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Tips for Charitable Organizations to Consider When Hiring Consultants

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POSTED:

Aug 22, 2016

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Recent guidance from the Internal Revenue Service ("IRS") has made it easier for foundations, endowments and other charitable organizations to make investments that reflect their charitable missions while seeking competitive financial returns. In light of this guidance, many charitable organizations are considering whether their current investment practices are aligned with their missions, and may seek to hire outside consultants to advise them. We have identified below key practices for hiring consultants that are capable of providing these valuable services.

Legal Developments

In September 2015, the IRS issued Notice 2015-62 2015 39 I.R.B. 411 (the "Notice"), which formally confirms that private foundations[i] may make investments that further their charitable missions.[ii] Before the Notice, there was some uncertainty as to whether investments that further an organization's charitable mission and are also intended to produce a financial return would be subject to excise tax.[iii] This uncertainty led many charitable organizations to focus only on maximizing financial returns, regardless of the impact on the organization's charitable mission.

The Notice allows charitable organizations to consider investments that support the organization's charitable mission, even at a lower rate of return. The Notice provides:

> "When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or

the greatest liquidity. . . ."

Essentially, fiduciaries of charitable organizations are still bound by the same duty of care, but the Notice has alleviated any concern that investments aligned with the organization's charitable mission would be considered imprudent solely because they yield lower returns.

The Notice explicitly confirms that this standard of care is consistent with pre-existing guidance under state laws. Charitable organizations are typically organized as corporations or trusts governed by state statutes that impose fiduciary obligations on directors and trustees, including a duty of loyalty to the organization's charitable mission.[iv] In addition, nearly all of those state statutes are based on model laws called the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") or the Uniform Prudent Investor Act ("UPIA"), which describe fiduciaries' standard of care for the management and investment of charitable funds.[v] UPMIFA and UPIA require that charitable organizations consider the organization's charitable mission when developing the organization's investment strategy.[vi] The same fiduciary standard applies across all charitable institutions, including foundations and endowments.[vii]

Many charitable organizations have already taken steps to align their investment practices with their charitable missions. For example, the Heron Foundation deploys 100% of its assets (*i.e.*, not just earnings) towards fighting poverty. Heron Foundation President, Clara Miller, has encouraged other charitable organizations to "abandon the common practice of separating grant making from endowment investments, and to instead merge mission and finance functions into a single office of philanthropic capital deployment, looking at both the financial and social impacts of every outlay of capital."[viii] In other words, an organization's charitable mission should instruct both sides of the organization's balance sheet.

Delegating Investment Functions to Consultants

Charitable organizations with limited resources or expertise may choose to delegate the investment function from the governing body of the organization (typically the investment committee) to a consultant. The consultant then is responsible for developing an investment program that meets the organization's objectives and is consistent with its charitable mission.[ix] Delegating full discretion is the "outsourced CIO" or "OCIO" model. Many charitable organizations choose to delegate essentially the entire investment function to the consultant, retaining approval of only the highest level policy issues, such as asset allocation.

Whether a charitable organization decides to delegate its investment decisions to an outside consultant or merely selects consultants to advise the organization in managing investment functions internally, fiduciaries must exercise reasonable care, skill and caution in selecting the consultant and monitoring the consultant's performance, consistent with the fiduciary duty of care.[xi] With the recent guidance from the IRS, fiduciaries may explicitly prioritize hiring consultants that are capable of aligning investment decisions with the organization's charitable mission, consistent with the fiduciaries' duty of loyalty.

Charitable organizations may consider adopting the following practices when hiring consultants:

1. **Clarifying Mission and Investment Policy.**

For many charitable organizations, the first step of the selection process will include clarifying the organization's charitable mission as well as governance and investment considerations. An organization's charitable mission is central to its existence and is likely stated in its charter documents. Ideally, the organization uses its mission to guide both the programs developed by the organization and the investments made to fund those programs. For example, many universities are considering how to address climate change in their portfolios. Some are focusing on measuring carbon efficiency and reducing the exposure to carbon-intensive companies or are actively engaging with portfolio companies to improve business practices. The University of Toronto has considered divesting from the fossil fuel industry because the risks associated with climate change are inconsistent with the universities' focus on future generations.

