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## The Rules for Non-Profit-Portfolio Fiduciaries

by W. Scott Simon | 01-07-10

I thought that it might be a good idea to start off the new year by discussing the investment behavior exhibited by fiduciaries responsible for non-profit pools of money, particularly in response to the gyrations in financial markets over the last few years. Before delving into these issues, however, it will be necessary to describe the legal framework in which such fiduciaries must operate in order to provide needed context. (By the way, I wrote a [five-part series](#) on non-profits in this column in 2006).

### **The 2006 Uniform Prudent Management of Institutional Funds Act**

The investment conduct of fiduciaries responsible for the investment and management of non-profit pools of money (such as endowment funds at hospitals, colleges and universities, and foundations) is governed not by federal law but by state law. That state law (now enacted in 44 states and the District of Columbia) is some (very close) version of the Uniform Prudent Management of Institutional Funds Act promulgated by the National Conference of Commissioners on Uniform State Laws in 2006.

Much of the language of UPMIFA was taken virtually verbatim from the 1994 Uniform Prudent Investor Act (now law in 44 states, the District of Columbia and the U.S. Virgin Islands, in which UPIA governs the investment conduct of fiduciaries of private family trusts; in my own state, UPIA comprises sections 16002(a), 16003 and 16045-16054 of the California Probate Code).

The 23-page UPIA is derived from the "bible" of modern prudent fiduciary investing: the 300-plus-page Restatement (Third) of Trusts (Prudent Investor Rule), which was promulgated by the American Law Institute in 1992. UPIA is a codification of the essential principles of the Restatement.

Much of the language of UPIA was copied not only into UPMIFA but also into the 1997 Uniform Management of Public Employee Retirement Systems Act (now law in two states in which UMPERSA governs the investment conduct of fiduciaries of public employee retirement plans), the 2000 Uniform Principal and Income Act (now law in 42 states and the District of Columbia) and the 2004 Uniform Trust Code (now law in 22 states and the District of Columbia).

### **The Variety of Non-Profit Institutions Subject to UPMIFA**

Many believe that UPMIFA pertains only to non-profits organized under non-profit corporation law and not to charitable trusts. Not so. In fact, any form of institution organized and operated exclusively for charitable purposes is subject to UPMIFA. This includes any charitable organizations created as non-profit corporations, trusts, unincorporated associations, governmental subdivisions or agencies, or any other form of entity that is organized exclusively for charitable purposes.

UPMIFA does not, however, apply to pools of money managed by non-charitable trustees such as individual trustees; the conduct of such trustees is governed by UPIA. Nonetheless, the standards for investing and managing pools of money under UPMIFA and UPIA are much the same given the fact that the drafters of the model acts that, together with the Restatement, comprise the great reformations in the law of modern prudent fiduciary investing set out to make them that way.

### **The Four Mandatory Duties of Investment Fiduciaries Under UPMIFA**

Commentary to section 3 of UPMIFA notes that "the duty of care, the duty to minimize costs, and the duty to investigate [are] mandatory."

UPMIFA's duty of care, which is derived from non-profit corporation law, incorporates the elements of care, skill and caution which together comprise the very definition of prudence under the Restatement and UPIA.

The duty to minimize costs is described in UPMIFA section 3(c)(1) (which tracks the language of UPIA

section 7): "In managing and investing an institutional fund, an institution . may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution . " Commentary to section 7 of UPIA is blunt about the critical importance of maintaining low investment costs in modern prudent fiduciary investing: "Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs."

The duty to investigate is described in UPMIFA section 3(c)(2) (which tracks the language of UPIA section 2(d)): "[A]n institution . shall make a reasonable effort to verify facts relevant to the management and investment of the fund." Commentary to section 3 of UPMIFA notes, in part: " . subsection [3(c)(2)] requires persons who make investment and management decisions to investigate the accuracy of the information used in making decisions." Commentary to UPIA notes that a fiduciary has a responsibility "to examine information likely to bear importantly on the value or the security of an investment."

