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## Due Diligence Considerations for Nonprofit Investment Fiduciaries

**Thursday, May 7, 2009**

8:00 AM - 10:00 AM

Venable's Washington, D.C. office  
575 7<sup>th</sup> Street, N.W.  
Washington, D.C.

### **Speakers:**

Moderated by **Jeffrey S. Tenenbaum** of Venable LLP

**Rory Cohen**, Venable LLP

**Michael H. Graham**, CIMA, First Vice President – Investments, Institutional Consultant, Merrill Lynch

**Charles F. Tate**, CPA, Partner, Tate and Tryon, P.C.

# Presentations

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## Due Diligence Considerations for Nonprofit Investment Fiduciaries

Rory Cohen, Partner

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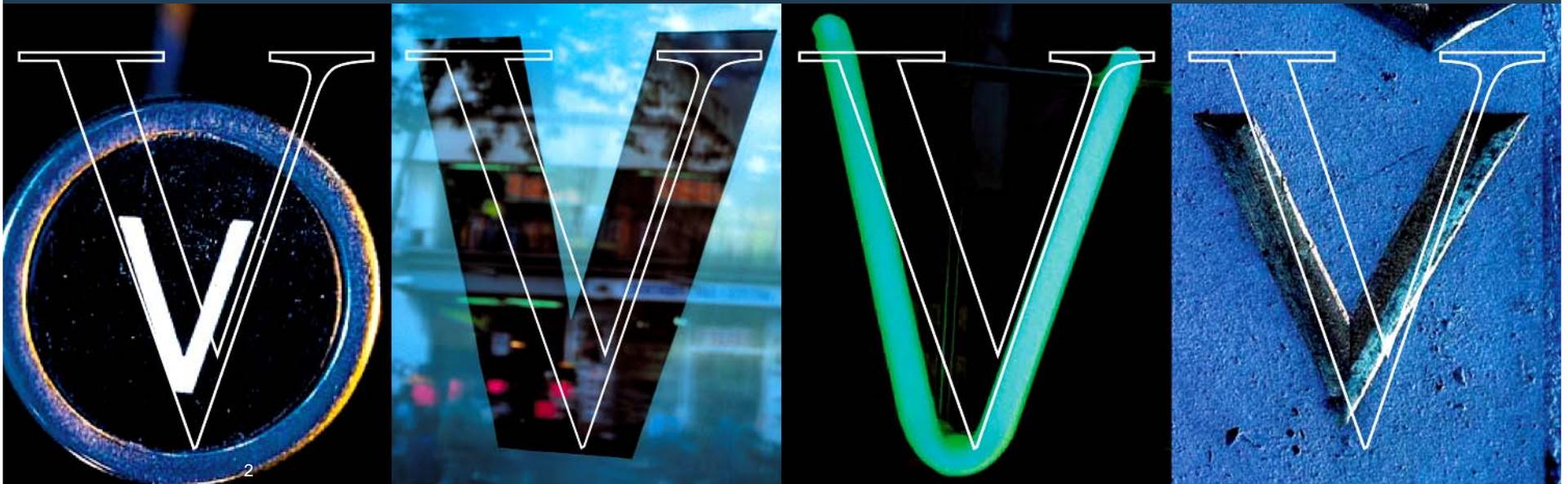
Venable LLP

Rockefeller Center

1270 Avenue of the Americas, 25<sup>th</sup> Floor

New York, New York 10020

May 7, 2009



## Statutory Guidance

- Uniform Prudent Management of Institutional Funds Act
  - applies to charities organized as charitable trusts and nonprofit institutions
  - modernized UMIFA (see below)
    - rules governing expenditures
    - management of investment management function
  - incorporates many standards set forth in Uniform Prudent Investor Act (adopted in 1994)
    - applies to trustees of trusts, including charitable trusts
  - harmonizes standards for managing and investing institutional funds
  - added “prudent” to emphasize the prudence in management
- Uniform Management of Institutions Fund Act (UMIFA)
  - drafted in 1972; adopted by 47 states



## Prudent Management and Investment

- 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
  - 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 of decision
      - Consider the organization's risk/return objective
      - 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



## Prudent Decision Making

- In managing and investing an institutional fund, consider:  
(Section 3 of UPMIFA; substantially mirrors UPIA § 2(c))
  - general economic conditions
  - the possible effects of inflation and deflation
  - the expected tax consequences, if any, of investment decisions or 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



## 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
- Diversify unless due to special circumstances
- Dispose of unsuitable assets
- Develop investment strategy appropriate for the fund and charity



## 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:
  - Evidence competence: be able to illustrate awareness of fiduciary responsibilities
  - Substantiation:
    - document analysis
    - timing of reviews/analysis
    - details of reviews and analysis (e.g., issues reviewed, persons involved, supporting calculations; background research and analysis)
  - Have a process to review your process



# Due Diligence In A Nutshell



## Firm/Firm History

- **Ownership structure**
- **Investment team**
  - backgrounds; lives outside the office;
  - education; prior employment history; experience of key personnel;
  - personal investments in the fund; amount of net worth/liquid net worth invested in the fund;
  - compensation/motivation/retention incentives;
  - office environment; turnover and terminations;
  - length the team has been together and individual investment experiences of key team members;
  - background checks of principals/investment decision makers;
  - litigation
  
- **Relative composition of onshore vs. offshore in the strategy and master (if applicable)**
- **AUM and AUM growth over time (and separately with respect to onshore and offshore funds)**
- **Capacity of strategy**
- **Investor composition (concentration; quality (high net worth vs. institutional; fund of funds and other platforms)**
- **Maximum/sizeable drawdowns**
- **Any predecessor firms liquidated or closed**



