	☐	☐
ESG factors used in the investment management process	ESG factors should be used when appropriately applied to adhere to lawful client instructions. When required by law to serve investors' financial best interests (e.g., ERISA), ESG factors may be used when doing so is consistent with meeting this obligation (e.g., the investments are competitive when evaluated using the criteria above).	☐	☐	☐

Practice 3.3

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 service provider may focus on what the provider wants the advisor to hear and not necessarily what the advisor needs to know.

Consideration of account types

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

Relative advantage of account types

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

Special considerations under ERISA

Suggested procedure for the selection of in-plan lifetime income solutions

Retirement income solutions (RICs) include those with embedded insurance features and those offering managed payouts from investments.

First, it is important to keep in mind that the decision of a retirement plan sponsor to offer one or more retirement income solutions may be, and generally should be, made as a business — or "settlor" — decision. [The only distribution options mandated for 401(k) plans are lump-sum distributions and required minimum distributions]. The process of selecting an appropriate annuity option would then be a separate decision subject to fiduciary due diligence.

Under the settlor function, the plan sponsor may first review worker demographics in addition to its business objectives in establishing employee benefits. If the sponsor determines retirement income solutions are appropriate, it may direct the plan's fiduciaries, such as the investment committee, to further review specific options. The direction should be in the plan's governing documents.

At this stage, the plan fiduciaries should engage in a prudent process to make the required decisions. The following steps should be considered as part of a prudent due diligence process:

1. Ensure that the applicable documents governing the plan operation permit the type(s) of RICs under consideration and are compliant with ERISA and the Internal Revenue Code.

2. Ensure the IPS contains sufficient detail to define, implement and, if required, monitor the RICs, including the due diligence process for controlling and accounting for expenses.

3. Consider statutory or regulatory safe harbors that apply to RICs, and elect those that advance the best interests of plan participants and beneficiaries.

4. Evaluate the types of RICs available to the plan, including considering participant demographics and needs, and whether the existing plan platform can support the types of RICs under consideration.

5. Consistent with the duty of care, a due diligence process should be followed in selecting the RIC providers, taking into consideration the range of solutions offered, the provider's long-term financial strength, and its ability to pay all income

obligations. Evaluation includes consideration of product and service features, benefits, costs, and effectiveness in mitigating material risks.

6. Keep in mind that no single implementation structure is right for all plans or clients. The plan fiduciary should be able to document why selected strategies and products are suitable for plan participants and consistent with generally accepted investment theory.

7. During the evaluation and selection process, plan fiduciaries should identify conflicts of interest and address conflicts consistent with the duty of loyalty. As such, plan fiduciaries should receive full disclosure of material conflicts from the service provider in order to make informed, prudent decisions regarding conflicts.

8. Ensure that provisions in signed agreements are reasonable in light of costs and the services will be delivered with appropriate accountability by the product provider.

It is worth noting that there are a variety of charges associated with annuities, insurance riders, and other lifetime income solutions beyond the costs of the investment component. Accordingly, RICs tend to be more expensive than investments that do not have insurance features. There are many possible features and riders that may be associated with the product. The added expense of each needs to be evaluated based on plan demographics or the needs and circumstances of the plan and participants.

Suggested procedure for the use of ESG factors in selecting investments under ERISA

1. The fiduciary advisor's duty of prudence in selecting investments in a plan governed by ERISA requires due diligence that is focused on serving the economic best interests of participants and beneficiaries. That involves a risk and return analysis that may include consideration of the economic effects of climate change and other ESG considerations to the extent that they are material factors in evaluating the risk and return profile of the investments being reviewed. However, a fiduciary cannot subordinate the interests of plan participants in their retirement benefits from the plan to favor ESG or other factors. (See Practice 2.7)

2. As a best practice, the fiduciary advisor should refrain from using investments in which a regulatory action has been taken alleging "greenwashing," (i.e., inflating ESG benefits with misleading claims), or any other regulatory finding of material misrepresentation, ESG-related or not.

Other considerations in the selection of investments using ESG factors for retail clients

1. Retail clients may direct a fiduciary advisor to apply ESG factors in the investment due diligence process, even if doing so may involve reduced economic returns. The fiduciary advisor should clearly explain the due diligence process applied and the basis for recommendations. The advisor must follow lawful client instructions. (see Practice 2.7)

2. Fiduciary advisors must be aware of and comply with all SEC and state securities rules and required disclosures related to the use of ESG factors.

3. Fiduciary advisors referencing ESG investing strategies or products in marketing materials should ensure ESG-related statements are consistent with Form ADV and other investor-facing documents, including due diligence questionnaires.

4. Fiduciary advisors also should ensure that the firm's voting processes are in line with its ESG disclosures and marketing materials.

Suggested best practices for the selection of target-date funds (TDFs) in a plan

1. Plan fiduciaries should first consider how well the TDF's characteristics align with covered workers' ages, likely retirement dates, and other factors, such as demographics and investment sophistication. That involves consideration of the TDF's asset allocation and glide path.

2. The fiduciary advisor narrows the list of potential TDFs to those with a performance history of at least three years and a minimum of $75 million in the series and all share classes.

3. To reduce potential liability in a class action (while acting in accordance with fiduciary obligations), consider a TDF series comprised of passively managed funds.

4. Determine whether a "through" or "to" TDF is best for the plan. If the TDF is a "through" fund, review whether the fund keeps significant exposure to volatile assets after the retirement date.

5. Identify benchmarks that best fit the TDF glidepath with respect to comparable asset classes. As part of the analysis, consider a widely recognized TDF benchmark that tracks either "to" or "through" TDFs.

6. Although plans are not required to select the lowest expense ratio, the selection process should consider TDFs in the top quartiles for lowest expenses and highest 3-, 5-, and 10-year returns as compared to similarly designed TDF suites, depending on retirement date and the ”to” or “through” glide path.

7. Select the lowest-cost share class when available and carefully examine and document revenue-sharing arrangements or controlled revenue-sharing in which the recordkeeper is paid a reasonable amount.

8. Analyze the expense ratios of the individual fund components of the TDF. If these ratios are substantially lower than the TDF ratio, ask what services and expenses make up the difference.

9. Consider the extent to which the underlying funds within a TDF series are prudent, stand-alone investments.

10. Carefully document the selection process and ensure that the TDF series is subject to periodic monitoring including specific policies regarding fund manager turnover and procedures in the IPS for placement on a watch list.

Issues that fiduciary advisors should consider in the use of managed accounts as the plan’s QDIA

Managed accounts are considered an attractive alternative to TDFs as a plan’s QDIA. Beyond age factors in a TDF, managed accounts can be designed to address other factors, such as out-of-plan assets, personal savings rates, income needed for retirement, and a personalized risk tolerance profile.

Fiduciary advisors assisting in the selection of managed accounts for a plan should address the following questions:

1. Does the benefit of the management services provide sufficient additional value to offset the cost differential?

2. Are participants providing sufficient and unique personalized data designed to match their individual risk/return objectives, or is the provider simply filling in basic demographic data for an off-the-shelf portfolio?

3. Is the service provider offering a revenue-sharing arrangement that reduces recordkeeping fees if managed accounts are offered? If so, the plan sponsor must consider whether managed account users are subsidizing the cost of recordkeeping fees that should be shared equally with other participants.

4. What are the range of asset classes offered with the managed account services?

5. Does the managed account service appropriately factor in an appropriate glide path as the participant nears retirement?

Substantiation

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

Regulations
29 C.F.R. §2550.404a-1 (and the Preamble); 29 C.F.R. §2550.404c-1(b)(3)

Case Law
Metzler v. Graham, 112 F.3d 207 (5th Cir. 1997); Marshall v. Glass/Metal Ass’n and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 (D. Hawaii 1980); Smith v. CommonSpirit Health, 37 F.4th 1160 (6th Cir. 2022); Johnson v. The PNC Fin. Servs. Grp., Inc., Civil Action No. 2:20-cv-01493-CCW (W.D. Pa. Mar. 31, 2022); Trauernicht v. Genworth Fin., Inc., Civil Action No. 3:22-cv-00532 (E.D. Va. Aug. 29, 2024)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974); DOL Prohibited Transaction Exemption 77-4, 42 Fed. Reg. 18732 (Apr. 8, 1977); DOL Advisory Opinion 2003-09A (June 25, 2003); DOL Field Assistance Bulletin 2007-01, A Look at 401(k) Plan Fees, DOL (September 2019)
Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries (February 2013)

Investment Advisers Act of 1940

Other
Risk Alert: Investment Adviser Due Diligence Processes for Selecting Alternative Investments (Jan. 28, 2014)
Risk Alert: The Division of Examinations’ Review of ESG Investing (Apr. 9, 2021)

Investment Company Act of 1940
§35(d), and Rule 35d-1 (17 CFR §270.35d-1)

Regulations
Investment Company Names Rule (Sept. 20, 2023)

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

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

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

Step 4

Monitor

Step 4: Introduction

The fourth step of the Fiduciary Quality Management System is to monitor. No one should be lulled into thinking that the "heavy lifting" was done in the previous three steps and the client portfolio is now on "auto pilot," marked only by periodic re-balancing, quarterly performance reports, and routine client meetings.

