C | A

CAMBRIDGE ASSOCIATES LLC

INVESTMENT COMMITTEE GOVERNANCE: RECENT DEVELOPMENTS

August 2006

Ann Bennett Spence

CONTENTS

Investment Committee Governance: Recent Developments

The past 18 months have seen a cascade of events with implications for the governance of nonprofit institutions in general and investment committees in particular. Many of these events were driven by the spreading adoption of best practices based on the Sarbanes-Oxley legislation of 2002 (SOX), by judicial settlements, and/or by concern about the effects of market volatility on endowment portfolios. The following pages are intended to be a concise review of issues pertinent to investment committee members, offered with the *caveat* that further developments are pending. Full implications are still unfolding as of the date of this report.

The most significant developments are the following:

- Revision of Uniform Management of Institutional Funds Act (UMIFA);
- Evolving definition of fiduciary responsibility as a consequence of court settlements against Enron and WorldCom directors;
- Implementation of the American Institute of Certified Public Accountants' (AICPA) guidelines on fair valuation of alternative assets;
- The growing role of audit committees;
- Moody's focus on the strength of management and governance practices as critical to Moody's assessment of risk in the context of alternative investments by institutions with debt;
- Continuing efforts by the Senate Finance Committee, headed by Charles Grassley, to extend federal regulation of nonprofit entities, and the report of the Panel on the Nonprofit Sector which has been spearheading the nonprofits' response to such Congressional initiatives;
- Greater focus on accountability and risk, both of which terms are subject to multiple definitions; and
- The increasingly widespread adoption of conflict of interest policies not only at the board level but also at the investment committee level.

These seemingly disparate developments actually fall within four categories: (1) the law applicable to fiduciary responsibility; (2) its enforcement; (3) its evolving interpretation; and (4) second-order effects centering on changing views of accountability and risk, and coming from auditors and debt rating agencies.

The Law

The laws applicable to any given nonprofit entity[1] will differ according to (a) whether the organization has been established as a nonprofit corporation or as a trust; and (b) which particular state's laws apply to that organization. If the organization is a private foundation, then it will also be governed by federal legislation enacted in 1969. Additionally, all 501(c)(3) entities (i.e., tax-exempt entities) fall within the purview of the U.S. Internal Revenue Service (IRS).

The states' interpretations of fiduciary responsibility are (in most cases) based upon standards promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL). For *trusts*, this standard is the Uniform Prudent Investor Act (UPIA), promulgated in 1994 and substantially adopted by 40 states and the District of Columbia. For nonprofit *corporations*, the states have been guided by the UMIFA, which was promulgated in 1972 and substantially adopted by 47 states and the District of Columbia. As a standard to guide investment of assets, UMIFA has been badly outdated. Since the stock market tumble that started in 2000, which plunged many smaller or more recent endowments under water, there has been a strenuous effort to revise UMIFA in order to bring it in line with UPIA and modern portfolio theory. The effort had been bogged down by differences between corporate law and trust law, but a revised standard was finally issued by NCCUSL on July 13, 2006.[2]

The revised standard, called UPMIFA (with the "P" standing for Prudent) generally covers such investment practices as diversification of assets, whole portfolio management, and pooling of assets, as well as the total return investment approach. UPMIFA is expected to:

- Remove proscriptions or limits on specific types of assets for investment purposes, freeing fiduciaries to consider a broader range of investment strategies.

- Declare a 7% rule, under which annual spending in excess of 7% of endowment assets would be deemed imprudent.[3]

- Abolish historic value limitations on endowment spending; i.e., eliminate the spending effects of underwater endowments.

The promulgation of UPMIFA is good news for investment committees of nonprofit boards. If, as expected, it is adopted by most states, then the statutory basis for the fiduciary responsibilities of investment committee members will likely be more forgiving and certainly more in line with current approaches to endowment investment. The legitimacy of certain kinds of portfolio diversification, for example, will come more directly from statute rather than through prudence demonstrated by business judgment exercised in relation to the successful investment practices engaged in by other, respected institutions. In other words, for

[1] For the purposes of this report, the term nonprofit refers to an institution or organization that is exempt from taxation under Section 501(c)(3) of the 1986 Tax Code.
[2] Press release, *Major Overhaul of Rules Governing Charitable Institutions Approved,* July 13, 2006, www.nccusl.org.
[3] There is concern that this would seem to suggest that it is prudent to spend up to 7% when many argue that endowment spending should not exceed 5% or even 4%.

most sophisticated investment committees (which have undoubtedly consulted legal counsel), UPMIFA will simply mean firmer footing, rather than a change in investment approach.

