Fiduciary Self-Audits for Nonprofits: Evaluating Decision-Making Processes and Controls

November 10, 2011
12:30 – 2:00pm

Moderator:

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Key Considerations for Nonprofit Investment Fiduciaries

Rory Cohen, Partner, Venable LLP

November 10, 2011

Key Objectives

- Understand the key provisions of the Uniform Prudent Management of Institutional Funds Act
- Discover the components of an effective and disciplined investment process
- Find out about underwater endowment options

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Prudent Management of Institutional Funds Act

- Statutory Guidance
  - Drafted by the National Conference of Commissioners on Uniform State Laws
  - Enacted in 2006; now enacted in 49 states, in some form or another
- Key Implications
  - Modernizes rules governing appropriations and endowment spending rules
    - While providing greater flexibility and broader authority to spend, UPMIFA also seeks to strengthen Board oversight and governance
  - Provides greater flexibility and guidance in connection with the investment and management function
    - Sets forth certain investment factors and standards for delegating management and investment functions to outside agents
  - Provides greater flexibility in releasing donor restrictions on institutional funds

New York Prudent Management of Institutional Funds Act

- UPMIFA applies to all “institutions” as defined by UPMIFA
- Institution is defined to mean:
  - A person, other than an individual, organized and operated exclusively for charitable purposes
  - A government or governmental subdivision, agency, or instrumentality to the extent it holds funds exclusively for a charitable purpose
  - A trust that had both charitable and noncharitable interests, after all noncharitable interests have terminate.

Prudent Management of Institutional Funds Act

- Applies to not-for-profit corporations and to wholly charitable trusts where the trustee is a not-for-profit corporation
  - Not-for-profits formed exclusively for charitable purposes (Section 501(c)(3) organizations)
  - Non-charitable not-for-profits, including
    - Social welfare organizations (Section 501(c)(4) organizations)
    - Business leagues and trade associations (Section 501(c)(6) organizations)
    - Social clubs (Section 501(c)(7) organizations)
- Apply to endowments created by third parties, not the institution

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Prudent Management and Investment of Institutional Funds

- "Institutional Funds" include endowment funds and other assets held primarily for investment purposes
- Give primary consideration to donor's intent
- Duty of loyalty – different standards for NFP corporations and charitable trusts
  - NFP directors – "best interests"
  - Trustees – "sole interests"
- Duty of care

Fiduciary Responsibilities

- Duty of care
  - Prudent investor / you are not a guarantor
    - Reasonable care, skill and caution; portfolio approach
    - Good faith and with care an ordinarily prudent person in a like position would exercise under similar circumstances
      - Prudence under the facts and circumstances prevailing at the time of the action or decision
      - Consider the organization's risk/return objectives
      - High standard for directors selected who have particular expertise or experience in investment management
  - Duty to minimize costs: reasonable costs to invest and manage, considering:
    - Size of assets
    - Purposes of the institution
    - Skills/sophistication of investment committee
    - Third party adviser costs should be reasonable

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Fiduciary Responsibilities

- Duty to investigate: reasonable efforts to verify facts pertaining to investment management
  - How are the assets going to be managed?
    - By board or subcommittee
    - Delegation to another officer (e.g., CIO)
    - Delegation to third parties (e.g., RIAs, BDs, banks)
- Modern Portfolio Theory: decisions about each asset in the context of the portfolio
    - e.g., consider risk and return objectives of entire fund
    - Hedge funds, private equity, real estate funds
- Duty to diversify unless due to special circumstances
  - When a decision is made not to diversify, NYPMIFA specifically requires that such decision be reviewed <u>at least annually</u>
  - In light of today's market environment, does prudence dictate more frequent reviews of less diversified portfolios?
- Dispose of unsuitable assets
- Delegation to External Agents
- Develop investment strategy appropriate for the fund and charity

