

# Recommended Best Practices in Managing Foundation Investments – Practice Tips and Resources

Updated October 2011

**Practice 1. The board (and investment committee and staff, if any) of a foundation should understand and fulfill their respective fiduciary responsibilities and duties under applicable law and the governing documents of the foundation and stay informed regarding any relevant changes in law, duties, or responsibilities.**

## Practice Tips

1. Ask an outside expert, such as a lawyer or investment professional, to periodically discuss with the persons responsible for investment management their respective duties and responsibilities
2. Attend conferences or take advantage of other continuing education opportunities to stay informed.
3. Review articles or other sources of information relating to the appropriate oversight of investment management and changes in law. Each year, all board members should review the foundation's articles of incorporation, bylaws, investment policy statement, and, the committee's charter if it has an investment committee.
4. Educate new board members, staff, or investment committee members by providing and explaining the foundation's organizing documents.

## Resources

### From the Council on Foundations

[Council Governance Documents](#)

[Changes in Intermediate Sanctions for Donor Advised Funds and Sponsoring Organizations](#)  
[Intermediate Sanctions Regulations Checklist](#)

[Prohibited Benefits from Donor Advised Funds](#)

[Changes in Intermediate Sanctions for Supporting Organizations](#)

[Excess Business Holdings](#)

## **From Others**

Association of Small Foundations, *Principles of Foundation Investment Management*, Griswold, John S. (Commonfund Institute) (available from <http://www.smallfoundations.org> ).

Cambridge Associates, [Endowment Management: Key Questions](#) (2008),

Commonfund Institute, [Principles of Nonprofit Investment Management](#)

CFA Institute, [Investment Management Code of Conduct for Endowments, Foundations and Charitable Organizations](#)

Fiduciary 360 ([www.fi360.com](http://www.fi360.com)):

*Prudent Practices for Investment Stewards* (2008)

*Prudent Practices for Investment Advisors* (2008)

*Prudent Practices for Investment Managers* (2006)

*Council / fi360 Council on Foundations [Webinar Archive](#): How to Meet Your Fiduciary Duty to Monitor Investments*; available from the Council's webinar archive

[Guidelines for Advisors on the Uniform Prudent Investor Act](#)

[Vanguard Fiduciary Toolkit](#)

**Practice 2. The foundation should adopt an Investment Policy Statement that contains a clear description of the roles of the board, an investment committee, if any, staff, and outside investment management service providers. The Investment Policy Statement should also include the foundation's investment objectives and strategy for achieving those objectives, the risks associated with the strategies, liquidity needs, asset allocation approach, permitted investments, and diversification among asset classes. The foundation should periodically, but at least annually, review its Investment Policy Statement to ensure compliance and determine whether or not any changes are warranted.**

## **Practice Tips:**

1. Retain an expert to assist in the development or review of a suitable investment policy statement.

2. If the foundation has sufficient experience or expertise without engaging outside experts, use available resources, including model policy statements, to develop an investment policy statement tailored to the foundation's particular needs. Include the following elements: the foundation's objectives and strategy, how it is organized to address investment matters, asset allocation for the portfolio, diversification strategy, risk tolerance, delegation of decision making authority, permitted investments, and excluded investments. Consider including the due diligence process for selecting, monitoring and terminating service providers or managers.
3. Address the liquidity needs of the foundation, ideally with a liquidity policy that is relevant to the circumstances of the foundation and its investment philosophy.
4. Schedule time at one board meeting each year to review the investment policy statement and keep minutes regarding the discussion. Plan for this review generally at the same time each year and develop a specific process for it.
5. Consider whether to adopt a policy of pursuing active ownership strategies such as proxy voting, filing shareholder proposals, and other forms of engagement with corporations represented in its investment portfolio. Some foundations believe active ownership is a critical part of the foundation's stewardship of its assets. Foundations that have adopted policies and procedures to guide this strategy may target selected areas, such as improving corporate governance, transparency, shareholder rights, executive compensation, or particular program areas.

