Governance and Compliance Issues for Foundation Financial Management

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I. Introduction

As mission-based nonprofit organizations, private foundations and community foundations share many common traits. Each type, however, possesses its own distinguishing characteristics.

This paper analyzes the major governance and compliance challenges that private and community foundations share and describes how statutes and regulations that govern private and community foundations create very different decision-making environments for their fiduciaries. Specifically, we seek to: 1) identify and summarize the critical governance issues that foundations of both types must consider to remain in compliance with prevailing and emerging laws and regulations at the federal and state levels; 2) define the role and responsibilities of the investment committees of these foundations; and 3) offer guidelines for board governance and leadership, with specific reference to the investment committee.

Sound governance and compliance with applicable laws and regulations are essential for all nonprofits, and a passive attitude toward these responsibilities may place these organizations at risk. Poor governance, whether in practical matters or matters of policy, and a lack of attention and adherence to relevant legal requirements may lead to legal and financial penalties, threatening the fulfillment of the institution's mission. Increasing media scrutiny of nonprofit institutions assures that a foundation's mistakes and failures will draw notice and that its reputation will suffer as a result. A tarnished image may, in turn, inhibit the foundation's ability to recruit skilled volunteer board and committee members and to attract gifts and donations from the public and from corporate entities.

Before reviewing the characteristics that differentiate private and community foundations and the practices that lead to excellence in governance of both types of foundation, let us briefly examine the historical and legal contexts that have shaped expectations of fiduciaries and have created today's evolving and ever more rigorous compliance environment.

II. Regulation: Foundations' Common Law Heritage and the Evolving Legal Environment

Foundations have long been subject to principles of common law and to statutory regulation. Among the time-honored principles expected of nonprofit fiduciaries are the duties of care, loyalty, and responsibility, as well as adherence to an overarching standard of prudence. A fiduciary, simply defined, is one who acts in a position of confidence or trust on behalf of another. Under traditional trust law, a trustee could not properly delegate to another the power to select investments. This model began to change in the mid-20th century and, although legal questions and challenges regarding delegation existed as late as the early 1970s, the law now generally recognizes the need for delegation and for portfolio diversification in the interest of improved investment returns for the endowment and its beneficiaries.

The duties of care, loyalty, and responsibility are legal requirements of a fiduciary; any individual who serves in this capacity for a nonprofit entity that benefits from tax exemption or receives other government dispensations must adhere to these duties. For fiduciaries who serve on investment committees, whether or not they are trustees, the duty of care demands that investment committee members acquaint themselves with all of the information and pertinent facts under the committee's purview. The duty of loyalty requires that they avoid conflicts of interest and be faithful to the institution. The duty of responsibility (sometimes also referred to as the duty of obedience) involves maintaining the institution's fidelity to its mission and charter and implementing its policies in a disciplined and consistent manner.

In 1830, the famous U.S. legal case *Harvard v. Amory* established the general standard of prudence which, in modified form, still governs the behavior of investment committees today. Originally formulated as the "prudent man rule" (and now known as the "prudent investor rule"), this standard holds that fiduciaries must invest as a prudent person would, not with a view to speculation but with a long-term perspective. From the time of the formulation of the rule through the mid-20th century, "prudent" endowment investments were deemed to consist primarily of fixed income instruments such as bonds and mortgages. Beginning in the 1950s economists and academics began to advocate investing in a diversified portfolio that would include equities, since bond investments were vulnerable to a loss of purchasing power over time due to inflation. College and university endowments were the focal point for this period of change, especially during the 1960s and early 1970s. Concepts such as total return investing, which held that investment return should be defined to include not only dividend and interest income from investments but also market appreciation or depreciation, gained gradual acceptance, as did the concept of delegating portfolio decisions to the professional investment management firms that had begun to supplant the old bank trust departments. In 1969 the Ford Foundation commissioned two landmark studies that influenced endowment management practices—*Managing Educational Endowments and The Law and Lore of Endowment Funds.*[1] The former study analyzed investment processes and recommended changes to those processes, while the latter recommended changes to the legal principles governing the management of endowments.

In 1972, these concepts among others were embodied in a proposed law, the Uniform Management of Institutional Funds Act (UMIFA), which established standards for the management, investment, and expenditure of the endowment funds of nonprofit institutions. UMIFA achieved a great success, significantly lightening the restrictions that traditional trust law had imposed and enabling institutions to pursue total return investing.