For most investment fiduciaries, monitoring can be labor-intensive, because it may involve a need to respond to changes in the economic or market cycle, the pricing of investment services, retirement plan arrangements, and circumstances directly impacting the client's financial situation or outlook.

For the investment fiduciary, the starting point of monitoring is working backwards through the four-step Fiduciary Quality Management System. The logic is simple: activities involved in monitoring are dependent upon what was done in the first three steps.

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

In Step 2, Formalize, we focused on establishing an appropriate asset allocation strategy and preparing the investment policy statement. The asset allocation strategy is the cornerstone of the IPS, which is the business plan for management of the plan or portfolio.

It may be necessary to go back to Step 1, Organize, to review the laws, regulations, and documents used to establish the governing principles for the portfolio.

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

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

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

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

Common claims in ERISA class-actions include failure to monitor recordkeeper costs, investments that underperform an appropriate benchmark over a period of time prescribed by the IPS, and whether a lower-cost share class is available. Another common complaint is failure by the named fiduciary of an ERISA plan to monitor other fiduciaries, such as the plan's investment committee.

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

Practice 4.1

Conduct periodic reviews of investment performance against appropriate market and peer group benchmarks and overall objectives for the portfolio.

Criteria

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

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

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

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

4.1.5 Investment performance is periodically reported to the client.

Quantitative analysis and rebalancing

The ongoing review and analysis of portfolio and investment performance are just as important as the initial decision-making process in Steps 2 and 3. The advisor's role is to ensure that the client remains best positioned to meet their objectives even as circumstances change over time.

The advisor, or a designated fiduciary, should establish appropriate benchmarks for each investment and for the overall portfolio. A target asset allocation for the portfolio should be specified in the IPS. When monitoring, the advisor should use that information to make informed decisions, using a prudent and consistent process, about the efficacy of the current strategy and specific investments.

For investment-level performance monitoring, each investment should be compared to appropriate index and peer group benchmarks and other due diligence criteria that are defined in the investment policy statement. Relevant peer groups can include sub-asset class or style, such as comparing a large cap value product to large cap value peer-group, rather than using the S&P 500 or other total market index for every equity position. The IPS should acknowledge that fluctuating rates of return characterize the securities markets and may cause variations in short-term performance.

Some of the more recent ERISA class-actions alleging underperforming investments have involved disputes over the appropriate benchmark, particularly with target-date funds. No matter what type of portfolio is involved, the responsible fiduciaries should take care to determine and document the appropriate benchmarks.

When considering the overall portfolio, appropriate benchmarks for the asset classes and sub-classes should be "blended" to create an investment policy **portfolio benchmark**. The investment policy portfolio (policy portfolio) is the target asset allocation for the portfolio that is specified in the investment policy statement. The investment policy portfolio benchmark captures the weighted average return and risk of the asset classes or sub-asset classes in the policy portfolio (i.e., the weights are the target percentage allocations specified in the policy portfolio). By comparing the actual risk and return profile of the portfolio to that of the policy portfolio, those monitoring the portfolio can assess whether management of the portfolio has met, exceeded, or fallen short of what would be expected from a passively managed portfolio.

Portfolio performance should be further evaluated in the context of the portfolio objectives and the strategy employed. Often, the investment policy statement provides the portfolio manager or investment committee latitude to tactically depart from the policy portfolio within certain boundaries (i.e., by specifying a range around each target allocation for the portfolio).

As a best practice, attribution analysis should be used to monitor the effectiveness of portfolio management and identify the sources of over- or under-performance. Performance attribution is a mathematical process that examines portfolio returns relative to a benchmark and relates the returns to the active management decisions of the portfolio manager.

This analysis isolates and quantifies the contributions of investment selection, tactical asset allocation, and other risk-taking decisions relative to a passively managed investment policy portfolio.

Absolute return analysis, also known as return contribution analysis, is not calculated relative to a benchmark. It simply identifies the weights and returns of the portfolio without reference to the weights and returns of an underlying benchmark.

Carl Bacon, author of a CFA Institute Research Foundation publication on this subject, highlighted key benefits of performance attribution in the publication's introduction:

"Attribution analysis provides a good starting point for a dialogue with asset owners on the positive and negative aspects of recent performance. Attribution analysis can be used aggressively to identify underperformance early and provide clients with a thorough explanation of underperformance and, hopefully, a rationale for improving performance. Attribution analysis is also crucial to gaining the confidence of asset owners by demonstrating a good understanding of the drivers of performance."

Retain or replace decision-making

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

1. Meet regularly to review the current situation.
2. Collect and carefully evaluate the evidence of whether the investments are serving their intended purposes.
3. Act appropriately based upon the evidence and precedents established through previous deliberations and actions.
4. Document the evidence gathered, the substance of deliberations held, and the decisions that were made. Apparent inconsistencies among watch list decisions, although permissible, should be specifically discussed and well-documented to reflect the line of reasoning applied.

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

Rebalancing

Monitoring procedures should consider the client's contribution or distribution schedule when planning to rebalance the portfolio to strategic allocation targets. This is particularly important for taxable accounts, but transaction costs are also relevant for tax-deferred accounts. Tax and transaction cost considerations during the rebalancing process often influence how cash flows can be managed most efficiently.

As is true of many practices referenced in this handbook, rebalancing procedures must be "reasonable." From a legal perspective, a "reasonable" standard of conduct is generally one that a reasonably prudent and knowledgeable professional would follow under a given set of circumstances. An investment fiduciary who follows a consistent process that meets this standard, as imprecise as it may seem, is more likely to avoid liability for negligence.

Suggested procedures

In keeping with the duty of care, an advisor must determine the frequency of reviews, considering such factors as: (1) prevailing general economic conditions; (2) the investment strategies employed; (3) the investment objectives sought; (4) the volatility of the investments selected; (5) the fiduciary or other regulatory obligations to the client; and (6) changes in client circumstances and requirements. The advisor should monitor every investment option implemented at least quarterly, or more frequently as required by the facts and circumstances.

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

A similar process should be followed in monitoring investment options on a 401(k)-type menu and discussing changes with the investment committee.

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a); §405(c)(2)(A)(iii); §408(g)

Regulations
29 CFR §2550.404a-1

Case Law
Hughes v. Northwestern University, 595 U.S. 170 (2022); Tibble v. Edison, Int'l, 575 U.S. 523 (2015), on remand 843 F.3d 1187 (9th Cir. 2016); Tussey v. ABB, Inc., 746 F. 3d 327 (8th Cir. 2014); Leigh v. Engle, 727 F.2d 113 (7th Cir. 1984)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17); DOL Field Assistance Bulletin 2018-01, ftnt. 7 (Apr. 23, 2018); DOL Tips for Selecting and Monitoring Service Providers (2005); DOL Field Assistance Bulletin 2007-01

Investment Advisers Act of 1940

Case Law
In the Matter of NPA Asset Management, LLC, Investment Advisers Act Release No. 6110 (September 8, 2022)

Other
Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019)
Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994)
Study on Investment Advisers and Broker-Dealers
(SEC Staff, Jan. 21, 2011)

Practice 4.1

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

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

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

Practice 4.2

Conduct periodic reviews of qualitative and/or organizational changes of the investment manager and other service providers.

Criteria

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

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

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

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

Qualitative analysis

The advisor's monitoring function extends beyond a strict examination of performance. Qualitative reviews should be used to detect warning signs about an investment manager. The advisor has a continuing duty to exercise reasonable care, skill, and caution when delegating the investment management function to others, including separately managed accounts, mutual and exchange-traded funds, collective investment trusts, hedge funds, and other third parties.

The advisor's review of an investment manager must be based on more than recent investment performance results, as all professional investment managers will experience periods of poor performance. Likewise, advisors should not replace their manager lineup simply because of the reported success of other managers.

Periodic reviews of qualitative factors and/or organizational changes to the managers should be made at reasonable intervals. On a periodic basis (e.g., quarterly), the advisor should review whether each investment manager continues to meet specified objectives. For example:

- The investment manager's adherence to the guidelines established by the IPS
- Material changes in the manager's organization, investment philosophy, and/or personnel
- Any legal or regulatory proceedings that may affect the managed fund or portfolio

Materiality standard

The materiality of an occurrence, event, or information under the law is generally defined as something that is sufficiently significant to influence the decision-making of a reasonable person acting in a like capacity and familiar with such matters. For example, turnover of an investment manager's key portfolio management team would usually be considered material to an advisor's decision about whether to recommend that investment manager's fund to clients. The SEC states "facts are 'material' if a reasonable investor would consider them to be important."