Efforts to change the law are also found at the federal level. Committees in both houses of Congress have sought to increase oversight of tax-exempt organizations. For the most part, these have been in response to headline cases of board conflicts of interest, excessively generous executive compensation, and cases of abuse of the gift laws. The most active committee has been the Senate Finance Committee, headed by Charles Grassley. Working with this committee, the Panel on the Nonprofit Sector convened by Independent Sector and representing many nonprofit entities, has tried to minimize the expansion of federal regulation of nonprofits.

In the last week of June (2006) the Senate Finance Committee surprised the nonprofits by quickly passing legislation that marginally advanced federal regulation. Among other things, the legislation would require that IRS 990 forms be filed electronically, impose higher penalties on board members or top officials who engage in illegal self-dealing, and permit the IRS to share information with state regulatory officials. While most of these legislative measures had been recommended by the Panel on the Nonprofit Sector, the legislation omitted a top priority of the Panel.[4] At the time of this writing, the response of the Panel on the Nonprofit Sector is unknown. In addition, this Panel is expected to issue a phase II report, to supplement its extensive phase I report of June 2005, supplemented in April 2006.[5] Overall, it is generally thought that the Panel has thus far successfully deflected much of the effort to federalize further the regulation of nonprofit entities.

Thus, for the foreseeable future, the laws pertaining to tax-exempt organizations will continue to lie largely in state statutes. About one-third of the states have active charity offices within the offices of their attorneys general. Some believe that the degree of activity in state attorney general offices is directly related to the politics and calendars of state elections.

Enforcement

But what about enforcement? Notwithstanding the primary role of state law in defining and enforcing fiduciary responsibility, the exemption from federal taxation leads also to enforcement by the IRS. One obvious consequence of the Senate Finance Committee hearings and recommendations has been to spur the IRS to more active scrutiny of tax-exempt organizations. If the IRS finds inappropriate behavior on the part of top officers or trustees, it can revoke tax-exempt status or invoke intermediate sanctions. The latter, based on 1996 legislation, provide for federal penalties on trustees who authorize or receive gain from an excess benefit transaction with a disqualified person. Trustees can avoid this kind of prosecution through the adoption of an adequate conflict of interest policy.[6]

[4] "The top priority for nonprofit groups is a change in tax law that would allow people who do not itemize deductions on their tax returns to take deductions for giving to charity." *Chronicle of Philanthropy,* June 29, 2006.
[5] Phase I and supplemental reports are available at *www.NonprofitPanel.org.*
[6] See pp. 12-15 of our 2005 report *Conflicts of Interest: A Trustee's Guide to Conflict of Interest Policies with a Particular Focus on Investment Committees*.

Thus, actions that drive enforcement of the laws pertaining to tax-exempt entities can come from the direction of the states' attorneys general or from the IRS. Lacking shareholders, nonprofit corporations are accountable mainly to the public, i.e., the state or federal government, representing the public or representing the ostensible beneficiaries of the charitable organization. However, some nonprofits have found themselves subjected to lawsuits by donors who argue that fund stewardship has been inadequate or at odds with the intent of the donor, by various constituencies (e.g., alumni), or even by trustees objecting to the actions of other trustees. Sometimes such actions are triggered by unflattering headlines that bring attention to trustee decisions that had previously captured no public interest whatsoever.

Observers disagree about the degree of ardor in IRS and state attorney general enforcement actions. On the one hand, the IRS has announced that it is expanding staff dedicated to scrutinizing tax-exempt entities, with the considerable encouragement of the Grassley Committee. So too have some state attorneys general and state legislatures announced stepped-up legislation and reviews. However, at both the state and federal levels, budget strictures cut the opposite direction.

Finally, there is the steadily spreading notion that the measures required of publicly traded corporations by the SOX legislation should be adopted by nonprofit corporations (and trusts) as best practice. Observers have noted that SOX was itself a federalization of corporate law. That is, SOX created "unprecedented internal corporate governance requirements that hitherto were the exclusive province of the states,"[7] and it charged firms with the responsibility of having internal and external auditors, working with the board's audit committee, ensure compliance. In the case of nonprofit corporations, the states' laws remain firmly in the driver's seat (except as noted elsewhere in this report), but with the perhaps ironic twist that state attorneys general and legislatures may *choose* to adopt a federal standard.

