



**Law
Commission**
Reforming the law

Social Investment by Charities A Consultation Paper



Law Commission

Consultation Paper No 216

SOCIAL INVESTMENT BY CHARITIES

A Consultation Paper

© Crown copyright 2014

You may re-use this information (excluding logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/> or e-mail: psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

Any enquiries regarding this publication should be sent to us at Law Commission, 1st Floor, Tower, Post Point 1.52, 52 Queen Anne's Gate, London SW1H 9AG

ISBN: 9780108560422

Printed in the UK for The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID 2638569 04/14 39943 19585

Printed on paper containing 75% recycled fibre content minimum.

THE LAW COMMISSION – HOW WE CONSULT

About the Law Commission: The Law Commission was set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are: The Rt Hon Lord Justice Lloyd Jones, *Chairman*, Professor Elizabeth Cooke, David Hertzell, Professor David Ormerod QC and Nicholas Paines QC. The Chief Executive is Elaine Lorimer.

Topic of this consultation: Evaluating the law relating to social investment by charities.

Geographical scope: England and Wales.

Availability of materials: This Consultation Paper is available on our website at <http://lawcommission.justice.gov.uk/consultations/charity-law.htm>.

Duration of the consultation: We invite responses from 24 April 2014 to **18 June 2014**.

Comments may be sent:

By email to propertyandtrust@lawcommission.gsi.gov.uk

OR

By post to James Linney, Law Commission, 1st Floor, Tower, Post Point 1.53,
52 Queen Anne's Gate, London SW1H 9AG

Tel: 020 3334 0200 / Fax: 020 3334 0201

After the consultation: In the light of the responses we receive, we will decide on our final recommendations and present them to Government.

Consultation Principles: The Law Commission follows the Consultation Principles set out by the Cabinet Office, which provide guidance on type and scale of consultation, duration, timing, accessibility and transparency.

The Principles are available on the Cabinet Office website at <https://www.gov.uk/government/publications/consultation-principles-guidance>.

Information provided to the Law Commission

We may publish or disclose information you provide us in response to this consultation, including personal information. For example, we may publish an extract of your response in Law Commission publications, or publish the response in its entirety. We may also be required to disclose the information, such as in accordance with the Freedom of Information Act 2000.

If you want information that you provide to be treated as confidential please contact us first, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

The Law Commission will process your personal data in accordance with the Data Protection Act 1998.

THE LAW COMMISSION

SOCIAL INVESTMENT BY CHARITIES: A CONSULTATION PAPER

CONTENTS

	<i>Paragraph</i>	<i>Page</i>
CHAPTER 1: INTRODUCTION		1
The Law Commission's project on Selected Issues in Charity Law	1.3	1
What are charities?	1.5	1
What is social investment?	1.11	3
Figure 1	1.18	5
Figure 2	1.21	6
Figure 3	1.24	7
The importance of social investment to charities	1.26	8
Barriers to social investment	1.33	10
Legal forms of charities	1.35	10
The Law Commission's project on Fiduciary Duties of Investment Intermediaries	1.39	11
Structure of this Consultation Paper	1.40	11
Acknowledgements	1.41	12
 CHAPTER 2: EXAMPLES OF SOCIAL INVESTMENT		 13
Introduction	2.1	13
Individual social investment	2.3	13
Collective social investment	2.6	14
Social impact bonds	2.11	16
 CHAPTER 3: SOCIAL INVESTMENT UNDER THE CURRENT LAW		 19
Introduction	3.1	19

	<i>Paragraph</i>	<i>Page</i>
Charity trustees' powers to make social investments	3.8	20
The charity's governing document	3.13	21
The power to spend	3.21	23
Does the power to spend permit social investment?	3.22	23
The power to invest	3.26	25
Statutory investment power for trusts	3.26	25
Limitations on the statutory investment power	3.28	25
Express power of investment	3.29	25
The meaning of "investment": does it include social investment?	3.31	26
Combining the power to invest and the power to spend	3.39	29
Conclusions about the power to make social investments	3.47	30
Charity trustees' duties	3.51	32
The core duties of all charity trustees	3.53	32
The duties of all charity trustees when investing	3.58	34
<i>Cowan v Scargill</i>	3.59	34
<i>Harries v Church Commissioners</i>	3.62	35
Charitable trusts: duties of charity trustees when investing	3.68	37
(1) Standard investment criteria	3.75	38
(2) Reviewing investments	3.77	38
(3) Obtaining advice	3.78	38
Conclusion	3.79	39
Private benefit	3.82	39
Introduction	3.82	39
Private benefit restrictions	3.84	39
Private benefit and social investment	3.95	43
Conclusion	3.99	44
The legal landscape: Charity Commission guidance	3.101	44

	<i>Paragraph</i>	<i>Page</i>
Private benefit	3.103	45
Quantification of mission benefit	3.105	45
Conclusion	3.109	46
CHAPTER 4: A NEW POWER TO MAKE SOCIAL INVESTMENTS, AND THE ASSOCIATED DUTIES		47
Introduction	4.1	47
A new power to make social investments	4.6	47
The scope of a new power	4.9	48
Duties when exercising the statutory power	4.14	49
Duties attached to the new power	4.14	49
Duties under the Trustee Act 2000	4.25	52
CHAPTER 5: PERMANENT ENDOWMENT AND SOCIAL INVESTMENT		54
Introduction	5.1	54
What is permanent endowment?	5.2	54
The purpose of permanent endowment	5.6	55
Permanent endowment and social investment	5.8	55
The current law	5.11	56
Removing permanent endowment limitations	5.17	57
Statutory power to release permanent endowment restrictions	5.18	57
Expenditure of permanent endowment pursuant to a Charity Commission order or scheme	5.23	58
Application to the court	5.24	59
Total return investment	5.25	59
Is the current law satisfactory?	5.27	59
Conclusion	5.31	61

	<i>Paragraph</i>	<i>Page</i>
CHAPTER 6: NON-LEGAL BARRIERS TO SOCIAL INVESTMENT		62
Introduction	6.1	62
Charity trustee awareness and caution	6.2	62
Charity governance	6.3	62
Emerging social investment market	6.4	62
Accountancy	6.5	63
Tax	6.6	63
Quantifying mission benefit	6.11	65
Transaction costs	6.14	66
Conclusion	6.15	66
CHAPTER 7: SUMMARY OF PROVISIONAL PROPOSALS AND CONSULTATION QUESTIONS		67
APPENDIX A: ACKNOWLEDGEMENTS		69
APPENDIX B: EXTRACTS FROM CHARITY COMMISSION GUIDANCE CC14		71

CHAPTER 1

INTRODUCTION

- 1.1 This Consultation Paper analyses the law as it applies to charities wishing to make social investments and makes provisional proposals that the law should be reformed.
- 1.2 We seek views from consultees on the questions raised in this Consultation Paper by 18 June 2014. Replies should be sent to the address on page iii.

THE LAW COMMISSION'S PROJECT ON SELECTED ISSUES IN CHARITY LAW

- 1.3 This Consultation Paper forms part of a wider review by the Law Commission of selected issues in charity law, most of which arose from the review of the Charities Act 2006 conducted by Lord Hodgson of Astley Abbotts in July 2012.¹ We have prioritised our work on social investment, which has led to the early publication of this Consultation Paper. We will publish a further consultation paper on the other issues to be covered by our project at a later date.
- 1.4 In relation to social investment, our terms of reference are:

[to] consider, within the parameters of the current law on private benefit:

(1) whether anything can be done by way of law reform to make clearer the powers and duties of charity trustees in undertaking mixed-purpose social investment, in particular whether to introduce a new specific investment power; and

(2) the introduction of a power for non-functional permanent endowment to be spent on mixed-purpose investments, with the requirement that capital levels must be maintained or otherwise restored within a reasonable period.²

WHAT ARE CHARITIES?

- 1.5 Charities exist for the benefit of the public.³ Each has a purpose, ranging from the relief of poverty to the promotion of the arts to the advancement of environmental protection.⁴ Charities come in all shapes and sizes, and their aims range from focusing on local issues to a nationwide or global sphere of interest.

¹ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012).

² Terms of Reference, para 8, available at http://lawcommission.justice.gov.uk/docs/charity_law_terms-of-reference_updated.pdf.

³ Charities Act 2011, ss 2(1)(b) and 4.

⁴ Section 3(1) of the Charities Act 2011 contains a list of charitable purposes.

- 1.6 It is a fundamental principle that, in order to be a charity, an institution's purposes must be exclusively charitable.⁵ A charity must exist for the benefit of the public, not for the benefit of private individuals or entities.⁶
- 1.7 Charities occupy a special place in society and in law. There is overwhelming public opinion that charities have an important role, and there is a high level of public trust and confidence in charities.⁷ Their value is reflected by the significant donations made to charities each year; charitable giving by individuals in the United Kingdom in 2011-2012 was estimated to have been £9.3 billion.⁸
- 1.8 Charities' special status is also recognised by their tax advantages. The Gift Aid scheme alone, under which charities can reclaim the basic rate of tax paid by donors on their donations,⁹ was worth £1.04 billion to charities in the United Kingdom in 2012-2013.¹⁰ Charities enjoy various other tax reliefs and exemptions, including exceptions from income and capital gains tax, inheritance tax exemptions, stamp duty land tax and stamp duty exemptions, and certain supplies being zero-rated for VAT purposes.¹¹
- 1.9 The contribution of charities to society is made possible by the work of their volunteers and staff, as well as by the spending of their resources. The 180,000

⁵ Charities Act 2011, s 1(1)(a).

⁶ We consider the issue of charities conferring private benefit on individuals and organisations in Chapter 3 below.

⁷ Ipsos MORI research in June 2012 found that 96% of people say that charities' role is essential, very or fairly important, and that 74% of people consider that charities are trustworthy and act in the public interest: Public trust and confidence in charities: research study conducted by Ipsos MORI on behalf of the Charity Commission (29 June 2012) pp 31, 32 and 36 available at https://www.charitycommission.gov.uk/media/92891/ptc_ipsos_mori_2012.pdf. YouGov research in January 2012 suggested that public trust in those who run charities is equal to trust in local police officers, and ranks behind only family doctors and school teachers of the listed professionals: http://d25d2506sfb94s.cloudfront.net/cumulus_uploads/document/fbzcrjzz4y/YG-Archives-Trackers-Trust-110112.pdf (last visited 9 April 2014).

⁸ NCVO & CAF, *UK Giving 2012: An overview of charitable giving in the UK, 2011/2012* (November 2012) p 9, available at <https://www.cafonline.org/PDF/UKGiving2012Full.pdf>. Total donations from individuals and companies in the United Kingdom on which Gift Aid was reclaimed in 2012-2013 were £4.13 billion: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/256812/table10-3.pdf (last visited 9 April 2014), but this does not include donations made outside the Gift Aid scheme.

⁹ Under the Income Tax Act 2007, Part 8, Chapter 2.

¹⁰ *UK Charity Tax Relief Statistics, 1990-1991 to 2012-2013*, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/256800/commentary.pdf, and Table 10.3, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/256812/table10-3.pdf (last visited 9 April 2014).

¹¹ For income tax see Part 10 of the Income Tax Act 2007; for corporation tax see Part 11 of the Corporation Tax Act 2010; for capital gains tax see section 256 of the Taxation of Chargeable Gains Act 1992; for inheritance tax see section 23 of the Inheritance Tax Act 1984; for stamp duty see section 129 of the Finance Act 1982; for stamp duty land tax see section 68 of and Schedule 8 to the Finance Act 2003; and for VAT see section 30 of and Part II (Group 15) of Schedule 8 to the Value Added Tax Act 1994.

charities in England and Wales registered with the Charity Commission¹² have a combined annual income of over £62 billion.¹³ Many charities are not registered with the Charity Commission and, when their income is included, the figure of £62 billion will increase.

- 1.10 At the core of this project is a consideration of how charities use their resources. Those in charge of a charity must use the charity's resources to achieve its purposes and the law should facilitate this.

WHAT IS SOCIAL INVESTMENT?

- 1.11 While charitable entities have existed for many hundreds of years, charities today face new challenges and opportunities as times change. One relatively recent opportunity is social investment.
- 1.12 To achieve their purposes, charities have traditionally either spent their funds in support of their initiatives, or invested them so as to generate further funds for future initiatives.
- 1.13 A charity making a social investment¹⁴ combines these objectives; it enters into a transaction from which it seeks to achieve both its charitable purposes (which we refer to as "mission benefit") and a financial benefit. "Financial benefit" can take one of two forms.
- (1) The charity may anticipate the return of the initial capital outlay together with an income return or capital appreciation or both. We refer to this as a "positive financial return". This is the traditional understanding of a financial return on an investment. As will be seen below,¹⁵ a transaction

¹² Charity Commission, "Charities in England and Wales – 31 December 2013", available at <http://www.charitycommission.gov.uk/find-charities> (Sector Overview) (last visited 9 April 2014). Charities with an annual income of £5,000 or less do not have to register: Charities Act 2011, s 30(2)(d). Certain other charities are exempt from registration with the Charity Commission (Charities Act 2011, ss 22 and 30(2)(a) and sch 3) including most English universities (for whom the principal regulator is the Higher Education Funding Council for England) and various museums and galleries such as the Victoria and Albert Museum, the Science Museum and the British Museum (for whom the principal regulator is the Department for Culture, Media and Sport).

¹³ Charity Commission, "Charities in England and Wales – 31 December 2013". The figure comprises voluntary income (£19.77bn), trading to raise funds (£4.91bn), investment income (£3.50bn), charitable activities income (£32.55bn) and other sources (£1.39bn).

¹⁴ Social investment can also be described as "impact investment" or "social impact investment".

¹⁵ See paragraphs 3.31 to 3.38 below.

is an “investment” in the legal sense if it is anticipated to provide a positive financial return.¹⁶

- (2) The charity may anticipate only the return of the initial capital outlay (with no income return or capital appreciation), or even the return of only part of the initial capital outlay. We refer to this as a “negative financial return”. Many would not consider this to be a financial return at all and, as will be seen below,¹⁷ it is unlikely to be an “investment” in the legal sense. Nevertheless, when compared with spending money outright, recouping some of the initial outlay is of financial benefit even if the overall financial return is negative.

1.14 We are considering social investment by charities only. Social investment, however, is not the exclusive preserve of charities; many individuals and non-charitable organisations make social investments.

1.15 Charities have, for some time, made investments which are intended to achieve their purposes, but which are also expected to produce a financial benefit. For example, the Sir Thomas White Loan Charity, founded in 1542, offers loans to poor young people to enable them to start a business or career.¹⁸ The concept became embedded into US tax law as “program-related investment” in 1969.¹⁹ In England and Wales, the term “programme-related investment” (“PRI”) has been adopted by the Charity Commission in its guidance²⁰ and is now fairly well known in the charity sector. Despite what its name suggests, a PRI may not be an

¹⁶ Where we refer to a particular level of financial return, we assume that that return has been adjusted for risk. Thus an investment with a high potential yield but a high risk may have a lower anticipated financial return than an investment with a lower yield but a lower risk. Economists have developed several formulae that can be used to measure the return from an investment relative to the risk it is exposed to. One such formula is the Sharpe ratio, which is the ratio of (1) the investment’s return less what the investor could have earned from a risk-free investment (typically a government bond) to (2) the investment’s standard deviation (the measure of how much it strays from its average performance or, in other words, its volatility). The higher the ratio, the more the investor is compensated for the risk taken on.

¹⁷ See paragraphs 3.31 to 3.38 below.

¹⁸ See paragraph 2.3 below.

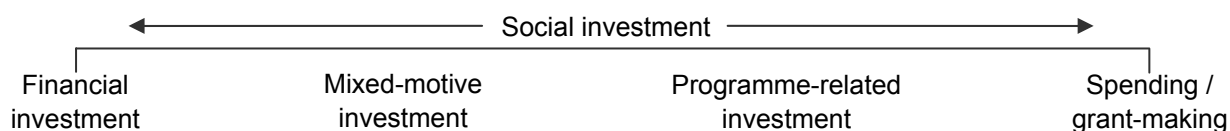
¹⁹ The Tax Reform Act of 1969 introduced Internal Revenue Code rule 4944 which imposes a tax on investments that “jeopardise” a private foundation carrying out its tax-exempt purposes. An investment is jeopardising if the foundation managers, in making the investment, have – in providing for the financial needs of the foundation to carry out its exempt purposes – failed to exercise ordinary business care and prudence under the circumstances prevailing at the time of making the investment. An exception was necessary for low-return and high-risk investments that were entered into for the primary purpose of achieving the tax-exempt purposes of the foundation, and so rule 4944(c) was enacted to exclude “program-related investments” from the scope of the rule. Such an investment has to satisfy three criteria: (1) the primary purpose of the investment has to be achieving the charitable, religious, scientific, literary, educational or other tax-exempt purpose; (2) no significant purpose of the investment can be the production of income or a capital return; and (3) the investment cannot be used for lobbying or political purposes. Rule 4944 of the Internal Revenue Code is still in force and is available at <http://www.law.cornell.edu/uscode/text/26/4944> (last visited 9 April 2014).

²⁰ Charity Commission, *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011), available at http://www.charitycommission.gov.uk/media/93859/cc14_lowink.pdf (last visited 9 April 2014).