# Investment Strategy, Objectives and Process

- **Overview of strategy and portfolio construction process (top down/bottom up)**
  - sector and geographic exposures;
  - leverage: net and gross exposures (how these are determined);
  - average position size (for both long and short positions);
  - hedging techniques;
  - how positions are built;
  - fixed income portfolio characteristics (duration/yield/credit quality).
- **Investment process and idea generation**
  - how do you articulate your process?
  - do you clearly articulate your process?
  - case studies: is security selection/asset allocation consistent with your articulation of process?
  - quantitative and qualitative factors used to construct portfolios and in security selection.
- **Portfolio constraints**
  - sector/market/position/leverage limits;
  - liquidity (e.g., days to liquidate/types of holdings).
- **Value proposition/what's your edge? use of sub-advisors consistent application of strategy?**
- **Research capabilities/investment team specialization; securities expertise;**
- **Targeted returns; best/worst environment for strategy; strengths/weakness of strategy.**



## Review of Performance

- **Review of composite and monthly track record since inception; is it sensible given strategy?**
- **Anything that might indicate strategy shifts? Any indication of smoothing?**
  - among strategies used;
  - instruments used;
  - sector or geographic exposure;
  - degree of leverage used.
- **Performance attribution (by sector/holdings/new issues); does it foot to client letters?**
- **Impact of leverage on returns;**
- **Relative performance versus peers; explanations of exceptionally strong and poor returns (relative and absolute); validity of explanations;**
- **Correlation of portfolio versus peers; comparison to indices.**



## Operational Due Diligence and Risk Management Controls

- Valuation process/controls (mark-to-market; fair valuation; any third party review, approval or triangulation); how often is the portfolio priced? have there been any NAV restatements?
- Review of service providers: review of audited financial statements since inception – review qualifications and unusual footnotes; evaluate quality/reputation of auditor; brokerage allocation; prime broker (evaluate quality/reputation of prime broker); any changes to service providers?
  - do you self-administer? who delivers NAV statements to clients?
  - verification that assets exist
- Cash movement and controls (evaluate organizational structure/evaluate org chart/legal oversight/CCO);
  - separation of responsibilities; independent checks;
  - how strong is the CCO? Is the compliance function robust; independent; adequacy of resources dedicated to compliance
- Trade processing and reconciliation (administrator strength/reputation); review of policies and procedures; CCO meeting;
- Registered/unregistered investment adviser (if not, why?);
- Third party marketing arrangements;
- Risk controls and analysis:
  - how do you assess and manage risks (e.g., market risk, liquidity risk; counterparty risk, operational risks);
  - stress testing and scenario analysis (best and worst case environment);
  - volatility and value at risk;
  - portfolio liquidity vs. investor liquidity – any matching issues;
  - who are the fund's material counterparties?
- How frequently does the manager test and verify the effectiveness of controls? What are the manager's reporting and communication procedures? How quickly do issues get resolved?
- Review of portfolio management systems; consider robustness/location of redundancy systems, data storage, firewalls, trading systems, disaster recovery.



## Conflicts of Interest Considerations

- Who serves as the chief compliance officer; Is the compliance function robust and independent? Does the CCO have sufficient authority?
- Is there a culture of fair dealing? What and to what extent are costs allocated to investors?
- Any related party transactions or use of affiliated broker or other service provider?
- How are prime brokers and other service providers selected? Does the manager utilize capital introduction services of prime brokers? How is best execution achieved/reviewed?
- Are there any side letters? How does the manager disclose the existence of side letters and types of terms that may vary?
- How transparent is the manager? Does the manager provide different levels of access (i.e., portfolio level positions, aggregated data)?
- Personal trading policies and procedures; error correction procedures; side-by-side trading/allocation procedures.
- Does the manager have information barriers? What are its policies to prevent insider trading?
- Will the manager permit access to its code of ethics, annual compliance review and/or regulatory audit letters?



# Underlying Document and Structured Features

- Investor eligibility and offering restrictions;
- Key terms:
  - fee structure (management and incentive) and other expenses;
  - frequency incentive allocation earned;
  - liquidity (frequency, notice period, key man provisions);
  - lock-ups; gates; suspension rights;
  - non-standard terms.
- Review of offering documents, subscriptions agreements and organization documents;
- Scope and depth of risk and conflict of interest disclosures;
- Review of pitchbooks and other marketing documents;
- Form ADV (Parts 1 and 2) if applicable; section 13D, 13G and 13F filings, if applicable; review for bad boy disclosures;
- SEC and other regulatory audits/disclosures (Form U4 and U5, if affiliated with a broker-dealer).
- Review of changes to fund documentation;
- Level of transparency/frequency of reporting; investor letters; side letters/preferential terms.

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# Investment Due Diligence Process

**Presented by**

Michael H. Graham, CIMA®,  
First Vice President – Investments  
Merrill Lynch Institutional Consultant

## Agenda

1. The “Seven P’s” for Investment Due Diligence
2. Due Diligence Process Overview and Criteria
3. A Professional Due Diligence Team
4. Asking the Right Questions

## The “Seven P’s” for Investment Due Diligence

### Factors for Consideration\*

People

Philosophy

Process

Portfolio

Product

Performance

Progress

\* Not every “factor for consideration” noted may be applicable to each and every fund. The factors noted are not necessarily attributes of any particular fund and one cannot assume that positive statements are true of any specific hedge fund.

## The “Seven P’s” for Investment Due Diligence

### People

Philosophy

Process

Portfolio

Product

Performance

Progress

- Background checks
- Track record
- Key-man risk
- Familiarity with asset classes and strategies
- Ability to manage
- Consistency of perspective
- Accessibility
- Meet with PMs, analysts, traders, risk officers and operations professionals

## The “Seven P’s” for Investment Due Diligence

People

**Philosophy**

Process

Portfolio

Product

Performance

Progress

- Driving principles
- Fiscally responsible perspective
- Transparency
- Risk and return targets
- View on taking risk
- Perspective on achieving returns
- Philosophy is consistent with historical return and risk patterns
- Consistency throughout the team members
- Consistency over time

## The “Seven P’s” for Investment Due Diligence

People

Philosophy

**Process**

Portfolio

Product

Performance

Progress

- Strategy
- Buy / sell discipline
- Risk management
- Positive differentiation from other managers pursuing same strategy
- Investment research process
- Areas of strength / weakness
- Pricing and valuation procedures

## The “Seven P’s” for Investment Due Diligence

People

Philosophy

Process

**Portfolio**

Product

Performance

Progress

- Transparency and analysis of holdings
- Appropriateness of positions
- Security of specific risks
- Concentration levels
- Illiquid or risky securities

## The “Seven P’s” for Investment Due Diligence

People

Philosophy

Process

Portfolio

**Product**

Performance

Progress

- Structure of individual hedge fund
- Alignment of manager’s incentives with those of investors
- Reputable administrator, board of directors and prime broker(s)
- Fees, liquidity limitations, high water mark, etc.

