impact investing institute

Can Charities Invest their Endowment with impact?[1]

November 2021

1 This paper has been produced by Bates Wells, Herbert Smith Freehills LLP, BDB Pitttman's and Farrer & Co, in order to provide a description and overview of the law and its application to impact investing by endowed charitable organisations of their endowment assets. It is not intended to be comprehensive or exhaustive and nothing stated in this document should be treated as an authoritative statement of the law. Trustees will need to consider obtaining legal and investment advice in the context of their own specific circumstances.

Esmée Fairbairn Foundation

Department for Digital, Culture, Media & Sport

Executive Summary

In the UK, the top 300 charities with endowments have approximately £72bn[2] in invested assets. The "classic investment approach" of charities with endowments involves investing the endowment in the capital markets with a view to, principally or exclusively, generating good risk-adjusted financial returns, with at least a portion of those returns applied to operational work or distributed as grants.

This "classic investment approach" is not the only one available to trustees and it appears that trustees are increasingly aware of alternative strategies to investing an endowment. The 2021 Newton Charity Investment Survey revealed that 94% of charities surveyed believe that, beyond exclusions, it is their responsibility to invest responsibly, a figure which is increasing year on year.[3]

It is generally permissible for charities to invest with impact,[4] provided that in doing so, charity trustees are acting within their duties and the law. However, as acknowledged by the Charity Commission, there is some hesitancy in deviating from the "classic investment approach"[5]. This is despite a number of pioneering charities with endowments leading the way, both through the incorporation of impact investing into their investment strategy and by collaborating - through key networks like the Social Impact Investing Group (hosted by the Association of Charitable Foundations) and the Charities Responsible Investment Network (hosted by ShareAction) – to share knowledge and practical guidance.

In this paper, we explain why we think charity trustees should feel confident in concluding that, in the round, both from a "mission lens" and a "financial lens", impact investing is an approach which can most effectively advance the objects, mission, and work of the charity as a whole. In addition, we have developed a **clear and practical guide** to impact investing that debunks myths, provides powerful arguments for foundations' delivery of impact investing, and outlines steps to get started. We have also produced a Q&A on key legal considerations that trustees should be aware of when setting the charity's investment strategy.

Thank you

In considering the legal case for impact investing by charitable endowments we are grateful for the support of the following lawyers who have drafted (Bates Wells and Herbert Smith Freehills) and reviewed, (Farrer & Co. and BDB Pitmans), this guidance. We are also grateful for the funding support from Esmée Fairbairn Foundation and the Department for Digital, Culture, Media and Sport (DCMS).

2 Foundations Giving Trend 2019: https://pearsfoundation.org.uk/wp-content/uploads/2019/10/Foundation-Giving-Trends-2019.pdf
3 https://www.newtonim.com/uk-charities/insights/the-newton-charity-investment-survey/
4 In this context, impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.
5 In January 2020, the Charity Commission began a listening exercise *"to help it understand the barriers that may deter trustees who wish to make responsible investments from doing so"*.

