

FIDUCIARY PROCESS BEST PRACTICES

UNIFIED TRUST
COMPANY, NA

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FIDUCIARY PROCESS BEST PRACTICES

SUMMARY

The purpose of the Unified Trust Company fiduciary process best practices compendium is to give an overview of the prudent process followed by our Trust Investment Committee for both employee benefit and personal trust clients. Our ultimate goal is to improve investment outcomes for our clients and increase the success probability of meeting their financial goals. Unified Trust Company seeks to follow a consistent and standardized process based on these best practices. Our clients can be confident that critical components for their investment strategy have been properly implemented. We believe such an approach improves participant and beneficiary investment outcomes.

This compendium cannot cover every important parameter of our procedural detail. Thus to a certain degree best practices are a merely a general template for prudence at the “thirty thousand foot level”. However we wanted to take our very detailed day-to-day process back up to the big picture level for descriptive purposes. This compendium describes our prudent investing process at the macro level of general overview.

We have enough confidence to believe that we know more about prudent investing than most of our competitors. Our day-to-day operations, research, asset allocation and asset quality investment processes, on the other hand, are comprised of hard detail on implementation of very specific investment and prudence philosophy. This best practices compendium allows our clients to visualize our process in enough detail to understand what we do, but not so much detail as to be overwhelming.

Recently a handful of select industry and academic groups have attempted to improve the fiduciary management of portfolios by establishing generally accepted national fiduciary standards and procedures. Unified Trust Company wishes to recognize the efforts of Donald Trone at the Foundation for Fiduciary Studies to create the twenty-seven best fiduciary practices, and author of the *Prudent Investment Practices Handbook*. In addition, we recognize W. Scott Simon, the author of *The Prudent Investor Act, A Guide to Understanding*. More information about these and other important fiduciary publications is contained in the bibliography on page 31 of this report.

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PART I:

**OVERALL FIDUCIARY PROCESS
BEST PRACTICES**

LEGAL STATUTES GOVERNING FIDUCIARY ACTIVITIES

Three statutes govern fiduciary conduct above all others. These three statutes require that a fiduciary have a detailed and well thought out process. The **Employee Retirement Income Security Act** (1974) “ERISA” covers fiduciary activities in both corporate retirement plans and public employee retirement plans. The **Uniform Prudent Investor Act** (1994) “UPIA” governs the trustee’s investment management conduct of private trusts in most states. It is included in the last section of this publication. The **Uniform Trust Code** (2000) was the first national codification of the law of trusts. The UPIA makes five fundamental improvements in the earlier criteria for prudent investing:

1. The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets.
2. The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration.
3. All categorical restrictions on types of investments have been abrogated; the fiduciary can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. A fiduciary can choose any investment, but there is no “safe” investment that protects the fiduciary from liability.
4. The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
5. The much criticized former rule of trust law forbidding the fiduciary to delegate investment and management functions was reversed. Delegation is now permitted, subject to safeguards.

Some portfolios require income, while others are oriented toward total return. As trusts and portfolios differ considerably in their risk-bearing capacities and needs, the fiduciary must determine the appropriate risk profile for each client through a detailed and systematic process. The plain language of the UPIA compels this conclusion. It requires that the trustee consider the “purposes, terms, distribution requirements and other circumstances of the trust” and develop “an overall investment strategy having risk and return objectives reasonably suitable to the trust.”

The UPIA provides a non-exclusive list of the factors a fiduciary must consider: general economic conditions, possible effects of inflation or deflation, expected tax consequences of investments and distributions, the role of each investment in the portfolio, the expected total return of the portfolio, and the liquidity and income needs of the beneficiaries. While trustees have always been charged with a familiarity with the purposes and needs of a trust, the UPIA increases that duty. A fiduciary cannot simply label a trust or portfolio as having a “conservative” risk profile and proceed accordingly. Instead the fiduciary must conduct and document a process to gather, record and analyze information about each trust’s time horizons, cash flow needs, risk aversion, tax status, intentions and other factors, not only at the trust’s inception, but on an ongoing basis.

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As mentioned above the **Uniform Trust Code** (2000) was the first national codification of the law of trusts. The primary stimulus concerning drafting of the Uniform Trust Code was the greater use of trusts in recent years, both in family estate planning and in commercial transactions. This greater use of the trust, and consequent rise in the number of day-to-day questions involving trusts, led to recognition that the trust law in many States was incomplete and fragmentary. The Uniform Trust Code was intended to provide States with precise, comprehensive, and easily accessible guidance on trust law questions.

Based on the three major statutes described above, the fiduciary is now required to conduct an ongoing investment process that is, in substance and procedure, more complex and sophisticated than was previously required by law. Furthermore, the Foundation for Fiduciary Studies may well establish the national standards by which not only professional trustees will be measured, but all financial intermediaries who provide professional investment advice at a fiduciary standard of care.

The legal and practical scrutiny a fiduciary undergoes is tremendous. The fiduciary standard is much greater than *merely which investments are selected for a portfolio*. More important, the investment *decision-making process* will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet the fiduciary standard if arrived at through a sound process, while the most simple and conservative one may not measure up if a sound process is lacking.

Optimizing asset allocation and maintaining high asset quality are arguably the most important tasks in this fiduciary process. Generally speaking, few investments are imprudent on their face. Unified Trust Company demonstrates prudence by the process through which we make investment decisions, rather than by showing that investment products and techniques were chosen because they were merely labeled as “prudent.”

A prudent investment process should be founded upon modern investment principles. Although there is no doubt good record keeping in terms of detailed minutes from investment committee meetings are important, a prudent process involves much more than good record keeping. Building upon these concepts, Unified Trust Company manages investments through a detailed process based upon fundamental investment rationale rather than a mere paper trail.

As a discretionary fiduciary, Unified Trust Company has one of the most important roles in the ERISA and trust wealth management investment process. We believe that any group attempting to manage investments without a well-defined process has a high probability of eventual failure. Therefore, unlike many providers, Unified Trust seeks to utilize a comprehensive series of best practices for every major fiduciary management process step. The Unified Trust best practices center on our fiduciary conduct, not the performance, of a specific portfolio.

The purposes of our best practices compendium are twofold: first to establish evidence that the Unified Trust Company is following a prudent investment process at the highest national fiduciary standard, which can minimize litigation risk to all parties, and second to improve the investment outcomes for both our personal trust clients and retirement plan participants.

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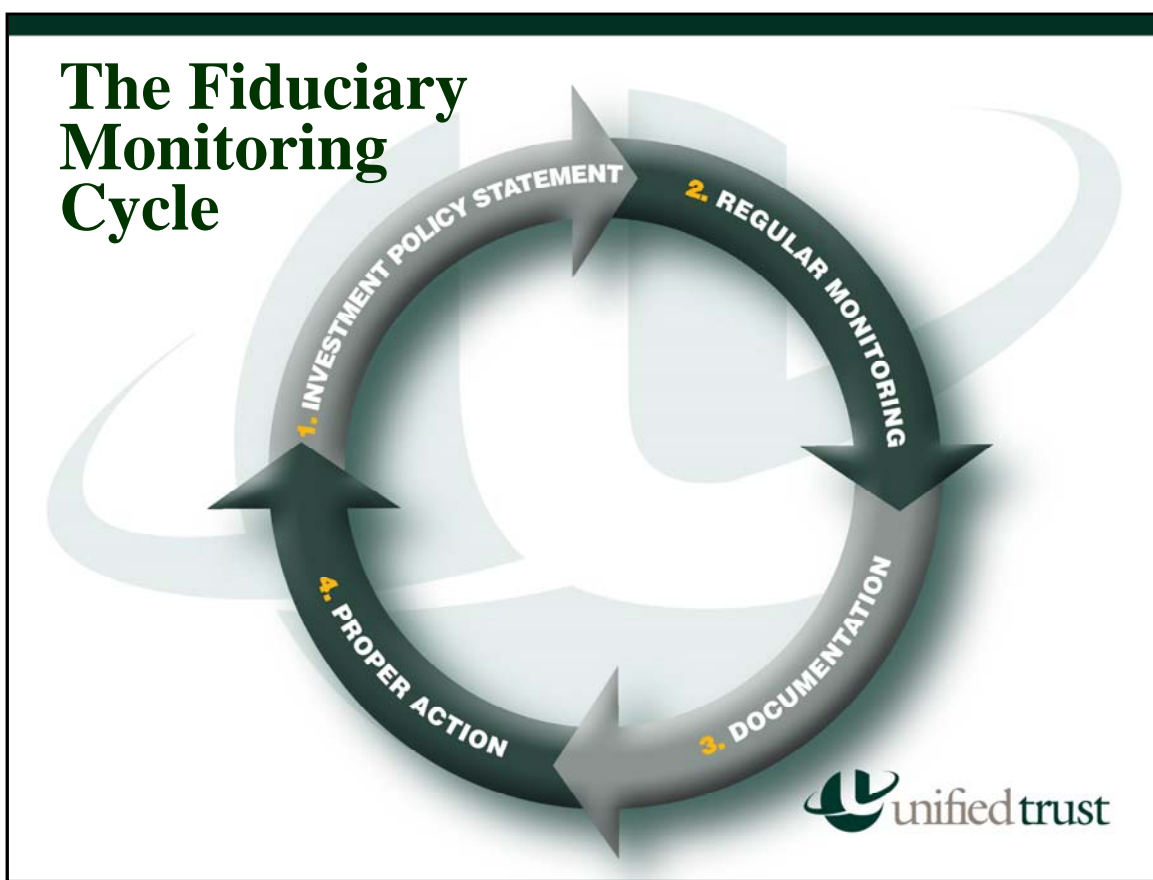
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FOUNDATION FOR FIDUCIARY STUDIES

Unified Trust Company seeks to conduct a detailed fiduciary process in a manner consistent the Foundation for Fiduciary Studies twenty-seven best practice national standards. We encourage you to learn more about the Foundation by visiting their website at www.FI360.com. The Foundation also publishes a national standards handbook entitled: *Prudent Investment Practices Handbook*. The primary purpose of the handbook is to outline the Practices that define a prudent process for investment fiduciaries. The Foundation divides the fiduciary decision-making process into five key steps:

1. ANALYZE CURRENT POSITION
2. DIVERSIFY AND ALLOCATE THE PORTFOLIO
3. FORMALIZE INVESTMENT POLICY
4. IMPLEMENT POLICY
5. MONITOR AND SUPERVISE

We believe investment outcomes are improved and liability reduced by utilizing our prudent fiduciary process. Building upon the Foundation's concepts, Unified Trust Company manages investment decisions through a detailed process based upon a sound ongoing process.