> "The University of Toronto and institutions like it have a significant and distinctive focus on the future and the people who will inhabit it. The University's research and education missions are distinguished by our dedication to advancing truth, knowledge, and understanding, and to making the world a better place. Climate change therefore represents an existential challenge for the University of Toronto."[xii]

Depending on whether the mission-related investments will be a small portion or most of the assets, the organization may choose to have a separate mission-related investment ("MRI") policy or embed it within the investment policy statement ("IPS"). Regardless, at a minimum, the charitable organization needs to state its definition of mission-related investing, its purpose and underlying philosophy, its roles and responsibilities, as well as a number of investment considerations. Key topics for an MRI or an IPS include investment objectives; views on risk, liquidity and portfolio diversification; criteria for selecting, evaluating and monitoring investments; and benchmarks. Here are a few questions to consider when developing an MRI or an IPS:

- What are our principles and investment philosophy?
- How do we define "mission-related investment"? How are environmental, social and governance ("ESG") issues relevant to our mission?
- Are we confident that ESG issues can be integrated into investment policies without reducing long-term returns? [xiii]
- How does linking investments to mission influence asset allocation and portfolio diversification decisions? What is our view of risk, and how much liquidity is needed?
- What types of investments and strategies would support or undercut our mission? Under what circumstances would we consider divestment?
- How do we define success? Are we willing to accept lower returns for investments aligned with our mission? If yes, how much?
- How active should we be as a shareowner? What is our proxy voting policy and how is it determined? Will we engage directly with companies?
- How will we assess the impact of our investments?

Within roles and responsibilities, the IPS should describe the fiduciary duties of the board of directors and/or investment committee. If the organization has adopted an OCIO model, then the IPS should clearly describe whether and to what extent fiduciary duties have been delegated to an OCIO and the OCIO's responsibilities, which may include determining asset allocation, selecting managers, overseeing proxy voting and actively managing the portfolio.

1. **Developing a Request for Proposal ("RFP").**

After a charitable organization has clarified the relationship between its mission and its IPS, the charitable organization may prepare an RFP with the intention of identifying consultants that are familiar with the process of tailoring a charitable organization's investment program to its mission. Charitable organizations may wish to identify a list of qualified consultants, which can be identified through networking with peers participating in trade associations.

In drafting the RFP, charitable organizations should be specific about the services being requested and outsourced. Charitable organizations may ask the following questions to provide insight into a responding firm's capacity to provide these services:

- How will you incorporate the organization's charitable mission into an IPS? How is the spending policy affected? Please provide a sample MRI policy and IPS.
- Describe how/to what extent the organization's charitable mission will be taken into consideration when developing an asset allocation strategy and establishing performance benchmarks.
- Describe the firm's philosophy on MRI strategies, management of risk, proxy voting, soft dollars and best execution.
- Are you active in organizations dedicated to mission investing (Mission Investors Exchange and the Intentional Endowments Network)?
- How have other clients performed, both in terms of financial performance and achieving mission objectives?
- Describe the firm's capabilities and experience advising clients on mission-related investing.
- Describe your process for evaluating, selecting and monitoring investment managers. How do you evaluate a manager's process for integrating environmental and social issues with financial analysis? Illustrate this process with examples.
- How do you identify when a manager is "greenwashing"? Illustrate with an example.
- What reporting requirements would you require of managers?
- How do you monitor a manager's compliance with investment guidelines?

- Do you provide mission goal reporting? If yes, please provide a sample report.
- What is the timeframe that is considered when developing an investment policy and measuring performance?

In addition, charitable organizations may request a sample of a firm's standard services agreements and client reports. Charitable organizations may examine whether these documents contemplate a sample client's mission or whether the reports are focused exclusively on financial returns without regard to mission. If a firm's standard services agreements and client reports do not appear to incorporate considerations relevant to the organization's charitable purpose, then this may be a warning sign that the firm may not be capable of fulfilling the organization's duty of loyalty to its charitable mission.

