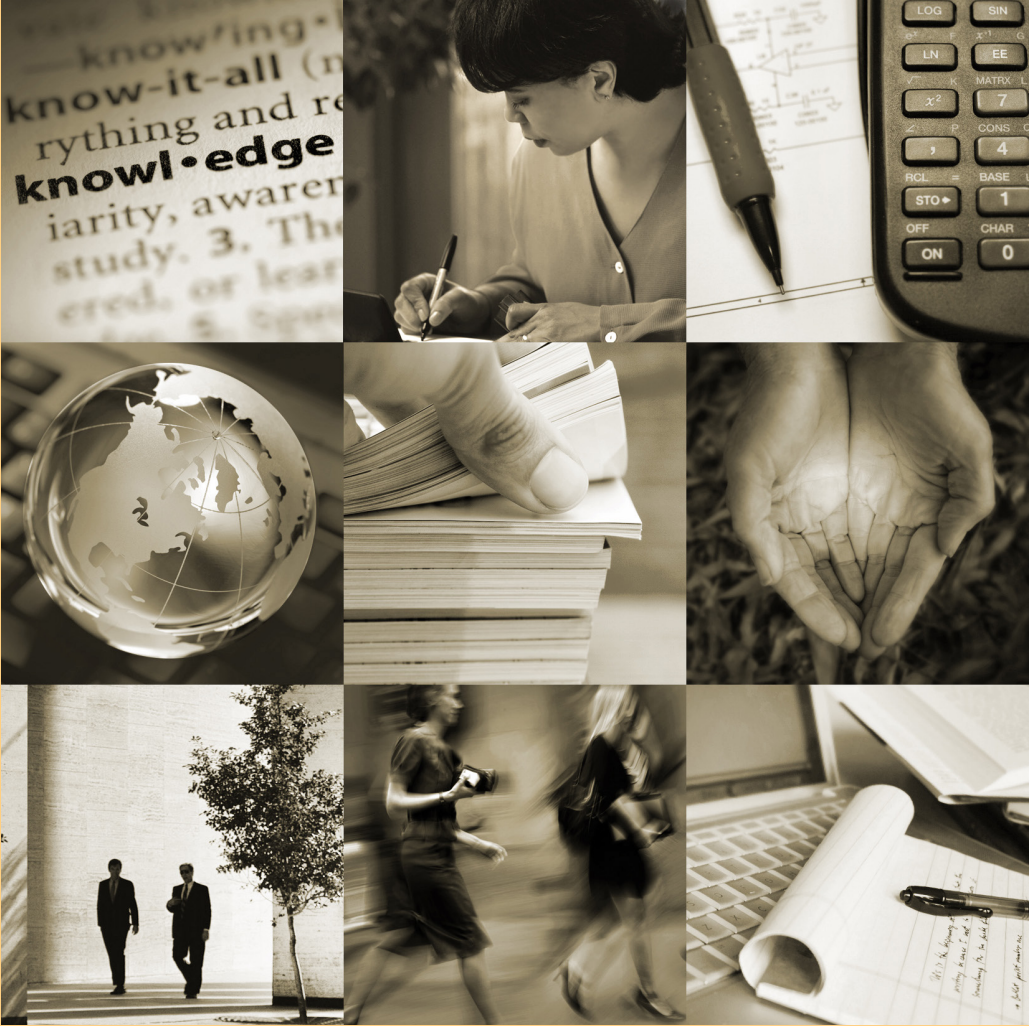


Legislating the Normative Environment

Nonprofit Governance,
Sarbanes–Oxley and UPMIFA

May 2015



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Legislating the Normative Environment: Nonprofit Governance, Sarbanes–Oxley and UPMIFA

Regulation of nonprofit investment and governance practices has migrated from traditional common-law principles to codified statutory law, affecting areas of nonprofit governance not addressed in the original legislation. Trustees will do well to heed this development.

A phenomenon with far-reaching effects on nonprofit investment management and governance has become a little-noticed yet powerful force in boardrooms over the past decade. Despite its wide-ranging implications, this development has largely gone undocumented. This paper seeks to draw attention to this change and its implications, and to trace a transformation in thinking that has gained momentum in recent years.