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FOUNDATION FOR FIDUCIARY STUDIES

TWENTY-SEVEN BEST PRACTICES

PRACTICES ASSOCIATED WITH STEP ONE: ANALYZE CURRENT POSITION

Practice No. 1.1 Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.

Practice No. 1.2 Fiduciaries are aware of their duties and responsibilities.

Practice No. 1.3 Fiduciaries and parties in interest are not involved in self-dealing.

Practice No. 1.4 Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

Practice No. 1.5 There is documentation to show timing and distribution of cash flows, and the payment of liabilities.

Practice No. 1.6 Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

PRACTICES ASSOCIATED WITH STEP TWO: DIVERSIFY AND ALLOCATE THE PORTFOLIO

Practice No. 2.1 A risk level has been identified.

Practice No. 2.2 An expected, modeled return to meet investment objectives has been identified.

Practice No. 2.3 An investment time horizon has been identified.

Practice No. 2.4 Selected asset classes are consistent with the identified risk, return, and time horizon.

Practice No. 2.5 The number of asset classes is consistent with portfolio size.

PRACTICES ASSOCIATED WITH STEP THREE: FORMALIZE INVESTMENT POLICY

Practice No. 3.1 There is detail to implement a specific investment strategy.

Practice No. 3.2 The investment policy statement defines the duties and responsibilities of all parties involved.

Practice No. 3.3 The investment policy statement defines diversification and rebalancing guidelines.

Practice No. 3.4 The investment policy statement defines due diligence criteria for selecting investment options.

Practice No. 3.5 The investment policy statement defines monitoring criteria for investment options and service vendors.

Practice No. 3.6 The investment policy statement defines procedures for controlling and accounting for investment expenses.

Practice No. 3.7 The investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable).

PRACTICES ASSOCIATED WITH STEP FOUR: IMPLEMENT INVESTMENT POLICY

Practice No. 4.1 The investment strategy is implemented in compliance with the required level of prudence.

Practice No. 4.2 The fiduciary is following applicable “Safe Harbor” provisions (when elected).

Practice No. 4.3 Investment vehicles are appropriate for the portfolio size.

Practice No. 4.4 A due diligence process is followed in selecting service providers, including the custodian.

PRACTICES ASSOCIATED WITH STEP FIVE: MONITOR AND SUPERVISE

Practice No. 5.1 Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives.

Practice No. 5.2 Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.

Practice No. 5.3 Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting.

Practice No. 5.4 Fees for investment management are consistent with agreements and with the law.

Practice No. 5.5 “Finder’s fees,” 12b-1 fees, or other forms of compensation that have been paid for asset placement are appropriately applied, utilized, and documented.

WHO IS A FIDUCIARY?

It is surprising, and sometimes downright distressing; to see so many individuals functioning in a fiduciary capacity who are unaware that they are a fiduciary. A fiduciary is an individual, company, or association that is responsible for managing another's assets. In some cases the status of fiduciary may be defined by statute. In other cases it is a functional definition and is based on facts and circumstances. In general, the issue is whether an entity or a person has *discretion, control or influence over investment decisions*.

Fiduciaries include executors of wills and estates, trustees, and those responsible for managing the finances of a minor. Black's Law Dictionary describes a fiduciary relationship as "one founded on trust or confidence reposed by one person in the integrity and fidelity of another." Generally speaking, stockbrokers and insurance agents selling investment products are not considered a fiduciary since they do not have discretion to make buy and sell decisions.

ERISA Section 3(21)(A) provides that a person is a fiduciary with respect to an employee benefit plan to the extent that such a person does any of the following:

1. Exercises any discretionary authority or control over the management of a plan, or over the management or disposition of plan assets;
2. Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan; or
3. Has any discretionary authority or discretionary responsibility in the administration of such plan.

ERISA defines "fiduciary" not in terms of formal title but rather in functional terms of control and authority over the plan. In various court cases, such as *Mertens v. Hewitt Assocs*, 508 U.S. 248 (1993); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984); *Yeseta v. Baima*, 837 F.2d 380 (9th Cir. 1989) an individual was fiduciary since he exercised control, even though it was unclear whether he was authorized to do so).

In addition fiduciary status is based on the functions performed for the plan, not just a person's title. The functional test is fact intensive. The focus of the inquiry is on the extent to which a person has any control or authority over the management or administration of an employee benefit plan or its assets.

Activities that give rise to fiduciary status include:

- ✓ Appointing other plan fiduciaries;
- ✓ Selecting and monitoring plan investment vehicles;
- ✓ Selecting and monitoring third party service providers;
- ✓ Interpreting plan provisions; and
- ✓ Exercising discretion in denying or approving benefit claims.

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Under ERISA, a person or entity may be deemed a fiduciary either by assumption of the fiduciary obligations (the functional or defacto method) or by express ERISA section 402(a) requires each covered plan to provide for one or more “named fiduciaries” who jointly or severally shall have authority to control and manage the operation and administration of the plan.

The term “named fiduciary” means a fiduciary who is named in the plan instrument or who pursuant to a procedure specified in the plan is identified as a fiduciary by a person who is an employer or employee organization. Plan documents commonly name the employer or an administrative committee as the named fiduciary.

In most cases a plan must have at least one fiduciary named in the written plan. A person or entity that has the power to appoint, retain and/or remove a plan fiduciary from his or her position has discretionary authority or control over the management or administration of a plan and is a fiduciary to the extent that he or she exercises that power.

A fiduciary has a duty to act primarily for the beneficiary’s benefit in matters connected with the undertaking and not for the fiduciary’s own personal interest. Scrupulous good faith and candor are required. Fiduciaries must always act in complete fairness and may not exert influence or pressure, take selfish advantage, or deal with beneficiaries in such a way that it benefits themselves or prejudices beneficiaries. Activities such as business shrewdness, hard bargaining, mis-representation, and taking advantage of the forgetfulness or negligence of beneficiaries by a fiduciary are prohibited.

A fiduciary has rights and powers that would normally belong to another person. The fiduciary holds those rights and exercises them to the benefit of the beneficiary. Fiduciaries must not allow any conflict of interest to distort their duties toward their beneficiaries and must exercise a high standard of care in protecting or promoting the interests of beneficiaries.

Whereas financial services salespeople may have their own motives and interests at heart and offer goods and services for a high or low price, a fiduciary must serve the beneficiary, if necessary at the cost of the fiduciary’s own interests. It is generally believed that fiduciaries perform their trades for reasons other than money alone and feel a sense of responsibility that goes beyond simply making a living.

To paraphrase Supreme Court Justice Louis D. Brandeis: “It is an occupation that is pursued largely for others and not merely for oneself. It is an occupation in which the amount of financial return is not the accepted measure of success.” A fiduciary’s duties are the highest known to the law, and they are held to something stricter than the morals of the market place; fiduciaries are subject to three different although overlapping standards of ERISA.

The fiduciary must establish investment goals, select an appropriate asset allocation strategy, formulate a written investment policy, select appropriate investment managers and/or mutual funds to implement the investment policy, monitoring the activities of the overall investment program for compliance with the investment policy, and avoid at all times conflicts of interest and prohibited transactions.

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TRUST INVESTMENT COMMITTEE

Unified Trust Company as discretionary fiduciary of a client's account is responsible for all decisions regarding the prudent management of those assets over which it has discretion. Within Unified Trust Company, the Trust Investment Committee ("TIC") is the body entrusted with the actual task of implementing a prudent process for the account. The TIC membership generally consists of ten or more investment and ERISA specialists within the company. The TIC keeps regular minutes of every meeting and investment decision as part of its documentation of each step in the best practices process. The TIC conducts regular reviews and educational seminars with regards to current regulations, laws and industry standards.

The TIC analyzes and reviews all of the documents pertaining to the establishment and management of the investments. As in financial decisions, the discretionary trustee has to set ascertainable goals and objectives that are consistent with the portfolio's current and future resources; the limits and constraints of applicable trust documents and statutes; and, in the case of individual investors, the goals and risk tolerance objectives of the individual investor. It is logical to assume that proof such a process has been implemented necessitates written documentation exists in some fashion.

In order to prudently fulfill its duties, ERISA and general trust law permits a fiduciary to seek assistance from outside professionals such as investment advisors, consultants and money managers if the fiduciary lacks the requisite knowledge. In addition, the fiduciary must review the plan's trust documents to ascertain the document permits the delegation of investment responsibilities.