“investment” in a strict financial sense because it may not anticipate a positive financial return.²¹ Crucially, a PRI will usually be made by a charity exercising its power to spend or apply its funds for its charitable purposes, rather than exercising its power to invest charitable funds.²²

- 1.16 More recently, new and varied social investment opportunities have emerged and there has been an increasing desire by charities to utilise these opportunities to further their purposes and obtain a financial benefit. Social impact bonds, which directly link the financial performance of the investment to its social impact, are an innovation that we discuss further in Chapter 2. Traditional examples of PRIs are often driven primarily by the anticipated mission benefit, with the anticipated financial benefit being of marginal importance to the charity. Some emerging social investment opportunities place more emphasis on the anticipated financial benefit rather than focussing primarily on the anticipated mission benefit.
- 1.17 In 2011, the Charity Commission published revised guidance for trustees on the investment of charitable funds, known as “CC14”.²³ Relevant extracts from CC14 are included in Appendix B. The Charity Commission states that some investment opportunities could not be entirely justified as a financial investment or as a PRI, but had elements of both and were in the charity’s best interests based on “the dual nature of the return”.²⁴ The Charity Commission calls these “mixed motive investments” (“MMI”).
- 1.18 We consider that the use by charities of their funds will fall somewhere along a spectrum, ranging from financial investment at one end, through to spending or grant-making at the other: see Figure 1. PRI and MMI fall between these two extremes.

Figure 1: spectrum showing the range of possible applications of charitable funds



- 1.19 This consultation considers charities’ use of funds along the full spectrum excluding the two extremes. This encompasses both PRI and MMI, as those terms are understood in the Charity Commission’s guidance. We refer to any use of funds between the two extremes of the spectrum as “social investment”.
- 1.20 In Chapter 2 we set out various examples of different social investments. They show that the same social investment can be a PRI to one charity, a MMI to another and even a purely financial investment to another. Much depends on the

²¹ As defined in paragraph 1.13(1) above. We consider this issue further in paragraphs 3.31 to 3.38 below.

²² See paragraph 3.21 and following below.

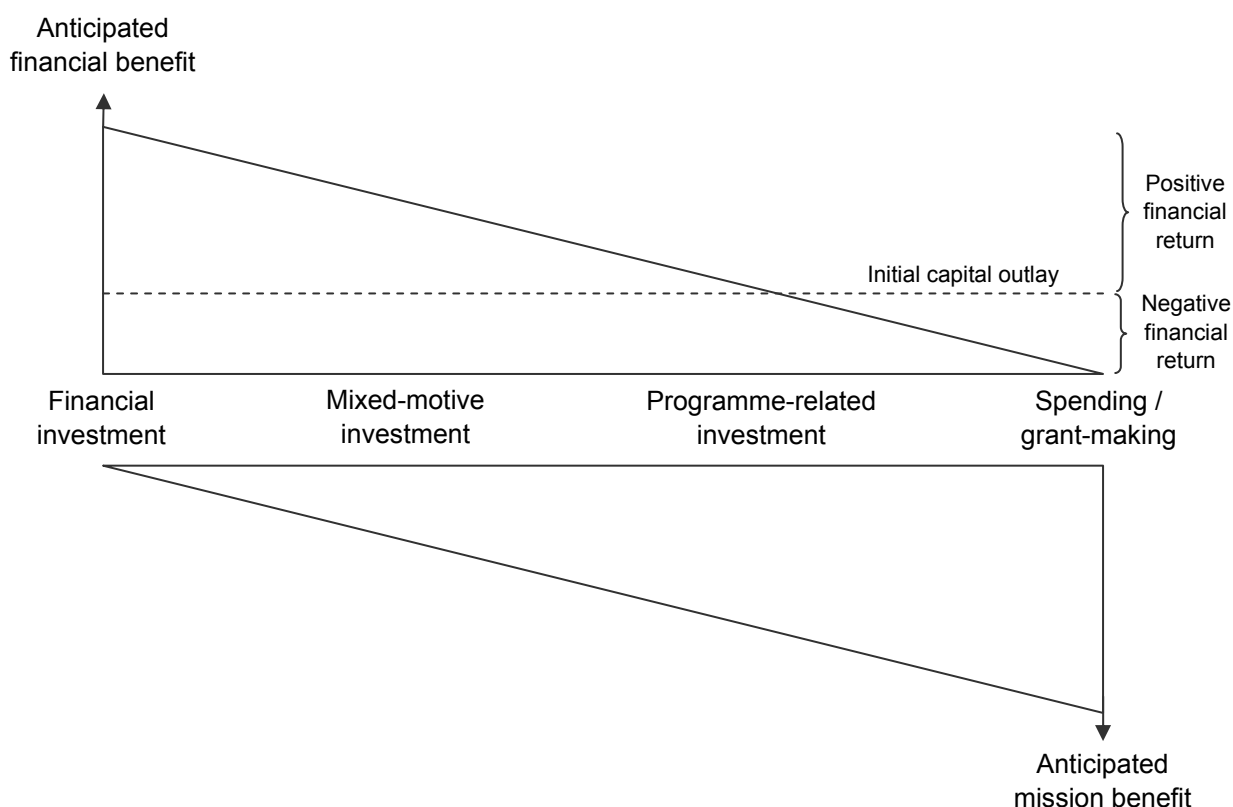
²³ See fn 20 above.

²⁴ CC14, pp 48 and 49.

charity trustees' intentions when making the social investment and upon the width of their purposes. There are no clear dividing lines along the spectrum.

- 1.21 Regardless of how a charity uses its funds and where upon the spectrum the use falls, charity trustees must always act with the sole objective of pursuing the charity's purposes. Charity trustees will nevertheless consider themselves to have different motivations in pursuit of that sole objective if their decision falls at one or other extreme of the spectrum. A charity making a financial investment does so in order to secure the best possible financial return²⁵ to be used for future spending on its charitable activities. This is indirectly achieving its charitable purposes. A charity's motivation when spending is to achieve its charitable purposes directly. When engaging in social investment, a charity is seeking to achieve both, to differing extents, albeit with the sole overriding intention of achieving the charity's purposes. There is a spectrum: see Figure 2.

Figure 2: spectrum showing benefits from different applications of charitable funds



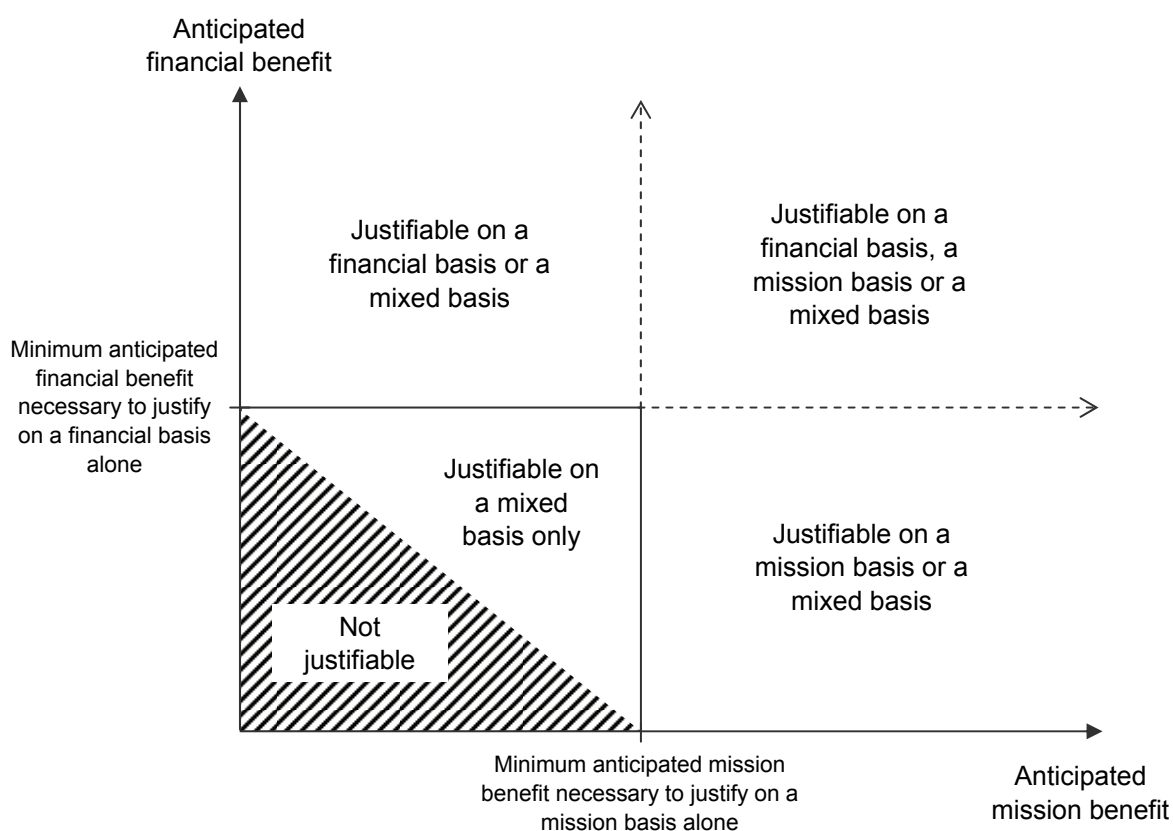
- 1.22 The line on each graph in Figure 2 shows a minimum, not a maximum, financial or mission benefit. It shows that a lower financial return may be acceptable if the transaction goes a certain way to achieving the charity's purposes. Conversely, it shows that a more limited mission benefit (or a benefit that goes beyond the

²⁵ There are likely to be limits to the extent to which trustees are willing to maximise financial return. For example, they may exclude certain investments which conflict with their aims or could alienate supporters, or they may operate an ethical investment policy: see paragraph 3.63 below. These matters fall outside the scope of this project, but are being considered as part of the Law Commission's project on the Fiduciary Duties of Investment Intermediaries (Law Commission Consultation Paper No 215).

charity's specified purposes) may be acceptable if the transaction is anticipated to provide some financial benefit.

- 1.23 Figure 2 is intended to demonstrate the theory of social investment in a simple way. Inevitably it has limitations. It may, but is not intended to, give the impression that a charity's mission benefit can be ascribed a financial value which can then be compared to the financial return achieved on a social investment. That is a particular issue we consider in more detail at paragraphs 3.105 to 3.108 and 6.11 to 6.13 below.
- 1.24 An alternative representation is Figure 3. Any outlay of funds by a charity can be represented by a point on the graph, reflecting its anticipated financial benefit and mission benefit. The outlay must deliver sufficient total benefit to the charity to be a justifiable use of those funds. Accordingly, no outlay in the hatched triangle on the graph can be justified. Elsewhere on the graph, an outlay of funds can be justified on the bases set out.

Figure 3: diagram showing the justifications for applications of charitable funds



- 1.25 Figures 2 and 3 have limitations, but together they may provide helpful diagrammatic representations of the various uses to which charities may put their funds so as to set the context for our review of the law.

THE IMPORTANCE OF SOCIAL INVESTMENT TO CHARITIES

- 1.26 Charities may be recipients of social investment by others and also key investors in the market. Charities, unlike many other bodies, can justifiably invest their money for social impact as well as financial return.
- 1.27 The range of new and emerging social investment opportunities allows charities to pursue their objects in ways that would not, traditionally, have been available. Further, social investment has the potential to offer a more efficient use of charities' limited resources; if charities can achieve their charitable purposes by making social investments that also generate financial benefits, those financial benefits can be used in the future for their charitable purposes. That option is not available if charities simply spend their money on their purposes or make outright grants. Social investment potentially allows charities to recycle their money.
- 1.28 Charities, taken together, have significant resources at their disposal. It was noted above that the charities registered with the Charity Commission have an annual income of over £62 billion. Those registered charities have investment assets worth over £126 billion.²⁶ If there are new ways, or more efficient ways, to put those resources to good use, there is significant potential benefit to the public.
- 1.29 The data collected by the Charity Commission reveal that, of the £62 billion annual income of registered charities, £3.5 billion comes from investments, and over £32 billion is generated from charitable activities, including the sale of goods or services as a charitable activity or provided by charities' beneficiaries, and income from property let to further charities' objects.²⁷ These categories would include charities' social investments, but there are no specific data on the total value of charities' social investments. However, research based on a survey of members of the Association of Charitable Foundations suggests that charitable foundations alone have allocated an estimated £100 million of risk capital to social investment over the last decade.²⁸
- 1.30 The social investment market as a whole is in its embryonic stages. It has been estimated that the value of the social investment market in 2011/2012 was over £200 million²⁹ and that demand could increase to £1 billion by 2016.³⁰ It should

²⁶ Charity Commission, "Charities in England and Wales – 31 December 2013".

²⁷ Charity Commission, "Charities in England and Wales – 31 December 2013".

²⁸ N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) pp 4, 6 and 14, available at http://www.acf.org.uk/uploadedFiles/Publications_and_resources/Publications/Publication_repository/ACF%20Research%20Briefing%20-%20Charitable%20trusts%20and%20foundations%20engagement%20in%20the%20social%20investment%20market.pdf (last visited 9 April 2014). This figure does not, however, include many social investments made by those charities because some survey respondents did not classify their activities (such as offering loans) – which would fall along the social investment spectrum in Figures 1 and 2 – as "social investment": see pp 10 and 16.

²⁹ ICF GHK and BMG Research, *Growing the Social Investment Market: The Landscape and Economic Impact* (July 2013) para 1.2.1, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210408/Social-Investment-Report1.pdf (last visited 9 April 2014).

be noted, however, that these figures do not relate specifically to charities and do not include all potential social investments by charities along the spectrum in Figures 1 and 2.³¹

- 1.31 In April 2000, the Social Investment Task Force was established at the request of Government to consider how higher social and financial returns could be achieved from social investment, possible new sources of investment and the roles of the voluntary sector, business and Government. Over the course of the 10-year project, the Task Force made various recommendations and reported on their implementation.³²
- 1.32 Since then, there have been various Government initiatives to promote social investment,³³ including the £10 million Investment and Contract Readiness Fund,³⁴ the £10 million Social Incubator Fund,³⁵ the £20 million Social Outcomes Fund,³⁶ the creation of Big Society Capital, a wholesale social investment bank capitalised with £600 million from dormant bank accounts and high street banks,³⁷ the promotion of social impact bonds,³⁸ and the promotion of co-mingling

³⁰ A Brown and A Swersky, *The First Billion: A forecast of social investment demand* (September 2012), available at <http://www.bcg.com/documents/file115598.pdf> (last visited 9 April 2014).

³¹ The research used a narrower definition of social investment, which only included investments that anticipated a positive financial return (see fn 29 above, para 2.1); it only looked at Social Investment Finance Intermediaries ("SIFIs") (paras 2.1 and 3.2) which would not include some charities engaged in social investment; it found only 29 SIFIs making social investments (para 3.1.1), so cannot include many social investments made by charities, in particular PRIs; and it also includes social investments by non-charitable investors (para 2.1).

³² The Task Force's initial report, *Enterprising Communities: Wealth Beyond Welfare* (October 2000), available at http://www.socialinvestmenttaskforce.org/downloads/SITF_Oct_2000.pdf, was followed by two progress reports and a final report, *Social Investment: ten years on* (April 2010), available at http://www.socialinvestmenttaskforce.org/downloads/SITF_10_year_review.pdf (last visited 9 April 2014).

³³ Reported in HM Government, *Growing the Social Investment Market: A vision and strategy* (February 2011), and progress updates in 2012 and 2013, all available at <https://www.gov.uk/government/publications/growing-the-social-investment-market-a-vision-and-strategy> (last visited 9 April 2014).

³⁴ HM Government, *Growing the social investment market: 2013 progress update* (5 June 2013), para 2.8; see <http://www.beinvestmentready.org.uk> (last visited 9 April 2014).

³⁵ HM Government, *Growing the social investment market: 2013 progress update* (5 June 2013), para 2.7; see <http://www.biglotteryfund.org.uk/socialincubatorfund> (last visited 9 April 2014).

³⁶ HM Government, *Growing the social investment market: 2013 progress update* (5 June 2013), para 2.12; see <http://www.biglotteryfund.org.uk/sioutcomesfunds> (last visited 9 April 2014).

³⁷ HM Government, *Growing the social investment market: A vision and strategy* (February 2011), ch 5; HM Government, *Growing the social investment market: Progress update* (July 2012) paras 2.1 and 2.2; see <http://www.bigsocietycapital.com> (last visited 9 April 2014).

³⁸ HM Government, *Growing the social investment market: 2013 progress update* (5 June 2013), para 2.9; see http://data.gov.uk/sib_knowledge_box (last visited 9 April 2014). Social impact bonds are discussed in more detail in paragraphs 2.11 to 2.18 below.

funds.³⁹ At an international level, social investment was discussed at a G8 Social Impact Investment Forum in June 2013⁴⁰ which saw the creation of the Social Impact Investment Taskforce which is due to report on its work in September 2014.⁴¹

BARRIERS TO SOCIAL INVESTMENT

- 1.33 In an embryonic market, there are limited investment opportunities and some charities are cautious about a new approach to the use of their resources. Nevertheless, numerous charities make social investments. We understand that many charities have been assisted by the Charity Commission's recent guidance confirming that PRI, and in some cases MMI, are acceptable and this has increased charity trustees' willingness to engage in social investment. However, our impression is that charity trustees feel more comfortable making social investments that can be defined as PRI rather than MMI,⁴² and that some charities have concerns about the scope of their powers to make, and duties when making, social investments.
- 1.34 As a law reform body, in this project we are focussing on the legal barriers that prevent charities from engaging in social investment and how those barriers can be removed. We are aware, however, that there are also various non-legal barriers to social investment. These issues fall outside our review, but we comment on them in Chapter 6 below. It is hoped that removing legal barriers will facilitate social investment by charities but, in light of the other barriers we have identified, law reform alone is not a guarantee of a flourishing social investment market.

