COMSTOCK

Uniform Prudent Management of Institutional Funds Act

Its impact on public & private charities

Smart Investing Conference Call Series Transcript

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Conference Call Presenters

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Alison Comstock Moss: Good afternoon, my name is Alison Moss, Vice President of Strategic Development at Paul Comstock Partners. As we celebrate our 25th year of providing innovative, independent investment consulting, we have initiated a new monthly conference call series entitled, "Smart Investing" in which we invite experts from all over the country to participate with members of the Comstock team on various investment topics. Our goal at Comstock is to provide you with information that enables you to make investment decisions you can trust.

This afternoon we will be discussing the important provisions found in the Uniform Prudent Management of Institutional Funds Act. Presenters on today's call include Paul Comstock, Chairman, Paul Comstock Partners and Barry Hawkins, partner at Shipman Goodwin LLC and Chairman of the National Drafting Committee for the Uniform Prudent Management of Institutional Funds Act.

A couple of housekeeping items – all participants are on a listen-only mode during the presentation and will be taken off mute during our Q&A session at the end of the call so please hold your questions until that time. Also, this call is being recorded, as all of our calls are. If you'd like a copy for yourself or a colleague, let us know. Copies of previous calls are also available. Mark your calendar for next month's call on August 21st at 2:00 pm (CST) as we discuss Subprime Mortgages, Wall Street's Latest Fiasco.

It is also important for me to note that Mr. Hawkins will be providing general background on the drafting and interpretation of UPMIFA and will not be providing specific legal advice on any matter or otherwise engaging in the practice of law. His comments and opinions on the Act are his own and not those of NCCUSL or any other organization. For specific application of the Act to any set of facts, all participants on this call should refer such questions to their own legal advisor(s) for legal guidance. I'd like to now turn the time over to Paul.

Paul Comstock: Thank you, Alison. We are particularly pleased to be sharing with you some thoughts on this new act that is going quickly into many of the states, for instance it was just adopted in the state of Texas effective June 12th, going into effect Sept 1st. We at Comstock have always

believed that smart investing incorporated a process that is void as much as possible of the emotion and the daily noise of the economy and markets. We recently had a chance to visit with Professor Keith Ambusher at the University of Toronto. We were at a conference together and discussed a book that he recently came out with that deals with some historical research he'd done on large pension funds. In his research, Keith discovered that those funds that were well organized as an institution of management and those that were following consistent policies of prudent investing over a long period of time and not paying attention to the fads of the moment were those that produced added returns above the markets from their colleagues.

When Keith and I were discussing this further, we realized that his principles really needed to be applied to the nonprofit world where we have a turnover in volunteers, directors and personnel. It's important that we have a structure in place that provides consistency of action and decision making that will serve the organization and the funds over time. To that end, over the years various model standards have been provided for us to follow, both as fiduciaries of trusts under UPIA and for endowment funds of nonprofits under UMIFA. We as a firm have embraced those standards as providing principles that were sound, long term principles to follow in managing organizational funds or funds that were really for the benefit of others. The National Conference of Commissioners on Uniform State Laws introduced its newest investment guideline for all nonprofits in July of 2006 and we are very fortunate to have Barry with us as the leader of that committee to provide us today with insights and opportunity for inquiry for one who drafted it. Barry thanks for being with us today and I will turn the time over to you for your remarks.

Barry Hawkins: Thank you very much Paul. Good afternoon everyone. It's a pleasure to talk with you. The material that they have asked me to cover in about 25 minutes normally takes a little over an hour and a half so if you will bear with me, I will try to run right through it. I apologize if I am providing material that you are already familiar with but for the purpose of putting it in context I would like to explain where we were and how we got to where we are today. To do that, we need to go back to 1972 when the National Conference of Commissioners of Uniform State Laws from all over the country promulgated UMIFA, the original act which is now being modified. That was one of the most successful acts in NCCUSL history. It was designed to allow for a change from what had gone before it.