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

Prudent practices for investment managers

This handbook is about the practices that define a fiduciary standard of care for investment advisors. A companion handbook, Prudent Practices for investment managers, covers a fiduciary standard of care for investment managers. Advisors should be familiar with these practices to help guide reviews of the qualitative and organizational issues that may affect the quality of investment manager performance. Shown below is a list of the practices addressed in the Prudent Practices for investment managers handbook.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Prudent monitoring practices for retirement income solutions

There are special considerations involved for in-plan retirement income solutions. Advisors to retirement plans are encouraged to consult and apply Broadridge's Prudent Practices for Retirement Income Solutions when advising investment committees and other ERISA fiduciaries on the selection, implementation, and monitoring of retirement income solutions in their plan.

Broadly speaking, advisors who are responsible for monitoring providers of retirement income solutions should apply sound due diligence in evaluating relevant information about competitive providers in the marketplace. The timing of reviews may be more or less frequent than annually, based upon facts and circumstances. Factors that may influence the frequency of reviews include the following:

- A change in the depth, breadth, or scale of services needed may make a different service provider better suited to the objectives of the plan sponsor or the needs of plan participants than the existing provider.
- Rising competition and falling costs may change marketplace dynamics.
- The range and terms of retirement income solutions offered by the existing provider have changed.
- New technology offers the opportunity to secure improved services and/or lower costs elsewhere.

Also, note that the Annuity Selection Safe Harbor discussed in Practice 3.2 of this handbook requires certain representation from insurers of retirement income solutions providers. These representations should be obtained and reviewed prior to the time the insurance company (or companies) is selected; moreover, if the plan continues to offer insured guaranteed income from the same insurer, it will need to obtain these representations annually. Plan fiduciaries must not have received notice of any change in the insurer's circumstances or other information that would cause it to question the representations provided initially or annually thereafter. If the fiduciaries have received material adverse information that brings an insurer's statements into question, the fiduciaries cannot rely on those representations and will not have the protections afforded by the safe harbor until and unless they are satisfied that the insurer's representations were accurate. To help plan fiduciaries satisfy the safe harbor, most providers of insured retirement income solutions include these disclosures in the offering materials given to plan fiduciaries to review.

Suggested procedure

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

- Staff turnover
- Changes in organizational structure
- Level of service provided
- Accuracy, completeness, and timeliness of reports

Practice 4.2

- Accuracy, completeness, and timeliness of responses to requests for information
- Investment education or other special services provided
- Recent regulatory actions or media coverage

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

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

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a)(1)(A)(ii) and (B); §405(d)(1); §408(b)(2)

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

Cases
Fink v. National Savings and Trust Co., 772 F.2d 951 (D.C. Cir. 1985); Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998); Tussey v. ABB, 746 F.3d 327 (8th Cir. 2014)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17); Booklet: A Look at 401(k) Plan Fees, U.S.
Department of Labor, Pension and Welfare Benefits Administration; DOL Interpretive Bulletin 96-1; DOL Field Assistance Bulletin 2007-01

Investment Advisers Act of 1940

Regulations
17 C.F.R. §275.206(4)-7

Case Law
In the Matter of Horter Investment Management, LLC, Investment Advisers Act Release No. 4823 (December 8, 2017); In the Matter of First Allied Advisory Services, Inc., and Cetera Investment Advisers LLC, Investment Advisers Act Release No. 6734 (Sept. 27, 2024)

Other
Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 18, 2003)
Regulation of Investment Advisers, SEC Division of Investment Management (March 2013), Discussion of material disclosure, p. 23

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

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

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

Practice 4.3

Conduct periodic reviews of policies for trading practices and proxy voting.

Criteria

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

4.3.2 Procedures are in place to periodically review each investment manager's policies for special trading practices such as payment for order flow, "soft dollars," directed brokerage, and commission recapture.

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

Trading practices and proxy voting

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

Monitoring trading practices

Over the years, SEC staff have provided periodic guidance to registered investment advisers regarding their obligation to seek and obtain best execution when trading securities in individual and institutional accounts.

The SEC's inspection arm, the Office of Compliance and Inspections (OCIE) stated in 2018: "As a fiduciary, when an adviser has the responsibility to select broker-dealers and execute client trades, the adviser has an obligation to seek to obtain 'best execution' … taking into consideration the circumstances of the particular transaction."

Obtaining best execution does not necessarily require the adviser to always seek the lowest trading cost (i.e., actual execution price), but to consider other factors including:

1. Speed of execution
2. Quality and reliability (timing) of the trade
3. Likelihood of price improvement
4. The merits of any payment for order flow that may be in place

Best execution trading practices can require even more complex analysis and monitoring if the adviser receives other cash or non-cash compensation as part of trading activities. The four practices of primary interest to the SEC and FINRA are:

1. Soft dollar arrangements
2. Commission recapture programs
3. Directed brokerage
4. Payment for order flow

Soft dollar arrangements are a form of compensation that investment managers use in the financial services industry, primarily concerning the execution of trades and obtaining research services. These arrangements allow investment managers to pay for research and other services using client brokerage commissions rather than direct payments. Here's an overview of how these arrangements work and their implications:

- **Brokerage Commissions:** Typically, when executing trades on behalf of clients, investment managers incur brokerage commissions. In a soft dollar arrangement, a portion of these commissions is used to pay for services that benefit the client.
- **Research and Services:** The primary services obtained through soft dollars are research related. This can include reports, analyses, data, software tools, and even seminars and meetings that help investment managers make informed decisions.
- **Third-Party Providers:** The services and research covered by soft dollar arrangements might come from the brokerage firm executing the trades or from third-party research providers.

How soft dollar arrangements work?

1. **Execution of Trades:** An investment manager directs trades to a brokerage firm. The firm executes the trade and charges a commission.
2. **Allocation of Commissions:** Instead of the entire commission going to the brokerage firm purely as payment for trade execution, a portion of it is allocated to pay for research and related services.
3. **Research and Services:** The manager receives access to research reports, market analysis, trading software, etc., which is intended to enhance the manager's ability to serve the client.

Benefits of soft dollar arrangements:

- **Access to High-Quality Research:** Investment managers can access sophisticated research and tools that might be too expensive if purchased outright.
- **Informed Decision-Making:** The research obtained can improve investment decision-making, potentially leading to better performance for clients.
- **Cost Sharing:** By using client commissions, managers share the cost of research indirectly with their clients, potentially allowing for better service without increasing management fees.

Challenges and criticisms:

- **Conflict of Interest:** Soft dollar arrangements can lead to a conflict of interest, as the investment manager might choose brokers based on research offerings rather than best execution of trades.

- **Transparency and Disclosure:** Critics argue that these arrangements can lack transparency, making it difficult for clients to understand what they are paying for.

- **Regulatory Scrutiny:** Regulatory bodies, like the U.S. Securities and Exchange Commission (SEC), require detailed disclosure of soft dollar arrangements to ensure clients understand the nature and extent of these practices.

In the United States, soft dollar arrangements are subject to regulation under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. The SEC provides guidance through its "Section 28(e) safe harbor," which permits the use of client commissions for research and brokerage services under certain conditions.

Soft dollar arrangements are a widely used practice in the financial services industry that can benefit both investment managers and their clients by providing access to valuable research at no direct cost. However, they must be managed carefully to mitigate potential conflicts of interest and ensure transparency and fairness to clients. Investment managers need to navigate these arrangements within the framework of regulatory guidelines to maintain trust and compliance.

Commission recapture programs are arrangements in the financial services industry that allow institutional investors, such as pension funds and mutual funds, to recover a portion of the brokerage commissions paid when trade orders are executed. These programs are designed to help investors reduce transaction costs and improve overall investment performance.

Key features of commission recapture programs:

- **Rebate Mechanism:** Under these programs, a broker or a commission recapture agent rebates a portion of the commissions back to the institutional investor, effectively reducing the overall cost of trading.

- **Eligible Trades:** Typically, the program is applied to trades executed through participating brokers. The investor works with the recapture agent to set up agreements with these brokers.

- **Flexibility:** Investors have the flexibility to choose where to direct their trades and can select brokers based on various criteria, including execution quality and recapture agreements.

How commission recapture programs work

1. **Setup:** Investment managers or institutional investors enter into agreements with specific brokers and commission recapture agents willing to participate in these programs.

2. **Execution of Trades:** Trades are executed through participating brokerage firms. Investors direct a portion of their trades through these brokers to qualify for rebates.

3. **Rebate Process:** After executing trades, the commission recapture agent calculates the commissions paid and rebates an agreed-upon percentage back to the investor. This can be done periodically (e.g., quarterly or annually).

4. **Usage of Rebates:** Rebate funds can be used at an investor's discretion, often to offset other investment management fees, improve fund performance, or reduce overall expenses.

Benefits of commission recapture programs

- **Reduced Costs:** By recovering a portion of the brokerage commissions paid, investors can significantly reduce their transaction costs.

- **Improved Fund Performance:** Lower costs can enhance net returns, benefiting end investors such as pension fund beneficiaries.

- **Flexibility and Control:** Investors retain control over trade execution decisions, allowing them to maintain high execution quality standards while benefiting from commission recapture.

- **Transparency:** Commission recapture can provide a clear and measurable reduction in costs, contributing to better transparency in financial management.