LEGAL FORMS OF CHARITIES

- 1.35 Charities take many different legal forms. They will either be incorporated with their own separate legal personality, or unincorporated. Incorporated charities include:
- (1) companies, usually limited by guarantee rather than by shares;
 - (2) charitable incorporated organisations ("CIO"), a new form of charitable corporation introduced by the Charities Act 2006;
 - (3) industrial and provident societies ("IPS"), shortly to be re-named community benefit societies; and

³⁹ HM Government, *Growing the social investment market: 2013 progress update* (5 June 2013), para 4.2; see paragraph 2.10 below.

⁴⁰ This resulted in the *Outputs and Agreed Actions* report (July 2013), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/225547/G8_Social_Impact_Investment_Forum_-_Outputs_and_Agreed_Actions.pdf (last visited 9 April 2014).

⁴¹ See <https://www.gov.uk/government/policy-advisory-groups/social-impact-investment-taskforce> (last visited 9 April 2014).

⁴² This was also a finding of the Institute for Voluntary Action Research in *Charities and social investment: a research report for the Charity Commission* (March 2013), section 7, available at http://www.charitycommission.gov.uk/media/170711/social_investment.pdf (last visited 9 April 2014).

- (4) charities incorporated by royal charter, by statute, by grant of letters patent, or by persons acting under royal licence.⁴³
- 1.36 Unincorporated charities include trusts and unincorporated associations.
- 1.37 The definition of “charity” in section 1 of the Charities Act 2011 does not distinguish between the different legal forms of charities set out above. Similarly, references to a charity in this Consultation Paper are references to any charity within the definition in the Charities Act 2011 and, save where necessary, we do not distinguish between the different legal forms of charities.
- 1.38 In this Consultation Paper, as in section 177 of the Charities Act 2011, those responsible for the control and management of charities are referred to as “charity trustees”. Strictly speaking, not all of those who govern charities are trustees; for example, charitable companies are run by directors, not trustees. Nevertheless, this term is widely accepted as covering all who run charities. We use it in that sense, save where we make clear that we are referring to trustees whose charity is a trust and who are subject to the Trustee Act 2000.

THE LAW COMMISSION’S PROJECT ON THE FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES

- 1.39 The Law Commission is currently carrying out a separate project on the Fiduciary Duties of Investment Intermediaries. We published a Consultation Paper⁴⁴ on 22 October 2013 and plan to publish our final report in June 2014. That project focuses on the powers and duties of pension trustees, but our analysis of the law in that Consultation Paper applies equally to charity trustees when they are making financial investments. However, that project does not consider investments which are intended to achieve a charity’s objects and may produce a below-market financial return. Accordingly, in that project we are not considering the use of funds along a spectrum such as that in Figures 1 and 2 above; rather, that project focuses on financial investment alone, at the left-hand extreme of the spectrum.

STRUCTURE OF THIS CONSULTATION PAPER

- 1.40 In Chapter 2 we set out examples of social investments, ranging from social investments that have existed for many years through to new and emerging investment opportunities. In Chapter 3 we consider the current law as it applies to charity trustees when making social investments and comment on the deficiencies in the current law. In Chapter 4, and in light of the deficiencies in the current law, we provisionally propose the creation of a new statutory power to make social investments, to be accompanied by a checklist of factors to be considered by charity trustees. We also make provisional proposals concerning the application of the Trustee Act 2000 when charity trustees make social investments. In Chapter 5 we consider the special position of charities with a permanent endowment. In Chapter 6 we comment on the various non-legal

⁴³ J Warburton, *Tudor on Charities* (9th ed 2003) ch 3; H Picarda QC, *The Law and Practice Relating to Charities* (4th ed 2010) ch 18.

⁴⁴ Law Commission Consultation Paper No 215.

barriers to social investment. Finally, Chapter 7 contains a summary of our provisional proposals and consultation questions.

ACKNOWLEDGEMENTS

- 1.41 We are extremely grateful to Con Alexander and Rachel Tonkin of Veale Wasbrough Vizards LLP for their comments on an earlier draft of this paper. We are also indebted to those listed in Appendix A who gave so freely of their time to attend our pre-consultation meetings about social investment or have otherwise spoken to us about social investment. Their insights have been invaluable.

CHAPTER 2

EXAMPLES OF SOCIAL INVESTMENT

INTRODUCTION

- 2.1 In this Chapter we set out various examples, both real and fictitious, to illustrate how charities can and do engage in social investment. We first look at individual investments, such as simple loans and share purchases, where the charity enters into a direct relationship with the investee as the sole investor. Such arrangements have existed for centuries and continue to play an important role in the social investment market. We then turn to collective social investment, a relatively recent innovation that involves multiple investors pooling their funds to achieve certain social outcomes. Finally, we look in more detail at a particular type of collective investment: the social impact bond.
- 2.2 In Chapter 1 we suggested that a social investment be defined as an outlay of funds that is calculated to achieve both financial benefit and mission benefit for the charity. In each of the examples that follow, the investment is capable of producing both financial and mission benefits for the investor, but it does not follow that the investor must justify their investment decision by reference to both of these benefits. In some cases the investor may base its decision on the mission benefit of the social investment alone; in others the investor may proceed on a wholly financial basis. Social investments may present themselves differently to different investors.

INDIVIDUAL SOCIAL INVESTMENT

- 2.3 Individual social investment has a long history. One of the first social investors was Sir Thomas White, whose eponymous loan charity, founded in 1542, offered loans to poor young people to enable them to start a business or career. The purpose of the charity was the relief of poverty, but the method by which the charity carried out its purpose was investment: in addition to the repayment of the capital sum advanced there could be a positive financial return in the form of interest (albeit usually at a nominal rate). The charity still exists today, providing loans of up to £12,000 to young businesses. The loans are interest-free for 9 years and repayable by equal instalments after 3 years.¹
- 2.4 The following are further examples of individual social investment.
- (1) A homelessness charity purchases empty properties to be renovated and let at a low rent to homeless people. The charity achieves its purposes by providing housing for the homeless, and additionally achieves a financial return from the rental income and any increase in value of the properties.²

¹ See <http://www.stwcharity.co.uk/about/> (last visited 9 April 2014). We are grateful to Francesca Quint for drawing this charity to our attention.

² This type of social investment is contemplated by section 117(3)(d) of the Charities Act 2011; unlike other disposals of charity land, it does not require an order of the court or the Charity Commission: see paragraph 3.42 below.

- (2) An overseas development charity invests in a fair trade tea production enterprise for a modest financial return. The investment is intended to achieve the charity's purposes by bringing social benefits to the local population as well as providing a financial return.³
- (3) A charity which aims to help people with disabilities find employment purchases shares in a company that employs disabled people. This furthers the charity's purposes and also achieves a financial return in the form of dividends and capital appreciation on the shares.⁴
- (4) A charity established for the relief of unemployment grants leases of its properties at a low rent to start-up businesses. The charity achieves its charitable purposes by securing jobs and achieves a financial return from the rental income.⁵
- (5) A poverty relief charity provides a loan to another charity that helps the unemployed find work. This is intended both to achieve the charity's purposes of relieving poverty and to generate a financial return from interest on, and repayment of, the loan.⁶
- (6) A charity which aims to improve healthcare invests in a medical research enterprise which is in the early stages of developing a potential new treatment. This pursues the charity's objects and may also provide a financial return if the project is successful.

2.5 Depending on the charity investor's charitable purposes, and the charity trustees' intentions when entering into the transaction and the anticipated financial return, these social investments may be considered to be PRIs, MMIs, or even purely financial investments. Many such investments will generate a positive financial return, but not all charities expect or even want their social investment portfolio to generate a positive financial return.

COLLECTIVE SOCIAL INVESTMENT

2.6 In recent times there has been considerable growth in the practice of social investors pooling their money together to invest on a collective basis. Whereas collective investment has been commonplace in financial investment markets for

³ This example is given by HMRC in *Charities: detailed guidance notes*, available at http://www.hmrc.gov.uk/charities/guidance-notes/annex3/annex_iii.htm (last visited 9 April 2014). The guidance suggests that, if the investment could achieve a 5% rate of return as a mainstream investment, an investment of £25,000 at a 2% rate of return could be justified if the charity would have been willing to make an outright grant of £15,000. In effect, the charity is receiving a 5% market rate of return on the £10,000 balance. We discuss charity trustees' decision-making process for a social investment, and the necessity for such a calculation, at paragraphs 3.105 to 3.108 and 6.11 to 6.13 below.

⁴ This example is given in CC14, section J9, p 43.

⁵ This example is taken from the Charity Commission's *Review of the Register of Charities: Charities for the Relief of Unemployment* (March 1999) paras 5 and A7, available at <http://www.charitycommission.gov.uk/media/95177/rr3text.pdf> (last visited 9 April 2014). The guidance states that the Charity Commission would regard such a disposition as being to a beneficiary of the charity in furtherance of its objectives; accordingly it would fall within section 117(3)(d) of the 2011 Act.

⁶ This example is given in CC14, section J1, p 36.

many years, it is only in the past decade or so that the social investment market has acquired the size and infrastructure necessary to follow suit.

- 2.7 Collective investment can result in economies of scale to investors (that is, lower transaction costs) and reduce each investor's own risk when compared with individual investment. However, it can also be more difficult for the investor to know exactly how its contribution to the fund is being used. Charities that invest to achieve both financial benefit and mission benefit must be able to monitor the success of the fund on both of these levels.
- 2.8 Like individual social investment, collective social investment can be used to raise debt or equity finance. Collective social investment vehicles can take several different legal forms, including unit trusts,⁷ open-ended investment companies⁸ and limited partnerships.⁹
- 2.9 The following are examples of collective social investment by charities.
 - (1) A charity established for the protection of the environment invests in a fund which is used to purchase shares issued by companies that develop green technologies.¹⁰ The potential financial return from the investment is high, but so too is the risk. The charity is using its funds to support commercial endeavours which, if successful, will promote its charitable purposes but generate at least some positive financial return. The trustees of the charity may decide that there is a small niche for a high-risk, high-return equity investment such as this within the charity's financial investment portfolio. Alternatively, they may consider that the financial risk is too great and instead justify their investment on mission grounds, classifying their investment as a PRI or MMI.

⁷ A unit trust is established by a trustee entering into a trust instrument and a contract with a fund manager. The fund manager is responsible for the management of investments while the trustee is responsible for the safeguarding of the trust assets. The trustee holds the fund on trust for investors, who have a beneficial proprietary interest, represented by an allocation of units, in their proportionate share of the fund. Their units increase and decrease in value in accordance with changes in the value of the fund. See D Frase, *Law and Regulation of Investment Management* (2nd ed 2011) para 15-015.

⁸ An open-ended investment company ("OEIC") is a company set up under the Open-Ended Investment Companies Regulations 2001 (SI 2001 No 1228) and regulated by the Financial Conduct Authority. The fund is owned and managed by the company as a separate legal entity. Investors purchase shares in the company; they have no proprietary interest in the fund, though they do have the usual residual right, as shareholders, to share in the distribution of the company's assets on its winding up. An OEIC can increase and decrease its share capital, and issue and redeem shares at will, so that the value of its shares matches the value of the underlying fund.

⁹ A limited partnership is a partnership registered with the Registrar of Companies under the Limited Partnerships Act 1907. It is governed by general partnership law, including the common law and the Partnership Act 1890. Management of the fund is the responsibility of the general partner (usually a limited company) which has unlimited liability for obligations to third parties. Investors are limited partners, which means that their liability as partner is limited to the value of their investment. Like a unit trust, a limited partnership has no legal personality and limited partners have a direct proprietary interest in the fund.

¹⁰ This example is adapted from the example given in CC14, section J10, p 45.

- (2) A charity invests in a fund which provides unsecured loans to social sector organisations to support their expansion plans.¹¹ Investment in unsecured debt usually carries a high level of financial risk, so investors may require a high rate of return to proceed on a wholly financial basis. Alternatively, the charity may conclude that the provision of expansion capital to social sector organisations will further its purposes and therefore classify its investment as a PRI. Charity trustees doing so will need to be satisfied that it is their charity's purposes that are being furthered and not charitable purposes generally; charities with objects narrower than those of the organisations that the fund was set up to support may find it more difficult to justify their investment on mission grounds alone. In those circumstances, the investment might be justified as a MMI.
- 2.10 Collective social investment is primarily marketed at charitable foundations and other philanthropic investors. However, there are now at least two examples of "co-mingling funds" (which are expected to achieve both a financial return and a social benefit) where charities invest alongside commercial investors.
- (1) *Bridges Social Entrepreneurs Fund*.¹² The fund was created as a limited partnership in 2009 and provides development capital to social enterprises through equity and quasi-equity¹³ investments.
 - (2) *Big Issue Invest Social Enterprise Investment Fund*.¹⁴ The fund was created as a limited partnership in 2010 to provide secured and unsecured loans and quasi-equity and equity investments to social enterprises.

SOCIAL IMPACT BONDS

- 2.11 In recent years Government departments have commissioned non-public bodies, including charities and social enterprises, to perform public services on a "payment by results" basis. Payment by results means that the service provider will only be paid if a certain outcome is achieved by the service.

¹¹ This example is based on a fund that was recently launched by the FSE Group: see http://www.civilsociety.co.uk/finance/news/content/16932/fse_group_launches_big_society_capital-backed_unsecured_loan_fund (last visited 9 April 2014).

¹² See Cabinet Office, *Achieving social impact at scale: Case studies of seven pioneering co-mingling social investment funds* (May 2013) p 17, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193697/2900897_HMGCO_Co-mingling_acc.pdf; and <http://www.bridgesventures.com/bridges-social-entrepreneurs-fund> (last visited 9 April 2014).

¹³ Quasi-equity is a form of finance that possesses some of the characteristics of both debt and equity. It differs from equity in that it does not involve the purchase of shares (usually because the investee is structured in such a way that it cannot issue shares) and from debt in that it permits the investor directly to share in the success (or failure) of the investee's enterprise. An example of a quasi-equity instrument is a revenue participation agreement, where the investor acquires a right to a percentage share in the revenue of the investee, the value of which may increase or decrease over time.

¹⁴ See Cabinet Office, *Achieving social impact at scale: Case studies of seven pioneering co-mingling social investment funds* (May 2013) p 18.

- 2.12 Often the service provider will be unable or unwilling to bear the risk that the service fails to achieve the desired outcome. Social impact bonds enable service providers to transfer performance risk to external investors who have an interest in the social aspect of the service.
- 2.13 The investors provide funds to the service provider (or, as is more common, a special purpose vehicle set up to structure the investment) and if the service achieves the desired outcome then the investors receive a payment from the commissioning Government department representing a percentage of its savings from the service. Social impact bonds are not “bonds” in the traditional sense as all of the investor’s capital is at risk of being lost if the service underperforms.
- 2.14 With its blend of financial and social benefit, the social impact bond is a good example of an emerging social investment opportunity, particularly for charities. By their very nature, and because they are emerging, they pose a relatively high degree of financial risk to the investor. Consequently, at present they are predominantly being funded by large organisations – such as the Big Lottery Fund, Big Society Capital, the Esmée Fairbairn Foundation and the Barrow Cadbury Trust – that are better able to absorb high financial risk for social return. However, according to Social Finance:

once [social impact bonds] have developed a track record, the aim is to attract a range of impact investors, including retail customers, broadening the available pool of capital.¹⁵

- 2.15 It remains to be seen whether commercial investors will invest in social impact bonds and whether they will require additional financial incentives to invest. The latest social impact bond to be launched in the US, which seeks to raise \$13.5 million to fund employment programmes for those recently released from prisons in New York State,¹⁶ is an example of a scheme where a charitable foundation, in this case the Rockefeller Foundation, has agreed to assume the first loss from the fund in order to make the bond more financially attractive to commercial investors. As we discuss in Chapter 3 below,¹⁷ such arrangements raise fundamental questions about the limits of charities’ investment activities: how far can a charity confer private benefits on its co-investors before it has strayed beyond its mission?

¹⁵ http://www.socialfinance.org.uk/sites/default/files/SF_Peterborough_SIB.pdf (last visited 9 April 2014).

¹⁶ <http://www.governor.ny.gov/press/12302013-pay-for-success-project> (last visited 9 April 2014).

¹⁷ See paragraphs 3.95 to 3.100 below.

2.16 Below are two examples of the 14 social impact bonds currently in operation in the UK.¹⁸

- (1) *Peterborough Social Impact Bond*. In September 2010 the UK's first social impact bond was launched to raise £5 million to fund interventions aimed at reducing recidivism among short-sentence adult males leaving HM Prison Peterborough. In return for their investment, investors receive payments representing a percentage of the cost savings to Government from a reduction in reoffending of 7.5% or greater over a six-year period. If the threshold impact is not achieved then investors will receive no return and may lose their capital.
- (2) *Essex Social Impact Bond*. In November 2012 Essex County Council became the first local authority in the UK to commission a social impact bond to raise £3 million to fund the use of family therapy to provide long-term support to 11 to 16 year-olds on the edge of care or custody in Essex. The key metric on which outcome payments are made is the saving in care placement days for participants over a 30-month period, benchmarked against a historical comparison group. If enough care placement days are saved by the introduction of the therapy programme then investors will receive a return on their investment. However, the investors' capital is put at risk if the programme fails to achieve the requisite saving.

2.17 Social impact bonds rely on the measurability of the outcomes they are set up to achieve, whether a reduction in the rate of reoffending by adult males leaving HM Prison Peterborough or a reduction in the number of days spent in care by vulnerable 11 to 16 year-olds in Essex. The performance data available to the investors in social impact bonds will enable them better to understand the social benefit that their investments bring. For many social investments, however, the quantification of mission benefit is extremely difficult, an issue which we discuss in paragraphs 3.105 to 3.108 and 6.11 to 6.13 below.