## **Resources**

### **From the Council on Foundations**

#### ***Council publications***

[What You Need to Know: Developing an Asset Allocation Strategy](#) (2008)

[Council governance documents: investments](#)

#### ***Council Webinars***

[What Every Fiduciary Must Embrace about Investment Risk and Volatility](#)

[Practical Applications of Achieving Fiduciary Excellence](#)

[The Fiduciary's Business Plan -- The Investment Policy Statement](#)

### **From Others**

CFA Institute, [Elements of an Investment Policy Statement for Institutional Investors](#)

Ford Foundation, [Charter for Proxy Committee](#)

Hartford Foundation for Public Giving, Proxy Voting Policy Statement (need hyperlink)

[Rockefeller Brothers Fund, Investment Policy Statement](#)

[Guidelines for Voting Proxies,](#)

Nathan Cummings Foundation, [Shareholder Activity Guidelines](#)

Nathan Cummings Foundation, [Proxy Voting Guidelines](#)

[Vanguard Sample Investment Policy Statement](#)

## **Examples of Proxy Voting Advisory Services**

[Risk Metrics Group](#) (ISS)

[MoxyVote](#)

**Practice 3. The foundation’s board, consistent with state law, should determine whether to delegate primary oversight of the investment function to an investment committee which has the requisite experience and knowledge to provide prudent oversight; if the board elects not to constitute such a committee it must ensure that the board has the necessary experience and knowledge to perform the oversight function.**

## **Practice Tips**

1. Assess, with the help, if necessary, of a financial management expert, whether the foundation has the persons and resources to prudently manage its investment portfolio. Consider in this regard the practices of other similarly situated foundations. If the board does not have the necessary expertise, consider retaining an expert financial management consultant to assist in managing investments.
2. Depending on the size and sophistication of the foundation’s governing board, consider forming an independent investment committee, and delegating to it principal authority for the oversight of investments. If the board or committee lacks sufficient expertise, consider adding such persons to the board or including them on the committee. Adopt a written statement that sets forth the role, authority, and duties of the investment

committee. This could take the form of an amendment to the foundation's bylaws, a committee charter, or a provision in the investment policy.

## Resources

### From the Council on Foundations

#### ***COF Publications***

[What You Need to Know: Developing an Asset Allocation Strategy](#) (2008)

#### ***COF Webinars***

[What Every Fiduciary Must Embrace about Investment Risk and Volatility](#)

[Practical Applications of Achieving Fiduciary Excellence](#)

[The Fiduciary's Business Plan -- The Investment Policy Statement](#)

### From Others

[2008 National Board Governance Survey for Not-for-Profit Organizations](#), Grant Thornton

[Legal, Ethical, Prudent and Effective: Investment Advisory Committee](#)

[Best Practices](#), 2007 Fall Conference for Community Foundations, Thayer, Scott, CIMA (Sept. 2007).

Mintz, Joshua J., *The Roles and Responsibilities of Investment Committees of Not-for-Profit Organizations* (2009) (Available at [www.macfound.org](http://www.macfound.org))

[Vanguard Investment Committee Checklist, Investment Committee Member Checklist](#)

[What financial information should board members review?](#) Governance practices for nonprofit board members and executives, Issue 12, Grant Thornton

**Practice 4. The foundation should adopt procedures for selecting, monitoring, evaluating, and terminating each investment management service provider that includes ongoing due diligence. The foundation should periodically review its compliance with the procedures and the effectiveness of these procedures.**

### **Practice Tips:**

1. Create or adopt a written checklist or set of procedures for the foundation to follow in the due diligence, evaluation, and monitoring of its investment processes. (Sample checklists are listed under Practice 2.) Review the checklist annually and evaluate the compliance with it at a board meeting.
2. Persons responsible for investment oversight (whether the board, a committee, outside consultants, or investment staff) should:
  - a. Understand and be able to explain the investment management service providers' investment strategy.
  - b. Understand and be able to explain the amount and calculation of fees charged or to be charged.
  - c. Evaluate the need for an independent custodian to hold or have custody of the foundation assets.
  - d. Visit, inspect, and verify what the foundation's investment management service providers are doing.
  - e. Engage in efforts to minimize the risk of fraud, including confirming the identify and role of the auditing firm for an investment management service provider, understanding how the service provider is regulated and reviewing the service provider's filing with regulatory authorities if available (including, as applicable, Form ADV required by the Securities and Exchange Commission for investment dealers or filings required to made with other accreditation authorities and state and federal reporting authorities).
3. Report investment performance to the board at least quarterly, with comparisons to the relevant asset class benchmarks.