Considerations and challenges

- **Broker Selection:** While commission recapture can reduce costs, investors must ensure that broker selection prioritizes execution quality to avoid negatively impacting trade outcomes.

- **Potential Conflicts of Interest:** There is a potential for conflicts of interest if the desire to recover commissions influences the choice of brokers over service quality and execution.

- **Regulatory Compliance:** Programs must comply with regulatory guidelines and ensure that trades are executed in the best interest of clients.

- **Impact on Relationships:** Participating in commission recapture programs might affect relationships with brokers not participating in the program or offering lower commission rates.

Commission recapture programs are a useful tool for institutional investors seeking to reduce trading costs and improve net returns. By carefully selecting participating brokers and managing trade execution effectively, investors can harness the benefits of these programs while maintaining high levels of service quality and regulatory compliance. The key is balancing cost savings with the quality of brokerage services to ensure optimal outcomes for end investors.

Directed brokerage arrangements are practices in the financial services industry where an investment manager or an institutional investor directs brokerage transactions, typically the execution of trades, through a particular broker. These arrangements are often used to fulfill specific criteria or requirements, such as obtaining better execution, accessing research, or meeting other financial or strategic needs. Here's an overview of directed brokerage arrangements' key features.

- **Client Direction:** In some cases, the direction comes from the client, who instructs the investment manager to use specific brokers for executing trades. This can be based on existing relationships or specific transaction requirements.

- **Broker Selection:** The investment manager might choose brokers based on evaluating execution capabilities, research services, or other considerations that support their investment strategies.

- **Custom Objectives:** These arrangements may be used to achieve custom objectives, such as ensuring best execution, reducing transaction costs, or accessing certain investment research.

How directed brokerage arrangements work

1. **Establishment of Preferences:** The client (often an institutional investor) may express a preference or requirement to execute trades through specific brokers, either based on past relationships or to meet certain service criteria.

2. **Agreement on Terms:** The investment manager and client agree on the directed brokerage terms, which may involve accessing certain brokerage services or complying with client mandates.

3. **Execution of Trades:** Trades are then executed according to the directives, ensuring that the selected brokers are utilized as agreed.

4. **Performance Monitoring:** The performance of directed brokers is monitored to ensure they meet execution quality and cost-effectiveness benchmarks.

Benefits of directed brokerage arrangements

- **Customization:** Clients can customize their trading relationships to ensure specific needs and preferences are met, such as maintaining relationships with particular brokers.

- **Potential for Enhanced Services:** Clients may access higher-quality brokerage services, including advanced research or analytics, which can enhance the investment decision-making process.

- **Cost Management:** Arrangements can be structured to focus on cost-effectiveness, potentially reducing overall transaction costs.

Considerations and challenges

- **Potential Conflicts of Interest:** Directed brokerage could potentially lead to conflicts of interest if the selection of brokers lacks alignment with achieving best execution for clients.

- **Regulatory Compliance:** Investment managers must ensure compliance with regulatory requirements that prioritize the best interests of the client, particularly regarding execution quality and cost transparency.

- **Impact on Execution Quality:** Over-reliance on client-directed brokers might impact the quality of trade execution if the chosen brokers do not provide competitive execution services.

- **Reporting and Disclosure:** Investment managers must maintain transparency regarding the use and rationale for directed brokerage arrangements, often providing detailed disclosure in client reports.

Regulators, such as the U.S. Securities and Exchange Commission (SEC), emphasize clear client benefits and compliance with fiduciary duties when using directed brokerage arrangements. Managers are encouraged to evaluate execution quality continuously and ensure that such practices align with the client's best interests.

Directed brokerage arrangements provide a mechanism for investment managers and institutional clients to tailor trading relationships to specific needs and objectives. While they offer potential benefits like enhanced service and cost management, careful execution and compliance with regulatory guidelines are essential to minimize conflicts of interest and ensure that client interests are consistently prioritized.

Payment for order flow (PFOF) arrangements are practices in the financial services industry where a brokerage firm receives compensation from a third-party market maker or trading venue for directing client orders to them for execution. This arrangement has become increasingly common, particularly in the retail trading space, and has implications for how trades are executed and priced.

Key features of payment for order flow arrangements

- **Compensation for Order Routing:** Brokers are paid by market makers for routing client orders to them rather than directly to exchanges or other venues. The compensation can be a fixed fee per share or per order.

- **Market Makers:** Third-party market makers typically involved in PFOF arrangements are firms that actively provide liquidity in financial markets by quoting buy and sell prices for securities.

- **Retail Brokerage Focus:** PFOF is primarily associated with retail brokerage firms, especially those offering commission-free trading. This model helps subsidize the costs of offering free trades to investors.

How payment for order flow arrangements work

1. **Order Routing:** A retail investor places an order through their brokerage platform. The brokerage firm then routes the order to a specific market maker instead of directly to a stock exchange.

2. **Execution and Price Improvement:** The market maker executes the trade, ideally at a price equal to or better than the current market price (often providing a tiny price improvement over the national best bid and offer).

3. **Compensation Mechanism:** The market maker compensates the brokerage firm for routing the order. This payment helps to offset the cost structures of commission-free trading platforms.

4. **Benefits to Retail Investors:** Brokerage firms argue that PFOF allows them to offer commission-free trading to retail investors and could contribute to better or equivalent execution quality through aggregated price improvements.

Benefits of payment for order flow arrangements

- **Reduced Trading Costs:** By receiving PFOF, brokerage firms can offer zero-commission trading, making investing accessible to a broader audience.

- **Potential Price Improvements:** Market makers often provide small price improvements on trades, which can benefit investors in terms of slightly better execution prices.

- **Liquidity Provision:** By routing orders to market makers, PFOF arrangements help ensure liquidity in the markets, facilitating smoother trade execution.

Challenges and criticisms

- **Conflict of Interest:** Critics argue that PFOF creates a conflict of interest, as brokers might select market makers based on payment benefits rather than the execution quality provided.

- **Transparency Concerns:** There are concerns about whether retail investors fully understand the implications of PFOF and whether sufficient transparency is provided.

- **Impact on Market Structure:** Some critics suggest that widespread PFOF could affect market dynamics, potentially influencing market pricing and fairness.

- **Regulatory Scrutiny:** PFOF arrangements have been subject to regulatory scrutiny, particularly from agencies like the U.S. Securities and Exchange Commission (SEC), which emphasize disclosure and transparency.

Regulatory bodies require firms to disclose PFOF practices and ensure that they do not compromise their duty to provide best execution. This includes ongoing assessments to ensure that the routing decisions genuinely benefit clients in terms of execution quality.

Payment for order flow arrangements have become a central component of the business model for many retail brokerages, particularly in offering commission-free trading. While they provide benefits in terms of cost savings and liquidity, they also present challenges related to potential conflicts of interest and the need for transparency. As such, both brokerage firms and regulators must carefully manage these arrangements to align them with investors' best interests.

Payment for order flow is banned in the EU and other countries but not the U.S.

Suggested procedures

Practice 1.5 requires a regular review of all service provider agreements. For example, a separate account manager's agreement should address (as appropriate) trading practices, including best execution, soft dollars, directed brokerage, and commission recapture, as well as proxy voting.

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

With respect to other securities transactions, it is recommended that fiduciary advisors discuss price execution with the brokers they use and periodically seek comparisons with other brokers on a quarterly, semi-annual, or annual basis. The advisor should ask for a copy of the introducing broker's policies and procedures used to route orders and analyze how the broker manages the conflict of interest and whether the firm has a practice of routing to the highest bidder or is otherwise achieving best execution pricing.

Proxy voting policies

The advisor should ensure that each client relationship has an established policy in place for proxy voting, consistent with the duties of loyalty and care.

If the advisor holds voting responsibility, unless directed otherwise by the client, proxies should be voted in a manner that preserves or enhances the value of the security. The proxy policy and responsibility for who is to vote proxies should be in the investment policy statement, especially for ERISA plans. In the case of institutional clients, responsibility for voting proxies normally rests with the steward or is delegated by the steward to investment managers. Individual investors normally retain proxy voting responsibility unless the advisor has been delegated investment discretion and proxy voting authority.

When voting on behalf of clients, or using a third-party proxy voting service, the SEC-registered adviser must establish procedures for voting in the clients' best interests, disclose the policies to them, and provide access to proxy voting records.

Special considerations

1. When assuming voting authority, the advisor must have a reasonable understanding of the client's objectives and base voting decisions on complete and accurate information.

2. The advisor should consider the costs of voting, such as if a translation is needed to vote on foreign securities.

3. If the advisor has a conflict of interest, or a difference of opinion between clients, it may transfer those duties to a proxy voting service.

4. Shareholder resolutions dealing with climate change are expected to escalate as investor awareness of ESG grows. As a result, the advisor should ensure that the advisory firm's proxy voting decision-making process is consistent with its ESG disclosures and other related marketing materials.

When using a proxy advisory firm:

1. Perform due diligence on the proxy firm with regard to capacity and competency to analyze potential voting recommendations.

