# Fiduciary Standards
# Applicable to the Investment of Assets

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## Introduction

Different fiduciary standards apply regarding the investment of assets in different circumstances. This article explores several areas of financial responsibility in the law and the fiduciary standards applied therein. The following areas are discussed:

- Uniform Prudent Management of Institutional Funds Act ("UPMIFA")
- Employee Retirement Income Security Act ("ERISA")
- Illinois Prudent Investor Rule
- Illinois Charitable Trust Act
- Investment Advisors
- Broker-Dealers

While the focus is on federal law as well as the law one particular State (Illinois), the analysis should be able to extend to varying instances, with more specific reference being made to laws of other appropriate jurisdictions.

## Uniform Prudent Management of Institutional Funds Act ("UPMIFA")

In 2006, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") approved the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). This replaced the Uniform Management of Institutional Funds Act ("UMIFA"). UMIFA, now UPMIFA, governs investment and expenditures of charitable funds and endowment spending. UPMIFA applies, as did UMIFA, to charities organized as nonprofit corporations and to charities organized as trusts, but only to those trusts that have a charity as a trustee. Illinois adopted UPMIFA in 2009 as 760 ILCS 51 *et seq*.

<u>Fiduciary Standard Under UPMIFA.</u> UPMIFA requires four mandatory duties of investment fiduciaries: duty of care, duty to minimize costs, duty to investigate, and duty of loyalty. UPMIFA also imposes a duty to delegate prudently and a duty to spend prudently from the endowment.

UPMIFA's duty of care is a mix of corporate law and trust law standards, and also incorporates the Restatement's "prudence" standard for managing and investing funds. Under the RMNCA, a manager must act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."  Applied to charitable funds, the "similar circumstances" indicate that the standard is how other fiduciaries investing charitable funds, and not for-profit funds.

The duty to minimize costs requires trustees to "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."  UPMIFA Section 3(c)(1).  760 ILCS 51/3(c)(1).

The duty to investigate requires that an "institution shall make a reasonable effort to verify facts relevant to the management and investment of the fund."  UPMIFA Section 3(c)(2).  760 ILCS 51/3(c)(2).  Institutions must investigate the accuracy of the information they use in making investment decisions or any decision affecting the value of an investment.

Under UPMIFA, the duty of loyalty owed by directors of nonprofit corporations varies slightly from the duty owed by charitable trustees.  760 ILCS 51/3(b).  While directors of nonprofit corporations must act in the best interests of such corporations, charitable trustees must act in the sole interests of the beneficiary.

The UPMIFA lists various factors that a prudent nonprofit board <u>must</u> consider when managing and investing an institutional fund but notes that they are subject to the intent of a donor expressed in a gift instrument.  The factors include:

- The charitable purposes of the institution and the purposes of the institutional fund;
- General economic conditions;
- The possible effect of inflation or deflation;
- The expected tax consequences, if any, of investment decisions or strategies.
- The role that each investment or course of action plays within the overall investment portfolio of the fund;
- The expected total return from income and the appreciation of investments.
- Other resources of the institution;
- The needs of the institution and the fund to make distributions and to preserve capital; and
- An asset's special relation or special value, if any, to the charitable purposes of the institution.  760 ILCS 51/3(e)(1).

In the absence of express donor intent, UPMIFA directs trustees to manage charitable funds from the perspective of keeping the entire portfolio balanced with an eye on the purpose of the charity and overall market trends.  760 ILCS 51/3(a).

<u>Endowment Spending.</u> UPMIFA also modifies the rules governing expenditures from endowment funds, both to provide better guidance on spending from endowment funds and to give institutions the ability to cope more easily with fluctuations in the value of the endowment.  Some states have adopted a version of UPMIFA where any spending of over 7% of the endowment fund creates a presumption of imprudence.  Illinois did not adopt this optional provision of UPMIFA.  760 ILCS 5/et seq.

First, all spending subject to donor specifications, if such specifications exist. 760 ILCS 51/4(a). If a gift instrument states a particular spending rate or formula, that rate or formula will apply and the board will have no discretion in determining the spending policy with respect to that particular fund. Absent such strict specifications, however, under the former UMIFA, the board could only spend investment earnings and never touch the original contribution amount. Under the updated UPMIFA, an institution may spend however much its board determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. 760 ILCS 51/4(a). It follows that if the endowment does not earn a return on its investments one year, the board can authorize spending from the endowment so long as such spending is prudent. UPMIFA lists the factors an institution should consider in making decisions about whether an expenditure from an endowment fund is prudent:

- The duration and preservation of the endowment fund;
- The purposes of the institution and the endowment fund;
- General economic conditions;
- The effects of inflation or deflation;
- The expected total return from investments;
- Other resources of the institution; and
- The investment policy of the institution. 760 ILCS 51/4(a).

Because Illinois did not adopt the option provision of UPMIFA creating a presumption of imprudence if spending exceeds 7% of the endowment, boards subject to Illinois law may spend any prudent amount. Still, the Attorney General enforces the charitable interests of the public and may bring a suit against a board if it suspects certain spending – or investing or managing – of a charity's funds is imprudent.

