Strategic Risk

Conclusion: Aggregate strategic risk posed to the bank by the RIA is (low, moderate, high).

Objective: To identify and estimate strategic risk posed to the bank by the RIA's business activities.

1. Analyze the RIA's strategic plan by considering the following strategic factors:

   - The magnitude of change in established corporate mission, goals, culture, values, or risk tolerance;
   - The financial objectives as they relate to the bank's short- and long-term goals;
   - The market situation, including product, customer demographics, and geographic position;
   - Diversification by product, geography, and customer demographics;
   - Past performance in offering new products and services;
   - Risk of implementing innovative or unproven products, services, or technologies;
   - Merger and acquisition plans and opportunities; and
   - Potential or planned entrance into new businesses, product lines, or delivery channels, or implementation of new systems.

2. Discuss the strategic plan with appropriate bank risk managers and assess the impact of the following external factors on strategic risk.

   - Economic, industry, and market conditions (impact on projected revenue);
   - Legislative and regulatory change;
   - Technological advances; and
   - Competition.

3. Analyze conclusions from the "Quality of Risk Management" procedures completed during the review. Incorporate those conclusions into the evaluation of strategic risk from the RIA's business activities. Also consider the following factors:

- The expertise of senior management and the effectiveness of the board of directors;
- The priority and compatibility of personnel, technology, and capital resources allocation with strategic initiatives;
- Past performance in offering new products or services and evaluating potential and consummated acquisitions;
- Performance in implementing new technology or systems;
- The effectiveness of management's methods of communicating, implementing, and modifying strategic plans, and consistency with stated risk tolerance;
- The adequacy and independence of controls to monitor business decisions;
- The responsiveness to identified deficiencies in internal controls; and
- The quality, integrity, timeliness, and relevance of reports to the board of directors necessary to oversee strategic decisions.

4. Reach a conclusion on the impact of the RIA's business activities on the bank's level of strategic risk.

Reputation Risk

Conclusion: Aggregate reputation risk to the bank from the RIA is (low, moderate, high).

Objective: To identify and estimate reputation risk posed to the bank by the RIA's business activities.

1. Discuss with appropriate bank risk managers the impact of the strategic factors listed below on reputation risk from the RIA:

   - The volume and types of assets and number of accounts under management or administration;
   - Merger and acquisition plans and opportunities; and
   - Potential or planned entrance into new businesses, product lines, or technologies (including new delivery channels), particularly those that may test legal boundaries.

2. Discuss with appropriate risk managers the impact of the factors listed below on reputation risk from the RIA:

   - The market's or public's perception of the corporate mission, culture, and risk tolerance of the bank and the RIA;
   - The market's or public's perception of the bank's and the RIA's financial stability;
   - The market's or public's perception of the quality of products and services offered by the bank and the RIA; and
   - The impact of economic, industry, and market conditions; legislative and regulatory change; technological advances; and competition.

3. Analyze conclusions from the "Quality of Risk Management" procedures completed during the review. Incorporate those conclusions into the evaluation reputation risk from the RIA's business activities. If applicable, consider the following factors:

   - Past performance in offering new products or services and in conducting due diligence prior to startup;

- Past performance in developing or implementing new technologies and systems;
- The nature and amount of litigation and customer complaints;
- The expertise of senior management and the effectiveness of the board of directors in maintaining an ethical, self-policing culture;
- Management's willingness and ability to adjust strategies based on regulatory changes, market disruptions, market or public perception, and legal losses;
- The quality and integrity of management information systems and the development of expanded or newly integrated systems;
- The adequacy and independence of controls used to monitor business decisions;
- The responsiveness to deficiencies in internal control;
- The ability to minimize exposure from litigation and customer complaints;
- The ability to communicate effectively with the market, public, and media;
- Policies, practices, and systems protecting information customers might consider private or confidential from deliberate or accidental disclosure; and
- Management's responsiveness to internal, external, and regulatory review findings.

4. Reach a conclusion on the impact of the RIA's business activities on the bank's level of reputation risk.

Quality of Risk Management — Registered Investment Advisers

Conclusion: The quality of the bank's risk management over the RIA is (strong, satisfactory, weak).

Policies

Conclusion: The bank has adopted (strong, satisfactory, weak) risk management policies applicable to the RIA.

The following are the core assessment standards applicable to risk management policies that should be considered when completing these procedures:

- The consistency of policies with the bank's overall strategic direction and throughout the organization.
- The appropriateness of guidelines that establish risk limits or positions and whether periodic revaluation is required.
- The reasonableness of definitions that determine policy exceptions and guidelines for approving policy exceptions.
- The structure of the bank's operations and whether responsibility and accountability are assigned at every level.
- The periodic review and approval of policies by the board or an appropriate committee.
- The structure of the compliance operation and whether responsibility and accountability are assigned at every level.

Objective: To determine the adequacy and effectiveness of bank policies applicable to the RIA.

1. Identify and obtain bank policies related to the RIA, including those related to information systems.

2. Review policy documents and determine whether they

    - Are formally approved by the board, or a designated committee(s);

- Effectively address the bank's relationship with the RIA and applicable law;

- Outline the bank's investment management goals and objectives, investment philosophy, fiduciary responsibilities, ethical culture, risk tolerance standards, and risk management framework that will be applied to the RIA;

- Address all significant products and services provided by the RIA to the bank including

  – The types and size of acceptable accounts,
  – A list and description of investment products and styles,
  – Compensation schedules,
  – Descriptions of marketing and distribution channels, and
  – How new products and services are developed and approved.

- Address the bank's organizational structure and supervisory framework for managing risk associated with the RIA by establishing

  – Organizational and functional charts;
  – Defined lines of authority and responsibility;
  – Delegation authority and approval processes;
  – Processes to select, employ, and evaluate legal counsel;
  – Standards for dealings with affiliated organizations; and
  – Personnel practices.

- Establish portfolio management processes for accounts managed by the RIA, if applicable, that include appropriate guidelines for

  – Reviewing and accepting accounts and performing periodic portfolio reviews,
  – Economic and capital market analyses and reporting,
  – The development and implementation of portfolio investment policy programs,
  – Portfolio trading and broker selection, and
  – Selecting and monitoring third-party service providers.

- Address bank information systems and technology applications for monitoring RIA activities such as

   - Accounting and other transaction record keeping systems;
   - Management information system requirements;
   - Portfolio management software that provides valuation, performance analysis, simulation, and trading interface applications and abilities;
   - Investment trading systems; and
   - Systems security and disaster contingency plans.

- Establish appropriate bank information reporting and risk monitoring processes for accounts managed by the RIA, if applicable, that include

   - Internal investment performance and risk management reporting standards;
   - Policy exception tracking and reporting processes;
   - Client reporting guidelines;
   - Control self-assessment processes;
   - Portfolio stress-testing, back-testing, and model validation processes;
   - Customer complaint resolution procedures; and
   - Performance reviews of third-party service providers.

3. Evaluate the policy review process and determine whether changes in risk tolerance, strategic direction, products and services, or the external environment are adequately and effectively reviewed.

4. Through discussion with management and other examiners, identify parts of the policy requiring development or revision. Consider the following as they relate to bank usage of RIA products and services:

   - Recently developed and distributed products and services;
   - Discontinued products, services, organizational structures, and information systems; and
   - Recent updates or revisions of existing policies and procedures.

5. Draw a conclusion on the adequacy and effectiveness of the bank's risk management policies relating to the RIA.

Processes

Conclusion: The bank has (strong, satisfactory, weak) processes for managing risk posed by the RIA.

The following are the core assessment standards applicable to risk management processes that should be considered when completing these procedures:

- The adequacy of processes that communicate policies and expectations to appropriate personnel.
- The production of timely, accurate, complete, and relevant management information.
- The adequacy of processes and systems to approve, monitor, and report on compliance with policy.
- The appropriateness of the approval process for policy exceptions.
- The adequacy of internal control, including segregation of duties, dual control, and authority commensurate with duties.
- Management's responsiveness to regulatory, industry, and technology changes.
- The adequacy of processes defining the systems architecture for transaction processing and for delivering products and services.
- The effectiveness of processes developed to ensure the integrity and security of systems and the independence of operating staff.
- The adequacy of processes to ensure the reliability and retention of information (e.g., data creation, processing, storage, and delivery).
- The quality of physical and logical security to protect the confidentiality of customer and corporate information.
- The capabilities of the front and back office systems to support current and projected operations.
- The adequacy of corporate contingency plans and business resumption plans for relevant data centers, file servers, PCs, networks, service providers and business units.
- The adequacy of contracts and management's ability to monitor relationships with the RIA and other third-party vendors.
- The capacity to deliver timely services and to respond rapidly to normal service interruptions or to attacks and intrusions from external sources.

- Whether risk measurement systems are appropriate to the nature and complexity of activities, and how these systems are incorporated into the decision-making process.
- The adequacy of processes assimilating legislative and regulatory changes into all aspects of the company.
- The commitment to allocate appropriate resources to training and compliance.
- The extent to which violations or noncompliance are identified internally and corrected.
- The adequacy of integrating compliance considerations into all phases of corporate planning, including the development of new products and services.

Objective: To determine the adequacy and effectiveness of supervision by the bank's board and senior management.

1. Determine how supervisory oversight of the RIA is organized and whether clear lines of authority, responsibility, and accountability are established through all levels of the organization. Obtain and evaluate the following:

    - Bank bylaws and resolutions.
    - Strategic plan and business strategies, including those related to functionally regulated entities.
    - Board and management committees, charters, minutes, and reports.
    - Management structures, authorities, and responsibilities.
    - Other organizational structures.

2. If the board has delegated RIA supervisory oversight to one or more committees, review each committee's composition, charter, meeting frequency, attendance, information reports, and board reporting processes for consistency with board guidance and regulatory requirements.

3 Evaluate the bank's strategic planning process for the RIA. This procedure generally applies to the bank's subsidiary RIA. Consider the following questions:

    - Does the process require the formulation and adoption of a long-term strategic plan supported by short-term business plans?