The fundamental duty of Unified Trust Company is to manage investment decisions for the exclusive benefit of the client, retirement plan participant, and/or trust beneficiary. The fiduciary should attempt to take reasonable steps to protect the portfolio from large losses, and to avoid misunderstandings when seeking the services of external professionals advisers.

The primary tool for documenting the investment process and setting clear, prudent criteria for investment selection and replacement is the Investment Policy Statement ("IPS"). Therefore, fiduciaries should follow a standard procedure that requires all agreements to be in writing in order to define the scope of the parties' duties and responsibilities: to ensure that the portfolio is managed in accordance with the written documents that govern the investment strategy; and to confirm that the parties have clear, mutual understandings of their roles and responsibilities. Legal counsel familiar with ERISA should generally review the document prior to execution.

The fiduciary must determine if the fees paid are reasonable, and this would difficult if the terms were not in writing. When duties are delegated to others, the agreement should be in writing so that the fiduciary and service providers have clear communication concerning their respective roles and responsibilities. The agreement should contain provisions for measuring and monitoring the service provider's activities.

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Fiduciaries must act solely in the interest of the trust account or retirement plan's participants and beneficiaries and for the exclusive purpose of providing benefits for these people. Further, fiduciaries must act prudently, diversify the investment of plan assets, and generally act in a manner consistent with plan documents. In addition to this general requirement, plan fiduciaries are subject to the "prudent man" standard of care. This standard requires a fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use."

The fiduciary has the responsibility to safeguard entrusted assets, which includes keeping the assets within the control of the U.S. court system. This provides any regulatory agency (such as the OCC or DOL) the ability to seize the assets if, in its determination, it is in the best interests of the beneficiaries and/or participants.

ERISA requires pension plans to obtain a fidelity bond to protect the plan against theft of plan assets by fiduciaries and other "plan officials." The fidelity bond only covers dishonesty and does not cover fiduciary breaches. Thus the ERISA required bond coverage is limited to protection against loss through fraud or dishonesty.

Though not required for all other fiduciaries, it's a good industry practice to maintain similar coverage. In addition to bonding it is a best practice that the fiduciary carry sufficient liability insurance. Fiduciary liability insurance is designed to protect plan fiduciaries that, although acting in good faith, violate the complex fiduciary rules as expressed in federal rules, regulations, and court rulings.

There are several voluntary "safe harbor" provisions that, if all implemented by the fiduciary, would insulate the fiduciary from claims that they breached their fiduciary duty with regards to the plan's investments. There are four requirements to the safe harbor rules when Unified Trust, as discretionary trustee, is managing investment decisions:

1. The final authority for the investment decision is the responsibility the discretionary prudent expert.
2. The plan sponsor or trust committee must demonstrate that the discretionary prudent expert was selected by following a due diligence process.
3. Unified Trust as discretionary prudent expert acknowledges their fiduciary status in writing.
4. The plan sponsor or trust committee must monitor the activities of the discretionary prudent expert to ensure that the expert is performing the agreed upon tasks.

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PORTFOLIO RISK ANALYSIS

A significant risk is cash flow risk. One of the fundamental duties of every retirement plan or personal trust fiduciary is to ensure there are sufficient liquid assets to pay liabilities. The fiduciary should assess both the short-term and long-term cash flow needs of the client. In some cases detailed Monte Carlo modeling may be necessary to obtain a higher degree of certainty that the cash flow needs of the client will be met on a reasonable probability basis

The term risk has different connotations, depending on the fiduciary's and/or the investor's frame of reference. In a participant-directed plan the risk tolerance is determined by each individual for his or her personal account. In a trustee-directed plan, however, the trustee will use a risk tolerance questionnaire combined with the investment time horizon to determine the client's risk tolerance profile.

Traditionally, standard deviation was used to represent risk. It measures the variability of returns, not the possibility of a loss. Thus standard deviation measures uncertainty, not true risk. Recently, a new way to measure risk from the investor's perspective has been introduced. It is called downside risk, or by the name of its inventor, Dr. Frank Sortino of San Francisco's Pension Research Institute, the Sortino Ratio. Downside risk has the following advantages:

- Downside risk considers the investor's goal, while most traditional risk measures, such as beta, Sharpe Ratio or standard deviation, do not.
- Standard deviation is a statistical measurement of dispersion around an average, which, for an investment, depicts how widely the returns varied over a certain period. The variation can be up or down.
- The main problem with standard deviation is that it is not a measure of risk. Rather, it is a measure of uncertainty.
- Downside risk defines risk in accordance with an investor's perception of risk, i.e., failure to meet the goal. Standard deviation measures only the dispersion of returns around the average.
- Downside risk uses a method of "bootstrapping" that gives a view of many observations, rather than just a few, in order to understand what the true downside potential might be.

AUDITS, BANK EXAMS AND INSURANCE COVERAGE

As a fiduciary, Unified Trust Company has the responsibility to safeguard entrusted assets, which includes keeping the assets within the control of the U.S. court system. This provides any regulatory agency (such as the OCC or DOL) the ability to seize the assets if, in its determination, it is in the best interests of the beneficiaries and/or participants.

ERISA requires pension plans to obtain a fidelity bond to protect the plan against theft of plan assets by fiduciaries and other “plan officials.” The fidelity bond only covers dishonesty and does not cover fiduciary breaches. Thus the ERISA required bond coverage is limited to protection against loss through fraud or dishonesty.

Though not required for all other fiduciaries, it’s a good industry practice to maintain similar coverage. In addition to bonding it is a best practice that the fiduciary carry sufficient liability insurance. Fiduciary liability insurance is designed to protect plan fiduciaries that, although acting in good faith, violate the complex fiduciary rules as expressed in federal rules, regulations, and court rulings. However, no insurance protects from general market declines.

As mentioned earlier, the most important protection for our clients is the prudent process followed by Unified Trust Company. In our entire operating history we have never had a claim filed by a client nor had any insurance carrier pay any settlement to a client. In each of following Federal mandates for bonding and insurance policy requirements, we always equal and generally exceed such standards for a national bank trust company. In addition to our prudent process we have an overwhelming number of additional protective “safe guards” in place to protect clients:

- 1) We maintain at least \$2 million in regulatory capital.
- 2) We maintain the following insurance coverage:
 - \$5 million in fidelity bond, and
 - \$5 million in errors and omissions liability, and
 - \$5 million in directors and officers liability
- 3) We operate by established Federal agency operating procedures--including complete segregation of duties so no employee can control a transaction from start to finish.
- 4) Client assets are always segregated from Unified Trust Company operating accounts.
- 5) We utilize SunGard trust accounting software with built in audit trails.
- 6) We undergo an independent financial audit at least once per year.
- 7) We undergo a Federal Office of the Comptroller of the Currency (“OCC”) bank examination at least once per year, and generally the bank exams are every six months.
- 8) We undergo an IT audit (data integrity) at least once per year.
- 9) We undergo a SAS 70 audit (operating procedures) once per year.
- 10) We undergo a fiduciary activities audit at least once per year.
- 11) We undergo Collective Investment Fund audits at least once per year.
- 12) We file quarterly financial reports with appropriate federal regulatory agencies.
- 13) We communicate all of this to the Unified Trust board of directors in a timely fashion.
- 14) We also regularly communicate all of this to the Unified Financial Services, Inc. (holding company) board of directors in a timely fashion.

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COMPARISON TO FDIC AND SIPC COVERAGE

The “SIPC” stands for Securities Investor Protection Corporation. The SIPC is a brokerage customer’s first line of defense *in the event a brokerage firm fails* owing customers cash and securities that are missing from customer accounts. SIPC coverage is generally \$100,000 for cash and \$500,000 for securities, but many brokerage firms offer higher limits.

The SIPC does not cover fiduciary decision-making nor reimburse for breaches of fiduciary duty. The SIPC coverage is therefore vastly narrower than the insurance and bonding protections offered by Unified Trust Company. SIPC cannot cover fiduciary decision-making since brokerage firms and brokers are not fiduciaries. The SIPC coverage has nothing to do with brokerage investment recommendations or a broker’s negligence when giving advice. *SIPC coverage does not protect the customer from a market decline.*

Congress created SIPC in 1970 to address the failure of several large brokerage houses. In these cases, the brokerage customers were unable to retrieve their cash and securities from the failed firms. When a brokerage company is closed due to bankruptcy or other financial difficulties and customer assets are missing, SIPC steps in and, within certain limits, works to return customers’ cash, stock and other securities. Without SIPC, investors at financially troubled brokerage firms might lose their securities or money forever, or wait for years while their assets are tied up in court. SIPC does not replace any market losses. They just make sure that a customer’s 100 shares of IBM are returned. Whatever the 100 shares of IBM are worth is up to the market to determine. It could be more or less than the investor’s purchase price.

SIPC is not the FDIC. The Securities Investor Protection Corporation does not offer to investors the same blanket protection that the Federal Deposit Insurance Corporation provides to bank depositors.

How are SIPC and the FDIC different? When a member bank fails, the FDIC insures all depositors at that institution against loss up to a certain dollar limit. The FDIC’s no-questions-asked approach makes sense because the banking world is “risk averse.” Most savers put their money in FDIC-insured bank accounts because they can’t afford to lose their money.

That is precisely the opposite of how investors behave in the stock market, in which rewards are only possible with risk. Most market losses are a normal part of the ups and downs of the risk-oriented world of investing. That is why SIPC does not bail out investors when the value of their stocks, bonds and other investments falls for any reason. Instead, SIPC replaces missing stocks and other securities where it is possible to do so.

