Legal, Governance and Accountability Issues

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Over the years when discussing endowments I've played a word association game with charity boards. I ask directors to say the first word that springs to mind when they hear "endowment". Most boards shout out "investments" followed quickly by "perpetual" both understandable answers, but neither are complete.

An endowment is a long-term fund that is invested to produce an annual payout to support the charity's mission. "Endowment" is not a legal term, and it is not found in Canadian law, but it is commonly used to describe long-term – sometimes "perpetual" – investment funds held by charities. Strong investment management is essential, but it is important to understand the context in which these funds operate. The legal, governance and accountability issues related to endowments have changed significantly over the last decade.

This article provides an overview of some of the key issues for charity boards and staff to consider when building and operating an endowment. The list is not meant to be exhaustive, nor is it a replacement for professional legal, accounting or investment advice. Instead it is a practical primer that is intended to assist registered charities better understand the elements that affect the management and growth of endowments. Many of the legal and governance issues relate directly to investments, but all have implications in terms of public and donor accountability. With the advent of public information derived from the annual T3010 form filings to Canada Revenue Agency (CRA), charities should assume that their actions are public and plan accordingly.

Legal

The legal landscape for Canadian charities is complex. Canadian registered charities are subject to overlapping legal authorities, which include the Income Tax Act (Canada), common law of charity, and provincial trustee acts. Endowments are affected most by the disbursement quota in the Income Tax Act and provincial trustee acts. The primary charity regulator is CRA's

Charities Directorate, which registers, deregisters, audits, and regulates charities under the Income Tax Act. The Act addresses matters related to the tax-exempt status of charities and tax treatment of charitable gifts, not governance. However, through the disbursement quota provisions in sub-section 149.1, the Act is concerned with the use of charitable property. Provincial trustee acts address the fiduciary requirements that charity directors must exercise.

Disbursement Quota: The disbursement quota states the minimum spending requirement for registered charities on charitable purposes. The quota was greatly simplified in 2010 to focus on payout from assets "not used directly in charitable activities or administration", which normally means investments. The requirement is that the charity must utilize the equivalent of 3.5% of the average value of assets in the previous 24 months. In practice this is typically the average market value at the prior two year-ends. (Some charities calculate this formula using quarterly or semi-annual market values. Speak to your auditor about options and advantages.)

There are different minimum requirements based on the type of registered charity. Charitable organizations must have minimum assets of $100,000 before the 3.5% formula applies, while the minimum for private and public foundations is $25,000. CRA has good support materials on the disbursement quota.

A few comments on the disbursement quota:

1. The 3.5% rate is roughly equal to the historical real rate of return, which is the rate of return after inflation. Prior to 2002 the rate was 4.5%.
2. Due to the minimum asset requirements, the 3.5% disbursement quota affects only a minority of larger Canadian charities.
3. The 3.5% disbursement quota is calculated on the basis of the charity's entire annual expenditures on its charitable purpose, not linked to investment returns alone. Hence most public charities that fundraise may receive and spend significantly more than the equivalent of 3.5% of its investment assets. This amount is added to a disbursement quota surplus, which may be carried forward for up to five years.
4. In summary, the 3.5% is not an onerous requirement for charities that have multiple revenue streams and do not rely on investment payouts alone to support their charitable activities. Most public charities now have disbursement quota surpluses, although there are exceptions.

The new disbursement quota rules provide registered charities with significant management flexibility. Prior to 2010, the disbursement quota rules were more onerous. Now if a charity has a disbursement quota surplus, for example, low investment return years can be offset with the accumulated surplus. It is theoretically possible for a charity to reinvest all returns in the endowment to grow capital, however, there are other practical considerations that should be considered that are discussed below.

Trust Law: Endowments are funds held in trust for a charitable purpose. The charity is the trustee and its mission or some aspect of the mission is the beneficiary. Even if there is no formal trust deed or document, trust law applies the management of endowments. The charity and its directors have a fiduciary obligation for the funds and their use, which represents the highest standard of care. This obligation has two primary facets: ensuring funds are dedicated to the stated purpose and prudent investment of the funds.

In Canadian law, trusts are a provincial responsibility. Every province has a trustee act, which is relevant to the management of charitable endowments. Charities should seek legal guidance to understand the obligations in their province, as there are distinctions despite many common principles. One of the key concepts in the modern trustee act is the obligation to be a "prudent investor." The challenge is that there is no readily available statutory definition of a "prudent investor" and there is some legal debate about the parameters. That said there are standard descriptions. “In investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent person would make in making investments.”[1]

There are a couple of practical provisions in the Ontario Trustee Act. Subsection 27(2) authorizes trustees to invest in any type of property that a prudent investor might invest. Put another way, there are no restrictions on asset classes, such as real estate or foreign equity, as long as the overall approach is prudent. There are restrictions in the Income Tax Act, however. Public foundations are restricted in the Income Tax Act from carrying on business, which (perhaps unintentionally) restricts foundations from investing in investment funds structured as limited partnerships. Private foundations have restrictions on non-arm's length investments and significant equity holdings.

The Ontario Trustee Act has a list of seven criteria related to planning the investment of trust property.[2] A trustee should consider the following:

1. general economic conditions;
2. the possible effect of inflation or deflation;
3. the expected tax consequences of investment decisions/strategies;
4. the role each investment or course of action has within the overall portfolio;
5. the expected total return of income and growth of capital;
6. need for liquidity, regularity of income and preservation or appreciation of income;
7. an asset's special relationship or special value to the charity or beneficiaries.

Together these points provide a basis for translating the theory of prudent investing into the practical reality within a charity.