- Is the RIA's strategic planning process part of the bank's overall strategic and financial planning processes?

- Does the bank's process require periodic assessment, updating, and re-affirmations of the RIA's strategic plans?

- Does the bank's process consider significant factors that affect the RIA, such as internal risk tolerance standards, the corporate ethical culture, available financial resources, management expertise, technology capabilities, operating systems, competition, economic and market conditions, and legal and regulatory issues?

- Does the bank's planning process relating to the RIA evaluate and determine the amount of capital necessary to support the business?

- Does the bank's planning process include an effective means of communicating strategies, financial performance goals, and risk tolerance standards to the RIA?

4. Evaluate bank management processes for monitoring how the RIA implements the strategic plan and reports performance to the bank's board or the designated oversight body. Consider the following:

   - Are policies and procedures consistent with the bank's strategic plan and policy guidelines?

   - Are the development, implementation, and monitoring of short-term business plans consistent with board-established planning processes?

   - Does the bank's board, or its designated oversight body, receive reports from the RIA that provide accurate, reliable, understandable, and relevant information about the following:

     – Success in meeting strategic goals and objectives;

     – Quantity and direction of investment management risks;

     – Adequacy of risk management systems;

- Financial performance analyses, including the adequacy of capital allocated to the business; and

- Summaries of changes to risk and business strategies, corrective actions, and proposed recommendations to address excessive risk levels or remedy control weaknesses.

5. Reach a conclusion on the quality of the bank's supervisory oversight of the RIA.

Objective: To determine the adequacy and effectiveness of third-party service provider selection and monitoring processes.

1. Evaluate bank policies and processes for reviewing the selection and monitoring of third-party service providers used by the bank's affiliated RIA. Discuss the policies and processes with appropriate bank risk managers. Document significant weaknesses in risk management processes. Consider the following in reaching conclusions:

   - The quality of the due diligence review process;
   - The contract negotiation and approval process;
   - Risk assessment processes;
   - Risk management and audit division participation;
   - Vendor monitoring processes, such as the assignment of responsibility, the frequency of reviews, and the quality of information reports reviewed; and
   - How well the vendor resolves problems.

Personnel

Conclusion: The bank has (strong, satisfactory, weak) personnel managing risk posed to the bank by the RIA.

The following are the core assessment standards applicable to personnel that should be considered when completing these procedures:

- The depth of technical and managerial expertise.

- The appropriateness of performance management and compensation programs.
- The appropriateness of management's response to identified deficiencies in policies, processes, personnel, and control systems.
- The level of turnover of critical staff.
- The adequacy of training.
- The ability of managers to implement new products, services, and systems in response to changing business, economic, or competitive conditions.
- The understanding of and adherence to the strategic direction and risk tolerance as defined by senior management and the board.

Objective: To determine the adequacy of the bank's evaluation of the RIA's management and supporting personnel.

1. Review the bank's process for evaluating the experience, education, and other training of the RIA's management and key supporting personnel. The bank's personnel review should include portfolio managers, research analysts, traders, business line managers, and other personnel who manage risk within the RIA.

2. Determine whether the bank's review assesses the adequacy of the RIA's personnel by considering the following:

   - The types and complexity of clients and the investment advisory services provided;
   - The RIA's compatibility with the bank's investment management services and corporate strategic initiatives,
   - The types and complexity of information processing and reporting systems; and
   - Knowledge of the bank's investment management policies and code of ethics, if applicable.

3. Review recent RIA staffing analyses plans that are available from the bank. Evaluate the bank's determination regarding the adequacy of the RIA's staffing level. Determine whether it considers

   - Current strategic initiatives and financial goals;
   - Current business volume, complexity, and risk profile;
   - The impact of company-initiated cost-cutting programs, if applicable;

- Success in hiring and retaining high-quality personnel;
- Level and trends of staff turnover, particularly in key positions;
- The quality and reasonableness of management succession plans; and
- The quality of training programs.

4. Assess the quality of bank personnel responsible for monitoring risk with the RIA. Determine whether

   - Lines of authority and individual duties and responsibilities are clearly defined and communicated.

   - Personnel are qualified and adequately trained for their positions and responsibilities.

   - Personnel perform tasks outside their job descriptions that lower their overall performance or increase risk to the bank.

Control Systems

Conclusion: The bank has (strong, satisfactory, weak) control systems for managing risk posed by the RIA.

The following are the core assessment standards applicable to risk management control systems that should be considered when completing these procedures:

- The timeliness, accuracy, completeness, and relevance of management information systems, reports, monitoring, and control functions.
- The scope, frequency, effectiveness, and independence of the risk review, quality assurance, and internal/external audit functions.
- The effectiveness of exception monitoring systems that identify, measure, and track incremental risk exposure by how much (in frequency and amount) the exceptions deviate from policy and established limits, and corrective actions.
- The independent testing of processes to ensure ongoing reliability and integrity (e.g., Internet penetration testing).
- The adequacy of systems to monitor capacity and performance.

- The adequacy of controls over new product and systems development.
- The independent use and validation of measurement tools.

Objective: To determine the adequacy and effectiveness of the bank's control and monitoring systems relating to the RIA.

1. Determine and evaluate the types of control and monitoring systems used by the bank's board and senior management. Consider the following:

   - Board and senior management risk monitoring processes,
   - Risk management groups,
   - Committee structures and responsibilities,
   - Management information systems,
   - Quantitative risk measurement systems,
   - Compliance programs,
   - Control self-assessment processes, and
   - Audit program.

2. Determine the extent to which the bank's board and senior management is involved in supervising the RIA's business activities. Consider

   - Types and frequency of board and senior management reviews used to determine adherence to policies, operating procedures, and strategic initiatives, including those related to functionally regulated entities;
   - The adequacy, timeliness, and distribution of management information reports; and
   - The board's and senior management's responsiveness to risk control deficiencies and the effectiveness of their corrective action and follow-up activities.

3. If the bank has a separate risk management function responsible for the RIA, review its purpose, structure, reporting process, and effectiveness. Consider the following:

   - Size, complexity, strategic plans, and trends in investment management services activities;
   - Independence and objectivity;
   - Quality and quantity of personnel; and

- Quality of risk assessment, transaction testing, monitoring systems, and reporting processes.

4. Review the bank's assessment of the RIA's compliance program. Consider the following:

   - Extent of board and senior management commitment and support;
   - Line management responsibility and accountability;
   - Formalization, transaction testing, reporting structures, and follow-up processes;
   - Qualifications and performance of compliance officer and supporting personnel;
   - Communication systems; and
   - Training programs.

6. If the bank has implemented a control self-assessment program, obtain information on the control self-assessments performed by the RIA. Evaluate the results of control self-assessments completed by the RIA.

7. Obtain internal and external audit reports and follow-up reports pertaining to the RIA completed since the previous supervisory review:

   - Determine the adequacy and effectiveness of the internal and external audit work on the RIA by considering the following:

     – The independence, qualifications, and competency of audit staff;
     – The timing, scope, and results of audit activity; and
     – The quality of audit reports, work papers (if reviewed), and follow-up processes.

   - If the review of audit reports and work papers raises questions about audit effectiveness, discuss the issues with appropriate examiners and determine whether the scope of the audit review should be expanded. Issues that might require an expanded scope include

     – Unexplained or unexpected changes in auditors or significant changes in the audit program,
     – Inadequate scope of the investment management audit program,
     – Audit work papers that are deficient or do not support audit conclusions,

    - High-growth areas in investment management that lack adequate audit coverage, and
    - Inappropriate actions by insiders to influence the findings or scope of audits.

- Draw conclusions about the adequacy and effectiveness of the bank's RIA audit program and forward the findings and recommendations, if applicable, to the examiner responsible for evaluating the bank's overall audit program.

Conclusions — Registered Investment Advisers

Objective: To consolidate and communicate the findings of the RIA review and initiate corrective action, if applicable.

1. Prepare a summary document that includes the following information, if applicable:

    - Conclusions on the types and level of risk posed to the bank by the RIA's business activities.

    - Conclusions on the impact of the RIA on the bank's core assessment and applicable risk assessment factors. Conclusions should address

        – The effectiveness of the bank's system for monitoring and controlling operational and financial risks that may pose a threat to the safety and soundness of the bank; and

        – Compliance with federal law that the OCC has specific jurisdiction to enforce with respect to the RIA.

    - Other findings and recommendations for bank management.

    - Whether the RIA should be examined. The OCC may examine a RIA only when:

        – The OCC has reasonable cause to believe that the company is engaged in activities that pose a material risk to the national bank;

        – The OCC reasonably determined, after reviewing relevant reports, that examination of the company is necessary to adequately inform the OCC of the system for monitoring and controlling operational and financial risks that may pose a threat to the safety and soundness of the national bank; or

        – The OCC, based on reports and other available information, has reasonable cause to believe that the company is not in compliance with federal law that the OCC has specific

jurisdiction to enforce against that company, including provisions relating to transactions with affiliates, and the OCC cannot make such determination through examination of the national bank.

2. Discuss the review's findings with the bank and asset management EICs and adjust findings and recommendations as needed. Decisions relating to an examination of the RIA should be made only after consultations with and the approval of the appropriate supervisory office authority.

3. Hold a meeting with appropriate bank oversight committees or the appropriate risk managers to communicate the review's conclusions and recommendations, if appropriate and if authorized by the bank EIC. Allow management time before the meeting for preliminary examination conclusions and draft report comments.

4. Prepare appropriate comments for the memorandum containing the fiduciary examination's conclusions. Supplement the memorandum, when appropriate, to include the following:

   - The objectives and scope of completed supervisory activities;
   - Reasons for changes in the supervisory strategy, if applicable;
   - Overall conclusions, recommendations for corrective action, and management commitments and time frames; and
   - Comments on recommended administrative actions, enforcement actions, and civil money penalty referrals, if applicable.

5. Prepare final comments for the bank report of examination as requested by the EIC. Perform a final check to determine whether comments

   - Meet OCC guidelines for reports of examination,
   - Support the review's conclusions and recommendations, and
   - Contain accurate violation citations.