When SIPC gets involved. When a brokerage firm fails owing customers cash and securities that are missing from customer accounts, SIPC usually asks a federal court to appoint a trustee to liquidate the firm and protect its customers. With smaller brokerage firm failures, SIPC sometimes deals directly with customers. SIPC does not cover individuals who are sold worthless stocks and other securities. SIPC merely helps individuals whose money, stocks and other securities are stolen by a broker or put at risk when a brokerage fails for other reasons.

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PART II:

**INVESTMENT POLICY STATEMENT
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INVESTMENT POLICY STATEMENT DESIGN

One of the most important fiduciary services Unified Trust Company performs is the design and maintenance of the Investment Policy Statement (“IPS”). Unified Trust Company believes the IPS should be viewed as the essential management tool for directing and communicating the activities of the portfolio. It is a formal, long-range, strategic plan that allows the fiduciary to coordinate the management of the investment program in a logical and consistent framework. The IPS should not be vague. There should be enough specific detail in the IPS to allow a person unfamiliar with the client’s situation to implement and manage the investment plan.

The investment policy statement should define the duties and responsibilities of all parties involved in the investment process. This ensures continuity of the investment strategy when there is a change in fiduciaries; helps to prevent misunderstandings between the fiduciary and beneficiaries; and helps to prevent omission of critical fiduciary functions. The IPS should include sections on the role of the investment committee and any external investment consultants.

The IPS should address the “information overload” problem plan fiduciaries face. It should help them select and monitor their investments based upon objective outcome studies. In general the primary criterion for the selection, monitoring, retention, and replacement of investment managers is the Unified Fiduciary Monitoring Index[®] (“UFMI[®]”). While the UFMI[®] cannot be universally applied and cannot be the sole basis for investment decisions, Unified Trust Company as discretionary trustee will use it as the first step in the decision-making process.

Unified Trust Company may use the following modeling tools to help determine the likely investment return for the plan: Sortino Downside Risk Analysis, Mean Variance Optimization, Stochastic Probabilistic Modeling or Monte Carlo Analysis. In this context, the term “model” means to “replicate” in order to determine the probable returns of an investment strategy given current and historical information.

The fiduciary should describe the presumptions that are being used to model the probable outcomes of a given investment strategy. The fiduciary may in some cases compare results of analyses using both historical and projected assumptions. In one form of stochastic modeling the fiduciary’s simulations go beyond using mere historical assumptions by basing the modeling on actual returns of each asset class.

The fiduciary’s role is to choose the appropriate combination of asset classes that optimizes the identified risk and return objectives, consistent with the portfolio’s time horizon. We have found that asset allocation usually can be improved using Sortino Downside Risk analysis. Using this methodology the initial choice of asset classes and their specific weighting will have a significant impact on the long-term performance of the plan. Sortino Downside Risk analysis improves the appropriate combination of assets in order to optimize a required return subject to the level of acceptable downside risk. In a participant-directed plan, the fiduciary should take into account the investment sophistication and knowledge of the plan participants. The fiduciary should also consider how the various asset classes would interact together in various model portfolios.

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EXPECTED MODELED RETURN

The fiduciary will fulfill its investment duties if it takes into account the facts and circumstances that the fiduciary knows or should know are relevant to the particular investment course of action required in the client's financial plan. One of these facts and circumstances is to determine the likely investment return of a particular asset class. Therefore it is a fiduciary best practice to "model" or determine the probable returns of an investment strategy based upon both current and historical information. The expected modeled return and risk characteristics for each asset class are shown in Appendix A of the Sample Investment Policy Statement section of this compendium.

ASSET CLASS CATEGORIES

When investment managers make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the client. By spreading investments over several prudently selected asset classes, a fiduciary may reduce the client's exposure to losses due to adverse economic and market conditions, or against the misfortunes of a particular business and thereby minimize the risk of large losses.

The client's investment objectives investment objectives and compliance with safe harbor provisions for employee benefit plans such as ERISA Section 404(c) can be achieved by making available mutual funds or collective investment funds consisting of securities of either domestic, global or international issuers. Unified Trust Company includes the following categories of funds for possible inclusion in the managed portfolio or retirement plan fund menu:

Money Market or Stable Value	Mid Cap Equity Blend
Bond, Intermediate Term	Mid Cap Equity Value
Bond, Short Term	Small Cap Equity Growth
Balanced	Small Cap Equity Blend
Large Cap Equity Growth	Small Cap Equity Value
Large Cap Equity Blend	Real Estate Investment Trust
Large Cap Equity Value	International Equity (includes world and
Mid Cap Equity Growth	global)

The discretionary fiduciary may make a carefully controlled number of funds available to plan participants in the participant-directed portion of the plan. The discretionary trustee will exercise caution when selecting relatively new and untested risky asset classes. The minimum number of funds is dictated by the minimum asset class coverage described above. The fiduciary should consider that too many choices can be counterproductive to the plan participants and may actually reduce their success probability.

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MULTIPLE FUNDS IN AN ASSET CATEGORY

The fiduciary standard of care, including the standards for prudent investment management, is generally not related to the portfolio size. However, the size of a portfolio has been recognized to be a factor in determining which investments are appropriate for the account or retirement plan. The discretionary fiduciary may offer multiple funds in a single category, subject to the following general guidelines:

1. The portfolio should undergo a review of the fund menu for an excessive amount of funds, particularly an excessive amount of funds per each asset class. As a general rule the fund menu should not contain more than two funds per asset class, and no more than 20 funds in total. When more than one fund per category is offered, the fiduciary should consider choosing more than one manager or mutual fund family to diversify managers.
2. The fiduciary may determine that a fund, which is not failing the Unified Fiduciary Monitoring Index[®], needs to be removed from the fund menu because of an excessive number of funds per asset class. The fiduciary should then document their actions, and then communicate with the appropriate trust administrator or benefit consultant assigned to the plan.
3. As a general rule, the deleted fund should have the worst Unified Fiduciary Monitoring Index[®] score of the groups of funds for that particular asset class. Secondary considerations would be the amount of assets held in the fund with attention given to delete a fund with the smallest amount of assets in that particular plan so as to be as least disruptive to the plan participants as possible. Another secondary consideration would be the revenue sharing amount that the fund pays to the plan through the DOL Frost Model.
4. The categories in which multiple funds are offered will most often be those in which a prudent asset allocation dictates the largest position. For example, large company stocks may represent a larger position in a prudent portfolio than mid cap or small cap stocks and the plan may therefore include more large cap funds.

The above four general guidelines highlight the challenges of writing an IPS to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the general guidelines of multiple funds in a particular asset class.

The “art” of the trustee must lie in the methodology, based on accumulated experience of the Trust Investment Committee, to apply the tools available in a way that gives the highest chances for success in the widest range of possible investment environments. This “art” might include varying the assumptions in certain ways, changing the constraints based on asset classes in the optimization software, or simply noting when a result is not significant enough to warrant a change.

INVESTMENT SELECTION AND MONITORING CRITERIA

Unified Trust Company seeks to prudently manage investment policy through outcomes-based investment research. Results matter. The ideal investment process is one that not only meets the legal requirements of procedural prudence but which also delivers desirable investment results. The fiduciary therefore designs its investment process around insights from outcomes-based research. In other words, the fiduciary searches for academic studies that attempt to establish actions that may be taken to deliver predictable, desirable outcomes. Outcomes-based research attempts to answer the question, “What works?”

In selecting investment managers (“funds”) for the plan, the Unified Trust Company will rely on the Unified Fiduciary Monitoring Index[®] as the primary criterion and a range of supplemental criteria as well.

The discretionary trustee must exercise reasonable care, skill, and caution in selecting investment managers or mutual funds. The discretionary trustee retains the fiduciary responsibility to continually evaluate the manager’s performance in light appropriate benchmarks that are peer group adjusted. After the fund or manager is reviewed, reports should be prepared to document the information reviewed.

In order to conduct a prudent process that improves outcomes, Unified Trust Company reviewed most major academic finance publications to understand which mutual fund measurement criteria may have a predictive outcome. We compiled these predictive criteria into a single mathematical formula to create the Unified Fiduciary Monitoring Index[®]. The Unified Trust Company recalculates the current score on more than 14,000 mutual funds every quarter.

The Unified Fiduciary Monitoring Index[®] (“UFMI[®]”) overall composite score ranges between 1 and 100. A score of 1 is in the top 1%; a score of 10 is in the top 10%, etc. The mathematical calculation does not look at raw investment performance, but instead incorporates several factors shown to be somewhat predictive in prior academic studies.

In order for the data to be meaningful, the fiduciary must compare each individual fund to its’ peer group, or in other words, its’ investment category. In order for the process to be meaningful, it should have a positive impact on outcome. We now have more than 120,000 fund-years of prospective, or forward-looking data. We found that, in the aggregate as measured across many thousands of mutual funds, the UFMI[®] tends to produce consistent effects. In general, this effect tends to persist for at least 12-24 months after the fund is scored.

The trustee can utilize a bright line test as follows: The portfolio or retirement plan should initially select funds scoring in the top 25% (UFMI[®] 1-25) and replace any funds when subsequent scores are worse than the top 40% (UFMI[®] 41-100). When a fund has a score worse than 40 for one quarter it is placed on the “**Watch List**.”

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If the fund has a score worse than 40 (UFMI[®] 41-100) for two consecutive quarters it is placed on the **“Replacement List.”** The discretionary trustee replaces a failing fund with an acceptable fund in the same investment category. Following the fiduciary activities, the review is documented in plan fiduciary/ investment committee due-diligence file, including the materials reviewed by the committee and any other notes or analysis used to determine whether to retain, add or remove investment options.