## The “Seven P’s” for Investment Due Diligence

People

Philosophy

Process

Portfolio

Product

**Performance**

Progress

- Interpretation of historical returns and downside risk
- Style or holdings based attribution analysis
- Rank fund in comparable peer group based on risk and return characteristics
- Meet objectives of absolute performance
- Assess relative performance compared to other similar managers on a risk-adjusted basis

## The “Seven P’s” for Investment Due Diligence

People

Philosophy

Process

Portfolio

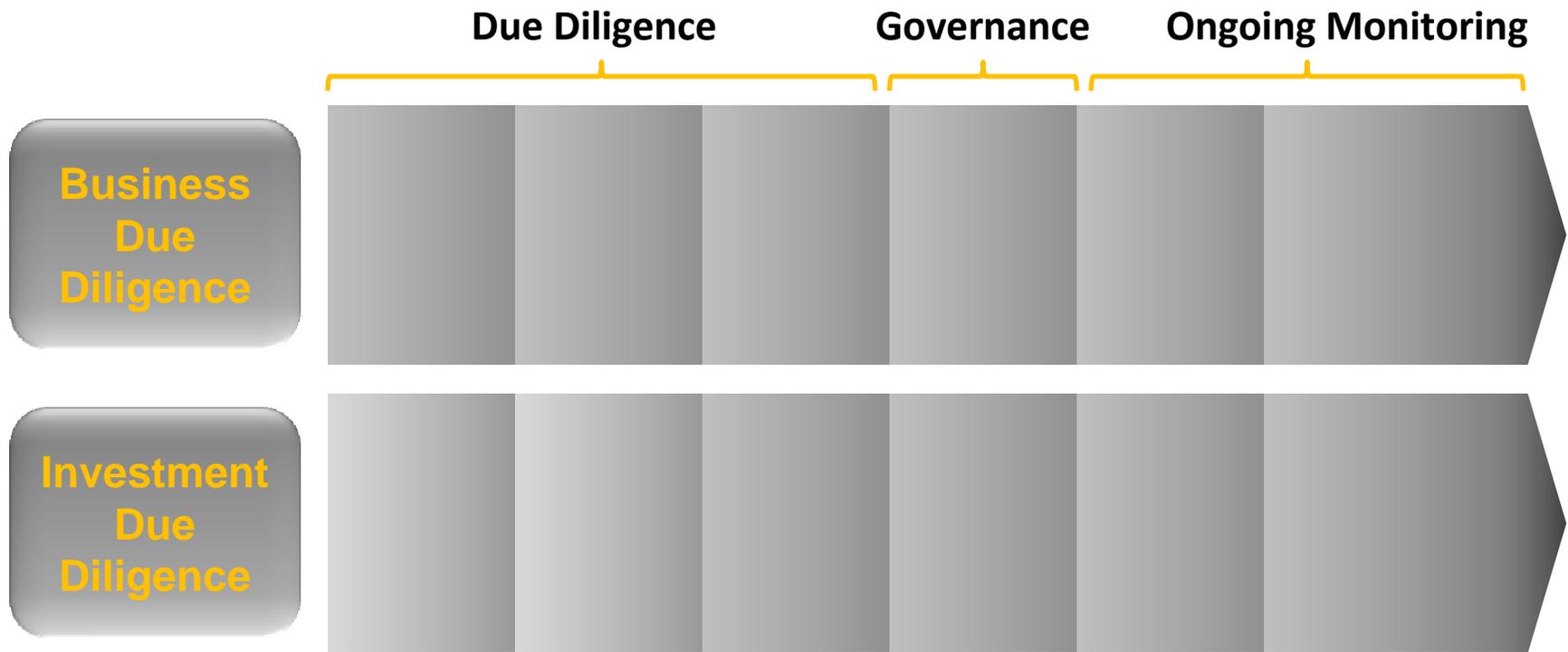
Product

Performance

**Progress**

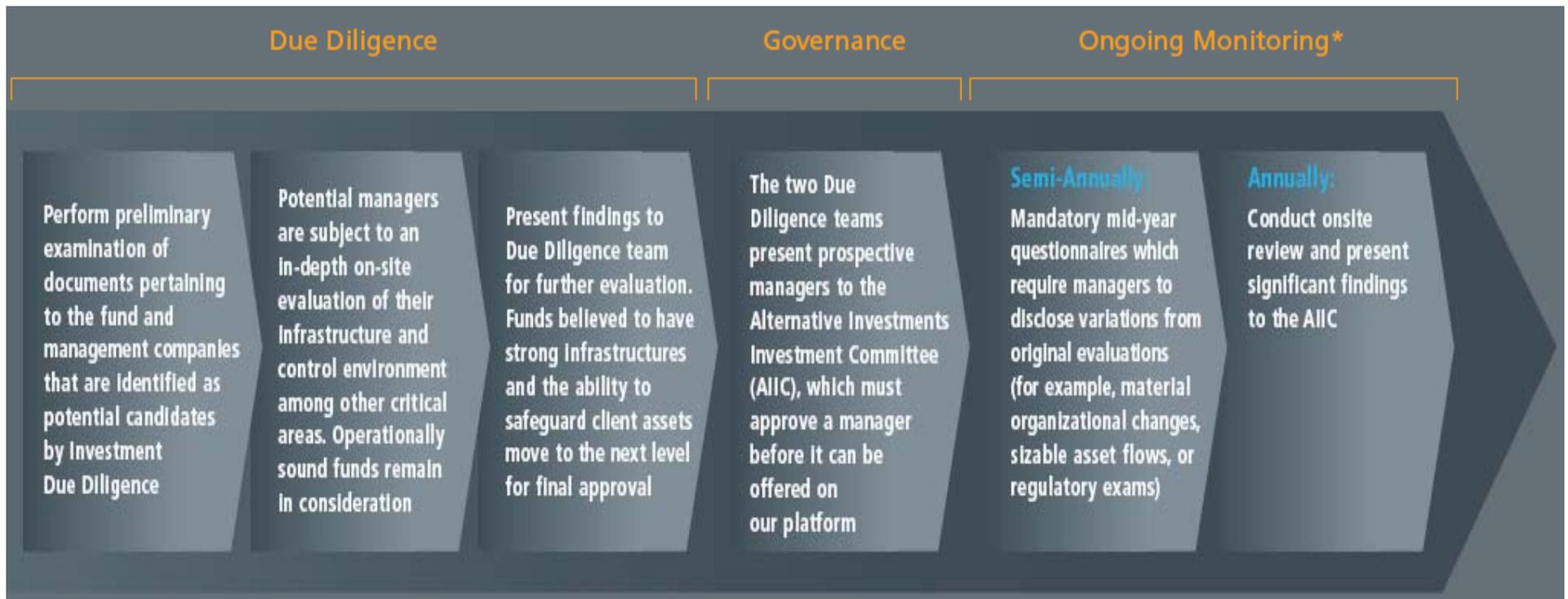
- Organizational stability and growth
- Successful build-out of management and support staff
- Training on firm-wide research and compliance policies intact
- Fund company is competently managing growth
- Historical track records
- Reflect current organization and management

# Due Diligence Process Overview



# Due Diligence Process Overview

## Business Due Diligence



\*Although the IDD and BDD teams are in contact with the managers, they will fast track a semi-annual or annual review should markets dictate, the timing of a more formal review process is as shown.

# Due Diligence Process Overview

## Investment Due Diligence



\*Although the IDD and BDD teams are in contact with the managers, they will fast track a semi-annual or annual review should markets dictate, the timing of a more formal review process is as shown.

## Due Diligence Criteria

### Business Due Diligence

- Valuation Procedures
- Cash Controls
- Organization and Staffing
- Systems and Tradeflow
- Compliance
- Trade Allocations
- Fees and Expenses
- Business Continuity
- Disaster Recovery
- Legal and Regulatory
- Conflicts of Interest

### Investment Due Diligence

- Performance
- Research Team
- Trading
- Risk Management
- Asset Growth
- Strategy Capacity
- Manager/Firm
- Reputation
- Reference Checks

### Manager status levels, driven by these criteria

#### Active Status

No material concerns outside of normal investment risk of investing in hedge funds

