Commonfund Commentary

Uniform Prudent Management Act proposes major changes in investment standards for nonprofits

Nonprofit investors are familiar with the Uniform Management of Institutional Funds Act (UMIFA), the landmark statute that, on its passage in 1972, established standards for the management, investment and expenditure of the endowment funds of nonprofit institutions. Now, the National Conference of Commissioners on Uniform State Laws (NCCUSL) has approved a comprehensively revised version of UMIFA, called the Uniform Prudent Management of Institutional Funds Act, or UPMIFA. This new law, if adopted by the various state and territorial legislatures, is anticipated to have widespread implications for nonprofit organizations, including:

- Elimination of the historic dollar value limitation on spending (the so-called "underwater funds" rule).
- Broadening the scope covered by the statute, which is intended to apply to trusts, governmental agencies, and any other type of entity dedicated to charitable purposes, as well as nonprofit organizations.
- Comprehensive incorporation of modern portfolio investment standards by providing for diversification of assets, pooling of assets, total return investment and whole portfolio management.
- An endorsement of the concept of intergenerational equity via an optional provision that allows states to find that an organization spending more than 7 percent of its endowment in one year is acting imprudently.

UPMIFA was approved by 300 state law commissioners on July 13, 2006 at NCCUSL's annual meeting. The act will now go to the American Bar Association for approval; after that, it will be introduced into the legislature of each jurisdiction. If signed into law, UPMIFA will replace UMIFA, which has been the standard in 48 states for the past three and one-half decades.

Over the last four years Commonfund personnel have followed the deliberations of the drafting committee, providing advice and input when asked. Now that a bill has been proposed, Commonfund intends to publish educational materials for those in the nonprofit community who seek a better understanding of its proposed provisions.

John S. Griswold, Jr., Executive Director of the Commonfund Institute, noted that "Commonfund and UMIFA were conceived from the same body of thought leadership. As such, UMIFA and Commonfund have been inextricably linked for over 30 years. Commonfund was founded in 1971 through a grant from the Ford Foundation. UMIFA was approved the very next year, partly as the result of a series of studies commissioned by the Ford Foundation that recognized nonprofit organizations were being hampered by outdated state laws that discouraged modern total return investing."

UMIFA broke new ground

Before the approval of UMIFA, there was no consistent body of law to guide nonprofit decision-making concerning investment authority and the use of appreciation for endowed funds. Overly conservative and restrictive trust and investment laws in the various states caused institutional funds to be invested largely in low yielding bonds and fixed income instruments that delivered reasonably safe and dependable income but whose market value was constantly eroded by inflation. With great success, UMIFA significantly broadened the list of permissible investments for nonprofits, allowed boards to delegate investment authority to outside managers within a general fiduciary standard of prudence, and enabled institutions to pursue total return investing. Now, UPMIFA fully incorporates the concepts of modern portfolio theory from the Uniform Prudent Investor Act and the Uniform Principal and Income Act, both of which have been widely adopted, for the more efficient management of nonprofits' endowed funds.

UPMIFA is the product of four years of drafting efforts and extensive coordination among donors, managers and nonprofit organizations. NCCUSL, a nonprofit association of lawyers, has been working for uniformity in state laws since 1892, filling the gap between national legislation enacted by Congress and individual state laws. NCCUSL is perhaps best known for its drafting of the Uniform Commercial Code, which exists in every U.S. jurisdiction and provides the uniform legal framework governing commerce.

While UPMIFA adds only one word to UMIFA's title, the underlying change in the law is major in both structure and significance. UMIFA had gone unchanged over its entire 34-year existence. If adopted, UPMIFA will likely reshape the landscape of nonprofit fund management and investment.

Four major areas of change

- As its name suggests, UPMIFA adopts the prudence standard for investment decision-making. The act directs those responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering a variety of factors, including the purpose and risk and return objectives of the fund.

- Under UPMIFA, the rules governing expenditures from endowment funds have been modified to give a governing board more flexibility in making investment and expenditure decisions within the general standard of prudence, so that the board can cope with fluctuations in the value of the endowment. It does this primarily by providing investment freedom (portfolio managers are not limited in the kinds of assets that may be sought for the portfolio), and by providing updated rules on the expenditure of funds (total return expenditure is expressly authorized under comprehensive prudent standards relating to the whole economic situation of the nonprofit institution).

- In this regard, an important change in the new act is the elimination of the "historic dollar value" rule governing "underwater funds" (those funds whose value, owing to stock market contractions of the type brought on by the 2000 – 2002 bear market, is below the value of the gifts at the time they were given by donors). Under UMIFA, institutions were not allowed to spend from a fund if its asset value was below its historic dollar value. UPMIFA replaces the use of historic dollar value with a more flexible spending rule, pursuant to which trustees may spend or accumulate as much of an endowment fund – including principal or income, realized or unrealized appreciation – as they deem prudent, taking into account the intended duration of the fund, the fund's purposes, economic conditions, expected inflation, investment returns, other resources of the institution and its investment policy.

- In an endorsement of the concept of intergenerational equity, the proposed text of UPMIFA includes an optional limitation available for those jurisdictions desiring to place limits on spending. This option is a "7 percent rule" that provides a rebuttable presumption that expenditures exceeding 7 percent of a fund's total return over a rolling three-year period are imprudent. Enactment of the 7 percent rule is left to the discretion of individual state legislatures. Spending more than 7 percent will not automatically mean an organization is in violation of UPMIFA, but its board may have to make the case to state regulators that their spending policy was, in fact, prudent under the circumstances.

UPMIFA applies to all types of nonprofit organizations – whether nonprofit corporations, trusts, unincorporated associations, governmental subdivisions or agencies, or any form of entity that is organized exclusively for charitable purposes. This reflects the fact that standards for investing and managing institutional funds are and should be the same regardless of the legal form of the organization.