6. If there are MRA comments, enter them in the OCC's electronic information system. Ensure that the comments are consistent with MRA content requirements.

7. Update applicable sections of the electronic file, including

   - UITRS ratings,
   - RAS (if requested by the bank EIC),
   - Violations of law or regulation, and the
   - Core knowledge database.

8. Prepare a recommended supervisory strategy for the subsequent supervisory cycle, and give it to the asset management EIC for review and approval.

9. Prepare a memorandum or update work programs with any information that will facilitate future examinations.

10. Organize and reference work papers in accordance with OCC guidelines.

11. Complete and distribute assignment evaluations for assisting examiners.

Appendix A: Portfolio Management Processes

This section discusses the processes that a fiduciary investment manager may follow to achieve the objectives of an account and effectively manage risk in an investment portfolio. For most fiduciaries, the legal requirements for prudent investment management require investment managers to follow the course of action of an informed investor. The fiduciary duty of caution does not require an investment manager to avoid risk, only to manage it prudently. The courts will judge a fiduciary on the process he or she used to manage a portfolio, not necessarily the investments' results.

The portfolio management process is virtually the same for all types of portfolios, regardless of size or purpose. While a formally structured and disciplined investment management process does not guarantee investment success, it does significantly increase the likelihood of maintaining a portfolio that withstands the test of private and public scrutiny and fiduciary standards of loyalty and prudence. For any portfolio management process to be effective, it must be a continual process that is responsive to changes in client needs and characteristics and capital market conditions.

The following guidelines present standardized, but flexible, processes in three broad and sometimes overlapping stages: investment policy development, implementation, and monitoring. The guidelines incorporate modern portfolio theory and elements of prudent fiduciary conduct. They reflect portfolio management techniques developed and followed by the professional investment management industry and incorporate legal elements of fiduciary conduct established by the Prudent Investor Rule and ERISA.

Stage 1 — Development of Investment Policy

The development of an appropriate and realistic investment policy is critical to the long-term success of any portfolio. The development of an investment policy consists of analyzing the investment assignment, identifying investment objectives, developing asset allocation guidelines, and establishing appropriate performance benchmarks, and culminates with the creation of an investment policy statement.

The Investment Assignment

The fiduciary should examine the governing instrument (trust or agency agreement) and understand its purpose, intent, investment directives, and

granted investment authority and powers. It is important that all parties understand the purpose and intent of the document creating the fiduciary relationship. A fiduciary's investment responsibilities should be clearly established and documented. These actions will help the fiduciary develop a better investment policy and can limit future problems.

The fiduciary should develop an understanding of the characteristics and investment needs of the account's principals and beneficiaries. This may require reviewing each party's entire financial profile, if possible, to determine the portfolio's relationship to his or her other assets and income sources.

The fiduciary should evaluate the portfolio's current investment holdings to determine whether they are appropriate based on the account's purpose and investment needs. It is also prudent to analyze how others managed the portfolio and the recent investment performance of the portfolio.

Investment Objectives

After reviewing the governing document and account principals and beneficiaries, the fiduciary can identify and document the account's investment objectives. Investment objectives should

- Articulate the account's risk tolerance;
- Establish investment goals and return requirements; and
- Detail legal, liquidity, time horizon, taxes, and other special circumstances of the account, its principals, and beneficiaries.

Investment objectives should be a list of quantifiable investment results that are expected over a specified time frame. Objectives can be set for the total portfolio as well as for various asset categories and each individual investment, adviser, or fund. Objectives help to determine 1) which assets are allocated to the portfolio, 2) the portfolio's investment policy, and 3) how the portfolio's performance is evaluated and monitored.

A portfolio's investment objectives must make sense from the client's tax and legal standpoint. A portfolio's assets must be viewed together with the client's other assets, if possible, and blended with rational capital market

expectations. In taxable accounts, return goals should be expressed in after-tax terms. When developing investment objectives for persons, remember the wealth accumulation life cycle and understand its effect on the investor's needs and constraints.

Asset Allocation Guidelines

Once an account's investment objectives have been established, the fiduciary manager must decide how to efficiently allocate portfolio assets among the various investment opportunities. Asset allocation decisions may be the most important decisions the fiduciary manager makes in terms of a portfolio's long-term investment performance. Asset allocation guidelines establish the type and amount of assets to be held under normal conditions and the average level of risk tolerance over the expected life of the portfolio. The guidelines must conform to investment constraints imposed by a client. For example, one account may permit only equity investments, another may impose restrictions on the use of financial derivatives, and still another may prohibit investing in a certain type of industry or country.

Asset allocation involves dividing the investment portfolio among asset markets, or categories of assets, to achieve appropriate diversification or a combination of expected return and risk consistent with the portfolio's objectives and risk tolerance. The types of assets traditionally allocated by banks include publicly traded equity and debt securities, and their cash equivalents. An increasing number of alternative investments have become accepted and used by both institutional and personal investors. Some examples include real estate, private equity funds, hedge funds, managed futures, commodities, and mineral interests.

The primary types of assets are often broken down into sectors and investment styles. Sectors can be differentiated by industry, country, market, and other social and economic characteristics. Some examples of investment styles are active, passive, growth, value, large capitalization, and small capitalization.

The concepts of modern portfolio theory and efficient frontiers can be applied to the problem of deciding how to allocate portfolio assets among the major asset categories. For example, allocations can be established using mean-variance quadratic computer programs that mathematically determine efficient portfolio mixes for different risk levels. The basic inputs are expected return, expected yields, risk estimates, and correlations (or

covariances) for each asset category included in the analysis. Other inputs may include constraints such as target concentration limits of individual or group asset types and yield constraints on part, or all, of the portfolio.

The computer program determines the portfolio's expected return, variance, and standard deviation for different allocations of funds between the asset categories, and establishes the efficient set of portfolios, or optimal portfolios. The program can also develop portfolios based on the probability that an expected return will not be achieved, and can also be applied to multiple scenarios with probability forecasting. While asset allocation computer programs are useful and highly efficient for certain kinds of investment strategies, their effectiveness depends on the quality of modeling input and the knowledge, expertise, and judgment of the user.

Tax-exempt portfolios have been the focus of most asset allocation modeling programs. Personal investors are now requiring tax-aware asset allocation planning in order to minimize taxes and develop strategies that enhance estate planning structures. To be competitive, a bank will need asset allocation tools that can be efficiently applied to taxable portfolios.

A bank does not need to develop and maintain its own sophisticated asset allocation programming and computer capability. There are a variety of companies that provide quantitative asset allocation services.

Performance Benchmarks

From the asset allocation guidelines, an appropriate performance benchmark can be selected as a passive representation of a portfolio's investment objectives, strategy, and style. Performance benchmarks are used to make risk and return comparisons. Useful and effective benchmarks are:

- **Unambiguous**. The names and weights of investments comprising the benchmark are clearly delineated.
- **Investable**. The option is available to forego active management and simply hold the benchmark.
- **Measurable**. The benchmark's return can be readily determined on a reasonably frequent basis.

- **Appropriate**. The benchmark is consistent with the portfolio's investment strategy or the portfolio manager's investment style or biases.

- **Reflective of current investment opinions**. The manager has current investment knowledge of the benchmark.

- **Specified in advance**. The benchmark is constructed prior to the start of the performance evaluation period.

Selecting an appropriate benchmark is not an easy task, particularly for accounts with many different asset categories and beneficiaries. Each type of asset, and even each sub-sector, may have its own separate benchmark. This process reinforces the importance of having a clearly written investment policy with specific goals and objectives to improve a manager's ability to establish appropriate performance benchmarks. Subsequent changes to selected benchmarks must be carefully considered and fully documented by the fiduciary manager.

The most commonly used benchmark is a market index, such as the S&P 500 or a corporate bond index. Market indexes are viewed as independent representations of the market and are publicly available. Market indexes can also be combined to reflect a specific portfolio strategy or asset allocation structure. Problems with market indexes include the following:

- The index may not accurately reflect a portfolio's strategy or style;
- Indexes implicitly assume cost-free transactions;
- Most indexes assume that income is reinvested; and
- Investors cannot invest in some market indexes.

The "normal portfolio" of a particular manager, fund, or account is a specially constructed portfolio that represents an investment strategy's neutral position and displays average market exposures over time. While this type of benchmark may provide greater insight into a portfolio's performance, its construction can be costly, is easily manipulated, requires ongoing maintenance, and may be difficult to explain to clients.

Whether a benchmark is a publicly available index or a customized product, the fiduciary manager must understand the mechanics behind its construction before effectively analyzing portfolio performance relative to the benchmark. Benchmarks facilitate both the assessment of active management skill and the

efficient allocation of funds among managers within all asset categories of a portfolio. They are essential investment tools for fiduciary managers.

The Investment Policy Statement

The creation of an appropriate investment policy document, or statement, is the culmination of analyzing the investment assignment, identifying investment objectives, determining asset allocation guidelines, and establishing performance measurement benchmarks. The lack of an investment policy statement, or the existence of a poorly developed one, is a weakness in portfolio management risk control.

A properly constructed investment policy statement can ensure the continuity of the investment program and limits second-guessing of investment decisions. It may also limit the temptation to increase portfolio risk to take advantage of perceived short-term market trends. The length and explicitness of the policy statement depends on the type of client, and the policy statement should be customized for each client. Refer to appendix E for guidance on developing investment policy statements.

Stage 2 — Implementing Investment Policy

Once the investment policy has been developed, the fiduciary portfolio manager must implement the policy's investment strategies (according to its guidelines and limits) and assign operational responsibilities. Specific activities include

- Selecting investment managers and advisers, if this function is to be outsourced;
- Selecting and acquiring investments based on the asset allocation guidelines in the investment policy;
- Monitoring and re-balancing the portfolio according to the investment policy and asset allocation guidelines; and
- Reviewing risk management reporting information and providing appropriate risk managers with investment performance and compliance reports.

Investment managers, internal and external, are selected for each asset category and decisions are made concerning the amount of money placed with each manager. Refer to appendix F for guidance on selecting and monitoring third-party investment managers and advisers.