## **Resources:**

Council on Foundations Webinar Archive: [What Every Fiduciary Must Know about Investment Fees and Speculation](#)

AICPA, [What Does Audit Standard SAS No. 99 \(Consideration of Fraud in a Financial Statement Audit\) Mean for Business and Industry Members?](#)

[Auditing Alternative Investments\\* A Practical Guide for Investor Entities, Investee Fund Managers and Auditors, PriceWaterhouseCoopers \(April 2007\).](#) (Comprehensive guide)

[National State Attorneys General Program at Columbia University Law School](#)

DeLucia, Michael, [Preventing Fraud: From Fiduciary Duty to Practical Strategies](#), New Hampshire Law Journal, (Summer/Autumn 2008). (<http://www.nhbar.org/uploads/pdf/BJ-Fall2008-PreventFraud.pdf> )

Proskauer Rose LLP, [\*Four times Five is \(Fifty\) and Four Times Six is \(Eighty\): A Discussion of Investment Management Practices for Charities in the Wake of Madoff \(January 2009\)\*](#). (Recommends list of specific internal governance and investment policies)

[Statement by Leon M. Metzger before the Committee on Financial Services, United States House of Representatives \(January 5, 2009\)](#). (Due diligence checklist)

Tate & Tryon, [Summary of New Audit Standards and their Impact on Nonprofits](#) =

U.S. Securities and Exchange Commission, [REPORT OF INVESTIGATION, Case No. OIG-509, Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme, Executive Summary](#) (2009)

Venable, LLP, [Due Diligence Considerations for Nonprofit Investment Fiduciaries, Seminar \(Thursday, May 7, 2009\)](#) ([http://www.venable.com/files/Publication/405c67c9-d836-4ea0-a87e-6b93598b128e/Presentation/PublicationAttachment/22441015-12ac-4c38-8c33-6eb5abbcfb3c/Due\\_Diligence\\_Seminar\\_5.7.09.pdf](http://www.venable.com/files/Publication/405c67c9-d836-4ea0-a87e-6b93598b128e/Presentation/PublicationAttachment/22441015-12ac-4c38-8c33-6eb5abbcfb3c/Due_Diligence_Seminar_5.7.09.pdf))

**Practice 5. The foundation should have, and should ensure that investment management service providers have, policies and procedures that provide reasonable assurance of compliance with applicable law and of the prevention or timely detection of unauthorized investment or use of the foundation's assets.**

### **Practice Tips:**

1. Obtain written assurances from provider of commingled funds as to the provider's legal compliance process as well as its risk management controls.
2. When opening separate accounts with a service provider enter into written agreements that set forth among other things:
  - a. The service provider's investment strategy, including use of leverage if any;
  - b. Limitations on the types of securities in which the service provider may invest;
  - c. A statement (or incorporation by reference) of the applicable provisions of the foundation's investment policy statement;
  - d. The service provider's fee structure; the right to prompt notification upon certain major service provider events (e.g., departure of key persons, change of control of the company, withdrawal of a material percentage of assets from the strategy, material litigation);
  - e. The type and frequency of reports the service provider will provide the foundation;
  - f. The benchmarks(s) against which the service provider's performance will be measured;
  - g. Reports, at least monthly of the service provider's performance; and

- h. A periodic affirmations of the service provider's compliance with all of the provisions of the agreement.
3. Regularly review reports from the service provider and third parties (e.g. the service provider's auditors) to monitor the provider's performance and compliance with the agreement. Consider periodic site visits as part of the review process.

