

The Roles and Responsibilities of Investment Committees
of Not-For-Profit Organizations
(Revised July 2009)

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Introduction

The dizzying drop in financial markets, frauds like the Madoff scandal, hedge fund blow-ups, diminished liquidity and the prospect of a deep and lengthy recession has cast a spotlight on the role, responsibilities, and duties of the investment committee² of not-for-profit organizations.

Investment committees of not-for-profit organizations and the portfolios they oversee can vary widely. On one end of the spectrum are committees with sophisticated investors as members overseeing complex portfolios managed by experienced investment staff of the organization. At the other end are committees consisting of volunteer board members who may lack investment expertise responsible for small endowments with few if any investment staff.

Consequently, the appropriate role of an investment committee will depend on a number of factors. These include the size of the organization and its portfolio, the organization's culture and history, the presence of experienced in-house investment staff, the experience and sophistication of members of the committee and the financial objectives of the organization. Investment committees of large and sophisticated organizations, such as many universities or larger foundations that have professional in-house investment staff, will play a different role than committees for smaller not-for-profits that may lack access to experienced investment professionals.

Despite the differences, however, there are underlying principles that should guide the work of all committees. This article suggests practices that investment committees of large and small organizations should consider, identifies what makes an investment committee effective, and describes generally the legal framework governing the investment committee's decisions. These suggestions are based on the author's experience with a variety of committees and observations by experienced investment professionals.³

¹ The author is the Vice President and General Counsel of the John D. and Catherine T. MacArthur Foundation where he has worked closely with the Foundation's Investment Department and the Investment Committee since 1994. He also is the Treasurer and Chair of the Audit and Finance Committee of the Donors Forum where he led a review of the Donors Forum Investment Policy Statement and retention of outside experts, and he is a Vice-President and on the Finance Committee of the Juvenile Protective Association, a not-for-profit organization in Chicago, Illinois that also recently brought in an outside consultant to assist in investment matters. The author thanks John Vail of Quarles & Brady LLP for his comments on this article.

² The term investment committee is used broadly to include any committee (such as finance or audit committee) with responsibility for the management of the financial assets of a not-for-profit organization.

³ For example, Byron Wien, an internationally recognized investment professional and commentator who sits on a number of investment committees (including the MacArthur Foundation), provides a number of suggestions of how investment committees for larger organizations can be more effective in various settings. Wien, [Improving the Performance of Investment Committees](#) (2005). Other useful guidance is offered by Cambridge Associates in [Endowment Management, Good Governance and the Right People](#) (Cambridge Associates LLC, 2005). Michael Peregrine, a prolific writer regarding governance in the not-for-profit arena, also offers useful guidance for smaller organizations in particular. See Peregrine, [How Board Members Can Respond to Investment Turmoil](#), Chronicle

Although the suggested practices, if followed, would benefit most not-for-profits, each organization should consider these recommendations in light of their own circumstances and use those most relevant. Like many aspects of not-for-profit governance, one size may not fit all.

Suggested Practices

The Role and Authority of the Investment Committee Should Be Clearly Articulated and Understood by the Committee and the Board

The role and authority of the investment committee should be clearly spelled out in a committee charter or an investment policy statement approved by the board of directors. These governance documents should be periodically reviewed.

The investment policy statement should describe the purposes of the portfolio and how it relates to the spending needs of the organization. The investment policy statement should also specify risk parameters, set asset allocation ranges and rebalancing rules, provide for management selection and termination, and related matters. See, generally, The Practical Guide to Managing NonProfit Assets, Schneider, DiMeo and Benoit (2005).

The Committee Should Understand the Processes Used by the Organization for Retention and Termination of Investment Managers and Consultants

In cases where in-house investment staff is selecting outside managers, the committee should be comfortable with the processes used by staff for due diligence, analysis of risks, assessment of the transparency of the managers, reporting, and ongoing monitoring. If an investment fails because of fraud, malfeasance or inadequate due diligence, the committee should insist on a review describing the lessons learned and implementation of the steps to prevent a repetition of the problem.

In smaller organizations without in-house investment staff, a committee must assess whether it has the competency to perform the necessary due diligence to select investment managers and to make the often difficult decision to terminate managers when warranted. Committees lacking the time or expertise to select managers or funds or make the decision to terminate managers should consider using passive index funds based on an agreed upon asset allocation.

