The oldest and perhaps most articulated source of fiduciary duties is the management of trust assets under state laws. These laws are informed by nearly two centuries of evolutionary developments in the statutory and case law of trusts and have given rise to such key fiduciary concepts as the prudent man rule and the duty to diversify. They also go beyond the Investment Advisers Act of 1940 (Advisers Act)1 and its implied fiduciary duty to act in the client’s best interest and make suitable investment recommendations to explicit fiduciary obligations under trust law that center on the foundational duties of loyalty and care. For this reason, the prudent investment process for the management of private trust and charitable organization portfolios also represents a best practice model suitable for all clients.

In this article, we review the basic purposes of the Uniform Prudent Investor Act (UPIA)2 and Uniform Prudent Management of Institutional Funds Act (UPMIFA),3 identify some of the key differences from fiduciary practices under securities laws, and detail some of the specific duties that an advisor must follow in managing trust assets. The wealth management firm that is able to conform to the rigorous standards under model trust laws and adapt those practices to all its clients will be in an ideal position to minimize liability, to reduce inefficiencies in the investment process, and to serve all of its clients effectively.

Underlying Purpose of UPIA and UPMIFA
The origins of UPIA and UPMIFA can be traced to changes in the prudent man standard that occurred over time in common law. In particular, the groundbreaking research by Harry Markowitz on risk and return relationships among assets and portfolio construction in the 1950s played a role in the drafting of the UPIA in the early 1990s and to updating the model law for charitable trusts, UPMIFA, in 2006. The drafting notes to both model laws readily acknowledge the influence of a “large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets,” namely modern portfolio theory and the importance of diversification.4

As part of this legal rewriting of state trust law, the more conservative (and outdated) imperatives in the standard that singularly focused on preservation of principal fell by the wayside. Today, under both model laws, the default standard of prudence applied to any investment in the trust fund is in relationship to the total portfolio rather than in isolation.5 In other words, the central consideration for the investment fiduciary is the tradeoff between risk and return. The once categorical restrictions mandated by courts of the 19th and early 20th centuries on certain stocks and other investments deemed to be a threat to protecting principal are no longer.

The form, substance, and intent of UPIA and UPMIFA intentionally are closely
1. clearly establish the scope and terms of the investment arrangement, which must also be consistent with the purposes of the private trust or institutional fund; and
2. periodically review the agent’s activities, including investment performance, consistent with the terms of the agreement.

In performing his or her duties, the agent owes a duty to exercise reasonable care in complying with the terms of the delegation. Both model laws clearly state that by performing a due diligence search with reasonable skill and care, as well as a periodic review of performance, the trustee or institution will not be liable for the decisions of the agent.

It is important to remember that in delegation, the advisor serves as a co-fiduciary subject to the standard of care under trust law. The advisor is still subject to any particular requirements of securities regulation, such as delivery of Part 2 of Form ADV and maintenance of client communications and the books and records rule. Additionally, certain business practices of nonfiduciaries (e.g., brokers) that involve inherent conflicts of interest, such as engaging in principal transactions, are not likely to be available to fiduciary advisors operating under UPIA or UPMIFA. The authors are not aware of any court decisions permitting self-dealing by agents operating under these acts.

Fiduciary Duty of Loyalty
In general, the fiduciary duty of loyalty is the most widely recognized characteristic of trust and securities laws. Both areas of law require the investment fiduciary to act in the best interest of the client. However, the duty of loyalty under trust law goes much further because the trustee must act solely in the interest of the beneficiaries, rather than be guided by the interests of either the agent or a third person involved in the sale of trust assets. UPIA, Section 5 is titled “Loyalty” and simply states that “[a] trustee shall invest and manage the trust assets solely in the interest of
the beneficiaries."12 Commentary to this section makes reference to ERISA in noting that requirements of prudence and loyalty are merged, driving home the point by asserting that “[a] fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.”13

Similarly, UPMIFA treats the duty of loyalty as a matter of settled law. Significantly, commentary to UPMIFA asserts that “[t]he duties imposed by this section [Section 3. Standard of Conduct in Managing and Investing Institutional Fund] apply to those who govern an institution, including directors and trustees, and to those whom the directors or managers delegate responsibility for investment and management of institutional funds.”14 Thus, the “sole interest” loyalty standard defined in UPIA would logically apply under both acts to an advisor acting under delegated authority. That would mean, for example, that the use of proprietary products of the advisor’s firm in the trust portfolio almost certainly would violate the duty of loyalty if the products provide the advisor greater compensation than comparable nonproprietary products.15

An additional duty of impartiality under Section 6 of the UPIA comes into play if there is more than one beneficiary. In this instance, the trustee (and the advisor to which portfolio management is delegated) must take into account any differing interests of the beneficiaries, such as a preference for income or capital accumulation. A duty of impartiality is not required under UPMIFA because the obligation of the trust fiduciaries is to the overall fund and maintaining an appropriate spending rate. The beneficiaries of a charity do not have enforceable rights in the same way that beneficiaries of a private trust do.16

**The Fiduciary Duty of Care**

In contrast to the Advisers Act, the model trust laws provide explicit guidance on investing under a fiduciary duty of care. This guidance, while explicit, ranges from broad governing principles to specific factors that must be considered.

