

This document and any attachments are superseded by Comptroller's Handbook - Asset Management.

## Introduction to Portfolio Management

Most savings associations use a team approach when engaging in portfolio management activities. However, the two key players in the portfolio management process are the account portfolio manager and the account administrator. The portfolio manager is responsible for the account investments. In fulfilling this responsibility, the portfolio manager must choose investments that are suitable for the account. In making these choices, the portfolio manager keeps in mind the investment management objective for the account while operating within defined risk parameters. In order to achieve the identified objectives, each account's needs should be defined as specifically as possible. These needs and the account objectives are generally identified by the account administrator. Once the needs have been established and the account objectives identified, the portfolio manager can then design a portfolio that will achieve the desired rate of return, keeping within an acceptable level of risk.

### Determining Account Objectives

The account administrator must determine the objectives of the account. This can be accomplished through a combination of discussions with the settlor and other interested parties, as well as a review of the governing account instrument. In order to establish the account objectives, the account administrator must first determine the specific income requirements and needs of the account and/or the beneficiaries.

The account administrator must carefully consider the amount of income that the beneficiaries need from the account. Although guidance for a specific amount may be found in the governing instrument, most instruments simply provide that the beneficiaries should receive income sufficient to maintain a standard of living to which they have grown accustomed or that sufficient income be generated to meet the ascertainable standards of health, education, maintenance and support. In order to determine this amount, the account administrator must be aware of the beneficiary's current financial condition, including the beneficiary's current and future expenses as well as income from other sources. Also important in determining the income requirements, are the interests of the remainder beneficiaries in preserving and increasing the principal of the account. All this information must be weighted together and certain conclusions reached which is then passed on to the portfolio manager to devise an investment strategy that meets the needs of the account.

### Designing the Portfolio

In designing a mix of assets for an account, the portfolio manager must consider the timing of probable distributions from the account. For example, if the account beneficiary is elderly or disabled, then the portfolio should contain enough liquid assets to meet expected medical expenses.

It may be in the best interest of a beneficiary to minimize income, estate and generation-skipping taxes and the portfolio manager should design a portfolio accordingly. For example, tax-sheltered investments such as municipal bonds may be more appropriate for an account whose beneficiaries are in a high tax bracket, other considerations being equal. Although the tax consequences of retaining, purchasing and selling investments should not be the primary determinant for investment decisions, the tax consequences of such actions may be significant and the portfolio manager should be aware of such effects.

Investment objectives should, to the extent possible, be related to the age of the beneficiaries and the expected duration of the account. Establishing long-term investment goals for fiduciary accounts, which terminate within a relatively short period, would be inappropriate. For example, an account that will remain

in existence through several levels of beneficiaries (spouse, children, grandchildren) should ordinarily have different investment objectives than an account that will terminate within a short period of time.

There are various investment strategies that may be utilized by a portfolio manager to achieve the objectives of an account. If the account's objective is to minimize risk, then a conservative strategy will provide stability of income and principal and will also allow as much opportunity for appreciation as is consistent with that objective. If the objectives are to provide large financial returns to the account, then a more aggressive strategy will provide higher yields or principal appreciation; however, this strategy requires a greater degree of risk and wider tolerances for losses to achieve the objective. Attainment of these or other objectives can in most cases be best achieved by adopting specific investment vehicles or an appropriate mix of those vehicles. The portfolio manager should carefully document the decision-making process to show how the chosen investment strategy will achieve the stated goals of the trust account.

Next, the portfolio manager must implement the investment strategy. The implementation should correspond closely to the initial review of assets required by 12 CFR §550.210, one purpose of which is to compare assets used to fund the trust or received from a prior trustee for suitability and compatibility with the needs of the account. Assuming some restructuring of the portfolio is necessary, the portfolio manager should develop and implement a systematic program for retaining assets, purchasing appropriate assets and/or disposing of assets that are unsuitable for achieving the investment objectives. This restructuring may involve an extended time period so as to avoid sharp initial losses, take advantage of market timing or avoid adverse tax consequences, such as large capital gains. Documentation of the decision-making regarding the restructuring process is a good risk management practice.