## Resources:

Fiduciary 360, [Prudent Practices for Investment Advisors; Prudent Practices for Investment Managers](#) (available at [www.fi360.com](http://www.fi360.com))

[Self-Assessment of Fiduciary Excellence for Investment Managers, Self-Assessment of Investment Advisors](#) (available at [www.fi360.com](http://www.fi360.com))

**Practice 6. The foundation's board (or its investment committee, if any) should ensure that its members are provided with information, including regular reports, sufficient to permit the board (or committee) to fulfill its ongoing oversight function.**

## Practice Tip

Schedule time at one board meeting each year to review the investment policy statement, and investment performance. Keep minutes of the discussion. Plan for this review generally at the same time each year and develop a specific process for it.

## Resources

[Vanguard Fiduciary Toolkit](#)

**Practice 7. The foundation should adopt procedures to ensure that any conflicts of interest of members of the foundation's board, investment committee, foundation staff, and investment management service providers are appropriately addressed and that the foundation carries out the investment function in compliance with all applicable ethical policies and guidelines.**

## Practice Tip

Adopt a conflict of interest policy that has certain core components with respect to the entire business of the organization, including, as applicable, grantmaking investments and other



business transactions. Require annual written disclosures from persons participating in the investment process (board, committee, staff, etc.) in which such parties disclose material affiliations with organizations with which the foundation could reasonably be expected to do business. Disclose any affiliation with any organization involved in any proposed transaction, investment, or retention of a consultant or manager.

## **Resources:**

### **From the Council on Foundations**

[Council sample conflict of interest policies](#)

### **From Others**

Boucher, Toni and Hudspeth, Stephen, [Ethics and the Nonprofit](#), Commonfund Institute (December 2008)

Ford Foundation, Policies on Conflicts of Interest ([www.fordfoundation.org](http://www.fordfoundation.org); [www.macfound.org](http://www.macfound.org))

## **Other Useful Resources**

### **Key Statutes and Regulations**

The [Uniform Prudent Management of Institutional Funds Act](#), see the Uniform Law Commission Web site (<http://www.upmifa.org>).

The [Uniform Prudent Investor Act](#), see the commentary accompanying the act by the National Conference of Commissioners on Uniform State Laws

### **IRS and Internal Revenue Code**

[IRS, Intermediate Sanctions – Excess Benefit Transactions](#)

[Taxes on Excess Benefit Transactions, 26 CFR 53.4958-1](#)

[Definition of Disqualified Persons, 26 CFR 53.4958-3](#)

[Excess Benefit Transaction \(defined\), 26 CFR 4958-4](#)

For information about state law requirements, consult your state's charity officials office, which is available from the [National Association of State Charity Officials](#) Web site ([www.nasconet.org/agencies](http://www.nasconet.org/agencies)), or your state's association of nonprofit organizations, which is available from the [National Council of Nonprofits](#) Web site ([www.councilofnonprofits.org/salocator](http://www.councilofnonprofits.org/salocator)).

For more information about IRS requirements, public charities and private foundations should consult the [IRS Lifecycle of an Exempt Organization](#) Web site.

# Appendix A

A collection of state and federal laws govern foundation investments. Some of these statutes codify the fiduciary obligations of a foundation's directors and officers. Others, such as the federal excess business holdings rule, regulate particular investments.

## State Law

Some foundations are organized as nonprofit corporations, while others take the form of charitable trusts. Different state laws apply to each type, although statutory enactments in recent years have done much to minimize the differences in the standards applicable to each.

The fiduciary duties of a nonprofit corporation's board derive from two basic sources: the nonprofit corporations act of the state in which the foundation is incorporated and, in all but a few states, the Uniform Prudent Management of Institutional Funds Act (UPMIFA).<sup>1</sup>

The fiduciary duties of trustees of charitable trusts stem from the common law of trusts and from the Uniform Trust Code (UTC) in states that have adopted that act. Trust investments are governed in most states by the Uniform Prudent Investor Act (UPIA).<sup>2</sup>

Despite these differences in the statutory construct, the standards both apply to foundation directors and trustees are substantively quite similar. This is due, in part, to a conscious effort on the part of those who drafted UPMIFA to conform that act as much as possible to the standards set forth in UPIA. However, there are a few differences in the two laws as drafted and there may be more in practice as some state legislatures made changes to the original during the enactment process.