In 1972 most endowment funds for nonprofit institutions believed themselves to have been constrained by requirements to invest only in things that produced ordinary income, interest income and dividends but could not find their way in the statutes in many of the states, could not find themselves legally free to invest for capital gains and find any way to use the appreciation which came from those types of investments or to invest in alternative investments at all. The UMIFA statute that was enacted in 1972 was a radical departure from the law that had existed up until that point and represented the first entrée into modern portfolio investing in the United States and it was a wildly successful act in terms of how we judge them. 47 jurisdictions adopted it - we count 50 states plus the Virgin Islands, Puerto Rico, and Washington, D.C. for a total of 53 jurisdictions that can enact by state law or territorial law a national uniform law commission. It was adopted in 47 of those jurisdictions and

it was extremely successful from 1972 until the late 1990's when we started getting requests on a national level, particularly from nonprofits, their leaders and advisors that there were many, many changes in the law that had occurred, many changes in the investment world, and many new laws had been adopted, Uniform Prudent Investor Act for example in 1994. There had been developments of a number of state laws with interpretations of UMIFA that were creating conflicts and problems for nonprofits. In particular a number of problems with the limitation contained in UMIFA is called the historical dollar value (HDV) limitation which basically provided that a nonprofit could not lawfully expend money that would take the value of endowment fund below that amount which had been the product of the original gift of the endowment plus any additional gifts that had been added to it. That historic number was a limitation that served as a bright line test and created a number of problems in the late 1990's as the dot com industry went bust. A lot of people, especially newer institutions and newer gifts to older institutions were limited in their ability to make expenditures from those gifts from the moment they were made because the stock which had funded them had gone down in value from the date that the gift had been made to the time the gift arrived at the university or museum. It was no longer lawful to make any expenditure of appreciation from that fund because it was in words under water and until its value rose above water no expenditure could be made which created a very unfortunate situation especially for newer institutions and those institutions which badly needed the gifts that were being made to them.

This combination of changes in the world of law, changes in the world of investments and problems associated with the historic dollar value led to many requests from the nonprofits world to NCCUSL to take another look at the statute and see if after the 35 years plus since it had taken place whether it would be worth and possible to modify it and bring it into the 21st Century, making it more user friendly and relevant to the modern world. That lead to a study committee that was appointed by NCCUSL in the year 2000 which I was privileged to serve on along with three law professors John Langbein from Yale which many of you may know, Richard Wellman who unfortunately is now deceased from the University of Georgia, and a Supreme Court Judge from Oklahoma, Marion Opala who had also previously been a law professor. The three of them, plus me, became the study committee that took a look at the act and checked with regulators and the regulated community, reviewed the decisions that had been made and the many letters that we had received from around the country and a drafting committee was recommended by that study committee to NCCUSL. The drafting committee was appointed in 2002. We worked on the drafting with a reporter from the University of Oregon Law School, Susan Gary. We had advisors from the American Bar Association; we had observers from all over the country from nonprofits, educational institutions, regulators, and members of the attorney general staff that attended our meetings. For three years we worked on the drafting of a new act to replace, update and fine tune UMIFA. That process was a voluminous one that cost about $500,000 in just hard cost expenses, not including $2 million of donated legal fees. Members of the drafting committee, observers and various advisors would contribute their time and effort, meeting three to four times a year and many phone calls and conference calls beyond that.

In 2006, as Paul indicated the final product was promulgated and by this time we changed the name of it to distinguish it from UMIFA, calling UPMIFA which basically reflects the fact that it is a new act,

quite different from UMIFA and it also is infused with the benefits from the UPIA so that the concepts of prudence very much weigh in and we honored the historical background by calling it UPMIFA to recognize the contributions of prudence to the new product. There are many, many adjustments that were made in the act but I want to concentrate today on what I call the Big 3 or the 3 most important standards which should be of the greatest interest to most of you. Trying to go through, highlighting those 3 major changes and spend more time if possible in addressing and answering questions which I think would be more relevant to the vast majority of us if we can get into specific questions of why we made some of the decisions that were made and what lead to the decisions.

The most important one which is really one that I've already highlighted with the name was adding the prudent standards, clearly articulated to the investment, management and expenditure of all institutional funds. The prudent standards were grafted in all three categories and that's a big change from UMIFA which basically left those standards unarticulated. Now we have a number of clearly articulated standards which infuse not only the investment side but also the expenditure side of institutional funds.

The second major change was to change the endowment spending rules to eliminate the requirement of historic dollar value. The historic dollar value requirement had become extremely antiquated as I mentioned a few minutes ago. It became very problematic for newer institutions because funds that were given to those newer institutions were more typically going to be effected by the temporary loss in value but in the meantime the donors wishes to support a particular charity could be frustrated because the institution was unable to make an expenditure of the appreciation that they were expecting, were reasonable to expect that there would be appreciation. That requirement became an albatross and a real problem and UPMIFA changes that and says that the historic dollar value concept is antiquated and out-moded and it can be dropped. In fact what the nonprofit organization has to do is to be prudent in their expenditure even if it includes spending below the historic dollar value. That will not be an inappropriate expenditure as long as the decision is made prudently. The prudent standards are articulated within the act so that there is a clear reference to what it is that the nonprofit board must look to when they are making expenditures.