In 2006, UMIFA and other statutes were combined and updated in the Uniform Prudent Management of Institutional Funds Act (UPMIFA). The new act combined concepts from UMIFA, the Uniform Prudent Income Act (UPIA, adopted in 1994), and other sources to create a comprehensive framework for investing, spending, and managing donor-restricted funds other than trusts managed by a corporate trustee. UPMIFA combined UMIFA's endorsement of total return investing with the standard of prudence that had been embodied in statutory form in the UPIA. The adoption of UPMIFA meant a number of changes for nonprofit organizations:

[1] *Managing Educational Endowments: Report to the Ford Foundation* (New York: Ford Foundation, 1969); William L. Cary and Craig B. Bright, *The Law and the Lore of Endowment Funds; Report to the Ford Foundation* (New York: Ford Foundation, 1969).

- greater freedom in investing, removing limits on the type of assets that managers may select for a portfolio
- focus on the specific needs of nonprofits, providing for diversification of assets, pooling of assets, total return investment, and whole portfolio management
- codification of the overall standard of prudence as a common standard for investing, spending and delegation
- elimination of UMIFA's restrictions on spending from an "underwater" fund, defined as one whose value had fallen below its original amount when established (its "historic dollar value")
- an optional provision allowing states to determine that an organization spending more than 7 percent of its endowment is acting imprudently.

Other legal changes in the investment environment have come in more subtle ways as, in recent years, the governance and compliance environment has become more rigorous. The Sarbanes-Oxley Act of 2002 (SOX), although primarily aimed at curtailing fraud, malfeasance, and similar misbehavior in the for-profit sector, has two provisions that apply to nonprofits. Both relate to criminal offenses: retaliation against whistleblowers and destruction of documents that could be used in an official investigation.

Other sections of SOX, however, have since been widely accepted within the nonprofit sector, in particular the requirements that the institution have an independent audit committee and certified financial statements. At a more fundamental level, the greatest change wrought by SOX may have been at the fiduciary level:

> *Perhaps most relevant to the [nonprofit] 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.*[2]

Compliance and commitment go hand in hand

A foundation's compliance with SOX, UPMIFA, and other statutory requirements, and its commitment to board excellence are ideal complements: the latter goes a long way toward ensuring the former.

What steps can foundations take to ensure their organizations are complying with SOX and UPMIFA? Trustees should consider the following:

The Sarbanes-Oxley Act

Is your organization's governance structure compliant with Sarbanes Oxley? The law raises the standards demanded of fiduciaries. Increasingly common influences from Sarbanes-Oxley include an independent audit committee, certified financial statements, document retention, prohibition on retaliation against whistle-blowers, and an up-to-date conflict of interest policy. To help ensure compliance, trustees should ask:

- How informed are our board members about the organization?
- What level of orientation and education should the organization require of its board members?
- How should our board structure its ongoing self-assessment and its continuing improvement?
- How should the organization identify new trustee candidates?
- What level of working commitment should the organization require of its trustees?
- What is the role of term limits in ensuring our board's vitality, and how can the board plan for succession?

UPMIFA

Your organization's actions should be true to the spirit of UPMIFA. This law sets a standard that an organization should depart from only if it can convince its beneficiaries, donors, and regulators that a different standard would be more appropriate. Among questions that trustees should ask themselves are the following:

- When did our organization last update our investment policy statement?
- Did 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 concepts of trust law?
- Does our IPS acknowledge the many issues that we must consider under UPMIFA, including investing and spending from a fund, choosing an agent to whom we will delegate investment responsibilities, and actively supervising that individual or organization?
- How is our organization meeting UPMIFA's standard of the "prudent investor"?
- Is our organization's endowment appropriately diversified?
- If not, has our board documented the reasons we believe that our decision not to diversify the fund's investments is appropriate?

[2] William F. Jarvis, "Legislating the Normative Environment: Nonprofit Governance, Sarbanes-Oxley and UPMIFA" (White Paper, Commonfund Institute, Wilton, Conn., May 2015), 4.