Within each asset category and associated sectors, decisions are made concerning the specific assets to purchase and the amount of money to be invested in each one. The organization normally maintains an approved list of individual securities in each asset category or sub-sector. This regularly updated list should provide portfolio managers with recommendations in the form of expected return and risk characteristics of the security, including sensitivity to various factors. Portfolio managers use the securities list to construct investment portfolios according to the asset allocation guidelines.

Portfolio monitoring and revision is a continual and complicated process that requires extensive analysis and sound judgment. Asset categories may become over- or under-weighted in relation to the asset allocation guidelines because the returns on individual asset categories will vary over time. Portfolio re-balancing involves restoring the portfolio to appropriate percentage allocation ranges. Re-balancing requires the portfolio manager to make critical decisions about the cost of trading versus the cost of not trading. Re-balancing, when completed in a disciplined and controlled manner, can enhance performance and ensure compliance with the investment policy.

Tactical asset allocation (TAA), or targeted, short-term changes in the asset mix or sectors, may have a place in the portfolio management process. It is a variation of market timing, albeit a highly quantitative form. TAA managers shift their portfolio between asset categories in hopes of exiting overvalued markets and concentrating on undervalued markets. TAA managers hope to extract alpha, or investment performance in excess of expected return, by examining the long-term fundamentals of entire asset categories.

TAA style differs slightly from firm to firm, but the market leaders all evaluate the relative current expense of buying future cash flows for different asset categories and sectors. TAA assumes that the client's objectives and risk tolerance stay constant, but that the market environment changes and inefficiencies exist. To control TAA, the investment policy's asset allocation guidelines should incorporate prudent ranges of permissible reallocations.

Portfolio managers review performance and risk measurement reports to evaluate their success in achieving the goals and objectives of the portfolios.

Their performance and compliance with investment policies and strategies should be demonstrated through reports to appropriate risk managers in the investment organization. This reporting process should be formalized and documented. The reports should supply the following information:

- Total return over relevant time periods.
- Total return breakdown and attribution.
- Comparisons to portfolio objectives and benchmarks.
- Risk-adjusted return comparisons over relevant time periods.
- Compliance with portfolio guidelines and client needs.

Stage 3 — Monitoring Investment Policy

An effective monitoring program will provide the fiduciary manager with information to evaluate the investment policy's strengths and weaknesses and to keep the investment strategy on track in achieving the client's goals and objectives. The fiduciary manager must establish and monitor performance measurement standards suitable for the client and the portfolio. An effective monitoring program includes the following:

- A formalized and documented account review process that includes an annual investment policy review to analyze performance and reaffirm or change the investment policy, including asset allocation guidelines.

- The maintenance of current and relevant client information.

- Appropriate communication with clients.

- Comprehensive risk management reports relating to investment performance, risk levels, and policy exception identification and follow-up.

- Interim reviews of adherence to asset allocation and individual security guidelines, and of performance relative to established benchmarks.

- Monitoring of global and domestic economic conditions, capital markets trends, political environments, regulatory climates, and other competitive factors.

Appendix B: Trust Investment Law

This section provides an overview of trust investment law and the development and application of the Prudent Investor Rule of the Restatement (Third) of Trusts (PIR) and the Uniform Prudent Investor Act (UPIA). Bank trustees should consult with qualified legal counsel to determine if and how the PIR, the UPIA, or other applicable trust laws apply to the bank's trust accounts.

The foundation of trust law defining prudent investment decisions by trustees was established in 1830 by the Massachusetts Supreme Court in *Harvard College v. Amory*. The Harvard College standard is commonly known as the Prudent Man Rule (PMR).

> **"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."**

Over the next century, the philosophies of state legislatures and courts changed from favoring flexibility in trust investing to a desire for more certainty and conservatism. In the first half of the twentieth century, most states enacted lists of specific types of investments that trustees were permitted to make, and courts established a series of subrules on what was prudent and what was not. Although this original standard compares a trustee to his contemporaries, suggesting a flexible standard, state courts and legislatures progressively restricted the latitude of trustees' investment decisions by introducing "legal lists" and requiring trustees to assess the prudence of each individual investment in isolation. Thus the flexibility and discretion of *Harvard College v. Amory* gave way to rules and restrictions.

In 1942, the American Bankers Association (ABA) promulgated its Model Prudent Man Investment Statute, which slightly modified the PMR.

> **"In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as probable safety of their capital."**

Since then, a significant majority of states have amended their statutes in recognition of changes in the economy, financial theory, and widely accepted investment products and techniques employed by the professional investment management community. Many state legislatures eliminated the legal investment lists and replaced them with prudent investment standards similar to the PMR, now the Prudent Person Rule (PPR). In addition, Congress imposed a similar prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA) enacted in 1974.

The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the "reasonable person" rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Almost all rules of trust law are default rules, that is, rules that the settler may alter or abrogate. Traditional trust law also allows the beneficiaries of the trust to excuse a trust's investment performance if all beneficiaries are capable and properly informed.

Of the standards to which a trustee must adhere, the most important are that it exercise care, skill, and caution, and manifest loyalty and impartiality. A trustee's compliance with these duties is judged as of the time an investment decision is made, and not with the benefit of hindsight or subsequent developments, nor on the outcome of his or her investment decisions.

Modern Portfolio Theory

Modern portfolio theory (MPT) is a variety of portfolio construction, asset valuation, and risk measurement concepts that rely on the application of statistical and quantitative techniques. Among the concepts and models associated with the MPT are Markowitz's portfolio theory, the capital asset pricing model, the arbitrage pricing theory, and the Black-Scholes option pricing model. MPT is widely employed by the professional investment management community because it provides insights and principles for determining the optimal allocation of wealth among available investments in the marketplace and offers a generally accepted methodology for systematically evaluating risk.

MPT reflects contemporary economic understanding of the portfolio management process. It embraces scientific methods of understanding risk

and return relationships and the importance of portfolio diversification. It gives substance to the legal parameters of prudence by developing quantitative techniques to assist in evaluating volatility, suitability, investment productivity, and diversification. It focuses attention on both the purpose and reasoning behind an investment decision.

MPT has significantly influenced the evolution of the standard of care governing trustees as enunciated in ERISA, the PIR, and the UPIA. It has also influenced how the investment management community develops, implements, and monitors an investment strategy and, in turn, has influenced the evolution of the standard of prudence governing trustees. MPT offers the following conclusions:

- The investment strategy and its performance must be judged for the whole portfolio rather than for each particular investment component.

- It is portfolio risk, not the risk posed by individual securities, that determines suitability and diversification decisions.

- An investment manager should consider any market instrument or investment vehicle that can be used to manage portfolio risk.

- An investment manager does not eliminate any investment opportunities simply because an investor has certain attributes. Investor-specific attributes like tax status, time horizon, and risk tolerance merely tilt a portfolio toward or away from certain types of securities.

A major insight of MPT is that an investment strategy and its performance must be judged on the basis of the portfolio as a whole, rather than on the basis of each investment in isolation. It is the effect on total portfolio risk that determines the prudence of including an investment in a portfolio. An investment manager should consider all available investment opportunities that can be used to manage portfolio risk.

MPT assesses risk in terms of the interrelationships of investments within a portfolio and the relationship of an individual investment to the entire portfolio. A portfolio may be diversified by investments whose values react oppositely to the same factors or stimuli. Investments whose values move in the same direction in response to stimuli may diversify a portfolio if the scale

of their reaction is markedly different. The risk of a portfolio is a function of the interrelationships of its component investments.

A fiduciary applying elements of MPT can use investments viewed as risky individually to assemble a portfolio that provides an acceptable level of risk. An investment that might appear too risky by itself might, in fact, enhance a portfolio because of its imperfect correlation with other portfolio investments and its effect on the overall risk and return characteristics of the portfolio. MPT suggests that such a portfolio may have a significantly higher expected return than a portfolio constructed based on the restrictive PPR, without increasing overall portfolio risk.

The Prudent Investor Rule

The incorporation of MPT into trust law was significantly advanced by the adoption of the Restatement (Third) of Trusts by the American Law Institute in May 1990. ERISA's statutory and regulatory standards for prudent investing, diversification, and delegation of pension plan fiduciaries are also reflected in the Restatement (Third). Specifically, section 227 of the Restatement (Third) recognizes an expansion of the fiduciary responsibilities of trustees and provides greater latitude in fulfilling such responsibilities.

The American Law Institute's restatements of trusts have been influential with lawyers, professional trustees, and the courts over the years as summaries of state laws and judicial decisions governing the conduct of trustees. It has greatly influenced the development of trust law in the United States. But the positions adopted by the Institute are only commentaries on the law, not the law itself, and depend on the willingness of courts to follow them.

The PIR articulates standards by which a trustee's conduct can be guided and judged. The standards are intended to be general and flexible enough to accommodate changes in knowledge and concepts in the financial world and to allow the prudent use of any investments or investment techniques that serve the individual purposes of any specific trust. The PIR has five major principles:

- Sound diversification is fundamental to risk management and is ordinarily required of trustees.

- Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trust.

- Trustees have a duty to avoid fees, transaction costs, and other expenses not justified by the needs and realistic objectives of the trust's investment strategy.

- A trustee's duty to be impartial toward all beneficiaries requires a trustee to balance investment returns between producing current income and promoting purchasing power.

- Trustees have a duty as well as the authority to delegate investment authority as a prudent investor would.

From the Restatement of the Law Third, Trusts

§ 227. General Standard of Prudent Investment

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

(1) conform to fundamental fiduciary duties of loyalty (§ 170) and impartiality (§ 183);

(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§ 171); and

(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§ 188).

(d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.

A portfolio's structure must reflect how a trust instrument views producing income for life tenants in relation to building residual assets for the trust's remaindermen. In most states, the allocation between income and principal, and thus between life tenants and remaindermen, is set forth in the Uniform Principal and Income Act of 1931 and the Revised Uniform Principal and Income Act of 1962. Although these acts are default rules that may be modified by the trust instrument, the vast majority of trusts simply follow the statute. These standards do not give trustees unlimited discretion to reclassify receipts as either income or principal. And the PIR does not alter traditional trust accounting and its allocation of income to income beneficiaries and principal to remainder beneficiaries.