In addition to the primary criterion of the UFMI[®], the discretionary trustee will consider the following supplemental criteria in the selection and retention of funds for the plan.

CONSISTENCY OF UFMI[®] RESULTS

Unified Trust Company will give greater consideration to funds with consistently acceptable historical UFMI[®] scores. In addition, the fiduciary will generally seek funds and managers with higher performance as compared to peer group over relevant trailing time periods. Such superior performance will be viewed favorably, but not to the extent that higher is always viewed as better since relative performance changes significantly year after year.

NET COST OF MONEY MANAGEMENT

Prudent asset management in general and ERISA specifically require fiduciaries to control and account for the costs of administering an employee benefit plan, including investment expenses. Unified Trust makes every reasonable attempt to ensure that all costs are reasonable. ERISA Section 404(a) requires the fiduciary of an employee benefit plan to: ... discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries, and for the exclusive purpose of. (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan. [ERISA §404(a)(1)(A)(i) and (ii)]

Unified Trust Company as fiduciary will consider funds that revenue share. Since mutual fund revenue sharing payments are always passed through 100% to the retirement plan under the DOL Frost Model, the true cost of a fund is its total expense minus the revenue sharing amount. In general the fiduciary will favor funds with lower net cost.

STYLE CONSISTENCY

When the types of securities a manager invests in change, the portfolio may “drift” into a different investment style, a result known as style drift. While the trustee does not view style drift in and of itself as a reason for firing a manager, it is nonetheless important to maintain control over the plan’s asset class coverage. When a manager changes styles it may inadvertently change the portfolio risk and return characteristics and necessitate a change. The trustee will therefore generally prefer managers who have demonstrated style consistency over relevant trailing time periods when selecting and retaining managers.

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MANAGER ORGANIZATION

In general the fiduciary will give consideration to multi-manager funds versus single manager funds due to the implied consistency of management. The ability of the mutual fund's board of directors to act independently of management, and always in the best interests of shareholders, will be considered. The impact of the recent mutual fund scandal will also be considered.

MANAGER TENURE AND FUND LONGEVITY

In general a more experienced manager, or multi-manager team, is preferred to a less experienced manager. Unified Trust Company will not, however, implement a rigid cutoff "screen" to eliminate managers below a certain threshold of years managing a particular fund. In general, the fiduciary will select funds with at least a three-year operating history.

SIZE OF FUND

Unified Trust Company will not hire funds with a level of assets in all share classes combined that could likely result in the fund maintaining an insufficient asset level whereby the fund creates a situation such that the viability of the fund is suspect, or produces a situation where the expenses charged to the shareholder are unreasonable. In addition, the fiduciary will monitor a fund's level of asset growth so that an excessive asset level or sudden period of growth does not cause the fund to become unwieldy and unlikely to produce its historical performance.

CREDIT QUALITY

Unless it is clearly not prudent to do so, the Unified Trust as discretionary trustee will not select fixed income securities or funds with average credit quality below investment grade. In general the fiduciary may consider the credit quality of a bond fund and the mix of credit qualities of its underlying assets when comparing similar funds.

SORTINO DOWNSIDE RISK ANALYSIS

Sortino downside risk analysis allows the use of an absolute minimal acceptable return ("MAR"), or a relative MAR, such as the peer group performance each quarter. The downside risk and downside probability values are helpful in distinguishing risk characteristics between funds with good UFMI[®] scores. Unified Trust Company portfolio research found the following downside risk attributes to be extremely helpful in further segregating and examining low risk funds with good UFMI[®] scores.

MAR = Peer Group

Sortino Downside Risk < 3.00%

Sortino Downside Probability < 30%

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USE OF ASSET ALLOCATION TOOLS TO DETERMINE POLICY

Since the introduction of Markowitz's mean-variance optimization ("MVO") and the "efficient frontier" in the 1950's, a variety of tools has emerged to assist fiduciaries in establishing asset allocation policy. The discretionary trustee may in some cases compare results of analyses using both historical and projected assumptions. Newer forms of downside risk analysis, such as the Sortino Downside Risk Analysis process may also be employed.

The discretionary trustee will make available to the Trust Investment Committee the following tools to help determine allocation policy for the plan. The committee will consider the limitations of such software, including that correlation coefficients between various asset classes change over time.

1. **Sortino Downside Risk Analysis Portfolio Optimization**
2. **Mean-Variance Optimization ("Efficient Frontier" Software)**
3. **Stochastic/Probabilistic Modeling Software**
4. **Monte Carlo Probability Analysis Software**
5. **Economic Forecasting And Asset Class Modeling**

Prudent investment management in general, and ERISA specifically, had as one of its central purposes a public policy of ensuring the adequate investment returns necessary for participants. While based in large part on traditional principles of trust law, ERISA recognized the limitations of these principles in portfolio management and thus departed somewhat from the Prudent Man Rule by setting a standard of prudence to govern pension investments that is more attuned with economic reality and important academic developments in financial theory.

The overall investment strategy should be based upon risk and reward objectives suitable for the trust. ERISA rejects a per se rule as to imprudent investments and provides a safe harbor from liability if the fiduciary has given "appropriate consideration" to the facts and circumstances of the investment and its relationship to the needs of the pension plan. *It is process oriented rather than rule oriented.*

The standard of prudence applies to the trust as a whole rather than to individual investments, with a realization that particular investments that would have been viewed as speculative on their own may be sensible, risk-reducing additions to a portfolio viewed as a whole.

There is a duty to diversify unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms of the governing instrument. Diversification should be considered both within an asset class and also across asset classes, unless it is clearly not prudent to diversity.

PART III:

**INVESTMENT MONITORING
BEST PRACTICES**

INVESTMENT MONITORING

Under ERISA the plan fiduciary has a fiduciary obligation to prudently select such vehicles, such as mutual funds, as well as a residual fiduciary obligation to periodically evaluate the performance of such vehicles to determine, based on that evaluation, whether the vehicles should continue to be available as participant investment options.

ERISA Section 404(a) requires that fiduciaries performing such duties act “for the exclusive purpose of providing benefits” and that they manage their plan's investments in accordance with the “prudent man rule.” Under the prudent man rule, fiduciaries must use “the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This means that the standard is that of a hypothetical person who is knowledgeable about selecting investments for retirement plans or trust accounts for the purpose of accumulating benefits. For this reason, it is sometimes referred to as the “prudent expert rule.” To satisfy that standard, fiduciaries should engage in both substantive and procedural prudence. That is, they should determine what information is material and relevant to their decision; gather, examine, and understand that information; and then make an informed decision based on their findings.

The investment monitoring function extends beyond a strict examination of performance; by definition, monitoring occurs across all policy and procedural issues covered in this compendium. The ongoing review, analysis, and monitoring of investment decision-makers, and/or money managers, is just as important as the due diligence implemented during the manager selection process.

Unified Trust Company recognizes that generally fluctuating rates of return characterize the securities markets, and may cause variations in performance. We evaluate performance from a long-term perspective and utilize both our proprietary and academic research demonstrating certain evaluation methodologies can have a meaningful effect on improved outcomes.

The discretionary trustee will review model portfolios against appropriate blended benchmarks. The discretionary trustee will deliver to the plan sponsor and the plan's advisors, if any, a quarterly Fiduciary Monitoring Report showing the UFMI[®] scores of each fund in the plan, performance vs. benchmarks, and performance vs. IPS criteria. No investment action is required of the plan sponsor. The plan sponsor should review the report with its investment committee, board of directors and other interested parties.

WATCH LIST

When a fund falls below the minimum retention UFMI[®] score, or such other factors deemed important by the discretionary trustee, it is placed on the Watch List. At this time the Trust Investment Committee will begin the process of considering a replacement fund and the plan sponsor and advisor should take this opportunity to communicate any feedback with regard to a potential replacement.

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REPLACEMENT LIST

When a fund falls below the minimum retention UFMI[®] score for two consecutive quarters, it is placed on the Replacement List and is replaced as soon as administratively feasible in accordance with Unified Trust's replacement protocol.

The plan sponsor, its advisors and the discretionary trustee should review the entire plan status to determine the likelihood of participant success. Such an evaluation should include not only the investment performance of the manager, funds and asset allocation models related to the plan, but also the savings rate and overall funding of the participant account balances necessary for success

In keeping with the duty of prudence, a fiduciary appointing a money manager or selecting a mutual fund must determine the frequency of the reviews necessary, taking into account such factors as: (1) the general economic conditions then prevailing; (2) the size of the portfolio; (3) the investment strategies employed; (4) the investment objectives sought; and, (5) the volatility of the investments selected. The discretionary trustee may in its discretion place a fund on Watch List or Replacement List based on secondary considerations in addition to the UFMI[®].

An abbreviated example of the fiduciary investment reports that Unified Trust makes available to the plan sponsor and its advisors are shown as an attachment to this compendium. These reports should be reviewed during committee meetings with the plans sponsor. The plan sponsor should permanently retain them as part of their documentation process.

RE-BALANCING

Annual (or more frequent) rebalancing is a simple and effective tool that can help plan participants improve their success rate. It is most effective if applied to the plan participant's account via a default pathway, so the desired action is not dependant upon the participant to overcome their inertia and procrastination behaviors. Rebalancing is inherent to the element of diversification, where the goal is to create a portfolio that balances appropriate levels of risk and return.