2. Consider the factors used by the proxy firm in making recommendations, its reliance on third-party information, interactions between the firm and issuers and third parties, and the firm's processes for identifying, mitigating, and disclosing conflicts of interest.

3. Follow up with the proxy firm if the advisor has reason to believe that it is relying on incomplete information.

4. Require the proxy firm to periodically update the advisor on changes to its policies and procedures.

The North American Securities Administrators Association includes proxy voting policies and procedures in its Model Rule for Investment Adviser Written Policies and Procedures Under the Uniform Securities Acts of 1956 and 2002 (last amended Nov. 24, 2020). Similar to federal law, in states that have adopted this rule, advisers with voting authority are required to vote in the client's best interest.

Substantiation

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

Regulation
§2550.404a-1

Case Law
Herman v. NationsBank Trust Co., (Georgia), 126 F.3d 1354, 21 E.B.C. 2061 (11th Cir. 1997), reh'g denied, 135 F.3d 1409 (11th Cir.), cert. denied, 525 U.S. 816, 19 S.Ct. 54, 142 L.Ed.2d 42 (1998); Spence v. American Airlines, Inc., No. 4:23-cv-00552-0 (N.D. Tex. Jan. 10, 2025)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17Q); Interpretive Bulletin 08-2, 29 C.F.R. §2509.08-2; Prohibited Transaction Exemption 86-128; DOL Information Letter, Prescott Asset Management (Jan. 17, 1992) (fn. 1); DOL Information Letter, Refco, Inc. (Feb. 13, 1989); ERISA Technical Release 86-1 (May 22, 1986); Prohibited Transaction Exemption 2020-02

Investment Advisers Act of 1940
§206(4); Securities Exchange Act of 1934

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

Case Law
In re Arleen W. Hughes, Act Release No. 4073, (Feb. 20, 1948); In the Matter of Focus Point Solutions, Inc., Advisers Act Release No. 30196 (Sept. 6, 2012); In the Matter of KMS Fin. Servs., Inc., Advisers Act Release No. 4730 (July 19, 2017)

Other
Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (Sept. 10, 2019)
Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (Sept. 3, 2020)
Investment Advisers, Fiduciary Duties, and Voting Obligations: Harvard Law School Forum on Corporate Governance (Sept. 23, 2019)
NASAA Model Rule for Investment Adviser Written Policies and Procedures Under the Uniform Securities Acts of 1956 and 2002 (Adopted Nov. 24, 2020)
Securities Exchange Act Release No. 23170 (Apr. 23, 1986); Investment Advisers Act Release No. 232 (Oct. 16, 1968); SMC Capital, Inc. SEC No-Action Letter (Sept. 5, 1995); Charles Lerner, Esq., SEC No-Action Letter (July 25, 1990); SMC Capital, Inc. No-Action Letter (Sept. 5, 1995); Pretzel & Stouffer No-Action Letter (Dec. 1, 1995); Investment Advisers Act Release No. 2106 (Jan. 31, 2003); Investment Company Act Release No. 25922 (Jan. 31, 2003); Salomon Bros., SEC No-Action Letter (May 23, 1972); Risk Alert: Most Frequent Best Execution Issues Cited in Adviser Exams

Securities and Exchange Act of 1934
§28(e)

Regulation
Disclosure of Order Handling Information, SEC (Apr. 24, 2019)

Case Law
In the Matter of Robinhood Financial, LLC, Securities Exchange Act Release No. 90694 (Dec. 17, 2020)

Other
Broker-Dealers and Payment for Order Flow, Congressional Research Service (Apr. 2, 2021)
Policy Brief: Payment for Order Flow, CFA Institute (July 2016)

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

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

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

Practice 4.4

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

Criteria

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

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

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

Fee, compensation and expense analysis

The advisor has a duty to control and account for all dollars spent for investment management services, whether the dollars are paid directly from the account or in the form of soft dollars and other fee-sharing arrangements. In addition, the advisor has the responsibility to identify those parties that have been compensated from the fees and apply a reasonableness test to the amount of compensation received. Justification for paying unusually high fees should be documented and disclosed to the client.

Finder's Fees

If the advisor pays finder's (and/or solicitor's) fees, these must be disclosed and approved in writing. Under the Investment Advisers Act and some state laws, the previous "cash solicitation rule," which requires special disclosures by the person referring prospective clients to the RIA for compensation, (and which may also trigger registration of that person as an investment adviser representative under state law) has been combined in a new Marketing Rule by the SEC. For public retirement plans, some states, such as California and New York, may regulate or prohibit placement agents.

As of September 2023, the states were preparing a similar model rule for state RIAs.

Fees for professional services

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

Subscription fees charged to retail clients on an ongoing basis have caught the attention of state securities regulators. Their primary concern is reasonableness of compensation, the practice of not providing any (or sufficient) services to justify being paid an ongoing "subscription" (i.e., retainer) fee. Subscription fees are typically paid on a monthly or quarterly basis.

Advisors offering financial planning or other non-portfolio management services (estate planning, insurance advice, cash and debt management, etc.) should document these additional activities. The SEC is also concerned with robo-advisors charging subscription fees without any corresponding asset management services being provided.

Retirement plan fees

The advisor's responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from ERISA plan assets (see also Practice 1.2), and (2) whether the fees are reasonable in light of the services being provided (see also Practice 1.5). In addition, the Internal Revenue Code limits fees for services to individual retirement accounts (IRAs) to reasonable amounts relative to the services provided. Accordingly, the advisor should ensure all forms of compensation are reasonable for the services rendered.

See Practice 3.3 for detailed information on fees associated with individualized investment advice to plan participants and IRA holders.

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 (known as a revenue sharing arrangement). Particularly for a new plan with few assets, such an arrangement can be beneficial to the participants. Fiduciaries should not, however, assume that all revenue sharing arrangements are justified. The fiduciary should determine whether it is more advantageous to pay for the recordkeeping and administrative costs on a per participant basis using funds that forego revenue sharing and have lower expense ratios. As a best practice, revenue sharing dollars that are rebated back to the plan should be allocated to those participants invested in the funds that included revenue sharing fees.

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

Wrap fees

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

The SEC is also concerned with reverse-churning in which a wrap fee is paid without trading activity in the retail client's portfolio over an extended period of time. Documentation of investment management activity is strongly recommended.

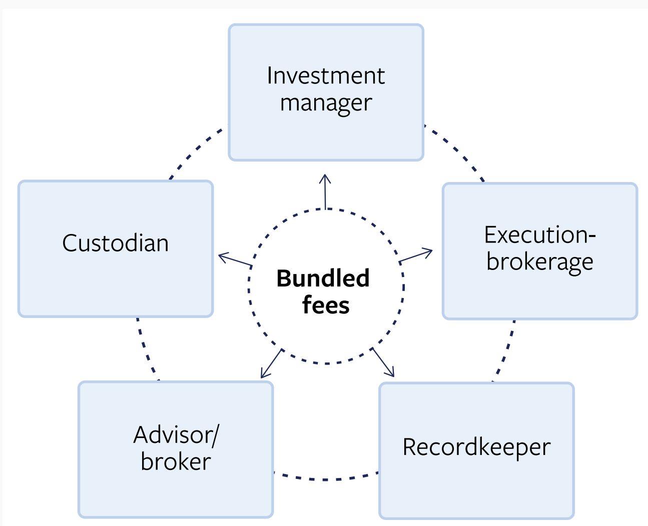
Suggested procedure for bundled products

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

These five cost components are:

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

Unbundling fees and expenses



In other markets, custody and recordkeeping services may be bundled, although other services may be broken out separately.

Examples of fiduciary breaches under ERISA

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

- A large financial services company breaches its fiduciary duties by offering proprietary mutual funds to retirement plans, which results in higher fees for plan participants that are not justified by any unique benefits provided
- A retirement plan sponsor fails to prudently select and monitor the investment options in its 401(k) plan, resulting in excessive fees and poor performance for plan participants
- A financial advisor breaches their fiduciary duties by recommending high-cost and/or underperforming investments to a client's individual retirement account when superior alternatives are readily available
- A large investment management firm breaches its fiduciary duties by charging excessive fees to its retirement plan clients and failing to adequately disclose the fees
- A retirement plan sponsor fails to prudently monitor administrative fees by periodically soliciting bids for new recordkeepers, resulting in excessive fees and a breach of fiduciary duties

Substantiation

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B); §404(a)(1)(A) and (B) and (D); §406(a) and (b); §408(b)(2)

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

Case Law
Brock v. Robbins, 830 F.2d 640 (7th Cir. 1987); Coppel v. SeaWorld Parks & Entertainment, Inc., 2024 WL 1231234 (S.D. Cal. 2024); Perkins v. United Surgical Partners International, Inc., 78 F.4th 637 (5th Cir. 2024)

Other
Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter 2001-01A; DOL Advisory Opinion Letter 89-28A; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR17Q); DOL Advisory Opinion 97-15A (May 22, 1997); DOL Advisory Opinion 97-16A (May 22, 1997); DOL Interpretive Bulletin 2007-01; DOL Prohibited Transaction Exemption 2020-02

