Fiduciary Duties in Investment Matters

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Overview

Boards of directors of charitable organizations, particularly private foundations, are increasingly being asked to think about how their investment portfolios can align more closely with their charitable mission. In the management of an organization's investment assets, the board is a fiduciary[2] and must act consistent with the fiduciary duties of loyalty and care (or prudence).

Yet today, there is a lively debate about the scope of fiduciary duties in light of the growth of impact investing and the use of environmental, social, and governance ("ESG") factors in investing endowments. There is a spectrum of arguments regarding the scope of fiduciary duty in this context: Some assert a fiduciary is required to consider ESG factors; others argue that considering ESG factors for purposes, other than assessing the return on the investment, that is, for collateral purposes, could violate fiduciary duties. Still others argue a middle ground: that fiduciary duties do not require consideration of ESG, but fiduciaries may do so in appropriate circumstances, particularly when assessing the merits of an investment and its relationship to charitable mission. There are also ongoing efforts to redefine fiduciary duty to address the evolving considerations of the impact of investments beyond just financial return.

This debate is complicated by a number of factors: different interpretations of existing law; confusing language and inconsistent use of terms, concepts, and rationales and their application to evolving investment theory; different legal regimes in Europe and the United State regarding the scope of fiduciary duty which makes relying on European regimes problematic; and different rules applicable to different types of organizations, such as pension funds and charitable organizations.

Both ESG investing and impact investing have been used as umbrella terms with different meanings depending on the speaker and the audience. For foundations, different legal rules apply depending whether an investment is a program-related investment or a mission-related investment and yet both often fall under the rubric of impact investing. When it comes to ESG investing, there are a multitude of

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[1] Updated January 2023. The use of ESG in investment decisions and the backlash continues to evolve and may warrant further updates to this article.

[2] A fiduciary duty is the highest duty under American law. Justice Cardozo long ago described the meaning of fiduciary duty and it is still widely cited: "something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 249 N.Y. 458, 464 (N.Y. Ct. App. 1928).

ESG factors and measurement standards across industries that contribute to confusion about the effectiveness of various strategies.

In addition, terms and approaches, such as socially responsible investing, negative and positive screens, corporate social responsibility, and divestment strategies, have evolved over time and can mean different things to different people, thereby further complicating the picture.

The rationale for using such strategies also differ across organizations. For example, while some argue investors should use ESG factors for moral or ethical reasons, others assert an ESG strategy also results in stronger investment returns than an investment program that eschews such strategy. Still others argue that all investments have impact and, therefore, investors must consider the impact of their investments more broadly across society, including on the environment. A growing number of smaller foundations also argue that investments should be used to further the mission of the organization.

Despite this confusion and differences in views, it is clear that ESG investing and other investment strategies that consider the impact of investments is a growing trend across philanthropic and commercial investments[3]. It is wise for a board to periodically carefully consider these issues as part of a review of its investment objectives within the scope of its fiduciary duties.

This paper provides a broad overview of the legal concepts and attempts to sort through the confusion so that a board has a clear understanding of the current fiduciary requirements.[4] It further suggests a framework for a board as it considers these critical questions.

The bottom line is that a board may, consistent with its fiduciary duties, adopt an investment approach that takes into account ESG factors and/or the impact of its investments provided it does so after (i) carefully considering the implications, including any impact on returns; (ii) articulating and documenting clearly its objectives, philosophy, rationale, and tactics and how they link to the foundation's expected financial returns, charitable mission, and overall objectives; (iii) monitoring performance over time; and (iv) making such changes as are necessary given performance and changing circumstances.

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[3] Most recently, beginning in 2022, there has been a strong backlash against ESG from treasurers and other financial officers in certain "red" States. The scope of that backlash and the response from ESG proponents is beyond the scope of this article. For additional context see the following article..
https://www.fundfire.com/c/3866204/502663/backlash_shakes_pension_space?referrer_module=emailReminder&_sso_code=02c53b2c75eaddeda941bc518df8cd0ad2f273ee

[4] There have been volumes of materials, articles, law review articles, and other commentary on these issues and I do not purport to cover the background or issues in-depth. A list of additional materials is available for those interested.

