ATTORNEY GENERAL ISSUES GUIDANCE ON NEW YORK PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (NYPMIFA)

April 4, 2011

To Our Clients and Friends:

On March 17, 2011 the New York State Attorney General's Charities Bureau issued guidance on the New York Prudent Management of Institutional Funds Act ("NYPMIFA" or the "Act"). NYPMIFA, which took effect in September 2010, made significant changes to the rules governing the management, investment and expenditure of funds held by New York not-for-profit organizations. The new guidance from the Charities Bureau, entitled "A Practical Guide to the New York Prudent Management of Institutional Funds Act" (the "Guide"), answers some, but not all, of the open questions about the legislation. This update summarizes the Guide.

NYPMIFA applies to (i) "institutional funds," which are any funds held by not-for-profit corporations organized under the New York Not-for-Profit Corporation Law or by charitable trusts whose trustees are New York not-for-profit corporations; and (ii) "endowment funds," which are institutional funds subject to restrictions imposed by the donor as to the amount that can be spent on a current basis. NYPMIFA imposes significant new requirements for the investment of institutional funds while at the same time liberalizing rules regarding the expenditure of endowments. In general, its requirements apply except to the extent otherwise provided by a donor in the gift instrument establishing a fund.

The texts of NYPMIFA and the Guide can be found at http://www.charitiesnys.com/nypmifa_new.html

MANAGING AND INVESTING INSTITUTIONAL FUNDS

Written Investment Policy

NYPMIFA requires not-for-profit organizations to adopt written investment policies with guidelines on investments and the delegation of management and investment functions. While many charitable institutions already had written investment policies before the new legislation, NYPMIFA specifically requires that an investment policy comply with the standards of the Act. The Act does not, however, delineate what topics such a policy should address.

The Guide helps to fill this gap by stating that an investment policy may address topics including: (i) general investment objectives; (ii) permitted and prohibited investments; (iii) acceptable levels of risk; (iv) asset allocation and diversification; (v) procedures for monitoring investment performance; (vi) scope and terms of delegation of investment management functions; (vii) the investment manager's accountability; (viii) procedures for selecting and evaluating investment managers and other outside agents; (ix) processes for reviewing investment policies and strategies; and (x) proxy voting. The Guide further notes that there is no "one size fits all" investment policy that applies to all charities and that the content of an organization's written policy will depend on factors such as the resources available to the institution, the types of investments it holds, the charitable purpose of the organization and the nature and scope of its activities or programs.

The Guide suggests that charities review their investment policies at regular intervals and whenever a change in their financial condition or other circumstances so require.

Investment Factors

NYPMIFA requires not-for-profit organizations to consider eight factors in managing and investing institutional funds: (i) general economic conditions; (ii) the possible effect of inflation or deflation; (iii) the expected tax consequences, if any, of investment decisions or strategies; (iv) the role that each investment or course of action plays within the fund's overall investment portfolio; (v) the expected total return from income and investment appreciation; (vi) the institution's other resources; (vii) the needs of the institution and the fund to make distributions and to preserve capital; and (viii) an asset's special relationship or special value, if any, to the purposes of the institution. The Guide does not expand on these factors.

Diversification

NYPMIFA requires not-for-profit organizations to diversify the investments of each of their funds unless they prudently determine that, because of special circumstances, the purposes of a fund are better served without diversification. The Guide does not expand on the diversification requirement or what might constitute "special circumstances." This may present a potential issue for private family foundations that have been funded primarily with stock of a single issuer (such as stock of a company controlled by the family).

Delegation of Management and Investment Functions

Under NYPMIFA, a charity may delegate the management and investment of an institutional fund to outside investment advisors and managers but must assess, among other things, the independence of these agents. Investment management contracts must be terminable by the charity, without penalty, on not more than 60 days notice. The Guide says that the selection of an outside agent should be based on the agent's competence, experience, past performance and proposed compensation, and not on any business or personal relationships between the agent and board members or other insiders. Although it is not required by the statute, the Guide recommends that institutions adopt conflict-of-interest policies requiring full disclosure by interested officers and directors of their business or personal relationships with any outside agent.

SPENDING FROM ENDOWMENT FUNDS

Under prior law, charities could appropriate unrealized appreciation of an endowment fund but could not spend below the fund's "historic dollar value"—i.e., the original value of the gift that created the fund and of subsequent donations. NYPMIFA provides more flexibility by allowing institutions to spend from an endowment fund even if it is below its historic dollar value, so long as the spending is prudent in accordance with newly prescribed statutory standards.

Appropriation Factors and Contemporaneous Records

As part of the prudence standard, NYPMIFA requires charities to consider eight factors, if relevant, in deciding whether to spend from an endowment fund: (i) the duration and purpose of the fund; (ii) the purposes of the institution and the fund; (iii) general economic conditions; (iv) the possible effect of inflation or deflation; (v) the expected total return from income and investment appreciation; (vi) the institution's other resources; (vii) possible alternatives to spending (discussed further below); and (viii) the institution's spending policy.

The Guide says that although the factors should be considered individually, an institution's governing board should also look at the "big picture" and consider how the factors, viewed together and weighted appropriately, affect an appropriation decision. This process may vary among institutions in view of their size, financial condition, goals and other considerations.

