Fiduciary Responsibility Post Madoff

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The following materials support the topics discussed during the Comstock Smart Investing Conference Call.

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Markets, Madness, Madoff, Miscellaneous, and More:
Evolving Process-Focused Standards for Charities

Overview. Charities, while exempt from income taxes, are heavily regulated.

All charities have to use their assets exclusively for charitable purposes and, under provisions of the laws of most states, to manage assets responsibly in the interest of their charitable mission.

Private foundations – charities that are not significantly supported by the general public through contributions or fees – are regulated more heavily.

A. Private Foundation and Public Charity. The distinction between private foundations and public charities is important to an understanding of the current regulatory climate.

1. Public charities are:

   (a). organizations that have broad public support, as defined by their meeting either of the two tests in Code sections 509(a)(1) (significant contributions from the general public) and 509(a)(2) (significant dependence on income from operations); or

   (b). "supporting organizations," defined in Code section 509(a)(3), which are not themselves publicly supported but which

      (i). have close ties with one or more publicly supported organizations,

      (ii). exist to benefit or further the purposes of that organization or those organizations, and

      (iii). are presumed to be under the supervision of the supported organizations.

2. Private foundations are charities that are not public charities.

   (a). Both private foundations and public charities are considered tax-

exempt charities (despite the excise tax on private foundations), often referred to as "501(c)(3)" organizations because both private foundations and public charities are described in Code section 501(c)(3).

(b). The distinction between private foundation and public charities is often expressed by reference to one or more Code sections. The Code being what it is, there are different sections that can be used. The distinction is sometimes also stated in terms of the maximum deduction allowed for contributions of cash to the organization as a percentage of the donor's modified adjusted gross income – 50 percent or 30 percent. The following table summarizes the terms one is likely to encounter:

Charities Generally – Both Private Foundations and Public Charities 501(c)(3) 170(c)	
Public Charities 509(a)(1) 509(a)(2) 509(a)(3) 170(b)(1)(A) 50% charities	*Private Foundations* 30% charities

B. Various provisions of the Internal Revenue Code (the "Code") require private foundations, in addition to following the rules for public charities, to:

1. avoid transactions with their donors or parties related to their donors;

2. distribute or use a minimum amount of their assets regularly for their charitable purposes;

3. make distributions only to defined classes of beneficiaries;

4. divest themselves of large holdings in any one business;

5. avoid inappropriately risky “jeopardizing” investments;

6. pay an excise tax of 1 or 2 percent on their investment income; and

7. make their tax documents available for public inspection.

C. It helps to understand the understanding of public scrutiny behind the rules.

1. The Tax Reform Act of 1969 put the private foundation rules into place based

on a concern that charities funded by one donor or one family presented generous opportunities for tax abuse, without oversight from the general public.

2. Public charities, in general, are those that are significantly supported by, or used by, the general public, or are answerable to another public charity. There is an assumption that the public will monitor public charities in a way that it will not watch private foundations. Public charity status depends on the belief that someone is watching.

(a). If a charity receives significant public contributions, at least some donors may be watching the charity's programs and the propriety of its expenditures.

(b). If a charity receives significant support from operations, its users presumably care about the same matters.

(c). Supporting organizations are overseen by the public charities they support.

3. For years, the annual returns of charities (Form 990 for public charities, Form 990-PF for private foundations) were legally matters of public record. Private foundations were required to publish annual notices of the availability of their returns. However, in practice few members of the public had the interest, time, or knowledge to seek out those returns. The IRS and state attorneys general were likely to be the main detectors of problems and enforcers of the rules.

4. Then came the web. Now 990s and 990-PFs are available, whether the charity takes action to publish them or not, at www.guidestar.org and some other sites. The idea of the public as watchdog has meaning as never before.

D. The New 990. Most tax-exempt organizations in the US file an annual Form 990 – only private foundations file a 990-PF. To date the two forms have been significantly similar, but beginning with 2008, the Form 990 has been radically redesigned:

1. The form is much longer. A charity that had to file every schedule – probably not possible unless the charity is a teaching hospital operating outside the United States that has issued tax-exempt bonds and is in the process of termination – would have to complete a 65-page tax form, almost certainly with attached statements of great length.

2. The form makes extensive use of narrative questions. Its first question, after identifying information, is a narrative ("Briefly describe the organization's mission or most significant activities"). Narrative statements are suggested or required to many questions.

3. The new form will likely be much more expensive to prepare. It will require

an information-gathering process similar to that used by accountants in an audit.