Managing and Investing Institutional Funds

- In managing and investing an institutional fund, consider:
  - General economic conditions
  - The possible effects of inflation and deflation
  - The expected tax consequences, if any, of investment decisions of strategies
  - The role that each investment or course of action plays within the overall investment portfolio of the fund
  - The expected total return from income and the appreciation of investments
  - Other resources of the institution
  - The needs of the institution and the fund to make distributions and to preserve capital
  - An asset's special relationship or special value, if any, to the charitable purposes of the institution

Delegation to External Agents

- Delegation to External Agents
  - Subject to the terms of the gift instrument, delegation is explicitly permitted by UPMIFA (authority to delegate was implied under the prior statutes)
  - External agents include an independent investment adviser, investment counsel or manager, bank or trust company
  - UPMIFA not only clearly reflects the authority to delegate, but makes clear that the duty of care extends to the following:
    - Selecting, continuing or terminating an agent and assessing the agent's independence and conflicts of interest
    - Establishing the scope and terms of the delegation, including the payment of compensation, consistent with the purposes of the institution and the institutional fund
    - Monitoring the agent's performance and compliance with the scope and terms of the delegation

Delegation to Third Party Advisers – Key Practice Considerations

- Duty of care in connection with selection and continued retention
  - Affirmative duty to assess the independence of outside agents and conflicts of interest before and after retaining them
  - Selection should be based on competence, experience, past performance and proposed compensation, not business or personal relationships
  - Coordinate with Conflicts of Interest Policy
  - Directors and investment committee members are not liable for the actions or decisions of such third parties <u>if</u> the selection and retention are proper
  - Key considerations:
    - Transparency of portfolio
    - Transparency of the portfolio manager
    - Regulatory filings and other disclosures

- Good practice to formalize RFPs to ensure consistency of information obtained and reviewed, and the objectivity of selection process

Prepare and Maintain Investment Policy Statement

- Best Practice: Maintain "written" investment policies
  - No one size fits all
  - Examples of subjects an IPS may include
    - General investment objectives
    - Permitted and prohibited investments
    - Acceptable levels of risk
    - Asset allocation and diversification
    - Procedures for monitoring investment performance
    - Scope and terms of delegation of investment management functions
    - The investment manager's accountability
    - Procedures for selecting and evaluating "external agents"
    - Processes for reviewing investment policies and strategies
    - Proxy voting
  - Frequency of Review – at regular intervals and whenever a change in the institution's financial condition or other circumstances require

Due Diligence in a Nutshell

- Can you answer the following:

  - Do you know what you are buying?
  - Who is managing the money?
  - How were they selected?

- Specific Due Diligence Considerations
  - Firm/Firm History (ownership structure; investment team, AUM and AUM growth; capacity of strategy; investor composition)
  - Investment strategy, Objectives and Process
  - Review of Performance
  - Operational Due Diligence and Risk Management Controls
  - Transparency and Frequency of Reporting
  - Conflicts of Interest Considerations and Related Disclosures
  - Underlying Document and Structured Features
  - SEC Registration and Other Regulation
- Absolute and Relative Analysis

It’s All About Process

- Educate yourself
- Develop Asset Allocation Strategy
- Prepare and Maintain Investment Policy Statement
- Implement Investment Strategy
- Monitor and Supervise Implementation of Investment Strategy
- Procedures for Controlling and Accounting for Expenses
- Process is key

It's All About Process

Best Practice: Have a Process to Review Your Process

- Evidence competence: be able to illustrate awareness of fiduciary responsibilities
- Substantiation:
  - Document analysis of portfolio-level asset allocations, individual investment decisions and investment manager performance
  - Timing of reviews/analysis
  - Details of reviews and analysis (e.g., issues reviewed, persons involved, supporting calculations; background research and analysis)
- Periodically review overall compliance with investment policies and authority of committee
- Prepare written summaries