### Asset Review

One of the most important steps in the asset management process is the review and monitoring of the approved account objectives and investment strategies. Compliance with the agreed upon objectives and investment strategies is an important aspect to monitoring and controlling risk to both the individual account and the savings association. Both the objectives and the investment strategies must be periodically reviewed and monitored in order to determine conformance. The process should include a review of the account's objectives to ensure that they remain valid in light of current circumstances or developments. The overall investment portfolio, as well as the individual assets held in the portfolio must be reviewed to determine if they conform to the investment strategy designed to meet the account objectives.

By way of illustration, an asset review will normally consider the following:

- account objectives and beneficiary needs for continued applicability;
- characteristics of the overall portfolio, for conformance with account objectives;
- transactions since last review, for accuracy and conformance with objectives and department policies and procedures;
- asset holdings, for adequacy (e.g., rate of return, risk attributes, quality, asset mix, diversification); and
- future needs of the account, for liquidity (e.g., anticipated or unusual expenses or distributions).

The frequency of an asset review for individual accounts should be based on the volume and complexity of the department's overall business as well as the complexity of a particular account. For example, most accounts may be set up for an annual review but specific accounts, due to the nature of their holdings, may need to be reviewed more frequently. 12 CFR §550.200 - 220 establishes the outer limits of an asset review,

by requiring that such reviews be conducted promptly after the account has been accepted and at least once during every calendar year thereafter.

### Types of Investments

There are various investment vehicles available for the investment of trust account assets. With the increased use of the “modern portfolio theory” and the majority of states adopting some version of the uniform prudent investor rule, no single investment within a portfolio is considered to be per se imprudent. It is the overall portfolio holdings or the overall investment strategy that can be considered imprudent and subject to examiner criticism, beneficiary complaints or lawsuits.

There are many types of investments that may be found in a trust department of a savings association. Some of these investments are described in the narrative sections attached to a specific examination program. One type of investment not described elsewhere is a cash management instrument.

#### Cash Management Instrument

A savings association may provide various instruments for the short-term investment of idle cash. As fiduciary, the savings association is responsible for making all assets productive, even those assets awaiting investment or distribution, as outlined in 12 CFR §550.140(e). Given the current technology and the prudent investor standards, there are few defenses for fiduciaries that permit idle cash to remain unproductive and not invested. There are several vehicles available for managing short-term investments. These instruments can include money market funds, sweep arrangements and deposits. The use of these instruments should be for short-term purposes and be appropriate for achieving the overall investment objective for the account.

Money market funds are a type of mutual fund that has relatively low risks compared to other mutual funds. They are limited by law to certain high-quality, short-term investments. Money market funds try to keep their value net asset value (NAV) at a stable \$1.00 per share but the NAV may fall below \$1.00 if their investment performs poorly, in which case management should be aware of “breaking the buck.” Investor losses are rare but they are possible. Some of the more common investments held in these funds include time deposits of financial institutions, commercial paper, bankers acceptances and short-term U.S. Government or agency obligations.

Another alternative for achieving the investment of idle cash is the use of a sweep arrangement. This arrangement allows the fiduciary to automatically invest all cash into an interest earning short-term investment. In most instances the investment is a money market fund. The investment instrument into which the cash is swept should be reviewed on a periodic basis to ensure appropriateness.

Deposits are another alternative, however, given the number of other available alternatives, the use of deposits should be limited. Deposit investments can be with the same institution conducting the fiduciary activities, however this does create a conflict of interest and should only be permitted when allowed by applicable law.

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## Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's investment of trust and asset management account assets. Consider whether:

- policies and procedures are in place to ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- the investment selection and review processes are designed to meet account objectives as well as comply with investment policies and procedures;
- portfolio management risks are identified, measured, monitored and controlled;
- investment decisions are adequately documented; and
- deficiencies are identified and corrective action is promptly initiated.