Foundation directors, officers, and trustees should determine which body of law applies to the foundation, trust or corporate. Directors of nonprofit corporations should be familiar with the substantive standards established by the state in which the corporation is incorporated. Trustees of charitable trusts should determine which state's laws govern the trust. Under the Uniform Trust Code, this could be a state designated in the trust instrument or, in the absence of such a designation, the jurisdiction that has the most significant relationship to the matter at issue, normally the state in which the trust is principally administered.

State law generally identifies three essential duties of foundation fiduciaries: the duty of care; the duty of loyalty; and the duty of obedience. As applied to investment management:

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<sup>1</sup> UPMIFA, which replaces the older Uniform Management of Institutional Funds Act, has been adopted in forty-eight states and the District of Columbia. The states that have not enacted UPMIFA are Mississippi and Pennsylvania.

<sup>2</sup> Twenty-two states and the District of Columbia have adopted the Uniform Trust Code. Forty-six and D.C. have adopted the Uniform Prudent Investor Act.

- i. The duty of care generally requires that investment management decisions be made in good faith with the care of an ordinarily prudent person in like circumstances;
- ii. The duty of loyalty requires that when making decisions for the foundation that the decisions are made in the foundation's best interests – this is the conflicts standard; and
- iii. The duty of obedience requires that foundation fiduciaries know the law that applies to the foundation and that all actions taken comply with that law and the foundation's governing documents (e.g., its articles of incorporation, bylaws, instrument of trust).

## **Uniform Prudent Management of Institutional Funds Act (UPMIFA)**

UPMIFA requires that investment stewards act in good faith and with the care of an ordinarily prudent person in selecting investment agents and managers and in establishing the scope and terms of the decisions delegated to them. While internal and external investment management service providers consequently owe a duty to the foundation as a result of the delegation, the foundation investment fiduciary or fiduciaries exercising delegation authority have a continuing duty to the foundation to periodically review the agent's actions to monitor performance and compliance with the scope and terms of the delegation.

Most states have enacted UPMIFA, which updated and largely replaced the Uniform Management of Institutional Funds Act (UMIFA). UPMIFA generally does not cover charitable trusts, which are covered by the state's Uniform Prudent Investor Act (UPIA) and/or the Uniform Principal and Income Act. State enactments of UPMIFA may vary, but the essential requirements of UPMIFA, as they apply to investments, are:

- The duty of good faith prudent decision-making;
- The duty to diversify investments except in special circumstances;
- The duty to investigate, that is to engage in reasonable efforts to verify facts relevant to the management and investment of the fund;
- The duty to make decisions about selling or holding an asset within a "reasonable" time;
- The duty to minimize costs (fees); and
- The duty of board members with specialized skills to use those skills when participating in board matters.

Under UPMIFA, the factors that foundations fiduciaries or stewards must take into consideration when evaluating its investments include but are not limited to:

- The long- and short-term objectives of the foundation and its needs to make distributions and to preserve capital;

- General economic conditions;
- The possible effect of inflation or deflation;
- Expected tax consequences, if any;
- The role of each investment or course of action within the overall investment portfolio of the fund;
- The expected return from income and appreciation; and
- The asset's special relationship or value, if any, to the charitable purposes of the foundation.

## **Uniform Prudent Investor Act (UPIA)**

UPIA has been adopted in some version in the majority of states and the District of Columbia, and is applicable to charitable trusts. UPIA, many provisions of which were purposefully included in UPMIFA, similarly requires that trustees exercise “reasonable care, skill, and *caution*” in the selection of the agent, establishing the terms and scope of the delegation, and regularly reviewing the agent's actions to monitor performance and compliance with the scope and terms of the delegation.