The Changing Landscape

Over the past ten to fifteen years, trustees have come under increasing pressure to consider ESG factors (and the potential impact of investments) in their investment decisions, including, for example, through divestment strategies and otherwise accounting for environmental or social costs and impact in making investment decisions.[1] This consideration is driven by external forces (peer pressure and commentary) and from internal trustees and staff who draw from their own experiences and knowledge as well as a desire to see more alignment between investments and mission, avoid charges of hypocrisy and not undercut grant making strategies.

Divestment strategies currently focus largely on fossil fuel companies but can also include other industries/companies such as tobacco, firearms, private prisons, and, more recently, the boycott, divestment, and sanctions movement targeting Israel companies. Prior to the use of divestment strategies focused on fossil fuels, divestment was used most prominently with respect to South Africa during the apartheid period and there is considerable debate as to its effectiveness in driving change and whether it was consistent with fiduciary duty. See Max M. Schanzenbach & Robert H. Sitkoff, Reconciling Fiduciary Duty and Social Conscience, 72 Stan. L. Rev. 381, 394 nn.56-58 (2020) [hereinafter Schanzenbach/Sitkoff].

Some proponents of impact investing suggest that fiduciary duties **require** trustees to consider the social impact of their investment decisions, including using ESG factors, while some lawyers and commentators suggest such consideration is not mandatory in all cases (and, indeed, could be a violation of fiduciary duties in some cases). Compare Susan N. Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, 90 U. Colo. L. Rev. 731, 734, 736 (2019) [hereinafter Gary] with Schanzenbach/Sitkoff.

Applicable Law and Evolving Context

Fiduciary Duty In Investment Matters

The law of trusts supplies the relevant fiduciary principles for trusts, pension funds, and charitable endowments. The Uniform Prudent Management of Institutional Funds Act ("UPMIFA") applies trust law to charitable endowments as a matter of state law. UPMIFA calls for the application of a series of factors for fiduciaries to consider, including an asset's special relationship to the organization's mission. These factors must be assessed and balanced as part of a comprehensive analysis. Exhibit A includes a description of the required analysis and factors.

Private foundations are also subject to the jeopardizing investment rules of section 4944 of the Internal Revenue Code that prohibits foundations from making investments that jeopardize "the carrying out of any of its exempt purposes" and require fiduciaries to exercise ordinary business care and prudence in the making of all investments so as to provide for the long-term and short-term financial needs of the foundation to carry out its exempt purposes.[2]

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[1] The use of negative screens, sometimes called socially responsible investing, to avoid companies or industries is not new. For a history, see Schanzenbach/Sitkoff at 392-393.

[2] A complete description of the jeopardizing investment rules is beyond the scope of this paper. Program-related investments are an exception to the jeopardizing investment rules.

It is largely understood that the underlying fiduciary principles require a duty of loyalty to beneficiaries and a duty of prudence (or care) in the manner in which investments decisions are made.[3] The duty of loyalty depends on the nature of the organization. With trusts, a trustee must administer the trust solely in the interest of the beneficiaries and cannot be influenced by the interest of any third person or motive other than the accomplishment of the trust. Acting with mixed motives creates an irrebuttable presumption of a breach of duty. With respect to charitable corporations, the fiduciary must act in the best interest of the beneficiary, avoid conflicts of interest, not make decisions on the basis of personal preferences or values, and not engage in self-dealing.

The duty of prudence requires a fiduciary to exercise the care and attention that a reasonable investor would exercise in a similar situation and requires a documented analysis showing the rationale for the investment, including risk/return aspects and any considerations allowable by the law applicable to the organization. Generally, absent a directive from the person setting up the trust, this requires a diversified portfolio with risk and return objectives reasonably suited to the purpose of the trust.