Committees of smaller organizations should also weigh the benefits of using an outside consultant to help manage the portfolio. If a committee uses an outside consultant to select managers, the committee should understand clearly the consultant's processes for due diligence and risk analysis. An honest appraisal of a committee's competency and insisting that a consultant spell out how it approaches manager selection can help avoid the types of surprises illustrated by the Madoff scandal and other fiascos.

Committees Must Ask the Tough Questions

Committees should not shy away from asking tough questions of the organization's management or consultants or be fearful of asking questions that others may think are self-evident or "dumb". An atmosphere must be engendered that encourages questions. Given the responsibility of the committee, there should be no such thing as a dumb question. Assumptions that others know the answer or that the consultant has asked the right types of questions have led to some serious losses that possibly could have been avoided. Committees also benefit from members who ask provocative questions in a professional manner and force management, consultants, or the committee itself to look hard at underlying assumptions.

A Committee Should Consider Including Outside Professionals on the Committee if Board Members Lack Expertise, Experience, or the Time to Spend on the Portfolio

If an organization believes it does not have sufficient members on their board with the experience and sophistication to oversee investment matters, it should seriously consider including outside professionals on the committee who have the requisite expertise if permitted by state law. Under Illinois law, for example, a majority of members of an investment committee must be directors of the organization. The inclusion of experienced outside members does not, however, excuse other members of the committee from responsibility to stay informed and provide oversight. Outside members of a committee should have the same duties as board members and ordinarily all committee members should be treated the same with respect to voting rights and duties. Whether to pay outside members of the investment committee should be carefully considered in light of the resources of the organization, the need to attract outside members and the underlying history and culture of the organization.

A Committee's Work Must Be Covered By the Organization's Conflict of Interest Policy And Other Policies Addressing Ethics and Confidentiality

There remains little debate that every not-for-profit organization must have in place a conflict of interest policy. This policy should also address investment matters. A conflict of interest policy should for example address whether the organization can invest with firms with which an investment committee member or board member are affiliated. Some organizations permit this if certain rules are followed (See interview with David Swanson, Wall Street Journal, January 13, 2009) while others do not. What is important is that the policy be clear and that there be procedures followed that protect the organization's interests.

In addition, an organization should have policies on ethics and confidentiality that apply to the work of the committee. An ethics policy or code of conduct will provide guidance to a committee regarding the types of behaviors that are encouraged, discouraged, or prohibited. Some types of behavior should be flatly prohibited (e.g., front running on inside information). Other types of behavior can be more subtle, but potentially disruptive. For example, there should be a clear understanding of the role of committee members in suggesting managers to retain or in implementing strategy. Some

organizations may benefit from the contacts that committee members have, particularly if the organization's resources are limited. In circumstances where experienced staff is given the responsibility to pick investment managers, however, committee members who push specific managers may be overly intrusive and put management in an awkward if not untenable position. The nature of the relationship between the committee and staff will impact whether suggestions are welcome, but an organization is well served to be sure there is a clear understanding of the acceptable conduct by committee members.

Similarly, there should be a policy on confidentiality so committee members have a clear understanding of what information is considered confidential and what may be shared with other organizations.

The Size of the Committee Should Be Limited to a Number that Provides Diversity of Views without Risking Paralysis

A committee should have sufficient number of members to ensure meaningful discussion and debate while allowing a consensus to be formed. Some universities burdened by committees in excess of fifteen have formed smaller executive committees to carry on business. While there is no perfect number, any committee that reaches double figures is probably too large. See Cambridge Associates LLC, Endowment Management, Good Governance and the Right People (six is about right and more than eight generally problematic).

Rotation of Committee Members Helps Ensure Fresh Perspectives

A committee should consider term limits especially with respect to any outside members. This helps ensure the committee obtains the benefit of different views and fresh perspectives. Mandated rotation always creates the potential problem of losing valuable committee members, but the committee can address the potential loss of expertise through the selection of new members. A committee also can retain flexibility to assure the continuation of persons that, in rare circumstances, may be considered invaluable such as by bringing them back on the committee after a year or two.