One of the very first standards that they will come to is the preservation of the value of the funds. If it's an endowment fund it's clearly prudent to consider whether an expenditure is going to take you below the historic dollar value and whether that will threaten the long term integrity and viability of the fund. Or is it something that is reasonable and prudent to do under the circumstances where one can anticipate that the investment cycle will bring the value of these funds back within a reasonable expenditure. At this point there was a major decision to be made.

You'll find many of the states have enacted UPMIFA, there are now 13 states which have adopted it so we are off to an excellent start. In the first year of legislative enactment it was introduced in over 20 states and has been enacted in 13 of them and there is still hope for another 3 or 4 in this legislation season. In some of those states they have enacted it with a bracketed provision that calls for a prudence or an assumption that it would be imprudent to spend more than 7% of the value of a fund

based on a bright line testing, being defined as a bracketed alternative. In 4 or 5 states they have now adopted the version of UPMIFA with the bracketed version calling for that bright line test. But in removing the historic dollar value a number of states wanted to continue to have some standard which they could look to and say it would be deemed to be imprudent to spend more than 7% of the value of a fund in any given year. It then becomes the burden of the nonprofit board to overcome that presumption that it was imprudent. We'll go back to that and I'm sure there will be questions on that one issue.

The third major change was to add greater flexibility to the rules allowing for the termination of small old funds and giving nonprofit organizations a greater ability to eliminate funds which have become outdated, outmoded and not useful. In particular the nonprofits notified us that they were concerned with the legal costs and the time that it took to get rid of many older funds that were of small dollar value.

Let me give you an example. Funds had been given to a medical facility for the elimination of polio and the fund is under $20,000 and is suppose to be used only for the research of the eradication of polio. Well, as everyone knows polio is no longer an issue of public health in the United States. We found the cure and an institution looking to take those very valuable dollars and use them for aids research found themselves frustrated by the obligation to go into probate court and get judicial determination that the purposes of the fund had become outmoded and therefore was lawful for that institution to take the $20,000 and spend it on aids research rather than on polio eradication. When it found that it needed to spend $25,000 in legal fees in order to redirect $20,000 in donated funds it became a gloomy prospect.

One of the modifications in UPMIFA is adding in a provision that, after notification to the states chief charitable regulator, the attorney general in most states, allows the nonprofit institution to take a fund which is more than 20 years old and is under a certain amount, we have suggested in brackets of $25,000 which may be appropriate for smaller states and in some states that number has been raised to as much as $50,000 and some states are considering $100,000. At some point a fund which is under a certain dollar amount, the nonprofit institution notifies the attorney general and gives them 60 or 90 days to notify them if they have a problem with it and absent any notification from the attorney general the nonprofit is enabled to redirect the money to another charitable purpose. In most cases, one that most closely follows the intents and wishes of the donor so that if the donor had intended for medical research it certainly would be appropriate to take those funds and redirect them to aids or breast cancer eradication rather than spending them on polio where the funds are not needed.

Those have been the points which have been of greatest interest to the legislatures. I've had the privilege and honor of speaking to legislative committees in 7 jurisdictions, by phone to 3 others and there certainly has been a great deal of interest around the country to making those types of changes. Those have been the types of things which have mostly driven the legislative success that we have had so far. At that point, I think the purposes of this discussion by phone would be best served by opening it to question and answer.

Alison: We will now open it up for questions.

Jennifer: I'm curious, one of our issues is prior to the enactment of the new legislation is who exactly does UPMIFA apply to, in terms of whether it applies to trusts or not. Could you go into some details on who the new one applies to?

Barry: Sure, I can do so on the way it was drafted nationally and I have not had a chance to look at the Texas draft so it will not be a Texas specific answer. On the draft that was approved by NCCUSL we thought long and hard about extending the UMIFA rules and broadening them to all charitable organizations of any sort whatsoever no matter how formulated. That would have included those charitable organizations in which the funds were being held in trust by an individual or by an institution. After quite a bit of debate, including concern by the American Bankers Association that it would be confusing for its members to have two sets of rules. The final product removed funds which are held in trust by an individual or by an institution and are not covered by UPMIFA nor were they covered by UMIFA with a very few small exceptions. So the current rule on coverage will be the same on UPMIFA as it was in UMIFA. It will cover all charitable institutions whether corporations or how they are organized and as long as they are holding the funds for themselves in their own account it governs them and it will not govern those organizations which are having their funds held for them in trust by an individual or an institution.