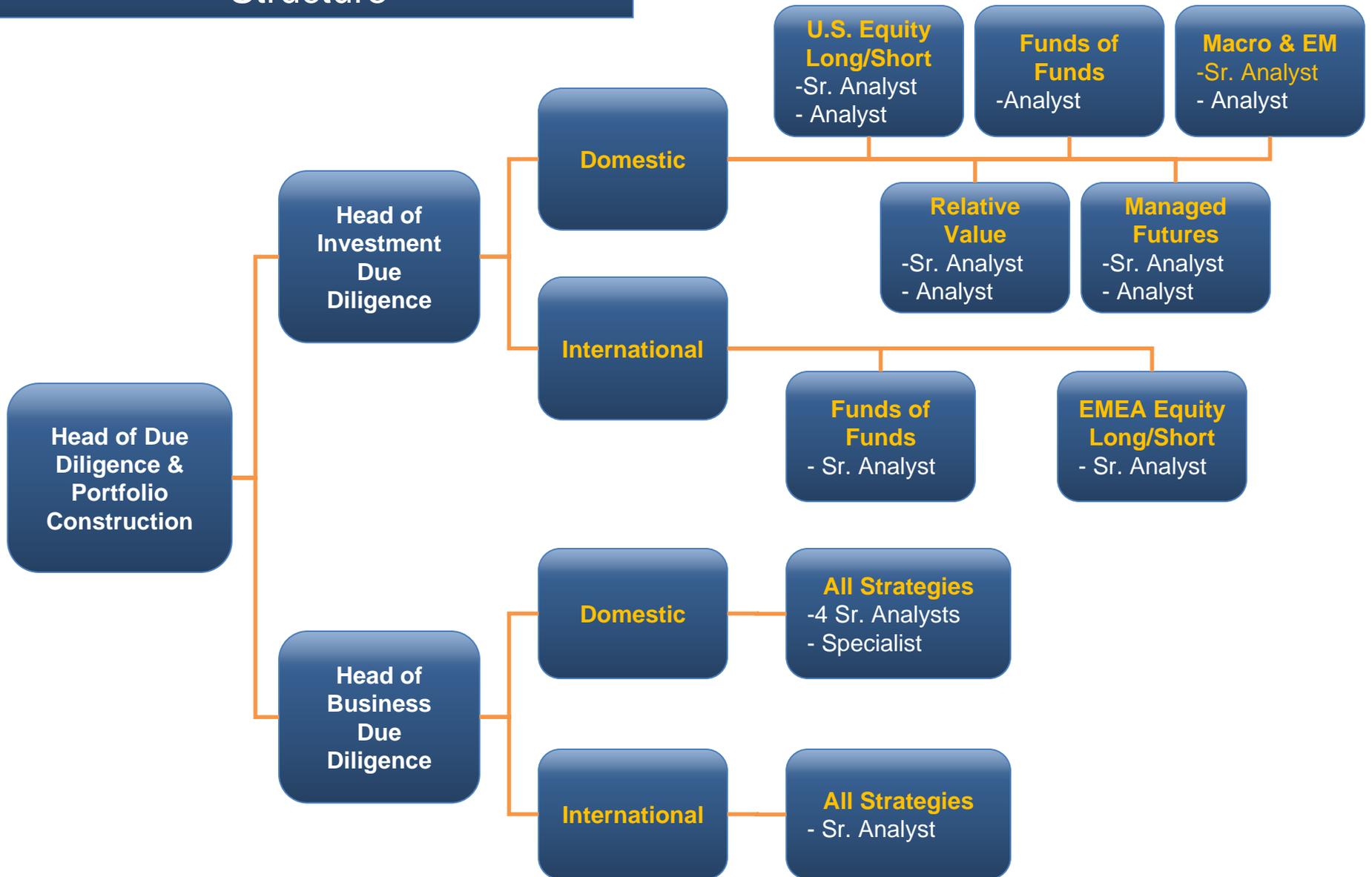
#### Administrative Hold

A material change is identified at the fund. Review period will last until the appropriate review committees approve a change. This status level may be extended if conditions require additional review. Clients may not commit new capital to the fund during this period.

#### Termination

An issue is identified which is sufficiently material that AI management review committees deem termination is appropriate.

# Sample Due Diligence Team Structure



## A Professional Due Diligence Team

- Labor intensive process
- Time intensive process
- Requires specific expertise
- Important to have a dedicated team in place

## Asking the Right Questions

- Describe your due diligence process:
  - Initial evaluation
  - Ongoing monitoring
- What is the structure of your due diligence team?
- Do individuals on the due diligence team have responsibilities other than due diligence?
- What written reports do you provide on an ongoing basis?

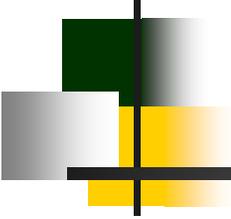
# Q & A

## **Hedge Fund Risk Factors**

This document is not an offer to purchase any security. An offer to purchase interests in any hedge fund may be made only pursuant to the fund's private placement memorandum, which contains important information concerning risk factors, performance and other material aspects of the fund. Hedge funds are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. There is no secondary market, nor is one expected to develop, for investments in hedge funds and there may be restrictions on transferring fund investments. Hedge funds may be leveraged and performance may be volatile. Hedge funds have high fees and expenses that reduce returns.