2.18 Social impact bonds are usually high-risk, both in terms of financial return and in terms of mission benefit, and charities may therefore be cautious before making such social investments. In view of their relatively high financial risk, it is anticipated that few charities seek to justify their investments in social impact bonds on a purely financial basis, instead opting to classify them as either MMIs or, more likely, PRIs.¹⁹

¹⁸ The remaining 12 social impact bonds in operation in the UK are: a £5 million bond to fund interventions to tackle rough sleeping in the Greater London area; a £2 million bond to fund efforts to find adoptive families for children considered harder to place; and 10 bonds commissioned by the Department for Work and Pensions to increase youth employment, improve educational attainment and provide job training. See http://data.gov.uk/sib_knowledge_box/case-studies-existing-sibs (last visited 9 April 2014).

¹⁹ The Charity Commission uses investment in a social impact bond as an example of a PRI: CC14, section J10, p 45.

CHAPTER 3

SOCIAL INVESTMENT UNDER THE CURRENT LAW

INTRODUCTION

3.1 In this Chapter, we look at the potential legal obstacles to social investment by charity trustees. We say “potential” obstacles because it is not clear that the law in this area is problematic; but of course any lack of clarity in the law itself causes difficulties.

3.2 We look at three possible sources of difficulty:

- (1) charity trustees’ powers to make social investments;
- (2) charity trustees’ duties when they are considering social investments; and
- (3) the law relating to private benefit.

The final section of this Chapter is a discussion of the relevant parts of the Charity Commission’s guidance paper, CC14.¹ Although it has no legal force, CC14 is inevitably influential and charity trustees are naturally uncomfortable about adopting a policy or making an investment that seems to be out of kilter with it. We assess the statements of law in CC14 and the “legal underpinnings” document that accompanies it.² We would be grateful if consultees would draw to our attention any other legal issues which they think cause difficulties.

3.3 In Chapter 4 we make some provisional proposals for law reform to address the difficulties highlighted in this Chapter. We consider the position of charities with a permanent endowment separately in Chapter 5. In Chapter 6 we look at issues outside the law which may also hamper charity trustees who wish to make social investments.

3.4 The legal starting point for everything we say in this Chapter is that any use by charity trustees of a charity’s funds must be with the sole intention of pursuing the charity’s objects and, as we said in paragraph 1.6 above, those objects must be exclusively charitable. It is useful to recall the way this was put by Sir Donald Nicholls VC in *Harries v Church Commissioners*:

it is axiomatic that charity trustees, in common with all other trustees, are concerned to further the purposes of the trust of which they have accepted the office of trustee. That is their duty. To enable them the better to discharge that duty, trustees have powers vested in them.

¹ Charity Commission, *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011).

² Charity Commission, *Legal Underpinning: Charities and Investment Matters* (CC14) (October 2011), available at http://www.charitycommission.gov.uk/media/89876/legal_underpinning_cc14.pdf (last visited 9 April 2014).

Those powers must be exercised for the purpose for which they have been given: to further the purposes of the trust.³

3.5 This statement refers to “trust” purposes, but applies equally to charities that are not trusts.

3.6 To achieve the charity’s purposes, charity trustees have traditionally either:

- (1) exercised their power to spend the charity’s resources or make grants to further the charity’s purposes directly; or
- (2) exercised their power to invest the charity’s resources to generate a financial return for spending at a later date, thereby furthering the charity’s purposes indirectly.

3.7 The division between these two functions – at either end of the spectrum in Figures 1 and 2 above⁴ – can be seen from the fact that many charities allocate the two functions to separate committees. Social investment, between the two extremes of the spectrum, disturbs the traditional order because it does not fit neatly within either of these two functions but spans both; and there lies the root of much of the legal difficulty, or perceived difficulty, in this area. Statute, case law and many charities’ governing documents recognise the two extremes of the spectrum, but not the ground between the two.

CHARITY TRUSTEES’ POWERS TO MAKE SOCIAL INVESTMENTS

3.8 Charity trustees need powers to achieve the charity’s purposes. We have to ask whether they have power to make social investments, and the answer is not wholly straightforward. It is imperative that charity trustees know the limits of their powers, for failure to observe these limits can have serious consequences for both charity trustees and the parties with whom they transact.

- (1) Charity trustees who act in excess of their powers when making a social investment can be held personally liable to account to the charity for any losses sustained as a result of the unauthorised investment.⁵

³ [1992] 1 WLR 1241 at 1246.

⁴ See paragraphs 1.18 and 1.21 above.

⁵ Trustees of a charitable trust (similarly to all trustees) may be required to account to the trust as if the investment had not been made: see *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1513] by Lewison J, and J Mowbray QC and ors, *Lewin on Trusts* (18th ed 2012) para 39-02 and following. An action for breach of trust may be taken by the Attorney General (under the Crown’s power to enforce the execution of charitable trusts: see *Wallis v Solicitor General of New Zealand* [1903] AC 173 at 181 by Lord Macnaghten), or by the Charity Commission exercising the same powers as are exercisable by the Attorney General with respect to the taking of legal proceedings concerning the affairs of charities (Charities Act 2011, s 114(1)). Directors of a charitable company are under a statutory duty to act in accordance with the company’s constitution: Companies Act 2006, s 171(a). Failure to do so may result in the directors being required to replace the company’s assets as if in breach of trust: Companies Act 2006, s 178(1); *Re Oxford Benefit Building and Investment Society* (1886) 35 Ch D 502; *Leeds Estate Building and Investment Company v Shepherd* (1887) 36 Ch D 787; see P Davies and S Worthington, *Gower and Davies’ Principles of Modern Company Law* (9th ed 2012) paras 16-45 and 16-52.

- (2) In many cases the fact that a social investment was beyond the scope of the charity trustees' powers will not affect the validity of the investment from the perspective of the counterparty.⁶ In some cases, however, it will render the investment a nullity.⁷
- 3.9 The source of those powers may be the charity's governing document or statute, and their scope is to some extent defined by case law.
- 3.10 Inevitably the law here is difficult because of the recent emergence of many forms of social investment. No case law considers the extent of charity trustees' powers to make social investments; we have to proceed by analogy from cases that are relevant but not entirely four-square with the issue we are examining. Yet the outcome of, and reasoning in, the particular cases that have come before the courts may be driven by the merits of the case rather than providing clear principles that can be applied by analogy in other circumstances.
- 3.11 Moreover, any discussion of trustees' power to make social investments is complicated by the fact that social investment takes many forms. Whether charity trustees have the power to make a social investment will therefore depend not only on the interpretation of their powers, but also on the nature of the proposed social investment transaction.
- 3.12 In the following paragraphs we discuss, first, the possibility that a charity's governing document will give the trustees power to make social investments. It may not and so we have to go on to consider:
 - (1) charity trustees' power to spend;
 - (2) charity trustees' power to invest; and
 - (3) the use of a combination of those powers to make social investments.

The charity's governing document

- 3.13 The governing document of a charity will depend on the legal form that the charity takes. A charitable trust will be governed by its trust deed, a charitable unincorporated association by its constitution or rules, a charitable company by

⁶ For charitable trusts see *Donaldson v Smith* [2006] EWHC 1290 (Ch), where it was said at [54] to [55] that "the power of the trustee to conclude a contract with a third party derives from the general law, like that of any other natural or legal person, and is unqualified. ... [T]he failure of a trustee to observe an internal restriction in entering into a contract does not render the contract void, since even a bare trustee acts in his own name and the legal efficacy of his act is not tied to authority from his beneficiary". For charitable companies see sections 39, 40 and 42 of the Companies Act 2006, which offer protection to third parties giving full consideration in money or money's worth who are unaware that the company or its directors lacked capacity to enter into the transaction. The position is similar with respect to CIOs (Charities Act 2011, s 218; see paragraph 1.35(2) above) and friendly societies (Friendly Societies Act 1992, ss 8 and 9).

⁷ For instance where the charity is incorporated under the Industrial and Provident Societies Act 1965: see *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd* [1986] 1 WLR 1440 and J Warburton, *Tudor on Charities* (9th ed 2003) para 3-049, or where the charity is a limited company and the third party is aware of the lack of capacity of the company or its directors: Companies Act 2006, s 42(1)(b).

its articles, a CIO by its constitution, and a charity incorporated by royal charter by its charter.

- 3.14 When considering charity trustees' powers, the charity's governing document will always be the starting point. If the governing document provides an express and explicit power to carry out social investment, then charity trustees will have certainty on the point. They also have certainty, albeit potentially unwelcome certainty, if the governing document imposes an express prohibition against making social investments. In that event the charity trustees will only be able to make social investments if the governing document is amended in accordance with its terms permitting amendment (if any) or under a statutory power; we discuss that possibility in paragraphs 3.28 and 3.49 below.
- 3.15 Given the relatively recent emergence of some forms of social investment, existing charities' governing documents are unlikely to make explicit provision about it. However, the governing document may provide a "catch-all" power to do any lawful thing that is necessary or desirable for the achievement of the charity's objects.⁸ A CIO has a statutory catch-all power.⁹
- 3.16 Whether such a power permits charity trustees to make social investments will, of course, depend on its proper construction and on the nature of the proposed social investment. It seems to us that a catch-all power would generally permit charity trustees to make social investments in order to achieve their charity's purposes.
- 3.17 We understand, however, that charity trustees and their advisers have been given cause for concern by the decision in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd*.¹⁰ The claimant was a charitable housing association. Its objects were to provide housing for people in need and the elderly. It had "power to do all things necessary or expedient for the fulfilment of its objects". The defendant agreed to provide a loan to another company to carry out a housing development. The developer company was under virtually the same control as, but did not have a legal relationship with, the claimant. The claimant guaranteed the developer's liability under the loan and provided security for that guarantee.
- 3.18 The Judge held that the claimant's guarantee and mortgages were void as the claimant had no power to guarantee the developer company's obligations. He held that neither the general power nor any implied power permitted the claimant to give away its assets, and that that was what the gratuitous guarantee amounted to. The Judge said that the claimant "merely received the satisfaction of knowing that work it desired to see carried out would be carried out by a third party. But the [claimant] must advance its own charitable purposes either by its

⁸ This is taken from clause 5(10) of the Charity Commission's model trust deed, available at <http://www.charitycommission.gov.uk/media/94727/gd2text.pdf>. Similar catch-all powers are in clause 19 of the Charity Commission's model constitution for unincorporated associations, available at <http://www.charitycommission.gov.uk/media/94739/gd3text.pdf>, and clause 5 of the model articles for a charitable company, available at <http://www.charitycommission.gov.uk/media/94703/gd1textc.pdf> (last visited 9 April 2014).

⁹ Charities Act 2011, s 216(1), although the power may be excluded by the CIO's constitution.

own actions or through its agents or subsidiaries. In guaranteeing [the developer company] it was not advancing its interests in that way.”¹¹ Whilst the Judge accepted that claimant was “seeing its objects ... promoted”, that “[did] not remove the difficulty ... of the [claimant] committing itself gratuitously to bear the liabilities of a third party.”¹²

- 3.19 The Judge’s statements (i) that the charity must advance its purposes itself or through its agents, and (ii) that the guarantee was not permitted even though it promoted the charity’s objects, arguably suggest that a general catch-all power does not permit charity trustees to make a social investment. In our view, statement (i) goes too far; charities can use third parties to advance their purposes; and we are, with respect, unconvinced by statement (ii). We find it difficult to see why the charity trustees in *Rosemary Simmons* did not have sufficient power to execute the guarantee. We do not think that the case would, or should, be interpreted so as to preclude charities from making social investments; the case can be confined to its particular facts or explained on other grounds.¹³ Nevertheless, we appreciate that the decision creates uncertainty for charity trustees and those who advise them.
- 3.20 In summary, the charity’s governing document may not provide an explicit power to make social investments, and there may be either no catch-all power or the charity trustees may not be confident about using it. They must then look to their powers to spend and to invest, to which we now turn.

The power to spend

- 3.21 Charity trustees have a power to spend the charity’s funds in pursuance of the charity’s objects.¹⁴ Such a power will either be set out expressly in the charity’s governing document, or it will be implied.¹⁵

Does the power to spend permit social investment?

- 3.22 The power may be limited by the governing document. For example, if the charity trustees have a power to make grants, that power may not include the power to

¹⁰ [1986] 1 WLR 1440.

¹¹ [1986] 1 WLR 1440 at 1446.

¹² [1986] 1 WLR 1440 at 1446.

¹³ For example, it is arguable that the decision is explicable on the basis that the guarantee conferred an unacceptable private benefit on the non-charitable developer company. We consider the law relating to private benefit in paragraphs 3.82 to 3.100 below.

¹⁴ By referring to a power to spend, we intend to encompass any power to apply a charity’s funds directly for its purposes, including the power to spend on the charity’s activities and to make grants. This power should be distinguished from other powers to spend the charity’s funds in the course of carrying out a charity’s objects, such as the power to pay staff, accommodation costs and overheads.

¹⁵ The implication of a power, like the implication of any term in a written instrument, is part of the exercise of construing the instrument as a whole to ascertain the meaning that the instrument would convey to a reasonable reader with the relevant background knowledge that was reasonably available to the audience to whom the instrument is addressed: *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10, [2009] 1 WLR 1988 at [12] and [19]; see also G Thomas, *Thomas on Powers* (2nd ed 2012) paras 2.22 to 2.23 and 3.06.

make a social investment. However, in many cases, the power to spend will permit charity trustees to make social investments. Many PRIs are currently made on this basis. If the charity trustees could spend the charity's funds to achieve its purposes (or make an outright grant), it seems to us that structuring the spending in such a way as to provide a financial return is unobjectionable.

- 3.23 The point is not, however, entirely free from doubt. All social investments, as we have defined them, involve something more than just spending. At one end of the spectrum, all PRIs are intended or anticipated to involve some sort of financial return, although it may be negative.¹⁶ A power to spend (or make grants) suggests that the charity will divest itself of its funds. If the spending anticipates some financial return, and so is not a complete divesting of the charity's funds, does that mean that it is, as a matter of definition, not "spending" or "grant-making"? We think not. Many charity trustees think not, since many now engage in PRI which is justified on this very basis. Nevertheless, the point may be arguable.
- 3.24 But the uncertainty becomes greater as we move along the spectrum in Figures 1 and 2 above¹⁷ so that more of a financial return is anticipated. Does the financial return element of the social investment mean that it cannot be justified wholly by a power to spend? The question is at its most potent at the far left of the spectrum where the trustees anticipate both the return of all the capital and some income in addition; the social investment is clearly an investment in the legal sense,¹⁸ albeit not a very good one – is it realistic to justify it by a power to spend? The difficulty, if there is one, would disappear if it were clear that social investments can be wholly justified by a power to invest; but we conclude below that while some can, others cannot. Similarly, there is no difficulty if a power to spend and a power to invest (and most charity trustees will have both) can be used in combination, which we discuss below.
- 3.25 A similar problem arises where a charity wishes to make a social investment the impact of which extends beyond the charity's objects. The power to spend only permits charity trustees to apply the charity's resources to achieve its objects. If the proposed social investment goes further than the charity's objects, the power to spend will not permit the charity trustees to make it. For example, a charity whose objects are the relief of unemployment in London would not be able – by using its power to spend or make grants – to make a social investment in an enterprise which aims to reduce unemployment in both London and Birmingham. Nor would, a charity for the welfare of donkeys be able, by using its power to spend or make grants, to make a social investment in an enterprise which aimed to benefit both donkeys and horses. Again, this is problematic unless either the social investment can be justified wholly by the power to invest (which may not be possible) or if powers can be used in combination so that the social investment can be justified by a power to invest insofar as it goes beyond promoting the welfare of donkeys.

¹⁶ In paragraph 1.13 above we explain that the financial benefit from a social investment may be a "positive financial return" (preserving the initial capital and providing an income and/or capital growth) or a "negative financial return" (merely preserving the initial capital, or only a part of the initial capital).

¹⁷ See paragraphs 1.18 and 1.21 above.

¹⁸ That is, giving a positive financial return: see paragraphs 3.31 to 3.38 below.

The power to invest

Statutory investment power for trusts

- 3.26 Charitable trusts, and any other charities which hold some or all of their funds on trust for their charitable purposes,¹⁹ have a power of investment under section 3(1) of the Trustee Act 2000.

Subject to the provisions of this Part, a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust.²⁰

- 3.27 The general power of investment under section 3(1) of the Trustee Act 2000 does not permit investment in land, other than loans secured on land.²¹ Investments in land are instead governed by section 8(1) which permits trustees to acquire land “(a) as an investment, (b) for occupation by a beneficiary, or (c) for any other reason” but only in the United Kingdom.²²

Limitations on the statutory investment power

- 3.28 The statutory power of investment may be restricted or excluded by the trust deed.²³ If the trust deed contains a limit on the trustees’ power to invest or if there is uncertainty as to the scope of the power, an application to court can be made under section 57 of the Trustee Act 1925,²⁴ or to the Charity Commission under section 105 of the Charities Act 2011,²⁵ to authorise a particular transaction or to expand the trustees’ powers. The trustees may also pass a resolution modifying their investment powers under section 280 of the Charities Act 2011.

Express power of investment

- 3.29 Where charities are not trusts and do not hold their funds on trust, they cannot rely on the Trustee Act 2000 for a power of investment. However, a power of

¹⁹ By which we mean trustees in the technical legal sense, as opposed to “charity trustees” generally as defined in section 177 of the Charities Act 2011: see paragraph 1.38 above.

²⁰ For an explanation of the position before the Trustee Act 2000, see the Law Commission’s and Scottish Law Commission’s Report, *Trustees’ Powers and Duties* (1999) Law Com No 260, Scot Law Com No 172, paras 2.3 to 2.12.

²¹ Trustee Act 2000, s 3(3).