The application of these principles results in some differences depending on the nature of the organization. Fiduciaries of pension funds must, for example, administer assets solely for the beneficiary of the pension plans and, therefore, focus on the risk-adjusted investment return. Consideration of other collateral or social benefits at the expense of returns would potentially subject the fiduciary to damages.

On the other hand, and importantly to private foundations, the application of fiduciary duty law provides more flexibility for fiduciaries of charitable organizations, including foundations, which permits fiduciaries to consider the charitable mission of the organization when making investment decisions as explained above.[4]

An Evolving Context

Historically, in reliance on the trust principle of loyalty, many trustees of investment assets understood their duties to focus solely on maximizing the financial return of the assets in light of the risks as in the best interests of their beneficiaries. Consequently, even as interest in mission-related investing and use of ESG factors grew, some trustees were reluctant to embrace mission-related investing wherein considerations of other factors, including ESG, might play a role in the investment decision-making process rather than solely the best risk-adjusted return[5]. To address this perceived reluctance and

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[3] Some commentators assert directors also owe a duty of obedience to the terms of establishing the fiduciary's authority and a duty of impartiality (requiring fiduciaries to treat different generations of beneficiaries impartially). See Gary at 784. Professor Gary summarizes the duties as follows: a "fiduciary must treat all generations of beneficiaries impartially, must act in the best interests of the beneficiaries and not for the fiduciary's own benefit, and must follow the prudent investor standard in investing assets held by the entity. These three duties interrelate, especially for long-term trusts, pension plans, and endowments." Id. at 796.

[4] The Restatement of Law Charitable NonProfit Organizations (2022) addresses fiduciary duty in the context of investment matters in sections 2.01- 2.04. Section 2.04 addresses in particular the duties and approach in the management, investment, and expenditure of a charity's assets.

[5] In a 2018 survey of U.S. investment professionals, approximately 22% of those not using ESG factors believe that doing so would violate fiduciary duty. Schanzenbach/Sitkoff at 385, n.7. Another study found that 22% of investment professionals not considering ESG factors suggested they would do so if they had clarity that it would not conflict with fiduciary constraints. Id. It wouldn't be surprising if evolving

encourage more investment using impact principles, proponents of mission-related investing began urging a reconsideration of the historical view of fiduciary duty. Important developments included a report by the law firm of Freshfields Bruckhaus Deringer[6] (focused largely on European fiduciaries) that analyzed fiduciary duties applicable to investment decision-making and concluded that integrating ESG considerations into investment analysis was “clearly permissible” and “arguably required” and, thereafter, the establishment of the Principles for Responsible Investment, an investor initiative in partnership with the UN Environment Programme Finance Initiative and the UN Global Compact (“PRI”), that also took the view that there are “positive duties on investors to integrate ESG issues”. The PRI also recently initiated a project to promote consideration by trustees of the collateral sustainability effect of their investment practices. See Schanzenbach/Sitkoff at 389, n.29.

Meanwhile, beginning roughly fifteen years ago, efforts picked up in the United States to encourage ESG investing and mission-related (and impact) investing including, through the creation of the Mission Investors Exchange, important reports and papers from FSG and Rockefeller Philanthropy Advisors, among others, addressing the legal requirements and efforts by Rockefeller Foundation and other proponents of mission-related investing. Some foundations took up the clarion call for the divestment from fossil fuel companies and pressure mounted on those foundations maintaining exposure to such assets.[7]