The one exception that I'm talking about is in Connecticut and two other states. There's an exception that has been engrafted on the old UMIFA for community foundations which follow what we call the Cleveland Model where the community foundation funds are being held for the benefit of the community foundation by a number of banks but they are the trustees of the funds dollars. Because that's much more similar to a normal charity holding its own funds those states which had foundations following the Cleveland Model had an amendment put into UMIFA and that amendment will continue to apply by amendments to UPMIFA by a change applicable to those states.

Rauli: Barry, the Act mentions that costs can be incurred as long as they are appropriate and reasonable. Did the committee change the costs that they considered to be appropriate and reasonable or is that more of a general statement?

Barry: More of a general statement to make it clear that it is really up to each nonprofit organization to apply rules which are very similar to those that apply under UPIA that its reasonable standards are to be in the first place decided upon by the nonprofit's board of directors and will be judged by the courts using the reasonable person standard.

Steve: In terms of some of the language in regards to verifying facts of the investment and the management, did the committee consider one of the phenomena's of the last couple years which has been what I would call the wide spread adaptation of the Yale Model asset allocation with large investments in alternative asset classes which has been done very successfully by some large

endowments? Is the scope of those sorts of engagements something that you all considered?

Barry: Yes, very much so. That really goes back to the genesis of UMIFA itself that under the old trust laws before you had UMIFA and now UPMIFA there was a widespread belief that basically investments left before the generation of the endowment needed to stay away from alternative investments. There was really no ability to seek the types of total return investment where you have an allocation between different types of risk classes. With the historical dollar value it became even more of a problem because the first reaction of many institutions when they had funds which were under water was to say, we can't use those funds to invest for growth so we will have to revert to the historic method of generating income by way of interest or dividends or rent and use non-appreciated values so that we will not be afoul of the historic dollar value limit. It ended up forcing a distortion of investment in which people with underwater funds would take the funds, in many cases sell the assets for well below what they could've expected to be a growth instrument over a period of time and use the funds to invest in treasury bills or savings bonds to generate income which they thought would be free of the historic dollar value limitation. They then in fact ended up running investments which were turning 4% or 5% when inflation was running at 6% & 7%. In a short order doing more damage to the true historic dollar value and growth potential of the funds than they would've if they had not had to contend with HDV as a limitation.

Paul: A follow-up on that, it states in the act that there has to be a level of verification of this delegation. With these funds now we're finding transparency is not always available. We're certainly seeing it as a challenge with those that are blowing up and no one knew what they were doing. What were the committee's thoughts on the level of verification that was reasonable to do?

Barry: We didn't spend a lot of time on that subject frankly and with some of the questions that have come up in the legislative process that may be a subject that's worthy of further exploration. The one way that it did come up is that most nonprofit organizations will have an investment committee and will often have people who are qualified by virtue of their day job in the investment world. We made it clear that people who are qualified investment professionals will be held to that standard and those people who are appointed to a board or to an investment committee of a board by virtue of their claimed expertise in investments will be held to the standard that they claimed.

That's been very controversial. A number of legislatures have been very concerned that that will discourage some people from serving on nonprofit boards, especially from serving on their investment committees but there are other statues in most states which give aid and comfort to volunteers who have served on those boards and they're certainly entitled to that protection but we think it is important that if someone is appointed to a board or is asked to serve in a particular position because of that claimed expertise that that's a standard they should be held to.

Kurt: I'd like to follow-up with that. Does it seem advisable to be even more careful under the new act, assuming that it is implemented in the resident states, in terms of the types of people you pick for an investment committee? It seems to me that this was certainly an issue under the old law also. Do you

have some suggestions on that?

Barry: I don't think that the committee deliberately is tempted to change that dynamic. I think that there are some safe guard rules and protection rules as you know in most states for those who are serving without compensation on boards certainly that they can look to for protection but I think it is true that all through the nonprofit world the off shoots of Sarbanes Oxley are starting to be heard and starting to be felt in the nonprofit world as well as in the stock corporations. People are being held to scrutiny and there certainly has been a great deal more publicity paid over the last couple of years to unreasonable compensation for the executives of nonprofit organizations, several nasty public disputes and public criminations and things gone array in the nonprofit world. A board member who thinks that he or she has the ability to not pay attention to their board responsibilities on a nonprofit as they would on a stock corporation is going to be very much surprised. I think it's very clear that the trend is holding board members to reasonable standards even though they're not getting the compensation that they would if serving on a stock corporation but there's a public scrutiny and a need for transparency that is being widely felt in the United States. I think that it's much greater than the UPMIFA/UMIFA change but we're certainly effected by it.