²² Where property already forms part of the trust, the trustees have all the powers of an absolute owner: *Trusts of Land and Appointment of Trustees Act 1996*, s 6(1). There are limits on charity trustees’ powers to dispose of, and mortgage, land in Part 7 of the *Charities Act 2011*, which will be considered in the next phase of our project on *Selected Issues in Charity Law*: see paragraph 3 of our terms of reference.

²³ Trustee Act 2000, s 6(1). However, the general power of investment overrides any restriction in a trust deed pre-dating 2 August 1961 when the *Trustee Investment Act 1961* came in to force: section 7(2). In any trust post-dating 2 August 1961, any power of investment conferred under the *Trustee Investment Act 1961* is deemed to confer the general power of investment under section 3(1) of the *Trustee Act 2000*: section 7(3).

²⁴ See D Hayton, P Matthews and C Mitchell, *Underhill & Hayton – The Law of Trusts and Trustees* (18th ed 2010) paras 43.21 and 43.108.

²⁵ The Charity Commission cannot, however, authorise anything that is expressly prohibited by the trust deed: *Charities Act 2011*, s 105(8).

investment may be conferred on charity trustees by the governing document.²⁶ The articles of a charitable company, for example, will often include a power of investment.²⁷ A catch-all power in the governing document may be sufficient to confer a power to invest.

- 3.30 A CIO's constitution may also include a power of investment, although this is probably unnecessary given the wide power conferred on CIOs by statute to "do anything which is calculated to further its purposes or is conducive or incidental to doing so".²⁸

The meaning of "investment": does it include social investment?

- 3.31 In the light of what we say above it is unlikely that any charity trustees will find themselves without a power to invest. The question then arises: can social investments be made by using that power?
- 3.32 Where there is an express power of investment, the meaning of "invest" and the extent of the trustees' power will depend on the construction of the governing document.²⁹ As to the meaning of "investment" under section 3 of the Trustee Act 2000, there is some uncertainty (which may also exist when construing an express power to invest in a trust deed), because the Trustee Act 2000 does not define "investment". In the Law Commission's Report, *Trustees' Powers and Duties*, on which the Trustee Act 2000 was based, it was stated that the absence of a definition was deliberate and that "the notion of what constitutes an investment is an evolving concept, to be interpreted by the courts".³⁰
- 3.33 Originally an "investment" had to produce income as well as safeguarding the capital.³¹ It is clear that "investment" now includes an asset that does not produce an income but which grows in capital value.³² In discussing the general power of

²⁶ In the absence of an express power, charities may be able to amend their governing document to include an express power of investment: see paragraph 3.49 below.

²⁷ The Charity Commission's model articles for a charitable company, available at <http://www.charitycommission.gov.uk/media/94703/gd1textc.pdf> (last visited 9 April 2014) confer a power of investment in clause 5(10).

²⁸ Charities Act 2011, s 216(1).

²⁹ See, for example, *Re Wragg* [1919] 2 Ch 58 at 64 by Lawrence J.

³⁰ *Trustees' Powers and Duties* (1999) Law Com No 260, Scot Law Com No 172, para 2.28, fn 56.

³¹ *Re Somerset* [1894] 1 Ch 231 at 247. These comments were not affected by the appeal to the Court of Appeal. Lawrence J took a similar view in *Re Wragg* [1919] 2 Ch 58 at 64 to 65. (These cases predated the Trustee Act 2000, but would have been relevant to the interpretation of the earlier Trustee Act 1925 and Trustee Investment Act 1961 – see fn 20 above.) This view was criticised in Andrew Hicks, "The Trustee Act 2000 and the modern meaning of 'investment'" (2001) 15(4) *Trust Law International* 203. Hicks argued that "the meaning of investment for the purpose of trust law is relative and, in the absence of any special considerations to the contrary, evolves in line with commercial practice": at 204.

³² This was the conclusion of the Law Commission in *Trustees' Powers and Duties* (1999) Law Com No 260, para 2.28, fn 56, noting Sir Donald Nicholls VC's statement in *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1246 that one reason for trustees holding property is "for the purpose of generating money, whether from income or capital growth, with which to further the work of the trust. In other words, property held by trustees as an investment." See also *Marson (Inspector of Taxes) v Morton* [1986] 1 WLR 1343 at 1350 by Sir Nicholas Browne-Wilkinson VC.

investment in section 3(1) of the Trustee Act 2000, the authors of *Underhill and Hayton* say:

an investment is considered to cover any asset acquired for a portfolio for the sake of its income yield or anticipated capital profit or both. Thus, the purchase by trustees of depreciating chattels for a villa that is trust property or the purchase of a depreciating car for use by a beneficiary would not amount to an investment.³³

- 3.34 The trustees' intention is relevant to whether something is an "investment".³⁴ Something can be an investment even if the financial return is not the principal purpose of the outlay of funds.³⁵ Similarly, something can be an investment even if it does not achieve a market rate of return.³⁶
- 3.35 What is not clear is whether a power of investment can be used even where there is no anticipated positive financial return,³⁷ or where the financial return is so uncertain that it cannot be said that a positive financial return is reasonably anticipated. From one case it appears not.³⁸ It has been suggested in a New

³³ D Hayton, P Matthews and C Mitchell, *Underhill & Hayton – The Law of Trusts and Trustees* (18th ed 2010) para 49.9. See also J Warburton, *Tudor on Charities* (9th ed 2003) para 6-024 to similar effect.

³⁴ See *Re Power* [1947] Ch 572 at 575 by Jenkins J.

³⁵ For example, in *Cook v Medway Housing Society* [1997] STC 90, the court considered whether the Medway Housing Society was an "investment company" under section 130 of the Taxes Act 1988 so as to entitle it to a certain tax relief. The statutory definition required consideration of whether the company's business involved "the making of investments". The company's objects were to provide housing to people in need at low rents. The housing portfolio "was intended over time to produce a profitable capital and income return" and was therefore an "investment". Lightman J said "it seems to me perfectly possible for a property at the same time to be held to provide affordable housing and to provide a profitable return, and for the Society's business to be the provision of affordable housing and to be that of holding such housing to achieve a profitable return": at 98.

³⁶ In *Cook v Medway Housing Society* [1997] STC 90, Lightman J said that "the critical question is whether the holding of assets *to produce a profitable return* is merely incidental to the carrying on of some other business, or is the very business carried on by the taxpayer. In this case the very business of the Society is the provision of housing at a return below the market return, *but nonetheless a return producing a profit*" (emphasis added): at 101.

³⁷ That is, nothing over and above repayment of the initial capital outlay: see paragraph 1.13 and fn 16 above.

³⁸ In *CIR v 1933 Housing Society Limited* [1946] ATC 355, the relevant tax relief was available unless the society's business involved dealing in or holding investments. The society provided housing for the working classes. The society's housing stock did not produce a profitable income stream and had a life expectancy of only 30 to 40 years. Atkinson J held that the society's business did not involve dealing in or holding investments; the housing stock was held for the purposes of occupation by the working classes, not for the benefit of the society's members or for the society's own benefit. This may, however, be a prime example of a case where the decision was (very properly) driven by its own facts and not by any wish to lay down a general principle. It can be contrasted with *Cook* (see fn 35 above), where the relevant tax relief was only available if the property was an investment.

Zealand case³⁹ that a partial return of capital, together with other non-monetary benefits can be regarded as an investment. So it is arguable that a social investment that only anticipates the repayment of some of the initial capital outlay – a negative financial return – is still an investment by reason of the totality of the benefits from the transaction, and that a power of investment can therefore be used to make such a social investment. Our view of the current law, however, is that a power to invest can only be used to make a social investment if it is anticipated to provide a positive financial return, by which we mean a return beyond mere repayment of the initial capital outlay.⁴⁰

- 3.36 However, in many cases of social investment the charity trustees will know that there will not be a return in this sense – for example where the social investment is likely to result in the return only of part of the capital outlay.⁴¹ Other social investments may be high risk so that charity trustees cannot reasonably conclude that they will produce a positive financial return. On the English authorities, we cannot say with confidence that charity trustees can make such social investments solely by relying on a power to invest, although of course we do not know what view a court would take if the point were to be tested.⁴²
- 3.37 There is a further difficulty. Where the social investment is expected and intended to produce a return, but a very poor one, we take the view that it amounts to investment. So the trustees have power to make it. But charity trustees who are trustees in the technical legal sense⁴³ are subject, when they invest, to duties imposed by the Trustee Act 2000.⁴⁴ Those duties may mean that it is not feasible to rely solely on a power to invest when making social investments because to do so may amount to a breach of duty – in particular, the duty to have regard to the standard investment criteria including the importance of maintaining a balanced portfolio of investments in the light of the risks involved and the return anticipated (which we discuss below). A social investment may achieve a lot in terms of the charity’s mission even though, if it were looked at without the mission achievement and purely as a financial proposition, it would have to be regarded

³⁹ *Culverden Retirement Village Ltd v Registrar of Companies* [1997] AC 303 concerned the owners of dwellings at a retirement village who were obliged to transfer back their dwellings, when they ceased to occupy them, at an adjusted price. The Privy Council considered whether the purchasers had made an “investment of money” under section 5(1)(b) of New Zealand’s Securities Act 1978. The Privy Council stated that “buyers of units would say they have invested their money in buying a townhouse in Culverden Retirement Village on terms that they will occupy this, with necessary services provided, for so long as they wish and that they will then get back all or a large part of their outlay. The return from their outlay is to be found in the totality of these benefits, not just the financial repayment at the end”: at 311.

⁴⁰ See paragraph 1.13 above.

⁴¹ See paragraph 2.5 above.

⁴² It might be that a court in England or Wales would follow the approach taken by the Privy Council in *Culverden Retirement Village Ltd v Registrar of Companies* [1997] AC 303; if it did, there would cease to be an issue of whether charity trustees with a power to invest can make social investments.

⁴³ See paragraph 1.38 above.

⁴⁴ Even charity trustees who are not trustees in the technical legal sense may be concerned by the duties imposed by the Trustee Act 2000 since many, following section C2 of CC14, will wish to comply with those duties as a matter of good practice.

as too risky or yielding too low a financial return, even in the context of the charity's overall portfolio.

- 3.38 Accordingly, we think that there is real uncertainty as to the use of a power to invest, by itself, to justify social investment where there is no anticipated positive financial return. We cannot be confident that an interest-free loan, or an arrangement whereby less than the initial outlay will be returned, can be justified in this way. And there is a risk that trustees (in the technical legal sense) will be in breach of their duties under the Trustee Act 2000 where a social investment is particularly risky or where it is regarded as yielding too low a (positive) financial return. Again, there is no difficulty if the social investment in question can be justified solely by the power to spend, by a combination of powers, or by a catch-all power.

Combining the power to invest and the power to spend

- 3.39 It will be seen from the discussion above that there are circumstances where charity trustees have a power to spend and a power to invest, but neither power alone will permit them to make particular social investments. Either the financial element may be thought to make it implausible to describe the activity as spending; or the investment may achieve neither income nor capital growth even though the charity trustees expect to get some of their expenditure back so that the social investment cannot be safely regarded as an investment; or even where there is a positive financial return it may be too low⁴⁵ for the trustees to regard it, safely, as an exercise of a power to invest because they may be at risk of failing in the duties that accompany the power to invest.
- 3.40 In our view, in these circumstances charity trustees are likely to be able to exercise those powers concurrently in order to make social investments.
- 3.41 A social investment is, by definition, intended to yield some form of financial return,⁴⁶ which could realistically be regarded as a positive financial return on part of the initial outlay if not on all of it; and at the same time, again by definition, it is intended to achieve the charity's purpose. If charity trustees want to do both at once, it is difficult to see why they should not be able to exercise their powers to spend and to invest in the same transaction to achieve their charitable purposes.
- 3.42 Indeed, certain social investments are anticipated by legislation. The restrictions on disposals of a charity's land⁴⁷ do not apply to the grant by the charity of a lease at below-market rent to enable a beneficiary of the charity to occupy the property for the charity's purposes. This would permit a housing charity to grant a lease to a beneficiary at a low rent, or a charity for the relief of unemployment to grant a lease at a low rent to a start-up business which would offer jobs.⁴⁸ The grant of a low-rent lease to such a business would amount to a social investment – it is a transaction from which the charity will receive a positive or negative

⁴⁵ In the sense either that it will certainly yield a very low financial return or that the financial return anticipated is so high risk as to be improbable.

⁴⁶ See paragraph 1.13 above.

⁴⁷ See Charities Act 2011, ss 117 to 121.

⁴⁸ The latter is an example given by the Charity Commission in *Review of the Register of Charities, Charities for the Relief of Unemployment* (March 1999), paras 5 and A7.

financial return,⁴⁹ and it also achieves the charity's objects. The Charities Act 2011 therefore anticipates social investment.

3.43 However, there is some doubt whether charity trustees can exercise both powers in order to make a social investment.

3.44 First, as discussed above, *Rosemary Simmons* may suggest that a general catch-all power does not permit social investment. The charity in that case would also, in all likelihood, have had a power to invest and a power to spend, yet those powers did not give the charity power to execute the guarantee any more than did the general catch-all power.

3.45 Secondly, as discussed in paragraphs 3.31 to 3.38 above, it seems that the power to invest can only be used if a social investment is anticipated to provide some income or capital return. If a social investment is not anticipated to provide a positive financial return, or if the financial return is so uncertain that it cannot properly be called an investment, it is arguable that the power to invest provides no assistance; an investment power cannot be "topped up" by a spending power to justify no, or a negative, financial return. We would counter that argument by saying that a negative return can be justified as an investment of part of the sum advanced. So the expenditure of £100,000 as an interest-free loan cannot be regarded as an investment of £100,000; but it might be regarded as an investment of £90,000, leaving £10,000 to be regarded as a grant and justified by the power to spend. That might be seen as rather an artificial way of looking at the social investment, and we conclude later⁵⁰ that this sort of calculation is unhelpful. But this way of looking at social investment would enable the charity trustees to regard loss-making social investments as, nevertheless, investments.

3.46 Thirdly, the author of *Tudor on Charities* states: "[charities] must generally invest in such a way as to provide the greatest financial benefits for the beneficiaries." The author continues:

Charity trustees, however, cannot use their powers of investment to make, say, loans at low rates of interest to an organisation or individual which is carrying out a project that will aid the charity's beneficiaries. A charity may well be able to make this type of social- or programme-related investment to assist projects within its objects by using other powers, for example, that to make grants.⁵¹

The author's suggestion that there are two separate powers and that they cannot both be used at the same time to make a social investment indicates that there is some uncertainty as to whether the powers can be exercised together.

Conclusions about the power to make social investments

3.47 The discussion above leads us to the conclusion that while charity trustees will often have the power to make social investments, they may not be sure they have it, and in some cases they will not have it. This is because unless their

⁴⁹ See paragraph 1.13 above.

⁵⁰ See paragraphs 3.105 to 3.108 below.

⁵¹ J Warburton, *Tudor on Charities* (9th ed 2003) para 6-026.

governing document provides an express power to make social investments they are reliant on either the power to spend – which may involve a strained interpretation of that power, depending on the level of financial return envisaged,⁵² and is limited to social investments that only pursue the charity's purposes⁵³ – or the power to invest – which may not be available where there is a negative or high-risk financial return,⁵⁴ and may put trustees at risk of breach of duty.⁵⁵ And it is not entirely clear that the powers to spend and to invest can be combined where neither justifies the social investment by itself.

- 3.48 For charity trustees to ascertain whether they have the power to make social investments, they may have to carry out a detailed legal analysis (as we have done above) or, more likely, to engage lawyers to do that analysis for them. Many charity trustees do not have the necessary legal expertise and many do not wish to use their charity's limited resources to obtain legal advice. Even when charity trustees seek legal advice, they may be told that the law is unclear.
- 3.49 A further option is for charity trustees to seek to amend their charity's governing document to ensure that they have the necessary power. Unincorporated charities may pass a resolution to modify the powers exercisable by their charity trustees "in the administration of the charity" under section 280 of the Charities Act 2011, but we have heard that this power is little used.⁵⁶ Charity trustees may be able to make such amendments by other means,⁵⁷ but the procedures may be administratively burdensome, time-consuming and expensive, and an attempt to use a statutory power of amendment may be unsuccessful. Indeed, the costs may not be justified if the charity trustees only wish to make one small social investment in the first instance. Charities established by royal charter or by statute often face particular difficulties in amending their governing documents and we will be considering this issue in the next stage of our project.

⁵² See paragraphs 3.23 to 3.24 above.

⁵³ See paragraph 3.25 above.

⁵⁴ See paragraphs 3.31 to 3.36 above.

⁵⁵ See paragraph 3.37 above. We discuss the consequences of such a breach in paragraph 3.8 above.

⁵⁶ There is minimal discussion of the power in textbooks or in Charity Commission guidance, the latter being limited to *Changing your charity's governing document* (CC36) (August 2011), section C3 and *OG519 Unincorporated Charities: Changes to Governing Documents and Transfer of Property (Charities Act sections 268, 275 and 280)* (updated October 2012), section B5.4. We can see three potential difficulties with using this power of amendment to authorise charity trustees to make social investments. First, it is of no assistance to incorporated charities. Secondly, the meaning of the phrase "in the administration of the charity" is uncertain; it could be interpreted broadly as covering any power for carrying out the charity's purposes, which would include a power to make social investments, but it may be interpreted narrowly as being confined to administrative powers such as employing staff (although such an argument ought to apply equally to the same phrase in section 105 of the Charities Act 2011, which is interpreted broadly by the Charity Commission: see Charity Commission, *OG545-1 Identifying and Spending Permanent Endowment* (December 2012), section E1.2). Thirdly, section 280 permits modification of powers and arguably conferring a new power to make social investments would be the creation, rather than modification, of a power.