In addition, as a result of the growth of mission-related investing, various regulatory authorities were prompted to provide guidance, some of which added to the confusion, but others allowed for greater clarity regarding the permissible practices for fiduciaries of investment assets. For example, the Department of Labor (“DOL”) issued a series of guidance for fiduciaries of pension plans in 2008, 2015, 2018, 2020, and 2022 touching upon the use of ESG or other impact factors with each one attempting to clarify the previous one. In 2020, the DOL issued revised proposed guidance which was perceived widely as skeptical of using ESG in investment decisions and received hundreds of comments. Thereafter, the final guidance largely stayed away from using the ESG language but indicated that trustees of pension funds had to focus on risk-adjusted returns and that factors (labelled “pecuniary factors”)[8] that might influence those returns could be considered in that context. Then, in 2022 the Biden Administration DOL issued its final rule that, among other things, adopted a neutral approach to the use of ESG factors that permits (but does not require) the use of ESG factors when appropriate in the determination of the risk/return factors of the investment. See

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norms and law and the Restatement as described above change the results of the survey if administered again in 2023 but the ESG backlash could also muddy the waters.

[6] Asset Management Working Group of the UNEP Finance Initiative, A legal framework for the integration of environmental, social and governance issues into institutional investment (Oct. 2005), a report developed by a project team led by a British law firm, Freshfields Bruckhaus Deringer. The view that ESG consideration was **required** was a bridge too far for many U.S. professionals, but has generated support in a number of circles. It is important to note that the European Union, in general, is far more supportive of ESG investing.

[7] Divest/Invest is an effort led by the Wallace Global Fund and others encouraging foundations to divest from fossil fuel companies and reinvest in clean energy. See https://www.divestinvest.org/.

[8] See https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030. Pecuniary factors are described as “any factor that the responsible fiduciary prudently determines is expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan’s investment objectives and funding policy”. As noted, the new Biden Administration rule has modified this approach.

https://www.dol.gov/newsroom/releases/ebsa/ebsa20221122. [9] in January 2023, 25 States sued to stop the implementation of the DOL rule. A final resolution of the authority of the DOL to issue the rule will likely require appellate review.

Most importantly for private foundations, the IRS provided some guidance in 2015 that clarified that foundations could consider, among a range of factors, an asset's relationship to the foundation's charitable purposes when considering investment options (essentially confirming the application of UPMIFA to the investment process). I.R.S. Notice 2015-62, 2015-39 I.R.B. 411. This was seen as an important clarification for some even though, for many lawyers in the field, the IRS only confirmed what many previously understood. The Notice provided in part:

> *When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business and prudence…. For example, a foundation will not be subject to tax under section 4944 if foundation managers who have exercised ordinary business care and prudence make an investment that further the foundation's charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes.*

The guidance also noted that it was consistent with the general state law requirements of UPMIFA[10]. Taken together, an investment undertaken consistent with the UPMIFA factors and section 4944 requirements, which is expected to result in a below market return, will not by itself cause a breach of duty if the investment and its intended impact is also expected to serve the purposes of the charity.

The Commercial Investment World Moves Toward ESG and a Backlash Ensues[11]

In the last five years, an increasing number of commercial investment firms have embraced the notion of investing with an eye on ESG factors or other impact. In 2020, Larry Fink, CEO of Blackrock, the investment firm with most assets under management, sent a letter heard around the investment universe informing companies that Blackrock would view a company's approach to ESG, and, particularly, climate-related issues as an important part of its investment process. See

[9] See also https://www.ropesgray.com/en/newsroom/alerts/2022/november/dol-final-rule-embraces-principles-based-approach-to-esg-factors-in-investments-and-proxy-voting#:~:text=On%20November%2022%2C%202022%2C%20the,exercise%20of%20shareholder%20rights%2C%20including

[10] In 2018, Delaware amended its prudent investor statute to become the first state to specifically address ESG investing, providing, in part, that "when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries. 81 Del. Laws 320 § 5 (2018).

