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## Where are the Prudent Men and Women? Due Diligence and Responsible Policies for Boards of Directors

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### & Non-Profit Example: Case Study of an Investment Committee

If you sit on a Board of Directors or are considering a Board position:

- ☺ Were you informed of your fiduciary responsibilities as a Board member?
- ☺ Have you seen the Board's policy manual?
- ☺ Have you received an annual report of investment activity for the organization?
- ☺ Are you satisfied that there is adequate risk assessment regarding the organization's investments?

**If the answer to any of these questions is: "I don't know if we have one", or "I think someone else on the Board handles this area" – Please read the following article with care.**

Many people consider tracking environmental outputs of carbon dioxide, philanthropy in the local community and SEC compliance as part of their Corporate Responsibility program. How many realize that your basic board governance is just as important or even more important? So much has been made of recent corporate scandals and so few fingers have pointed to the trustees of companies and charities, yet these are the very people entrusted to carry out their fiduciary responsibilities to guide organizations. Ideally, a Board of Directors consists of capable individuals with a diverse range of backgrounds. They bring experience and wisdom to the table.

However, many directors are not properly prepared or informed of their full responsibilities. Being asked to be a director of a corporation or trustee of a charity is an honor and a serious responsibility having legal ramifications. Board leaders must ensure that an explanation of directors' fiduciary responsibilities and board policies are complete, clearly written, and communicated to all members. Whether it is a corporation, pension fund, foundation, charity or endowment, directors are responsible to help safeguard the organization's assets. Members are legally bound to the duties of care and loyalty. While "care" and "loyalty" seem vague as a job description, they should become clearer over the next year as the intricacies of corporate failures are unraveled and a magnifying glass is placed over boards. When the dust settles, directors will be questioned on their investment practices as well as other risk management strategies. It is one thing to point to the destruction of wealth by a stock or real estate market freefall as part of a cyclical history of any capitalistic economy. It is quite another to hide behind that market and excuse the fact that you have not exercised your responsibility of due diligence by ensuring processes are in place to best safeguard the assets you were entrusted to protect.



What does “fiduciary responsibility,” “due diligence” and the “prudent man rule” mean as they apply to a board of directors? A director has a legal responsibility to act with “loyalty,” meaning acting in the best interest of the organization while avoiding conflicts of interest as a board member. The director must comply with the duty of “care,” which includes acting with the diligence of an ordinary prudent person in a similar role. To be prudent, a person must review and understand the risks facing the institution and monitor actions of management and controls in place to manage these risks. All board members are not required to be financial experts, however they are expected to call upon outside specialists in various fields to advise them as needs arise. In court cases regarding the liability of directors, it is the process by which directors make their decisions which has been examined to decide whom is to blame. If directors exhibit due care in their business judgment, they are generally not personally liable for a decision with negative consequences to the organization. If directors ignore situations or transactions which put the organization at risk, or do not research them with care, they can be personally liable. These principles apply to board members of all types of organizations.

Madoff’s ponzi scheme has been making big headlines recently, but he is not the only culprit. The attorney general of Connecticut, Richard Blumenthal, has announced that he is not investigating Madoff, but rather nonprofits who invested with him. The boards of these nonprofits had a role in choosing Madoff and should have exercised caution when presented with either investment statements which were not transparent or investing policies which were not clear. Blumenthal stated “the standard is that the director or fiduciary at any nonprofit has to exercise due diligence and the care and caution of any ordinary prudent investor.”

There are a number of much smaller, but equally corrupt money managers who have been exposed to this market downturn. Case in point, Joseph Forte, a Philadelphia investment manager, investing over \$50 million for individuals and charities was exposed using a similar scheme. With over \$25 million in assets under direct management, he should have registered with the SEC and fulfilled the legal duties of a Registered Investment Advisor. He did not. While individuals had the right to risk their money with him, any board that used him to manage funds for a charity is in danger of being liable for not researching his qualifications to manage the funds.

### **CASE STUDY EXAMPLE OF A NON-PROFIT INVESTMENT COMMITTEE**

You have been recently invited to join the investment committee of a local charity. You have some experience in finance and accounting, been successful in business, and have been doing well with your personal investment portfolio. Therefore, you are considered a good candidate to guide the assets of this organization. As a new member of the board, you decide to seek information on the organization’s background in this area.

*What are some documents you should review?*

1. *Request a copy of the Board policy manual with a list of responsibilities of the board members, description of committees and their Charter statements.*
2. *Request a written copy of the Investment Policy for the Investment Committee.*
3. *Request Investment Committee meeting minutes for the previous eighteen months.*

After asking these questions, you are given a Board policy manual dated 15 years ago with the original articles of incorporation and a list of committees with a few brief Charter statements. You are told that some of those committees don’t exist anymore and the Charter statement doesn’t even look familiar to anyone on the Investment Committee. As for an Investment Policy, you are told that it is to “*make the*



*recently granted endowment grow in a reasonable manner without incurring excessive risk to the principle.” Finally, one of the committee members has invested his or her own money with a “money manager” and has been extremely successful in the latest bull market. The committee looked at statements of investment results of the money manager, liked the results and placed all the endowment funds in the manager’s “Three Best Performing Stocks of the Future” Fund.*

*Although this is a fictitious organization, the situation is all too common. What should you do? Run? Say, “sounds good! Meeting adjourned!”? Here are a few suggestions to start:*

1. Discuss with the President of the Board and CEO, the updating of the Board policy manual to more adequately reflect the current structure and operation of the board and its committees.
2. Discuss with the Investment Committee the need for a written Investment Policy and Charter as a necessary part of your fiduciary responsibilities and a reasonable guide for the Committee’s investment decisions.
3. Work with your Committee to draft the Investment Policy to clearly outline the process of investing, the expectations and how it will be monitored. It should state the investment goals, including risk tolerance and limitations on the investment process. Remember, what the money will be used for is important for deciding how it will be invested. It should identify the types of investment vehicles which are appropriate, the asset allocation and how or who can manage it. Determine how the investments will be monitored and how success will be measured. Finally, outline how changes in investments and managers will be processed and how all of this will be communicated to the full Board.
4. Question the ability of the Investment Committee member who engaged the Advisor regarding their own money to make independent decisions on the performance of the Advisor. Also, consider any conflicts of interests or relationships that could impair independent decision making of the Committee and Board.
5. Ask for a formal review of the current Advisor. Is he or she a Registered Advisor? Are they free of conflicts of interests?
6. Consider the risk appetite of the Board, the Investment Committee, and how they manage it.
7. Conclude if the Board has a culture, or at least the willingness to build a culture, that will help ensure that all directors can reasonably meet their fiduciary duties.
8. Retain meeting minutes. In particular, ensure that the minutes provide evidence that investments have been evaluated and that the selections match investment guidelines.

## **Conclusion**

Don’t be afraid to ask questions. It is your duty. Don’t be afraid of asking for an independent review of the committee’s actions or assistance from other advisors. It is good due diligence. Don’t assume that a person who manages money for another individual has all the qualifications necessary or uses investment policies which are appropriate for your organization. Overseeing money for the organization’s good is an important duty of a director and is very different than experimenting with your own nest egg. Serving on a board is a rewarding experience and the wisdom of individuals sitting on boards can be immensely useful to the management team. With this honor and reward comes responsibility. Take the initiative to educate yourself and all directors to serve as effective trustees in guiding your organization.



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