Governance

Policy is the key instrument for charity boards to translate applicable laws into good governance. With the advent of modern trustee acts and the concept of the prudent investor, there is a corresponding demand for documentation. Good work is not enough. Policy is required to show that trustees have a prudent plan, are exercising direction and control over investment managers, and have defined key concepts. For example, the Ontario Trustee Act includes provisions about developing an investment plan and agreement with the investment manager.[3]

In practice, the key policy document is an investment policy statement or IPS. The IPS is a risk management tool that states goals, responsibilities, and limits of delegated authority from the board to the investment manager. It also helps articulate expectations, which can calm nerves in choppy markets by focusing on long-term goals. Here are some of the elements typically found in an IPS:

- Goals for returns based on spending requirements and inflation assumptions. Best to state as a range over a period of a number of years.
- Decision-making process and timetable, ie meetings per year, review periods.
- Roles of parties (board, investment committee, staff and investment manager).
- Approved assets and asset mix by range.
- Constraints, i.e. asset quality rating.
- Benchmarks for evaluating performance.
- Other criteria for reviewing investments, i.e. social responsibility measures.

There are a few practical issues regarding the development of an IPS:

1. **Who develops the IPS?** The board or investment committee should draft the policy, but it is important to ensure that the document is reviewed regularly. Soliciting input of investment managers is important, as sometimes assumptions are made at the drafting stage that may not be practical in implementation. Compliance with the policy is non-negotiable, and typically the policy needs input from the investment manager to ensure both sides are aware of regulatory or investment instrument limitations.

2. **Discretionary Investment Counsel.** The advent of a policy-driven investment process has resulted in the increased use of discretionary investment counsel.[4] A discretionary investment manager is licensed to construct and implement a portfolio and make trading decisions in accordance with the IPS. By contrast, the charity must make individual investment decisions if they have a portfolio of securities with a non-discretionary manager.

3. **Other policies.** Charities often have separate policies that define “endowment” and establish the annual valuation and payout rate formulas. Boards should also address the establishment of named endowment funds, minimum fund values, reporting standards to donors, template fund agreements, and limitation of purpose/restrictions. Charities that want to grow their endowments through donations – especially major gifts and bequests – need to establish a policy environment that address donations, reporting and use of funds.

A major topic of debate within the charitable sector since the financial crisis of 2008 has been the definition of endowment. Traditionally an endowment has been defined as a perpetual (i.e. forever) fund, which was reinforced by the 10-year gift rule that restricted use of capital that existed in the Income Tax Act prior to the 2010 reforms. But the financial crisis underscored the need to balance current charitable needs with long-term capital preservation and growth.[5] Charities have been changing their endowment policies and agreements to ensure greater flexibility about the use of capital to address annual needs. Some charities have even introduced intermediate fund models such as spend-down funds.

Accountability

Most public charities depend on donors, especially those who make lifetime major gifts and bequests at death, to build their endowment. Current "major gifts" can be in the six or even seven figure range. The size of these donations is prompting modern donors to ask more questions, review investment policies, and request ongoing reporting. This is an outgrowth of a philanthropic culture where the dollars and expectations are greater, as well as the access to information.

There are a few practical issues regarding the accountability that Boards should consider:

1. **Regulatory reporting and internet dissemination:** All registered charities must file an annual report called the T3010 to CRA. This report includes financial information, including assets, investment returns and amount spent on mission. For the past decade CRA has been putting these reports online, but the data was not searchable and was rarely reviewed except by professionals and members of the media. Within the past three years there have been a number of free, searchable databases, such as Charity Focus, that accumulate this information into multi-year reports. More donors are looking at this information and it is affecting their giving decisions.

2. **Public reporting:** Most large public charities produce an annual report, but there are other accountability mechanisms that many boards are willing to share with donors and members of the public. These include audited financial statements, investment policy statements, and annual fund reports to individual donors. There is an increased expectation that charities will be transparent.

3. **Focus on charitable impact.** Sometimes we assume accountability is all about financial prudence and investment returns. In the charity context, however, donors are looking for organizations that provide maximum social "impact". A key part of accountability is reporting on effectiveness. How is the charity's mission being advanced? Often the best way to get more donations is to achieve stellar results with the current funds. In my experience, boards that choose to build an endowment by reinvesting all of the annual returns back into the fund risk alienating the very donors they want to attract. Similarly, using endowment distributions to pay for the charity's administrative costs may alienate donors who want to see their "gift of a lifetime" be

used directly in mission. Boards should always remember how "investment" decisions will look to prospective and existing donors.

Conclusion

While investment management is an essential aspect of a charity's endowment management, it is by no means the only aspect. Charities and foundations need to understand the legal considerations and governance mechanisms that frame the definition and operation of endowments. Formal policies and procedures are required to demonstrate that the charity is a prudent investor and a trustee that is dedicated to advancing the charitable purpose. The last decade has seen more changes to endowments and the environment in which they operate than any period within the last 50 years. We hope this article provides a helpful overview of the legal, governance and accountability issues related to the modern charity endowment. Charities should consult their professional advisors to review the issues raised.

1 Subsection 27.1(1), Ontario Trustee Act, R.S.O. 1990, CHAPTER T.23
2 Subsection 27.1(5), Ontario Trustee Act, R.S.O. 1990, CHAPTER T.23
3 Subsection 27.1(2) & (3), Ontario Trustee Act, R.S.O. 1990, CHAPTER T.23
4 "Investment Practices of Private Foundations in Canada", 2007, Scotia Private Client Group, page 22. Study found that 59% of private foundations in the survey group used investment counsel.
5 "The End of Endowments?" Burrows, Malcolm, The Philanthropist, Vol 23, No. 1(2010)