[11] But see footnote 3 infra regarding the backlash to ESG.

https://www.blackrock.com/corporate/investor-relations/2020-blackrock-client-letter: "Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors."[12] In 2021, Mr. Fink doubled down on the importance of investing with considerations of ESG, and particularly climate, calling on all companies to "disclose a plan for how their business model will be compatible with a net zero economy." https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter. It is, of course, not only Blackrock that is pushing this view. The growth of assets under management devoted in one way or another to ESG investing is undeniable across many firms yet slowed in 2022 amidst the backlash to ESG.[13] The emerging backlash from financial officers of "red" States noted in fn3 has challenged Blackrock and Mr. Fink on the use of ESG and some states have moved money from Blackrock mandates in response and threatened other firms that are viewed as sympathetic to ESG style investing or that have limited funding of fossil fuel companies.

The Explanation of Investment Rationales Depends on a Variety of Factors

Continuing concerns about complying with fiduciary duties does help explain, however, the approach taken by a variety of fiduciaries to justify decisions whether to divest or use ESG investing. Pension funds are generally careful, therefore, to base their public explanations of potentially controversial investment decisions on the basis of an investment thesis, not an ethical or moral concern. For example, CalPERS responded to criticism that it might be violating its duties by relying on ESG factors by arguing that it used ESG factors as "an informed investor … not because they make us feel good but because there is sound economic reasoning to do so." https://www.calpers.ca.gov/page/newsroom/for-the-record/2017/slanted-study-esg-falls-apart. Similarly, some universities have framed decisions in response to student demands to divest from fossil fuels or other industries deemed objectionable on the basis of an investment thesis or a broader institutional response to the climate issue and not the morality or ethics of investing in fossil fuels.[14] See, e.g., message from President of Harvard (https://www.harvard.edu/president/news/2020/message-from-president-bacow-on-climate-change);[15] Michael Katz, Swarthmore Endowment Will Not Divest from Fossil Fuels, Chief Investment Officer, June 15, 2018, https://www.ai-cio.com/news/swarthmore-endowment-will-not-divest-fossil-fuels/; and Board of Trustees commits to accelerating transition to net-zero greenhouse gas emissions, reports major reduction in fossil fuel investments, Stan. News, June 12, 2020,

[12] In a similar vein, more recently, the Business Roundtable announced a reconceptualization of the purpose of a corporation suggesting that companies cannot be solely focused on shareholder return, but CEOs must commit to all stakeholders including customers, employees, suppliers, communities, and shareholders. See https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[13] See https://www.cnbc.com/2020/12/21/sustainable-investing-accounts-for-33percent-of-total-us-assets-under-management.html.

[14] Press releases are not always the best mechanisms to determine precisely what an organization may be doing or reflect the complexity of investment portfolios. Interesting examples include Stanford's explanation of its decision not to divest from fossil fuels in 2016 (https://news.stanford.edu/2016/04/25/stanford-climate-change-statement-board-trustees/) and, more recently, Rockefeller Foundation's announcement of a divestment strategy on fossil fuels that appears, in practice, to be less of a complete divestment but rather to cease investing further in private energy investments, similar to what some foundations have decided (https://www.rockefellerfoundation.org/news/the-rockefeller-foundation-commits-to-divesting-from-fossil-fuels/).

[15] Harvard's Sustainable Investment Policy considers material ESG factors in the course of its investment analysis and how that may impact the performance of its investments. http://www.hmc.harvard.edu/content/uploads/2020/11/HMC-Sustainable-Investment-Policy.pdf. Stanford takes a similar approach. https://smc.stanford.edu/wp-content/uploads/2020/01/SMC-Ethical-Investment-Framework.pdf.

https://news.stanford.edu/2020/06/12/trustees-commit-accelerating-transition-to-net-zero-greenhouse-gas-emissions/.

Differing Claims of Investment Impact and Returns

Another element contributing to heated debate is whether socially responsible investing ("SRI") (the use of screens), impact investing (seeking a double bottom line and not the use of program-related investments), and/or the use of ESG factors will diminish investment returns. Many investment professionals have long argued that restricting an investment universe through eliminating exposure to certain assets by the use of screens or consideration of non-investment-related factors will inevitably mean lower returns under modern portfolio theory. While initial efforts of SRI were largely premised on moral or ethical concerns, arguments have evolved to address concerns about the potential for breaches of fiduciary duty. The debate, like others, is often confused because studies may evaluate different strategies such as screens versus the use of ESG factors, use different benchmarks as comparisons, and occur over different time periods.