Briefly stated, regulation of key aspects of nonprofit governance and investment has, in important ways, ceased to be a matter of unwritten common law and has become primarily a matter of codified statutory law. While interpretation by courts remains fundamental to the application of these laws, it is nevertheless true that standards which previously varied from state to state around a set of core fiduciary principles are now being interpreted against much more uniform statutory standards.¹

¹ Federal tax law, particularly the revised and expanded Internal Revenue Service Form 990, has also exerted a strong influence on nonprofit governance practices. While we provide a brief summary of Form 990 in this paper, it has already been the subject of extensive analysis (*see, e.g.*, Hopkins, Anning, Gross and Schenkelberg, *The New Form 990: Law, Policy and Preparation* (Wiley, 2009)), whereas the other developments we trace are, we believe, less well understood.

As important, perhaps, is the “aura” that this process creates, in which the norms created by these statutes are being applied to situations that were not directly contemplated by their drafters.

Most of the standard laws that govern the nonprofit sector are the result of work undertaken over the last century by volunteer groups of attorneys aiming to provide clarity and a measure of uniformity in two main areas: a basic governance structure for nonprofit corporations that would parallel that for business corporations and a clarification and codification of fundamental common-law trust principles. The results, which we summarize below, are of long standing and their application has been more or less as intended, affecting the subjects for which they were drafted but without spilling over into other areas.

The two more recent examples that we will discuss in this paper, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or SOX) at the federal level and the Uniform Prudent Management of Institutional Funds Act (UPMIFA) at the state level, are different in that the effects of both have gone beyond their drafters’ original scope. While just two provisions of Sarbanes-Oxley, which was passed primarily to address governance

issues at publicly-listed for-profit corporations, were intended to apply also to nonprofit entities, the entire statute has now become a de facto default best practice standard for nonprofits. And the standards set under UPMIFA, which by its terms was designed to apply to donor-restricted funds (other than those in trust form administered by a corporate trustee), are increasingly being extended by inference to the governance and management of unrestricted and board-designated endowments.

The title of this paper refers to this phenomenon: these two laws, enacted to address specific areas and issues, have seen their impact expand far beyond their original scope or intention. In this newly-created “normative environment,” nonprofits can appear to be departing from best practice if they fail to comply with the standards set by these laws, even if the laws were not intended to apply directly to those situations, and boards of such institutions may increasingly face questions as to why they choose not to comply with these standards. This legislated normative environment fills in voids that were previously the purview of common law fiduciary, corporate governance and investment jurisprudence and raises fundamental challenges to trustees and others charged with oversight of nonprofit institutions.

Background: The Codification of Nonprofit Corporation and Trust Law

Until the 20th century, nonprofit governance and investment in the U.S. were a matter of common law, based on general fiduciary principles derived from English legal precedents. These principles had evolved gradually from centuries of court decisions and commentary, and were taken up in U.S. courts as part of our legal inheritance from England.

Importantly, however, each state had a separate court system and, while agreement on certain basic principles existed, variations did emerge between states in their treatment of key governance, investment and fiduciary matters. As the American economy began to function on a more truly national basis in the closing decades of the nineteenth century, it became apparent that users of the legal system – including corporations, financial institutions and trustees – would benefit from a greater degree of legal uniformity among the states, at least with respect to the law affecting commercial transactions and corporate and nonprofit governance, investment and trust matters. Groups of attorneys and lawmakers such as the National Conference of Commissioners on Uniform State Laws² and the American Bar Association (ABA) undertook the task of drafting proposed statutes with the goal of defining areas in which uniform practices and standards could be agreed among the various states. These uniform laws, proposed to the various state legislatures, could be adopted as drafted or – as not infrequently occurred – modified to suit local preferences. The results, taken as a whole, did indeed serve to rationalize the patchwork of individual practices that had previously existed. In this section, we review a few of the uniform laws that were most relevant to the nonprofit sector.

² Also referred to as the Uniform Law Commission.
<http://www.uniformlaws.org>.

Uniform Principal and Income Act

Adopted by 46 states and the District of Columbia, the Uniform Principal and Income Act—originally drafted in 1931 and most recently amended in 2008 — was created “to provide procedures for trustees administering trusts and personal representatives administering estates in allocating assets to principal and income, and to govern their proper distribution to beneficiaries, heirs and devisees.”³ Recent amendments have focused on bringing the concept of principal and interest, which have their antecedents in English trust law, into alignment with the total return investment concepts of Modern Portfolio Theory discussed more fully below.