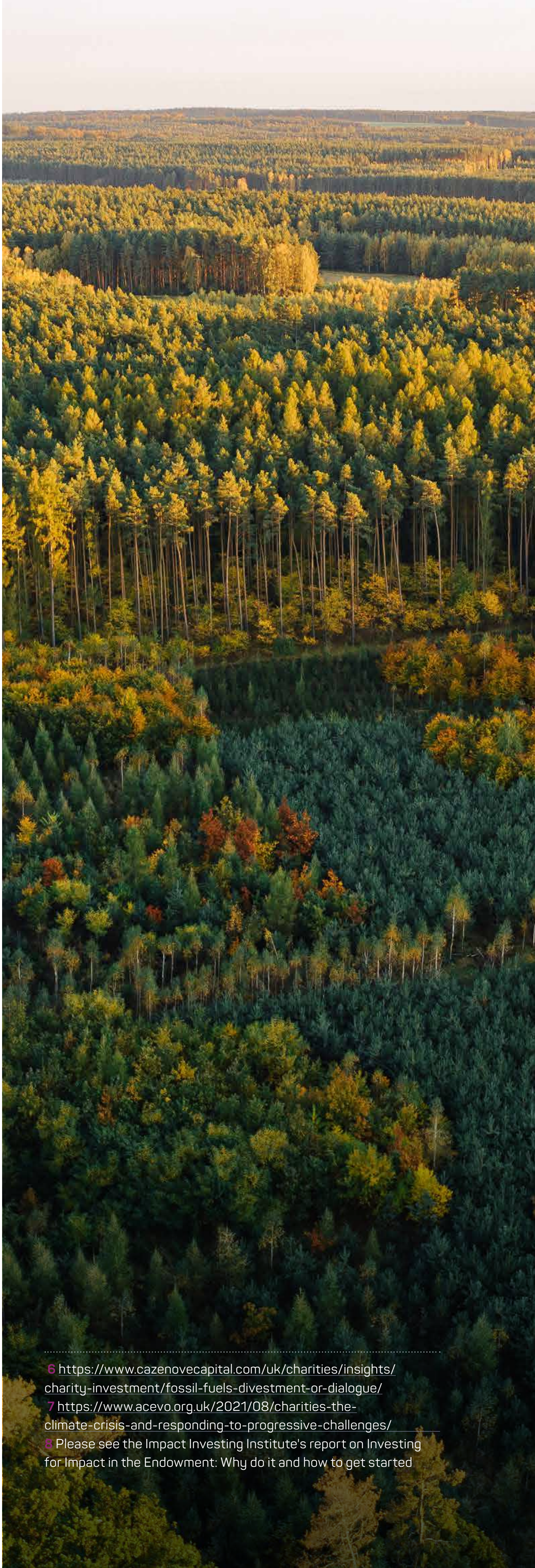
Mission-related impact factors

When developing an investment strategy, a helpful question to guide charity trustees is: what approach to investment is most likely to advance your charitable purposes over time?

Traditionally, answering this question has been exclusionary – that is, operating a policy of exclusions for certain forms of potentially harmful investments that (e.g.) directly conflict with a charity's purposes – but in considering whether an investment is in the best interests of a charity, it might be prudent for charity trustees to consider the social or environmental impact of an investment more extensively.

The primary duty of a trustee is to act in the way they consider, in good faith, is most likely to advance their charitable purposes. When applied to investment decisions, trustees need to assess which approach to investment is most likely to achieve this goal. Understandably, many trustees will conclude that the best way to advance their charitable purposes from this "mission lens" will be to adopt an investment strategy which, alongside seeking good financial returns, seeks to directly mitigate or avoid negative impacts which threaten to undermine their charitable purposes and mission. This traditionally has resulted in many charities operating a policy of exclusions in areas such as tobacco, alcohol, pornography, and arms. More recently, many charities have also committed to divest from fossil fuel investments [6] and to align their investments with the goal of the 2015 Paris Climate Accords to limit the rise in mean global temperature to well below 2 degrees Celsius (and preferably limit the increase to 1.5 degrees Celsius) compared to pre-industrial levels.[7]

Prudent trustees will likely already be considering the risk of negative impacts arising from investment activity which might undermine the charitable purposes. However, based on available evidence and information, and taking advice where appropriate, trustees may also consider whether it is possible to adopt a positive impact investment strategy i.e. one that more actively achieves positive impacts which support or advance the charity's purposes and mission beyond just excluding those investments which may directly conflict with its purposes.[8]



6 https://www.cazenovecapital.com/uk/charities/insights/charity-investment/fossil-fuels-divestment-or-dialogue/
7 https://www.acevo.org.uk/2021/08/charities-the-climate-crisis-and-responding-to-progressive-challenges/
8 Please see the Impact Investing Institute's report on Investing for Impact in the Endowment: Why do it and how to get started

Financially material impact factors

Impact factors may be financially material too. Increasingly, investment professionals are aware of risks to financial returns that arise from weaknesses in companies' approach to ESG issues[9]. Those risks must be considered in relation to the time horizon of the relevant investment portfolios, which can usually be measured in decades or longer.

