Attorney General Guidance on the New York Prudent Management of Institutional Funds Act

March 17, 2011

On March 17, 2011 the New York State Attorney General's Charities Bureau released "A Practical Guide to the New York Prudent Management of Institutional Funds Act" (the "Guide"), setting forth the Attorney General's interpretation of and guidance on various provisions of the New York Prudent Management of Institutional Funds Act ("NYPMIFA" or the "Act").

Guidance issued by the New York State Attorney General does not have the weight of law or regulation, but provides insight as to how the Charities Bureau will enforce the law. NYPMIFA is New York's version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). Certain provisions of the Act are not contained in the uniform law and are unique to New York. As the Attorney General's Charities Bureau is believed to be the source of certain of these unique provisions and will enforce the new law, the nonprofit sector places great weight on its views.

NYPMIFA was enacted by New York State on September 17, 2010, and applies to institutions organized and operated exclusively for charitable purposes, certain charitable trusts and other corporations incorporated under section 102(a)(5) of the New York Not-For-Profit Corporation Law (the "N-PCL").[1] The law updates prior rules regarding investment conduct, expenditure of funds, delegation of management and investment, and release or modification of restrictions. The most significant change made by the new law is the elimination of the concept of "historic dollar value" for endowment funds. Under NYPMIFA, a detailed prudence standard governs appropriation from endowment funds, and there is no longer a requirement to maintain historic dollar value.

The following is a summary of the Guide. For background on NYPMIFA, please see our previously issued client memorandum on the subject, which can be found at http://www.simpsonthacher.com/siteContent.cfm?contentID=4&itemID=75&focusID=1062.

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[1] This means that public charities, private foundations, associations, social welfare organizations and other entities incorporated under the N-PCL, educational institutions formed under the New York Education Law, and, with a few exceptions, institutions formed under the New York Religious Corporations Law, are governed by the Act.

I. Focus of Attorney General Guidance.

A. Notice Prior to Appropriation of Endowment Funds.

With respect to a gift instrument executed by the donor before September 17, 2010, the Act requires an institution to provide 90 days advance notice to the donor, if available, before appropriating from the applicable endowment fund for the first time. The Act requires that notice be substantially in the form of boxes that the donor may check providing either that (i) the institution may spend as much of the endowment gift as is prudent (i.e., box #1), or (ii) the institution may not spend below the original dollar value[2] of the endowment gift (i.e., box #2). If the donor does not respond within 90 days from the date notice was given, the institution will not be subject to the original dollar value limitation. If the donor does respond, the institution must follow the donor's direction. The Act specifies certain circumstances under which notice is not required.

In the period following enactment of NYPMIFA, questions arose regarding the appropriate interpretation of the notice requirement, which is a New York-only provision not found in UPMIFA. The Guide provides the Attorney General's views with respect to some of these questions, as follows:

- Unless an exception applies, notice must be given to the donor prior to any appropriation from all endowment funds where the gift instrument was executed prior to September 17, 2010. There are no exceptions to the notice requirement for endowment funds which are not underwater or for institutions which do not intend to spend from underwater endowments.[3]

- Once notice is sent, an institution may appropriate income and net[4] appreciation over the original dollar value during the 90-day donor-response period, but the institution may not invade original dollar value during this period.

- The Guide states that institutions that, acting in good faith, appropriated from endowment funds between September 17, 2010 and the issuance of the Guide, without giving the required notice, should promptly send notice to donors. If the donor checks box #2, it is the view of the Attorney General that the institution must restore the

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2 We note that the Act uses the term "original dollar value" which we believe is synonymous with "historic dollar value," the term used by prior law. The Guide confirms that the Attorney General also views the terms as synonymous.

3 This means that notice is required prior to appropriation even for endowment funds that are valued at the time of appropriation at more than the original dollar value of the endowment gift, even if the amount appropriated would constitute solely income and appreciation and would not invade the original dollar value of the fund, and even if the institution does not intend to ever appropriate original dollar value.

4 The Guide uses term "net appreciation." This term is in the prior, repealed law and is not in the Act.

endowment fund to its original dollar value if any pre-notice appropriation reduced the fund below that value.

- The Guide clarifies that if the donor checks box #2, it is only the ability to appropriate original dollar value that will not apply to such a gift; the prudence rules set forth in the Act will still apply. Therefore, an institution will need to consider the eight prudence factors set forth in the Act prior to appropriating any income or appreciation from such a gift, and contemporaneously document this consideration. The Guide notes that institutions may wish to add an assurance to the notice to donors, stating that if box #2 is checked, decisions to appropriate from the endowment fund must still be prudent under the Act.

- To determine whether a donor is "available" for purposes of notice, an institution should make reasonable efforts to locate the donor, including conducting Internet searches and contacting known associates of the donor. Records should document the search even if it is unsuccessful.