Model Nonprofit Corporation Act (MNCA)

The MNCA was originally prepared in 1952 by the American Bar Association’s Committee on Corporate Laws to provide a uniform framework for governance of incorporated nonprofits. A revision was adopted in 1987 by the ABA and subsequently enacted in whole or in part by a large number of states and the District of Columbia. Other jurisdictions, while not formally adopting it, follow many of its terms. A companion law, aiming to apply the MNCA’s principles to unincorporated nonprofits, was promulgated by the Uniform Law Commission in 1996; this law was most recently revised in 2008. A 2008 revision of the MNCA by the ABA has been the subject of debate and has not yet been widely adopted.

Uniform Management of Institutional Funds Act (UMIFA)

A major breakthrough in nonprofit governance with respect to endowment management came in 1972 with the introduction by the Uniform Law Commission of the Uniform Management of Institutional Funds Act (UMIFA) and its subsequent passage in 47 states and the District of Columbia.

UMIFA followed the investment principles outlined in Modern Portfolio Theory, departing from traditional trust law in establishing the validity of total return investing and enabling fiduciaries to spend from capital appreciation as well as interest and dividend income and to delegate investment management responsibilities to professional investment managers. It did, however, retain the historic trust law limitation on spending from a donor-restricted fund if such spending would cause the fund’s value to fall below its level when originally donated (the “historic dollar value”). This limitation on spending from so-called underwater funds varied from state to state, sometimes being expressed as a complete prohibition and sometimes as a direction to spend only current income (i.e., dividends and interest) from the affected fund.

Uniform Prudent Investor Act (UPIA)

The Uniform Prudent Investor Act, adopted in 1994 by the Uniform Law Commission and subsequently enacted in 41 states and the District of Columbia, codified the common-law Prudent Investor Rule, stating that a fiduciary, in investing and managing charitable assets, should behave “as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances” of the fund in question. Consistent with Modern Portfolio Theory, it endorsed a total return approach to investment management. Subject to the rule of prudence, it removed traditional restrictions on the type of investment permitted by nonprofit fiduciaries, which had in many states historically taken the form of “legal lists” of approved types of securities promulgated by attorneys general. Under the new law, fiduciaries were required to diversify the investments in the portfolio and, importantly, to engage in an analysis of risk versus return; performance was thus to be measured with reference to the entire portfolio, rather than for individual investments as under traditional trust law. It also allowed fiduciaries to delegate the task of investment management, which had been prohibited under trust law.

³ http://www.uniformlaws.org/Act.aspx?title=Principal_and_Income_Act (2000).

Significantly, although the Uniform Prudent Investor Act was created to apply to assets held in trust form, the drafters anticipated that the law would, if successful, create an “aura” that would lead to its being applied to other types of charitable investment as well. In the Prefatory Note to the law, they note that “although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.”

It can thus be seen that the late 20th century was a period in which the reform of traditional trust law concepts gathered pace, led in large part by the Uniform Law Commission and the ABA, with the result that the foundation of governance and investment by nonprofit entities became more standardized and more subject to statutory, as opposed to common law, criteria.

Sarbanes-Oxley and UPMIFA

Sarbanes-Oxley Act of 2002

With the advent of the new century, corporate governance scandals in the for-profit sector led to the passage of the Sarbanes-Oxley Act. Unlike the other uniform statutes we have reviewed, which had depended on adoption by the states, SOX was enacted at the federal level. For nonprofits, the importance of SOX lies in the fact that while the act was intended to address governance shortcomings at publicly-traded, for-profit corporations, many of its key principles were quickly applied to the nonprofit sector.