⁵⁷ The governing document may have a defined procedure for its amendment by resolution. If it does not, there are statutory powers under the Trustee Act 1925, s 57, and Charities Act 2011, s 105, for charities' constitutions to be amended: see paragraph 3.28 above.

- 3.50 Accordingly, in our view, the current law concerning charity trustees' powers is uncertain, at best, and probably also inadequate.

CHARITY TRUSTEES' DUTIES

- 3.51 In addition to their need to be sure that they have the power to make social investments, charity trustees will be concerned not to be in breach of any of their duties when doing so. Compliance by charity trustees with their duties is important to maintaining the reputation of charities. Further, if trustees breach their duties, they may be personally liable for their actions, which can visit a significant financial loss on charity trustees.⁵⁸
- 3.52 We have to consider charity trustees' duties under a number of headings. First, we look at the duties to which all charity trustees (in the broadest sense in which we are using that term, whether or not the charity is in fact a trust)⁵⁹ are subject, whether or not they are investing. We mention them by way of background only because they do not appear to give rise to difficulties in the context of social investment.⁶⁰ Secondly, we look at the duties to which all charity trustees (in the broadest sense, again) are subject when they are investing. We note the possibility of concern, if it is thought that social investment conflicts with a supposed duty always to get the best financial return from investments. Thirdly, we look at the duties arising under the Trustee Act 2000, which apply only to trustees in the technical legal sense, when they are investing. We take the view that the nature of social investments may bring such trustees into conflict with these duties.

The core duties of all charity trustees

- 3.53 The core duties of all charity trustees, in the broadest sense and whether or not the charity is in fact a trust, are the same.⁶¹ Principally, they must act in the best interests of the charity.⁶² There has been some statutory codification of the core duties for company directors⁶³ and for the charity trustees of CIOs.⁶⁴ All charity

⁵⁸ See paragraph 3.8 above.

⁵⁹ See paragraph 1.38 above.

⁶⁰ Trustees' duties are being considered in the Law Commission's project on the Fiduciary Duties of Investment Intermediaries (Law Commission Consultation Paper No 215): see paragraph 1.39 above.

⁶¹ See Charity Commission, *The Essential Trustee: What you need to know* (CC3) (March 2012), sections D and E2, available at http://www.charitycommission.gov.uk/media/94159/cc3_lowink.pdf (last visited 9 April 2014).

⁶² *Harries v Church Commissioners* [1992] 1 WLR 1241; *Cowan v Scargill* [1985] Ch 270. There is some academic debate in the trust context as to the meaning of a duty to act in the best interests of the beneficiaries of the trust: see S Hulme, "The Basic Duty of Trustees of Superannuation Trusts—Fair to One, Fair to All?" [2010] *Trust Law International* 130; J Lehane, "Delegation of Trustees' Powers and Current Developments in Investment Funds Management" (1995) 7 *Bond Law Review* 36 at 37; G Thomas, "The Duty of Trustees to Act in the 'Best Interests' of their Beneficiaries (2008) 2 *Journal of Equity* 177 at 202; Lord Nicholls, "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) 70 *Australian Law Journal* 205 at 211.

⁶³ See Part 10 of the Companies Act 2006, and in particular section 172(1) (as altered by s 172(2) in the case of charitable companies).

⁶⁴ Charities Act 2011, s 221(1).

trustees, in this broad sense, are fiduciaries, and owe fiduciary duties.⁶⁵ We considered the nature of trustees' fiduciary duties in detail in our consultation paper *Fiduciary Duties of Investment Intermediaries*.⁶⁶ The distinguishing feature of the fiduciary duty is the duty of loyalty,⁶⁷ which has four elements: the "no conflict rule"; the "no profit rule"; the "undivided loyalty rule"; and the "duty of confidentiality".⁶⁸

- 3.54 In *Scott v National Trust for Places of Historic Interest or Natural Beauty*,⁶⁹ the Judge said:

I have heard a lot of submissions about the duties of trustees in making decisions in exercise of their fiduciary functions. Certain points are clear beyond argument. Trustees must act in good faith, responsibly and reasonably. They must inform themselves, before making a decision, of matters which are relevant to the decision. These matters may not be limited to simple matters of fact but will, on occasion (indeed, quite often) include taking advice from appropriate experts, whether the experts are lawyers, accountants, actuaries, surveyors, scientists or whomsoever. It is however for advisers to advise and for trustees to decide: trustees may not (except in so far as they are authorised to do so) delegate the exercise of their discretions, even to experts. This sometimes creates real difficulties, especially when lay trustees have to digest and assess expert advice on a highly technical matter (to take merely one instance, the disposal of actuarial surplus in a superannuation fund).⁷⁰

- 3.55 The standard expected of trustees was considered in *Pitt v Holt*.⁷¹ In considering the duty to take into account relevant matters and to disregard irrelevant matters, Lord Walker said:

it is not enough to show that the trustees' deliberations have fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way.

⁶⁵ For charitable trusts see *Keech v Sandford* 25 ER 223; *Price v Blakemore* 49 ER 922; H Picarda QC, *The Law and Practice Relating to Charities* (4th ed 2010) p 633. For unincorporated associations see J Warbuton, *Tudor on Charities* (9th ed 2003) para 6-037 which states that members of the committee "are probably under a fiduciary duty although there is no direct authority on the point". Warbuton concludes that they are subject to fiduciary duties in "Charity Members: Duties and Responsibilities" [2006] *Conveyancer and Property Lawyer* 330 at 349. For charitable companies and other incorporated charities see *Aberdeen Railway Company v Blaikie Bros* (1854) 17 D (HL) 20, 2 Eq Rep 1281; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134; and *Re French Protestant Hospital* [1951] 1 Ch 567.

⁶⁶ Law Commission Consultation Paper No 215.

⁶⁷ Law Commission Consultation Paper No 215, paras 5.15 to 5.32.

⁶⁸ Law Commission Consultation Paper No 215, para 5.19 and following. The fourfold classification was taken from the 1992 Law Commission Consultation Paper on *Fiduciary Duties and Regulatory Rules*: see Law Commission Consultation Paper No 124, para 2.4.9.

⁶⁹ [1998] 2 All ER 705.

⁷⁰ [1998] 2 All ER 705 at 717.

⁷¹ [2013] UKSC 26, [2013] 2 AC 108.

Apart from exceptional circumstances ... only breach of fiduciary duty justifies judicial intervention.⁷²

- 3.56 Further, when deciding how to apply their funds, charity trustees must comply with the charity's governing document and pursue the objects of the charity. Naturally, trustees should seek to obtain the greatest mission benefit from the money they spend, but they have a wide margin of discretion. There is no duty to consider particular factors and no duty to obtain advice.
- 3.57 The core duties of all charity trustees are well-established and we have heard no indication that they give rise to any concern or confusion in the context of social investment by charities. Of course, when they consider making a social investment, as with all decisions of charity trustees, they must satisfy themselves that a social investment is in the charity's best interests before they commit to it.

The duties of all charity trustees when investing

- 3.58 Next, we consider the duties specifically associated with investment, again for all charity trustees in the broadest sense. Here we have to consider two well-known cases.

Cowan v Scargill

- 3.59 *Cowan v Scargill*⁷³ concerned a dispute between the trustees of a mineworkers' pension fund. Half of the trustees were appointed by the National Coal Board and half by the National Union of Mineworkers. The Union trustees raised objections to any overseas investment and investment in oil. These were points of Union policy and, the Union argued, were for the benefit of the beneficiaries. Sir Robert Megarry VC held that the Union trustees were in breach of their fiduciary duties by refusing to approve an investment plan which involved such investments. He said:

the starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.⁷⁴

⁷² [2013] UKSC 26, [2013] 2 AC 108 at [73].

⁷³ [1985] Ch 270.

⁷⁴ [1985] Ch 270 at 286 to 287.

- 3.60 The Judge said that trustees can take into account social and political reasons when making investment decisions, provided this is not to the financial detriment of the beneficiaries.⁷⁵
- 3.61 He concluded that the success of the mining industry would not affect all of the beneficiaries;⁷⁶ applying rigid Union policy was not for the benefit of the beneficiaries;⁷⁷ and imposing blanket prohibitions on certain investments would not assist the trustees to pursue the beneficiaries' best interests.⁷⁸ The Union trustees were therefore in breach of their duties.

Harries v Church Commissioners

- 3.62 In paragraph 3.4 above, we set out Sir Donald Nicholls VC's statement in *Harries v Church Commissioners*⁷⁹ that trustees' duties are to further the purposes of the trust. The case concerned the Church Commissioners' investment policy. The Judge said that property will usually be held by a charity for functional purposes (for example, a village hall) or as an investment for the purpose of generating money. As regards investment property, he said that:

where property is so held, prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish.

In most cases this prima facie position will govern the trustees' conduct. In most cases the best interests of the charity require that the trustees' choice of investments should be made solely on the basis of well-established investment criteria, having taken expert advice where appropriate and having due regard to such matters as the need to diversify, the need to balance income against capital growth, and the need to balance risk against return.⁸⁰

- 3.63 The Judge then went on to set out the extent to which charity trustees could take ethical considerations into account in making investment decisions. He concluded that trustees should not invest in organisations that conflicted with the charity's objects⁸¹ and that they can decline to invest if a particular investment would hamper the charity's work for example by alienating those who support the

⁷⁵ [1985] Ch 270 at 287, though the Judge added that if the beneficiaries are a small class and are known by the trustees to share a strong ethical view, it may be permissible for the trustees to reflect those views in their investment decisions even if that would be financially detrimental: at 288.

⁷⁶ [1985] Ch 270 at 292.

⁷⁷ [1985] Ch 270 at 293 to 294.

⁷⁸ [1985] Ch 270 at 294 to 295.

⁷⁹ [1992] 1 WLR 1241.

⁸⁰ [1992] 1 WLR 1241 at 1246.

⁸¹ [1992] 1 WLR 1241 at 1246.

charity financially.⁸² Beyond that, charity trustees can only consider moral matters when making investment decisions “so long as the trustees are satisfied that course would not involve a risk of significant financial detriment”.⁸³

3.64 During the course of this discussion, the Judge also said:

no doubt there will be other cases where trustees are justified in departing from what should always be their starting point. The instances I have given are not comprehensive. But I must emphasise that of their very nature, and by definition, investments are held by trustees to aid the work of the charity in a particular way: by generating money. That is the purpose for which they are held. That is their *raison d'être*. Trustees cannot properly use assets held as an investment for other, *viz*, non-investment, purposes. To the extent that they do they are not properly exercising their powers of investment.⁸⁴

3.65 The principles in *Cowan* and in *Harries* apply to all charity trustees, whether they are trustees of an unincorporated charity or those responsible for running an incorporated charity.⁸⁵ In our view, the two cases should not be read as preventing social investment. The purpose of the trust in *Cowan* was to provide pensions. The best interests of the beneficiaries in that case necessarily required the trustees to maximise the financial return from their investments. This is not the case for all charities; it should not be assumed that funds which are not spent should always be invested to achieve the best financial return.

3.66 Similarly, *Harries* concerned trustees' powers of investment where the purpose of holding the money was to generate a financial return. The objects of the Church Commissioners were “[to provide] financial assistance for clergy of the Church of England”.⁸⁶ The reasoning does not prevent charity trustees from engaging in social investment where the purpose of the trust is to pursue charitable objects, rather than to generate a financial return. Indeed, in *Harries*, it was anticipated there would be circumstances in which trustees would be justified in making investments that did not yield the best financial return; the Judge said that the best financial return was only “the starting point”.

3.67 However, if charity trustees consider that, when exercising an investment power in a social investment context, they have a duty to obtain the best financial return, then it may be that the case law, and in particular *Cowan* and *Harries*, is causing problems and that clarification is needed.

⁸² [1992] 1 WLR 1241 at 1247.

⁸³ [1992] 1 WLR 1241 at 1247.

⁸⁴ [1992] 1 WLR 1241 at 1247.

⁸⁵ *Harries* concerned the Church Commissioners, a corporate body incorporated by Act of Parliament. Sir Donald Nicholls VC said that the assets were held by the Commissioners as a corporate body and not as trustees, following Slade J's reasoning in *Liverpool & District Hospital for Diseases of the Heart v Attorney General* [1981] Ch 193 at 209. However, the Judge said that this was not relevant in the proceedings, and that the position would have been no different if the Commissioners were unincorporated and they held the assets as trustees.

⁸⁶ [1992] 1 WLR 1241 at 1248.

Charitable trusts: duties of charity trustees when investing

- 3.68 Thirdly, we turn to trustees who are in the technical legal sense trustees and who are therefore subject to the provisions of the Trustee Act 2000.⁸⁷ Here we enter rather different territory because, on these charity trustees only, the statute imposes three specific duties when they exercise a power of investment, whether arising under section 3(1) of the Trustee Act 2000 or under the trust deed.
- 3.69 First, the trustees must have regard to the “standard investment criteria”.⁸⁸ These are:
- (a) the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind, and
 - (b) the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust.⁸⁹
- 3.70 Secondly, trustees must review their investments periodically and consider whether they should be varied, again having regard to the “standard investment criteria”.⁹⁰
- 3.71 Thirdly, before exercising a power of investment and when reviewing their investments, a trustee must obtain and consider “proper advice”,⁹¹ unless he or she “reasonably concludes that in all the circumstances it is unnecessary or inappropriate to do so”.⁹²
- 3.72 The Trustee Act 2000 duties apply whenever trustees exercise “any power of investment”. Accordingly, if a social investment is an “investment”, then trustees must comply with the Trustee Act 2000, whether the trustees are exercising an express power to make a social investment, or relying on a catch-all power. Arguably the Trustee Act 2000 will not apply if the trustees can make the same social investment using their power to spend. If the trustees are exercising an investment and a spending power together, there is some logic to suggesting that the Trustee Act 2000 only applies to the exercise of the investment power, and that the trustees must therefore separate the social investment into two elements and obtain advice on the financial aspect, but not the mission aspect, of the social investment. However, that would be an artificial exercise as the social investment is just one transaction and should be considered holistically. If considered holistically, then the Trustee Act 2000 requirements would have to apply to the entire transaction.

⁸⁷ See paragraph 1.38 above.

⁸⁸ Trustee Act 2000, s 4(1).

⁸⁹ Trustee Act 2000, s 4(3).

⁹⁰ Trustee Act 2000, s 4(2).

⁹¹ “Proper advice” is “the advice of a person who is reasonably believed by the trustee to be qualified to give it by his ability in and practical experience of financial and other matters relating to the proposed investment”: Trustee Act 2000, s 5(4).

⁹² Trustee Act 2000, s 5(1) to (3).

- 3.73 The Trustee Act 2000 will not apply if the power of investment is being exercised by non-trustees, for example, by the directors of a charitable company or by the charity trustees of a CIO. Arguably it is arbitrary that the requirements differ depending on the legal form of the charity.
- 3.74 We need to consider whether the three duties just considered cause difficulty in the context of social investment.

(1) Standard investment criteria

- 3.75 The first requirement is to consider the standard investment criteria. This ensures that an investment portfolio comprises investments that are suitable for the trust, suitable in their own right when compared with like investments, and diversified to take account of risk. There are at least some social investments which may be entirely appropriate for a charity to make, but which would not rate highly under the standard investment criteria; when compared with a mainstream financial investment, a given social investment may carry a particularly high risk or it may be unjustifiably large within a charity's investment portfolio (or conversely, unjustifiably small and disproportionate to the fixed transaction costs). Whilst the standard investment criteria may be an appropriate and complete set of considerations for some social investments, it is likely that they will either be inappropriate or at least insufficient in themselves for many social investments.
- 3.76 Moreover, our discussions have indicated that trustees may be unaware that they are required to consider the standard investment criteria when making a social investment because the activity does not fall within their mainstream investment activities. So this aspect of the Trustee Act 2000 duties may constitute a trap for the unwary.

(2) Reviewing investments

- 3.77 The second requirement is to review investments periodically against the standard investment criteria. Trustees have a discretion as to the frequency of review, and are likely to review their social investments on a periodic basis as a matter of good practice in any event. Arguably, review does no harm; the mischief here, if there is one, is again that trustees may be unaware of the specific duty.

(3) Obtaining advice

- 3.78 The third requirement is to obtain "proper advice", unless the trustees consider this unnecessary or inappropriate. Trustees are not required to obtain advice, but they are expected to consider whether to do so and make a decision. They will often wish to obtain advice but may find a dearth of appropriate advisers on social investments. Many established financial advisers have not yet developed the relevant experience or expertise in relation to such investments. Social investments necessarily stray away from the field of mainstream investments and into the territory of the charity's mission – on which the trustees' own judgement is invaluable – and trustees may legitimately consider that advice on a social investment is unnecessary.

Conclusion

- 3.79 In the light of what we say above about duties we take the view that there are two possible reasons why charity trustees making social investments may be, or may feel that they are, in danger of being in breach of their duties.
- 3.80 First, charity trustees may be dissuaded from making social investments because they believe it conflicts with their duty – and this is a general duty applying to charity trustees in the broadest sense⁹³ – to obtain the best financial return.
- 3.81 Secondly, so far as trustees in the technical legal sense are concerned, the application of the Trustee Act 2000 to social investment decisions is unclear and confusing. In so far as the Trustee Act 2000 does apply, the duty to consider the standard investment criteria may not be appropriate and – together with the duty to review investments periodically and to consider taking advice – may present traps for unwary trustees.