Investment Advisers Act of 1940
§205(a)(1), Section 206(1) and Section 206(2)

Regulations
17 C.F.R. §275.205-3; 17 C.F.R. § 275.206(4)-3
Investment Adviser Marketing Rule (Dec. 22, 2020)

Case Law
SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); In the Matter of Barclays Capital Inc., Investment Advisers Act Release No. 4705 (May 10, 2017); In the Matter of Morgan Stanley Smith Barney, LLC, Investment Advisers Act Release No. 4607 (Jan. 13, 2017); In the Matter of Capital Dynamics, Inc., Investment Advisers Act Release No. 4746 (Aug. 16, 2017); In the Matter of Pruco Securities, LLC, Investment Advisers Act Release No. 5657 (Dec. 23, 2020); In the Matter of Waddell & Reed, LLC, Investment Advisers Act Release No. 6136 (Sept. 19, 2022)

Other
News Release: SEC Adopts Modernized Marketing Rule for Investment Advisers (Dec. 22, 2020)
News Release: SEC Charges Investment Adviser for Failing to Conduct Adequate Follow-up After Client Accounts Were Flagged for Potential Reverse Churning (Sept. 19, 2022)
SEC Investor Bulletin: Subscription-based Advisory Fees (Sept. 6, 2023)
SEC Enforcement Division, Observations from Examinations of Investment Advisers Managing Client Accounts That Participate In Wrap Fee Programs (July 21, 2021)
BISYS Fund Services, Inc., SEC No-Action Letter (Sept. 2, 1999); SEC Investment Adviser Examination Manual (1980); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2017 (Feb. 5, 2003); Don P. Matheson & Co.¸ SEC No-Action Letter (May 15, 1976); Risk Alert: Overview of Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (April 12, 2018)

Other
NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, Model Rule 102(a)(4)-1 (Adopted April 27, 1997, amended April 18, 2004, and Sept. 11, 2005)
NASAA Investment Adviser Representative Definition, Model Rule USA 2002 102(16), (Adopted Sept. 17, 2008)
NASSA Investment Adviser Section Guidance: Set Labels Aside: Investment Advisory Fees Must Be Reasonable (Nov. 18, 2022)

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

Case Law
Matter of Derek W. Bryant, 188 Misc. 2d 462, 729 NYS 2d 309 (June 21, 2001)

Other
McKinneys EPTL112.3(d)

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

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

Practice 4.5

Conduct periodic reviews of the organization's effectiveness in meeting its fiduciary responsibilities.

Criteria

4.5.1 Fiduciary assessments are conducted at planned intervals to determine whether appropriate policies and procedures are in place to address all fiduciary obligations and that such policies and procedures are effectively implemented and maintained.

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

Organizational effectiveness reviews

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

Under the Pension Protection Act of 2006 (PPA), the practices of plan sponsors and fiduciary advisers who are party to eligible investment advice arrangements (EIAAs) must be examined as part of the required annual independent audit of the EIAA. Advisors who provide services to ERISA plans and who serve as fiduciary advisers should take special note of this audit requirement in the PPA. For more information, see Practice 3.2.2.

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

Suggested procedures for assessments

There are three levels of fiduciary assessments:

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

Level 2: If deficiencies are identified, then a level 2 remediation assessment should be conducted. Typically, an objective and competent assessor is best positioned to conduct remediation. The assessor, acting as a consultant, can recommend revisions to policies and procedures designed to address deficiencies.

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

Substantiation

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

Case Law
Fink v. National Savings & Trust Co., 772 F.2d 951, 957 (D.C. Cir. 1985); Liss v. Smith, 991 F. Supp. 278, 299300 (S.D.N.Y., 1998); Harley v. Minnesota Mining and Manufacturing Company, 42 F. Supp. 2d 898, 906 (D. Minn. 1999); In re Enron Corp. Securities, Derivative & ERISA Litigation, 284 F. Supp. 2d 511 (S.D. Tex. 2003); Spence v. American Airlines, Inc., No. 4:23-cv-00552-0 (N.D. Tex. Jan. 10, 2025)

Other
DOL Advisory Opinion 1992-24A; DOL Advisory Opinion 2002-06A; DOL Employee Benefits Security Administration, Meeting Your Fiduciary Responsibilities (May 2004); 29 C.F.R. 2509.75-8; 29 C.F.R. 2509.08-2; 17 C.F.R. § 275.206(4)7; DOL Field Assistance Bulletin 2007-01

Investment Advisers Act of 1940

Regulation
17 C.F.R. §275.206(4)-7

Case Law
In the Matter of Trust & Investment Advisors, Inc., Larry K. Pitts, and George M. Prugh, Investment Advisers Act Release No. 4087 (May 18, 2015); In the Matter of Institutional Investor Advisers, Inc., Investment Advisers Act Release No. 4824 (Dec. 8, 2017); In the Matter of OEP Capital Advisors, L.P., Investment Advisers Act Release No. 6514 (Dec. 26, 2023)

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

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

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

The approach used to structure the Practices in this handbook is modeled after that used by the International Organization for Standardization (ISO). Recently, the financial services community has begun to recognize the value of certification of conformity to standards. An ISO standard for financial planning (ISO 22222) was promulgated in 2005 and investment performance reporting practices can be certified to Global Investment Performance Standards (GIPS). In 2006, the Centre for Fiduciary Excellence (CEFEX) was formed to certify conformity with the practices covered in the Prudent Practices for Investment Fiduciaries handbook series.

Glossary of terms

This glossary was compiled from the following sources:

Eugene b. Burroughs, CFA, Investment Terminology (revised Edition), International Foundation of Employee Benefit Plans, Inc., 1993

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

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

Joshua P. Itzoe, CFP®, AIF®, Fixing the 401(k): What Fiduciaries Must Know (and Do) to Help Employees Retire Successfully, Mill City Press, 2008

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

Broadridge Financial Solutions, Inc. Retirement Income Consortium, Prudent Practices for Retirement Income Solutions, 2022

For more information, visit the Investopedia website:

Fi360 Task Force

AICPA Task Force

Accredited Investment Fiduciary® (AIF®) – The purpose of the Accredited Investment Fiduciary certification is to assure that those responsible for managing or advising on investor assets have a fundamental understanding of the principles of fiduciary duty, the standards of conduct for acting as a fiduciary, and a process for carrying out fiduciary responsibility.

Accredited Investment Fiduciary Analyst® (AIFA®) – The purpose of the accredited investment fiduciary analyst certification is to assure that those responsible for independently assessing or auditing entities understand the internal policies, procedures, and workflows to conform to prudent fiduciary standards.

Alpha – The excess return an investment or portfolio generates compared to its benchmark, essentially measuring how much a fund performs relative to the market after adjusting for risk.

- Formula: Alpha = Portfolio Return - [Risk-Free Rate + Beta (Market Return - Risk-Free Rate)].

Key points about alpha:

- Positive alpha: indicates the investment outperformed the benchmark
- Negative alpha: indicates the investment underperformed the benchmark
- Beta: represents the volatility of an investment relative to the market
- Risk-free rate: represents the return on a completely risk-free investment

Example:

- If a portfolio returns 12% while the market benchmark returns 10%, and the risk-free rate is 2%, with a beta of 1, the alpha would be 2%.
    — 12% - [2% + 1(10%-2%)] = 2% alpha

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

Asset Allocation – A fundamental investment strategy that aims to balance risk and reward by distributing an investor's portfolio across different asset classes. For example, asset classes may include equities (stocks), fixed income (bonds), cash and cash equivalents, real estate, and sometimes alternative investments, such as commodities or hedge funds.

The strategic goal of asset allocation is to determine an appropriate mix of assets that aligns with the investor's risk tolerance, investment goals, time horizon, and financial situation. Since different asset classes perform differently under various market conditions, diversifying across asset classes can help reduce the volatility of an investment portfolio and potentially enhance returns.

Attribution Analysis – A sophisticated technique used in finance to understand the sources of a portfolio's performance relative to a benchmark. It breaks down the portfolio's returns into various components to determine how specific investment decisions and strategies contributed to overall performance. This analysis is crucial for evaluating the effectiveness of asset managers and investment strategies.

Glossary

The main components assessed in attribution analysis typically include:

1. Allocation Effect: Measures the impact of the portfolio manager's decision to allocate funds among different asset classes or sectors. It shows whether the manager's choice to overweight or underweight certain sectors compared to the benchmark contributed positively or negatively to performance.

2. Selection Effect: Assesses the impact of selecting individual securities within each asset class or sector. It reflects the manager's ability to pick securities that outperform the average returns of those in the benchmark.

3. Interaction Effect: This examines the combined impact of allocation and selection decisions. It accounts for the interaction between security selection and asset allocation decisions and is sometimes considered in more detailed analyses.

4. Currency Effect: In international portfolios, changes in exchange rates can affect returns. The currency effect measures how currency fluctuations contribute to the portfolio's performance relative to the benchmark.