Only two provisions of SOX were originally meant to apply to nonprofits, and both are criminal offenses: retaliation against whistleblowers (Section 1107) and destruction of documents that could be used in an official investigation (Section 1102). The latter section also forbids impeding or obstructing official proceedings. Other sections of SOX, however, particularly the requirements that the institution have an independent audit committee and certified financial

statements, have now become essentially universal expectations in the nonprofit world even though the law by its terms does not require nonprofits to have them. Indeed, after SOX’s passage several state attorneys general were quick to propose that some of its elements be applied to nonprofits and, in fact, both California and New York subsequently enacted comprehensive new statutes in the spirit of the SOX legislation (see box on page 5), a possible harbinger of more comprehensive state governance statutes that may, among other measures, incorporate concepts from SOX.

Perhaps most relevant to the sector, the potential liability to which corporate directors became exposed as a result of SOX led to a change in the perception of the nonprofit fiduciary’s role. Service as a trustee or director on a nonprofit board could no longer be considered a purely honorary position. While it had always been assumed that board members would be involved in and informed about their organizations, the standards set under SOX meant an increased scrutiny of the fiduciary function, consistent with the implication that fiduciary responsibility and good governance are linked to organizational effectiveness and compliance with the law.

Uniform Prudent Management of Institutional Funds Act (UPMIFA)

UPMIFA, drafted by the Uniform Law Commission and sent to the states for adoption in 2006, combined concepts from UMIFA, UPIA and other sources to create a comprehensive framework for investing, spending and managing donor-restricted funds other than trusts administered by a corporate trustee. As its title implied, the key concept in UPMIFA was the fusion of UMIFA’s endorsement of total return investing with the long-established standard of prudence embodied in UPIA.

UPMIFA adopted the “prudent person” standard as an overarching framework for decision-making by fiduciaries. The law directs those responsible for managing and investing the funds of an institution

to act “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances”. Under UPMIFA, prudence is in part demonstrated by compliance with lists of items that the fiduciaries must show they have considered when investing and spending from a fund and when delegating responsibilities to an agent.

To take one example, total return expenditure is expressly authorized. The introduction of UPMIFA occurred shortly before the collapse in portfolio values that accompanied the global financial crisis of 2008-2009, and the limitation on spending below historic dollar value contained in UMIFA meant that, in many states, endowed nonprofits found that their ability to spend from underwater funds would be limited or blocked entirely. UPMIFA replaced the use of historic dollar value with a more flexible standard that allowed spending from dividends, interest, realized and unrealized appreciation, provided that the fiduciaries took into account the duration and preservation of the fund, the institution’s and fund’s purposes, economic conditions, expected inflation or deflation, expected total investment returns, other resources of the institution and the institution’s investment policy. This clarity was part of UPMIFA’s appeal to nonprofits and legislators; its adoption was swift, and it has become the law in 49 of the 50 states and the District of Columbia.⁴

NEW DEVELOPMENTS:

IRS FORM 990 AND NONPROFIT STATUTES IN TWO LARGE STATES

Internal Revenue Service Form 990

Linked to the reforms promulgated by SOX, the new Form 990 was released in December 2007. Unlike its predecessor, a relatively simple form first promulgated in the 1940s, the new form requires participation and ratification by the organization’s directors and trustees as part of the annual filing process. Specific questions about whether a nonprofit has an independent audit committee and whistleblower protections clearly reflect the enactment of SOX earlier in the decade. New questions require disclosure about the governance processes of the organization, its compensation practices and its operating policies. In addition, as a document available to the public, Form 990 has made possible a level of transparency and scrutiny of the affairs of nonprofit organizations not seen previously.

California Nonprofit Integrity Act of 2004

Coming soon after SOX, this law was enacted to improve nonprofit corporate governance, accountability and transparency in California. Among the act’s major provisions were requirements for audited financial statements at many types of nonprofit, for an audit committee appointed by the board, and for approval of CEO and CFO compensation by the board. The act also prescribed detailed rules governing the conduct of commercial fundraisers and their relationships with charitable organizations.

New York Nonprofit Revitalization Act of 2013

Effective as of July 1, 2014, this law was designed to reform the statutory requirements for governance of New York nonprofit organizations, expand the attorney general’s enforcement powers, and modernize and clarify some of the New York rules applicable to nonprofits. Among the law’s major changes were a requirement for a conflict of interest policy; an audit committee for nonprofits above a certain size; and a prohibition on having an employee of the nonprofit serve as board chair or hold a position with similar responsibilities.

⁴ Pennsylvania has its own statute and has not adopted UPMIFA.