One way or another, the governing principles associated with due care derive from the prudent investor rule. The rule, which is central to both UPIA and UPMIFA, requires investment fiduciaries to invest and manage assets in good faith and with the care and skill of a prudent person in a like position under similar circumstances. In everyday terms, this means that fiduciaries should honestly attempt to serve the best interests of beneficiaries.

A number of well-established fiduciary duties recognized under UPIA and UPMIFA fall under the overarching due care obligation and must be fulfilled to conform to the prudent investor rule. The duty to investigate requires fiduciaries to exercise diligence in gathering facts relevant to fulfillment of their responsibilities, analyzing those facts, and taking actions appropriate to the situation.

The duty to investigate applies broadly to virtually all decision making by fiduciaries, but UPIA and UPMIFA provide specific guidance with respect to decisions about managing and investing institutional funds. The acts list eight nearly identical factors that, if relevant, must be considered:

1. general economic conditions;
2. the possible effect of inflation or deflation;
3. the expected tax consequences, if any, of investment decisions or strategies;
4. the role that each investment or course of action plays within the overall investment portfolio of the fund;
5. the expected total return from income and the appreciation of investments;
6. other resources of the institution;
7. the needs of the institution and the fund to make distributions and to preserve capital; and
8. an asset’s special relationship or special value, if any, to the purposes of the trust or institution or beneficiaries.16

Additionally, the acts make clear that fiduciaries must control and account for expenses in their decision making. Specifically, UPMIFA states that “an institution may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.”17

The duty to diversify entails the obligation to make management and investment decisions about individual investments in the context of the institution’s overall portfolio and as part of an overall investment strategy.18 The investment strategy must, in turn, have risk and return objectives reasonably suited to the fund and the institution. Investments comprising an institutional fund must be diversified to properly manage portfolio risk unless the purposes of the fund are better served without diversification.19

The duty to monitor involves ongoing oversight of investment positions and strategy as well as the performance of advisors and other service providers to whom responsibilities have been delegated. The duty to monitor includes the obligation to make course adjustments as necessary and appropriate.20

As mentioned earlier, UPIA and UPMIFA permit trustees to delegate investment responsibilities. This relatively recent latitude to delegate falls well short of a duty to delegate. Even so, it is fair to say that the acts encourage fiduciaries with limited skills to delegate responsibilities to experts by providing safe harbor protection from liability for actions taken by experts to whom responsibilities have been properly delegated. Experts are obligated to apply their special skills diligently, which means that they typically are held to a higher standard than would be true for the typical trustee without special investment expertise.

**Special Due Care Considerations Pertaining to Charitable Institutions**

Two areas deserve special consideration in regard to due care obligations of fiduciaries managing and investing funds of charitable institutions. The first pertains to spending policies of charitable organizations. The second relates to socially responsible investing (SRI).
Similar to the financial planning process requiring review and documentation of a retail client’s cash-flow needs, the advisor to a charitable fund must be keenly aware of the organization’s schedule of disbursements from the fund each year. Because charities are organized in perpetuity, the investment time horizon should accommodate a sustainable rate of annual spending. UPMIFA offers an optional provision for guidance. The equilibrium spending rate (or ESR) represents the rate of spending (as a percent of total fund assets) that is deemed to be sustainable into perpetuity. The ESR is equal to the expected gross return of the portfolio minus an estimated annual inflation rate and annual rate of expenses required to administer and manage the fund (expressed as a percent of total fund assets).

UPMIFA replaced outdated laws prohibiting expenditures that exceed principal with the ESR concept to permit charitable organizations to focus on the purposes and needs of the charity rather than a static ceiling on spending. In general, the ESR should be no more than 7 percent per annum based on market values assessed quarterly and averaged over the most recent three-year period.21

The ESR provision is optional so it is important to verify the actual terms of the spending provision that applies in the state where the organization is domiciled. Many organizations may be able to operate comfortably below a 7-percent ceiling under normal conditions, and the model law’s drafters note that during inflationary periods the 7-percent limit may be too low. As such, UPMIFA commentary notes that a presumption of imprudence under a state law for spending above a prescribed amount is not definitive. An institution can override the presumption if circumstances in a particular year make expenditures above that amount prudent.22

The charity is the ultimate decision-maker on spending decisions, but an advisor charged with delegated investment responsibilities should be acutely aware of the organization’s spending rate in developing appropriate risk-return measures for the portfolio. Moreover, the advisor should verify that spending-rate provisions are clear in the investment policy statement (IPS) and educate other fiduciaries in the organization about the important connection between cash-flow analysis and investment strategy.