This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be specific offer by any Merrill Lynch entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available through Merrill Lynch.

There is no assurance that any of the objectives of any hedge funds will be met, including contributing to overall portfolio performance and diversification or avoiding significant losses. Past results are not necessarily indicative of future performance, so that the performance records included in the relevant offering material may not be representative of how any hedge fund can reasonably be expected to perform in the future. Merrill Lynch does extensive research and diligence to determine the general viability of hedge funds – this is not to be construed as an endorsement, sponsorship, and/or implied guarantee. Please note that our due diligence process is subject to change at any time.



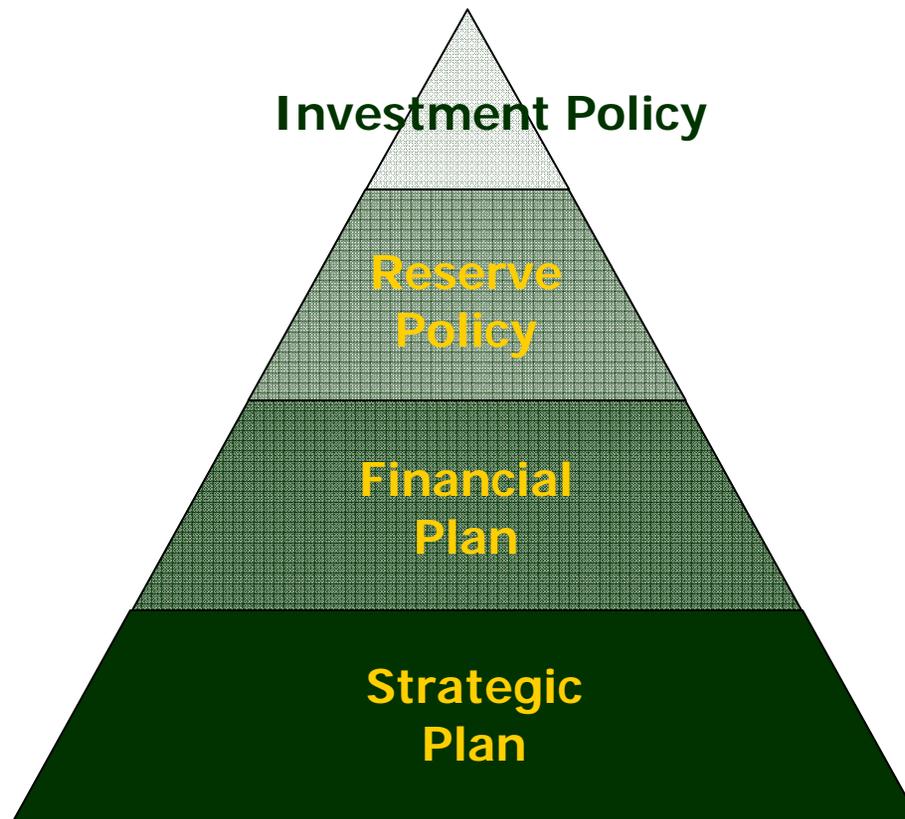
# Due Diligence Considerations For Nonprofits

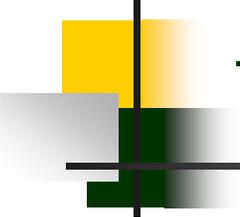
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## Financial and Accounting Considerations

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Washington, DC 20005  
202-419-5101  
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# The Foundation of a Sound Investment Policy

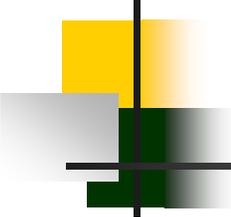




# FAS 117-1 - Endowments of Not-for-Profit Organizations

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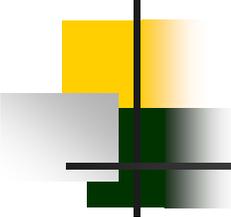
- *Donor-restricted* endowments in states which have enacted UPMIFA
- Investment earnings are time restricted until appropriated for expenditure
- Eliminates historic-dollar threshold
- Retention of purchasing power