4. The main audience for the narratives is likely the public reviewing 990s on the web. The form amounts to a decision to

(a). place a greater compliance burden on charities, and

(b). promote public review

rather than relying on IRS audits and enforcement.

E. Implications for Private Foundations.

1. The new form likely will make it easier to review potential grantees' information. The equivalent of a full financial statement will be published on the web.

2. The "advance ruling" process – a tentative 5-year initial grant of public charity status while an organization tried to show it met a public support test – is gone. Many private foundation grantmakers were concerned about making multi-year grants to organizations in the advance ruling stage. The process involved an IRS review of a public support schedule at the end of the organization's 5-year initial ruling period. The IRS determined that, given the full information that will now be disclosed each year on the organization's 990, the process was unnecessary.

3. Are private foundations next in line to have the same reporting requirements? IRS officials have publicly stated there are no plans and no current budget for a Form 990-PF overhaul. However, private foundations are historically more regulated than public charities and it is hard to imagine that some of the 990 features will not find their way into private foundation compliance.

F. Major issues:

1. Good governance practices.

(a). See page 6 of the new Form 990, attached.

(b). *"My view is clear. Despite the absence of explicit federal statutory provisions setting forth clear governance standards, what I am calling jurisdictional gaps, we are not interlopers trying to regulate an area that is beyond our sphere. Rather, the effects of good or bad nonprofit governance cut across virtually everything we see and do in our work. It impacts whether the organization is operated to further exempt purposes and public, rather than private, interests. It dictates whether the organization's executives are compensated fairly or excessively. It*

influences whether the organization makes informed and fair decisions regarding its investments or its fundraising practices, or allows others to take unfair advantage. The question is no longer whether the IRS has a role to play in this area, but rather, what that role will be."

-- Remarks of Steven T. Miller, Commissioner, Tax-Exempt and Governmental Entities, IRS, April 23, 2008

(c). In a world in which the public, as well as enforcement agencies, will be responsible for detecting problems in charities, governance processes make take on a greater importance than ever. A good process may be significantly easier to identify than good results in evaluating a charity's compensation, overhead, or programming effectiveness.

2. Compensation. See Form 990 Schedule J attached.

3. Investment management. Questions are being asked to which process is a large part of the answer.

(a). General standards of prudent investment in the Uniform Prudent Investor Act, are applicable in most states to charities in trust form. The standards may also apply, explicitly or by analogy, to charities organized as corporations. These standards are explicitly standards of conduct, not outcome. In answering claims of imprudent investment management, a key fact will likely be process.

(b). Historically, restrictions on risky "jeopardizing" investments have been interpreted to allow many types of investments as long as they are undertaken in light of a reasonable evaluation of overall risk and return. Multiple private letter rulings approve foundations investing in hedge funds and private equity vehicles. There are informal indications that this area is under reconsideration by the IRS. The following are questions from the IRS in the review of an application for recognition of tax-exempt status for an organization that indicated investment in hedge funds:

(i). *If you have invested or plan to invest in hedge funds, what percentage of your total assets do you plan to invest in hedge funds?*

(ii). *What percentage of the total assets of each hedge fund, in which you have invested, is owned by (a) you [the foundation] and (b) your disqualified persons?*

(iii). *Do you set a cap on your total hedge fund investments? If so, what is the cap? What will be the maximum percentage of your total assets to be invested in hedge funds?*

(iv). *Discuss if you have invested or plan to invest in any hedge funds, which are founded by your disqualified persons or managed or advised by companies related to your disqualified persons. Submit the names of related hedge funds, management companies, and advisory committees, if any.*

(v). *If the limited partnership agreement or the operating agreement of the hedge fund requires an investor to notify the hedge fund or its management company a period of time (for example, 30 days, 60 days, 90 days, etc.) in writing prior to the sale of the investment, will the hedge fund or its management company allow you to bypass and redeem your investment without having to give this advance notice? Discuss.*

(vi). *Do you have any mechanism in place to avoid excess business holdings, self-dealing transactions and jeopardy investments? Discuss.*

(vii). *Do you have any mechanism in place to avoid risky or high risk investments? If so, what is it and how do you define risky or high risk investments?*

(c). Senator Grassley recently stated that private foundation governing boards that invested entirely with Bernard Madoff may be liable for a "jeopardizing investment" penalty tax because of a failure to exercise proper investment oversight. The senator's tax counsel acknowledged that the determination was "a very facts-and-circumstances test" but also stated, "It's fair to ask if those that chose to invest with Madoff actually conducted due diligence as opposed to maybe relying on a personal relationship or a simple referral."

Notice. We are required by IRS Circular 230 to include the following notice: Any advice concerning federal tax issues provided above is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

Has the definition of diversification changed for Trustees after Madoff?