Many companies, for example, now have a significant risk exposure to the transition to a low-carbon economy. Social issues, including diversity and inclusion, workforce protections, and health and wellbeing can also affect the long-term success of an investee company.

However, there is also opportunity in a changing and challenged world. Even from a purely financial perspective, there is an increasingly powerful argument that fiduciary duty compels trustees to consider the implications of exposure to ESG risks in their endowment portfolios. In this respect, it is also important to consider financially-material impact factors in the context of expendable and permanent endowments.

It also worth noting that some impact factors (such as carbon emissions,[10] child labour, or modern slavery in a company's workforce or supply chain[11]) may well be financially material now and should therefore be considered by charity trustees. Other impact factors may not currently be seen as financially material (or relevant to financial performance) but may become relevant in the future, such as payment of taxes. Therefore, it is important to note that impact factors may be relevant to different financial objectives when investing. Trustees in the UK and throughout the world are finding competitive investments across a range of sectors and asset classes that provide capital growth, income, or diversification as well as a positive impact and which are consistent with their fiduciary duties. This shows there can be sound financial reasons for making impact investments.

Expendable Endowment

In the case of expendable endowment, charity trustees are free to spend the capital of the endowment in advancement of its objects. Some charities with an endowment which is all or partly expendable may, nevertheless, choose to invest the endowment with a view to seeking a financial return over time which will enable the charity to continue its grant making and programmes in perpetuity. It is worth noting that many charities with an expendable endowment may also choose to allocate part of the endowment to impact investments involving concessionary returns or higher risk. Charities taking this approach, unless established by Act of Parliament or Royal Charter, will usually be able to rely on the statutory social investment power set out in the Charities (Protection and Social Investment) Act 2016. Social investment powers are considered in more detail in the Q&A below.

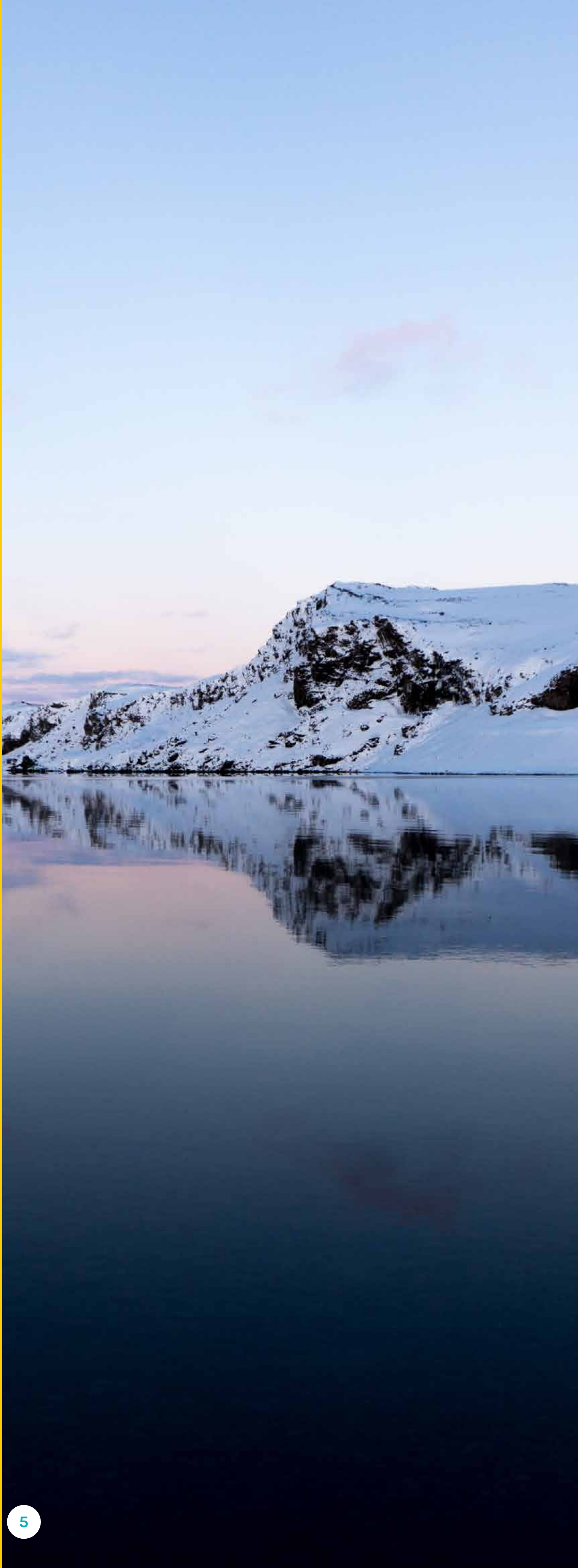
9 Please see the Impact Investing Institute's report on Investing for Impact in the Endowment: Why do it and how to get started