<u>Duty to Delegate Prudently.</u> UPMIFA allows institutions to delegate investment and management duties to either an external agent or its committees, officers, or employees. 760 ILCS 51/5. UPMIFA cuts off liability to the board if it complies with certain requirements in selecting the agent, maintaining good faith and acting with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. 760 ILCS 51/5(c). The institution must act in good faith and with prudence when:

- Selecting an agent;
- Establishing the scope and terms of the delegation, consistent with the purposes of the institution and institutional fund; and
- Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation. 760 ILCS 51/5(a)(1-3).

<u>Release of Restrictions on Certain Qualifying Gifts.</u> UPMIFA allows institutions to modify restrictions contained in certain gift instruments valued under $50,000.00 if it determines that the restrictions have rendered the fund unlawful, impracticable,

impossible to achieve, or wasteful. 760 ILCS 51/6. Modification or release is subject to the state's Attorney General, who must be given a 60-day notification prior to action. The institution may modify or release restrictions on a gift if 1) the restricted fund has a total value of less than $50,000.00; 2) more than 20 years have elapsed since the fund was established; and 3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument. 760 ILCS 51/6(d)(1).

## ERISA Fiduciary Standards

In 1974 ERISA, 29 USC 1100, et seq., modified common law requirements for certain qualifying retirement and health and welfare trust funds. The statute differs from the common law prudent person standard in three critical respects. First, the plan fiduciary is required under ERISA to invest plan asses not in the way he or she would do so at a personal level, but as similar pension plans invest their assets. Second, a fiduciary must exercise the skill of a prudent expert, and not simply as that of a prudent man would I the management of pension assets. Third, the focus is not on the performance of individual assets, but on the performance of the portfolio as a whole.

Under ERISA, fiduciaries are defined as a person who either: exercises any discretionary authority or control over the management of the plan; exercises any authority or control concerning the management or disposition of its assets; or has discretionary authority or responsibility in the administration of the plan. Fiduciary status depends upon a person's function, authority and responsibility and does not merely rest on a title.

Fiduciaries must act solely in the interest of the beneficiaries for the exclusive purpose of providing benefits or defraying administrative expenses. The fiduciary must follow strictly the terms of the written plan document and administrate the plan in a fair, uniform, and nondiscriminatory manner. The fiduciary cannot allow the plan to engage directly or indirectly in transactions prohibited under ERISA. A fiduciary may be held personally liable for breaches of his or her fiduciary duties.

The fiduciary must use the care, skills, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Fiduciaries must diversity investments so as to minimize the risk of large losses unless it is clearly prudent to do otherwise. 29 USC 1104. The statute has no quantitative specifications, which preserves flexibility in its implementation, but also presents interpretation problems that inevitably lead to litigation.

Parties "in interest" are compelled under ERISA to not engage in prohibited transactions. A "party in interest" is defined as a plan fiduciary, legal counsel or employee of the plan, any person providing services to the plan, an employer whose employees are covered by the plan, a direct or indirect owner who owns 50% or more of an employer sponsor of the plan, certain relatives of the foregoing persons, employees, officers, directors, and certain shareholders of certain parties, and parties having a defined direct indirect relationship with parties in interest. "Prohibited transactions" include transactions between a plan and a "party in interest" for the sale, exchange, or leasing of property, the lending of money or other extension of credit, the furnishing of goods, services, or facilities, the transfer of assets, or the acquisition of any employer security or employer real property.

Fiduciaries are required to act in strict accordance with the plan documents in so far as the documents are consistent with ERISA. The plan fiduciaries are required to uniformly follow the express, written, terms of the plan. Decisions by the plan as to benefit claims are accorded deference unless certain circumstances arise. First, if there is a substantive issue raised on whether the plan is overly vague or ambiguous. Second, if the plan fails to expressly include a provision that the courts should defer to the administrative decisions of the plan fiduciaries. Third, if there is an apparent conflict of interest and the fiduciary would be personally affected by the benefit decision.

Plans must have a funding policy document that addresses the level and timing of contributions necessary to fund benefit obligations throughout the life of the plan. Plan sponsors must hire enrolled actuaries to perform calculations regarding the funding policy. An investment policy statement ("IPS"), while not specifically required by ERIS, is routinely requested in Department of Labor compliance audits. The IPS is narrower in scope than the funding policy in that the IPS pertains to only the governance of plan assets, and not the actuarial calculation of both the benefit and funding schemes of the plan. The IPS typically addresses the monitoring of invested assets, the evaluation and performance of investment policies, and funding and investment policies establishing formal investment policies. So long as investment decisions are in accord with the IPS and funding policy, a legally defensible position can be maintained.

The IPS should contain several items that establish the general tone and policy for the investment of assets in the plan. Such items include:

- Asset allocation targets for the plan and/or for the various asset classes of the plan.
- Policies for rebalancing the portfolio to adjust for deviations from these target allocations.
- Statement of investment objectives.
- Policies for reviewing investment objectives and liability assumptions.
- Benchmarks and/or performance expectations for the portfolio and each investment manager.
- Policies regarding proxy voting.
- Policies specifying percentages if manager trading to be directed by plan sponsors.
- Diversification requirements and restrictions, along with liquidity and quality constraints on individual assets.
- Projected cash flow of the plan over relevant time periods.

