Memorandum # 38/2003

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M E M O R A N D U M

TO: Retirement Boards

FROM: Joseph E. Connarton

RE: Due Diligence and Oversight

DATE: October 31, 2003

The recent allegations and disclosures related to Putnam Investments highlight the fact that, in both selecting and monitoring investment managers, retirement boards must consider and evaluate other factors besides investment style, organizational strength, and performance record.

In the event it is not already included in the due diligence that a board and/or its investment consultant conducts on investment managers, the firm's code of ethics (as it applies to executives, staff, and particularly, to portfolio managers) should be examined. Among its provisions, the code of ethics would specify what restrictions are placed on the ability of executives, staff, and managers to execute trades in their personal accounts involving either mutual funds or other products of the firm or specific securities that may be held in those funds. Of course, just as important as the provisions of this code is how stringently the firm monitors and enforces compliance with this code.

In addition to the restrictions on the trading practices of the firm's employees, it is also important to know the firm's general policies and practices with regard to market timing as it relates to its mutual funds or similar products. Furthermore, there must be assurances that no clients or shareholders of the firm have special privileges to trade in and out of the firm's funds without regard to the restrictions that the firm may have for clients or shareholders in general.

Some other aspects of ethical practices that should be subjects of inquiry are the firm's policy in allowing portfolio managers, analysts, or traders to accept gifts of any type from securities firms and whether a firm's trading practices are determined by best execution or influenced by a firm's interest in compensating those brokerage firms that may be selling the money manager's mutual funds or other products. Similarly, boards should be informed about an investment management firm's policies and practices relative to soft dollars; specifically, to what extent commissions emanating from the retirement board are being used for purposes that may not benefit the retirement board.

If these and other ethical considerations pertaining to their investment managers have not already been addressed, retirement boards should contact their client service officers immediately to obtain the necessary information and assurances regarding these firms.

While the alleged transgressions at Putnam, and ongoing investigations at other firms appear to be confined to “retail” mutual funds, it is also important that clients of “institutional” mutual funds or of separate account management be certain that their money managers enforce a strict code of ethics applying to all employees and that no clients are given any trading advantages of any type over others.