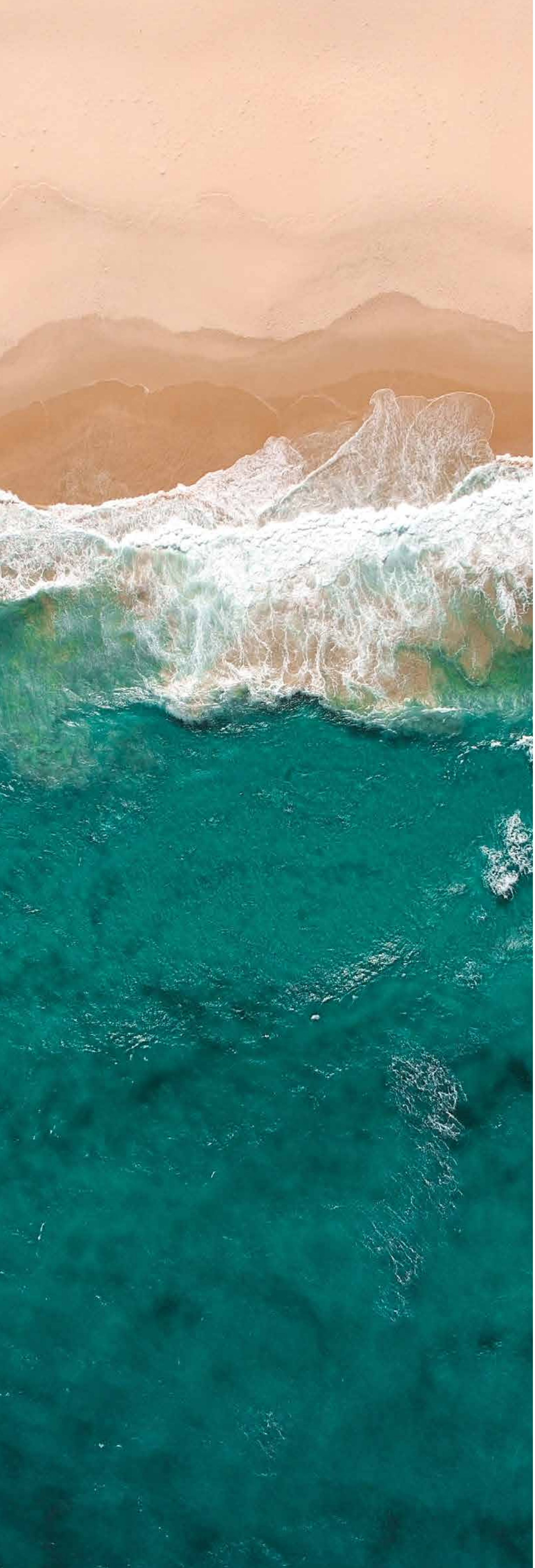
10 https://docfinder.bnpparibas-am.com/api/files/1094E5B9-2FAA-47A3-805D-EF65EAD09A7F l

11 https://www.cnbc.com/2020/02/07/esg-high-controversy-events-can-cost-stocks.html