A Committee Should Consider Use of an Outside Consultant to Manage the Portfolio Where Appropriate

A committee and board should periodically assess the adequacy and time availability of the committee and evaluate whether outside assistance should be retained in the management of the portfolio. For smaller organizations without experienced in-house staff, the events of the last year suggest that a committee needs to give serious thought to using consultants to assist in the management of the portfolio. Retaining a consultant increases costs, but there can be benefits: Better oversight and reporting, comfort that fiduciary obligations will be fulfilled and the comfort that allows directors and committee members to "sleep at night. Committee members, even if sophisticated in their own right, usually have other jobs and seldom can devote the time necessary to oversee the portfolio appropriately, make necessary changes and evaluate existing managers. There are a

number of competent firms using different approaches who can assist not-for-profits.⁴ The committee, however, retains the ultimate responsibility for the portfolio.

A Committee Should Insist on Understandable Reporting from Management and Consultants; In Turn Committee Members Must do Their Homework and Review Reports and Materials

Reports to investment committees can rely on jargon and assumptions of knowledge and expertise by the audience that may not be present. Committees should insist on transparency in the investments made by the organization and require understandable reporting on the performance and risk of the portfolio. Committee members not versed in the jargon of investments must insist on explanations that they understand. Having experts on the committee helps, but all committee members have a fiduciary duty and must take the time to understand what is being presented. Committees have an obligation to carefully review the reports presented. The committee should provide feedback to management or consultants if the committee finds the reporting inadequate.

Committees should also require presentations of how the portfolio might perform under different market or economic scenarios. The current economic crisis demonstrates again the wisdom of careful planning and consideration of impact when almost all asset classes plummet at the same time. The assumptions underlying the investment strategy should be periodically tested to ensure consensus of the committee.

The Board Should Receive Periodic Reports from the Committee

A board may delegate responsibility to an investment committee, but it should receive periodic reports from the committee on performance, risk, and other matters. A board should understand the overall strategy being followed, the objectives and the potential risks. A board's interest in the oversight of the investment portfolio goes beyond any potential liability concerns. An organization can suffer serious damage to its reputation or even endanger its existence if it loses substantial money because of inadequate due diligence, poor investment choices or failure to monitor adequately its portfolio, even when the organization is duped or defrauded. The unfortunate charities that invested large sums with Bernie Madoff and had to shut down when their investments were lost in their entirety is the latest vivid example of the consequences of poor investment choices. It is worth a board's time therefore to be comfortable that the investment committee is keeping a careful eye on the portfolio.

An Effective Chair is Important to a Well-Functioning Committee

A good committee chair can be worth his/her weight in gold (in a manner of speaking). The chair should facilitate discussion but ensure that members may disagree with each other and staff in a professional and courteous fashion. As stated by Byron Wien, "A committee chairperson is critical. That person does not need to be an investment

⁴ The Donors Forum recently determined to use an outside consultant to assist in the management of its portfolio and initiated a procedure to obtain bids from a number of qualified organizations. Interested parties may contact the author for additional information regarding the bid process.

professional, but he or she should be someone who knows when the talk should cease and the decision should be made.” Wien infra at 4. An effective chair can also set the right atmosphere to encourage the types of questions necessary for prudent oversight.

The Characteristics of Effective Committees

For larger organizations with experienced investment staff, the most effective investment committees play an oversight role focusing on setting objectives and policy (including the long-term policy portfolio), evaluating results, and providing advice and reaction to strategic options, tactical shifting, or choices proffered by investment staff. (See generally Endowment Management, Cambridge Associates (2005) where the characteristics of a successful investment committee are described.)

Charles Ellis, an experienced investor, author, and one time chair of the Yale Investment Committee, suggests that best practices for an investment committee include delegating substantial authority to a chief investment officer who has a strong role and is authorized to implement policy.

Long-term policy formation is the role and responsibility of investment committees. What’s the right asset mix, what’s the spending rule going to be? It’s not manager selection. ... It’s awfully easy to slip into a short-term focus, while maintaining a long-term focus can be hard. But, what committees can do wonderfully, wonderfully well is policy formation and thinking through which policies would be wise and why they would be wise. (See Charles Ellis, Effective Endowment Management, CAIS/NYSAIS Business Affairs Conference, May 4-6, 2005.)

Effective committees have a blend of expertise and perspective and encourage debate and discussion on key issues.

Conversely, in the case of portfolios managed by in-house staff, less successful committees involve themselves in more day to day management and the selection and termination of managers. Committees should respect the role of staff in making final judgments on certain decisions, but not abdicate their responsibility to probe and question. Of course, the difference between being directive and suggestive can be a matter of perception and both the committee and staff need a common understanding of when the committee should be directive or merely suggestive.