The Act requires institutions to keep contemporaneous records describing the consideration given to each factor in making spending decisions, including the extent to which a factor affects the decision to appropriate and how much to appropriate, and permanently keep such records. The Guide says that if a governing board determines that any factor is not relevant to a decision, it should document how it reached its conclusion. The Guide also says that to be contemporaneous, the record should be prepared at the time the board makes a decision to appropriate endowment funds for expenditure. Outside advice from professionals may be incorporated into the record if it is not privileged or confidential. The Guide states that decisions can be memorialized in minutes or in another form, and that the substance of the record is more important than the form.

These new requirements obviously create potential administrative burdens for institutions that hold numerous endowment funds. The Guide addresses this concern by saying that in the view of the Attorney General's Office, a board may make a single decision to appropriate from multiple endowment funds that are similarly situated and this decision may be documented in a single contemporaneous record. Written procedures should be in place explaining why a group of funds is similarly situated (e.g., because of their purpose, type of investments or other factors). The Guide says that any decision to appropriate from funds collectively would be justified if the eight factors described above could be applied to each fund individually in the same way.

As noted above, the Act requires charities to consider alternatives to expenditure of an endowment fund, but it does not expand on what is meant by "alternatives to expenditure" or how institutions should give consideration to this factor. The Guide says that this factor (which is unique to New York) is intended to ensure that boards will not automatically decide to spend from endowment funds if circumstances warrant exploring other possible alternatives. As an example, the Guide says that if a fund has decreased in value, it may be prudent to consider steps such as increasing fund-raising efforts, decreasing or deferring expenditures, selling non-essential assets or reducing non-essential staff. The consideration of alternatives should be documented contemporaneously as described above.

Presumption of Imprudence

Under NYPMIFA, expenditure in any year greater than 7% of the fair market value of an endowment fund (calculated based on average quarterly market values over a period of at least five years preceding the year of appropriation) creates a rebuttable presumption of imprudence. This presumption applies only to endowment gifts made after September 17, 2010.

Many charitable organizations have spending policies that are based on a three-year average of an endowment fund's fair market value. The Guide notes that such spending policies may result in appropriations that are presumptively imprudent under the 7% standard and that all spending policies must be reviewed to determine how they interact with the new standard. As a practical matter, many institutions will now have to perform separate calculations to determine whether particular spending decisions would be presumptively imprudent.

The Guide also states that an appropriation of 7% or less of the value of an endowment in any year does not create a presumption of prudence.

Notice

Before the new spending rules can be applied to an endowment for the first time, NYPMIFA generally requires an institution to provide 90 days notice to "available" donors to the endowment who signed gift instruments before September 17, 2010. The statute suggests notice language asking donors whether the institution can spend as much of a donor's gift as may be prudent or whether the institution may not spend below the gift's historic dollar value.

The Guide clarifies that notice is required even if the endowment fund is above its historic dollar value and the institution has no plans to appropriate below that amount. If an institution, acting in good faith, appropriated from an endowment fund before notifying donors during the period between the enactment of NYPMIFA and the release of the Guide, it should promptly send notice to its donors. If a donor ultimately responds to the notice and says he or she does not wish the institution to spend below the original dollar value of the gift, the institution must restore the endowment fund to its historic dollar value if any pre-notice appropriation reduced it below that amount.

The Guide says that to determine whether a donor is "available" for purposes of the notice, an institution should make reasonable efforts to identify and locate the donor, including Internet searches and contacting known associates of the donor. Efforts to locate donors should be documented even if they are unsuccessful.

After notice is sent, an institution may appropriate the income and net appreciation over the historic dollar value of an endowment fund during the 90-day notice period if it is prudent to do so under NYPMIFA—there is no need to wait for the donor's response or until the end of the notice period.

RELEASE OF DONOR RESTRICTIONS ON INSTITUTIONAL FUNDS

NYPMIFA permits institutions to seek court release or modification of donor-imposed restrictions on the investment, expenditure or use of a fund even if the donor does not consent to the release or modification (unlike prior law, which permitted court release only if the donor was not available to consent). Notice of the court proceeding must be provided to the donor and the Attorney General, both of whom will have an opportunity to be heard. The Guide notes that court proceedings can be expensive and time-consuming, and therefore suggests that institutions seek donor consent to a proposed release or modification where possible before initiating a court proceeding.

In those situations where a donor is not available or withholds consent, the Guide urges institutions seeking court release or modification of a restriction to submit draft petitions to the Charities Bureau before filing with the court so that potential issues can be identified and resolved efficiently.

NYPMIFA also provides a new procedure allowing institutions to release or modify a restriction without court approval for funds with a value of less than $100,000 that have been in existence for more than 20 years (referred to in the Guide as "small, old" funds) on notice to the Attorney General. The Act provides that notice to the donor is not required, but the Guide says this appears to be a drafting error and that absent legislative clarification, the Attorney General's position is that notice must be given to any donor who is available. In any event, the Guide suggests that institutions holding small, old funds seek donor consent where possible so that notice to the Attorney General can be avoided.

The Act sets forth the information that notice to the Attorney General must contain. The Guide says that in addition to these statutory requirements, the notice should include a copy of the gift instrument and other documentary evidence that the fund is a "small, old" fund.

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