The Revised Uniform Principal and Income Act of 1997 gives a trustee the discretion to allocate receipts either to income or principal if needed to rebalance the interests of income and remainder beneficiaries and to carry out the purposes of the trust. This change was made to alleviate the tension between modern investing practices and the traditional ideas about what constitutes the return on a trust portfolio. The revised act, however, has been adopted in only thirteen states as of July 31, 2000. States are also free to modify uniform acts when they adopt them, and not all states have included this provision.

The PIR represents an evolution in the definition of prudence incorporating the generally accepted analytical framework of MPT. It was promulgated to ameliorate the impact of restrictive judicial interpretations of the PPR. The PIR follows the evolutionary trend established by ERISA's statutory and regulatory standards for prudent investing, diversification, and delegation. A trustee's prudence is to be judged as of the time an investment decision is made. The benefit of hindsight or consideration of developments that occurred after a decision to acquire, retain, or dispose of an investment was made are not permissible in assessing prudence.

By adopting the basic elements of MPT, the PIR brings the standards governing trustee investment decision-making processes in line with the generally accepted practices of the larger professional investment management community. It authorizes trustees to formulate and implement an investment strategy that embraces more investment asset classes than were permitted by the restrictive judicial interpretations of the PPR. It provides trustees with more discretion in determining the investments that should comprise a trust portfolio, and creates the expectation that trustees will consider the entire universe of investment opportunities and not ignore any type or class of investment in constructing a portfolio. The PIR emphasizes that no specific investments or investment techniques are prudent or imprudent per se.

The PIR requires that the standard of prudence must be applied to the portfolio as a whole, not just to each individual investment in the portfolio. A trustee is required to determine the prudence of an investment not in isolation, but in terms of its anticipated effect on the whole portfolio. Also, in the case of structured products or assets with unique risk and return properties, the PIR does not eliminate the need for the trustee to evaluate the investment separately. All risks unique to any investment being considered must be evaluated and understood by the trustee, and then applied in the context of the whole portfolio.

The PIR makes the duty to diversify trust investments part of the standard of care. It recognizes that a trustee must seek the lowest level of portfolio risk for a particular level of expected return, or the highest return commensurate with acceptable risk. This trade-off between risk and return is optimally achieved through portfolio diversification. A trustee is under a duty to minimize unsystematic risk (elements of risk that are unique to a particular investment but that can be largely eliminated through diversification), because theory holds that the market will not compensate the investor for taking such risk. PIR commentary endorses the use of pooled investment vehicles, such as mutual and collective investment funds, as a prudent means of achieving adequate diversification in a trust portfolio.

The PIR abrogates the older trust law that forbade trustees from delegating decision-making authority over investments. This follows the trend of ERISA, the Uniform Management of Institutional Funds Act, and the Uniform Trustees Powers Act in encouraging the delegation of investment responsibilities to specialists. The PIR requires a trustee who delegates to act

prudently in selecting, instructing, and monitoring the performance of agents, including investment managers.

The trustee must act prudently in deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust. The trustee should consider all relevant circumstances in connection with the delegation of investment functions, including the knowledge, skill, capabilities, and compensation of both the trustee and agent. Other circumstances to be considered include the size of the trust, the nature and complexity of the trust assets, and the particular goals of the investment strategy.

The trustee is under a duty to supervise any agents to whom investment responsibilities are delegated. Decisions of delegation are matters of the trustee's judgment and discretion, and are not to be controlled by a court except in cases of discretionary abuse. Such an abuse of discretion can involve an imprudent delegation of authority as well as an imprudent failure to delegate.

The PIR is intended for a trust only if it is consistent with the terms of a trust and state law. Generally, the terms of the trust will control. If a state has adopted the PIR, or permits a trust to adopt it, then the terms of the trust will dictate whether the PIR applies to its investment activity. The terms of the trust may expand or limit the provisions of the PIR. A trust's terms will control a trustee's investment authorities and duties, even if different from the PIR, so long as they do not conflict with the law. But absent contrary provisions, or silence, in the terms of the trust, the PIR will govern if a state has adopted it. As of December 1999, 38 states have adopted the PIR.

While the PIR addresses investment guidance for private trusts, it may be used as guidance for other types of fiduciaries. Courts and regulators who supervise other types of fiduciaries will probably turn to the PIR for guidance just as they looked to the previous Restatement in the day of the old PMR. Since a significant majority of states and the professional investment management community have embraced the PIR, it is reasonable to anticipate that the remaining states, by statute or judicial decision, will implement the precepts of the PIR in determining the nature and extent of a trustee's duty of prudence in trust investment management.

The PIR asserts that the duty of caution does not call for the total avoidance of risk by trustees, but rather for its "prudent management." The emphasis is on active risk management processes. Under the PIR, the trustee has an affirmative duty to assess the risk tolerance of the trust and its beneficiaries and actively manage the risk elements of its investment portfolio. No objective, general legal standard can be set for a degree of risk that is or is not prudent. The degree of risk permitted for a particular trust is ultimately a matter of interpretation and judgment. This requires that a trustee make reasonable efforts to ascertain the purposes of the trust and to understand the types of investments suitable to those purposes in light of all the relevant circumstances.

The Uniform Prudent Investor Act

In response to the PIR, the National Conference of Commissioners on Uniform State Laws (NCC) in 1994 promulgated the UPIA. The NCC's charter is to promote uniformity among the 50 states in certain areas of law. The UPIA was created as a mode to be used by the states to update and codify trust investment law. The UPIA reflects the influence of MPT and incorporates the knowledge and experience of the professional investment management community. The act draws upon the revised standards for prudent trust investment in the PIR.

The UPIA governs the investment responsibilities of trustees, but it may also provide guidance for other types of fiduciary investment managers. The UPIA has been adopted in full by a majority of the state legislatures. Many other states have revised their PPR to conform to certain aspects of the UPIA. There are only a handful of states that have not adopted either the PIR or the UPIA.

Uniform Prudent Investor Act

§ 1. Prudent Investor Rule

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this Act.

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

§ 2. Standard of Care: Portfolio Strategy; Risk and Return Objectives

(a) A trustee shall invest and manage trust assets as a prudent investor would, but considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among the circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of the Act.

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

§ 3. Diversification

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

§ 4. Duties at Inception of Trusteeship.

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this Act.

§ 5. Loyalty

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

§ 6. Impartiality

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

§ 7. Investment Costs.

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

§ 8. Reviewing Compliance.

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

§ 9. Delegation of Investment and Management Functions.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this state.

§ 10. Language Invoking Standards of Act.

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this Act: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," and "prudent investor rule."

§ 11. Application to Existing Trusts.

This Act applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this Act governs only decisions or actions occurring after that date.

§ 12. Uniformity of Application and Construction.

This Act shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this Act among the states enacting it.

§ 13. Short Title.

This Act may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

§ 14. Severability.

§ 15. Effective Date.

This Act takes effect _______.

§ 16. Repeals.

The purpose of the UPIA is to bring the standard of care expected of a trustee up to the standards of the investment management industry as a whole and to codify the new standards of prudence by which the conduct of fiduciaries will be measured. The main reforms embodied in the UPIA are designed to capture for trust beneficiaries the efficiencies and enhanced returns that have been made possible by MPT and resultant investment management practices.

The UPIA makes the following five fundamental changes in the text, scope, and direction of most state trust investment statutes:

(1) The standard of prudence applies to the trust portfolio as a whole rather than to each individual investment on its own.

(2) There is a trade-off between risk and return, and a portfolio that is appropriate for one person or trust is not necessarily appropriate for another person or trust.

(3) Diversification is inherent in prudent investment.

(4) All specific restrictions on investment types are eliminated; a trustee may invest in anything that plays an appropriate role in achieving risk and return objectives of the trust and that meets the requirements of prudent investing.

(5) Delegation by a trustee is permissible, subject to certain safeguards.

The UPIA is model uniform legislation and is directly applicable only to trustees in states that have adopted the UPIA. Nevertheless, courts in the future may consider the UPIA the standard governing trust investments. And, although the UPIA does not apply to ERISA fiduciaries or charitable trusts, courts may one day consider it the investment standard for them as well.

The UPIA also recognizes one of the basic principles of trust law, which is that trust law is default law. It provides that the PIR may be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust. Compliance with the PIR and the UPIA is determined in light of the circumstances at the time of the trustee's action, not by hindsight. A trustee is not an insurer or guarantor.

Section 2, which is the heart of the act, defines the standard of care imposed on trustees and includes integral features of that standard such as the employment of portfolio strategy and analysis of risk and return objectives. This section provides an explanatory, but not exhaustive, "laundry list" that a trustee should consider when determining how to manage and invest trust assets. A trustee need not review every item for every account, but only those relevant to the trust or its beneficiaries. This section also includes three provisions on investment policy requiring trustees to

(1) Make reasonable efforts to verify relevant facts,

(2) Invest in any kind of property or investment consistent with the standards of the act, and

(3) Use the special skills or expertise they have represented themselves as possessing.

A trustee must identify the point on the risk and return curve that is appropriate for a specific trust, based on its size, objectives, and beneficiaries. Once the risk and return balance has been identified, portfolio characteristics can be designed to generate the greatest return for the identified level of risk. After asset allocation decisions are made, actual investments are made that meet the risk and return characteristics identified in the portfolio plan. Each of the selected investments must be viewed for its suitability within the trust portfolio and the targeted risk and return characteristics.

If the trustee has developed a trust's investment policy in a manner that reflects the needs and objectives of the trust and its beneficiaries and adheres to the investment policy in a prudent manner, it is reasonable to conclude that courts will view the trustee as having met the UPIA standard of care. The subsequent performance of any investment, or the portfolio in general, should only reflect on the trustee's performance of his duty to monitor the investments, not on his duty to initially develop and invest the trust portfolio.