1. **Evaluating an RFP**

Before evaluating RFP responses, charitable organizations need to identify their priorities and consider how they will weigh responses, particularly firms' responses to mission-related questions. What do they care about most? What answers are important to achieving both the organization's financial returns and mission objectives? How has the respondent demonstrated that it has experience aligning investment practices to its clients' charitable missions?

In reviewing RFP responses, charitable organizations should be aware of consultants that claim they have the capability and resources to integrate an organization's charitable mission into investment practices, but have not demonstrated knowledge or experience with MRIs. For investors concerned with environmental impacts, for example, this is known as "greenwashing." For example, presume one of the charitable organization's objectives is to help society transition to a lower carbon economy. Is the OCIO/consultant evaluating the carbon intensity of a manager's portfolio? If so, how? Is the OCIO/consultant using outside ESG data providers (*e.g.*, MSCI, Sustainalytics, Bloomberg) for manager assessment? If so, how is the information used? Are they using this research in evaluating, selecting and monitoring managers? Identifying how relevant information is actually used will be helpful in identifying whether a respondent is capable of aligning investment practices with an organization's charitable mission.

1. **Negotiating Contracts with Consultants**

Charitable organizations may negotiate contracts with consultants that incorporate key terms that will ensure that the consultant is performing its obligations in a manner that is consistent with its RFP response and fiduciary duties to the charitable organization. Specifically, charitable organizations may consider incorporating the following topics in consultants' contracts:

- **Fiduciaries**. Consultants may acknowledge and agree that they are fiduciaries of the charitable organization and therefore have a duty of care, and a duty of loyalty and obedience to the organization's charitable mission.
- **Compliance with the IPS**. Consultants and investment managers may agree to make investments that are consistent with the charitable organization's IPS (or MRI policy) and guidelines. (If the consultant perceives a conflict between its fiduciary duties and other contractual obligations, then the consultant may confer with the board of directors or the investment committee, as appropriate.)
- **Due Diligence**. Charitable organizations may require a minimum of an annual on-site due diligence visit to the consultant's location, including access to the systems and processes used in management of the charitable organization's investment program.
- **Mission Investing Process and Goal Reporting**. Charitable organizations may require that the consultant report annually on (1) the consultant's process for incorporating the organization's charitable mission in its decision-making process, and (2) mutually agreed upon topics and metrics that relate to the organization's charitable mission.
- **Shareowner Activity**. The contract may require the consultant to provide reports on proxy voting and company engagement.
- **Consultant's Performance Metrics**. The contract may describe how and when the consultant's performance will be evaluated. As discussed above, charitable organizations may pursue investments that may not provide the highest rate of return but further the organization's charitable mission. Financial performance should be reviewed over appropriate timeframes, which are typically long term.
- **Termination**. The contract may allow the charitable organization to terminate the contract if the consultant fails to perform its fiduciary duties, including its duty of loyalty to align investments with the organization's charitable mission.

1. **Monitoring Consultants**

After entering into a formal relationship with a consultant, charitable organizations have ongoing fiduciary duties to monitor these firms. Establishing a monitoring process will help the charitable organization hold the consultant accountable and ensure that contractual obligations agreed to by consultants are actually being implemented. Performance-based metrics included in the contract will help guide the assessment.

Conclusion

Recent guidance from the IRS has confirmed that charitable organizations may align their investment programs with their charitable missions without creating tax liability. This guidance is consistent with existing state law interpretations of fiduciary duties, including a duty of loyalty to the organization's charitable mission.

In light of this guidance, many charitable organizations will look to consultants to develop an investment program aligned with their charitable missions. It is important for these organizations to exercise due care in selecting, contracting and monitoring consultants, consistent with their fiduciary duties. Every charitable organization will have unique needs with respect to aligning mission and investments. By intentionally considering mission at every step of the hiring process, the charitable organization may find it easier to identify a consultant that is best positioned to help achieve the organization's objectives.

For further guidance, please contact your Reinhart attorney.

[This Reinhart Institutional Investor Services article provides general information and should not be construed as legal advice or a legal opinion. Readers should seek legal counsel concerning specific factual situations confronting them.]