That balance, once achieved, only can be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification. The rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing, in essence, controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles, without attempting to time the market.

Several methods exist by which fiduciaries may rebalance an account. Rebalancing refers to placing trades so that the asset allocation once again conforms to the target allocation after periods of relative gains/losses in each category lead to inevitable changes in the actual allocation.

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The discretionary fiduciary will rebalance at times it determines in its discretion to be best, based on the following considerations.

1. Scheduled Rebalancing
2. Deviation from Target
3. Tactical Rebalancing

In general the discretionary trustee will show a slight preference for multi-manager funds vs. single manager funds due to the implied consistency of management. The trustee will evaluate from time to time the mutual fund or investment manager board of director's commitment to shareholder fairness, fiduciary oversight, and regulatory compliance.

ERISA provides that any employee benefit plan may provide that the discretionary fiduciary named by the plan to manage the plan's assets may appoint an investment manager or mutual fund to manage any assets of the plan. An investment manager or fund must be prudently selected and monitored, and must satisfy the requirements of ERISA Section 3(38). If an investment manager is appointed, the named fiduciary that made the appointment has an ongoing responsibility to monitor the performance of the investment manager at reasonable intervals.

The recent mutual fund trading scandal provides insight into the monitoring duties of the discretionary trustee and plan sponsor. Generally, ERISA requires a plan fiduciary to be responsible for either investing plan assets or maintaining a plan's menu of permissible investment alternatives under a participant-directed plan.

These concepts have generally been interpreted to mean that fiduciaries must not only be prudent in choosing to invest in or offer a particular mutual fund, but must also be prudent in deciding to maintain such investment or continue to make such fund available under the plan. Thus, the fiduciaries, even absent a scandal, have a general fiduciary obligation to monitor investments and alternatives on a periodic basis to ensure that they remain prudent choices.

In summary, merely hiring an advisor is not enough. The advisor must be prudently selected and monitored, and the advice must be carefully evaluated before being relied upon. Fiduciaries may not rely blindly on the investment advice they receive. Instead, they must review, evaluate, and understand the advice. The fiduciary must investigate the expert's qualifications and also provide the expert with complete and accurate information. The fiduciary should make certain that reliance on the expert's advice is reasonably justified under the circumstances. After reviewing the advice provided by their experts, fiduciaries must determine whether that advice is well-founded and is appropriate for their plan and, if so, take measures to implement the advice.

PART IV:

**INVESTMENT FEES AND
REVENUE SHARING
BEST PRACTICES**

CONTROLLING AND ACCOUNTING FOR INVESTMENT COSTS

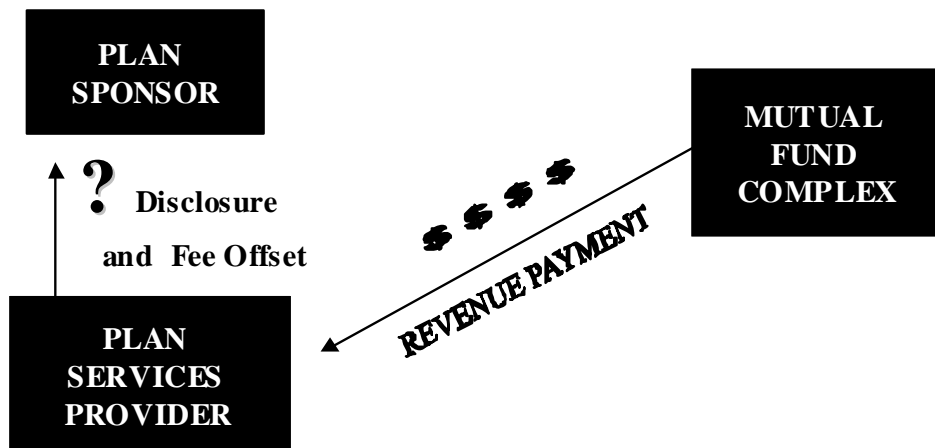
Prudent asset management for all in general and ERISA specifically requires fiduciaries to control and account for the costs of administering an employee benefit plan, including investment expenses. Unified Trust Company bears the responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from portfolio assets; and (2) whether the fees are reasonable in light of the services to be provided.

As fiduciary, Unified Trust Company reviews compensation to be paid for investment management to ensure that the aggregate (and individual components) is reasonable compensation for the services rendered. An accounting is provided for all dollars spent on investment management services, whether those dollars are paid directly from the account or through soft dollars, 12b-1 fees, or other fee-sharing arrangements. In the case of an all-inclusive fee (sometimes referred to as a bundled or “wrap” fee) investment product, it is necessary to analyze the total fee and each component (as if purchased separately) to make sure the costs are prudent.

REVENUE SHARING DEFINED

Revenue sharing is the allowance of payment of some portion of the internal fees associated with an investment product to a group providing services to the plan sponsor. Historically such allowance may or may not be known to a plan sponsor. Revenue sharing provides a practical and useful way to compensate for qualified retirement plan management, and helps ensure that appropriate fees are paid to the individuals and firms providing services to a plan, but it must be fully disclosed and in some cases offset dollar for dollars against the service provider’s billed fees.

Mutual Fund Revenue Sharing Program



12(B)1 FEES

Revenue sharing can take many forms. A common means of revenue sharing in the mutual fund industry is the use of 12(b)1 fees. 12(b)1 fees have long been a part of the industry, and traditionally have been included as part of a mutual fund's expense associated with marketing and distribution. This fee, if charged, is deducted from fund assets to compensate sales professionals for providing investment advice and ongoing services to mutual fund shareholders and to pay fund marketing and advertising expenses.

Rule 12b-1 of the U.S. Securities and Exchange Commission allows a mutual fund, under specified circumstances, to use fund assets to pay for distribution expenses. The size of the annual 12b-1 fee can vary from 0.05% of assets to 1.00% of assets. Since the adoption of the rule in 1980, mutual funds have used 12b-1 fees, often in combination with contingent-deferred sales charges, as an alternative to front-end sales loads for compensating sales professionals for assistance provided to purchasers of fund shares.

Other uses of 12b-1 fees have included advertising, sales materials, and activities involving the marketing of fund shares to new investors. Finally, mutual funds have used 12b-1 fees to pay for administrative services provided by third parties to existing fund shareholders. According to recent industry surveys, covering the costs of compensating broker-dealers for the sale of fund shares and related expenses is the most important use of 12b-1 fees. Expenses related to this type of distribution activity accounted for 63% of 12b-1 fees.

SHAREHOLDER SERVICING FEES

These expenses include, for example, fees paid to a fund's transfer agent or other groups for providing fund shareholder services, such as toll-free phone communications, help centers, computerized account services, Web site services, recordkeeping, printing, and mailing. In many cases the shareholder servicing fee is equal to or larger than the 12b-1 fee. Many funds show up in mutual fund databases as "not paying a 12b-1 fees", but instead pay a shareholder servicing fee.

SUB-TRANSFER AGENCY FEES

These fees represent a portion of the compensation normally paid to fund transfer agents diverted to those performing shareholder recordkeeping, recording daily activity and handling all shareholder servicing, from issuing account statements, confirmations, and tax statements to maintaining customer service departments on behalf of the funds. Most of these duties fall to the plan's administration provider in a participant-directed, defined contribution plan, and the administrator can be compensated for taking over this function if arrangements are made and contracts negotiated. Such revenues take the form of asset-based fees, fixed fees on a per-participant basis, or a combination of both.

When paid as a per-participant fee, payment formulas for subtransfer agent fees have a broad range. Annual compensation varies from \$3 per participant position (owning shares in a fund) in a given fund family to as much as \$23 per position. Some funds compensate for all positions; others cap at, say, three positions within the family for any given participant. Hybrid approaches, intended to reduce exposure to adverse selection, have formulas that pay, for example, \$10 per position capped at 10 basis points (0.10%) on total plan assets. Some families pay higher amounts, if the plan participant's personal information is shared by the record-keeper.

FINDERS FEES

Some mutual fund groups will pay a one-time finders fee for the placement of the money. Finders fees represent a very attractive revenue sharing vehicle for the plan sponsor and plan participants, since they are entirely paid for by the mutual fund group. In addition, new contributions to the fund also qualify for the finders fee. The mutual fund may pay a 1.00% finders fee, and yet have an annual expense ratio below 0.75%. Finders' fees create opportunities for plan sponsors to reduce expenses without reducing services or to increase services without increasing fees. Many plans operate with the finders fees secretly retained by the investment provider, but Unified provides full disclosure of the finders fees and the services provided. This is consistent with the Frost National Bank DOL letter.

COLLECTIVE INVESTMENT FUND REVENUE SHARING FEES

The final form of revenue sharing is a Collective Investment Fund revenue sharing fee. Such fees are very similar to the mutual fund 12(b)1 fees. 12(b)1 fees have long been a part of the industry, and traditionally have been included as part of a mutual fund's expenses associated with marketing and distribution. The revenue sharing fee of the Collective Investment Fund is a very attractive 0.75% annual fee. The Collective Investment Fund annual 0.75% revenue sharing fee dwarfs the traditional mutual fund 0.25% 12(b)1 fee.

A REVIEW OF THE RULES

ERISA Section 404(a)(1)(a): The Exclusive Benefit Rule. Fiduciaries must act in the exclusive interests of plan participants and beneficiaries. In other words, fiduciaries may not even consider the size of their own compensation in making investment decisions for the plan; they may consider only what is best for participants.

