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Fiduciary Guidelines for Foundation & Endowment Trustees

SUMMARY

Serving as a fiduciary for a charitable or nonprofit organization requires knowledge of investment issues and an understanding of how investment-related decisions may impact the organization. Poor execution of one's fiduciary responsibilities may result in personal liability for fiduciary negligence.

A combination of regulations and governing entities oversee the financial operation of nonprofit organizations. Learning about these structures and the steps that can be taken to demonstrate the prudent management of organization assets—such as developing spending and investment policy statements; rigorous investment manager selection and oversight processes; and comprehensive administrative and record-keeping procedures—is an important first step in meeting your fiduciary obligations.

AN OVERVIEW OF FIDUCIARY CONSIDERATIONS

Pursuing a position on a charity board or serving as director for a non-profit organization offers a way to make a lasting contribution to a community, social issue or cause. Accepting this commitment, however, may entail becoming a fiduciary for the organization—which in turn requires knowledge of investment issues and an understanding of how investment-related decisions may impact the organization. Failure to comply with regulations that govern fiduciary responsibility may result in personal liability for fiduciary negligence.

LEGAL AND REGULATORY OVERSIGHT

The regulations and governing entities that oversee charitable organizations in the United States include:

- **UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (UPMIFA).** The Uniform Prudent Management of Institutional Funds Act was approved in July 2006 by the National Conference of Commissioners on Uniform State Laws. UPMIFA is a revision of the Uniform Management of Institutional Funds Act of 1972 (UMIFA). As of January 2011, it has been adopted in 47 states, the District of Columbia and the US Virgin Islands, and provides guidelines for management, investment and expenditures of endowment funds of charitable institutions. The new UPMIFA incorporates the provisions of modern portfolio theory from the Uniform Prudent Investor Act and the Uniform Principal and Income Act. It is intended to provide more efficient management of funds for charitable purposes. Governing boards are allotted more flexibility in making spending decisions under the rules governing expenditures from endowment funds. The boards can adjust to the fluctuations in the value of the endowment.
Among other revisions, UMIFA's "historic dollar value" rule, which—among other directives—required organizations to differentiate between an endowment's in-

come and principal, was replaced with a more flexible spending standard regarding expenditures from endowment funds.[1] The types of covered institutions were broadened to include charitable organizations created as non-profit corporations, governmental subdivisions or any form of entity that is organized exclusively for charitable purposes.

In brief, the UPMIFA aims to give charities the freedom to make more effective use of endowment and other investment funds while encouraging more productive management of such funds.[2]

- **UNIFORM PRUDENT INVESTOR ACT (UPIA).** The Uniform Prudent Investor Act helps set a new standard for judging investment decisions and requires trustees to diversify portfolios. The goal of UPIA is to reduce investment risk and optimize returns. As of March 2011, UPIA has been adopted by at least 44 states and the District of Columbia.
- **INTERNAL REVENUE SERVICE (IRS).** The Internal Revenue Service requires the filing of detailed records of an organization's income, assets and expenditures.
- **ATTORNEYS GENERAL (AG).** The states' attorneys generals are responsible for ensuring compliance with their state's laws. Depending on the state, different regulations govern non-profit organizations, including some that hold charitable fiduciaries to strict trustee standards. In addition, many states also require charitable corporations to file periodic reports with the office of the Secretary of State. The reports describe the organization's activities and should also include information about directors and officers.

Knowledge of the state and federal legal and regulatory requirements coupled with a documented fiduciary process will help your organization meet its philanthropic goals. Document your fiduciary process by:

- Developing a spending policy;
- Establishing a written investment policy statement;
- Determining an asset allocation policy;
- Selecting appropriate investments and investment managers;
- Monitoring investments over time and periodically conducting portfolio rebalancing; and
- Documenting administrative procedures and maintaining detailed records.