Points to consider

- Under UPMIFA & UPIA the requirement to diversify has been generally interpreted to be in regards to the number of securities held within the portfolio.
    - In the New York case of Will of Charles G. Dumont, 2004, the court measured the trustee's damages for failing to diversify by assuming that the trustee should have sold enough Eastman Kodak stock to bring the holding down to 5% of the trust assets.
- Requirements of Fiduciaries under UPMIFA that go beyond the diversification issue:
    - Act in good faith, with the care and ordinary prudent person would exercise
        - What is deemed prudent regarding the engagement of external money managers, custodians, etc.
    - Make a reasonable effort to verify relevant facts
        - Where are the assets held?
        - Is there 3rd party verification of holdings, etc.?
        - Is there a reputable audit firm involved?
        - Is there an independent calculation of costs and returns?
        - Are the terms of the engagement being followed?
        - What are the current anti-fraud procedures in place and are they being followed?
    - Make decisions about each asset in the context of the portfolio of investments, as part of an overall strategy
        - If a partnership invests in multiple securities, real estate, etc., what limits are placed on the total partnership investment?
        - Is there a maximum level of investment responsibility per management option that will be followed?
    - Diversify investments unless due to special circumstances, the purposes of the fund are better served without diversification
        - What are the consequences of non-diversification in fulfilling the terms of the trust or the non-profit corporation?
        - What are the advantages and disadvantages of a single custodians/manager structure?

- In general, develop an investment strategy appropriate for the (trust) or the charity
    - What are the beneficiary risks if an investment goes away?
    - What levels of principal loss are acceptable?

- In managing and investing an institution (trust) fund, the following factors, if relevant, must be considered:
    - General economic conditions
        - Warrants a broad diversification of asset classes to be considered
        - Determines cash, debt and equity levels of allocation at a given time
    - The possible effect of inflation and deflation
        - Again, warrants a broad basket of asset classes to provide adequate protection in each instance
    - The role that each investment or "course of action" plays within the overall investment portfolio of the fund (trust)
        - Course of action constitutes delegation decisions
        - Each delegated management engagement should be viewed as a concentrated holding and diversified as such when possible, especially when the management is difficult to verify by a third party

- Management and investment decisions should be made…..as a part of an overall investment strategy having risk and return objectives reasonably suited to the (trust) fund and the institution

- Comments of NCCUSL on UPMIFA
    - Considering the risk and return objectives of the fund
    - Ordinary business care and prudence
    - Reference to RMNCA (Revised Model Non-profit Corporation Act) business judgment standards
        - While not covered specifically under UPMIFA, under the duty of loyalty a director of a non-profit corporation should act "in a manner the director reasonably believes to be in the best interest of the corporation"
    - UPMIFA makes the duty of care, the duty to minimize costs, and the duty to investigate a default provision.

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Risk Factors for Hedge Fund Investments

- **Limited Operating History** – The fund has a limited operating history upon which to evaluate the performance of the management team. The past performance of the fund and/or its principals should not be relied upon as an indication of future results.
- **Business Dependent upon Key Individuals** – Authority for investment decisions is delegated to a few individuals for whom there is no guarantee of their continued participation in the fund.
- **Absence of Regulatory Oversight** – The fund is not registered under applicable US securities regulatory authorities.
- **Limited Liquidity** – An investment in the fund is not liquid and withdrawals are only available per the terms of the limited partnership agreement.
- **General Investment Risks** – The fund is subject to the general economic, regulatory, geopolitical and liquidity risks of investing in equity and debt securities. Additionally, fund's investments may be subject to commodity price risk. Any of these factors could potentially lead to a complete loss of invested capital.
- **Risks of Illiquid Securities** – The fund's investments may not be readily saleable. Investments may be dependent upon events beyond the control of the manager for liquidity.
- **Possible Lack of Diversification** – The fund may make concentrated investments with a substantial portion of the net asset value subject to idiosyncratic risk factors such as bankruptcy, lawsuits and geopolitical factors.
- **Income Tax** – The fund issues an annual K-1 which reports each investor's share of the fund's gains and losses. Investors may not be able to deduct expenses against income and reported gains and delays in issuing the K-1 may cause investors to file late.

Potential Additional Risks (see fund description to see which are applicable)

A. **Master-Feeder Fund Structure** - The fund utilizes a master-feeder structure, commingling onshore and offshore investors into a single master fund. The assets of the master fund are held offshore and are outside the prevue of US securities regulation.