Proponents of SRI, impact investing, or ESG investing have historically made two arguments: first, that the societal or impact benefits of using screens or ESG factors to avoid morally or ethically problematic investments more than made up for any potential limit on returns; and second, and more recently, that using ESG factors as part of an investment process would, in fact, lead to equal or better returns. This latter argument has gained more traction over the last ten years as proponents have pointed to a bevy of studies allegedly showing that investing with companies that have high ESG scores outperform other potential strategies.[16] For example, divestment efforts targeting fossil fuel companies initially focused on the moral and ethical issues associated with such investments, including the impact on the environment and the conduct of companies in allegedly denying climate change or misleading the public. Proponents of divestment today are more inclined to also rely on an investment thesis of stranded assets to argue such investments are a bad investment; the argument is that fossil fuel companies are valued, in part, based upon the inventories they may have on hand or in the ground but that valuation is too high because they will never be able to extract the assets because of regulatory concerns, the threat of litigation, and market forces. This type of argument would, therefore, be consistent with fiduciary duties of loyalty and prudence because it is based on an active investment strategy.

The Debate Continues and an Effort to Address the Confusion

Notwithstanding the guidance offered by regulatory agencies and efforts by proponents of ESG investing to provide clarity, there remains confusion in many circles because of the difference in organizations and the understanding of the applicable law.

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[16] See variety of studies cited by Schanzenbach/Sitkoff at 395-397, nn.65-75 and Gary at 753-754, nn.82-89.

The Schanzenbach/Sitkoff article offers a useful construct in thinking about how to cut through some of the potential confusion consistent with fiduciary duties. In short, they argue for the following proposition:

They first define ESG investing (a strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or services). They argue that the "term 'ESG investing' is inherently ambiguous as to whether the investor's purpose is collateral benefits (what they term classic socially responsible investing) or improved risk-adjusted returns (and it is widely and confusingly used today to encompass both") Schanzenbach/Sitkoff at 397.

They, therefore, divide ESG investing into two categories: risk-return ESG investing and collateral-return ESG investing. Risk-return ESG investing is investing using ESG factors because the investor expects to obtain a better risk-adjusted return. Collateral-return ESG investing is investing using ESG factors to address collateral benefits other than to the beneficiary of the trust, such as cleaner air generally or better conditions for workers, etc. The distinction turns on the investor's motive. Id. at 397. They argue that, under relevant trust law, a trustee's use of ESG factors if motivated by the trustee's own sense of ethics or to obtain collateral benefits for third parties violates the duty of loyalty. Id. at 399.

With respect to risk-return ESG investing, the authors suggest that risk-return ESG can be consistent with the duty of loyalty provided that the fiduciary's sole or exclusive motive is benefiting the beneficiary by improved risk-adjusted returns. They further argue that while "there is theory and evidence in support of risk-return ESG … this support is far from uniform, is often contextual, and in all events is subject to change, especially as markets adjust to the growing use of ESG factors." Id. at 454. They assert that "[p]roponents of risk-return ESG have conflated evidence of a relationship between an ESG factor and firm performance with evidence that such a relationship, if any exists, can be **exploited by an investor for profit**." Id. at 390 (emphasis supplied). They conclude that a trustee could undertake a program of ESG investing via active investing, provided that the trustee has a documented, reasonable analysis showing expected return benefits that offset any associated costs, and that the trustee updates this analysis periodically in light of experience with actual costs and returns. Id. at 390-391.

Importantly, for our purposes, they also recognize that a third-party benefit obtained via a charity's investment program that is within the charity's charitable purpose is not a collateral benefit but rather a benefit that falls within the sole interest of the charity's purpose. Id. at 391.

