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W. Scott Simon | 12-04-03 |

As a result of publication of my book, *The Prudent Investor Act: A Guide to Understanding*, Morningstar has given me the opportunity to write what we hope will be a highly useful series of monthly columns on fiduciary issues.

I provide services as an expert witness and consultant on fiduciary issues in litigation and arbitrations. In addition, my certification as an Accredited Investment Fiduciary Auditor™ qualifies me to conduct independent fiduciary reviews for advisors and others concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts as well as high-net-worth individuals.

My hope is to take this experience and share it to enhance understanding of your fiduciary duties so that you can use that understanding to be a better advisor to your clients--and keep yourself out of trouble.

The Current and Timeless Importance of Fiduciary Duties

The prudent fulfillment of investment fiduciary duties has always been extremely important--if for no other reason than the fact that fiduciaries can put their personal net worth at risk if their conduct is deemed imprudent.

An understanding of fiduciary duties is now particularly relevant given the numerous scandals that have engulfed the financial services industry over the past few years. For example, the most common cause of action in NASD arbitrations is breach of fiduciary duty. In the complaint filed by New York Attorney General Elliott Spitzer against Canary Capital, which brought to light the sales and trading practices scandal in the mutual fund industry, Spitzer cited numerous breaches of fiduciary duties.

In a full page ad in the Nov. 14 issue of *The Wall Street Journal*, Putnam Investments promises to "[adhere] to the highest possible level of fiduciary standards" and "work to

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create the highest standards of integrity and reliability in the industry."

Clearly, fiduciary duties are now front and center in the news--just as they always should be in your thinking as you work with your clients.

Background of the Uniform Prudent Investor Act

Since the Uniform Prudent Investor Act defines the standards of modern prudent fiduciary investing, it seems a good idea to start our exploration of fiduciary issues with a discussion of the act.

The Uniform Prudent Investor Act was introduced in 1994 by the National Conference of Commissioners on Uniform State Laws. The act is a model that serves as a drafting guide for the states as they go about enacting their own versions of the Uniform Prudent Investor Act into law. So far, 40 states and the District of Columbia have done so. The American Bar Association endorsed the act in 1995, as has the American Bankers Association.

The 1992 Restatement 3rd of Trusts (Prudent Investor Rule) is the scholarly and authoritative forebear of the act. The 23-page act and its commentary codify and embody principles of prudence laid down by the 300-page plus restatement and its commentary.

Those Governed by the Uniform Prudent Investor Act

While the standards of the Uniform Prudent Investor Act govern the investment conduct of trustees of private family trusts, the act also has a bearing on the investment conduct of fiduciaries--and *those who advise them*--in other fields of trust investing.

These fiduciaries include those responsible for investing and managing the assets of (1) ERISA retirement plans such as 401(k) plans and Taft-Hartley union pension plans, (2) public employee retirement plans and (3) charitable nonprofits including foundations and endowments. The investment standards of the Uniform Prudent Investor Act, therefore, govern, directly or indirectly, the conduct of a wide variety of fiduciaries in the investment and management of billions of dollars.

The relevance of the Uniform Prudent Investor Act to ERISA fiduciaries is summarized by John H. Langbein, the reporter for the act and the Chancellor Kent Professor of Law and

Legal History at Yale University Law School: "ERISA has always been interpreted with a strong eye on the common law, and it is therefore quite clear that the Uniform Prudent Investor Act will powerfully affect the federal courts in their interpretation of ERISA."

The relevance of the Uniform Prudent Investor Act to fiduciaries of public employee retirement plans is readily apparent since the text of the act has been incorporated nearly verbatim into large sections of the Uniform Management of Public Employee Retirement Systems Act.

The relevance of the Uniform Prudent Investor Act to fiduciaries of charitable nonprofits such as foundations and endowments seems, at first blush, to be slight. Indeed, the 1972 Uniform Management of Institutional Funds Act governs the investment activities of governing boards of nonprofit institutions such as colleges, hospitals, churches, and museums. But even in this area, the Uniform Prudent Investor Act is quite relevant.

Any doubts about this have been put to rest in the recent case of the *Bishop Estate*. That case involved a multi-billion-dollar charitable educational trust established over a century ago in Hawaii by the great-granddaughter of King Kamehameha the Great. The judge in the *Bishop Estate* retained a Master of the Court who suggested that the standards of the Hawaii Prudent Investor Act should be used to evaluate the conduct of the nonprofit trust's fiduciaries. This recommendation was made despite the fact that the Uniform Management of Institutional Funds Act is law in Hawaii and much of the fiduciaries' investment conduct took place *before* adoption of the Hawaii Prudent Investor Act.

Fiduciaries responsible for investing and managing the assets of nonprofit organizations should pay careful attention to the *Bishop Estate* case so that they can understand the potential impact of the Uniform Prudent Investor Act in assessing fiduciary conduct--even *outside* its primary domain of private family trusts. (Key documents of the *Bishop Estate* can be found at http://starbulletin.com/specials/bishop.html.)

It is important to understand that the investment standards of the act can also be borrowed to help assess the conduct of stockbrokers, bankers, investment advisors, insurance agents and financial planners when they provide fiduciary investment services to their clients.

Any lingering doubts about the fiduciary status of such

advisors will be erased when Congress enacts the Pension Security Act in 2004 and explicitly confers such status on them--at least with respect to their investment conduct in advising ERISA retirement plans. It won't be much of a stretch for fact-finders charged with establishing legal liability to extend fiduciary status to these classes of financial intermediaries in non-ERISA cases.

The Honor and Responsibility of Being a Fiduciary

The landmark reformation of American trust investment law in the 1990s by the Restatement 3rd of Trusts (Prudent Investor Rule) and the Uniform Prudent Investor Act was undertaken to bring legal thought closer to modern finance. But the fundamental, underlying goal of this effort was to enhance the protection of beneficiaries.

Fiduciaries, who *manage money that's not theirs*, must always keep this goal in mind and do all they can to ensure its achievement. Even apart from the requirements of modern prudent fiduciary investing, the ancient concept of a fiduciary's duty of loyalty to its beneficiaries demands nothing less.

This monthly column will, in part, be an effort to help educate fiduciaries and their advisors so that they can participate in an informed way in a truly noble undertaking: enhancing the protection of their beneficiaries.

Some fiduciary issues I will explore in future columns include (1) who is a fiduciary, (2) the effect of arguing that you are *not* a fiduciary, (3) a description of the process standard of modern prudent fiduciary investing, and (4) implications for fiduciaries that focus solely on return and forget to manage risk. I welcome any suggestions you may have for future columns.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as

well as high net worth individuals.

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The views expressed in this article are the author's. They do not necessarily reflect the views of Morningstar.