# FAS 117-1 Disclosures

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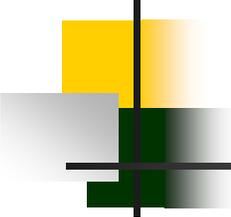
- Interpretation of law
- Appropriation/spending policies
- Investment policies
- Composition by net asset class
- Reconciliation of balances
- Nature and type of restrictions
- Aggregate deficiencies



# UPMIFA's Spending Criteria

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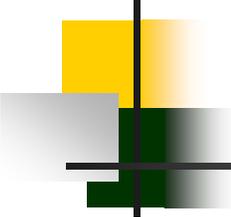
1. Duration and preservation of the endowment fund
2. Purposes of the institution and the endowment fund
3. General economic conditions
4. Effect of inflation or deflation
5. Expected total return from income and the appreciation of investments
6. Other resources of the institution
7. Investment policy of the institution



# UPMIFA in DC, MD, VA

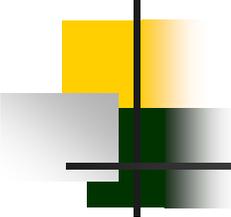
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- DC – enacted in 2008
- VA – enacted in 2008
- MD – introduced in 2009



# FSP 117-1 Accounting

	Board Designated (Unrestricted)	Temporarily Restricted	Permanently Restricted	Total
<b>Balance, June 30, 2007</b>	\$ 35,922	\$ 14,369	\$ 93,398	\$ 143,689
<b>Accumulated earnings without restriction</b>	(28,738)	28,738		-
<b>Reclassified Balance, June 30, 2007</b>	7,184	43,107	93,398	143,689
<b>Investment income</b>	287	2,587		2,874
<b>Net appreciation</b>	835	7,786		8,621
<b>Total investment return</b>	1,122	10,373	-	11,495
<b>Amount required to maintain purchasing power</b>		(275)	275	-
<b>Contributions</b>			2,000	2,000
<b>Appropriated for expenditure</b>	(359)	(6,825)		(7,184)
<b>Transfer to operating fund</b>	(1,000)			(1,000)
<b>Balance, June 30, 2008</b>	\$ 6,947	\$ 46,380	\$ 95,673	\$ 149,000



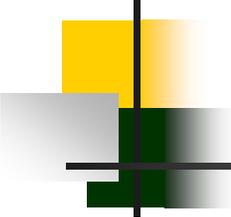
# FSP 117-1 Accounting

	Board Designated (Unrestricted)	Temporarily Restricted	Permanently Restricted	Total
Balance, June 30, 2008	\$ 6,947	\$ 46,380	\$ 95,673	\$ 149,000
Interest and dividends	298	2,396	286	2,980
Net depreciation	(288)	(2,310)		(2,598)
Total investment return	10	86	286	382
Contributions			2,000	2,000
Appropriated for expenditure	(373)	(7,077)		(7,450)
Transfer from unrestricted funds	500			500
<b>Subtotal</b>	<b>7,084</b>	<b>39,389</b>	<b>97,959</b>	<b>144,432</b>
Amount required to restore original gift	(125)	125		-
Appropriated for expenditure	(75)	75		-
Fair value below amount required	(200)	200	-	-
<b>Balance, June 30, 2009</b>	<b>\$ 6,884</b>	<b>\$ 39,589</b>	<b>\$ 97,959</b>	<b>\$ 144,432</b>

# FSP 117-1 Accounting

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Balance, December 31, 2007	\$ -	\$ 750,000	\$ 21,000,000	\$ 21,750,000
Interest and dividends	-	1,000,000	-	1,000,000
Net depreciation	(7,750,000)	(1,750,000)	-	(9,500,000)
Total investment return	(7,750,000)	(750,000)	-	(8,500,000)
<b>Balance, December 31, 2008</b>	<b>\$ (7,750,000)</b>	<b>\$ -</b>	<b>\$ 21,000,000</b>	<b>\$ 13,250,000</b>

	December 31	
	2008	2,007
Investments		
U.S. government obligations	-	500,000
Certificates of deposit	200,000	400,000
Corporate bonds	1,200,000	600,000
Mutual funds	3,500,000	6,200,000
Foreign certificates of deposit	-	6,600,000
Limited Partnerships	3,700,000	3,700,000
Rare coins and bullion	400,000	500,000
	<b>9,000,000</b>	<b>18,500,000</b>



# FSP 117-1 Disclosure

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**Funds with deficiencies:** From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or SPMIFA requires the Organization to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature that are reported in unrestricted net assets were \$7,750,000 as of December 31, 2008. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs that was deemed prudent by the Board of Trustees. There were no such deficiencies as of December 31, 2007.

# Speaker Biographies

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## Jeffrey S. Tenenbaum

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### AREAS OF PRACTICE

Tax and Wealth Planning

Antitrust

### INDUSTRIES

Nonprofit Organizations

Credit Counseling and Debt Settlement

### BAR ADMISSIONS

District of Columbia

### EDUCATION

Catholic University of America  
Columbus School of Law, J.D.,  
1996

Political Science, University of  
Pennsylvania, B.A., 1990

### MEMBERSHIPS

American Society of Association  
Executives

California Society of Association  
Executives

New York Society of Association  
Executives

Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group, as well as its Credit Counseling and Debt Settlement Industry Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished and respected author, lecturer and commentator on nonprofit legal matters. Based in the firm's Washington, D.C. office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting trade and professional associations, charities, foundations, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and arbitration.

Mr. Tenenbaum devotes his full time and attention to the legal issues facing nonprofit organizations, as well as credit counseling agencies and debt settlement companies. His exclusive concentration and his broad-based experience in this unique legal discipline enable Mr. Tenenbaum to provide his clients with pragmatic solutions to their legal challenges on a responsive and cost-efficient basis.