ERISA Section 406(b): A broad prohibition against fiduciary self-dealing in a variety of forms. In the case of revenue sharing, fiduciaries are prohibited from receiving compensation of any sort that might influence the decision-making process. As a .50% payment by Fund A might influence a fiduciary to choose Fund A over Fund B, which only pays .25%, the receipt of such payments is a prohibited transaction. Overall, fiduciaries may not "receive any consideration from any party dealing with a plan in connection with a transaction involving plan assets," although specific exemptions exist.

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DOL Advisory Opinion 1997-15A: The Frost Letter. In the Frost Letter, the DOL clarifies that a fiduciary with control over the investment selection for a plan may collect revenue-sharing payments on behalf of the plan *but must account for each payment and pass it on 100% to the plan in the form of an expense offset or direct payment.*

The problem with the Frost Letter is that it goes further; it suggests that even an ERISA investment advisor or other fiduciary who does not have discretion is also bound by the prohibition against keeping the revenue-sharing payments. Thus, a directed trustee, or a fiduciary with no discretion over plan assets, or not giving advice about which funds to select for the plan, could be prohibited from accepting revenue-sharing payments, contrary to the existing practice of many directed trustees and other vendors. This concern led ABN/AMRO to seek clarification, which the DOL provided in 2003-09A.

DOL Advisory Opinion 1997-16A: The Aetna Letter. In the Aetna letter, the DOL clarifies that a nondiscretionary nonfiduciary can keep revenue-sharing payments. More importantly, however, the Aetna Letter provides a crucial insight: that plan fiduciaries have an obligation to discover the full amounts of compensation from whatever source derived, including revenue-sharing payments. In other words, the DOL believes that plan fiduciaries are expected to discover the existence and amounts of revenue-sharing payments to all vendors. Considering that the available disclosure is limited, proper discovery can be quite difficult.

DOL Advisory Opinion 2003-09A: The ABN AMRO Letter. Here the DOL solved the problem created by the language in the Frost Letter by clarifying that a directed trustee with no discretion over plan assets, and not giving “investment advice” as defined by regulation, could keep revenue sharing payments. Thus, those vendors who offer “co-fiduciary” services under various labels but do not accept true discretion over plan assets-or give investment advice-avoid the problem of not being permitted to continue accepting revenue sharing payments.

Since most vendor’s plan platforms are predicated on such payments, a different ruling from DOL would have had immediate and far-reaching consequences for the industry. In the ABN AMRO case, ABN AMRO serves as plan trustee but as directed trustee, not discretionary, and even though a trustee is always a fiduciary—which would seem to require conformance with the Frost Letter—this ruling agreed with ABN AMRO that it could keep the revenue sharing payments.

Over the last several years, several significant cases have been brought claiming breaches of fiduciary responsibility based upon 401(k) plan investment-fund selection, in some cases related to retail (through a broker) versus institutional (without broker involvement) fund use. In one such case, a substantial amount was paid (more than \$25 million) as part of a negotiated settlement. Others are still pending. Though three or four high-visibility court cases do not represent a tidal wave of litigation, some observers suggest that in the current environment, more may be expected, which may affect the decisions of other retirement plan fiduciaries.

Unified Trust follows the Frost Model for all ERISA cases in which we serve as discretionary trustee.

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THE FROST MODEL: “AN ACID TEST OF FIDUCIARY STATUS”

The DOL “Frost” model, in which vendors fully disclose and then pass through 100% of all revenue sharing payments, is in many ways an acid test of fiduciary status. Unified Trust follows the frost model for all retirement plans in which it serves as discretionary trustee. Vendors that offer to serve as a “plan fiduciary” but keep hidden revenue sharing payments either are not accepting discretion—and therefore liability—or operate in direct violation of the Frost Letter.

Service providers that are offering some type of co-fiduciary limited advice but not following the Frost Model expose the plan sponsor to significant fiduciary risk, since under all three DOL opinions described above (97-15, 97-16 and 2003-09) the plan sponsor has a fiduciary duty to know the facts and make a prudent decision for the exclusive benefit of plan participants.

Vendors that accept full discretion and fiduciary status over plan assets, on the other hand, are bound by the Frost Letter and are generally liable in the plan sponsor’s place for prudent management of plan assets—at least to the extent specified in the vendor’s contract or trust agreement.

Why is this “test” useful? Because most plan sponsors do not understand the distinction between directed and discretionary, or between a co-fiduciary responsible for only a small part of the plan and a co-fiduciary with full responsibility for plan assets. It might therefore be unclear to sponsors that vendors offering to serve in a fiduciary capacity come in all shapes and sizes, and that some accept more responsibility and liability than others. The only way to be certain of the true extent of a vendor’s responsibilities is to study the trust or service agreement, but noncompliance with the Frost model is a simple, useful indicator.

We have seen many instances where plan sponsors can misperceive the extent of a vendor’s fiduciary responsibility. For example, recently a vendor was offering to serve as “plan fiduciary,” a feature that the director of human resources found very appealing. The vendor was offering a passive, directed-trustee service—custodial only—yet the plan sponsor clearly was under the impression that the vendor was accepting full liability for the plan.

As the vendor followed the Aetna model, not the Frost model, with respect to revenue-sharing payments, it was not difficult to set the client straight. The vendor was actually offering only a passive, directed trustee service—custodial only—yet the plan sponsor clearly was under the impression that the vendor was accepting full liability for the plan. Since the vendor followed the Aetna model, not the Frost model, with respect to revenue sharing payments, it was not difficult to set the client straight.

Given the level of regulatory interest in these practices, however, it seems likely that more and more vendors in the future will adopt the Frost model regardless of their fiduciary status. It is even possible that SEC and DOL will create new rules that make the Frost model the de facto standard.

MANAGING AND AUDITING THE PROCESS

Tracking the various revenue sharing components can be an arduous task. Unified Trust has created a revenue sharing accounting system to track all aspects of this process. Each step must be measured and verified. For example, every revenue payment source due from each mutual fund is calculated by Unified. Our experience has shown that many fund groups incorrectly calculate the fee and remit an incorrect payment. Once each piece of revenue share is calculated and properly accounted for, Unified credits the fee to the plan. The plan sponsor receives regular detailed reporting illustrating all sources of revenue share and credits to the plan.

The first step in reaping the potential benefits from revenue sharing is for the plan sponsor find out how this element may apply to their retirement and savings plans either currently or potentially. The plan sponsor's job is to understand and document the full details of the fees their plan pays, including all investment management fees and other asset-based fees. This is the case whether the plan uses mutual funds, collective trust instruments, separate investment management accounts, brokerage accounts, an insurance contract, or any other form of funding instrument.

UNIFIED FIRSTRACSM SOFTWARE

1. Calculates the exact revenue share the plan should receive.
2. Reconciles the payment back to each plan.
3. Produces a statement for the plan sponsor every quarter showing all sources of revenue credits for their plan.
4. Offsets the Unified Trust fee dollar for dollar against the revenue share and credits all revenue back to the plan.
5. In cases where there is more revenue share than fees, the plan is paid a net dividend.

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APPENDIX:

THE UNIFORM PRUDENT
INVESTOR ACT

UNIFORM PRUDENT INVESTOR ACT

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-THIRD YEAR
IN CHICAGO, ILLINOIS
JULY 29 - AUGUST 5, 1994

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association
Miami, Florida, February 14, 1995

4/18/95

UNIFORM PRUDENT INVESTOR ACT

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UNIFORM PRUDENT INVESTOR ACT

PREFATORY NOTE

Over the quarter century from the late 1960's the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).

(3) All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.

(5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter's notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

Legislation. Most states have legislation governing trust-investment law. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states have already acted. California, Delaware, Georgia, Minnesota, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992).

Drafters in Illinois in 1991 worked from the April 1990 "Proposed Final Draft" of the Restatement of Trusts 3d: Prudent Investor Rule and enacted legislation that is closely modeled on the new Restatement. 760 ILCS § 5/5 (prudent investing); and § 5/5.1 (delegation) (1992). As the Comments to this Uniform Prudent Investor Act reflect, the Act draws upon the Illinois statute in several sections. Virginia revised its prudent investor act in a similar vein in 1992. Virginia Code § 26-45.1 (prudent investing) (1992). Florida revised its statute in 1993. Florida Laws, ch. 93-257, amending Florida Statutes § 518.11 (prudent investing) and creating § 518.112 (delegation). New York legislation drawing on the new Restatement and on a preliminary version of this Uniform Prudent Investor Act was enacted in 1994. N.Y. Assembly Bill 11683-B, Ch. 609 (1994), adding Estates, Powers and Trusts Law § 11-2.3 (Prudent Investor Act).

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement].

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. “In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust.” Restatement of Trusts 2d § 389 (1959). The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: “ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.’” *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The Uniform Prudent Investor Act regulates the investment responsibilities of trustees. Other fiduciaries – such as executors, conservators, and guardians of the property – sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust trust-investment law to the special circumstances of the state schemes for administering decedents’ estates or conducting the affairs of protected persons.

Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, “the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust.” Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment *b*, at 190 (1992). See also *id.* § 389, Comment *b*, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

UNIFORM PRUDENT INVESTOR ACT

SECTION 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.

Comment

This section imposes the obligation of prudence in the conduct of investment functions and identifies further sections of the Act that specify the attributes of prudent conduct.

Origins. The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Trustees should “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.” *Id.* at 461.

Prior legislation. The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 *Ohio State L.J.* 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see *id.* at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that “the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another”

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a

prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims”

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: “In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived” Restatement of Trusts 2d § 227 (1959).