Implications for Nonprofit Organizations

With Sarbanes-Oxley, UPMIFA and other statutory requirements now in place, and with their “aura” now widely apparent, what steps should nonprofit fiduciaries be taking to ensure that their organizations are seen to be aware of, complying with, and, indeed, embracing, their standards?

Here are a few items to consider:

- *How SOX-friendly is your organization’s governance structure?* In addition to the universal SOX requirements for document retention and the prohibition on retaliation against whistle-blowers, the norm for nonprofit organizations now includes an independent audit committee and certified financial statements. Beyond these requirements, however, the standard required of fiduciaries has become much higher. In addition to ensuring that their organization has an up-to-date conflict-of-interest policy, trustees should ask:
 - *How informed are our board members about the organization?*
 - *What level of board orientation and education should we require?*
 - *How should ongoing board self-assessment and continuing improvement be structured?*
 - *How should new trustee candidates be identified?*
 - *Apart from donating and fund-raising, what level of working commitment should we require of trustees?*
 - *What is the role of term limits, and how can succession planning be carried out at the board level?*
- *How can your organization be seen to act in alignment with the spirit of UPMIFA?* Even when considering the investment and spending of unrestricted, quasi-endowment or board-designated funds, the normative environment created by UPMIFA has set a standard from which an organization should depart only if it can convincingly justify to beneficiaries, donors and regulators that a different standard would be more appropriate. Here, a wide variety of questions suggest themselves:
 - *When did we last update our investment policy statement (IPS)?*
 - *Does our IPS reflect UPMIFA’s abolition of historic dollar value and adoption of total return investing and spending, or is it still based on outdated trust-law concepts such as corpus and income?*
 - *Does it acknowledge the lists of issues that must be considered, under UPMIFA, in investing and spending from a fund, in choosing an agent to whom investment responsibilities are delegated, and in actively supervising that individual or organization?*
 - *How are we meeting UPMIFA’s standard of the “prudent investor”?*
 - *Is our endowment appropriately diversified?*
 - *If not, given UPMIFA’s affirmative requirement of diversification, how have we documented our decision that not diversifying the fund’s investments is more appropriate?*
 - *How does our investment practice honor UPMIFA’s requirement that, absent instructions from the donor, a fund’s purchasing power is to be maintained, over successive market cycles, into perpetuity?*

Conclusion

The current state of nonprofit regulation can be viewed as the culmination of a long process of standardization that has, through a succession of uniform state and (more recently) federal laws, transformed the governance of nonprofit organizations.

While Sarbanes-Oxley did not directly address nonprofits, it nonetheless set a new threshold for best practice in nonprofit governance as it became clear that there would be increased external focus on fiduciary responsibilities, board independence, conflicts of interest, bylaws and investment policies. In this sense, SOX effected change as much through its creation of a normative practice as through specific requirements. To mention just one group of outcomes, the relationship between nonprofits and their auditors has changed, as have the independence and responsibilities of board audit committees. The close relationships that once existed between board members and the accounting firms that review and approve their financial statements and tax returns have become less personal. Many nonprofits have also adopted Sarbanes-Oxley-style ethics guidelines for their financial officers. Even the major credit-rating agencies have adjusted the way they monitor nonprofits. Several—including Standard & Poor's, Moody's and Fitch—now rate nonprofits on how well they follow Sarbanes-Oxley's prescriptions regarding internal controls, auditor independence and corporate governance.

At the state level, UPMIFA's effects have extended far beyond the specific language of the act. While generally bestowing greater freedom on boards, UPMIFA also imposed new responsibilities in the form of specific lists of issues to be considered, debated, resolved and recorded in board minutes when investing and spending perpetual funds and delegating responsibilities to external agents or managers.

Sarbanes-Oxley and UPMIFA, together with the other developments we have reviewed, are the most recent milestones in the formal codification of the rules and principles governing nonprofit organizations. A few decades ago, nonprofits were rarely in the public spotlight for reasons other than their core mission. Now, they are in the glare – a harsh one, sometimes – of regulators, media and constituents. Trustees and staff of nonprofits will do well to bear in mind the “aura” that radiates outward from these new laws, creating an environment that requires greater uniformity and consistency in governance, oversight and operations than in the past.

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