Another development linked to SOX was the 2007 revision of Form 990, the IRS form that all nonprofits are required to complete and submit annually:

> *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.*[3]

Recent state laws also reflect a more rigorous regulatory regime. The California Nonprofit Integrity Act of 2004, enacted in the wake of SOX to improve corporate governance, accountability, and transparency in California, requires that nonprofit boards have an audit committee to audit their organization's financial statements and to approve the compensation of the organization's CEO or CFO. The Act also addresses the conduct of commercial fundraisers and their relationship to charitable organizations. The New York Nonprofit Revitalization Act of 2013 reforms statutory requirements for the governance of nonprofit corporations in New York, expanding the New York attorney general's enforcement powers and updating and clarifying state rules regarding nonprofits. This law requires nonprofits to enact a policy regarding conflict of interest, mandates that nonprofits above a certain size have an audit committee and prohibits an employee of a nonprofit from also serving as board chair or holding a position with similar responsibilities.

III. Private and Community Foundations: Similarities and Differences

> *Foundations as a group commit significant financial resources to their missions and play a critically important role in the social fabric of the country. In that, they are alike. But it is important to understand the way regulatory and other considerations shape the unique characteristics of independent/private and community foundations as they pursue their essential work in our society.*[4]

Private and community foundations are alike in mission; the Internal Revenue Code recognizes this similarity, designating both types of foundation as 501(c)(3) nonprofit organizations. However, the two types have clear differences. Private foundations, which include both independent and family foundations, are the most prevalent type. They typically have their origin in a single source—an individual, family, or business. Unlike community foundations, which are public charities, private foundations fund their annual giving out of earnings on investable assets rather than from a mix of assets and external contributions. Thus, private foundations generally do not receive additional funds from outside sources once the transfer of private funds to the foundation is complete.

By contrast, community foundations, also sometimes referred to as public foundations, solicit and receive ongoing gifts and donations from outside sources including the general public, for-profit and nonprofit organizations, and government entities. Typically, community foundations focus their grantmaking on a specific geographic area such as a city, state or region. While a private foundation's board is usually composed of family members or those closely associated with the donor, the board composition of community foundations generally reflect the community that the foundation serves.

Distinct from private and community foundations, two other types of foundation are private operating foundations, which manage their own programs rather than make grants, and corporate foundations, which receive funding from a publicly owned company.

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[3] Jarvis, "Legislating the Normative Environment," 5.

[4] *2014 Council on Foundations-Commonfund Study of Foundations* (Council on Foundations and Commonfund Institute, Arlington, Va., and Wilton, Conn., 2015), 37.

The IRS determines whether an organization is a private foundation or a community foundation according to the definitions outlined in the Tax Reform Act of 1969. The IRS requires that private foundations annually file Form 990-PF and that community foundations file Form 990. Both returns are open to public scrutiny. In addition, the law seeks to ensure that private foundations serve the public good, requiring them to spend a minimum percentage of their investment assets for grants and other charitable disbursements and administrative expenses. The required amount of charitable payments, called qualifying distributions, is 5 percent of the average fair market value of a foundation's investment assets for the preceding year.[5] The original Act called for each private foundation to pay out either all of its adjusted net income or a percentage to be determined each year; Congress later set the rate at 5 percent. A private foundation must also pay a 2 percent excise tax on the income earned on its investments, including interest, dividends, royalties, rents, and capital gains. The rate can be reduced to 1 percent in a year in which a private foundation's percentage of charitable spending increases in relation to its total assets.[6]

The stringent requirements of this legal structure have continually challenged private foundations: "Certainly, the regulatory regime imposed on private foundations is unique. There is no category of tax-exempt organization that is subject to anything like the compliance burdens that comprise the sweep of Chapter 42 of the Internal Revenue Code."[7] As the *New York Times* recently reported, "The penalties for spending a private foundation's money inappropriately are severe. The IRS can demand that a transaction be undone and assess excise taxes from 10 percent of the disputed value up to 200 percent. If the offenses are egregious and persistent, it can strip the organization of its tax-exempt status."[8] Failure to comply may result in a tax on both the foundation and its disqualified persons, loss of tax exemption, and repayment of all tax benefits accrued during the life of foundation.[9]

Community foundations receive their funds from multiple unrelated sources, and they face less-arduous legal requirements than private foundations. The Tax Reform Act sets community foundations apart from private foundations, giving them favorable tax treatment as public charities. They are exempt from the 5 percent payout rule and the excise tax that the law imposes on private foundations, thereby enjoying greater flexibility and latitude in their spending policies than private foundations.