PRIVATE BENEFIT

Introduction

- 3.82 In Chapter 1, we explained that charities must have exclusively charitable purposes and must exist for the benefit of the public.⁹⁴ An organisation cannot be a charity if it is established for the purpose of benefiting an individual or an organisation otherwise than in the course of carrying out a charitable activity.⁹⁵
- 3.83 Charity trustees must be conscious of private benefit restrictions when deciding on any outlay of charitable funds. Indeed, the Charity Commission's investment guidance, CC14, makes frequent reference to it, alerting charity trustees to the risks. We are aware that private benefit is a particular concern for charities engaging in social investment.

Private benefit restrictions

- 3.84 Private benefit is relevant in two situations:
- (1) when considering whether or not an organisation has exclusively charitable purposes and exists for the public benefit in order to ascertain whether it has charitable status; and
 - (2) when charities (having already established their charitable status) carry out any activity; being a charity, they must continue to act for exclusively charitable purposes for the public benefit which, necessarily, requires them not to confer unacceptable private benefit.

⁹³ See paragraph 1.38 above.

⁹⁴ See paragraphs 1.5 and 1.6 above.

⁹⁵ The beneficiaries of a charity's charitable activities will necessarily derive some personal benefit from those activities, as where a homelessness charity provides accommodation to an individual, or a medical charity provides treatment to a patient. These personal benefits, which are inherent in achieving the charity's purposes, do not amount to unacceptable private benefit.

- 3.85 The case law on private benefit concerns (1) not (2). Accordingly, it is necessary to determine the relevant principles from (1) and apply them to (2).
- 3.86 In determining whether an organisation has exclusively charitable purposes, the courts distinguish between (i) the purpose or intention of the organisation, and (ii) the consequences of the organisation's actions. If private benefit is an organisation's purpose then the organisation will not be charitable. By contrast, if private benefit is merely a consequence of an organisation's activities, that will not preclude charitable status. Accordingly:
- (1) The Yorkshire Agricultural Society, with the object of holding an annual meeting for the exhibition of farming stock and for the general promotion of agriculture, was charitable despite the privileges enjoyed by its members, such as free admission to shows and the right to have manures and foodstuffs analysed at reduced rates.⁹⁶ The members were "benefitted in the course of promoting the charitable purpose".⁹⁷
 - (2) A trust for the benefit of orthopaedic hospitals was charitable, despite making provision for an annual dinner for the trustees and paying a fee to each committee member who attended a full meeting.⁹⁸ The testator's "motive and object in providing for the annual dinner and the guinea attendance fees was I think clearly to benefit the charity and not the members"; the private benefit was "essentially ancillary to the charitable trust".⁹⁹
 - (3) The City of Glasgow Police Athletic Association was not charitable.¹⁰⁰ Whilst increasing the efficiency of the police force would have been a charitable purpose, the recreational benefits enjoyed by members of the association were not merely incidental to the furtherance of such a charitable purpose but were ends in themselves.¹⁰¹ To be charitable, the promotion of charitable purposes does not have to be the "sole effect" of the organisation's activities, but it does have to be the organisation's "predominant object", with any private benefit being "of a subsidiary or incidental character".¹⁰²
 - (4) By contrast, a union of athletic and other clubs formed by students of the London Hospital Medical College was charitable since it existed for the purpose of assisting the college with its charitable purpose of teaching

⁹⁶ *Inland Revenue Commissioners v Yorkshire Agricultural Society* [1928] 1 KB 611.

⁹⁷ *Inland Revenue Commissioners v Yorkshire Agricultural Society* [1928] 1 KB 611 at 631.

⁹⁸ *Re Coxen* [1948] Ch 747.

⁹⁹ *Re Coxen* [1948] Ch 747 at 754 to 755.

¹⁰⁰ *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380.

¹⁰¹ *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380 at 395 to 396 by Lord Normand.

¹⁰² *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380 at 402 by Lord Reid.

medicine.¹⁰³ Benefits to the union's members, like those given to members of the Yorkshire Agricultural Society, were with a view to carrying out the union's main charitable purpose. The test was whether the private benefit was "incidental to the implementation of the purposes of the charity".¹⁰⁴

- (5) The Incorporated Council for Law Reporting for England and Wales, with the purpose of furthering the development of the law and making it accessible to all members of the community, was charitable, despite conferring a private benefit on members of the legal profession by supplying them with essential tools of their trade, *The Law Reports*.¹⁰⁵ This was "an inevitable and indeed necessary step" in achieving the Council's purposes.¹⁰⁶

3.87 The test has therefore been framed in different ways in these, and other,¹⁰⁷ cases:

- (1) the motive or intention must be the charitable purposes;
- (2) the predominant object must be the charitable purposes, even if the effect is to confer private benefit;
- (3) private benefit is acceptable if it is conferred in the course of pursuing charitable purposes; and
- (4) private benefit is acceptable if it is ancillary, subsidiary, or incidental to achieving charitable purposes, or if it is an inevitable and necessary step in achieving charitable purposes.

3.88 So much for the principles from which it can be determined whether there is unacceptable private benefit such that an organisation cannot be charitable. How, then, do they apply to the day-to-day activities of charities?

3.89 It is logical to infer that, if an organisation cannot be a charity by reason of its purposes involving the conferral of unacceptable private benefit, then equally it cannot be allowed to confer unacceptable private benefit through its day-to-day spending, investment, and other activities. In our view, the principles outlined

¹⁰³ *London Hospital Medical College v Inland Revenue Commissioners* [1976] 1 WLR 613. The express link between the union's objects and the student life of the medical college was said to distinguish the union from the City of Glasgow Police Athletic Association: [1976] 1 WLR 613 at 623.

¹⁰⁴ *London Hospital Medical College v Inland Revenue Commissioners* [1976] 1 WLR 613 at 620.

¹⁰⁵ *Incorporated Council for Law Reporting for England and Wales v Attorney General* [1972] Ch 73.

¹⁰⁶ *Incorporated Council for Law Reporting for England and Wales v Attorney General* [1972] Ch 73 at 87.

¹⁰⁷ Other cases contain similar reasoning: see, for example, *Re White's Will Trusts* [1951] 1 All ER 528, *Royal College of Surgeons of England v National Provincial Bank Ltd* [1952] AC 631, *General Nursing Council v St Marylebone* [1959] AC 540, *Neville Estates Ltd v Madden* [1962] Ch 832, and *Latimer v Commissioner of Inland Revenue* [2004] UKPC 13, [2004] 1 WLR 1466 at [35] and [36].

above concerning an organisation's charitable status (see paragraph 3.87 above) apply equally to the individual activities of a charity;¹⁰⁸ charities should not carry out an activity that confers more than an incidental private benefit. The application of those principles, and the relevant considerations, will differ depending on the nature of the activity in question.

- 3.90 It seems to us that the consequences of conferring unacceptable private benefit would be (a) to threaten the tax reliefs available in respect of charitable investing,¹⁰⁹ (b) potentially to threaten the organisation's charitable status, or (c) to render the transaction void as an ultra vires act of the charity and possibly to visit personal liability on the trustees.¹¹⁰ Much will depend on the facts.
- 3.91 The test for what amounts to an unacceptable private benefit can be formulated in the various ways set out in paragraph 3.87 above. The Charity Commission's view is that charity trustees may confer no more than an incidental private benefit when investing the charity's funds, "incidental" in this context meaning (a) necessary in the circumstances, (b) reasonable in amount, and (c) in the interests of the charity.¹¹¹
- 3.92 The various formulations of the test are perhaps different ways of expressing the same underlying concept; there are uncertainties as to the precise test.
- 3.93 Further, whether private benefit is unacceptable is a question of fact and degree and there will often be scope for argument. This is demonstrated by the differing judicial opinions in much of the case law referred to in paragraph 3.86 above.¹¹² This can cause charity trustees concern, particularly as unacceptable private benefit may have unfavourable tax consequences for the charity or may threaten its charitable status.

¹⁰⁸ Although it has been suggested to us that the principles are not the same and that, in relation to day-to-day activities, a charity can confer significant private benefit provided it obtains value for money. We acknowledge that there is difficulty in ascertaining the principles for day-to-day activities, given the dearth of case law on this issue.

¹⁰⁹ There are tax exemptions available for "approved charitable investments" and "approved charitable loans" under the Income Tax Act 2007 (for unincorporated charities) and the Corporation Tax Act 2010 (for charitable companies): see paragraphs 6.6 to 6.10 below. If an investment or loan is not an automatically approved investment, it will only be approved if HMRC is satisfied that it is "for the benefit of the charitable trust and not for the avoidance of tax". It is arguable that an investment that confers unacceptable private benefit is not for the benefit of the charity, and therefore is not an "approved charitable investment".

¹¹⁰ Charities' powers are expressly or impliedly subject to a requirement that they only be exercised in furtherance of the charity's purposes. By conferring unacceptable private benefit, the charity will be acting beyond the scope of its powers. As to the potential consequences of charity trustees acting beyond the scope of their powers, see paragraph 3.8 above. The conferral of unacceptable private benefit may be a ground on which to explain the decision in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd* [1986] 1 WLR 1440: see fn 13 above.

¹¹¹ CC14, section J8, p 42.

¹¹² For example, the first instance and appeal judges disagreed as to the outcome in both *Inland Revenue Commissioners v Yorkshire Agricultural Society* [1928] 1 KB 611 and *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380, the latter decision also including a dissenting judgment from Lord Oaksey.

- 3.94 Lord Hodgson considered that the private benefit test was too strict¹¹³ and recommended that the test be remodelled to focus on the proportionality of the private benefit.¹¹⁴ This recommendation was opposed by the Charity Commission and rejected by Government on the basis that it threatened to undermine the fundamental concept of charitable status.¹¹⁵

Private benefit and social investment

- 3.95 Charity trustees often consider that private benefit concerns are particularly acute when they are considering social investments. Taking the example of an investment in a medical research enterprise hoping to develop a new treatment in paragraph 2.4(6) above, as the medical research proceeds, and if it shows signs of success, other private investors may subsequently invest in the enterprise and receive a financial return.¹¹⁶ The charity's initial investment therefore has the potential to confer private benefit on other investors. We are aware that, in situations such as this, the Charity Commission has previously concluded that any private benefit is incidental (and therefore acceptable) if the healthcare product would not be developed but for the charity's investment.
- 3.96 The Charity Commission suggests that when a charity makes a purely financial investment, the private benefit conferred by the charity is deemed to be incidental to the benefit to the charity arising from the investment, but that where the charity is investing wholly or partly in the furtherance of its charitable purposes (making a PRI or MMI) then the trustees will need to show clearly that the private benefit is incidental to that task.¹¹⁷
- 3.97 Based on our analysis above, our view is that the test for unacceptable private benefit is the same, regardless of the nature of the outlay of funds along the spectrum in Figures 1 and 2 above.¹¹⁸ We see no reason why charities should consider private benefit when they are pursuing a social investment but ignore private benefit when making a financial investment. Private benefits in the investment context may include dividends or capital gains to other shareholders of investee companies or commissions to investment fund managers. In practice,

¹¹³ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) paras 9.11 and 9.27.

¹¹⁴ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) para 9.27 and recommendation 9.5.

¹¹⁵ Government Responses to 1) The Public Administration Select Committee's Third Report of 2013: *The role of the Charity Commission and "public benefit": Post-legislative scrutiny of the Charities Act 2006* and 2) Lord Hodgson's statutory review of the Charities Act 2006: *Trusted and independent: Giving charity back to charities* (September 2013) Cm 7800, p 42.

¹¹⁶ Alternatively, the charity may have made a "first loss" investment with other private investors such that the charity would bear a greater share of any financial loss arising from failure of the enterprise.

¹¹⁷ CC14, section J9, p 43; Charity Commission, *Legal Underpinning: Charities and Investment Matters (CC14)* (October 2011) paras 5.13, 5.17 to 5.19, 5.24 and 6.7; Charity Commission, *A brief guide to the investment of charitable funds* (19 November 2013) p 2, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/259584/CC_-_Brief_Guide.pdf (last visited 9 April 2014).

¹¹⁸ See paragraphs 1.18 and 1.21 above.

private benefit concerns are perhaps less likely to arise when charity trustees are making mainstream financial investments. Such investments are well-known and common to many charities, and costs to charities are controlled by market forces; few would realistically complain that they conferred unacceptable private benefit.¹¹⁹ However, some financial investments – particularly if they are not mainstream – may confer unacceptable private benefit. An investment in the equity of a company may be justified as a purely financial investment, or as a PRI or a MMI. Any private benefit must be incidental in all cases. We therefore do not agree that private benefit concerns do not arise simply because a charity is pursuing a financial investment but do arise when a charity is investing to further its purposes.

- 3.98 Nor do we consider that private benefit concerns should necessarily be any greater where a charity is making a social investment as opposed to spending its funds or making a grant. Put another way, a charity cannot escape the private benefit concerns arising from a proposed social investment simply by making a grant instead. So a charity making a social investment in a medical research enterprise which – if successful – may be highly lucrative for subsequent private investors (see paragraph 3.95 above) will have the same private benefit considerations if it were making an outright grant to that enterprise.

Conclusion

- 3.99 There is some uncertainty concerning the correct test for private benefit. Nevertheless, it seems to us that, however the test is formulated, and even if it were reformed, there will always be scope for argument as to how it applies to particular facts. Charities engaging in social investment must give particular consideration to private benefit, although we consider that similar concerns about private benefit arise in contexts outside social investment.
- 3.100 Ultimately, the extent of acceptable private benefit goes to the heart of what a charity is. The law relating to private benefit from social investment by charities falls outside the scope of our terms of reference for this project. However, we acknowledge that there is dissatisfaction with this area of the law.

THE LEGAL LANDSCAPE: CHARITY COMMISSION GUIDANCE

- 3.101 The Charity Commission published revised guidance on investment matters (CC14) in October 2011,¹²⁰ including its views on PRI and MMI and the matters that charity trustees should consider when contemplating social investments.¹²¹ Relevant extracts from CC14 are set out in Appendix B. The guidance has been well-received by many in the sector, particularly for providing clarity that charities can engage in PRI and, in some cases, MMI. We are aware, however, of some

¹¹⁹ Conversely, private benefit concerns are perhaps more likely to arise when charities are using their funds anywhere else along the spectrum in Figures 1 and 2. The difficulty is that, except when engaged in mainstream financial investment, charities' use of their funds will be unique, reflecting their particular purposes and their own trustees' decisions. Unlike mainstream financial investing, the use of funds to achieve a charity's purposes cannot easily be benchmarked to show that any private benefit is normal and acceptable.

¹²⁰ CC14 replaced the Charity Commission's earlier publications on the investment of charitable funds from 2003 and 2004.

¹²¹ CC14, sections J and K.

suggestions that the guidance on MMI is unclear and onerous for charity trustees.¹²²

- 3.102 We consider that the guidance is helpful for trustees in understanding the legal framework, but that some aspects of the guidance have the potential to cause confusion.

Private benefit

- 3.103 The formulation of the private benefit test is not consistent throughout CC14 and other Charity Commission guidance, which may cause charity trustees confusion.¹²³
- 3.104 Further, as explained above, private benefit must be considered at all points along the spectrum; there must be no unacceptable private benefit whether an investment in a company is made as a purely financial investment or as a PRI. So we do not agree that private benefit concerns necessarily render PRI equity investments as “exceptional”,¹²⁴ although we agree that it may be difficult to find an investment opportunity where the company’s purposes align with the charity investor’s purposes.

Quantification of mission benefit

- 3.105 When charity trustees consider social investments, they must consider both the mission benefit and the financial benefit that the investment is anticipated to achieve. In some cases, the mission benefit alone or the financial benefit alone will be sufficient to justify the social investment. However, in many cases, the social investment will only be justified by the combination of the financial and mission benefit¹²⁵ and it is inevitable that charity trustees must consider and compare both.
- 3.106 In order to carry out that comparison, we understand that some charities and their advisers have taken CC14 to mean that charity trustees are required to quantify the anticipated mission benefit of a social investment so that they can carry out a calculation to ascertain whether the mission benefit together with the quantified anticipated financial return can justify the social investment. Charity trustees may also consider that it is necessary to compare this combined anticipated financial and mission return with the return that could be obtained from other alternative uses of the funds. This view may be fuelled by certain passages of the Charity

¹²² See, for example, Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) paras 7 and 9.3.

¹²³ CC14, section J9, p 43; Charity Commission, *Legal Underpinning: Charities and Investment Matters (CC14)* (October 2011) paras 5.14 and 5.19; Charity Commission, *Public Benefit: the public benefit requirement (PB1)* (September 2013) Part 6; Charity Commission, *A brief guide to the investment of charitable funds* (19 November 2013).

¹²⁴ CC14, sections J2 and J9.

¹²⁵ See paragraph 1.24 and Figure 3 above.

Commission's guidance¹²⁶ and HMRC's guidance¹²⁷ which suggest that such a calculation is necessary.

- 3.107 Whilst this calculation reflects well the theory behind social investment (see, in particular, Figures 2 and 3 in Chapter 1 above¹²⁸), we do not see how charity trustees can realistically be expected to carry out such a mathematical exercise in practice. It may be possible if charities have significant resources and expertise at their disposal, so that they can engage with current theories and methodologies concerning mission benefit calculation.¹²⁹ For most charities, however, this will not be possible, and in some cases it may simply be impossible to quantify mission benefit in a meaningful way.
- 3.108 The law does not require charity trustees to carry out a calculation in order to consider whether a proposed social investment is appropriate. Rather, we consider that it should be a matter of trustee judgement, relying on trustees' expertise and understanding of their own charity's objects.