DEVELOPING A SPENDING POLICY

Sound spending policy analysis and strategy can help an organization plan for its future commitments. Tax laws generally require private foundations to spend an amount equal to at least 5 percent of their total investment assets each year. Financing this target while meeting inflation and investment costs can be a challenging process.

The development of spending policies varies widely from organization to organization. Generally, it begins with an examination of the resources required to meet an organization's charitable goals and an estimate of the funds necessary to do so. Spending policies require a delicate balance between the need to fund programs today and to preserve assets for the future. Current and future spending, along with investment risk and return expectations, must be evaluated.

A spending policy results in a target spending rate. This may need to be adjusted to smooth out fluctuations in funding or in response to the actual performance of the portfolio. In periods of market losses, many foundations may be faced with the difficult task of considering a reduction in spending rules and target portfolio returns. Other alternatives may include reducing grants and postponing planned projects.

The intended result of this process is a sustainable budget that can be accomplished when the rate of annual spending, after inflation, is held slightly below the average real rate of return on the endowment's assets.

INVESTMENT POLICY STATEMENTS

An effective investment policy statement, balanced with a spending policy statement, can have a major impact on endowment investment performance and future spending. A well-written and implemented investment policy statement is also one of the most powerful ways fiduciaries can demonstrate that they have prudently managed their investment responsibilities.

In general, an investment policy statement establishes a benchmark return that the foundation expects to achieve by investing its portfolio. In addition to this benchmark return, investment policy statements usually include asset allocation guidelines and strategies to follow when selecting, hiring or terminating investment managers or strategies in the portfolio. Investment policies demonstrate that these decisions have been made in a rational, documented way. According to a survey conducted by the Association of Small Foundations, 66% of respondents had a written investment policy in place.[2]

The steps to develop an investment policy statement may include the following:

STEP ONE: PRELIMINARY CONSIDERATIONS

Trustees and directors should determine the investment goals of their organization by examining:

- The funding needs of the organization, as guided by its budget and written spending policy;
- The organization's tolerance for investment risk, measured by the volatility of returns;
- The fund's investment time horizon—generally, the longer the time horizon, the more risk it may tolerate and the higher the return it can seek;

- The assignment of responsibilities and authority for investment decisions;
- The members or advisors that comprise its formal Investment Committee or other decision-making group;
- The potential use of alternative investments, such as real estate, hedge funds, private equity, natural resources and other alternative assets; and
- Guidelines for any proposed socially responsible investments and the establishment of proper monitoring procedures.

STEP TWO: DRAFTING AN INVESTMENT POLICY STATEMENT

A well-structured investment policy statement may include the following:

- A statement including the background of the organization;
- Responsibilities of all parties involved;
- Clear goals;
- An asset allocation strategy which diversifies the portfolio appropriately across asset classes and investment styles;
- Framework for investment selection decisions;
- The degree of risk permitted in the investment portfolio
- Factors used to evaluate investments;
- Criteria to determine whether to retain the services of a specific investment manager;
- Provisions for obtaining detailed reports describing the performance of investment managers and strategies;
- If deemed necessary, provisions for obtaining reports on capital markets trends from an objective, independent source;
- The process for obtaining information from investment managers regarding portfolio performance, specific assets and market trends;
- Guidelines for the regular evaluation of performance results, measured on a risk-adjusted basis and compared to appropriate, predetermined benchmarks; and
- The process that will be employed for portfolio rebalancing

STEP THREE: MONITORING THE INVESTMENT POLICY

Once the investment policy statement has been drafted and implemented, the fiduciaries responsible for that statement should monitor portfolio performance in accordance with the policy's guidelines.

Fiduciaries should understand the gravity of their decisions and the need to balance spending and investment policies. If appropriate or necessary, they should seek guidance from investment professionals and other advisors to fulfill their responsibilities under the investment policy statement.