For smaller organizations without the benefit of experienced investment staff where the investment committee must play a more active role, more effective committees do their homework, periodically assess the strategy and policy, and evaluate candidly whether the committee has the resources, expertise and talent to perform the necessary tasks. Effective committees of smaller organizations also encourage active participation by all committee members and ensure that the committee has the necessary expertise to provide competent guidance either through the composition of the committee or the hiring of investment consultants in accordance with a careful process.

The Committee Must Understand the Legal Framework Under Which It is Operating

The committee should understand its fiduciary duties and, in general, the legal framework governing the organization's investment activities. A committee should periodically consult legal counsel to ensure it is operating within applicable law and should discuss with counsel any unusual investments before the investment is made.

Generally, the duties of investment committee members will be similar to the duties that directors owe to not-for-profit corporations: The duty of care; the duty of loyalty; and the duty of obedience. Stated simply, the duty of care requires that directors inform themselves, prior to making a business decision, of all material information reasonably available to them and to act with care in the discharge of their duties. The duty of loyalty requires directors to act in good faith and in the best interests of the corporation and the duty of obedience requires a director to avoid committing acts beyond the scope of the powers of a corporation as defined by its charter or laws of the state.

With respect to the oversight of investments, directors or investment committee members will generally be governed by state law and, in the case of private foundations, by the various sections of the Internal Revenue Code. As of July 2009, forty two states have now adopted the Uniform Prudent Management of Funds Act ("UPMIFA"), a successor to the Uniform Management of Institutional Funds Act ("UMIFA"), and seven others have introduced UPMIFA for consideration. UPMIFA eliminates the historic value rule of UMIFA which prevented organizations from spending from their endowments if the value of the endowment was below its historic value without obtaining permission from the donors providing endowment funds. This restriction significantly hampered charitable organizations in light of the severe losses in many endowments over the latter part of 2009 and beginning part of 2009.

UPMIFA also revises the prudence standard that applies to management and investment of charitable funds under UMIFA by merging the laws applicable to private trusts and business corporations. It provides that each person responsible for managing and investing assets of a charitable institution shall manage and invest such assets in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. This standard is consistent with the business judgment rule under corporate law, as applied to charitable institutions. UPMIFA sets forth a number of factors that managers should consider in acting pursuant to the prudence standard:

- (a) General economic conditions;
- (b) The possible effect of inflation or deflation;
- (c) The expected tax consequences, if any, of investment decisions or strategies;
- (d) The role that each investment or course of action plays within the overall investment portfolio of the institution;
- (e) The expected total return from income and the appreciation of investments;
- (f) Other resources of the institution;

- (g) The needs of the institution to make distributions and to preserve capital; and
- (h) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

UPMIFA also incorporates a duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable.

As noted above in this article, institutions often seek individuals with special financial capabilities to serve on their investment committees. UPMIFA states that a person who has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

Private foundations are also subject to section 4944⁵ of the Internal Revenue Code that prohibits investments that "jeopardize" the carrying out of a foundation's exempt purposes. Penalties can be substantial and can include fines against the foundation's directors and officers, and the foundation. The regulations make clear that no category of investments are treated as a per se violation of section 4944, but gives examples of types or methods of investments which will be closely scrutinized to determine that foundation managers have met the requisite standard of care and prudence. These include "trading in securities on margin, trading in 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" (Treas. Regs. § 53.4944-1(a)(2)). Some of these strategies are used by sophisticated investors to hedge risk. Consequently, it behooves investment committees of private foundations to assure they consult counsel in cases where there may be a question regarding a particular investment.

Conclusion

The current financial crisis has demonstrated the importance of effective investment committees for not-for-profit organizations and the need for committees to be prudent stewards of the assets of the organization. Investment committees should evaluate their practices in light of the lessons learned in this bear market and incorporate the practices described herein or others that might be suggested that fit their circumstances to ensure they are taking all reasonable steps to safeguard the portfolio. By taking these steps, investment committees of not-for-profit organizations, regardless of the size of the portfolio, can help meet their responsibilities and duties for the eventual betterment of the beneficiaries of their organizations.

⁵ Section 4944 does not define jeopardizing investment but the regulations to that section do provide a definition. See Treas. Regs. § 53.4944-1. Private foundations are also subject to additional rules impacting their investments under section 4943 (excess business holdings) and section 510 (unrelated business income) of the Internal Revenue Code.