Permanent Endowment

In the case of permanent endowment, the power to make social investments does not apply to the treatment of funds held on permanent endowment. Generally, trustees are prohibited from spending the capital of the endowment and in practice, subject to any specific terms to the contrary, this will usually be interpreted in practice as an obligation to seek to maintain the real value of the capital element of the endowment. Trustees must ensure that any permanent endowment restrictions are honoured and respected and that any investments made are consistent with the restrictions applying to the endowment asset. However, many impact factors may contribute to positive financial outcomes when investing. Trustees are therefore entitled to consider the extent to which investing in enterprises which avoid harm can mitigate financial risk, while favouring enterprises that actively benefit people and planet and contribute to solutions that may provide opportunities for financial outperformance over the long term. For further information please see the Q&A below.





Conclusion

Charity law requires trustees to consider what kind of investment approach is most likely to advance the charitable objects over time. Where charity trustees have good reason to believe that an impact investment approach across the endowment would be in accordance with their legal duties and the law, there are strong imperatives to consider investing with impact. The world is changing – with new challenges relating to people and the planet – and there is good reason to believe that social and environmental factors can have a positive financial impact on long-term capital growth and the performance of an endowment. Accordingly, we would encourage all trustees to actively consider, in light of the duty to act in a way they consider to be in the best interests of a charity, whether an impact investing strategy would most effectively advance the charity objects over time.

Frequently asked questions on the legal framework of impact investing

Q: What are impact factors, and why can charities take them into account?
"Impact factors" can be defined as the wider social and environmental impacts of the investments in an endowment's portfolio.

Charity trustees have a duty to act in the best interests of the charity. In the context of investments, this means that trustees should assess what investment approach is most likely to achieve this goal. Trustees of charities are generally able to consider impact factors which are solely "non-financial" to the extent such factors have a material bearing on the charitable objects of the organisation, whether positive or negative. In this respect, charities are in a very different position from most other institutional investors, whose ability to consider non-financial impact factors is much more limited, such as where the incorporation of the relevant non-financial impact factors into decision-making is not expected to result in significant financial detriment.

There are impact investing strategies available which promise good risk-adjusted financial returns, and which, if suitably aligned, can contribute to the advancement of charitable objects. Therefore, trustees may have a mixture of good financial and mission-related reasons for investing an endowment for impact. It will generally be prudent for trustees to consider which approach to investment of the endowment is most likely to advance the charitable objects.

Q: Where does charities law come from and what does it allow charities to do in respect of investments?
The law, with respect to endowed charities, comes from a variety of different sources. The law is generally permissive in terms of the investments trustees can make, although the precise rules which apply to charities will depend on the constitution of the charity, any restrictions which apply to all or part of the endowment and the legal form of the charity. For more information on tax considerations, please see below.

Trustees of organisations which are constituted as charitable trusts or some other unincorporated legal form will be aware that they have additional statutory duties in relation to investment, which are set out in the Trustee Act 2000. These duties are generally considered by the Charity Commission to apply by analogy to trustees of charities which take other legal forms and following them in practice is usually prudent.

This paper does not seek to distinguish between charities which are trusts and charities which have other legal structures, such as charities which are created by Act of Parliament or Royal Charter or which are companies, as the general principles which apply to trustees are similar and analogous in most cases.

Q: What restrictions are placed on the investments trustees can make?
Trustees must ensure that any investments are in accordance with their investment powers, as set out in the relevant constitution or, if not expressly in the constitution, as provided by statute. Such powers are usually drawn very broadly and, at least in principle, typically allow trustees to invest in most types of investment.

Thus, save for constitutional restrictions on loans and investments which are connected to trustees, and some broad principles regarding matters such as derivatives, trustees generally have wide powers of investment, and the law does not generally proscribe certain types of investment. Consequently, impact investment is permissible, if the trustees of charities have taken the correct steps and properly considered relevant criteria when deciding how to invest.

Of course, trustees may need advice in specific instances on specific investments.

Q: What tax considerations should be considered?