However, as fiduciaries, trustees of community foundations are subject to specific responsibilities imposed by federal and state statutory laws:

> *Community foundations are different from any other form of public charity. With a mix of roles, they act as grantmakers, community leaders, donor service providers and fund developers. At any given time, community foundations juggle these roles, making sure their work in each remains vital and always aligned with their mission.*[10]

Community foundations are also distinct from private foundations in that they may house donor-advised funds through which a donor may, with a relatively small gift, establish an individual fund and retain the right to direct gifts to eligible recipients. The donor receives a tax deduction for contributions to the donor advised fund and makes recommendations about grants, but gives up formal control of its investment or distribution.[11]

The fundamental differences in the tax law's treatment of private foundations and community foundations have caused the two types of foundations to develop further variations in their practices. One of the most significant differences between private and community foundations relates to how assets are allocated under the foundation's investment policy; another major distinction relates to the broad governance of the investment function in the two types of organization.

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[5] Bruce R. Hopkins and Jody Blazek, *Private Foundations: Tax Law and Compliance* (Hoboken, N.J.: John Wiley & Sons, 2008), 3.
[6] Hopkins and Blazek, *Private Foundations, 4.*
[7] Hopkins and Blazek, *Private Foundations*, 1.
[8] New York Times, "When Family Members Run Foundations, Scrutiny Is Endless," September 12, 2015.
[9] Hopkins and Blazek, *Private Foundations*, 2.
[10] Elaine Gast, *Community Foundation Handbook* (New York: Council on Foundations, 2006), 4.
[11] The Foundation Center, "Foundation Fundamentals," *http://foundationcenter.org/getstarted/onlinebooks/ff/text.html.*

Asset Allocation

The differences in fund inflows and outflows that distinguish private and community foundations are reflected in observed differences in asset allocation. In general, private foundations, which do not as a rule expect to receive a stream of ongoing donations, have had to pursue higher returns in order to maintain the purchasing power of their endowments after qualifying distributions and fees. They have done this by adopting more diversified investment portfolios with a larger number of independent, non-correlated sources of return, including a greater emphasis on less liquid alternative investment strategies. Community foundations, by contrast, have been able to engage in ongoing fundraising to support endowment growth and have, perhaps as a result, maintained a preference for more liquid portfolios, characterized by higher allocations to listed stocks and bonds.

A recent Council on Foundations-Commonfund Study of Endowments® (CCSF) illustrates this difference. This study, by two preeminent authorities on foundation investment and governance policies and practices, represents the most comprehensive annual survey of its kind. The 2014 CCSF included 244 foundations, representing combined assets of $107.4 billion. The following table shows the asset allocations for private and community foundations, as of December 31, 2014:

	Private Foundations	**Community Foundations**
Domestic equities	25 %	34%
Fixed income	9	15
International equities	18	22
Alternative strategies	44	25
Short-term securities/ cash/other	4	4

The most significant difference between private and community foundations is the private foundations' 44 percent allocation to alternative investment strategies, an allocation that is 19 percentage points greater than that of community foundations. Alternative strategies include investment in private capital strategies (e.g., private equity, international private equity, venture capital, energy and natural resources, and commodities) and marketable alternative strategies (e.g., hedge funds, absolute return, market neutral, long/short, 130/30, event driven, and derivatives). In the three categories of public securities traded on the stock exchange—domestic and international equities and fixed income securities—the total allocation reported by community foundations is 19 percentage points greater than that of private foundations. Empirical evidence, including research studies, has shown that investors who choose to forego liquidity in their investments may receive a premium in returns over the long term. Enhancing a foundation's portfolio with a diverse range of alternative investments may produce a higher overall yield, given time.

Governance of the Investment Function

CCSF data have shown that private foundations generally have smaller investment committees than community foundations. Private foundation committees usually consist of the founder, family members and close advisers, whereas community foundations seek broader representation from the communities they serve and may include members with qualifications from outside the investment discipline.