Evolving Interpretation of Fiduciary Responsibility

In early 2005, the board members of Enron and WorldCom agreed to pay financial penalties for their alleged lapses in fiduciary responsibility. These unprecedented payments signaled an increased focus on a board's duty of care. In general, until these landmark settlements, successful board lawsuits tended to be based on charges of violation of the duty of loyalty rather than the duty of care. Thus, whereas previously a board member would typically worry only about avoiding conflicts of interest that might damage the corporation (violation of the duty of loyalty), now directors would also have to worry about failing to pay sufficient attention (violation of the duty of care).

To put it another way, previously the burden of proof was on the board member mainly in situations involving conflicts of interest, while the burden of proof was on *the party bringing suit* to prove that the board member had violated his/her duty of care. Now there is the perception that board members must also prove adequate care. After all, in the case of both Enron and WorldCom, board members did not enrich themselves from any of the transgressions of their firms; evidently they simply failed to grasp what was

[7] Delaware Supreme Court Justice Jack B. Jacobs, quoted in *Corporate Board Member Magazine, www.boardmember.com,* 2005.

going on or sufficiently inform themselves. Thus when these board members reached into their own pockets to settle pending lawsuits centered on their failure to exercise adequate care, many other corporate boards made haste to seek legal counsel, worried about this apparently broader definition of fiduciary responsibility.

It is important to bear in mind that these were cases of (a) evidently egregious board failure to pay attention and (b) for-profit corporations, not nonprofit corporations. Moreover, SOX applies only to publicly traded corporations, with two exceptions.[8] However, nonprofit boards should not overlook the spread of SOX standards as best practices for nonprofit corporations, as noted above. Nor should they ignore the fact that, in at least one high-profile case, the longstanding protection of the business judgment rule was sufficiently nullified by the *appearance* (no record to show otherwise) of insufficient care and attention—that a lawsuit that might otherwise have been thrown out actually went to trial. (See footnote 16 on page 8 for further discussion.) Hence, at least several leading authorities on the law believe that nonprofit board members would do well to become more attentive to their duties of care, chief among them the careful documentation of their decisions. Details appear in the "What to Do?" section on pages 7-9 of this report.

Changing Views of Accountability and Risk

The most obvious SOX effect has been the enhanced role of the audit committee. In some situations, the audit committee has begun to enter territory previously held exclusively by the investment committee, e.g., in valuation of alternative assets. Key developments with respect to audit committees are the following:

- Best practices specify an independent audit committee, consisting of independent board members (no internal officers except in an *ex officio,* non-voting capacity) and not constituted as part of the finance committee or any other committee of the board.

- External auditors report in executive session to the audit committee; they do not report to management.

- Audit committees are being advised by some external auditors to consider enterprise-wide risk, which includes (by some definitions) virtually anything that could have an adverse financial effect. To the extent that investment decisions are judged to have potentially material adverse financial consequences, investment committees should not be surprised to receive inquiries from audit committees.

- In particular, most recently, the AICPA has issued audit guidelines that suggest that external auditors extensively review the fair value of alternative assets.[9] This in turn has raised complex questions about how to provide adequate evidence of fair valuation for private investment partnerships whose underlying assets are not publicly disclosed, audited only at calendar year-end, or both. Because of

[8] The exceptions relate to whistle-blower protection and the prohibition on destruction of documents.
[9] This requirement is fleshed out in an audit advisory, *Alternative Investments – Audit Considerations: A Practice Aid For Auditors,* posted July 17, 2006, on the AICPA website, www.aicpa.org.

their relative opacity, and perhaps also because of adverse publicity in the popular press, hedge fund investments have raised particular concerns among external auditors. We expect that the just-issued auditor "practice aid" will, at the very least, lead to necessary communication between investment committees and audit committees in order to ensure that the latter are well-informed about the role of alternative assets in the overall investment portfolio and, in turn, their relation to overall portfolio risk. Absent such a perspective, there is a tendency to view alternative assets as stand-alone risks.[10]

- In short, corporate audit committees were explicitly charged by SOX legislation to oversee compliance. By the extension of best practices, this approach has spread to nonprofit institutions. Compliance is a broad mandate, and some audit committees have not been shy about stepping up to the plate. To date, much of the compliance effort has been focused on internal financial controls, but for organizations with sizable endowment assets, and particularly those with substantial investments in alternative assets, there will likely be considerable focus on asset valuation issues.