No doubt there is a lot on the plate of a non-profit fiduciary. But conscientious fiduciaries responsible for non-profit pools of money (indeed, all fiduciaries) can go a long way in mastering prudence and serving their institutions competently by doggedly fulfilling their duty to minimize costs and their duty to investigate. This notion, which if implemented prudently would have saved institutions a lot of anguish and money over the last few years, will be explored in a future column.

The duty of loyalty, which underpins all other fiduciary duties because it is the very essence of being a fiduciary, is also mandatory under applicable non-profit corporation law. But the loyalty standard will differ slightly for the directors of non-profit corporations (the best interests of the corporation) and for the trustees of charitable trusts (the sole interests of the beneficiary). The duty of loyalty under non-profit corporation law therefore applies to charities organized as non-profit corporations while the duty of loyalty under trust law applies to charitable trusts.

#### **Other Essential Considerations for Fiduciaries Under UPMIFA**

There are a number of essential considerations that fiduciaries subject to UPMIFA must contend with (such as the following) if they are to be prudent stewards of the assets entrusted to them by their institutions.

#### **Prudent Investor Standard**

UPMIFA requires that those responsible for investing and managing the assets of a charitable institution to act as a prudent investor would; in short, UPMIFA adopts the prudence standard for investment decision making. UPMIFA section 3(b) states: "In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."

#### **Central Consideration**

The "central consideration" of an investment fiduciary governed by UPIA is to determine the tradeoff between risk and return for each portfolio under her care. Fiduciaries whose investment conduct is governed by UPMIFA are also required to make this trade-off (in accordance with the objectives of the institution in question) given that UPMIFA incorporates the provisions of modern portfolio theory found in UPIA.

#### **A Portfolio Approach**

A basic tenet of modern portfolio theory is the primacy of the portfolio, not its individual parts. (That's why it's called modern portfolio theory, not modern investments theory.) UPMIFA section 3(e)(2) (tracking the language of UPIA section 2(b)) states: "Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution." Commentary to section 3 of UPMIFA notes, in part: "This subsection reflects the use of portfolio theory in modern investment practice. The language comes from UPIA § 2(b), which follows the articulation of the prudent investor standard in [the] Restatement."

**Diversification of Risk**

A fiduciary governed by UPMIFA is required ordinarily to (preferably broadly) diversify the portfolios under his care in order to minimize risk. UPMIFA section 3(e)(4) states: "An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification."

Commentary to section 3 of UPMIFA notes, in part: "A decision to retain property due to 'special circumstances' must be made based on the needs of the charity and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances." The Restatement has incorporated diversification of risk as a fundamental element of modern prudent fiduciary investing.

**No Investment Imprudent Per Se**

A fiduciary governed by UPMIFA shouldn't view any investment asset as imprudent per se before assessing whether it's prudent to be included in a portfolio. UPMIFA section 3(e)(3) states: "Except as otherwise provided by law other than this [act], an institution may invest in any kind of property or type of investment consistent with the standards of this section." Commentary to section 3 of UPMIFA notes, in part: "Consistent with the portfolio theory of investment, this subsection [derived from UPIA section 2(e)] permits a broad range of investments." In addition, commentary to UPIA notes: "The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio."

**No Judgment Based on 20/20 Hindsight Ordinarily Allowed**

It's impermissible ordinarily for fiduciaries subject to UPMIFA to be second-guessed about the performance of the portfolios under their care. Section 7 of UPMIFA states: "Compliance with this [act] is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight." Commentary to section 8 of the UPIA explains: "Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is ex ante, not ex post."

While a fiduciary cannot be second-guessed with 20/20 hindsight over portfolio performance, this prohibition applies only if its investment conduct has otherwise been prudent. Prudent fiduciary investment conduct under UPMIFA ordinarily includes, for example, broad diversification of portfolio risk. In return, then, for not judging fiduciaries with 20/20 hindsight, the law requires them ordinarily to diversify portfolio risk broadly.

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