The Guide does not address whether notice needs to be given to "subsequent" donors who did not sign the original gift instrument but who later contributed to an existing endowment fund. We believe that subsequent donors to an endowment fund do not need to receive notice prior to appropriation because typically it is the original donor who agreed to the endowment terms and would therefore be the person authorized to modify those terms.

B. Contemporaneous Documentation.

As stated above, one of the Act's most important changes to prior law is the elimination of the concept of "historic dollar value." Instead, the Act provides that an institution may appropriate so much of an endowment as the institution determines, subject to the intent of the donor expressed in a gift instrument, is prudent for the uses, benefits, purposes and duration for which the endowment fund is established. The Act lists eight factors that institutions must consider, if relevant, when making decisions as to expenditure of endowment funds. The Act requires that an institution keep a contemporaneous record describing the consideration given by the governing board or committee to each of the eight enumerated factors.

In the period following enactment of NYPMIFA, questions arose regarding the contemporaneous documentation requirement, which is a New York-only provision not found in UPMIFA. The Guide answers some of these questions as follows:

- The record-keeping requirement may be fulfilled through documentation in governing board or committee minutes, or by another means. If a particular factor is determined by the governing board or committee not to be relevant to its decision, the governing board or committee must document how it reached that conclusion.
- One of the eight factors required to be considered by NYPMIFA prior to appropriation from an endowment fund is unique to the Act. This factor states that when an institution is making a decision to appropriate from an endowment fund, it must consider, "where appropriate and circumstances would otherwise warrant, alternatives

to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution." We do not believe that it was the intent of the New York State Legislature to favor accumulation over expenditure of endowment funds through this factor. The Guide indicates that this factor was intended to ensure that, when circumstances warrant, the institution consider whether reasonable alternatives to endowment spending are available. The Guide gives as an example an endowment fund that has diminished in value, and states that the governing board may decide to avoid or reduce further spending of the fund. Alternatives may include fundraising, expense reductions, sale of non-essential assets, or reductions in non-essential staff.

- The governing board or committee may appropriate from multiple similarly-situated endowment funds simultaneously (e.g., by application of a specific spending rate to many endowment funds). The Attorney General advises that the governing board or committee develop written procedures for determining when a group of funds is similarly situated. In determining whether it is appropriate to treat multiple endowment funds as similarly-situated, the Attorney General has indicated that the governing board or committee should consider the purposes of the funds, the spending restrictions applicable to the funds, the durations of the funds, the financial condition of the funds, whether the funds are invested similarly, and other such factors as may be relevant. Interestingly, the Guide specifies that any decision to appropriate from multiple similarly-situated endowment funds simultaneously should be "made with care" to ensure that any decision to appropriate from the funds collectively would be justified if the factors were applied to each fund individually.[5] The appropriation from multiple similarly-situated endowment funds simultaneously may be documented in a single contemporaneous record.
- Contemporaneous records of appropriation decisions should be maintained as part of the permanent records of the institution.

C. Release and Modification of Restrictions.

Under prior law, an institution could seek release of restrictions placed upon a gift by obtaining the authorization of the donor. Where release by the donor was not possible due to the donor's death, disability, unavailability or impossibility of identification, an institution could seek court release. Under the Act, an institution may seek court release or modification of a restriction even if the donor is available, on notice to the Attorney General and the donor. In addition, under the Act an institution may release or modify a restriction without court approval for a fund with a total value of less than $100,000, where more than 20 years have elapsed since the fund was established. Court approval for such a release is not required, but the release must be on notice to the Attorney General and the donor.