Attribution analysis helps investors and portfolio managers understand which decisions led to positive or negative deviations from the benchmark, providing insight into areas of strength and potential improvement. This detailed reporting can inform future investment strategies and enhance accountability in fund management.

Basis Points – Often abbreviated as "bps" (and pronounced "bips"), a basis point is a unit of measurement used to describe changes in interest rates, bond yields, and other financial percentages. One basis point is equal to one one-hundredth of a percentage point, or 0.01%.

In other words:

- 1 basis point = 0.01%

- 10 basis points = 0.10%

- 100 basis points = 1%

Basis points provide a clear and precise method to express small changes in rates or yields, which is especially useful in contexts where fractions of a percentage can have significant financial implications. For example, if an interest rate increases from 5.00% to 5.25%, it rises by 25 basis points. Using basis points helps avoid confusion that might arise from using percentages to describe changes in percentages.

Cash Sweep Accounts – A financial arrangement used to automatically transfer excess cash or cash-equivalents (e.g., contributions, stock dividend income, bond interest income, etc.) from a primary account to an investment account, where the funds can potentially earn a higher return. This process helps maximize the use of idle cash, ensuring that excess balances do not just sit in non-interest-bearing accounts.

CEFEX™, Centre for Fiduciary Excellence – A Broadridge Fi360 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 Analyst – A person approved by CEFEX to conduct an assessment of an organization's fiduciary practices for CEFEX Certification.

CEFEX Certification – Independent recognition of an organization's conformity to Practices and Criteria within the Standard of Excellence. It confirms that an organization has demonstrated adherence to best practices and is positioned to earn the public's trust. CEFEX certification helps determine trustworthiness of investment fiduciaries.

Client – As used in the handbook, a client is an individual or organization served by the investment advisor in a fiduciary capacity under statutory or common law. The three types of "client" referenced in this handbook are:

- Retail investor – individual (including a family and household), legal entity, or person lawfully empowered to act on behalf of individual(s) (e.g., personal trust, trustee, legal representative);

- Retirement investor – a retirement plan, plan fiduciary, plan participant or beneficiary, IRA, IRA owner or beneficiary, or IRA fiduciary; and

- Institutional investor – a company or organization that invests on behalf of others, such as foundations, endowments, and entities that manage investments (e.g., fund companies).

Commingled Fund –Also known as a pooled fund, a commingled fund is an investment vehicle that pools capital from multiple investors to invest in a diversified portfolio of assets. This structure enables investors to gain exposure to a broader range of investments than they might be able to achieve individually, often at a lower cost. Commingled funds are managed by professional investment managers who oversee the pooled assets and make investment decisions on behalf of the investors.

Correlation Coefficient – A statistical measure that shows the strength and direction of a linear relationship between two variables in finance. It's a number between -1 and 1 that indicates how similar the measurements of two variables are across a dataset:

- **+1: Perfect positive correlation.** This means that the two variables move in exactly the same direction and proportion; when one variable increases, the other one increases by the same proportion.
- **0: No correlation.** This indicates that there is no linear relationship between the two variables, and the movement of one variable does not predict the movement of the other.
- **-1: Perfect negative correlation.** This means that the two variables move in exactly opposite directions and in the same proportion; when one variable increases, the other one decreases by the same proportion.

The correlation coefficient is used in investing to identify relationships between asset classes, sub-asset classes, and stocks. For example, it can measure how strongly and in what direction two data points, such as a financial security and an economic indicator, move with one another.

Correlation coefficients with magnitudes greater than 0.7 indicate highly correlated variables.

Criteria – The factors that define the scope and details of a Practice and provide a standard by which a Practice can be evaluated.

Environmental, Social, and Governance (ESG) Investing – The practice of considering environmental, social, and/or governance factors in investment decision-making. The motivations for doing so are generally to gain a broader understanding of the companies or portfolios in which investments may be made and to uncover ESG-related investment risks and opportunities.

Equilibrium Spending Rate (ESR) - A concept often used in the management of endowments, foundations, multi-generation trusts, and other institutions to determine the sustainable rate of spending from the assets over the long term or, theoretically, for an infinite time. This rate is crucial for ensuring that the assets can support their designated purposes without depleting principal, thereby maintaining its purchasing power and ability to provide financial support indefinitely.

- Formula: Equilibrium Spending Rate = Targeted Return – Inflation – Expenses

ERISA 3(21) Investment Advisor – A fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) who provides investment advice for a fee or other compensation with respect to any money or other property of an ERISA-governed retirement plan. This role is defined under Section 3(21)(A)(ii) of ERISA.

ERISA 3(38) Investment Manager - A specific type of fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) with discretionary authority to manage and control retirement plan assets. This designation is defined under Section 3(38) of ERISA, which assigns certain responsibilities and powers to the investment manager. In turn, the plan sponsor is relieved, under ERISA section 405(d)(1), of some fiduciary duties and liabilities related to investment decisions.

Expected Return – The anticipated average return on an investment over a specific period. It is calculated based on the probabilities of different possible outcomes. Expected return is used by investors to assess the potential profitability of an investment relative to its risk. Note that expected return is an estimate that can be based on historical data or probabilistic forecasts.

Fi360, Inc. – The legal business entity within Broadridge that promotes a culture of investment fiduciary responsibility. Since 2001, Fi360 has been helping financial intermediaries use prudent fiduciary practices to profitably gather, grow, and protect investor assets. It's our vision that all investors' wealth and retirement accounts be managed with a fiduciary standard of care.

Fiduciary – From the Latin word fiducia, meaning "trust." Someone who stands in a special relationship of trust, confidence, and/or legal responsibility. A fiduciary is held to a standard of conduct and trust above that of a stranger or casual businessperson due to the superior knowledge and/or training of the fiduciary. There are both formal and informal fiduciary relationships, and each always requires the highest standards of behavior.

Glossary

Fiduciary Excellence – A function of how well Investment Stewards, Investment Advisors, and Investment Managers comply with the practices and criteria defined in the Prudent Practices handbooks.

Generally Accepted Investment Theories – A set of principles, frameworks, and concepts that are widely recognized and endorsed by academics and practitioners in finance and investment management. These theories provide the foundational understanding and systematic approach towards making investment decisions. Here are some of the more prominent investment theories:

- Modern Portfolio Theory (MPT): Developed by Harry Markowitz, this theory emphasizes the importance of diversification. It suggests that investors can construct portfolios to maximize expected return based on a given level of market risk. The theory introduces the concept of an "efficient frontier," representing the set of portfolios that have the highest expected return for a defined level of risk.

- Capital Asset Pricing Model (CAPM): This model extends MPT and describes the relationship between systemic risk and expected return on assets, particularly stocks. According to CAPM, the expected return on an asset is determined by its beta, which measures the asset's sensitivity to movements in the overall market.

- Efficient Market Hypothesis (EMH): Proposed by Eugene Fama, this theory postulates that asset prices fully reflect all available information, making it impossible to consistently achieve higher returns than the overall market through stock selection or market timing. EMH suggests that it is more effective to invest in a diversified portfolio that mimics the market.

Investment Advisor – An individual or firm responsible for providing investment advice and/or managing investment decisions for compensation. Investment Advisors include wealth managers, financial advisors, trust officers, financial consultants, investment consultants, financial planners, and fiduciary advisers. Note that Investment Advisors is only a title, and these individuals or firms may not be registered with the SEC or States.

Investment Manager – An individual or firm who has discretion for securities selection and monitoring the portfolio on behalf of clients, which can include individuals, institutions, or funds.

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 to no risk of loss of principal. Any asset other than cash has some liquidity risk. Highly liquid assets include cash, insured bank accounts, and government securities money market funds. Other highly marketable assets, such as open-end mutual funds and publicly traded stocks and bonds, have significant volatility risk that preclude their categorization as truly liquid assets.

Liquidity Risk – The risk that the portfolio does not have sufficient liquidity to meet any immediate cash flow needs or unexpected obligations.

Marketability Risk – The potential challenges or costs associated with converting assets into cash or executing trades at desired prices within a specific time frame.

Payment For Order Flow (PFOF) – A practice in which brokerage firms receive compensation from a third party, often market makers or trading firms, for directing client trade orders to them. This arrangement primarily pertains to the trading of stocks, options, and other securities. This practice has led to many situations where clients may pay zero commissions for transactions executed.

Policy Portfolio – A strategic framework used in investment management that outlines the target allocation of assets across various asset classes to achieve long-term investment objectives. It serves as a benchmark for measuring the performance of an investment portfolio and guides the asset allocation process aligned with the investor's overall strategy, risk tolerance, and investment goals.

The Policy Portfolio defines the ideal long-term strategic allocation percentages for different asset classes, such as equities, fixed income, real estate, commodities, and cash. This strategic allocation is designed based on expected risk-return characteristics and correlations between asset classes.

Policy Portfolio Benchmark – A calculation that estimates a portfolio's return as if it were passively invested at policy targets. It's calculated by using a passive index for each asset class, weighted the same as the targets in the portfolio's asset allocation.

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 their shares at a stockholders' annual or special meeting called to elect directors or for some other corporate purpose.