Like the PIR, the UPIA shifts the legal focus from the performance of an individual security in a portfolio to the portfolio as a whole. The standard of prudence is judged on whether the trustee followed appropriate procedures or processes for managing risk, diversifying assets, and balancing the financial needs of the beneficiaries. Neither the performance of an individual

investment nor the overall performance of the portfolio is central to a legal determination of prudence. Prudence is demonstrated by the quality of risk management processes used to develop, implement, and monitor trust investment strategies.

There are no categorical inclusions or exclusions under the UPIA. In other words, no investment is prudent or imprudent per se. Without categoric restrictions on permissible trust investments, specific investments will not be automatically excluded from a particular trust portfolio. The prudence standard recognizes, however, that certain investments may be inappropriate for a particular trust portfolio because of their effect on the risk and return analysis for the trust.

The UPIA emphasizes the importance of diversification in a trust portfolio. A trustee should diversify a trust's investments unless, owing to special circumstances, he or she reasonably determines that the purposes of the trust are better served without diversification. There is no automatic rule or method for identifying how much diversification is enough. This provision creates a statutory presumption that diversification is required and places the burden on trustees to show why trust investments have not been diversified.

The trustee of a new trust, of an old trust to which assets are being added, or of a successor trust should conduct a review of trust assets within a reasonable period of time and decide whether to retain or dispose of those assets. This duty is old trust law and extends to investments that were suitable when acquired but subsequently become unsuitable. This provision derives from the Restatement's admonition that a trustee must constantly monitor a trust's investments. A specific rule for determining a reasonable time is not given, but the criteria and circumstances identified in section 2 as bearing on the prudence of decisions to invest and manage assets also pertain to the prudence of performing reviews of trust assets.

The duty of loyalty expressed in section 5 is perhaps the most characteristic rule of trust law. It requires the trustee to act exclusively for the beneficiaries as opposed to acting for the trustee's own interest or that of third parties. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries. Similarly, section 6 requires a trustee to act impartially when investing and managing trusts assets for two or more beneficiaries. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all beneficiaries, especially the conflicts between the interests of income and

principal. The UPIA prescribes no regime for allocating receipts of income and principal and the commentary to the UPIA refers to the Revised Uniform Principal and Income Act of 1997.

Section 7 provides that a trustee may incur only costs that are appropriate and reasonable. Wasting beneficiaries' money is imprudent. In devising and implementing investment strategies, trustees are obligated to minimize costs. Trustees should make comparisons on transaction and agent costs such as brokerage commissions, and calculate the cost-benefit ratio, considering the trust's size and ability to bear such costs. These costs include the trustee's own compensation. Although the trustee has a duty to control costs, a trustee is not obligated to pay only the lowest costs.

Consistent with both PIR and ERISA fiduciary standards, the UPIA provides that a trustee may delegate investment management functions that a prudent trustee of comparable skill could properly delegate under the circumstances. A trustee must, however, act prudently in selecting the agent, establishing the scope and terms of the delegation, and periodically reviewing the agent's actions. An agent who accepts delegation by a trustee is subject to jurisdiction of the courts of the state in which the trust is resident.

A trustee who complies with the delegation standards will not be liable to the beneficiaries or to the trust for the agent's decisions or actions. Not every state has adopted this provision, however. The agent is directly liable to the trust and its beneficiaries for the agent's performance pursuant to the delegation. A trustee would be liable to the trust or its beneficiaries for an agent's actions only if the trustee did not prudently make the initial delegation, or did not appropriately and continually monitor the agent's performance. The trustee could also be liable for failing to enforce the terms of the delegation against the agent.

By permitting delegation of a trust's investment and management functions, the UPIA facilitates the outsourcing of functions, such as administration, investment management, tax compliance, and accounting, similar to the outsourcing functions by pension trusts under ERISA. It enhances risk management by permitting trustees to delegate trust investment functions to other investment advisers who have specialized expertise.

Because the trustee is obligated under the UPIA to exercise care, skill, and caution in establishing the terms of a delegation, delegations must not be

overly broad. For instance, the commentary to the UPIA states that a prudent delegation by a trustee could not include an exculpation clause protecting an agent from liability for reckless management of trust assets. Leaving the trust beneficiaries without recourse against an agent for the agent's willful wrongdoing would be a breach of the trustee's duty to exercise care, skill, and caution in creating the delegation.

The UPIA provides that it will apply to trusts in existence on the date it is enacted by an adopting state and to trusts created thereafter. As to existing trusts, it applies only to investment decisions and actions made after its effective date.

Appendix C: ERISA Investment Standards

This section provides an overview of the Employment Retirement Income Security Act of 1974 (ERISA) fiduciary investment standards. Bank management should consult with qualified legal counsel to determine whether ERISA's fiduciary investment standards apply to the bank's accounts and, if so, how.

ERISA was a milestone in PIR's evolution. ERISA, which governs fiduciary administration of private employee benefit plans, was the first legislation to adopt elements of MPT as a standard for fiduciary investment conduct and the portfolio-as-a-whole approach to evaluating the prudence of fiduciary investment decisions. Under ERISA, each fiduciary of a plan is required 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 conducting an enterprise of like character and with like aims.

ERISA was drafted to address Congressional concerns with how private pension plans were funded and with whether the fiduciary duties imposed on persons administering these plans were adequate and consistent. Congress used ERISA's statutory preemption of all conflicting state laws to establish a national standard of fiduciary responsibility for persons administering any aspect of a pension plan. This accomplished Congress' primary goal of protecting pension plan participants in a federal law that subjects plan fiduciaries to a uniform standard, without reference to varying state laws on fiduciary responsibility. It also creates a standard incorporating a liberal and flexible interpretation of the PPR by which a fiduciary's conduct can be measured.

ERISA fiduciaries are subject to the same fundamental duties of loyalty, prudence, and investment diversification as other trustees. Unlike other trustees, ERISA fiduciaries cannot rely on exculpatory language in a fiduciary agreement to relieve them of any of ERISA's prudence requirements. Such language is forbidden by section 410(a) in agreements governing employee benefit plans.

ERISA casts a wide net of fiduciary responsibility. ERISA defines "fiduciary" in terms of functions performed rather than job titles (see section 3(21)(A)). A fiduciary is any person or entity that exercises any discretionary authority or control over the management of the plan or its assets, renders direct or indirect investment advice with respect to plan assets for compensation, has authority or responsibility to render investment advice, or has any discretionary authority or responsibility in the administration of the plan.

An ERISA fiduciary is generally subject to a higher standard of care than a common law trust fiduciary, because ERISA requires a plan fiduciary to act as one who is familiar with such matters. This heightened standard of care has been referred to by some commentators as the ERISA "prudent expert" rule (see section 404(a)(1) and 29 CFR 2550.404a-1). The statutory language has been interpreted by the courts as imposing a relational, flexible standard that requires fiduciaries to act like other trustees in similar circumstances. A plan fiduciary administering a small employee benefit plan will be compared with a trustee administering a small trust, while a plan managing a large pension trust will be compared with a trustee managing a similar trust.

ERISA, its implementing regulations, and court decisions interpreting ERISA generally establish the following:

- The elements of modern portfolio theory have been incorporated into the standard of care governing fiduciaries of employee benefit plans.

- ERISA explicitly prescribes a duty to diversify plan assets to minimize the risk of large losses.

- No investment is labeled prudent or imprudent per se; the universe of investments under ERISA is unlimited.

- Prudence is a rule of conduct rather than performance, and plan fiduciaries should document their decision-making processes concerning the design, implementation, and monitoring of an investment strategy for pension plan assets.

- ERISA allows delegation by permitting a plan to give its fiduciaries authority to delegate investment management functions.

ERISA's recognition of MPT as a significant element in judging fiduciary prudence was clearly emphasized by regulations interpreting the investment

duties of plan fiduciaries under ERISA, as promulgated in 1979 by the Department of Labor in 29 CFR 2550.404.a-1. Under this regulatory guidance, a fiduciary charged with investing plan assets will satisfy ERISA obligations "if the fiduciary . . . has given appropriate consideration to those facts and circumstances that . . . 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 the plan's investment portfolio . . . and has acted accordingly."

Appropriate consideration includes, but is not limited to, a determination that the particular course of action is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. The fiduciary is obligated to consider the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the funding objectives of the plan.

ERISA also explicitly prescribes a duty to diversify plan assets to minimize the risk of large losses as a responsibility imposed on a plan fiduciary. However, an ERISA plan fiduciary is relieved of this duty to diversify if it is clearly prudent not to do so under the circumstances (see section 404(a)(1)(C)). Congress directed plan fiduciaries making diversification decisions to consider the following:

- The purpose of the plan;
- The amount of plan assets;
- General financial and industrial conditions;
- The type of investment, whether mortgages, bonds, shares of stock, or otherwise;
- Distribution across geographical locations;
- Distribution across industries; and
- Dates of maturity.

ERISA does not label any investment as prudent or imprudent per se. The result is virtually no restriction on the universe of available investment opportunities. Thus, while the particular selection of investments from that universe could be imprudent, the universe itself is unrestricted. Prudent investing under ERISA should be documented by a systematic and procedural analysis of the proposed investment and its function within the plan's investment portfolio overall.

Plan fiduciaries are not expected to be infallible, and hindsight is not a viable method for assessing whether a fiduciary's investment decisions were prudent at the time the investment was made. Courts have based findings of imprudence largely on a fiduciary's failure to undertake a careful, independent inquiry into the merits of the investment. Emphasis has been placed on the competency of the fiduciary in executing his or her duties and the process followed in evaluating the suitability of an investment in the context of the entire portfolio.

ERISA permits a pension plan to authorize its fiduciaries to appoint an investment manager or managers to acquire, manage, and dispose of the plan's assets (see section 404(c)(3)). ERISA expressly relieves trustees of the exclusive responsibility for managing and controlling plan assets when the authority to manage, acquire, or dispose of those assets has been properly delegated to a qualified investment manager. A qualified investment manager is

- A bank,
- An investment manager registered with the SEC under the Investment Advisors Act of 1940, or
- An insurance company which is qualified under the laws of more than one state to perform services.