### HONORS

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

Legislative Assistant, U.S. House of Representatives, 1990-93

AV Peer-Review Rated by Martindale-Hubbell

## ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

## PUBLICATIONS

Mr. Tenenbaum is the author of the popular book, *Association Tax Compliance Guide*, published by the American Society of Association Executives, and is a contributor to numerous ASAE & The Center for Association Leadership books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. In addition, he is a frequent author for ASAE & The Center and many of the major nonprofit industry organizations and publications, having written more than 250 articles on nonprofit legal topics. For a listing of and links to Mr. Tenenbaum's published articles, please visit [www.Venable.com./nonprofits/publications](http://www.Venable.com./nonprofits/publications).

## SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer for ASAE & The Center for Association Leadership and many of the major nonprofit industry organizations, conducting over 30 speaking presentations each year, including many with top Internal Revenue Service, Federal Trade Commission, U.S. Department of Justice, Federal Communications Commission, and other governmental officials. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *The Washington Post*, *The Washington Times*, *The Baltimore Sun*, *Washington Business Journal*, *Legal Times*, *The New York Sun*, *Association Trends*, *CEO Update*, and other periodicals. For a listing of Mr. Tenenbaum's past and upcoming speaking engagements, please visit our website.

## REPRESENTATIVE CLIENTS

American Association of Homes and Services for the Aging  
American Association of Museums  
American College of Radiology  
Air Conditioning Contractors of America  
American Society for Training and Development  
American Society of Association Executives  
American Society of Civil Engineers  
American Society of Clinical Oncology  
American Staffing Association  
Association for Healthcare Philanthropy  
The College Board  
Homeownership Preservation Foundation  
Independent Insurance Agents and Brokers of America  
Money Management International  
National Association of Chain Drug Stores  
National Coalition for Cancer Survivorship  
National Defense Industrial Association  
National Fallen Firefighters Foundation  
National Hot Rod Association  
National Propane Gas Association  
National Telecommunications Cooperative Association  
The Nature Conservancy  
Project Management Institute  
Public Health Accreditation Board  
Public Relations Society of America  
Romance Writers of America  
Trust for Architectural Easements



## Rory M. Cohen

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### PRACTICE FOCUS

Rory Cohen focuses his practice on advising private investment funds, funds of funds and investment managers on structuring and formation as well as operational, distribution, regulatory and compliance issues. Mr. Cohen assists financial institutions in the structuring and implementation of separate account wrap fee programs, unified managed accounts, variable life insurance products, private fund distribution and regulatory examinations. Mr. Cohen has extensive experience negotiating and structuring seed capital arrangements, private fund access platforms and advising on investment manager and private investment fund due diligence. His counsel relates principally to the Investment Company Act of 1940, Investment Advisers Act of 1940, the Securities Exchange Act of 1934 and FINRA and state blue sky laws and regulations.

### SIGNIFICANT MATTERS

As a Managing Director at Bear Stearns, Mr. Cohen counseled several of the organization's entities on asset management activities, including Bear Stearns Securities Corp., Bear Stearns Asset Management Inc. and Bear Stearns & Co. Inc. During his tenure, among other things, Mr. Cohen supervised the development, implementation and distribution of separate account, mutual fund/ETF and hedge fund platforms. Mr. Cohen also played a key role during the spin-out of an \$8 billion asset manager by Bear Stearns Asset Management Inc. in mid-2007. As Associate General Counsel at Prudential Securities Inc., Mr. Cohen advised on development and implementation of investment advisory and wrap fee programs as well as day-to-day compliance and disclosure issues.

Mr. Cohen is a member of the Association of the Bar of the City of New York.

### EDUCATION

J.D., Boston University School of Law, 1994

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B.B.A., University of Michigan, 1991

### BAR ADMISSIONS

New York

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New Jersey

### AREAS OF PRACTICE

Business Transactions

## SPEAKING ENGAGEMENTS

Mr. Cohen is a frequent speaker on topics dealing with regulation of hedge funds and investment advisers. His recent speaking engagements include:

- "Legal Quick Hit: Practical Due Diligence Considerations for Nonprofit Investment Fiduciaries," Association of Corporate Counsel's Nonprofit Organizations Committee, March 10, 2009.
- "Regulatory Guidelines for Providing Timely and Informative Reports," Financial Research Associates' Marketing and Client Services for Hedge Funds Conference, New York, NY, February 25, 2009.
- "Investor Due Diligence In A Nutshell," Financial Research Associates' Hedge Funds A - Z Conference, New York, NY, January 22, 2009.
- "The Characteristics and Structure of Funds of Funds", Financial Research Associates' Hedge Funds A - Z Conference, New York, NY, January 22, 2009.
- "Exploring the Current and Future Regulatory Environment," Opal Financial Group's 11th Annual Alternative Investing Summit, Laguna Niguel, CA, December 9, 2008.
- "Seed Fund Investments: Legal, Regulatory and Compliance Issues," Financial Research Associates' 5th Annual Hedge Fund Incubation and Seeding Conference, New York, NY, July 29, 2008.
- "Discovering and Disclosing Conflicts of Interest: Obligatory Guide for the CCO," Hedge Fund Taxation & Compliance Forum Conference Sponsored by the Institute for International Research, New York, NY, June 19, 2008.
- "Hedge Fund Performance Presentation and Disclosure," Hedge Fund Taxation & Compliance Forum Conference Sponsored by the Institute for International Research, New York, NY, June 19, 2008.
- "Surviving an SEC Examination in Response to the New Inspection Letter," Half-Day Workshop at the Institutional Investor Chief Compliance Officer Forum, New York, NY, March 12, 2008.
- "Legal Issues Relating to Seeding Private Investment Funds," Faculty Presenter at Stroock & Stroock & Lavan LLP CLE Course, New York, NY, January 10, 2008.
- "Ensuring You Receive Optimal Fees and Terms for Your Investment," GAIM Hedge Fund Operational Due Diligence Conference, Grand Cayman, Cayman Islands, May 14, 2007.
- "Custody, Proxy Voting, Suitability and Investment Restrictions," The ABCs of Investment Adviser Regulation Sponsored by the Practising Law Institute, New York, NY, May 9, 2008, May 11, 2007 and November 17, 2006.
- "Wrap Fee Programs - New Challenges in a Familiar Framework," ALI-ABA Course of Study – Investment Adviser Regulation, Washington, D.C., January 27, 2007.

