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What is UPMIFA?

In institutional investing, fiduciaries can come under scrutiny regarding the decisions they have made and can be exposed to liability should even the most obscure rule be breached. In 1972, the Uniform Management of Institutional Funds Act (UMIFA) was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to provide rules regarding the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions[1]. The UMIFA document encompassed two major points: 1) fiduciaries were to prudently invest assets into a well-diversified portfolio to obtain both growth and income and 2) any appreciation of these assets could be spent in a prudent manner for the purposes of any endowment fund held by an institution. In 2006, the NCCUSL drafted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as a successor to UMIFA. UPMIFA is viewed as establishing a more unified basis for managing endowment and foundation assets. Currently, the Act has been passed into legislation in all US States except New York, Pennsylvania, Mississippi, Florida, Louisiana, and Alaska.

The first facet encompassed by UPMIFA builds upon the prudent investor rule set in statutory law by UMIFA. The original documentation of this rule allows for:

- the investment into any kind of assets,
- the ability to pool endowments for investment purposes, and
- the delegation of investment management to others.

From a fiduciary perspective, UPMIFA utilizes this foundation to set a more defined requirement for investing; adhering to the Prudent Man Rule. Investments under UPMIFA must:

- incur investment costs that are appropriate and reasonable,
- not be made in isolation, but rather in the context of the entire portfolio,
- should be part of a documented investment strategy,

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[1] National Conference of Commissioners on Uniform State Laws. "Uniform Prudent Management of Institutional Funds Act." Hilton Head, SC. NCCUSL. 2006.

- be diversified unless under special circumstances, and
- if in-house or hired investment experts are utilized, they should be bound by a standard of care consistent with their expertise.

UPMIFA also includes new guidelines for annual spending decisions and eliminates the historic dollar value limit set by UMIFA.

Therefore, fiduciaries under UPMIFA have a duty to ensure costs are reasonable, conduct proper due diligence on investment managers/funds, and to act with the good faith and care of a prudent person in a similar situation. Fiduciaries also have a duty of loyalty to the assets they oversee.

Financial Reform Bill & the Omission of a Fiduciary Standard

In March 2010, details of Senator Christopher Dodd's Financial Reform Bill were released, highlighting a number of initiatives targeted to provide broad safeguards and regulatory oversight for the financial system. However, one omission from the Bill was the provision of a fiduciary standard for broker-dealers or advisers providing investment advice.

After purported pressures from insurance groups and brokerage firms, Senator Dodd omitted the provision from his revised Bill. Senator Tim Johnson of South Dakota instead called for a one-year SEC study to "determine the obligations of brokers, dealers, investment advisors, and their associated persons relating to the provision of personalized investment advice about securities…"[2] Many supporters of this standard perceive this study as an unnecessary delay tactic and a relative setback for a provision numerous consumer and investor protection groups feel is well overdue.

Advocates for a fiduciary standard note that brokers and financial advisers who service personal clients or retirement plans are not required to prioritize the best interests of their client ahead of their own (fiduciary standard), but are only required to follow a suitability standard. A suitability standard only requires the recommendation of an investment to be suitable based on that client's specific needs. Insurance groups, brokers, and various financial advisers have battled the adoption of a fiduciary standard due to the provision's expected limitations upon sales of proprietary products (particularly with respect to annuities), as well as sales commissions that comprise a significant amount of broker and financial adviser compensation.

While the omission of this standard from the Bill remains a setback, industry experts believe uniform fiduciary standards for all brokers and advisers is not far away. A number of notable financial industry leaders, economists, and columnists have called for the application of a uniform fiduciary standard for all persons rendering financial advice under the Investment Advisers Act of 1940. Coupled with the growing support of various investor groups and securities regulators a uniform fiduciary standard will remain a hot topic of financial reform in the near future.

[2] Financial Planning Magazine Online. "Advisors and Broker Dealers Criticize Dodd's Reform Plan." http://www.financial-planning.com

Schedule C: Clarity or Confusion

In 2007, the DOL issued new Schedule C reporting requirements for plan years beginning on or after January 1, 2009. This will impact plan sponsors for the first time this calendar year as 5500's are filed for the 2009 plan year. The change requires more detailed reporting of fees and compensation received by plan service providers. The purpose of the greater disclosure on Schedule C of the form 5500 is to provide plan sponsors with more fee transparency.

Below is a brief summary of these new requirements as described in the DOL's 2009 Instructions for Schedule C.