The investment manager must acknowledge in writing its fiduciary status with the plan. Named fiduciaries, including trustees, are not responsible for the actions of the investment manager if

- The investment manager was prudently chosen and retained;
- The investment manager does not violate the fiduciary responsibilities of section 404(a)(1); and
- The named fiduciary appropriately monitors the performance of the investment manager.

Although ERISA directly applies only to fiduciaries administering private employee benefit funds, it is an important source of law for the regulation of other fiduciaries. Since a large percentage of the common stock of American companies is owned by pension funds, the conduct of those pension fund fiduciaries and the standards by which their conduct is evaluated is instructive in determining whether a corporate fiduciary acted prudently in investing personal trust assets in common stock. ERISA has had a significant influence on efforts to define "prudence" for all fiduciaries.

Appendix D: Investment Management and 12 CFR 9

National banks serving in a fiduciary capacity must comply with 12 CFR 9, Fiduciary Activities of National Banks. The following discussion covers selected sections of the regulation that relate to investment management.

12 CFR 9.4(a), Administration

The authority to administer and manage discretionary assets in fiduciary accounts may be assigned by the board of directors. The responsibility, however, for proper supervision of fiduciary assets remains with the board. A board must ensure that it is receiving adequate and timely reports to effectively assess and monitor risks in this line of business.

12 CFR 9.4(c), Administration

A national bank may enter into an agency agreement with another entity to purchase or sell services related to the exercise of fiduciary powers. In the context of investment management, this section authorizes a national bank to delegate its fiduciary authority to third-party service providers such as investment managers, advisers, property managers, appraisers, and custodians. When a national bank does delegate its investment authority, it should have the written contract reviewed by counsel to ensure that the contract complies with applicable law. If applicable, the PIR requires a fiduciary to exercise reasonable care, skill, and caution when selecting an agent and establishing the scope and terms of the delegation. It requires the fiduciary to monitor the agent's performance and compliance with the contract.

12 CFR 9.5, Policies and procedures

A national bank engaged in this activity must adopt and follow written policies and procedures for fiduciary investment management services. When appropriate, these policies and procedures should specifically address brokerage placement services, the use of material inside information, self-dealing and conflicts of interest, the selection and retention of legal counsel, and funds awaiting investment or distribution. Policies and procedures must be adequate to ensure compliance with applicable law.

12 CFR 9.6, Review of fiduciary accounts

This section describes three types of reviews for fiduciary accounts:

- Pre-acceptance,
- Initial post-acceptance, and
- Annual reviews.

The first type of review may be the most important to the bank because it represents the initial risk assessment and decision-making event for a specific account. The bank must review the proposed account to determine whether it can properly administer the account. The board, or its designee, should adopt policies that reflect the bank's administrative capabilities and define criteria for accepting or declining new business. This review is applicable to all fiduciary accounts.

When a bank accepts an account, it must promptly review all of the account's discretionary assets to determine if they are appropriate for the account. The regulation does not specifically define the term "promptly," so this time frame is left to the bank's discretion consistent with applicable fiduciary law standards. Only accounts in which the bank has investment discretion must be reviewed. In the context of the portfolio management processes described in appendix A, the initial post-acceptance review is a part of developing the portfolio's investment policy.

Every calendar year thereafter, the person or committee in charge of an account's investments determines whether the current investments are appropriate individually and collectively, given the objectives, risk tolerance, and other constraints of the account. This review is only applicable to discretionary fiduciary accounts. When conducting annual reviews, a bank should look first to any investment provisions in the governing instrument, then to the investment standards found in relevant statutes and case law; the bank should conduct its reviews according to these provisions and standards. Annual reviews required by the regulation can be part of the portfolio monitoring processes described in appendix A.

Account reviews do not have to be written, but the bank must be able to demonstrate that all required reviews have been performed. If a bank adopts a review system in which reviews are not documented individually, the bank

must be able to demonstrate that its review system is designed to perform all required reviews and that the reviews are completed.

12 CFR 9.10, Fiduciary funds awaiting investment or distribution

Funds in discretionary fiduciary accounts must be invested or distributed in a reasonable time frame and consistent with applicable law. The bank must also obtain a rate of return for such funds that is consistent with applicable law. A bank can deposit fiduciary account funds awaiting investment or distribution in the bank's deposit accounts unless prohibited by applicable law. The bank must set aside acceptable collateral as security for funds not insured by the Federal Deposit Insurance Corporation. Collateral market value must at all times equal or exceed the amount of the uninsured funds.

12 CFR 9.11, Investment of fiduciary funds

National banks must invest fiduciary account funds in accordance with applicable law. The general order of applicable law is the governing instrument, state and federal law, court orders, and common fiduciary law standards. In most states, national banks will generally be held to the prudent investor standards of a professional investment portfolio manager or adviser. Banks should be guided by general industry standards for investment management and advisory services.

12 CFR 9.12, Self-dealing and conflicts of interest

The section specifies certain investments, loans, and asset sales practices involving discretionary fiduciary accounts that are not permitted unless authorized by applicable law. Applicable law includes the governing instrument, state and federal law, court orders, and common law fiduciary standards. These restrictions are fully discussed in the "Conflicts of Interest" booklet of the *Comptroller's Handbook*.

It should be recognized that authorization by applicable law does not automatically make any particular transaction appropriate or prudent. The fiduciary must still ensure and document that such discretionary transactions are prudent and in the beneficiaries' best interest.

12 CFR 9.18, Collective investment funds

This section provides guidelines for the establishment and administration of collective investment funds by national banks. Please refer to the *Comptroller's Handbook for Fiduciary Activities* for information on collective investment funds.

Appendix E: Investment Policy Statements

An investment policy statement (IPS) is a written document that establishes a portfolio's investment objectives and strategies for a specified period of time. The policy may include investment constraints such as liquidity needs, tax considerations, regulatory requirements, and special circumstances of the client. A properly developed policy supports long-term investment discipline and helps prevent ad-hoc revisions of strategy prompted by panic or overconfidence. An investment policy is an effective risk management tool provided it is understood, agreed with, and consistently followed.

Investment Policy Benefits

Documentation and support for investment decisions: The IPS can be critical evidence in the defense against litigation or accusations of imprudence and disloyalty. It can also provide valuable documentation in support of fiduciary competence and prudence during probate or estate proceedings. Failure to create such a formal statement invites a presumption of imprudent conduct.

Continuity of strategy: As a source document, the IPS provides continuity when changes occur in trustees, portfolio managers, and board or committee members. It minimizes second-guessing and questions about decisions over time, and it reduces a strategy's vulnerability to subsequent review questions.

Investor confidence: The IPS is a tangible document that adds discipline and substance to the investment management process. It gives the client confidence that his or her money is being invested appropriately. It also helps the client to understand the investment process and what to expect from the portfolio manager.

Calming effect during adverse market conditions: The IPS provides assurance and comfort during difficult market conditions. It reminds managers and clients of the purpose of the investment objectives and strategies and the risks inherent in the portfolio.

Baseline to monitor portfolio performance: The IPS establishes goals, objectives, and appropriate performance benchmarks for the portfolio. Using them, the fiduciary manager and client can evaluate the portfolio manager's performance. It establishes the framework against which proposed strategy changes may be evaluated.

Structure and Content

The IPS combines elements of planning and philosophy, and, although not legally required, it clearly establishes investment intent. The primary fiduciary manager, in close consultation with the client, should develop the IPS. It should be formalized, clearly written, and agreed to by all parties involved. The IPS may be structured along the following lines:

Portfolio Background and Purpose

This section explains the reasons for establishing the IPS and the portfolio's purpose, legal structure, size, and tax status. It may describe the portfolio's relationship to other assets the client may own and the likelihood and amount of future contributions to and distributions from the portfolio. For employee benefit plans, a description of the financial health of the sponsor and participant demographics may be appropriate.

Statement of Objectives and Constraints

This section declares portfolio goals and return requirements subject to the risk tolerance and constraints imposed by the client and applicable law. Objectives should be depicted in terms of return requirements, risk tolerance, and other constraints such as time horizon, liquidity, taxes, legal and regulatory issues, and unique needs and circumstances. Return requirements should be specific to the needs and objectives of the account and should not be merely oblique references to such general requirements as "income" and/or "capital growth."

Investment Policy /Strategic Asset Allocation Guidelines

Investment policy guidelines outline the investment strategy and asset allocation plan. The guidelines should be specific enough to establish the desired investment management framework, yet allow enough latitude for reasonable flexibility on the part of investment managers. They must be consistent with the objectives, risk tolerance, and constraints of the client. They should be written with clarity and simplicity so a third-party reviewer can fully understand them.

This section can include strategic asset allocation and re-balancing guidelines. Strategic asset allocation establishes what percentage of the portfolio each asset category should comprise over the investment time frame. Percentage ranges are often used for each category. When an asset category position differs from the percentage, or range of percentage, established for that category, re-balancing may be necessary. Re-balancing is buying or selling investments to make allocations conform to their limits. Re-balancing guidelines, which define when an asset category should be adjusted, are necessary to maintain a policy's consistency and a portfolio manager's discipline.

Investment Guidelines

This section defines the types of investments within each asset category that are appropriate for the client's portfolio. Guidelines may detail authorized portfolio exposures to security instruments, economic sectors, countries, cash holdings, quality, etc.

Selection of Investment Managers/Advisers

An IPS should state how third-party investment managers and advisers are selected and monitored, if applicable. The approach should be systematic and documented. The key is to obtain enough information to ensure that the selected manager has the ability and commitment to strictly adhere to the IPS and applicable law. Refer to appendix F, "Guidelines for Selecting Investment Managers and Advisers," for additional information.

Control and Monitoring Processes

If appropriate for the client, the IPS establishes guidelines for monitoring investment performance, compliance with applicable law, economic trends, and capital markets. The IPS should establish the timing and content of information reports, the parties responsible for completing the reviews, and the documentation standards for monitoring activities. The specific duties and requirements of service providers should be described in the IPS.