HMRC automatically treats certain specified investments (see guidance **here**[12]) as 'approved charitable investments', and any investments that do not meet the criteria set out in tax law may be treated as 'non-charitable expenditure'. Where a charity makes an investment that is treated as non-charitable expenditure, the charity may lose exemption from tax on income equal to the amount invested, unless it can satisfy HMRC that the investments are made for the benefit of the charity and is not for the avoidance of tax (whether by the charity or by any other person).

The position for foreign investments will be governed by local tax law, and advice should be sought.

Q: What is a 'social investment'?

A 'social investment' is made when a 'relevant act' of a charity is carried out with a view to both: (i) directly furthering the charity's purposes, and (ii) achieving a financial return for the charity.

This is a statutory definition under section 292A (2) of the Charities Act 2011, as inserted by section 15 of the Charities (Protection and Social Investment) Act 2016. The legislation contains definitions of "financial return", but it does not define an act that directly furthers the purposes of a charity, which is a matter of judgement for the trustees of the charity on a case-by-case basis.

A "relevant act" includes two types of action:

- **A.** "A direct application/use of a charity's funds or other property". This will be seen to create a financial return if the outcome of the action would be better for the charity in financial terms than spending the whole of the funds/property in question; and
- **B.** "Taking on a commitment in relation to a liability of another person (such as a guarantee) that puts the charity's funds or other property at risk of being applied or used". This type of act would be seen to create a financial return if it is not called upon or, if it is called upon, it does not put the whole of the funds or property at risk.

In practical terms, this means that many types of investment (such as debt, equity, and guarantees) can fall under the definition of a social investment. It can also include forms of investment where there is some risk or even expectation of capital erosion or partial capital loss. Trustees should also have regard to the Charity Commission's interim guidance on the use of the social investment power and should document compliance with the statutory duties and interim guidance when investing.

In most cases, an investment decision which expressly involves investing an endowment with a view to financial return and achieving positive impact which is aligned with the organisation's charitable purposes will engage the statutory social investment power and, as a result, will require trustees to observe the specific duties set out in the legislation in relation to the exercise of the power to:

- **A.** consider whether in all the circumstances any advice about the proposed social investment ought to be obtained.
- **B.** obtain and consider any advice they conclude ought to be obtained; and
- **C.** satisfy themselves that it is in the interests of the charity to make the social investment, having regard to the benefit they expect it to achieve for the charity (by directly furthering the charity's purposes and achieving a financial return).

Q: Can this social power of investment be used in respect of permanent endowments?

In certain situations, a charity may hold land, buildings or other property which is subject to a restriction(s) on its being expended for the purposes of the charity. The current statutory social investment power under s292B (2) of the Charities Act 2011 prohibits using permanent endowment to make social investments unless the trustees expect that this will not contravene any restriction on expenditure which applies. In practice as capital preservation is likely to be the minimum requirement for permanent endowments, the law enables permanent endowments to make a social investment which only preserves capital value provided that the "mission benefit" from the social investment is broadly equivalent to the sacrificed income/capital gain. Where all or part of a charities' investment assets constitute permanent endowment, the trustees may also invest the relevant permanent endowment with impact where the trustees are seeking and expect a good risk-adjusted financial return according to normal investment principles.

12 https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-iii-approved-charitable-investments-and-loans

However, at the time of writing, a Charities Bill is passing through Parliament which contains several technical reforms to charity law which have been proposed by the Law Commission and agreed by Government. One of the proposed reforms in the Charities Bill is a provision which would allow a charity which has adopted a total return approach to investment of permanent endowment under s104A Charities Act, to also – under the new s104AA – resolve to use the permanent endowment fund or a portion of it and any capital gain and income returns, for making social investments under s292A even if the capital sum invested is likely to diminish.

This new power to make social investments from permanent endowment that may incur negative financial return will be subject to regulations made by the Charity Commission under amended s104B. It is likely that the regulations will prescribe certain conditions or parameters to the exercise of the new social investment power, such as a requirement for "portfolio offsetting" i.e. the trustees aim to offset any financial losses from the social investment through financial gains elsewhere in the portfolio.[13]

Q: What legislation applies to investments by trustees?