In the 2014 CCSF, community foundations reported having more voting members on their investment committees than did private foundations: community foundations reported an average of 7.8 voting members, whereas private foundations averaged 5.4 voting members. Moreover, community foundations reported a higher proportion of investment professionals on their investment committees, with an average of 4.7 members who were investment professionals, or 60 percent of the total number on the committee; in contrast, private foundations averaged 2.4 committee members who were investment professionals, or 44 percent of the committee membership. With respect to committee members who had experience with alternative investment strategies, community foundations reported an average of 2.6 such individuals, or 33 percent of the committee, while private foundations averaged 1.6 members with similar experience, or 30 percent. Furthermore, data showed that community foundations had reached beyond their board of trustees to obtain members for their investment committee. A significant proportion of voting members at community foundations were not trustees, at 3.8 members of the committee, or 49 percent of the total membership, whereas private foundations reported only 1.0 member on the investment committee who was not a trustee—only 19 percent of the total membership. While a healthy diversity of experience and views is welcome on an investment committee, the complex portfolios being pursued by private and, to a lesser extent, community foundations would seem to require committees possessing the necessary expertise to fulfill their fiduciary responsibilities.

IV. Achieving Excellence in Governance

Many authorities on nonprofit governance believe that excellence in nonprofit governance is clearly linked with improved investment returns over the long term. "Factors contributing to the investment success of leading endowments and foundations include strong governance, well vetted investment philosophies, and structured processes."[12] A recent Commonfund Institute white paper takes the same view: "Excellent boards are made, not born. Achieving excellence in board governance requires success in four critical areas: capable leadership, a sound organizational structure, attention to fiduciary duties and a culture that binds board members to each other in a cohesive unit."[13] Private and community foundations alike can benefit by taking steps along the path toward achieving this goal.

Engaging Trustees and Building a Culture

Selecting qualified board members who will actively and effectively serve on the board is a fundamental best practice of governance. Trustees should be engaged, effective team players, who are willing to work hard. BoardSource says, "A productive leadership culture requires having the right people on the board, achieving clarity around roles and responsibilities, and educating and engaging board members. Strengthening the culture requires leading with intent: thoughtful planning, determined dedication, and collective commitment from chief executives, board chairs and board members."[14] Increasingly, experts believe that trustees should commit to "generative governance"—using each individual's wisdom, experience, and skills to open discussions leading to a more dynamic and effective board, engaged in exploration of optional courses and new ideas.

Most governance experts agree that diversity of membership is a great source of board strength. In some positions, such as service on the audit or investment committee, members should have specialized knowledge, but effective boards are usually populated with members representing diverse backgrounds, experiences, and points of view.

For both private and community foundations, the qualities and characteristics of board members have a significant influence on the organization. As we have seen, private foundations tend to have smaller boards than do community foundations, and some trustees may be members of the founder's family. However, a foundation should not consider trusteeship an honorary position. Because many private foundations have small boards, each trustee must be engaged in the foundation's activities and committed to furthering its mission. In the case of community foundations, trustees are the public face of the organization, often chosen for board membership because of their visibility in and contacts throughout the area that the foundation serves.

[12] Lawrence E. Kochard and Cathleen M. Ritterreiser, *Foundation and Endowment Investing* (John Wiley & Sons, Hoboken, N.J., 2008), 40.
[13] John S. Griswold and William F. Jarvis, "Strive for the Best: Building and Maintaining an Excellent Board" (White Paper, Commonfund Institute, Wilton, Conn., May 2014), 1.
[14] BoardSource, "Leading with Intent," *http://leadingwithintent.org/leading-intent/*.

In fact, board members' responsibilities go beyond internal work. As trustees, they also serve as the public voice of the foundation and become strong advocates for the foundation's mission. In the case of community foundations, advocacy and outreach extend to active fundraising.

> *Board members are essential to successful community outreach and advocacy, and they have more work to do in these roles. In response to shifts in government funding and public policy, savvy nonprofits are broadening the definition of outreach and making advocacy an explicit priority. Board members need to raise their collective voices as committed and informed champions for their missions.*[15]

Recruitment and Orientation

Recruitment is the lifeblood of successful boards. The process of recruiting effective board members starts with a strong nominating committee and a system of vetting each candidate. Recruitment is an ongoing process which should involve every current board member, not only the nominating committee. Furthermore, clear communication regarding expectations of trustees is essential. "Fiduciary fatigue may be one of the greatest recruiting challenges. This gets to the education of potential board members because if they don't understand the demands of the nonprofit environment today they can quickly get overwhelmed by it."[16] The recruitment process is not complete until incoming board members are educated and oriented as to their role and responsibilities. Materials provided during a formal orientation should include at the minimum an annual report, budget, calendar, foundation history, investment policy statement, policy manual, and strategic plan.