First, in order to be reportable on the Schedule C, total compensation received by a party needs to exceed $5,000 for the plan year. This compensation falls broadly into two categories: direct and indirect.

Direct compensation is quite transparent.

Direct compensation would include any payment made from plan assets to pay for plan services. If a plan sponsor writes a check for plan services, it would not need to be reported on Schedule C because it is not being paid from plan assets. Only direct payments from the plan would be reportable as direct compensation. For example, using plan forfeitures or an ERISA budget to pay for plan services.

Indirect compensation is more opaque.

Fiduciaries to the plan or persons providing plan services such as recordkeeping, investment management, or investment advice would need to report indirect compensation such as commissions, float revenue, revenue sharing, transaction-based charges, and soft dollar payments even if these fees were netted out and reflected in an investment fund's value.

Indirect compensation can be reported in two ways.

First, indirect compensation reporting may be satisfied if a recipient provides appropriate disclosure. In order to satisfy the disclosure requirements, a plan sponsor must receive:

- Notice that there is indirect compensation
- What services the indirect compensation is being received for
- The amount of the indirect compensation or the formula used to calculate it
- The party or parties receiving the indirect compensation

This is referred to as "eligible indirect compensation" and if a plan sponsor received these disclosures, then they will only have to acknowledge on Schedule C that indirect compensation has been paid, but not the amount.

Second, if a plan sponsor did not receive the appropriate disclosure from parties receiving indirect compensation this would be considered "ineligible indirect compensation." In these situations, a plan sponsor would need to report the amount of indirect compensation and the party or parties receiving it on Schedule C.

One of the many challenges with disclosure of indirect compensation is that there are many variations and payment schemes for retirement plans. As an example, bundled providers do not need to itemize their compensation whereas unbundled arrangements will report compensation separately.

Bundled providers are able to report their compensation in aggregate even if they use subcontractors or affiliates to provide the services included in the bundled services arrangement. However, bundled providers would have to report compensation received by the affiliates or subcontractors if it was received on a per transaction basis. Examples of per transaction compensation would be brokerage fees or commissions.

So what seems to be a fairly straightforward process can become quite complicated.

To assist plan sponsors and industry professionals with understanding the changes, the EBSA has posted two sets of FAQs on their website. The FAQs can be quite technical, but serve as a helpful tool in better understanding the nuances of the new reporting requirements especially as it pertains to indirect compensation. To this end, plan sponsors may want to consider seeking assistance to ensure that all direct and indirect compensation is being reported appropriately.

What Comprises a Mutual Fund Expense Ratio?

An expense ratio shows the annual cost an investor pays to the fund as a percentage of their total investment. Information on a fund's expense ratio can be found in the prospectus and on a fund company's website.

In general, there are several different components that make up an expense ratio. The first and primary cost is the management fee paid to operate the fund. There may also be a 12b-1 fee, which can range from 25 to 100 basis points. This fee is strictly used by fund companies in order to further market or promote their funds. In addition, there are administrative and operating costs that are tied into the expense ratio as well. Some funds will choose to waive part of the expenses that are charged to investors for a specific period of time, which will lower the net expense ratio of the fund.

Trading costs and commissions are generally not factored into the calculation of the expense ratio. However, some funds have charges that are the result of the usage of derivatives in addition to dividend and interest expenses related to short sales. These are both accounting related expenses that the SEC requires fund companies to disclose. These two types of charges are both stated in the literature provided by the fund companies (including the prospectus, fact sheet and website) are included in the overall charge to investors.

PEI has reached out to compliance officers at different investment management firms to confirm that including these charges in the overall expense of the fund is considered best practice in the industry. Morningstar does not include these accounting related charges in its net expense ratio calculations. However, PEI has decided to include these charges in our reporting of expenses in a best effort to reflect the true cost of investing in a fund.