The IPS can establish and reference specific performance measurement criteria and benchmarks for the portfolio and its individual asset categories. The guidelines can include a discussion of items that trigger an immediate review of the portfolio such as changes in managers, account principals, beneficiaries, and ownership. Losses of a certain size may also bring a

review. Guidance may also define the type and level of portfolio performance that would trigger a bank to review whether it is prudent to continue using a certain manager.

Investment Policy Problems

An investment policy is weak if it:

- Lacks specificity.
- Fails to establish appropriate and realistic goals and objectives.

A fiduciary investment management organization is weak if it fails to:

- Effectively monitor client circumstances, economic trends, and capital markets, updating investment policies as conditions warrant.
- Ensure that portfolio managers consistently apply investment policy guidelines, preventing them from making ad hoc changes based on short-term views.
- Effectively monitor compliance with the bank's investment management policies and applicable law.

Investment Policy Statement Sample Format

I. Account/Client Type and Identification

II. Account Purpose and Background

General statement of purpose and background of client and portfolio.

III. Portfolio Objectives and Constraints

Return Expectations

- Level sought
- Composition: income, capital gains, currency appreciation
- Risk-adjusted: market, inflation, currency

Risk Tolerance

- High, medium, low.
- Specific comments on the risk tolerance characteristics of the client/beneficiaries.
- Reference to specific individual risk factors such as market, interest rate, currency, country, industry, etc.

Constraints

- Time horizon.
- Liquidity.
- Taxes.
- Regulation.
- Legal issues.
- Unique needs and circumstances.
  - Trust beneficiaries.
  - Investment restrictions.
  - Social/political concerns.

IV. Investment Policy Guidelines

- Strategic asset allocation.

- Re-balancing.
- Income distribution.

V. Investment Guidelines

- Equity (public and private).
- Fixed income (public and private).
- Real estate (public and private).
- Derivatives.
- Mutual funds.
- Hedge funds.
- Mineral interests.
- Timber.
- Other (art, collectibles, precious metals).

VI. Investment Manager/Adviser Selection Guidelines

VII. Risk Monitoring and Performance Measurement Guidelines

- Types of reporting mechanisms, documentation standards, and the parties responsible.
- Performance benchmarks and measurement standards.
- Frequency.
- Ticklers for tracking information.

Summary

An investment policy statement may be the most important document a fiduciary manager prepares for an account. Rather than a static or historical document, it is a dynamic instrument for the fiduciary and client to use. The document should ensure frequent communication with a client, prudent investment guidelines, and thorough monitoring and documentation.

Appendix F: Guidelines for Selecting Investment Managers and Advisers

Decisions concerning the delegation of investment authority to a third party are matters of fiduciary judgement and discretion and require the exercise of care, skill, and caution. At a minimum, a fiduciary manager should obtain full information on an investment firm's investment and business approaches, professional resources, financial strength, historical performance, regulatory history, personnel turnover, comparative fees, and other relevant factors.

Fiduciary managers should review the following items when considering investment firms for providing investment management and advisory services to the bank. The information is presented merely to assist in the selection process and does not supersede any provisions of applicable law.

Firm Background

- Name, date established, ownership, affiliations.
- Description of investment products and strategies.
- Past judgments against the firm or its employees, current litigation, and regulatory actions.
- Amount of fully discretionary assets under management, trends.
- Number of taxable accounts and percent of total accounts that are taxable.
- Copies of recent financial audits, if available.

Investment Methodology

- Description and inception date of investment philosophy and strategies.
- Description of investment styles used.
  - How are securities selected? How is a client assured of obtaining the best execution on security trades?
  - Who makes investment decisions?
  - Where is research developed (internally or externally)?
  - What types of valuation models are used and how are they tested?
  - Describe soft dollar arrangements with brokers, if applicable.
- Description of strategies for taxable clients.

  - Describe how the firm adapts its strategy to the circumstances of taxable clients.
  - Is there access to tax-lot accounting information?
  - Can the firm amortize or accrete fixed income securities?
  - What is the firm's normal portfolio turnover? How are portfolios monitored for consistency with client needs and circumstances?

Risk Management Processes

- Copies of policies and procedures.
- Description of insurance coverage.
- Describe diversification guidelines or concentration limits for the following factors:

  - Countries/currencies.
  - Industry sectors.
  - Issuers.
  - Securities.
  - Capitalization.
  - P/E, price-to-book ratios.
  - Leverage (portfolio borrowing and derivative usage).

- Methods of monitoring fixed income quality, duration, return, and distribution.
- Risk measurement and reporting systems.
- Internal compliance and audit programs.
- Contingency planning and disaster control systems

Management/Personnel

- Provide biographical sketches of senior firm managers.
- Provide names and experience of investment managers in firm by investment product and style.
- Provide names and experience of traders, analysts, or others with significant responsibilities in the firm.
- Provide the name and role of third-party service providers.

Investment Performance

- Provide short- and long-term investment performance reports for applicable styles, portfolios, and other investment products.
- Does the firm comply with the Association for Investment Management and Research (AIMR) performance presentation standards? Provide such a presentation, if available, including dispersion information.
- Are performance results audited? At what level of AIMR verification?
- How does the firm price securities and positions?
- Explain the firm's processes for developing benchmarks and assessing performance against established benchmarks.

Compensation/Fees

- Provide fee schedules. Will the firm negotiate fees?
- Does the firm manage separate accounts? If so, what is the minimum size?
- Will the firm aggregate assets when calculating fees for accounts related to a single family?
- Does the firm have a hurdle or high watermark for incentive fees?
- Is there a lock-up period?
- How early does a withdrawal notice have to be received?
- Has the firm ever exercised the option to forbid investors from withdrawing from a fund?

Reporting Capabilities

- Sample a client report, a Form ADV, an offering memorandum, a subscription document, and a schedule K-1 for the product or strategy.
- Describe client reporting capability and time frames.
- Are prices and positions reconciled with custodians?
- What type of market and portfolio commentary does the firm provide to clients and consultants, and how quickly does the firm provide it after the end of a period?
- Can the firm provide an after-tax return spreadsheet similar to the one in the AIMR proposal?

In general, the fiduciary manager should obtain as much information as possible. Problems arise not when a fiduciary has done too much, but when it has done too little. If necessary, seek advice and recommendations from other experts and consultants in the field. Consider and interview several firms before making the final decision. The due diligence process should be thoroughly documented and reviewed by appropriate risk managers prior to the execution of a contract with a third party.

Appendix G: Investment Management Policy Guidelines

Investment policies should establish a framework that enables the board and senior management to form business strategies and risk management processes that are consistent with the bank's risk tolerance and financial goals and objectives. In accordance with 12 CFR 9.5, Fiduciary Activities of National Banks, Policies and Procedures, a national bank administering fiduciary accounts must adopt and follow written policies and procedures that are adequate to ensure compliance with applicable law.

This appendix presents an organizational framework for establishing an appropriate policy for investment management services. It is not intended to be all-inclusive, but merely a guide that banks may use for structure and general content. A national bank must make its own determination of policy organization and content based on its diversity and complexity of operation.

Investment Philosophy and Culture

- Organization's statement of philosophy or purpose.
- Fiduciary duties and responsibilities.
- Investment styles.
- Risk tolerance.
- Code of ethics/employee conduct.
- Conflicts of interests.

Products and Services

- Types and size of managed or advised accounts.
- List and description of investment products or styles offered.
- Compensation schedules.
- Description of marketing and distribution channels.
- Policies and procedures for the development of new products and services.

Organization and Supervision

- Organizational structure.
- Defined lines of authority and responsibility.
- Standards for delegating authority and granting approvals.
- Relationships with affiliated organizations.
- Personnel practices:

  – Qualifications and hiring processes.
  – Compensation policies.
  – Performance evaluation.
  – Training program.
  – Code of conduct/disciplinary policies.
  – Personal trading guidelines and penalties.

Portfolio Management Processes

- Account acceptance and periodic review guidelines.

  – Guidelines for pre-acceptance, initial, and annual reviews and documentation standards.
  – Client disclosures; information guidelines.
  – Adherence to investment objectives and guidelines.
  – Investment performance.
  – Program success and strategic revision.

- Standards for economic and capital market analyses.
- Development and implementation of the investment policy program.

  – Establishing investment objectives.
  – Asset allocation modeling processes/model portfolio construction.
  – Investment selection criteria and risk control limits.

    ❑ For all asset categories, including financial derivatives; separate policy guidelines for each.
    ❑ Guidelines for temporarily investing permanent portfolio assets.

  - Benchmark selection, creation, and monitoring.
  - Investment performance calculation, analytics, attribution, and reporting processes.
  - Investment research processes.
  - Portfolio trading processes.
    - ❑ Selection of brokers/counterparties.
    - ❑ Best execution.
    - ❑ Soft dollars, commissions, and rebates.
    - ❑ Allocations, churning, and cross trading.

- Use of third-party service providers.
  - Selection criteria.
  - Contract criteria.
  - Monitoring and reporting criteria.

Information Systems

- Management information reports.
- Accounting and other record keeping systems.
- Portfolio management systems.
  - Valuation.
  - Performance analytics and attribution.
  - Risk measurement and reporting.
  - Simulations.
  - Trading interface.
- Trading systems.
- Disaster contingency plans.

Reporting and Monitoring

- Types, frequency, and receiving entity of internal investment performance and risk management reports.
- Policy exception tracking and reporting processes.
- Guidelines for reports to clients.
- Control self-assessment program.
- Stress testing, back testing, and model validation processes.

- Customer complaint resolution procedures.
- Third-party service provider reviews.

Compliance Program

- Program description, responsibility, and accountability.
- Operating procedures.
- Reporting and follow-up.
- Summaries of applicable law.

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Employee Retirement Income Security Act of 1974
The Gramm-Leach-Bliley Act of 1999
Investment Advisors Act of 1940
Investment Company Act of 1940
Securities Act of 1933
Securities Exchange Act of 1934

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12 CFR 9, Fiduciary Activities of National Banks
12 CFR 12, Record Keeping and Confirmation Requirements for Securities Transactions
29 CFR 2550.404a-1, ERISA Investment Duties

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