Role of the Board Chair

The role of the board chair is critical in all of these areas:

> *The board chair acts as the leader of the board. At the strategic level, the board chair determines the timing and need for the board to discuss mission, vision, and values. As a nexus of communication, the chair is responsible for setting agendas, building consensus, speaking for the organization, communicating regularly with the chief executive, and easing occasional tensions. At the structural level, the chair appoints committee leaders, task forces and makes other assignments within the board. The board chair sets the tone for the board's culture and decision making.*[17]

The board chair serves as leader, spokesperson, facilitator, and source of authority, as well as advocating with key constituencies. The chair determines the agenda for meetings and the strategy for populating the organization's committees. The following tasks are among the primary responsibilities of the chair:

- serve as chief liaison with the executive director and the senior staff (in the case of foundations large enough to have such a staff)
- lead periodic assessments of board strengths and weaknesses
- create and maintain a culture conducive to teamwork, collaboration, and mutual respect
- ensure that new board members are educated and mentored regarding their responsibilities and accountability to the organization and public

[15] BoardSource, "Leading with Intent."
[16] *Insight for Strategic Investors*, "A Governance Workbook," Spring 2012, 22.
[17] Council on Foundations and BoardSource, "10 Things Every New Foundation Board Member Should Know," 2011, 33.

Ethics and Standards of Conduct

Foundations must give careful attention to their policies for dealing with ethical issues, including such problems as conflicts of interest or self-interested financial activity. Reputation is the single most valuable asset for any nonprofit, and protecting the foundation's reputation depends on a culture that values high ethical standards. The best oversight comes from within the foundation itself rather than from regulatory bodies.

Foundations, whether large or small, must have a clear standard of conduct, as described in the organization's code of ethics; they must also designate an individual or committee to oversee the implementation of the standard. "A code of ethics states the key principles, values and standards that define what is right and wrong behavior within the areas covered by the code and informs all of the nonprofit's activities in these areas. It safeguards the nonprofit's reputation and is an important reason why people trust nonprofits and donors give to them."[18] The policy should ensure that, should an ethical conflict arise, a designated individual or committee will advise the board about all relevant issues, and the organization will follow an established process to deal with the matter.

Conflict of interest occurs when an individual—board member, officer, or staff member—determines that his or her obligation to further the charitable purposes of the organization is at odds with his or her own financial or personal interest. Such conflicts may occur with well-meaning, well-intentioned board members and may be inherent in the nature of the people who are serving in leadership roles. When conflicts arise, the foundation's method of resolving the issue is crucial. Most foundations have a process of disclosure or recusal or both. The requirement for disclosure and recusal is a principal ethical policy that can save a nonprofit from embarrassment and from potentially serious damage to its reputation. As the IRS has noted, a nonprofit should require its board, officers, and staff members to complete and sign an annual disclosure form regarding conflicts of interest.[19]

The previously mentioned CCSF provides information about foundations' policies regarding conflict of interest. In the 2014 study, 92 percent of participating private foundations and 100 percent of community foundations reported having a policy regarding conflict of interest; 78 percent of private foundations and 84 percent of community foundations dealt with conflicts of interest through a policy of recusal and disclosure. A much lower percentage of foundations of both types had a policy of recusal only or a policy of disclosure only.

A related challenge is duality of interest, as distinct from conflict of interest. Duality of interest may occur when a person serves on multiple boards. Many people serve on more than one board, a common practice. However, a member of more than one board must avoid serving one entity's interests to the detriment of the interests of the other organization—for example, a trustee who sits on two boards should not aggressively raise funds for one organization and not for the other.

The Investment Committee

> *[The] duties of [the investment] committee include creating and maintaining an investment policy, setting the investment portfolio's policy asset allocation, developing an appropriate spending policy, rebalancing the portfolio on a regular basis and providing an annual report to the board on the state of the endowment . . . the investment committee should work in close coordination with the finance committee and the organization's senior staff; at smaller nonprofits, the investment committee is often a subcommittee of the finance committee.*[20]

[18] Toni Boucher and Stephen Hudspeth, "Ethics and the Nonprofit" (White Paper, Commonfund Institute, Wilton, Conn., March 2013), 4.
[19] Boucher and Hudspeth, "Ethics and the Nonprofit," 5.
[20] Griswold and Jarvis, "Strive for the Best," 6.