## **Federal Law**

Federal law governing foundation investments takes place mostly through the tax code. Unlike the states, federal requirements do not differ based on whether a foundation is a corporation or a trust. However, they do differ based on whether a foundation is a private foundation or a public charity.

### ***Public Charities***

Investments by public charities are largely unregulated by the federal government. Section 4958 of the Internal Revenue Code imposes penalty excise taxes on public charity directors, and other persons having substantial influence over the charity, if they receive payments that exceed fair market value in connection with transactions with the charity. The Pension Protection Act of 2006 extended this penalty regime to include investment advisors to a public charity if they invest assets in a donor advised fund or pooled investments that include a donor advised fund. That act also prohibited paying compensation to an advised fund's donor or advisor and related parties, thereby barring payments to such persons in connection with managing the advised fund's assets. A similar prohibition applies to payments to a supporting organization's substantial contributor and related parties.

Section 514 of the Internal Revenue Code has the effect of substantially limiting the use of debt to leverage investments by imposing unrelated business income tax on investment income attributable to debt. This rule, which applies to both public charities and private foundations, has some exceptions but unless one of the exceptions applies, the tax will often diminish the

charity's return on a debt-financed income sufficiently to make it not competitive with investments that are not subject to debt.

Finally, the Pension Protection Act of 2006 extended the private foundation excess business holdings rule, see below, to assets held in a donor advised fund.

## ***Private Foundations***

In addition to the debt-financed property rules, the Internal Revenue Code directly regulates private foundation investments through its prohibition on "jeopardy" investments and indirectly through limits on a private foundation's ability to hold a controlling interest in most businesses – the excess business holdings rule. The Tax Code also bars most financial transactions between a private foundation and its directors, officers and trustees and persons related to them.

### **Jeopardizing Investments**

A private foundation is prohibited under the Internal Revenue Code and regulations from making an investment that jeopardizes the carrying out of a foundation's exempt purpose. Penalties can be substantial and can include fines against the foundation's directors and officers, and the foundation. Under IRS regulations, an investment is considered to jeopardize the carrying out of the exempt purpose of a foundation if the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long and short-term financial needs of the foundation under the facts and circumstances prevailing at the time the investment was made.

The tax regulations provide that the determination of jeopardy is made on an investment-by-investment basis, with certain investments and methods of investment, such as trading securities on margin, trading commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls and straddles, the purchase of warrants and selling short, subject to strict scrutiny.<sup>3</sup> However, the regulations also provide that individual investments are also to be viewed in the context of the foundation's portfolio as a whole. The IRS has ruled privately on several occasions that investments of the strict scrutiny variety will not cause a foundation to violate the jeopardy investment rule if the investments are part of a diversified portfolio.<sup>4</sup>

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<sup>3</sup> Treas. Regs. § 53.4944-1(a)(2)

<sup>4</sup> E.g., PLR 199939046 (investment of up to 20 percent of foundation assets in a partnership that took equity positions in private businesses and invested in other private equity partnerships).

## **Excess Business Holdings**

The intricacies of the excess business holdings rule are beyond the scope of this brief paper. However, the rule, which generally limits a foundation's ability to own a controlling stake in an active business enterprise, either by itself or in conjunction with interests held by its disqualified persons, closes off some investment opportunities. The principal exceptions cover businesses that are primarily investment vehicles – they receive 95 percent or more of their income from “passive” sources such as interest and dividends – and business that are “functionally related,” those that substantially further the foundation's exempt purposes.

## **Self-Dealing**

Private foundations generally are prohibited from engaging in financial transactions, directly or indirectly, with or benefiting “disqualified persons” even if the transaction is at fair market value or favors the foundation. While an exception to the self-dealing prohibition covers services by an investment manager who is a disqualified person of the foundation, the rule does prohibit the use of foundation resources to leverage a disqualified person's investments. Any participation by a private foundation in an investment partnership that includes disqualified persons should be preceded by careful review by the foundation's counsel with consideration given to obtaining a private letter ruling.