The Trustee Act 2000 is the primary source of legislation for charities with regard to the investment duties of charity trustees. It technically applies only to trustees of unincorporated charities but is generally considered by the Charity Commission and most charity lawyers to be applicable by analogy to trustees of corporate charities.

As a starting point, the legislation provides a general power of investment, which means that a trustee can make any kind of investment that he or she could make if he or she were absolutely entitled to the assets of the trust. This general power of investment is subject to a duty upon trustees to exercise such care and skill as is reasonable in the circumstances when exercising any investment power. When investing, trustees are required to have regard to the "suitability" of any proposed investment and to the need for diversification of investments of the trust, "in so far as is appropriate to the circumstances" of the trust.

There is also a duty to obtain advice from a qualified person, unless the trustees reasonably conclude that advice is unnecessary or inappropriate. Any delegation to an investment manager must be set out in a written agreement and must include an investment policy statement to guide the investment manager. The agreement must include a requirement for the investment manager to comply with the policy statement.

The principles set out in the Trustee Act 2000 with respect to investment are generally capable of exclusion or variation by the terms of the governing document of a charity.

Most charities, apart from those which were established by or whose functions are set out in an Act of Parliament or Royal Charter, also have the benefit of a statutory power under the Charities (Protection and Social Investment) Act 2016 which permits investments to be made where the investment is in the interests of the charity by virtue of the combination of the degree to which the investment is expected to advance the charitable objects and the financial return expected. This power may often permit impact investments to be made from a charities' unrestricted assets, even where the investment is concessionary in some way or involves some risk of loss. For permanent endowments the power can also be used even if there is some concession, but not if there is anticipated financial loss in breach of the permanent endowment restriction.

What do the leading charity law cases say on responsible investment?

The case of Harries v Church Commissioners for England [1991] 10 WLUK 372 (commonly known as the 'Bishop of Oxford case') is the leading case on responsible investment by charities.

It concerned a challenge on the part of the Bishop of Oxford to the ethical investment policy of the Church Commissioners. The Bishop of Oxford and the other claimants in the case felt that the Church Commissioners ought to divest more fully from companies with exposure to Apartheid-era South Africa.

The court refused to give the declarations sought by the Bishop of Oxford and determined that the Church Commissioners had exercised their discretion appropriately in deciding upon their ethical investment

13 Technical Issues in Charity Law, Law Commission 375: https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2017/09/6.3781_LC_HC304_Technical-Issues-in-Charity-Law_FINAL_080917_WEB.pdf

policy, which did involve divestment from companies with exposure to revenue generated in South Africa above certain thresholds. The court noted the Church Commissioners view that to divest more fully would involve a reduction in diversification which might lead to significant financial detriment.

The judge determined that in most cases, other things being equal, the purposes of a charity would best be served by the trustees seeking to obtain the best risk-adjusted financial return available. However, in his judgment in the case, Sir Donald Nicholls the Vice-Chancellor of the High Court set out the bases upon which a charity might legitimately adopt an ethical investment approach, namely:

- where there are direct conflicts with objects – a charity should not invest in investments which conflict with the objects of the charity.
- when trustees' holding of particular investments might hamper a charity's work– such as where an investment would alienate beneficiaries or supporters of a charity, trustees should weigh up what to do; and
- where an ethical investment approach 'would not involve a risk of significant financial detriment'.

In the context of impact investment, trustees may have very sound reasons financial reasons for taking an impact investment approach and may be of the view that such an approach will generate financial outperformance or will be similar in financial terms to alternative investment strategies. If so, trustees will be permitted to adopt an impact investment strategy under the principles in the case.

There may also be cases where trustees seek to screen out investments with harmful or negative impacts which risk conflict with objects and may, under the second principle in the case, consider that there are reputational or other benefits arising from an impact investment approach which might weigh in favour of an impact investment strategy which is intended to align investments with objects. This is, again, a legitimate approach for trustees to take.

Q: What is the relevant Charity Commission Guidance?

The Charity Commission has provided guidance with respect to the duties of charity trustees when investing, in the form of, "Charities and investment matters: a guide for trustees" known as 'CC14'.