## Examination Procedures

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### Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the portfolio management of account assets. Scoping material should include:
  - Risk profile
  - Relevant PERK documents
  - Previous trust and asset management examination report
  - Workpapers from the previous examination

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- Safety and soundness examination report
- Recent ADV and any amendments
- Board of director and other appropriate committee minutes
- Examination reports of subordinate, functionally regulated entities
- Savings association's web page

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2. Evaluate the trust department's policies and procedures related to the investment of account assets. Note any significant changes. Consider whether the policies and/or procedures:
- require account investments to be reviewed at least each calendar year to determine if they meet account objectives;
  - are communicated to appropriate personnel; and
  - require a review of investments to determine if churning or other similar trading practices have taken place.
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3. Determine if management has delegated investment authority or other asset management responsibilities to a third party. Assess the due diligence efforts with respect to the selection of the third party, and determine if applicable law permits such delegation. Ensure that the savings association has written agreements outlining the duties, responsibilities and obligations of the involved parties.
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4. Evaluate how management monitors the performance of all third party service providers providing asset management services.
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5. Evaluate management's expertise and ability to properly supervise the asset administration function. Note any significant personnel and/or organizational changes.

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6. Review the process for establishing account investment objectives and implementing strategies to achieve the objectives.

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7. Review portfolio allocation models and determine if they are reasonable based on applicable investment objectives.

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8. Evaluate any new investment product or service, noting whether appropriate policies and procedures have been implemented. Also, note whether there is an appropriate level of expertise available in regards to these new products and services.

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9. Review the trust and asset management account master investment list. Note any changes in overall asset composition as well as significant holdings in any one security or market sector. Compare this against lists obtained in prior examinations. Determine the cause of any significant change and assess if it presents undue risk to the savings association and/or the involved discretionary accounts.

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10. Ensure that deficiencies outlined in the prior examination were sufficiently addressed by management.

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11. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of portfolio management and investment risk?
  - Does management anticipate and respond well to market and technological change?
  - Do management information systems and reports provide credible and comprehensive information?
  - Are prudent due diligence efforts used in the selection of investment managers when this function is delegated?
  - Does management quickly identify weaknesses and take appropriate action?
  - Have issues noted in audit, compliance or examination reports been resolved?
  - Do policies and procedures address all significant activities?

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12. Interview management and appropriate personnel. Consider discussions that include, at a minimum:
- The trust department's structure and functional responsibilities
  - Strategic plans
  - Resource limitations in implementing security processing and asset management systems
  - New investment product offerings or the discontinuance of products or services
  - How changes in regulations are incorporated into the asset management process
  - How securities are selected and approved

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13. Review the list of approved investments for fiduciary quality and appropriateness.
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**The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.**

### Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Determine whether policies and procedures mirror actual practices and investment philosophy. Consider whether:
    - compliance with governing instruments, applicable law and accepted fiduciary principles is ensured;
    - adequate documentation of asset management and investment decisions is ensured;
    - a defined investment philosophy is present;
    - selection, retention and preservation of assets are adequately addressed;
    - suitability of investments with regard to defined risk tolerances as well as the investment review process is addressed; and
    - exception transactions are addressed.
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2. If any unusual concerns or mistakes are noted in the ADV, discuss with management and determine if an amendment is planned.

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3. If there is no formal approved list of investments, assess management's selection process. Consider:

- whether the investments have been appropriately approved and the approval is properly documented; and
  - proper investment research has been performed on the securities.
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4. Review the list of assets or master securities file to determine if unapproved investments are present in discretionary accounts. Determine if management utilizes exception reports.

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5. Evaluate monitoring and tracking systems designed to ensure if account reviews conform to 12 CFR §550.200-220.