Endowment Spending Considerations

- UPMIFA eliminates the historic dollar value limitation on spending of endowment funds
- An endowment fund is any institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis
- Replaces historic dollar value with prudence requirement; prior law required the preservation of the endowment's principal
- An institution may appropriate for spending as much of the endowment fund, including principal, that the governing board determines, subject to the intent of the donor expressed in the gift instrument, is prudent for the uses, benefits, purposes and duration for which the endowment funds is established

Endowment Spending Considerations

- When deciding whether and the extent to which to appropriate from an endowment fund, UPMIFA requires consideration, if relevant, of the following factors:
  - The duration and preservation of the endowment fund
  - Purposes of the organization and the fund
  - General economic conditions
  - Possible effect of the inflation or deflation
  - Expected total return from income and appreciation of investments
  - Other resources of the organization
  - The organization's investment policy

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Endowment Spending Considerations

- Additional Consideration:
  - Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization
- Best Practice ---- Maintain Contemporaneous Records
  - For each decision to appropriate funds, the organization must keep a record describing the nature and extent of the consideration that the governing board gave to these factors
  - How detailed should your board or investment committee minutes be?
  - If a particular factor is deemed not to be relevant, the reasons for this also must be documented
- A donor may otherwise limit or restrict expenditure by the gift instrument

Endowment Spending Considerations

- Rebuttable presumption of imprudence
  - Appropriation of more than 7% of the fair market value of an endowment fund (calculated on the basis of the market values determined at least quarterly and averaged over a period of not less than 5 years immediately preceding the year in which the appropriation for expenditure is made) in any one year creates a rebuttable presumption of imprudence
  - This presumption does not apply to appropriations that are permitted under law or pursuant to the terms of the gift instrument
  - Appropriation of less than 7% of the FMV of the endowment fund is not presumptively prudent either
- Appropriations may be determined simultaneously (and pursuant to a single decision) for multiple similarly-situated endowment funds

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Release of Donor Restricted Funds

- Prior law: could seek release of restrictions upon a gift by obtaining authorization of donor
- Court approval, with notice to Attorney General
  - Where donor release not possible due to the death, disability, unavailability or impossibility of identification, the institution, upon prior notice to the AG, may seek court release if the restriction is obsolete, inappropriate or impracticable
- Small, old funds
  - Release by institution, with notice to AG, and no court approval

Fiduciary Self-Audits for Nonprofits:

Evaluating Decision-Making Processes and Controls

Presented by: *Rob Olcott, CAE, CIMA, AIF®*
Managing Director, ORION Investment Advisors

Ken Lowe, AIF®
Investment Consultant, ORION Investment Advisors

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Three Types of Fiduciaries

Investment Steward – A person who has the legal responsibility for managing investment decisions.

Investment Advisor – A professional who is responsible for managing comprehensive and continuous investment decisions.

Investment Manager – A professional who has discretion to select specific securities for separate accounts, mutual funds, commingled trusts, and unit trusts.

Nonprofit Investments and Fiduciaries

Examples of Nonprofit Investments Requiring Fiduciary Oversight:

- Reserve Funds
- Endowment Assets
- Foundation Assets
- Defined Benefit Plans
- Defined Contribution Plans (401(k), 403(b), 401(a))

Examples of Fiduciaries overseeing Nonprofit Investments:

- Executive Director/President
- CFO
- Director of Finance
- Controller
- Director of Human Resources
- Board of Directors
- Members of Investment Committee
- Members of Finance Committee
- Members of Benefits Committee
- Investment Advisors
- Investment Managers

Global Fiduciary Precepts From Fiduciary360

- Know standards, laws, and trust provisions
- Diversify assets to specific risk/return profile of client
- Prepare investment policy statement
- Use “prudent experts” (for example, an Investment Manager) and document due diligence
- Control and account for investment expenses
- Monitor the activities of “prudent experts”
- Avoid conflicts of interest and prohibited transactions

