VENABLE LLP
nonprofit & investment management alert

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Practical Due Diligence Considerations for Nonprofit and Other Investment Fiduciaries

The December 11, 2008 arrest of Bernard Madoff and his alleged $50 billion Ponzi scheme and more recent arrests of several other investment managers alleged to have similarly defrauded investors have sent shock waves throughout the nonprofit and for-profit financial communities. As a result of these events, and the historic volatility and disruption in global financial markets, many trustees, board members and investment committee members ("Investment Fiduciaries") of foundations, charities, endowments, pension funds, family offices and high net worth investors have begun to more closely consider their investment policies (including the extent to which such policies include allocations to hedge funds and other alternative investments) and their due diligence processes for selecting third party investment managers. Many Investment Fiduciaries seek to use outside consultants and advisers to review, select and monitor investment managers, mutual funds, hedge funds and other pooled investment vehicles. Now is a good time to review their due diligence processes as well.

On January 15, 2009, the Investors' Committee to the President's Working Group on Financial Markets issued its final report entitled "Principles and Best Practices for Hedge Fund Investors" (the "Investors' Committee Report"). The Investors' Committee Report, delayed to permit the Investors' Committee an opportunity to refine its conclusions in light of recent financial market dislocations and the alleged Madoff fraud, sets forth a number of factors that should be considered by investment fiduciaries when evaluating the appropriateness of hedge fund investing. Though the Investors' Committee Report focuses on hedge fund investments, we believe many of the best practices identified can be equally effective with respect to both traditional long-only and hedge fund managers. The Investors' Committee notes that "one cannot eliminate investment risk, but one should be aware of the risks that are being undertaken when investing with individual managers and also in the portfolio as a whole." The Investors' Committee further emphasizes that "there can be no substitute for comprehensive and ongoing due diligence not only of hedge funds in the investment portfolio but indeed of the full portfolio."

Recognizing that due diligence will vary depending upon an organization's needs as well its financial resources, the best practices recommended by the Investors' Committee Report should be viewed as a guide for Investment Fiduciaries responsible for reviewing and implementing investment policies and analyzing the effectiveness of due diligence. Our discussion below touches on several best practices identified by the Investors' Committee and also reflects some of our own observations based upon our experiences advising Investment Fiduciaries.

Duty of Care of Investment Fiduciaries

Investment Fiduciaries are not guarantors of performance. They do, however, owe a "duty of care" with respect to the investment and management of investment funds. This "duty of care" is derived under state laws governing investments by nonprofit organizations. Most state laws incorporate principles derived from one of two uniform statutes approved by the National Conference of Commissioners on Uniform State Laws ("NCCUSL"): the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") and Uniform Management of Institutional Funds Act ("UMIFA"). UPMIFA was approved in 2006 with the intent of superseding UMIFA.[1] (These provisions are frequently incorporated into a state's nonprofit corporation statute).

Among other things, UPMIFA modernizes the standards for investing by nonprofits and, as discussed below, provides some protection for Investment Fiduciaries who properly delegate portions of the investment function. UPMIFA applies generally to charitable organizations organized as nonprofit corporations, unincorporated associations, governmental subdivisions or agencies, trusts (where the trustee itself is a charity) and other entities organized and operated exclusively for charitable purposes. Trusts managed by corporate or other fiduciaries that are not charities do not fall within the scope of UPMIFA but are subject to the "duty of care" set forth under the Uniform Prudent Investor Act as implemented and interpreted by the states.

UPMIFA sets forth a number of factors to be considered in managing and investing the assets of a nonprofit organization, including "the role that each investment or course of action plays within the context of the entire portfolio" and "the expected total return from income and appreciation of investments." UPMIFA also requires an Investment Fiduciary to reasonably seek to verify the accuracy of information used in making decisions and includes a general "duty to diversify" investments. In discharging these responsibilities, some degree of research, or due diligence, should be conducted.

So what does this mean? What can be done? Due diligence should be viewed as far more than a simple "check-the-box" exercise. It is not simply a matter of documenting the receipt and completion of questionnaires and filing them away. Investment Fiduciaries who are directly involved in due diligence and investment selection should be actively engaged. They should be sufficiently knowledgeable about financial markets and investment instruments and remain abreast of current events. If they engage investment managers, they should analyze information provided by such managers. They also should seek to obtain information from independent sources to help evaluate the accuracy and completeness of information provided by managers. In addition, Investment Fiduciaries should strive to ask thoughtful questions in an effort to understand the instruments or funds that they are investing in and to evaluate the relative risks and sources of investment returns.

Delegation of Investment Responsibilities

As contemplated by UPMIFA, Investment Fiduciaries are generally relieved from liability with respect to investment decisions made by third parties to whom investment discretion is delegated via written agreement, provided they exercise the appropriate degree of diligence, care and skill in selecting such third party advisers. For example, Investment Fiduciaries are not liable for decisions made by investment managers to purchase and sell individual securities or decisions by consultants or advisers to hire or fire portfolio managers, provided (a) discretion has been appropriately delegated; (b) they have exercised diligence, care and skill when engaging such parties; and (c) they periodically review the third party's actions to monitor such party's performance and compliance with the scope and terms of the delegation.