[i] The Notice applies to private foundations. The term "private foundation" includes every organization that qualifies for tax exemption under section 501(c)(3) of the I.R.C., unless it falls into one of the categories specifically excluded from the definition of that term (referred to in section 509(a)). While public charities, such as many churches, hospitals, colleges and universities, do not meet the definition of "private foundation" under section 509(a) of the I.R.C., the Notice notes that it still provides applicable guidance. "This standard is

consistent with investment standards under state laws, which generally provide for the consideration of the charitable purposes of an organization or certain factors, including an asset's special relationship or special value, if any, to the charitable purposes of the organization, in properly managing and investing the organization's investment assets."

[ii] For clarification, the Notice applies to investments intended to generate competitive returns rather than program-related investments ("PRIs"), which are intended to further the private foundation's charitable goals. PRIs are typically grants or loans made by the organization to accomplish its charitable purpose, and no significant purpose of PRIs can be the production of income. PRIs are sometimes referred to as "impact investments."

[iii] Section 4944(a)(1) of the I.R.C. imposes an excise tax on charitable organizations that invest "in such a manner as to jeopardize the carrying out of any of its exempt purposes," which has been interpreted to mean that the organization's managers failed to exercise ordinary business care and prudence in providing for the long-term and short-term needs of the organization to carry out its tax exempt purposes. Section 53.4944-1(a)(2)(i) of the Excise Tax Regulations. 29 C.F.R. § 53.4944 1.

[iv] This is sometimes called a duty of obedience to mission.

[v] The Acts are intended to apply uniform fiduciary standards. The UPMIFA Prefatory Note says it "reflects the fact that standards for managing and investing institutional funds are and should be the same regardless of whether a charitable organization is organized as a trust, a nonprofit corporation, or some other entity. . . . [t]he modern paradigm of prudence applies to all fiduciaries who are subject to some version of the prudent man rule, whether under ERISA, the private foundation provisions of the Code, UMIFA, other state statutes, or the common law."

[vi] The UPMIFA Drafting Committee (the "Committee") advised in its Prefatory Note to the model act that "UPMIFA requires that a charity and those who manage and invest its funds to . . . develop an investment strategy appropriate for the fund and the charity." The Committee also explains that the "decision maker must consider the charitable purposes of the institution and the purposes of the institutional fund for which decisions are being made." The UPIA has similar provisions in § 2.

[vii] Although endowments may contain both donor-restricted endowment funds

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and unrestricted endowment funds, UPMIFA provides that fiduciaries managing donor-restricted endowment funds have the same standard of care as other charitable organizations (subject to donor intent expressed in the gift instrument). Comments to UPMIFA § 4(a). UPMIFA explicitly confirms that "common standards of prudent investing apply to all charitable institutions." Comments to UPMIFA § 3.

[viii] *Building a Foundation for the 21st Century*, www.Heron.org/21C *(last visited on June 28, 2016).*

[ix] UPMIFA allows fiduciaries to delegate management and investment functions to external agents. UPMIFA § 5 (Unif. Law Comm'n 2006).

[x] Christine Williamson, "*Outsourcers Assets Slip in Latest Survey," Pensions & Investments*, June 13, 2016.

[xi] Comments to UPMIFA § 5.

[xii] Brian Karney et al., *Report of the President's Advisory Committee on Divestment from Fossil Fuels* 2 (December 15, 2015), http://www.president.utoronto.ca/secure-content/uploads/2015/12/Report-of-the-Advisory-Committee-on-Divestment-from-Fossil-Fuels-December-2015.pdf.

[xiii] Recent papers from Morgan Stanley, UBS, TIAA-CREF, Allianz Global, Cornerstone Capital and MSCI and Generation Foundation have all concluded that ESG investing generally performs comparably to non-ESG strategies. There is no performance penalty associated with pursuing such strategies. Intentional Endowments Network, *The Business Case for ESG,* https://d3n8a8pro7vhmx.cloudfront.net/intentionalendowments/pages/1031/attachments/original/1465487421/BusinessCaseforESG_2016.pdf?1465487421 (last visited Aug. 5, 2016).