At paragraph 3.3 of CC14, under the heading "Can a charity decide to make ethical investments?", the Commission states that:
"Trustees of any charity can decide to invest ethically, even if the investment might provide a lower rate of return than an alternative investment. Ethical investment means investing in a way that reflects a charity's value and ethos and does not run counter to its aims. However, a charity's trustees must be able to justify why it is in the charity's best interests to invest in this way."

The Commission therefore sees the question of whether ethical investment, which would include impact investment, is in a charity's interests as a matter for trustees to determine acting reasonably.

The Commission goes on to say in CC14 that "Trustees should also evaluate the effect of any proposed policy on investment returns and balance any risk of lower returns against the risk of alienating support or damage to reputation." The Commission therefore seems to take the view that trustees ought to look at financial factors and relevant non-financial factors when deciding on how to approach investments. The category of relevant non-financial factors includes impact factors and other non-financial factors which relate to the charitable purposes or the ability of the charity to advance its mission and work.

However, the Commission's guidance is only the Commission's interpretation of the law, which is in certain respects uncertain and subject to debate and current legal proceedings. Charitable trustees should consider seeking legal advice if in doubt about their legal duties or powers when investing.

Q: Has the Charity Commission consulted on and/or recently updated its guidance on impact investing?

On 8 April 2021, the Commission opened a consultation in relation to new draft 'responsible investment' guidance. At the same time, although it is not part of the consultation, the Commission also made available, for information, a 'legal underpinning' document, which shows that the Commission now has a refreshed interpretation of the Bishop of Oxford case and its application to charity investment matters.

The Commission hopes that its updated guidance on responsible investment will provide greater clarity about the discretion charity trustees have to make responsible investments and will reassure charity trustees that they can decide to adopt a responsible investment approach in most circumstances. In this context, impact investment would be one form of responsible investment. The consultation closed on 20 May 2021 and the Commission published a summary of consultation response on 18 August 2021. The development of the final investment guidance is currently on hold.

Q: Is there any clarity on when trustees can exclude certain financial investments on ethical grounds?
On 14 April 2021, in the case of Butler-Sloss v Charity Commission, the High Court granted permission under section 115(5) of the Charities Act 2011 for the trustees of the Ashden Trust and Mark Leonard Trust to bring charity proceedings in the High Court to obtain declaratory relief and directions concerning their investment duties and powers, with a view to clarifying the law on these matters.

The trustees wish to adopt investment policies which would involve excluding investments that are not aligned with the goal of the Paris Climate Accords to limit global warming to well below 2, and preferably to 1.5 degrees Celsius, compared to pre-industrial levels. In his judgment granting leave to the trustees to take charity proceedings, Mr Justice Michael Green acknowledged that the leading, and nearly only significant case on the issue of charity trustee investment, the Bishop of Oxford case, was nearly 30 years old.

The court observed that things had moved on considerably in terms of both charity investment policies and the severe impact of climate change. It concluded that the proposed proceedings were a highly desirable course for the claimants to take, would benefit charities generally and would inform the Charity Commission's guidance for charities on investment matters. The court noted that the fact that the Commission's draft revised guidance on responsible investment appeared to contain a new interpretation of the Bishop of Oxford case added to the need for the issues raised in the proceedings to be assessed by the court. It is hoped that the substantive judgment of the court, which is expected by mid-2022, will provide clarity and certainty on the question of trustee investment powers and duties.

The Charity Commission has noted that the court's decision in Butler-Sloss v Charity Commission may affect the Commission's investment guidance. The Commission is therefore waiting for the court judgment, at which point it will assess the case's implications for its published investment guidance.

The Impact Investing Institute is an independent, non-profit organisation which aims to accelerate the growth and improve the effectiveness of the impact investing market. Our vision is for lives to improve, as more people choose to use their savings and investments to help solve social and environmental challenges, as well as seeking a financial return.

We drive change through education and awareness raising, providing useful tools and resources, and advocating for supportive policies.

info@impactinvest.org.uk
www.impactinvest.org.uk