B. **Short Sales** – The fund has the ability to sell securities short, meaning securities are borrowed from a broker dealer and sold in the open market. The fund retains a liability to deliver the securities back to the broker, requiring the manager to purchase the securities at current market prices. As price increases can exceed 100%, the potential losses can be greater than the initial investment. Generally the manager will limit the size of individual short positions to mitigate this risk, but there can be no guarantees that this policy will be followed at all times.

C. **Derivatives** – The fund may engage in derivative transactions, potentially including, but not limited to, futures, options, swaps and credit default swaps. Derivatives can enable excessive amounts of portfolio leverage and create the potential for large losses.

D. **Leverage** – The fund may employ leverage which will magnify the potential gains and losses from its investments.

E. **Foreign Securities –** The fund invests in securities listed on non-US exchanges that are not subject to US regulatory requirements on reporting and other measures designed to protect investors.

F. **In-Kind Distributions –** The fund reserves the right to meet redemption requests with distributions of securities in-kind. Investors may incur substantial costs in liquidating these securities.

G. **Unrelated Business Taxable Income** – The fund's investments may generate Unrelated Business Taxable Income which under most circumstances is taxable to non-profit corporations and trusts at applicable corporate income tax rates. Unrelated Business Taxable Income may have serious adverse tax consequences for Charitable Remainder Trusts.

H. **Assets Held in "Street Name" in Brokerage Account** – The fund utilizes a brokerage account for custody of its assets which are held in the broker's name and is at risk should a bankruptcy of the broker occur. A complete or partial loss of the fund's assets is possible.

I. **Potential Non-Resident State Income Tax Liabilities** – The fund's investments may generate income taxable at the state level to investors who are not residents of that state.

The term "hedge fund" commonly refers to private investment partnerships whose predominant activity is investing in marketable securities and actual hedging of investment positions may not occur. This list is not a complete list of all the potential risks related to investments in hedge funds.
Potential investors should read the Private Placement Memorandum and Limited Partnership Agreement for a more complete discussion.

Risk Factors for Private Equity and Real Estate Investments

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- **Limited Operating History** – The fund has a limited operating history upon which to evaluate the performance of the management team. The past performance of the fund and/or its principals should not be relied upon as an indication of future results.
- **Business Dependent upon Key Individuals** – Authority for investment decisions is delegated to a few individuals for whom there is no guarantee of their continued participation in the fund.
- **Absence of Regulatory Oversight** – The fund is not registered under applicable US securities regulatory authorities.
- **Limited Liquidity** – An investment in the fund is not liquid and withdrawals of invested capital are generally not possible.
- **Liability to Meet Capital Commitments** – The fund's subscription agreement constitutes a binding contract to meet the committed capital when called by the manager. Failure to meet these obligations may result in civil penalties.
- **General Investment Risks** – The fund is subject to the general economic, regulatory, geopolitical and liquidity risks of investing in equity and debt securities. Furthermore the fund's investments may be subject to commodity price risk. Any of these factors could potentially lead to a complete loss of invested capital.
- **Risks of Illiquid Investments** - The fund's investments are not readily saleable. Investments generally are dependent upon events beyond the control of the manager for liquidity.
- **Possible Lack of Diversification** – The fund may make concentrated investments with a substantial portion of the net asset value subject to idiosyncratic risk factors such as bankruptcy, lawsuits and geopolitical factors.
- **Income Tax** – The fund issues an annual K-1 which reports each investor's share of the fund's gains and losses. Investors may not be able to deduct expenses against income and reported gains and delays in issuing the K-1 may cause investors to file late.

Potential Additional Risks (see fund description to see which are applicable)

A. **Leverage** – The fund may employ leverage which will magnify the potential gains and losses from its investments. Generally leverage will be tied to individual investments without recourse to the fund's other investments, but there are no assurances that assets will not be cross collateralized.

B. **Foreign Investments –** The fund invests outside the US and be subject to political and regulatory risk.

C. **In-Kind Distributions –** The fund reserves the right to make distributions of securities in-kind. Investors may incur substantial costs in liquidating these securities.

D. **Unrelated Business Taxable Income** – The fund's investments may generate Unrelated Business Taxable Income which is ordinarily taxable to non-profit corporations and trusts at applicable corporate income tax rates. Unrelated Business Taxable Income may have serious adverse tax consequences for Charitable Remainder Trusts.

E. **Potential Non-Resident State Income Tax Liabilities** – The fund's investments may generate income taxable at the state level to investors who are not residents of that state.

This list is not a complete list of all the potential risks related to investments in private equity and real estate funds. Potential investors should read the fund's Private Placement Memorandum and Limited Partnership Agreement for a more complete discussion.

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