

Private Foundations Bulletin

Investment Due Diligence – Best Practices in Any Market

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For the majority of private foundations, the management of a foundation's assets is a top priority along with grantmaking. The members of the Board or Investment Committee are the stewards of the foundation's investments, often its largest asset. Whether it's the foundation's Board, Investment Committee, in-house investment team or via an Outsourced Chief Investment Officer (OCIO), they should ensure that all parties are acting in the most prudent fashion and are within the parameters of the foundation's purpose. Their due diligence is not only good practice, it is also subject to federal and state oversight.

Federal law regulates foundations through prohibitions against self-dealing, rules surrounding excess business holdings, and through penalties for investments that are considered jeopardizing. State law often imposes fiduciary duties, not only on the foundation itself, but also on the internal and external investment managers and consultants.

Both the foundation's Board and its management share a significant responsibility for ensuring that foundation resources are carefully invested and used for the intended charitable purposes. It cannot be stressed enough that due diligence must be performed before an investment is made and on an ongoing basis, particularly as the foundation navigates through market cycles.

A few best practices in exercising investment due diligence may include, but is certainly not limited to, those contained in this bulletin.

General Practices

Some general due diligence practices include

- The Board, Investment Committee, and management should review, understand, and satisfy their fiduciary responsibilities under any and all applicable federal and state laws. This is an ongoing process and all parties should stay informed regarding any relevant changes, even if an OCIO is utilized.
- The foundation should implement and maintain an Investment Policy Statement (IPS).
- Procedures should be adopted for selecting, monitoring, evaluating, and terminating investment managers and consultants. These procedures may be included in the foundation's IPS.
- The foundation should ensure that outside investment managers and consultants have policies and procedures in place that provide reasonable assurance of compliance with applicable law. One useful tool in the monitoring of investment managers and custodians alike is to obtain and review their Service Organization Control (SOC) Report, otherwise known as a SSAE-18 report. These reports provide information on whether a Service Organization's internal controls are in place and are operating effectively.
- A conflict-of-interest policy should be adopted and implemented for members of the foundation's Board, Investment Committee, management, and internal investment managers. The policy should address all applicable ethical policies and guidelines.

Initial Due Diligence

Before making an investment, a private foundation's investment function should perform some form of initial due diligence. Some examples of initial due diligence procedures are as follows:

- Obtain recommendations or a risk profile for the investment. The investment advisor, Board, or Investment Committee should convey information about the investment opportunity to the foundation.
- Perform interviews and site visits with investment managers.
- Provide your IPS to the fund or brokerage account managers and ensure that the managers are aware of the regulatory limitations of a private foundation.
- Review the internal controls over the investment fund manager or brokerage account by obtaining a SOC report.
- Obtain, review, and gain an understanding of the conditions set forth in the investment's operating memorandum, private placement memorandum, or Investment Management Agreement. Determine if the liquidity provisions (if applicable) are in line with the foundation's liquidity needs.
- Request and review a copy of the investment's most recently audited financial statements. Consider whether there are any underlying investments that may be of concern or may add to the overall risk associated with the investment.
- Obtain an understanding of the fee structure.
- Obtain an understanding of the investment's prior performance and track record.
- Gain an understanding of the compliance and regulatory filings potentially associated with making an investment [i.e., associated Unrelated Business Income Tax (UBIT), state UBIT, foreign filings, etc.].

Ongoing Due Diligence

After an investment has been made, the due diligence must be continuous. Examples of some ongoing due diligence practices are:

- Monitor the manager relationship for any amendments, including any changes to fee structures, to the operating memorandum, private placement memorandum, or Investment Management Agreement.
- Obtain audited financial statements as they become available (annually or quarterly as available).
- Review interim and year-end investor letters from the investment managers regarding performance and outlook.
- Continue to obtain a SOC report on a yearly or regular basis to monitor and determine if internal controls remain in place and continue to operate effectively.
- Participate on quarterly investor calls and maintain a primary contact person at each investment entity to ensure an open line of communication and compliance needs.

Implementation

A private foundation should maintain, or ensure, that a reasonable and appropriate due diligence process is in place, and that it matches the needs of those charged with governance for the foundation and the complexity of its investment portfolio.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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