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6. Review and evaluate cash management practices and policies, giving consideration to the following:

- Do policies and procedures outline the process for promptly investing idle income and principal cash, including the use of an effective sweep arrangement?
  - Are sweep vehicles reviewed on a regular basis?
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| 7.    | Review and evaluate brokerage placement practices for appropriateness and compliance with 12 CFR §550.140(a).   |  |
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| 8.    | Assess management’s methodology for accepting and controlling the risks inherent in closely-held assets and nonmarketable assets such as real estate and partnerships.  |  |
| <hr/> |   |  |
| 9.    | Evaluate policies, procedures and internal controls regarding trade allocation, initial public offerings and private placements.  |  |
| <hr/> |   |  |
| 10.   | Ensure that proper controls exist over the personal trading and investing activities of trust department investment employees.  |  |
| <hr/> |   |  |
| 11.   | Assess systems for ensuring adherence to the trust or advisory agreement.   |  |
| <hr/> |   |  |
| 12.   | Ensure that proper controls are maintained and disclosures made in accordance with OTS TB 76-1, when the savings association pays or receives referral fees.  |  |
| <hr/> |   |  |
| 13.   | Ensure that the savings association has established proper controls pertaining to soft dollar or other agreements where the savings association or its affiliated broker dealer receives research reports, investment publications or other benefits from the trading activity associated with its trust and asset management accounts. Are the agreements approved by the board or other committee and fall within the Section 28(e) safe harbor established by the SEC? |  |
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14. Evaluate the savings association's policies, procedures and internal controls for ensuring that advertising, promotional programs and performance claims are factual, complete and in keeping with applicable law.

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15. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

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**If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion; Level III procedures may be necessary.**

### Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of different types of trust and asset management accounts for review selecting those that could pose the highest risk to the savings association. Perform the following:
  - Compare all assets in the accounts to the approved investment list and determine the reasons for the presence of unapproved investments. Inquire about the handling of such assets.
  - Determine if an undue asset concentration of a particular type or security is present within accounts. Inquire if there is a plan to diversify. If diversification is not planned, determine the reasonableness of that decision.

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- Review investment transactions with respect to the accounts and determine if they are appropriate and properly approved.
- Determine that an account investment objective has been assigned and is appropriate considering the characteristics of the account.
- Determine if the investments are in compliance with the governing document and applicable law.
- Determine if all required investment reviews have been performed.

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2. Are signed and updated investment objective and acknowledgment letters included in account files? If not, determine how the savings association ensures that the investment officer is aware of the investment objective for the account. Is documentation required?

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3. If unapproved assets are noted on the exceptions list, does the client or governing instrument authorize the investments? If not, is management's plan for retention or disposition valid and documented?

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4. Review a sample of accounts reviewed by the audit and/or compliance departments and determine if the findings of the audit/compliance review are consistent with examination findings. If not, determine the reasons for any discrepancy.

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5. Select a sample of discretionary accounts and determine if all asset reviews are performed when required. If exceptions are noted, determine the reason why.

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6. Evaluate account reviews for sufficient documentation considering synopses of governing instruments, background and needs of beneficiaries, and special reports on real estate, closely held companies and miscellaneous assets.

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7. Determine if minute books identify reviewed accounts and contain written conclusions on advisability of retaining or disposing of assets, as well as information and reasons for nonexecution of approved investment actions.

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## Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

### ***Policies and Procedures***

<ul style="list-style-type: none"><li>• Are policies and procedures adequate for services rendered?</li></ul>
<ul style="list-style-type: none"><li>• Does the board of directors or appropriate committees approve the policies?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the overall investment philosophy and standards of practice?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the expected code of conduct for the employees, officers and directors who have investment responsibilities?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline standard safeguards against conflicts of interest and self-dealing?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy discuss the process for the use of proprietary or affiliated products in discretionary fiduciary accounts?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy discuss overall portfolio guidelines regarding percentage distribution among types of investments relative to account objectives?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the functions and responsibilities of investment personnel, including officers and employees as well as any committees?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline standards and procedures to evaluate and monitor asset quality?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the process and criteria for selecting and evaluating potential investments?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the process for monitoring existing investments?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the documentation requirements to support investment decisions?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy discuss diversification guidelines and requirements?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the process for conducting initial and annual account reviews in conformance with the requirements of 12 CFR§550.200 - 220?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy establish standards for the acceptance and disposition of substandard assets?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the standards for developing and amending approved lists of investments?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy address the requirements for authorization and clearance of account overdrafts?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy establish standards for the selection and use of broker-dealers?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the process for voting proxies for investments held in fiduciary accounts?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy outline the process for approving deviations from established policy guidelines, as well as a process for monitoring policy deviations?</li></ul>