## **Illinois Prudent Investor Rule**

In Illinois, the common law duty regarding the investment of assets was generally incorporated into the Trust & Trustees Act. 760 ILCS 5/5. This Act directs the trustee to invest and manage a trust in accordance with six additional guidelines. The prudent investor rule requires the exercise of reasonable care, skill, and caution. 760 ILCS 5/5(a)(1). The rule allows for the trustee to exercise "reasonable business judgment" in managing investments by clarifying that this rule is a test of conduct and not a test of performance results. 760 ILCS 5/5(a)(2). Furthermore, the Prudent Investor Rule specifies that the trustee has a duty to diversify investments of the trust. 760 ILCS 5/5(a)(3). There may be an exception if, under the circumstances, the trustee reasonably believes that it is in the best interest of the beneficiary and furthers the purpose of the trust to not diversity. However, it should be noted that diversification is emphasized in this Rule.

A trustee also has a duty to review the trust assets and make decisions about the investments in the trust based on that review. 760 ILCS 5/5(a)(4). The trustee also has a duty to pursue an investment strategy that considers growth and stability and is impartial, focused on the purposes of the trust. 760 ILCS 5/5(a)(5). The final component of the Rule is a list of circumstances that the trustee may consider when making investment decisions. These include the general economic conditions, the potential effect of inflation, potential tax consequences, the role of each investment, the expected total return, and costs incurred. 760 ILCS 5/5(a)(6).

The Illinois Prudent Investor Rule is to be applied to investments, not in isolation but in the context of a portfolio as a whole and as part of an investment strategy. This distinguishes the rule under common law, where focus is on individual assets. Furthermore, there is not distinction in this rule between a corporate executor and an individual executor. Both must act with the highest degree of fidelity, utmost good faith, and a degree of skill and diligence that an ordinary prudent person would bestow on their own similar affairs.

The Illinois Prudent Investor Rule is a good legislative guideline for trustees to use in protecting themselves personally and protecting the trust at the same time. 760 ILCS 5/5(c) states that the courts are not restricted by the Rule and may direct or permit the trustee to deviate from the terms of the trust or to take or refrain from taking any other action. However, trustees should be attentive to this particular instrument and use it as a guideline for their actions or inactions with respect to the trust they manage.

## Illinois Charitable Trust Act

Illinois' Charitable Trust Act also imposes fiduciary duties on trustees of nonprofits. The Act defines "trustees" as "any person, individual, group of individuals, association, corporation, not-for-profit corporation, estate representative, or other legal entity holding property for or solicited for any charitable purpose; or any chief operating officer, director, executive director or owner of a corporation soliciting or holding property for a charitable purpose." 760 ILCS 55/3.

The duties of a charitable trustee can be found in Section 15 of the Act, and are as follows. The trustee of a nonprofit shall not make any investment in such a manner as to subject the trust to taxes. Monetary penalties can be imposed if any investment jeopardizes the organization's tax-exempt purposes. Trustees shall avoid "self-dealing" and conflicts of interest, wasting charitable assets, and incurring penalties. Trustees shall also adhere and conform the charitable organization to its charitable purpose, not make non-program loans, gifts, or advances to any person, except as allowed by the General Not For Profit Corporation Act of 1986. The trust must be utilized in conformity with its purposes for the best interest of the beneficiaries. Finally, the trust must timely file registration and financial reports required by this Act. 760 ILCS 55/15.

## Investment Advisors

An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Investment advisers' fiduciary duties originated with the 1940 Investment Advisers Act, 15 U.S.C. §§ 80b(1) - 80b(21). Included in the investor adviser's fiduciary standard are the duties of loyalty and care. An adviser that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict.

In addition, the Advisers Act expressly prohibits an adviser, acting as principal for its own account, from effecting any sale or purchase of any security for the account of a client, without disclosing certain information to the client in writing before the completion of the transaction and obtaining the client's consent. The states also regulate the activities of many investment advisers. Most smaller investment advisers are registered and regulated at the state level. Investment adviser representatives of state- and federally-registered advisers commonly are subject to state registration, licensing or qualification requirements.

## Brokers-Dealers

Under the antifraud provisions of the federal securities laws and self-regulatory organization ("SRO") rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers and are governed by the Financial Industry Regulatory Authority's ("FINRA") suitability standards. FINRA Rule Nos. 0100 – 1400 (available at http://finra.complinet.com).

While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, Commission and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent. The federal securities laws and rules and SRO rules address broker-dealer conflicts in one of three ways: express prohibition; mitigation; or disclosure.

An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation under FINRA Rule No. 2111, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customer. Broker-dealers also are required under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the completion of the transaction. The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. At the state level, broker-dealers and their agents must register with or be licensed by the states in which they conduct their business.