Approval of Rule 2a-7 Changes

As noted in prior editions of the *Prudent Press*, the proposed rules governing money market funds were approved by the SEC in early 2010. The new rules are intended to increase transparency, strengthen money market funds, and reduce the consequences of a run on the fund by placing restrictions on fund investments. The new rules are effective May 5, 2010; however, required compliance dates are staggered throughout 2010. Below is a brief summary of the changes along with the required compliance dates:

- **Suspension of Redemptions** – Funds may be permitted to suspend redemptions if in jeopardy of "breaking the buck." Funds must notify the SEC prior to suspending redemptions. (As of May 5, 2010)

- **Liquidity** - For all taxable money market funds, at least 10% of assets must be in "daily liquid assets," which are cash, U.S. Treasury securities or securities that convert into cash within 1 business day. In addition, for all money market funds, at least 30% of their total assets must be in "weekly liquid assets," which may only consist of cash, U.S. Treasury securities, certain government securities maturing within 60 days, or securities that convert into cash within the next 5 business days. Illiquid securities cannot exceed 5% of portfolio at time of purchase. Funds are required to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. (As of May 28, 2010)

- **Stress Testing** - Funds must adopt procedures that provide for the periodic testing of the ability to maintain a stable $1.00 net asset value (NAV) based upon certain hypothetical events. (As of May 28, 2010)

- **Credit Quality -** Second tier exposure is limited to 3% of a fund's total assets and 0.5% per issuer, and the maturities of these securities must be 45 days or less. (As of May 28, 2010)

- **Repurchase Agreements** - Collateral must be cash or government securities with creditworthy counterparties with look-through treatment provisions. A fund's board must evaluate the creditworthiness of the repurchase agreement's counterparty. (As of May 28, 2010)

- **Maturity** - Funds will be limited to a weighted average maturity (WAM) of 60 days and a weighted average life (WAL) of 120 days. WAM captures a fund's exposure to interest rate movements and the potential price impact resulting from interest rate movements. WAL is calculated based on a security's stated final maturity date and serves as an important metric for evaluating how a portfolio would react under volatile market conditions. Additionally, WAL will restrict the ability of a money market fund to invest in long-term floating rate securities that may expose the fund to spread risk. (As of June 30, 2010)

- **Monthly Website Posting** - Portfolio information and holdings must be posted to the fund's website within 5 business days after the end of the month and maintained for a period of at least 6 months. (As of October 7, 2010)

- **Processing of Transactions** - A fund or its transfer agent is required to have the capacity to redeem and sell its securities at a price based on the fund's current NAV per share. Shareholder transactions must be processed in an orderly manner, even if the fund "breaks a buck." (As of October 31, 2011)

- **Monthly SEC Reporting** - Within 5 business days after the end of the month, funds must report portfolio information including the fund's risk characteristics, yield, portfolio holdings, and mark-to-market ("shadow") NAV. (As of December 7, 2010)

- **Eligible Securities** - Funds are required to designate each year at least 4 Nationally Recognized Statistical Rating Organizations (NRSROs) that the fund's Board considers to be reliable for purposes of satisfying the minimum ratings requirements. (As of December 31, 2010)

The adopted amendments to Rule 2a-7 represent an initial step by the SEC to stabilize money market funds. In consultation with the President's Working Group on Financial Markets, the SEC continues to pursue more fundamental changes to the money market fund regulation.

What's New at PEI

Michael Sasso, PEI Principal and Cofounder, was appointed to the DOL's ERISA Advisory Council, representing Investment Counseling. He will serve a three year term. The ERISA Advisory Council is a group of benefits experts established by the DOL to identify emerging benefits issues and advise the Secretary of Labor on issues related to health and retirement policy. The group customarily holds four annual public meetings of the full council and numerous meetings of the various subcommittees based on three to four different working group topics.

Attila Toth, PEI Principal and Cofounder, was a finalist for the Retirement Plan Adviser of the Year award handed out by PlanSponsor. Nominations for the award were submitted online to PlanSponsor from plan sponsors and industry professionals. Over 425 nominations were received and it was an honor for him to be considered in such high regards by his clients and industry peers.

Marcia Peters, PEI Director of Product Research & Risk Management, was quoted in an article on liability-driven investing titled "If LDI Is So Great, How Come More Plans Aren't Doing It?" in the February 2010 edition of *Employee Benefit News*.

Underpinning our success has been our core philosophy – do everything in the best interest of the client. By being true to this tenet, we hope to continue to help our clients in achieving their investment objectives and meeting their responsibilities as fiduciaries, as well as to continue to grow as a firm.

This newsletter has been prepared exclusively for informational purposes. Every effort has been made to provide accurate and authoritative information in regard to the subject matter in this newsletter; however, accuracy and completeness cannot be guaranteed and is not warranted as such. Numerous sources were used in compiling the data for this newsletter. PEI does not assume responsibility for the accuracy or completeness of such information. The information contained in this newsletter is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this newsletter does not constitute the recommendation of any investment advisor or their services nor does PEI assume responsibility for the conduct of any investment manager.