Fiduciary Compliance Library Checklist

A prudent fiduciary will develop and maintain a compliance library, which documents their process, review and administration of the assets for which they are responsible. For every duty of care identified in the Prudent Investor Act the fiduciary should have an associated document that evidences that they have acted prudently and in good faith under the circumstances.

The following memo is designed to provide a checklist of the key documents that should be included in every fiduciary's compliance library. (Though California citations are provided, identical language from the Uniform Prudent Investor Act has been adopted by 44 States.)

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1. Duty to Develop a Plan:

- *"A trustee shall invest and manage trust assets…by considering the purposes, terms, distribution requirements, and other circumstances of the trust." - §16047(a)*

- A prudent fiduciary will create and maintain a "Plan" that records their rationale for how the trust capital has been deployed. This document should begin by noting the trust's purposes, terms, and distribution requirements.

- The trustee can use the time value of money functions as an outline for this document:
  - Present Value (PV) – Identify the value of the trust corpus.
  - Number of Periods (N) – What is the time horizon of the trust assets?
  - Payment (PMT) – What are the anticipated annual distributions from the trust?
  - Future Value (FV) – What is the targeted residual value of the trust when it terminates?
  - Interest Rate (I) – Solve for the rate of return needed to accomplish these objectives.

- Remember, an Investment Policy Statement (IPS) drafted by a money manager is *NOT* a substitute for "the Plan". Rarely does an IPS drafted by an investment manager make any reference to the trust purposes, term, distribution requirement or targeted rate of return for the trust assets. To be sure an IPS drafted by a money manager is an important document to have in the trustee's compliance library, but it is not a substitute for "The Plan".

2. Duty to Balance Risk and Return:

   - *"A trustee's investment and management decisions…shall be considered part of an overall investment strategy having risk and return objectives reasonably suited for the trust." - §16047(b)*

   - A prudent fiduciary will create and maintain a document that defines the types and measures of risk that are being taken to reach the targeted rate of return. The UPIA identifies this balancing of risk and return as the trustee's central consideration. Unfortunately, few money managers volunteer a meaningful risk measure for a particular portfolio or even a targeted rate of return. Instead, they prefer to commit to a more ambiguous figure like "low risk, medium risk or high risk." A prudent trustee will specifically define the various risks that will be accepted, how those risks will be measured, and the targeted return that this risk exposure is designed to produce.

   - On an annual basis, the fiduciary should ask the money manager to provide a memo calculating the "risk-adjusted return" of the portfolio (return/standard deviation). Ask that this analysis include a comparison to that of a blended benchmark that has an asset allocation comparable to the portfolio being managed.

3. Duty to Consider Prevailing Factors:

   - *"Among 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, 5) the expected total return from income and the appreciation of capital, 6) other resources of the beneficiary, and 7) the need for liquidity, regularity of income, and preservation or appreciation of capital." – 16047(c)*

   - The Prudent Investor Act admonishes the fiduciary to consider seven "prevailing factors" as they administer the trust assets. A prudent fiduciary will create and maintain a record that specifically addresses each and every one of these seven considerations and how these factors inform the trustee's administrative decisions.

4. Duty to Diversify:

- *"In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trusteeship unless, under the circumstances, it is prudent not to do so." - §16048*

- A prudent fiduciary will create and maintain a record of the level of diversification that has been directed with the trust assets. For liquid assets this review can note the following elements:
    - Stocks v. Bonds v. Other Assets
    - U.S. Stocks v. Non-U.S. Stocks
    - Large Stocks v. Small Stocks
    - Growth Stocks v. Value Stocks
    - Short-term Bonds v. Long-term Bonds
    - High Quality Bonds v. High Yield Bonds
    - Liquid Assets v. Illiquid Assets

- In some instances the trustee has made an affirmative decision to NOT diversify the trust assets. Common examples are when the trust holds low basis assets, directly held real estate, closely held business or a life insurance contract. Where the trustee has determined that diversification is not appropriate, a clear record of their rationale should be created, reviewed and reaffirmed annually.

5. Duty to Incur Only Reasonable Costs:

- *"In investing and managing assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust." - §16050*

- In many cases investment fees are unclear and difficult to track. A prudent fiduciary will create and maintain a record of all direct and indirect fees incurred by the trust. This summary should include: 1) the manager's annual fee if they are paid on assets under management; 2) the product level fee if mutual funds, ETFs or separately managed accounts are being used; and 3) any transaction costs incurred by the custodian that holds the trust assets.

- A prudent trustee will also include their own fee in this annual fee summary and the basis for why the trustee believes this level of compensation is reasonable. Where the trustee is providing dual representation to the trust as an accountant or an attorney, any state-required notices should be provided to the beneficiary. (See CPC §15687)

6. Duty to Act Prudently in the Selection of an Agent:

- *"The trustee shall exercise prudence in the…selecting of an agent." - §16052(a)(1)*

- Few trustees have a record demonstrating the rationale for why the money manager to whom investment duties have been delegated was originally selected. If a record does exist, too often the reason for the selection is "I inherited the money manager from the testator" or "The manager has good past returns" or "I know the manager socially." These explanations are not basis for a thoughtful and deliberate selection process.