Required Return – The total return on a portfolio needed by an investor in order to meet their financial objective.

Registered Investment Adviser (RIA) – A Registered Investment Adviser is an individual or firm that provides investment advice, guidance, and portfolio management services to clients for a fee and is registered with either the Securities and Exchange Commission (SEC) or the state securities authorities, depending on the amount of assets under management (AUM). RIAs are subject to regulatory oversight and are required to adhere to specific legal and ethical standards.

Retirement Income Solution – A product or service used to provide planned, reliable, and consistent income during the distribution phase of retirement. There are generally considered to be three types of in-plan retirement income solutions:

- Insured Income Solutions provide guaranteed income from immediate or deferred fixed annuities.
- Investment-based Income Solutions provide managed (non-guaranteed) payouts (systematic withdrawals) from accumulated retirement account savings and investments.
- Hybrid Income Solutions provide a combination of insurance-based guaranteed income and access to accumulated assets in retirement account savings and investments. These solutions include variable and indexed annuities procured from insurance companies, often including riders to guaranteed lifetime withdrawal benefits (GLWB) or managed payout services offered by asset managers who contract with insurers to provide guaranteed minimum withdrawal benefits (GMWB).

Risk-adjusted return – The return on an asset or portfolio modified to explicitly account for the volatility of the asset or portfolio. For example, Sharpe Ratio is a measure of risk-adjusted return that measures the performance of an investment compared to a risk-free asset after adjusting for its volatility. See definition of Sharpe Ratio below.

Risk-Free Rate of Return – The return on 90-day U.S. Treasury bills is generally used as a proxy for the risk-free rate of return 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" benchmark or point of comparison. See Sharpe Ratio.

R-squared (R2) – Formally called the coefficient of determination, R2 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 indicates more confidence in using the estimation for decision making. It is primarily used to determine the appropriateness of a given index in evaluating an Investment Manager's performance.

Risk Tolerance – An investor's capacity and willingness to endure volatility and potential losses in their investment portfolio in exchange for the possibility of higher returns. It essentially signifies how comfortable someone is with market fluctuations and the potential for volatility in their portfolio; it's a measure of how much risk an individual is prepared to take on when investing.

Safe Harbor – Provisions, legal guidelines, or regulatory frameworks that protect individuals, companies, or specific actions from liability or penalties under certain conditions. Safe harbors are designed to provide clarity and legal protection for entities operating within the bounds of these guidelines, helping to reduce uncertainty and foster compliance.

Sharpe Ratio – A commonly used measure of risk- adjusted return. It is calculated by subtracting the risk-free rate of return (usually the 90-day U.S. Treasury bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (as measured by standard deviation — see definition below). The result is a measure of return gained per unit of volatility 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.

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

Standard Deviation – A statistical measure of portfolio volatility. It reflects the average dispersion of the observations from the sample mean. Standard deviation is used as an estimate of volatility risk since it measures the width of the typical range of returns.

The wider the typical range of returns, the higher the standard deviation of returns, and the higher the volatility risk of the portfolio. If returns were normally distributed (i.e., has a bell-shaped curve distribution) then approximately two thirds of the returns would occur within plus or minus one standard deviation from the sample mean.

Strategic Asset Allocation (SAA) – A long-term investment strategy where an investor determines a set target mix of different asset classes (like stocks, bonds, real estate) within their portfolio, based on their risk tolerance, time horizon, and financial goals, aiming to maintain this mix over time by rebalancing periodically to manage risk and achieve optimal returns.

Glossary

Tactical Asset Allocation (TAA) –Also commonly known as market timing, tactical asset allocation is an investment strategy that involves adjusting a portfolio's asset mix to take advantage of short-term market opportunities. TAA is an active strategy that involves monitoring market trends to find opportunities to maximize portfolio performance. It combines a long-term strategic asset allocation with short-term tactical shifts.

Trading Costs – The expenses incurred by investors when buying or selling financial instruments such as stocks, bonds, commodities, or derivatives. These costs can significantly impact the overall profitability of investments. Key components of trading costs include:

- Commissions: Fees paid to brokers or financial advisors for executing buy or sell orders on behalf of the investor.
- Spreads: The difference between the bid price (the highest price a buyer is willing to pay) and the ask price (the lowest price a seller is willing to accept) of a financial instrument. The spread represents a cost to the trader.
- Slippage: The difference between the expected price of a trade and the actual price at which the trade is executed, often occurring in fast-moving or illiquid markets.
- Taxes and Stamp Duties: Government levies applied to certain financial transactions, which can vary by country or region.
- Exchange Fees: Charges imposed by the stock exchange or electronic trading platforms for executing trades.
- Market Impact Costs: The effect a large order can have on the market price of the financial instrument being traded, potentially moving the market against the trader.
- Foreign Exchange Fees: Costs associated with currency conversion when trading in foreign markets.
- Clearing and Settlement Fees: Charges related to the process of confirming and finalizing a trade.

Effective management of trading costs is essential for traders and investors to maximize their net returns and achieve their financial goals. Different strategies, such as using limit orders or exploring commission-free trading platforms, can help mitigate these costs.

Variance – A statistical measure that represents the dispersion or spread of a set of data points around their mean (average) value. It quantifies how much the returns of an asset, such as a stock or a portfolio, deviate from the expected return. Variance is a crucial concept in risk management and investment analysis, as it provides insights into the volatility and risk associated with an investment.

A higher variance indicates greater volatility, suggesting that the asset's returns are more spread out from the average, and therefore, it is perceived as riskier. Conversely, a lower variance indicates that the returns are more consistent and closer to the mean, suggesting lower risk.

Periodic Table of Prudent Practices for Investment Advisors

Practice 1.1
Demonstrate an awareness of fiduciary duties and responsibilities.

Practice 1.2
Provide investments and investment services consistent with governing documents.

Practice 1.3
Document the roles and responsibilities of all involved parties, whether fiduciaries or non-fiduciaries.

Practice 1.4
Identify, then avoid or manage, material conflicts of interest in a manner consistent with the duty of loyalty.

Practice 1.5
Execute written agreements that are consistent with fiduciary obligations.

Practice 1.6
Prudently protect sensitive personal identifying information and assets of clients from theft, embezzlement, business disruption, and cybersecurity risk.

Practice 2.1
Identify an investment time horizon for each investment objective.

Practice 2.2
Identify an appropriate risk level for the portfolio.

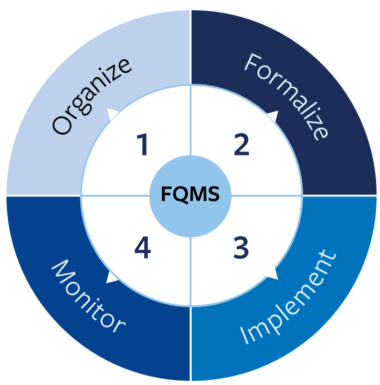
Practice 2.3
Evaluate the distribution of projected portfolio returns in the context of the client's risk and return objectives.

Practice 2.4
Ensure that selected asset classes are consistent with the time horizon and risk and return objectives for the portfolio.

Practice 2.5
Ensure that selected asset classes are consistent with implementation and monitoring constraints.

Practice 2.6
Confirm that the investment policy statement contains sufficient detail to define, implement, and monitor the portfolio's investment and distribution strategies.

Practice 2.7
Apply environmental, social, and governance (ESG) factors to investment due diligence in conformity to law, regulations, governing documents, and the fiduciary obligations of investment decision-makers.



Practice 3.1
Follow a prudent due diligence process to select each service provider and specific products and services.

Practice 3.2
Implement statutory or regulatory investment safe harbors in compliance with the applicable provisions.

Practice 3.3
Make and document decisions regarding investment strategies and types of investments in accordance with fiduciary obligations.

Practice 4.1
Conduct periodic reviews of investment performance against appropriate market and peer group benchmarks and overall objectives for the portfolio.

Practice 4.2
Conduct periodic reviews of qualitative and/or organizational changes of investment managers and other service providers.

Practice 4.3
Conduct periodic reviews of policies for trading and proxy voting.

Practice 4.4
Conduct periodic reviews to ensure that investment-related fees, compensation, and expenses are fair and reasonable for the services provided.

Practice 4.5
Conduct periodic reviews of the organization's effectiveness in meeting its fiduciary responsibilities.

Notes

Notes

Broadridge Financial Solutions (NYSE: BR) is a global technology leader with the trusted expertise and transformative technology to help clients and the financial services industry operate, innovate, and grow. We power investing, governance, and communications for our clients – driving operational resiliency, elevating business performance, and transforming investor experiences.

Our technology and operations platforms process and generate over 7 billion communications per year and underpin the daily trading of more than $10 trillion of securities globally. A certified Great Place to Work®, Broadridge is part of the S&P 500® Index, employing over 14,000 associates in 21 countries. For more information, please visit www.broadridge.com.

Broadridge.com

Broadridge®

Ready for Next

1100003_AM_L&D-Fi360PrudentPractices_Handbook_FY25