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## ***Audit Program***

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| <ul style="list-style-type: none"><li>• Does the audit program provide adequate coverage of the asset management section?</li></ul>         |
| <ul style="list-style-type: none"><li>• Does the audit report address weaknesses in asset management?</li></ul>                             |
| <ul style="list-style-type: none"><li>• Has corrective action been implemented to correct noted audit deficiencies or weaknesses?</li></ul> |

## ***Investment Delegation***

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| <ul style="list-style-type: none"><li>• Are delegated investment activities permissible under applicable law?</li></ul>   |
| <ul style="list-style-type: none"><li>• Is the selection and monitoring process effective?</li></ul>  |
| <ul style="list-style-type: none"><li>• Does a policy exist that outlines the delegation decision making process, the investment activities to be outsourced and the criteria for selecting and monitoring third parties?</li></ul> |

## ***Investment Objective***

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| <ul style="list-style-type: none"><li>• Does the investment selection process consider income and liquidity requirements, tax status, beneficiary ages, account termination date, customer preference and other items?</li></ul> |
| <ul style="list-style-type: none"><li>• Does the process provide for an investment action plan to achieve investment goals, including the restructuring and disposition of assets?</li></ul>                                     |
| <ul style="list-style-type: none"><li>• Are changes to strategies or account objectives tracked to ensure implementation?</li></ul>  |
| <ul style="list-style-type: none"><li>• Is the development and implementation of specific investment strategies to meet stated investment objectives timely?</li></ul>   |
| <ul style="list-style-type: none"><li>• Is the review and monitoring of investment strategies according to policy?</li></ul>   |
| <ul style="list-style-type: none"><li>• Do deviations from approved investment strategies require authorization and approval?</li></ul>  |

## ***Internal Asset Review***

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| <ul style="list-style-type: none"><li>• Are asset reviews conducted prior to acceptance, initially upon acceptance and annually thereafter?</li></ul>   |
| <ul style="list-style-type: none"><li>• Is there a process to ensure that all account circumstances are considered during the review? Items that should be considered in the asset review include asset quality, asset performance, asset mix, diversification, liquidity, etc.</li></ul> |
| <ul style="list-style-type: none"><li>• Do reports exist that identify assets that have not been reviewed or where the review was incomplete? If such reports are used, determine what methods are used to track and monitor delinquent and/or outstanding reviews.</li></ul>             |
| <ul style="list-style-type: none"><li>• Does the policy and practice provide for documentation of all asset reviews?</li></ul>  |

## ***Brokerage Placement Practices***

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| <ul style="list-style-type: none"><li>• Is there a process for determining the reasonableness of commissions paid in relation to the research services being provided?</li></ul> |
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| <ul style="list-style-type: none"><li>• Does the evaluation of the commissions include a review of the qualifications of the broker-dealer, to include: financial condition; knowledge of the market; access to sources of supply; timely and accurate record keeping; accuracy of services; and quality of research materials.</li></ul> |
| <ul style="list-style-type: none"><li>• Are brokerage placement decisions reviewed periodically by the appropriate oversight committee?</li></ul>   |
| <ul style="list-style-type: none"><li>• Is best execution being achieved and do soft dollars received conform to SEC safe harbor provisions?</li></ul>  |

### ***Cash Management***

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| <ul style="list-style-type: none"><li>• Does a process for promptly investing idle income and principal cash, including the use of sweep arrangement exist?</li></ul> |
| <ul style="list-style-type: none"><li>• Are effective sweep systems and procedures in place? Do procedures comply with applicable law?</li></ul>                      |
| <ul style="list-style-type: none"><li>• Are sweep vehicles reviewed for appropriateness on a regular basis?</li></ul>   |

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