As audit committees have been energized by changes in the law and its enforcement and interpretation, so too have the debt rating agencies. After the passage of SOX, Moody's in particular began to focus on governance.[11] With the 2005-06 advent of proposed new AICPA audit guidelines, the firm beefed up its appraisal of investment committee governance. The very title of Moody's most recent report on this subject tells the story: *Changes in Audit Guidelines for Alternative Investments . . . Moody's Emphasizes Strength of Management and Governance Practices.*[12]

This report makes it clear that Moody's has little concern about alternative asset investments by *institutions that devote sufficient resources to the governance and management of such assets.* However, "if the investment accounts for a substantial portion of the liquidity of the organization, or implies significant control and governance challenges, there could be downward pressure on the rating." The report states that alternative investments require the devotion of sufficient cost, time, and expertise—whether through internal staff or through use of consultants—to ensure proper governance and management of such assets. "Benchmarking and comparative data" are also important. "Reliance on a few key board members to oversee investments" has become insufficient. In short, with adequate governance and management, expect no debt downgrade to result from the proposed changes in audit guidelines—unless external auditors were to issue a scope limitation or qualified opinion that *in itself* (even without a debt downgrade) were to trigger bond covenants, accreditation problems, or ineligibility for federal financial aid.

In general, throughout all SOX-related literature, there are repeated references to accountability and the control of risk. Both these terms are fraught with multiple interpretations that are worth pointing out. For

[10] For example, the AICPA website states that "the continued increase in the percentage of alternative investments to both net assets and total investment portfolio subjects these entities to complex fair value accounting and has *exposed their investment portfolios to greater risk and volatility*." (Emphasis added.) www.aicpa.org/members/div/auditstd/alternative_investments.htm

[11] *Moody's Approach to Analyzing Governance of Private Higher Education and Not-For-Profit Organizations,* Moody's Investor Service, December 2004.

[12] The full title: *Changes in Audit Guidelines for Alternative Investments Held by Higher Education and not-for-Profits Highlight Risks of These Strategies: Moody's Emphasizes Strength of Management and Governance Practices,* Moody's Investors Service, March 2006.

example, risk can be simply a synonym for probability or it can be a quantitative construct referring to volatility or other measurable attributes. For audit committees, it may cover not only the risks associated with audit-related risks such as inadequate financial controls, but also the risk of litigation, the risk of unflattering headlines, the risk of financial underperformance or strategic blunders or operating errors or the collapse of computer systems or even the disruptions engendered by avian flu or floods. It is a very broad brush, and indeed some boards have even introduced a risk committee—ordinarily not a particularly good idea, inasmuch as board structures already must deal with overlapping committee agendas even without an additional committee specializing in risk. Moreover, a fundamental conceptual problem is that there is no obvious way to calculate the trade-offs among the many kinds of risk, even were it possible to quantify all of these risks (e.g., what exactly is the cost of an embarrassing headline? How do we trade this off against the expected diversification benefits of a portfolio that includes alternative assets ill understood by the general public?).

Investment committees have always dealt with risk. In terms of investment committee business, perhaps the main concern—with respect to this expanded focus on risk—is that the risks attendant on investment choices not be swept into the broader concerns about audit risks or enterprise-wide risk in such a way as to distort or to distract from portfolio construction and evaluation. Certainly there has been a broadening of approaches to investment risk (which subject is beyond the scope of this report), but these clearly should remain within the mandate of investment committees which, if and as necessary, should characterize and report the risks to audit committees.

Similarly, there are multiple definitions of accountability. Most recently, the term is used as a synonym for good governance. That is, a well-governed institution will be accountable in several meanings of the term:

- responsible with respect to its finances (including investments) and practices,
- faithful in its stewardship of assets (including meeting donor intent), and
- effective in its operations such that its mission is well-served.

Some would add that accountability also means being answerable to one's variously-defined constituents or stakeholders. However, this expanded concept of accountability is not without its detractors, who point out that the logical extension of this line of reasoning is to constrain the strategic choices of the board, quite possibly with the result that the mission becomes ill-served rather than better served.[13]

What to Do?

Amidst these cross-cutting developments, investment committees can certainly be forgiven for registering puzzlement or even exasperation. On the one hand, there are those who prefer to wait and see, particularly with the effects of the very recent guidelines issued by the AICPA's Alternative Investments

[13] This conundrum underlies some of the recent high-profile governance issues that have surfaced in the popular press.

Task Force still unfolding. On the other hand, there are matters that can be readily addressed, and should be addressed in any event. Although some might appear to be mere housekeeping matters, they should be dealt with in full. The four main issues are: documentation, conflicts of interest, other questions of governance, and investment decision making. A full report could be written on each; here we provide no more than an outline.