Objective standard. 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. Sections 2 through 9 of this Act identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by 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 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 this [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.

Comment

Section 2 is the heart of the Act. Subsections (a), (b), and (c) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (f) is derived from Uniform Probate Code § 7-302 (1969).

Objective standard. Subsection (a) of this Act carries forward the relational and objective standard made familiar in the *Amory* case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection (a), by relating the trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust,"

should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term “portfolio” embraces the entire trust estate.

Risk and return. Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under “Literature.” Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

Subsection (b) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing “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.”

Factors affecting investment. Subsection (c) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is nonexclusive. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes?*, *Journal of Portfolio Management* 15 (Spring 1993).

Another familiar example of how tax considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Subsection (c)(8), allowing the trustee to take into account any preferences of the beneficiaries respecting heirlooms or other prized assets, derives from the Illinois act, 760 ILCS § 5/5(a)(4) (1992).

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in

some trust settings but inappropriate in others. It is the trustee's task to invest at a risk level that is suitable to the purposes of the trust.

The abolition of categoric restrictions against types of investment in no way alters the trustee's conventional duty of loyalty, which is reiterated for the purposes of this Act in Section 5. For example, were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing, even though the investment would no longer automatically offend the former categoric restriction against fiduciary investments in junior mortgages.

Professional fiduciaries. The distinction taken in subsection (f) between amateur and professional trustees is familiar law. The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) and (c) of the Act emphasize factors that are sensitive to the traits of small trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship. Furthermore, it is always open to the settlor of a trust under Section 1(b) of the Act to reduce the trustee's standard of care if the settlor deems such a step appropriate. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *h*, *m*, at 28, 51; reporter's note to Comment *g*, *id.* at 83.

Matters of proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no

formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted for the purpose of ascertaining the settlor's intent. See Uniform Probate Code § 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

SECTION 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.

Comment

The language of this section derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., Duty of Trustee to Diversify Investments, and Liability for Failure to Do So, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in Section 3 of this Act, is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, *An Introduction to Modern Financial Theory* 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of “compensated” and “uncompensated” risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk – the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently – to include investments in different industries. This is uncompensated risk – nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. “As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings.” R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 103 (2d ed. 1983).

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: “Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries Broader diversification is usually to be preferred in trust investing,” and pooled investment vehicles “make thorough diversification practical for most trustees.” Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, *supra*, at 23-24; Brealey, *supra*, at 111-13.

Diversifying by pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: “The purposes of such a common or joint investment fund are to diversify

the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble.” 7 Uniform Laws Ann. 402 (1985).

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities “issued by an investment company registered under the Investment Company Act of 1940”

SECTION 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].

Comment

Section 4, requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that “[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year.” Restatement of Trusts 2d § 230, comment *b* (1959). The 1992 Restatement retreated from this rule of thumb, saying, “No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities.” Restatement of Trusts 3d: Prudent Investor Rule § 229, comment *b* (1992).

The criteria and circumstances identified in Section 2 of this Act as bearing upon the prudence of decisions to invest and manage trust assets also pertain to the prudence of decisions to retain or dispose of inception assets under this section.

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Comment

The duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. The language of Section 4 of this Act derives from Restatement of Trusts 3d: Prudent Investor Rule § 170 (1992), which makes minute changes in Restatement of Trusts 2d § 170 (1959).

The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), extracted in the Comment to Section 1 of this Act, effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust." Restatement of Trusts 2d § 170, comment *q*, at 371 (1959).

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 *Michigan L. Rev.* 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?*, 31 *Labor L.J.* 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 *American U.L. Rev.* 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 *Fed. Regis.* 32606 (Jun. 22, 1994), to be codified as 29 CFR § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing]

the interests of participants and beneficiaries in their retirement income to unrelated objectives.”

SECTION 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.

Comment

The duty of impartiality derives from the duty of loyalty. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all the beneficiaries. Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests of beneficiaries interested in income and those interested in principal.

The language of Section 6 derives from Restatement of Trusts 2d § 183 (1959); see also *id.*, § 232. Multiple beneficiaries may be beneficiaries in succession (such as life and remainder interests) or beneficiaries with simultaneous interests (as when the income interest in a trust is being divided among several beneficiaries).

The trustee’s duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly handled under specialized legislation, such as the Revised Uniform Principal and Income Act (1962) (which is presently under study by the Uniform Law Commission with a view toward further revision).

SECTION 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.

Comment

Wasting beneficiaries’ money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: “Concerns over compensation and

other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. . . . [I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.” Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *m*, at 58 (1992).

SECTION 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.

Comment

This section derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *b*, at 11 (1992). Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is *ex ante*, not *ex post*.

SECTION 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.

Comment

This section of the Act reverses the much-criticized rule that forbade trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed *infra*, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c) (1992).

Former law. The former nondelegation rule survived into the 1959 Restatement: “The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform.” The rule put a premium on the frequently arbitrary task of distinguishing discretionary functions that were thought to be nondelegable from supposedly ministerial functions that the trustee was allowed to delegate. Restatement of Trusts 2d § 171 (1959).

The Restatement of Trusts 2d admitted in a comment that “There is not a clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate.” Instead, the comment directed attention to a list of factors that “may be of importance: (1) the amount of discretion involved; (2) the value and character of the property involved; (3) whether the property is principal or income; (4) the proximity or remoteness of the subject matter of the trust; (5) the character of the act as one involving professional skill or facilities possessed or not possessed by the trustee himself.” Restatement of Trusts 2d § 171, comment *d* (1959). The 1959 Restatement further said: “A trustee cannot properly delegate to another power to select investments.” Restatement of Trusts 2d § 171, comment *h* (1959).

For discussion and criticism of the former rule see William L. Cary & Craig B. Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 *Columbia L. Rev.* 207 (1974); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 *American Bar Foundation Research J.* 1, 18-24.

The modern trend to favor delegation. The trend of subsequent legislation, culminating in the Restatement of Trusts 3d: Prudent Investor Rule, has been strongly hostile to the nondelegation rule. See John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 *Missouri L. Rev.* 105 (1994).

The delegation rule of the Uniform Trustee Powers Act. The Uniform Trustee Powers Act (1964) effectively abrogates the nondelegation rule. It authorizes trustees “to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary” Uniform Trustee Powers Act § 3(24), 7B Uniform Laws Ann. 743 (1985). The Act has been enacted in 16 states, see “Record of Passage of Uniform and Model Acts as of September 30, 1993,” 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

UMIFA’s delegation rule. The Uniform Management of Institutional Funds Act (1972) (UMIFA), authorizes the governing boards of eleemosynary institutions, who are trustee-like fiduciaries, to delegate investment matters either to a committee of the board or to outside investment advisors, investment counsel, managers, banks, or trust companies. UMIFA § 5, 7A Uniform Laws Ann. 705 (1985). UMIFA has been enacted in 38 states, see “Record of Passage of Uniform and Model Acts as of September 30, 1993,” 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

ERISA’s delegation rule. The Employee Retirement Income Security Act of 1974, the federal statute that prescribes fiduciary standards for investing the assets of pension and employee benefit plans, allows a pension or employee benefit plan to provide that “authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers” ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2). Commentators have explained the rationale for ERISA’s encouragement of delegation:

ERISA . . . invites the dissolution of unitary trusteeship. . . . ERISA’s fractionation of traditional trusteeship reflects the complexity of the modern pension trust. Because millions, even billions of dollars can be involved, great care is required in investing and safekeeping plan assets. Administering such plans—computing and honoring benefit entitlements across decades of employment and retirement—is also a complex business. . . . Since, however, neither the sponsor nor any other single entity has a comparative advantage in performing all these functions, the tendency has been for pension plans to use a variety of specialized providers. A consulting actuary, a plan administration firm, or an insurance company may oversee the design of a plan and arrange for processing benefit claims. Investment industry professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 496 (1990).

The delegation rule of the 1992 Restatement. The Restatement of Trusts 3d: Prudent Investor Rule (1992) repeals the nondelegation rule of Restatement of Trusts 2d § 171 (1959), extracted *supra*, and replaces it with substitute text that reads:

§ 171. Duty with Respect to Delegation. A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992). The 1992 Restatement integrates this delegation standard into the prudent investor rule of section 227, providing that “the trustee must . . . act with prudence in deciding whether and how to delegate to others” Restatement of Trusts 3d: Prudent Investor Rule § 227(c) (1992).

Protecting the beneficiary against unreasonable delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees’ powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees’ Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of these powers. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent’s specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

Section 9 of the Uniform Prudent Investor Act is designed to strike the appropriate balance between the advantages and the hazards of delegation. Section 9 authorizes delegation under the limitations of subsections (a) and (b). Section 9(a) imposes duties of care, skill, and caution on the trustee in selecting the agent, in establishing the terms of the delegation, and in reviewing the agent’s compliance.

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).

Although subsection (c) of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a), subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

SECTION 10. LANGUAGE INVOKING STANDARD 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," "prudent person rule," and "prudent investor rule."

Comment

This provision is taken from the Illinois act, 760 ILCS § 5/5(d) (1992), and is meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.

SECTION 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.

SECTION 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.

SECTION 13. SHORT TITLE. This [Act] may be cited as the “[Name of Enacting State] Uniform Prudent Investor Act.”

SECTION 14. SEVERABILITY. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 15. EFFECTIVE DATE. This [Act] takes effect
.....

SECTION 16. REPEALS. The following acts and parts of acts are repealed:

- (1)
- (2)
- (3)