However, many relationships with outside consultants and advisers are non-discretionary, whereby the consultant or adviser is engaged solely to "assist" in defining investment policies and/or to "assist" in reviewing, selecting and monitoring investments and investment managers. Investment Fiduciaries should review their advisory agreements to determine whether discretion has been granted and to see if they contain any limitations of liability and/or disclaimers of reliance. In any event, whether or not discretion is granted to outside consultants or advisers, Investment Fiduciaries should carefully consider and periodically review such party's investment selection and due diligence processes. Such reviews should test the robustness and consistency of the underlying advisers' processes and seek to verify, among other things, that such third parties understand the investments they are looking at and risks and sources of returns.

Review Your Investment Process and Portfolio

Due diligence will not solve all problems, but a well-designed process, together with thoughtful analysis can help identify red flags that suggest further questioning or abandonment of an investment opportunity. We offer the following non-exhaustive list of considerations for reviewing investment managers and portfolio performance (and, when applicable, to assess whether outside consultants or advisers include similar considerations as part of their process):

- Review the extent to which due diligence focuses on a manager's investment strategy and objectives. Can the manager clearly articulate his/her investment thesis? How are investment ideas generated? Is the investment manager willing to disclose portfolio positions and discuss specific investments --- both those that performed well *and* those that performed poorly? Are security selection and portfolio composition consistent with the articulated strategy and investment selection process?

- Is the investment manager registered with the Securities and Exchange Commission ("SEC")? If so, the Investment Advisers Act of 1940, as amended (the "Advisers Act"), requires the adviser to maintain written compliance policies and procedures, a Code of Ethics and policies and procedures to prevent insider trading, among other things. Registered investment advisers must also appoint a Chief Compliance Officer ("CCO") who should be sufficiently knowledgeable about Advisers Act requirements. The CCO should also be competent and "empowered", which, in the view of one prominent SEC Staffer, is one that has "…a position of sufficient seniority and authority within the organization to be able to compel others to adhere to the firm's compliance policies and procedures."[2] Query whether the CCO or person acting in a similar capacity actually has such independence and authority. Even in the absence of SEC-registration, does the investment manager conduct itself as if it was registered and maintain similar policies and procedures?

  Will the manager permit reviews of its compliance policies and procedures? Interview the CCO or person acting in a similar capacity to understand their strengths and weaknesses and to assess whether they have sufficient competence and independence within the organization.

- Review conflicts of interest. Evaluate how they are identified and how quickly they are resolved. Are they prevalent? Does the manager utilize affiliated broker-dealers, engage in principal trading or other related-party arrangements, permit personal trading or have side-by-side trading considerations that might impact allocations and other portfolio decisions? To what extent are conflicts disclosed in the manager's Form ADV (if registered with the SEC) and, if applicable, fund offering documents.

- Review the extent to which operational risk and risk controls are evaluated. Consider the effectiveness of such process. Some industry professionals distinguish between "risk management" and "risk measurement". Risk measurement is generally the ability to conduct scenario analysis to determine how securities and other portfolio positions may react based on historical reactions. Risk measurement is a quantitative measurement and hypothetical, based on historical behavior, but not a real-time reaction to actual events. Risk management is the ability to illustrate actual actions taken in response to live market events, based on, in large part, a manager's own expectations of future events.

  When evaluating an organization's risk controls, it is helpful to understand a manager's forward-looking views on the economy and financial markets (what do they actually think?) and how they are positioning their portfolios in light of their own future expectations. It is helpful to understand (a) how the manager's systems identify risks, including excess concentration, excessive leverage, changes in correlation (among securities, sectors, countries, etc.) and counterparty risks with prime brokers and other financial institutions and (b) how quickly they can react and reposition the portfolio. Focus not only on portfolio liquidity, but on organizational constraints that might hinder the timely implementation of changes. In other words, who does the risk manager report to and does he or she have sufficient independence to unilaterally make changes to the portfolio? Review the manager's valuation process and cash movement controls. Review trade processing and reconciliation controls.

- Do you apply your due diligence process consistently? Are your due diligence efforts tailored to reflect unique issues posed by different investment strategies? In other words, by way of example, does your process differ for equity, fixed income, currency and real estate managers.
- Review your documentation of due diligence to see if similar documents are collected from each investment manager and fund. Are you maintaining notes of your review and analysis and minutes of investment committee meetings and decisions?
- Monitor and periodically review investment performance, portfolio concentration and the relative merits of continuing to maintain each investment within the portfolio. These types of reviews are helpful with respect to each investment and the entire portfolio and with respect to separate account managers and managers of pooled vehicles such as mutual funds, hedge funds, private equity funds, real estate funds and funds of hedge funds.[3] Continued underperformance and excessive concentration might suggest the need for further consideration internally among Investment Fiduciaries and perhaps externally with outside consultants and advisers, if used.
- When investments perform poorly, re-evaluate your process to potentially identify factors that you may be able to change or emphasize in connection with future investments.

If you have any questions about this alert, your investment or due diligence process or legal considerations that may arise in connection with investment products used by your organization, please contact any member of Venable's Nonprofit Organization or Investment Management practice groups.

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1 UPMIFA has been enacted in twenty-six states and UMIFA in forty-seven according to NCCUSL. State statutes should be separately evaluated in order to determine the extent to which its provisions mirror the relevant uniform model statute.
2 Speech by Gene Gohlke, Associate Director, Office of Compliance Inspection and Examinations, U.S. Securities and Exchange Commission at the Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework; available at: http://investor.gov/news/speech/spch050505gg.htm.
3 Pooled investment vehicles are generally more difficult to evaluate and monitor due to certain inherent limitations, including limited transparency, limitations on withdrawal and the more frequent use of sophisticated investment strategies and instruments (that utilize various options and futures, commodities and currencies, etc.).

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