Documentation: "Lose the minimalist approach to minutes."[14] In other words, become more rigorous. For example, minutes should record the fact that the investment committee received background materials, discussed the issues, weighed the data, and considered any opposing arguments that were made, before coming to a decision—even if that decision ultimately leads to an adverse investment outcome. *The point is to demonstrate that the questions were considered in a systematic way*, not that the right answer was arrived at. Fulfillment of the duty of care is extraordinarily difficult to demonstrate unless there is documentation of discussion, deliberation and *decision*.[15] Indeed, the very existence of good documentation is thought to discourage litigation. "If you adhere to your duty of care, your decision is protected."[16]

Tighten governance. Some boards and investment committees already have tight governance. Others do not. The basic ingredients include policy statements, well-defined committee roles, adequate cross-communication among board committees with overlapping responsibilities (e.g., in the area of endowment spending), and a well-functioning discussion and decision-making process that includes adequate time devoted to key questions.

Develop a conflict of interest policy for the investment committee. As noted earlier, an unexamined conflict of interest is an invitation to critics to question a fiduciary's duty of loyalty. As with any material investment decision, for a board to decide to do business with a disqualified person—e.g., a board member—there must be information (disclosure and data), discussion, and documentation. Recusal is typically an additional requirement. Details about conflict of interest

[14] Joseph Grundfest, Professor of Law and Business, Stanford Law School and former Commissioner of the SEC. Remarks at Stanford Law School forum for endowments and foundations, June 22, 2006.

[15] "The protection of the business judgment rule is not determined by the results of the decision, but by the quality of the process employed . . . when a loss originates from the board's failure to consider a problem, there has been no process, there is no decision to protect, and the business judgment rule does not apply." (Bill Kleinman and Gary L. Thompson, *Corporate Responsibility: The Board of Directors' Duty of Oversight, Part I,* Haynes and Boone LLP, August 26, 2002.) Hence, in order to demonstrate that there has indeed been a process, rigorous documentation is necessary, including documentation of the decisions made.

[16] Anna Erickson White, Morrison & Foerster LLP, remarks at a forum for endowments and foundations at Stanford Law School, June 22, 2006. This was underscored in the 2005 Disney case. Although in this case the board ultimately prevailed, the shocker (for most) was that the case even went to trial, under Delaware's business-friendly law. In the absence of documentation to the contrary, the court ruled that the directors had "knowingly made material decisions without adequate information or deliberation," demonstrating that they "did not care" if their decisions came to naught. A better record might have avoided nearly ten years of litigation around the Michael Ovitz compensation package. ("The Top 10 Legal Milestones of the Past 10 Years," Bingham McCutchen LLP, *Corporate Board Member Magazine, www.boardmember.com.*) The Disney case is also cited as a worrying indication of a possible move from a "good faith" standard to a "negligence" standard in determining whether a board is protected by the "business judgment" rule (*The New Reality of Personal Liability for Directors,* McKenna Long & Aldridge LLP, February 18, 2005), which rule has also shielded trustees of nonprofit organizations in most states.

policies can be found in our earlier report[17] and an update of this report can be expected shortly. Within the context of growing intolerance for conflicts of interest—a consequence of the adoption of SOX-driven best practices—arrangements that were perfectly acceptable just a few years ago probably bear re-examination because of the changed regulatory environment. This is not by any means to say that all conflicts of interest must be avoided. It is merely to say that they must be considered, and that the process of consideration must be documented.

Make investment decisions with sufficient context. Sound investment decisions must be grounded in sufficient supporting data, typically provided by staff and/or outside experts. Information brought to the table by investment committee members should certainly be considered, but is generally deemed to be only part of the picture.[18] Investment decisions should also be couched in the broader institutional picture: operating needs, liquidity needs, the spending rule, debt covenants, and such other matters as might be affected by portfolio composition and valuation.

Conclusion

Governance, hitherto an afterthought for investment committee members, has moved higher on the agenda because of recent developments in the regulatory environment affecting tax-exempt institutions and organizations. While matters are still very much in flux, few would argue that the heightened focus on governance will go away any time soon. Moreover, there is a potentially high-profile intersection between the course of investment developments and the course of governance developments. This is because the timing of volatility in the capital markets cannot be predicted, and since volatility can sometimes raise questions about certain past investment decisions particularly in the case of asset classes not well understood by the public, it is advisable for investment committees to be prepared in advance for potential criticism. Whether enlightened or unenlightened, hindsight can be unforgiving. The best time to prepare for it is during times of relative investment calm.

[17] See footnote 5.
[18] This point is made repeatedly in the governance literature, but perhaps most pointedly by Moody's, in their several publications on the subject of good governance.