In short, their analysis "challenges both the current zeitgeist in favor of ESG investing by a trustee and the common knee-jerk reactions that ESG investing necessarily violates the duty of loyalty." Id. at 386.

It is important to note that other observers/commentators take a different view. See Gary at 733. Professor Gary[17] argues that shifts in investment practices and underlying duties to beneficiaries both now and in the future require trustees to consider ESG factors. It is also worth emphasizing that

[17] Professor Gary is a well-respected commentator on issues of fiduciary duty. The article was developed with financial assistance from Rockefeller Foundation.

companies that have strong ESG practices that might make them attractive investments will inevitably result in having a beneficial impact outside of their share price.

What this means for a private foundation

A private foundation subject to the jeopardizing investment rules of section 4944 and UPMIFA must consider a range of factors in making its investment decisions to meet its fiduciary duties as set forth in Exhibit A, including the relationship of an investment asset to the foundation's charitable purposes. Defining what the foundation means by its charitable purposes is an important step in this analysis so that it can have a workable framework to assess our choices. It is also important that the way the foundation talks and communicates about its decisions should be rooted in the context of the relevant duties and law, a point that is sometimes lost for other organizations or commentators in the passion for the desired end result.

A foundation constituted as a perpetual foundation for charitable purposes does provide some boundaries and requires a board to consider carefully the balance between immediate needs and the needs of future generations.

Consequently, the following are suggested steps and practices as a foundation considers its alternatives:

- The board should identify clearly (i) the objectives for the investment portfolio, (ii) the rationale underlying the objectives and how that links to accomplishment of our mission and our status as a perpetual foundation, (iii) the philosophy and tools to be used, and (iv) why any changes from the current approach are appropriate and needed.

- In determining any changes to our approach, the board should carefully assess a range of alternatives and their impact and articulate clearly the reasons for the decisions (this can be captured in a revised policy or in board minutes).

- The board should assess our investment decisions – and document changes – in light of expected returns and risks. When possible, the board should have support for the proposition that the investment changes will not limit returns, and may enhance returns.

- In those cases, where there is not solid support that changes will enhance returns, a board should articulate how the investments further the foundation's charitable mission as reflected principally in programmatic strategies and why any potential diminishment in financial returns is justified.

- The board[18] should monitor performance of the investment portfolio and make appropriate changes based on performance and changing circumstances.

[18] A board can exercise its responsibilities through an investment committee as long as it provides periodic oversight.

- In public statements and explanations, the foundation should be clear for the reasons for its approach (being clear, for example, that it is not compromising returns or are willing to sacrifice returns for desired programmatic impact, or some combination thereof). While using the phrase "alignment with our values" to explain investment decisions may be shorthand for a programmatic rationale, such language fits less neatly into the legal and fiduciary framework and might be buttressed with additional language relating to the foundation's charitable mission.

<u>EXHIBIT A</u>

Uniform Prudent Management of Institutional Funds Act (UPMIFA)

Section 760 ILCS 51/3 - Standard of Conduct in Managing and Investing Institutional Fund

(a) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

(b) 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.

(c) In managing and investing an institutional fund, an institution: (1) 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; and (2) shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(d) An institution may pool two or more institutional funds for purposes of management and investment.

(e) Except as otherwise provided by a gift instrument, the following rules apply:

(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:

- **(A) general economic conditions;**
- **(B) the possible effect of inflation or deflation;**
- **(C) the expected tax consequences, if any, of investment decisions or strategies;**
- **(D) the role that each investment or course of action plays within the overall investment portfolio of the fund;**
- **(E) the expected total return from income and the appreciation of investments;**
- **(F) other resources of the institution;**
- **(G) the needs of the institution and the fund to make distributions and to preserve capital; and**
- **(H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.**

(2) 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.

(3) 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 this Section.

(4) 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.

(5) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this Act.

(6) A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

(Source: P.A. 96-29, eff. 6-30-09.)