SELECTING AND MONITORING INVESTMENT MANAGEMENT FIRMS OR STRATEGIES

Once the investment policy statement has been developed, drafted and adopted, organization fiduciaries must select, hire and possibly terminate investment management firms or strategies. Choosing an investment management firm is an important decision and the process to do so is often subject to internal and external scrutiny.

With more than 24,000 investment advisors registered with federal and state regulatory agencies, possessing a prudent framework for all investment-related decisions is a critical component of the investment process. Coupling this with investors' increased interest in the diversification opportunities available through alternative asset classes can make this decision all the more important and more difficult.

UPIA authorized charitable fiduciaries to delegate investment decisions to qualified professionals. Generally speaking, if the delegation is done appropriately, the charitable director or trustee will not be held responsible for the manager's investment decisions.

Although the UPIA does not specify the particular steps that need to be followed in the selection of investment managers, fiduciaries should consider a number of important factors. These include the manager's professional qualities, services offered and the reasonableness of fees or other expenses. A thorough investment manager evaluation process may cover:

- Investment philosophy and portfolio construction process;
- Consistent application of that philosophy and process;
- Buy and sell guidelines;
- Experience and education of the portfolio management team and research analysts;
- Professional background of key administrative or management staff;
- Turnover of key investment professionals or other staff;
- Research capabilities and business operations;
- Technological capabilities and resources;
- Performance as measured on a risk-adjusted basis and compared to an appropriate market index or benchmark;
- A review of that performance on a regular (at least quarterly) basis; and
- An examination of the firm's ADV forms and filings or copies of the fund prospectuses (if appropriate).

If the time, resources or skills are not available within the organization to perform investment manager evaluations, investment consultants or other outside specialists may be valuable resources.

ADMINISTRATION AND RECORDS

It is important to keep records of all spending policies, investment decisions, manager selection and monitoring procedures. Fiduciaries should be able to demonstrate the existence of all these processes and their adherence to them.

Creating and maintaining detailed records, minutes or other documentation of all decisions, meetings and policy decisions can help fiduciaries demonstrate a prudent decision-making and policy framework, including areas that may require additional development. This framework also helps fiduciaries prepare and respond to regulatory or other inquiries.

Charitable fiduciaries should have on file:

- Articles of incorporation, bylaws or trust instruments, if applicable;
- Corporate bylaws, trust instruments and letters of trusteeship;
- Their application for recognition of tax-exempt status and an IRS letter of recognition of tax-exempt status;
- Form 990 or 990PF annual returns information for the previous three years or since inception, at minimum;
- All vendor contracts or other third-party provider agreements;
- Written evidence of a prudent process for carrying out fiduciary duties;
- A spending policy statement;
- An investment policy statement;
- Prospectuses or ADV forms for any funds, investment managers or other investment instruments retained by the organization;
- A written selection and review process for investment strategies, managers and consultants;
- Investment performance reports;
- Written minutes of all investment-related policy and performance review meetings;
- All investment-related forms, documents or other publications;
- Trustee, director, board and investment committee written meeting minutes;
- Written administrative policies and procedures; and
- Internal investment memoranda or other communications.

CONCLUSION

To fulfill their duties and obligations, nonprofit fiduciaries should adopt clearly defined spending policies, carefully crafted investment policy statements and documented administrative policies and procedures. Guidelines for spending, recommendations for investment policies and developing a framework for documentation and administrative procedures can help charitable trustees meet their fiduciary responsibilities and hopefully help fulfill their philanthropic objectives.

For further information on this process or any of the steps described in this report, contact your Morgan Stanley Smith Barney Financial Advisor.

1 Wilson, Elaine and Krupa Shah, "Illinois Adopts UPMIFA: Historic Dollar Value Rule for Endowments Eliminated." www.quarles.com/Publications.

2 The National Conference of Commissioners on Uniform State Laws, July 13, 2006.

3 2008-2009 Foundation Operations and Management Survey, Association of Small Foundations.

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