Fiduciary advisors also should be aware of the distinctions between the prudent application of SRI to a trust under UPIA or a charitable portfolio subject to UPMIFA. Under UPIA, an SRI investment strategy “is inconsistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries, for example, by accepting below-market returns.”23 Conversely UPMIFA requires the fiduciary to consider charitable purposes. Subject to donor intent, omission of SRI for certain charities could be a violation of state law when governing documents state that SRI is the preferred strategy, or a reasonable person would deduce that it would be inconsistent with the charitable purpose, such as a cancer research foundation investing in tobacco companies.

**Conclusion: Fiduciary Duties Frame a Prudent Investment Process**

Laws defining fiduciary obligations, including UPIA and UPMIFA, share seven common requirements for fiduciaries and they serve to frame a prudent investment process. These seven fiduciary precepts are embedded in the discussion above and summarized below as obligations of all investment fiduciaries.

**Know standards, laws, and trust provisions.** As a first step, in addition to being conversant with applicable law, the investment fiduciary should review and ensure that investment products and services are consistent with the purposes of the trust. In regard to UPMIFA, the fiduciary should consider the charitable purposes of the institution in managing the portfolio, including donor intent.

**Diversify assets to the specific risk-return profile of the fund.** Diversification is a generally accepted investment theory that is required unless unusual circumstances dictate that the interests of the beneficiaries or purposes of the fund will be better-served by not diversifying.

**Establish and follow an investment policy statement.** While a written IPS is not required under either UPIA or UPMIFA, prudent decision making requires conformity to an established investment strategy. Moreover, a well-crafted IPS serves as the business plan to properly manage and invest the institutional fund. It provides critical guidance in regard to the other six precepts listed here.

**Use prudent experts and document due diligence used to select them.** Experts provide the capacity to serve the best interests of the beneficiaries of the institutional fund. Fiduciaries who delegate responsibilities through sound due diligence are afforded liability protection for the decisions of the experts.

**Control and account for investment expenses.** “Wasting beneficiaries’ money is imprudent.”24 Proper due diligence necessarily includes an assessment of whether costs are appropriate and reasonable in light of the services provided and alternatives available.

**Monitor the activities of prudent experts.** Investment performance should be evaluated against appropriate indexes, peer group benchmarks, and IPS objectives. Watch-list procedures also should be applied to underperforming investments. Rebalancing procedures should follow a protocol defined in the IPS. Other monitoring criteria should review conformity with governing documents, investment-related contracts, fiduciary duties, qualitative factors applied to the selection of service providers, and the investment process itself.

**Avoid or manage conflicts of interest in favor of beneficiaries of the institutional fund.** Conflicts of interests make fulfillment of the fiduciary duty of loyalty less reliable. They also give rise to liability for investment fiduciaries. Fiduciaries must

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invest and manage assets solely in the interest of beneficiaries of the institutional fund.

By structuring a prudent investment process around these seven principles and applying them according to the standards found in trust law, the advisor has a practice model that should stand up to the requirements for any portfolio type with a focus on helping the client achieve its goals.

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Endnotes
1. UPIA, §9(c); UPMIFA, §5(c).
2. UPIA, §9; UPMIFA, §5.
3. UPIA, §9; UPMIFA, §5.
4. UPIA, §9(c).
5. UPIA, §9(c).
6. UPIA, §9(c).
7. The Uniform Law Commission, formerly the National Conference of Commissioners on Uniform State Laws, was founded in 1892 with the goal of offering model legislation for uniform adoption by the states. The best-known product of the ULC is the Uniform Commercial Code. The ULC consists of approximately 350 commissioners who are appointed by state governments. Its members are lawyers, who may also serve as legislators, judges, or legal scholars.
8. UPMIFA, Comment on §3, at 13 and 15.
9. UPIA, §9; UPMIFA, §5.
10. UPIA, §9(c); UPMIFA, §5(c).
11. UPIA, Comment on §3, at 13.
12. UPIA, §5.
14. UPMIFA, Comment on §3, at 15.
15. UPMIFA, Comment on §3, at 15.
16. UPMIFA, §3(e)(1).
17. UPMIFA, §3(e)(1).
18. UPMIFA, §3(e)(1).
19. UPMIFA, Comment on §3 Subsection (e)(4), Duty to Diversify, at 17.
20. UPMIFA, §3(e)(5).
21. UPMIFA, §4(i).
22. UPMIFA, Comment on §4, at 26.
23. UPIA, Comment on §6, at 14.
24. UPIA, Comment on §7 at 15.