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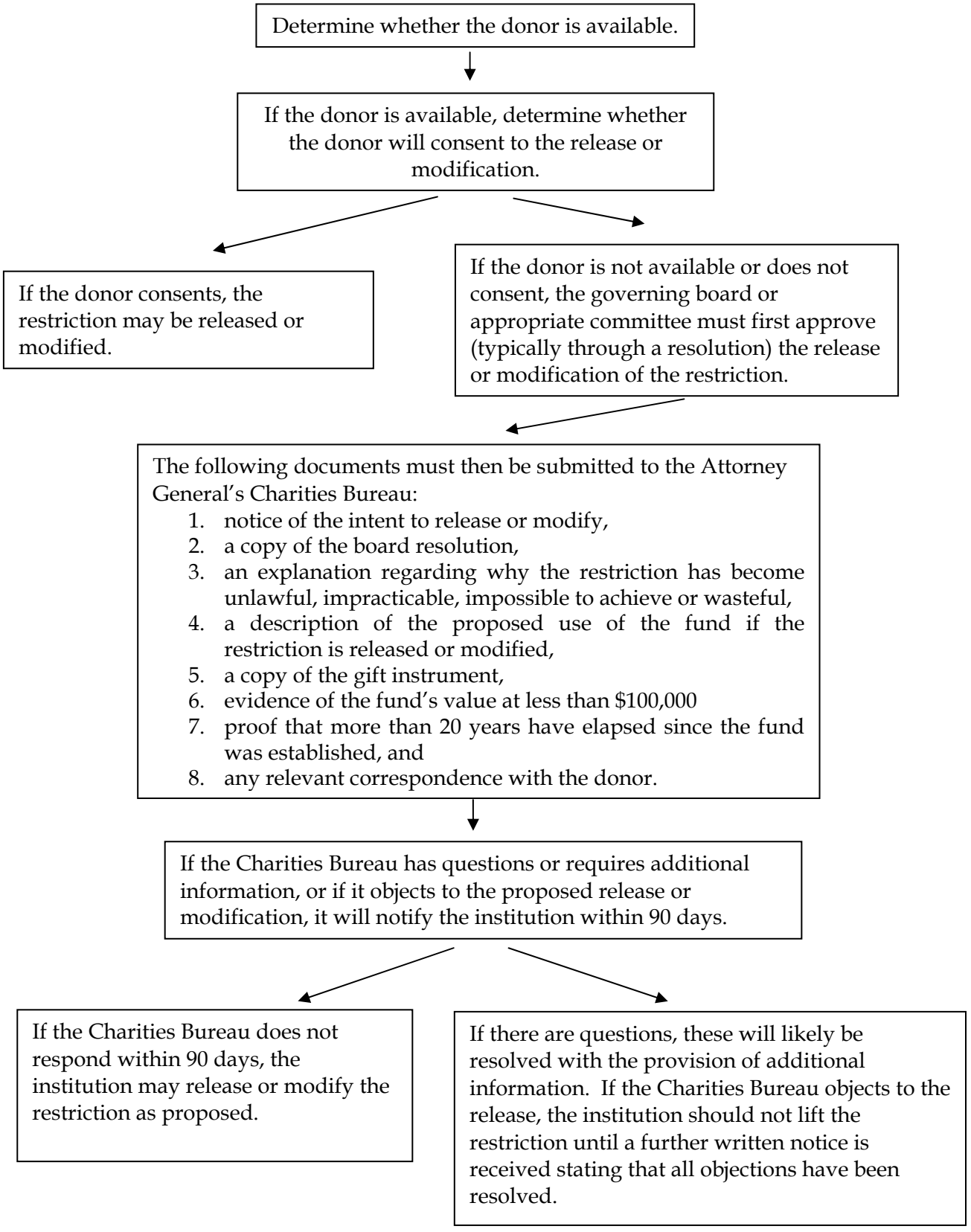
[5] The Guide does not address how consistently to ensure that any decision to appropriate from similarly-situated endowment funds collectively would be justified if each of the factors were applied to each fund individually.

The Guide provides the following directions for complying with the release and modification provisions of the Act:

- No donor approval is required before seeking court approval for release or modification of a restriction. However, the Guide suggests that in order to avoid a potentially expensive and time-consuming court proceeding, institutions may first wish to attempt to obtain the donor's consent to any proposed release or modification. The donor's written consent eliminates the need to seek court approval.

- If an institution wishes to seek court approval for release or modification of a restriction, it is recommended, but not required, that the institution first submit its petition to the Charities Bureau for review. The Attorney General believes that this procedure will help to expedite the court approval process. Since the Act requires an institution to give notice to the Attorney General when applying to the court for release or modification of a restriction, obtaining the approval of the Charities Bureau on draft documents prior to application should expedite the process since the court looks to the Attorney General for his view before acting.

- The Guide sets forth the following procedure for release or modification of restrictions on a fund with a total value of less than $100,000 that is more than 20 years old:


Determine whether the donor is available.
If the donor is available, determine whether the donor will consent to the release or modification.
If the donor consents, the restriction may be released or modified.
If the donor is not available or does not consent, the governing board or appropriate committee must first approve (typically through a resolution) the release or modification of the restriction.
The following documents must then be submitted to the Attorney General's Charities Bureau:
1. notice of the intent to release or modify,
2. a copy of the board resolution,
3. an explanation regarding why the restriction has become unlawful, impracticable, impossible to achieve or wasteful,
4. a description of the proposed use of the fund if the restriction is released or modified,
5. a copy of the gift instrument,
6. evidence of the fund's value at less than $100,000
7. proof that more than 20 years have elapsed since the fund was established, and
8. any relevant correspondence with the donor.
If the Charities Bureau has questions or requires additional information, or if it objects to the proposed release or modification, it will notify the institution within 90 days.
If the Charities Bureau does not respond within 90 days, the institution may release or modify the restriction as proposed.
If there are questions, these will likely be resolved with the provision of additional information. If the Charities Bureau objects to the release, the institution should not lift the restriction until a further written notice is received stating that all objections have been resolved.