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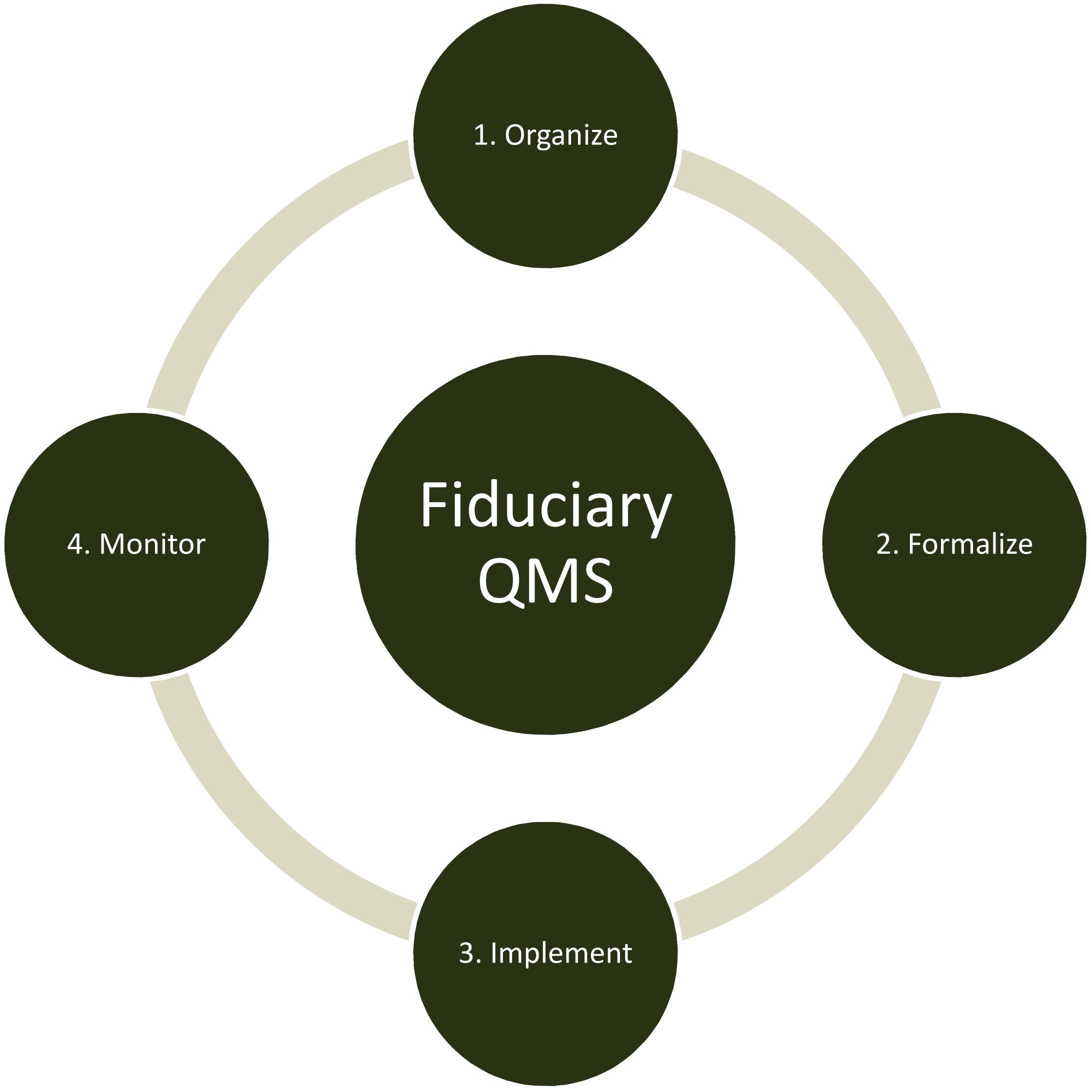
Fiduciary Quality Management System (QMS)

- Designed by Fi360™ to define a global fiduciary standard of excellence for investment stewards.