## Michael H. Graham

The Graham Group at Merrill Lynch



**Michael H. Graham, CIMA®**, *First Vice President, Institutional Consultant*, began working in the financial services industry in 1979 and joined Merrill Lynch in 2000. Michael is one of 63 designated Institutional Consultants at Merrill Lynch. Michael specializes in providing investment consulting services to non-profits such as associations, endowments, foundations, religious organizations, scientific societies and colleges/universities. Prior to joining Merrill Lynch, Michael was a Financial Advisor at Legg Mason from 1988-2000. While there, he founded the American Society of Association Executives (ASAE) *Association Investment Program* and served as Director of the program from 1992 to 1999. Under his leadership, the program grew to over \$1 billion. In addition, he provided investment consulting services to his clientele. Prior to joining Legg Mason, Michael was President of Capital Management Services, 1984-1988, a research analyst at T. Rowe Price, 1982-1984, and an investment banker at Dean Witter, 1979-1982.

Michael is a graduate of the University of Virginia's McIntire School of Commerce (BS Commerce) and the Darden School (MBA) where he was selected the Samuel Forrest Hyde Memorial Fellow. Michael is a Certified Investment Management Analyst (CIMA) and a member of the Investment Management Consultants Association (IMCA) where he serves on the Certification Committees. In addition, he is an associate member of the ASAE, a member of the Washington Financial Management Round Table and a member of the Finance and Administration Roundtable (FAR). In January of 2007, Michael obtained the Endowments and Foundations Certification from the University of Pennsylvania's Wharton School.

Michael has been a frequent speaker on the topic of managing the investments of nonprofit organizations. Groups he has spoken before include the ASAE, FAR, the Greater Washington Society of Association Executives (GWSAE), National Association of Treasurers of Religious Institutes (NATRI) and the Executive Offices Council of the National Association of Home Builders of the US (NAHB). In addition, Michael has educated other Financial Advisors at Merrill Lynch and his previous firm about the process required to successfully manage a non-profit organization's investments.



## Charles F. Tate, CPA

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### Function and Specialization

Mr. Tate is the Firm's managing partner and has more than 30 years of experience in the nonprofit sector.

### Education, Licenses & Certifications

B.S., Indiana University of Pennsylvania  
M.S., Finance, American University  
CPA licensed in the District of Columbia,  
Virginia, and Maryland  
CFP – Certified Financial Planner  
CLU – Certified Life Underwriter

### Education, Licenses & Certifications

- Co-Founder of Nonprofit CFO of the Year Awards
- ASAE Fellow and member of Public policy Committee
- Treasurer, Yellow Ribbon Fund
- Past President of the Greater Washington Society of CPAs
- Former Member, AICPA Tax-Exempt Organizations Committee
- Former Audit Committee Member, Chevy Chase Village Municipal Government
- Past Chair, Catholic Cemeteries of the Archdiocese of Washington, DC

### Background

Charles Tate is the Firm's managing partner and has over 30 years of experience working with nonprofit organizations. Prior to forming the Firm, he worked in the Washington, DC office of Ernst & Young, LLP where he began working with nonprofit organizations.

### Professional and Industry Experience

Mr. Tate has more than 30 years of experience providing auditing, tax and consulting services to nonprofit organizations and associations such as the Public Company Accounting Oversight Board, National Association of Insurance Commissioners, American Chemical Society, National Federation of Independent Business, and the National Association of Home Builders to name just a few.

### Speaking Engagements

He is also a regular presenter to nonprofit groups and boards on the topics of emerging financial practices and financial governance. A few of Mr. Tate's recent presentations include:

- **COSO Framework in the Nonprofit Environment**, 2008 GWSCPA Not-for-Profit Symposium
- **Living with the New Form 990: Major Changes and Implications for the Tax-Exempt Community**, 2008 ASAE and the Center for Association Leadership
- **Creating an Ethical Framework to Manage Your Organization**, 2008 Finance and Business Operations Symposium (FBOS), ASAE & the Center for Association Leadership
- **Overview of Deferred Compensation Plans in the Tax-Exempt Community**, 2008 ASAE Key Industry Association Committee (KIAC)
- **What Tax-Exempt Organizations Need to Know About the New Form 990, Issue Briefing with Lois Lerner, Director, IRS Exempt Organizations Division**, 2007 ASAE & the Center for Association Leadership
- **Emerging Financial Practices in the Aftermath of Sarbanes-Oxley: A Proactive Approach**, 2006 Annual Meeting, ASAE & the Center for Association Leadership, The Council of Engineering and Scientific Society Executives (CESSE) Institute
- **Internal Controls – Application of COSO's 2006 Guidance to Nonprofit Organizations**, 2006 Greater Washington Society of CPAs, Not-for-Profit Symposium
- **Internal Control for Nonprofit Organizations and Non-Public Companies**, 2006 Virginia Society of CPAs, Accounting and Auditing Conference

### Publications and Articles

- *Guide to the Newest IRS Form 990*, published by the American Society of Association Executives (ASAE) & the Center For Association Leadership
- "Enron-Proof Oversight," *Association Management Magazine*
- "Understanding Reserves and Investments," *Association Management Magazine*
- "The Truth About Audits," *Association Management Magazine*
- "Funding Your Future," *Association Management Magazine*

# Additional Materials

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Please contact any of the following attorney authors if you have any questions regarding this 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.<sup>[1]</sup> (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 firms compliance policies and procedures."<sup>[2]</sup> 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.<sup>[3]</sup> 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 Client 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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<sup>[1]</sup> 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.

<sup>[2]</sup> 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>.

<sup>[3]</sup> 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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