- A prudent trustee will create a record that demonstrates the subjective and objective reasons why the manager was originally selected. A few examples follow:

    - The manager has experience working with other clients who have fiduciary duties. (How many and of what level of assets?)

    - The manager is in good standing with the regulatory bodies that oversee their licensure. (Include a FINRA compliance report in the compliance library.)

    - The manager has professional credentials, experience and a code of ethics that governs their activities. (Cite the credentials, experience and code of ethics in the compliance library.)

    - The manager has a good reputation in the community. (Cite the source of this conclusion.)

    - Other manager candidates were considered and this manager was deemed to be the most competent for the delegation. (Cite other managers who were included in the vetting process who were passed over and the rationale for those decisions.)

7. Duty to Prudently Delegate:

- *"The trustee shall exercise prudence in…establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust." - §16052(a)(2)*

- In many cases the manager-drafted IPS does not include important terms of the delegation. A prudent trustee will adopt a Delegation of Duties document that specifically defines the scope of the investment delegation and is delivered to the investment advisor. It will include the following:

  - The manager's fee: Few IPS's document the fee the manager is to be paid.

  - The anticipated distributions from the trust: Few IPS's document the frequency or size of the distributions that the manager should expect, which necessarily inform their investment decisions.

  - The targeted rate of return: Few IPS documents establish a targeted rate of return for the trust assets. Instead, they frequently assign an ambiguous "low, medium or high risk" designation. More specificity is needed.

  - The benchmark by which to compare the manager's performance: Most managers provide a long list of benchmarks against which they compare their performance, but few of these are appropriate and reflect the portfolio's actual allocation. A blended benchmark of generally recognized asset classes should be developed and used for comparison.

  - Standardized performance reporting: The Global Institute of Performance Standards (GIPS) has established a protocol for performance reporting that a prudent trustee will insist the manager abide by.

8. Duty to Monitor an Agent's Activities :

- *"The trustee shall exercise prudence in…periodically reviewing the agent's overall performance and compliance with the terms of the delegation." - §16052(a)(3)*

- Once a comprehensive delegation of duties document is delivered, the prudent trustee will insist on the manager providing an annual writing reaffirming their acceptance of the terms of the delegation and affirming their compliance with these terms.

- A prudent trustee will seek a third party review of the manager's claims to substantiate the accuracy of their report.

9. Duty to Inform and Report:

- *"The trustee shall account at least annually…to each beneficiary to whom income or principal is required or authorized in the trustee's discretion to be currently distributed." - §16062*

- A prudent trustee will provide the beneficiaries they serve with an annual report which includes the following (outline from §16063):
  - A summary of the contributions and distributions from the trust during the year. This can look like a general ledger or transaction summary for the trust.
  - A summary of the assets and liabilities of the trust.
  - A summary of the compensation paid to investment managers.
  - A summary of the trustee's compensation.
  - A statement that informs the beneficiary of their right for a court review of these disclosure items and a notice of the three year statute of limitation on bringing claims if a breach of fiduciary duties is believed to have occurred.

- This annual report need not be submitted to the court for approval, but doing so materially reduces the trustee's liability.

Anodos is a Chief Compliance Officer for Trustees. We help our clients fulfill their fiduciary duties and minimize their personal risks. We do not sell insurance or manage money. We are advocates who fight for our clients' interests as if they were our own.

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Sample Compliance Library Document

Identification of the Duty:

Duty to Prudently Delegate

Code Section Defining the Duty:

"The trustee shall exercise prudence in the… selecting of an agent." - §16052(a)(1)

Relevant facts:

The trust is funded with $7,000,000 of liquid assets. The "Plan" for the trust calls for a targeted rate of return of 7.0% (inflation + 4%). The trustee identified three investment managers that have a long standing reputation for prudence in the community. The trustee submitted to each manager a "request for proposal" for management of the trust assets. This RFP included a "delegations of investment duties" document consistent with §16052(a)(2). The trustee received from each of these managers their written response to this inquiry along with a presentation of each manager's proposal. (The managers' responses are included in the trustee's books and records). The trustee conducted an independent investigation of each managers FINRA report to identify if there are any complaints or bad acts recorded for each managers. None were found.

Trustees Decision:

Based on this RFP process the trustee has selected Alpine Assets Mangers to delegate investment duties to. The trustee has delivered to Alpine a delegations of duties document which defines the anticipated distributions from the trust, the targeted rate of return for the trust, the measure of risk that manager's activities are to conform with, the level of fee the manage will be paid, and the reporting frequency for the manager.