Gary: I have a 2 part question and it is related to special circumstances and time frames towards diversification in those instances where say a fund or a board determines reasonably that because of whatever purposes their interests are best served without diversification. What might have been some of those special or exceptional circumstances that the committee would've discussed and part two to the question is, if so, was there a time frame for such diversification?

Barry: That's a difficult question to answer. Let me go back for one second to say something that I should've mentioned earlier and that is bottom line, UPMIFA and UMIFA are default statutes which really only kick in and become important when the donor or the donor of instrument has left unclear the intended specifics. If you have a gift which says I'm giving a million dollars and I've been in the oil business all my life and I'm giving one million dollars to the University of Texas and I want it to stay in oil because this is where I made my money and I don't care about diversity. I want it to stay in oil so it will darn well stay in oil and that's okay.

The need for diversification: one of the standards would be the purposes of the institution and the purpose of the instrument and if its then given for specific purposes which make it appropriate or have a limitation imposed that these funds will not be diversified that's entirely appropriate but absent that type of limitation normal prudence would indicate that the directors and officers of the nonprofit do attempt to diversify. How quickly they diversify is again governed by prudence and the standards that are articulated in the statutes. It may well be imprudent to sell a very large holding in an area that's very limited to somebody who controls all the stock of the XYZ chemical element and tries to diversify by getting out of that stock in a hurry they're going to do a lot of damage to that particular asset value. In those circumstances the diversification process might take longer and it might be much shorter in others.

We certainly have a number of different parameters, things which are appropriate for one institution to hold may be entirely inappropriate for a different type of institution. We've found charitable organizations that say under no circumstances in the world can they hold tobacco or alcohol stock and they attempt to get rid of those and diversify out of those assets as quickly as they can because its in their constitution or "DNA" to not be involved in holding that asset.

Paul: Barry I'd like to go back to the provision on the 7%. I think it's important for some further comment. We saw a circumstance in the late 1990's where three year average values were quite substantial in endowments and by 2002 while we were still just approaching the last year in the 3 year values they had really come down.

We had a circumstance where an institution received a substantial gift, this would be more for smaller institutions, they received a substantial gift in the third year and when they looked at the three year average, applying 7% to it frankly may only be 3% of the current value. Am I correct in understanding that this is really a guideline that you've suggested or is this in fact something you think the states are going to be looking at more rigidly that that's what it is?

Barry: It's a little bit of both. The 7% really came from the Massachusetts model which had taken the old UMIFA statute and added a bright line test to it that happened to be followed by Pennsylvania which had a bracketed from 5%-7% I believe. They didn't actually adopt UMIFA but they had something like it with the bracketed change. New Mexico and New Hampshire were the other states. 7% happened to be number chosen by three of those jurisdictions.

A number of us did not think that was a very good idea because it seemed like an open invitation for board members to say, since it's in the statute as an option or as a guideline then spending up to 7% must be okay. Frankly, as any of us who have looked at it long and hard, know that in many environments of inflation, spending 7% is a good invitation to spend yourself right out of existence. It would certainly not be good wisdom for people to think that they're being invited to spend 7% and frankly it would be a little bit of a political problem for some nonprofits to look at the CEO of the institution they're supporting.

If you're a college foundation and the college president wants to spend money that the board doesn't think is prudent to spend it may be a tempting thing for the president to say well, it's perfectly okay to spend up to 7%. I think that you're being very penny foolish with your 4.5% spending policy and why don't you go up to 7% because we really need the money. The ultimate outcome was to make it a bracketed provision so that in those states who thought they should really have a bright line test they could adopt this one and in the footnotes we tried to make it very clear that it's not an invitation or blessing to spend 7%. You still need to be prudent.

The majority of the drafting committee thought that being prudent and having the articulated standards of prudence was sufficient but we bowed to the political inevitability that it would be an un-enactable statute in at least half a dozen jurisdictions if we didn't give them the option of adopting the 7% bright

line test.

Alison: Thank you very much Barry for participating with us on this call and sharing your experience with us. I'd like to remind everyone about our call next month on August 21st at 2:00pm Central Standard Time as we discuss Subprime Mortgages, Wall Street's Latest Fiasco. Please be sure to rsvp for the call.

Have a great afternoon!

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