Central to the work of the investment committee is the investment policy statement (IPS), a written document that outlines the objectives of the asset pool and then sets forth the plan for managing, investing, and spending it. Among the topics that the IPS typically addresses are asset allocation and rebalancing methodology, benchmarks, investment restrictions, investment risk, and liquidity requirements. Based on the foundation's policy regarding spending level, the IPS will articulate a return target and an investment strategy for reaching the target, including asset allocation.

Foundations should have an IPS for several reasons. The IPS is a long-term, strategic plan for the asset pool and a way to insulate the fund from the vagaries of short-term investor sentiment. "Composed in calm to be used in crisis, it is both a shield, guarding trustees from the pressure to make unwise decisions in an atmosphere of panic, and a sword, by which the board establishes the territory it intends to occupy and cultivate, through its investment practice, as fiduciaries for the institution."[21]

Private foundations need an IPS that will enable them to meet the law's 5 percent spending requirement without depleting the corpus of their endowment. Owing to expenses and other spending requirements, many foundations target a return above 5 percent. The 2014 NCSE found that 36 percent of participating private foundations target a long-term annual rate of return in the 8.0 to 8.9 percent range; 21 percent target an annual rate ranging from 7.0 to 7.9 percent; and 10 percent target an annual rate ranging from 6.0 to 6.9 percent. Although they do not have a legal minimum spending requirement, community foundations also typically target rates of return beyond the IRS minimum for private foundations; for example, the 2014 NCSE found that 41 percent of community foundations have a long-term return objective in the 8.0 to 8.9 percent range.

In addition, an IPS must include an appropriate asset allocation and reflect the foundation's time horizon. Some foundations anticipate operating in perpetuity, as do colleges and universities; others have finite lives and intend to spend their endowment over a specified time period. As noted earlier, the inflow of gifts and donations to community foundations means that they frequently have a different asset allocation than do private foundations, which in general do not receive such inflows. A thoughtful spending policy is important to both private and community foundations to ensure that they are able to meet their commitments to grantees on a consistent basis. Historically, foundations and other nonprofit organizations have delegated portfolio decisions to external asset managers or consulting firms. Foundations using this time-honored model should consider the following issues. First, investment committee members may spend too much time and energy picking managers and not enough on the policy matters that form the basis of the IPS. Furthermore, increasingly complex portfolios and investment strategies require time and expertise that a volunteer committee may not possess. In addition, the legal and regulatory environment has become increasingly complex and more demanding of trustees' attention.

A wide range of models are available for outsourcing the investment management function to an external firm or "outsourced chief investment officer," also known as an "OCIO." The nonprofit's choice of OCIO models depends on the degree to which the institution wants to delegate investment management:

> *Smaller institutions may benefit from a set of efficient and standardized portfolio choices, while for mid-sized and larger investment pools the outsourcing provider designs a customized solution for the institution based on its risk tolerance, return targets and other requirements. Such a comprehensive approach includes investment policy review and counsel as well as implementation via portfolio construction and asset allocation, manager due diligence and ongoing monitoring, portfolio rebalancing, risk management and reporting.*[22]

[21] John S. Griswold and William F. Jarvis, "The Investment Policy Statement" (White Paper, Commonfund Institute, Wilton, Conn., August 2011), 1.
[22] John S. Griswold and William F. Jarvis, "Outsourced Investment Management: An Overview for Institutional Decision-Makers" (White Paper, Commonfund Institute, Wilton, Conn., November 2013), 1.

Foundations' use of firms offering OCIO services to manage their assets has grown steadily in recent years, and indications are that this trend is likely to continue. Of all foundations participating in the 2014 CCSF, 36 percent of private foundations and 35 percent of community foundations said that they had substantially outsourced the investment management function. Among smaller community foundations (those with assets under $101 million), fully 47 percent reported having substantially outsourced the function. Among smaller private foundations, the rate was about equal to that of all participating foundations.

Conclusion

The task of financial governance of a private or community foundation requires assimilation of a wide variety of legal, tax, regulatory and investment issues. While these issues may seem far removed from the charitable purpose for which the foundation was originally established, they constitute an essential support structure for that mission, and excellence in these fields is as much to be desired and pursued by fiduciaries as expertise in grant-making or program areas. As transparency and regulatory oversight become increasingly the norm for nonprofit institutions, donors and stakeholders will also be sensitive to these areas. It behooves foundation boards to be aware of these issues and to seek, through improved policies and procedures as well as through education and self-evaluation, to meet the expectations of the society they serve so well.