- Technical review by American Institute of Certified Public Accountants.

- Practices outlined in QMS are backed by substantiating code, regulations, and case law

Fiduciary Quality Management System (QMS)



Source: FI360

Fiduciary QMS: 1. Organize

1.1 Are investments managed in accordance with all applicable laws, trust documents, and written investment policy statements (IPS)?

1.2 Are the roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) defined, documented, and acknowledged?

1.3 Is there no indication that fiduciaries and parties in interest are involved in self-dealing?

1.4 Are service agreements and contracts in writing and are they written without provisions that conflict with fiduciary standards of care?

1.5 Are assets within the jurisdiction of appropriate courts, and are they protected from theft and embezzlement?

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Source: Fi360™

Fiduciary QMS: 2. Formalize

2.1 Has an investment time horizon has been identified?

2.2 Has a risk level has been identified?

2.3 Has an expected, modeled return to meet investment objectives been identified?

2.4 Are selected asset classes consistent with the risk, return, and time horizon?

2.5 Are selected asset classes consistent with implementation and monitoring constraints?

2.6 Is there an Investment Policy Statement (IPS) which contains the detail to define, implement, and manage a specific investment strategy?

2.7 Does the IPS define appropriately structured, socially responsible investment (SRI) strategies (where applicable)?

Source: Fi360™

Fiduciary QMS: 3. Implement

3.1 Is the investment strategy implemented in compliance with the required level of prudence?

3.2 Applicable “safe harbor” provisions followed (when elected)?

3.3 Are investment vehicles appropriate for the portfolio size?

3.4 Is a due diligence process followed in selecting service providers, including the custodian?

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Source: Fi360™

Fiduciary QMS: 4. Monitor

4.1 Are there periodic reports comparing investment performance against appropriate index, peer group, and IPS objectives?

4.2 Are periodic reviews made of qualitative and/or organizational changes of investment decision-makers?

4.3 Are control procedures in place to periodically review policies for best execution, "soft dollars," and proxy voting?

4.4 Are fees for investment management consistent with agreements and with all applicable laws?

4.5 Are "finder's fees" or other forms of compensation that may have been paid for asset placement appropriately applied, utilized, and documented?

4.6 Is there is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities?

Source: Fi360™

Fiduciary QMS: Deep Dive

Within each of the 22 practices highlighted in Fiduciary QMS, there are subsets of criteria designed to define the Standard of Excellence

Let's take a deep dive into one of the practices highlighted –

2. Formalize

2.6 Is there an Investment Policy Statement (IPS) which contains the detail to define, implement, and manage a specific investment strategy?

Source: Fi360™

Fiduciary QMS: 2. Formalize

2.6 Is there an Investment Policy Statement (IPS) which contains the detail to define, implement, and manage a specific investment strategy?

2.6.1 Does the IPS define the duties and responsibilities of all parties involved?

2.6.2 Does the IPS define diversification and rebalancing guidelines consistent with specified risk, return, time horizon, and cash flow parameters?

2.6.3 Does the IPS define due diligence criteria for selecting investment options?

2.6.4 Does the IPS define monitoring criteria for investment options and service providers?

2.6.5 Does the IPS define procedures for controlling and account for investment expenses?

Source: Fi360™

Fiduciary QMS: Formalize

The IPS should:

- Have sufficient detail that a third party would be able to implement the investment strategy
- Be flexible enough that it can be implemented in a complex and dynamic financial environment
- Not be so detailed that it requires constant revisions and updates
- Utilize addendums to identify information that will change on a more frequent basis such as the names of board members, accountants, attorneys, actuaries, investment advisors and investment managers
- Include the Capital Market Assumptions used to develop the plan's asset allocation

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Source: Fi360™

Fiduciary QMS: Formalize

Fiduciaries are required to manage investment decisions with a reasonable level of detail. By constructing a clear and effective IPS, fiduciaries can:

- Avoid unnecessary differences of opinion and the resulting conflicts
- Minimize the possibility of missteps due to a lack of clear guidelines
- Establish a reasoned basis for measuring their compliance
- Establish and communicate reasonable and clear expectations with participants, beneficiaries, and investors
- Create continuity as fiduciaries change

Source: Fi360™

Contact Us

If you would like a copy of this presentation or if you are interested in additional resources regarding Fiduciary Self-Audits feel free to contact us:

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Definitions & Disclosures

Periodic table asset class definitions

- **S&P 500** measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX and NASDAQ. The weightings make each company's influence on the Index performance directly proportional to that company's market value.
- **S&P/Citigroup 500 Growth** and **S&P/Citigroup 500 Value** measure the performance of the growth and value styles of investing in large cap U.S. stocks. The indices are constructed by dividing the market capitalization of the S&P 500 Index into Growth and Value indices, using style "factors" to make the assignment. The Value index contains those S&P 500 securities with a greater-than-average value orientation, while the Growth index contains those securities with a greater-than-average growth orientation. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.
- **Russell 2000** measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index. These securities are traded on the NYSE, AMEX and NASDAQ.
- **Russell 2000 Value** and **Russell 2000 Growth** measure the performance of the growth and value styles of investing in small cap U.S. stocks. The indices are constructed by dividing the market capitalization of the Russell 2000 Index into Growth and Value indices, using style "factors" to make the assignment. The Value index contains those Russell 2000 securities with a greater-than-average value orientation, while the Growth index contains those securities with a greater-than-average growth orientation. Securities in the Value index generally have lower price-to-book and price-earnings ratios than those in the Growth index. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.
- **MSCI EAFE** is a Morgan Stanley Capital International Index that is designed to measure the performance of the developed stock markets of Europe, Australasia and the Far East.
- **MSCI Emerging Markets** is a Morgan Stanley Capital International Index that is designed to measure the performance of equity markets in 21 emerging countries around the world.
- **BC Agg** is the Barclays Capital Aggregate Bond Index (formerly the Lehman Brothers Aggregate Bond Index). This index includes U.S. government, corporate and mortgage-backed securities with maturities of at least one year.

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Employee Benefit Plan Fiduciary Responsibility Overview

November 10, 2011

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Fiduciary Responsibility Overview

- What functions create a fiduciary under ERISA?
  - Exercising discretionary authority or control over the management of the plan or its assets
  - Rendering investment advice for a fee or other compensation
  - Discretionary authority or control in the administration of the plan

Fiduciary Responsibility Overview

- Who is a fiduciary under ERISA?
  - Plan Trustees
  - Custodian
  - Investment Advisors
  - Plan Administrator or any individual exercising discretion in administration of the Plan
  - Plan Administrative Committee
  - Board of Directors who appoint committee

Fiduciary Responsibility Overview

- What are the fiduciary duties under ERISA?
  - Required to act solely in the interest of plan participants and beneficiaries
  - Ensure plan assets are being used exclusively for the payment of plan benefits or for "reasonable" administrative expenses
  - Determine fees for services between a plan and a "party in interest" (for example, trustee, investment advisor or record keeper) are reasonable
  - Obtain sufficient information from providers to enable the fiduciary to make informed decisions about services and costs

How to Limit Fiduciary Liability

- **Demonstrate you have carried out your responsibilities properly**
  - Document processes used to carry out responsibilities
- **Give participants control over their investments to limit liability as a fiduciary for investment decisions made by participants**
  - Offer a variety of investment options
- **Hire service providers to carry out fiduciary functions**
- **Monitor service providers**
  - Review service provider's performance
  - Read reports provided by the service provider
  - Check actual fees charged
  - Ask about policies and practices
  - Follow up on participant complaints
- **Maintain proper fidelity bonding**

DOL 408(b)(2) Disclosure Rules

- The DOL issued the 408(b)(2) Interim Final Regulations effective July 16, 2011, which have the following objectives:
  - Provide plan fiduciaries with the information they need to determine the reasonableness of compensation paid to service providers
  - Help fiduciaries understand how those services are affected by potential conflicts of interest.