- The Act provides that notice need not be given to the donor for release or modification of a restriction on a fund with a total value of less than $100,000 that is more than 20 years old if the gift instrument already limits the institution's ability to appropriate below original dollar value. However, the Guide indicates that this exception to the notification rule relating to release or modification of restrictions on small, old funds may have been a drafting error, and that the notice exception was likely intended to be for small, old funds received as the result of an institutional solicitation. It is the view of the Attorney General that, absent clarification from the New York State Legislature, notice pursuant to the release and modification provision on small, old funds should be given to any donor that is available, including a donor that responded to an institutional solicitation.
- The Guide takes the position that the institution should not release or modify a restriction on a fund with a total value of less than $100,000 which is more than 20 years old if it does not have the consent of the Charities Bureau.

II. Other Recommendations of the Attorney General's Guide.

The Guide focuses on compliance with the Act's provisions relating to notice, contemporaneous documentation and release and modification of restrictions. However, the Guide also sets forth the Attorney General's views on other provisions of the Act, including the requirement to adopt and maintain a written investment policy, the 7% presumption of imprudence and the rules regarding assessing an external agent's performance and independence.

A. Investment Policy.

The Act includes a New York-only requirement that institutions adopt a written investment policy in accord with the standards of the Act. The Guide suggests possible topics for inclusion in an investment policy, but emphasizes that there is no "one size fits all" investment policy. Suggested topics include:

- general investment objectives;
- permitted investments;
- acceptable levels of risk;
- diversification;
- procedures for monitoring investment performance;
- scope and terms of delegation of investment management functions;
- the investment manager's accountability;
- procedures for selecting and evaluating external agents;
- processes for reviewing investment policies and strategies; and
- proxy voting.

The Guide states that the governing board or appropriate committee should review the investment policy at regular intervals and whenever a change in the institution's financial condition or other circumstances so requires.

B. 7% Rebuttable Presumption of Imprudence.

Expenditure in any year of greater than 7% of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than five years immediately preceding the year of appropriation, creates a rebuttable presumption of imprudence. The presumption applies only to appropriation from gift instruments executed on or after September 17, 2010.

The Guide states that in order to avoid triggering the presumption of imprudence, all spending policies should be reviewed to determine how they interact with the presumption. A spending rate that is under 7%, but is averaged over a shorter period than that required by the presumption, may be presumptively imprudent. The Guide states that a separate calculation may be necessary to determine whether a proposed appropriation is presumptively imprudent.[6]

C. External Agent Independence.

Under the Act, a governing board or committee responsible for managing funds may delegate authority for investment decisions to external investment advisors or managers (also called external agents). This provision of the Act includes the New York-only requirement that institutions assess an external agent's independence.

After enactment of the Act, questions arose regarding the meaning of this requirement, and the appropriate manner of compliance. The Guide provides the following directions for complying with the requirement to assess the independence of external agents:

- External investment agents should be selected based on competence, experience, past performance, and proposed compensation, and not on any business or personal relationships between the agent and board members or other insiders.[7]

- The Guide notes that while some institutions may adopt a policy requiring all external agents to be independent, this is not mandated by the Act. However, it is the Attorney General's view that institutions should adopt and follow a conflict-of-interest policy requiring full disclosure by interested officers and directors in decisions and transactions. Such a policy would require the institution to determine if any of its

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[6] We note that the presumption is based on a calculation determined *at least* quarterly and averaged over a period of *not less* than five years immediately preceding the year in which the appropriation for expenditure is made. Therefore, we believe an institution has great flexibility in determining the method of calculation. The calculation could be based on a determination made monthly over ten years. Or it could be calculated quarterly over eight years.

[7] We believe that this direction does not preclude taking into consideration recommendations about the work of an external agent by a board member familiar with the agent's work.

officers or directors are officers or directors of the external agent or have a financial interest in the external agent. Such a policy would also, in most cases, require the interested officer or director to abstain from the vote regarding the delegation to the external agent.[8]

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The text of the Act can be found through the Not-for-Profit Corporation Law link at http://www.charitiesnys.com/statutes_regs_new.html.

The text of the Attorney General's Guide can be found at http://www.charitiesnys.com/nypmifa_new.html.

The previous Simpson Thacher & Bartlett LLP client memorandum on the Act can be found at http://www.simpsonthacher.com/siteContent.cfm?contentID=4&itemID=75&focusID=1062.

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[8] An interested officer or director may participate, if necessary, in the authorization of a delegation to an external agent if the delegation can be established as fair and reasonable to the institution. For further information on transactions with interested officers and directors, see section 715 of the N-PCL.

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