- The final regulation applies to defined contribution and defined benefit plans covered by ERISA. Health & Welfare plans, SEPs, SIMPLEs and IRA's are exempt from the rules.

Prohibited Transactions

- The 408(b)(2) Final Regulations have the following requirements:
  - Covered providers will be required to provide disclosure of the services they provide and fees they "reasonably expect" to earn under any contract in which they expect to earn $1,000 or more
  - Covered providers would generally include fiduciary services, record-keeping or brokerage services, and virtually anyone who is being compensated indirectly (e.g. accounting auditing, actuarial, consulting, etc.)

DOL 408(b)(2) Disclosure Rules

- Effective for plan years beginning on or after November 1, 2011, the following plan-related and investment-related information must be provided to participants and beneficiaries on or before the date they are first eligible to direct their investments, and on an annual basis thereafter
  - General Plan information
    - ◊ Current list of investment options
    - ◊ Explanation of how individuals provide investment instructions under the Plan
    - ◊ If applicable, descriptions of a brokerage option and/or similar types of outside investments available under the Plan
  - Administrative expense information
    - ◊ Explanation of fees and expenses that may be charged to or deducted from all individual accounts
  - Individual expense information
    - ◊ Explanation of fees that may be charged to individual's account (i.e. loan fees, QDRO fees, hardship withdrawal fee, distributions fees)

DOL 408(b)(2) Disclosure Rules

- Investment related information
  - ◊ Performance data
    - One, five and 10-year returns for all mutual funds and other plan investment options that do not have a fixed rate of return
    - Annual rate of return and investment term for fixed rate of return
  - ◊ Benchmark data
    - One, five and 10-year returns for appropriate benchmark indexes (to match plan investment performance data periods)
  - ◊ Fee and expense information
    - Non-fixed-rate investments: Total annual operating expenses expressed as a percentage and as a dollar amount per $1,000 invested
    - Any shareholder-type fees or restrictions on purchases or withdrawals must also be provided
    - Fixed-rate investments: any shareholder-type fees or restrictions on purchases or withdrawals

DOL 408(b)(2) Disclosure Rules

- Investment related information (continued)
  - ◊ Internet resources
    - Addresses of websites that can provide additional detailed information about the investment options
  - ◊ Glossary
    - General glossary of terms to assist participants and beneficiaries in understanding the plan's investment options or the address of a website that can provide access to a glossary

- Additional quarterly disclosure
  - Individuals are to receive quarterly statements that report the dollar amount of any fee or expense deducted from their account along with a description of the services related to the fee or expense

DOL 408(b)(2) Disclosure Rules

- Responsibilities of the Plan Sponsor
  - Consider how the new disclosure rules affect the plan
  - Inquire of your service providers regarding their process to comply with the written disclosure requirements
  - Review the disclosures to determine if they satisfy the new disclosure requirements
  - Determine whether the compensation paid the service provider is reasonable based on the services rendered
  - Fiduciaries of the plan should document this review
  - Determine who is a Fiduciary to your Plan

DOL 408(b)(2) Disclosure Rules

- What if the Plan sponsor does not receive the proper disclosures?
  - Request in writing that the covered service provider furnish the required information
  - If the provider fails to comply with such written request within 90 days of the request, the plan fiduciary must notify the DOL of the covered service provider's failure
  - The Plan fiduciary should determine whether to terminate or continue the contract or arrangement
  - The Plan should evaluate the nature of the failure, the availability, qualifications, and cost of replacement service providers, and the covered service provider's response to notification of the failure

Thank You!

Questions?

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Questions and Discussion

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