Conclusion

- 3.109 The Charity Commission's guidance has been helpful to charity trustees considering social investments, in setting out the Commission's view of the law. However, it does not have the force of law and may not be followed by a court. In addition, some aspects of the guidance may cause confusion for charity trustees. We turn now to consider the introduction of a new power for charity trustees to make social investments, in an attempt to remove some of the uncertainty that charity trustees face.
- 3.110 **We invite consultees' comments on whether the current law governing social investment by charities is satisfactory.**
- 3.111 **We invite consultees' comments on the Charity Commission's guidance in CC14.**

¹²⁶ See, for example, CC14, sections J11 and K2 (when considering a social investment (in the context of permanent endowment) "the justification has to show that the extent to which the charity's aims are furthered is roughly equivalent to the reduction of income"), section K3 (charity trustees should consider "do we know how much of our investment can be justified by the PRI's contribution to our aims and how much can be justified by the financial return? This may not be easy to quantify, but to try to do so could be a useful analytical exercise in justifying the total mixed motive investment before it is made") and section K5 ("trustees may find it helpful to look into and apply emerging methods of reporting on impact or the social return on investment to measure, manage and communicate how the investment furthers the charity's aims").

¹²⁷ HMRC, *Charities: detailed guidance notes*, Annex III, para 4.12.

¹²⁸ See paragraphs 1.21 and 1.24 above.

¹²⁹ We consider this issue in more detail in paragraphs 6.11 to 6.13 below.

CHAPTER 4

A NEW POWER TO MAKE SOCIAL INVESTMENTS, AND THE ASSOCIATED DUTIES

INTRODUCTION

- 4.1 In Chapter 3 we concluded that, whilst charity trustees will often have the power to make social investments, they may not be sure that they have it, and in some cases they will not have it.¹ In this Chapter we provisionally propose the creation of a statutory power for charity trustees to make social investments and consider the duties that should apply when exercising the new power. We then go on to explore the duties to which charity trustees, and particularly those who are in the technical legal sense trustees, are subject when they make social investments, and we consider how their duties could be made clearer and more straightforward.
- 4.2 At the outset, we emphasise that we wish to facilitate social investment by charities, not impose it. Many charity trustees will not wish to engage in social investment for a variety of reasons. It would be harmful to impose a blanket requirement on charity trustees to consider making, or worse still to require them to make, social investments. The related question of whether social investment should be incentivised by the State, and how, is a matter for Government.
- 4.3 It is clear from the conversations that we have had with stakeholders in the charity sector that different charity trustees have different views as to how the law should govern social investment decision-making, and that no reform option will satisfy everyone. For example, some charity trustees find the “PRI” category of social investments useful and, indeed, comforting in decision-making on the basis that this category of social investment is well understood and that the decision to make PRIs is generally incontestable. Other charity trustees consider the categorisation too prescriptive and would prefer to carry out a more general consideration of how the charity’s funds can best be used without having to categorise their decisions.
- 4.4 Similarly, some charity trustees would find a new broad power and broad discretion helpful, considering that it gives them freedom and flexibility in deciding how to apply their charity’s funds. Others would consider such a broad power and discretion too vague and perhaps worrying, preferring more rigidly defined powers and duties to provide a clear focus for the decision-making process.
- 4.5 In devising our provisional proposals, we have sought to balance these competing preferences of different charity trustees.

A NEW POWER TO MAKE SOCIAL INVESTMENTS

- 4.6 In terms of charity trustees’ powers, the current law is unhelpful because of the lack of clarity as to whether charity trustees have the power to make social

¹ See paragraph 3.47 above.

investments and the fact that it may not be possible to make certain social investments by exercising their power to spend or to invest, or a combination of those powers. To overcome these deficiencies, we take the provisional view that charity trustees should be given a new statutory power to make social investments.

- 4.7 The new power should be a default power that applies unless it is expressly excluded or modified by the charity's governing document – like the statutory power conferred on all trustees by section 3(1) of the Trustee Act 2000.² Where the charity's governing document confers on the charity trustees a similar but more limited power, this should not be regarded as excluding or modifying the new statutory power.
- 4.8 In making provisional proposals for a new statutory power, we do not wish to remove or replace existing powers that charity trustees enjoy under their governing document or under the general law. Our conversations with charities thus far lead us to conclude that many have sufficient powers to enable them to make social investments. We do not want to upset that position. We envisage the new statutory power standing alongside charity trustees' other powers as part of the toolbox available to them in seeking to achieve their charity's objects.

The scope of a new power

- 4.9 We explained the breadth of social investments in Chapter 1 and this is demonstrated by the various examples of social investments set out in Chapter 2. The same transaction can be categorised as a PRI, a MMI, or a financial investment by different charities. In devising a new power, we wish to avoid categorisation of the different uses of charitable funds by charity trustees. For example, we do not wish to confer a power to make PRIs and a separate power to make MMIs; that would require fluid concepts to be defined, it might cause charity trustees difficulty in practice as the understanding of those terms varies within the sector, and it might constrain the future development of social investment by charities.
- 4.10 So the new power should be a single and broad power. As explained in paragraph 1.13 above, by "social investment" we mean any use of funds from which a charity seeks to achieve both its charitable purposes and a financial benefit. We consider that charity trustees have adequate powers under the current law when they are pursuing just one of those purposes, that is, when the outlay of funds falls at either extreme of the spectrum in Figures 1 and 2 in Chapter 1 above.³ The difficulties arise between the two extremes of the spectrum. The new statutory power would permit charity trustees to apply their charity's funds at any point along the spectrum in Figures 1 and 2, save for the two extremes.
- 4.11 The new power should apply to all charity trustees regardless of the legal form of the charity.

² See paragraph 3.26 above.

³ See paragraphs 1.18 and 1.21 above.

- 4.12 We provisionally propose that a new statutory power should be created conferring on charity trustees the power to make social investments, meaning any use of funds from which a charity seeks to achieve both its charitable purposes and a financial benefit.**

Do consultees agree?

- 4.13 We provisionally propose that the new power should apply unless it has been expressly excluded or modified by the charity's governing document.**

Do consultees agree?

DUTIES WHEN EXERCISING THE STATUTORY POWER

Duties attached to the new power

- 4.14** The general law governing charity trustees' duties must apply to the new statutory power in the same way as it applies to any power conferred on charity trustees by the charity's governing document. In particular, charity trustees should exercise the new power in the best interests of the charity, for proper purposes, and in accordance with their fiduciary duties.⁴ Charity trustees' duty to consider the Charity Commission's guidance on public benefit⁵ under section 17 of the Charities Act 2011 would apply, and charity trustees must ensure that they do not confer unacceptable private benefit on a third party by entering in to the transaction.⁶ Charity trustees are, necessarily, already familiar with their general duties, and would anticipate being required to comply with those duties when exercising the new power. There would be no need for the new statutory power to state this expressly.
- 4.15** Nevertheless, charity trustees may be assisted by further guidance on the exercise of the new statutory power. One possibility would be to provide a statutory statement of charity trustees' duties when exercising the new power to make social investments. This would be a complicated codification exercise as charity trustees are subject to numerous duties, and there are minor differences between those duties depending on the legal form of the charity. Any statutory statement would be likely to be long and complex to reflect the nuances. In addition, it is difficult to see why a statutory statement of charity trustees' duties should be provided when they are considering social investments between the two extremes of the spectrum in Figures 1 and 2 in Chapter 1 above,⁷ but not when they are engaging in traditional financial investment or spending and grant-making at either end of that spectrum.

⁴ See paragraphs 3.51 to 3.57 above.

⁵ Charity Commission, *Public Benefit: the public benefit requirement* (PB1) (September 2013), available at https://www.charitycommission.gov.uk/media/535059/pb1_the_public_benefit_requirement.pdf (last visited 9 April 2014).

⁶ See paragraph 3.82 above.

⁷ See paragraphs 1.18 and 1.21 above.

4.16 So we do not propose to create a statutory statement of charity trustees' duties when exercising the new power. Instead, we think that a sensible alternative to a statutory statement of charity trustees' duties would be a checklist of factors for charity trustees to consider when deciding whether to make or retain social investments. In our view, the factors to which charity trustees ought to give particular consideration are:

- (1) the anticipated overall benefit from the social investment;
- (2) the duration of the social investment;
- (3) the risks of the social investment failing or under-performing;
- (4) how the performance of the social investment will be monitored;
- (5) whether and how often the social investment will be reviewed;
- (6) whether the charity trustees should obtain advice from a suitable person on all, or any aspect of, the social investment and, if so, the substance of that advice;
- (7) the relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies; and
- (8) any other relevant factors.

4.17 These factors are intended to enable charity trustees to consider a proposed social investment holistically, rather than separate out the mission benefit and the financial benefit to be separately quantified and assessed.⁸

4.18 As social investments are often unique, it is impossible to provide a comprehensive checklist of relevant factors for charity trustees to take into account when making their decisions. We therefore consider that this checklist should not be an exhaustive list of matters for charity trustees to take into account when considering social investments, hence our inclusion of "any other relevant factors".

4.19 For similar reasons, we do not believe that the checklist factors should be mandatory considerations. For some proposed social investments, charity trustees will – quite properly – not wish to consider all of these factors and we do not wish to require charity trustees to engage in a futile process or impose an unnecessary burden on their decision-making process. Rather, the purpose of the checklist is to assist charity trustees in their decision-making process, if they wish to have that guidance.

4.20 Accordingly, failure to take into account one or more of these factors when making an investment decision would not necessarily amount to a breach of the charity trustees' general investment duties. But in order for charity trustees to comply with their duties under the general law it may be necessary for them to consider these and other factors as part of their decision-making process.

⁸ See paragraphs 3.105 to 3.108 above.

- 4.21 We provisionally propose that the new statutory power should be accompanied by a non-exhaustive list of factors that charity trustees may take into account.**

Do consultees agree?

- 4.22 We invite the views of consultees as to whether the following, or other, factors should be included in such a statutory checklist:**

- (1) the anticipated overall benefit from the social investment;**
- (2) the duration of the social investment;**
- (3) the risks of the social investment failing or under-performing;**
- (4) how the performance of the social investment will be monitored;**
- (5) whether and how often the social investment will be reviewed;**
- (6) whether the charity trustees should obtain advice from a suitable person on all, or any aspect of, the social investment and, if so, the substance of that advice;**
- (7) the relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies; and**
- (8) any other relevant factors.**

- 4.23 In Chapter 3 we noted that charity trustees' duties under the current law presented two potential obstacles to social investment. The first was that charity trustees' may consider that their duties prevent them from making social investments because they do not obtain the best financial return,⁹ although we stated that we did not believe that this is what the current law in fact requires.¹⁰ We think this difficulty would be overcome by the creation of a new statutory power, combined with the checklist proposed above. The new power, by definition, would enable charity trustees to use charitable funds to achieve both a mission benefit and a financial benefit. It follows that charity trustees' duties, when exercising that new power, would not require them to seek the best financial return from the outlay of funds to the exclusion of other considerations. Indeed, if charity trustees were exercising the new power to make a social investment, they would be failing in their duties if they sought only the best financial return from the outlay of funds. Rather, charity trustees should consider both the mission benefit and financial benefit and give such weight to each as they see fit when considering the proposed transaction holistically. So any confusion about the possibility of a duty, under the current law, to obtain the best financial return when exercising a power of investment would be overcome by the creation of a new statutory power.**

⁹ See paragraph 3.80 above.

¹⁰ See paragraphs 3.65 to 3.67 above.

- 4.24 The second obstacle to social investment presented by charity trustees' duties under the current law that we noted in Chapter 3 was the unclear and confusing application of the Trustee Act 2000 duties to social investments.¹¹ It is to that issue that we now turn.

Duties under the Trustee Act 2000

- 4.25 In Chapter 3 we explained that the duties that arise under the Trustee Act 2000 when trustees (in the technical legal sense) exercise a power of investment – to consider the standard investment criteria, to review the investments periodically, and to consider obtaining advice – do not sit comfortably with social investments.¹² They were designed for traditional financial investments rather than social investments.
- 4.26 In light of those difficulties, and given that we have proposed the creation of a checklist which is tailored to social investments, we think that those duties arising under the Trustee Act 2000 should not apply when charity trustees (in the broadest sense) exercise the new power to make social investments.
- 4.27 **We provisionally propose that, when exercising the new statutory power to make social investments, charity trustees should not be required to comply with the duties under the Trustee Act 2000 to consider the standard investment criteria, to review investments periodically, and to consider obtaining advice.**

Do consultees agree?

- 4.28 A more difficult question is whether the exclusion of those requirements under the Trustee Act 2000 should go further. At present, the Trustee Act 2000 requirements apply whenever trustees exercise “any power of investment”.¹³ As explained in paragraph 3.72 above, this is a test of substance not form; for example, if trustees make investments using a catch-all power, a court is likely to decide that they are exercising a power of investment and that the Trustee Act 2000 requirements therefore apply. The fact that the form of the power is not an investment power, but a catch-all power, should be irrelevant; trustees cannot escape their obligations under the Trustee Act 2000 by utilising a different power to make the same financial investment.
- 4.29 If that is the case, then whenever trustees exercise any power to make what is, in substance, an investment, then the duties under the Trustee Act 2000 will apply. We discussed the meaning of “investment” in paragraphs 3.31 to 3.38 above. It is likely that many social investments – namely those that are anticipated to provide a positive financial return¹⁴ (even if it is a below-market financial return) – will be “investments” within the meaning of the Trustee Act 2000. Accordingly, even if trustees exercise the new statutory power (or any other existing power) to make such a social investment, it is likely that the requirements under the Trustee Act

¹¹ See paragraph 3.81 above.

¹² See paragraphs 3.75 to 3.78 and 3.81 above.

¹³ Trustee Act 2000, ss 4(1) (duty to have regard to the standard investment criteria) and 5(1) (duty to obtain and consider advice).

¹⁴ As defined in paragraph 1.13 above.

2000 will still be engaged because the power is being used to make what is, in substance, an “investment”. This presents two problems.¹⁵ First, the standard investment criteria may not be appropriate considerations for some social investments. Secondly, trustees may not appreciate that the duties under the Trustee Act 2000 apply when they are making a social investment.

- 4.30 To avoid these problems, social investments made by charities could be excluded from the term “investments” under the Trustee Act 2000. This approach is not free from difficulty. It may create a loophole; trustees could define what would otherwise be a purely financial investment as a social investment, for example by relying on a small or remote mission benefit from the investment, thereby avoiding the Trustee Act 2000 requirements altogether.¹⁶
- 4.31 Yet the Trustee Act 2000 requirements were not designed for, and in some respects are inappropriate for, social investments. It would be futile to introduce a new power for charity trustees to engage in social investment if, in reality, the same inappropriate duties applied when some of those charity trustees (namely, trustees in the technical legal sense) exercised that new power; if that is true, then the creation of a new power would not improve the position of those trustees.
- 4.32 In addition, regardless of which power trustees (that is, charity trustees who are in the technical legal sense trustees) are using to make social investments, they currently face uncertainty as to whether the Trustee Act 2000 requirements apply. We think that those trustees would welcome the removal of this uncertainty by making clear that the Trustee Act 2000 requirements do not apply when they are considering social investments. This would assist those trustees making social investments whether they are using the new statutory power or using other existing powers.
- 4.33 We invite the views of consultees as to whether the requirements under the Trustee Act 2000 to consider the standard investment criteria, to review investments periodically, and to consider obtaining advice, should be excluded whenever trustees (in the technical legal sense) are making social investments.**

¹⁵ See paragraphs 3.75 to 3.78 above.

¹⁶ The size of any such loophole would depend on how “social investment” is defined in the statute: see paragraph 1.13 above.

CHAPTER 5

PERMANENT ENDOWMENT AND SOCIAL INVESTMENT

INTRODUCTION

- 5.1 In this Chapter we consider the restrictions faced by charities with permanent endowment in making social investments. We conclude that, under the current law, charities can generally use their permanent endowment to make social investments where the capital will be preserved and we do not propose that this position be altered.

WHAT IS PERMANENT ENDOWMENT?

- 5.2 Some charities have permanent endowment, meaning that certain assets are subject to a restriction allowing only the income from those assets, but not the capital, to be spent. Such charities must invest their endowment so as to generate an income which they can spend on their charitable purposes.¹
- 5.3 The Charity Commission identifies two different forms of permanent endowment.
- (1) *“Investment” permanent endowment.* This is capital which is to be used to provide an income for the charity and which cannot be spent as if it were income. The document² that directs how the property should be held and used will usually specify that the capital should be invested and the income from the investments spent on specific charitable purposes. That direction will represent the intention of a donor, who either set up the charity or gave money to it.
 - (2) *“Functional” permanent endowment.* This is property to be used for a specific purpose or purposes of the charity. In almost all cases this will be land. Common examples of functional permanent endowment include village halls, recreational grounds, housing, museums and historic buildings. With this type of permanent endowment the distinction between capital and income rarely applies as there is often no income.³
- 5.4 Whilst the legislation does not make this distinction, it is useful to distinguish between the two because they serve different purposes. The use of functional permanent endowment for the purposes of social investment is excluded from our terms of reference. We are considering whether charities can use their investment permanent endowment for the purposes of social investment.

¹ Under section 353(3) of the Charities Act 2011, a charity will have a permanent endowment unless all of its property may be expended for the charity’s purposes “without distinction between capital and income”; permanent endowment is “property held subject to a restriction on its being expended for the purposes of the charity”.

² This will either be the charity’s governing document or the trust deed under which a gift of permanent endowment is made.

³ Charity Commission, *OG545-1 Identifying and Spending Permanent Endowment* (December 2012), section E1.2, available at <http://ogs.charitycommission.gov.uk/g545a001.aspx> (last visited 9 April 2014).

References in this Chapter to a charity's permanent endowment are to its investment, as opposed to functional, permanent endowment.

- 5.5 In this Chapter we distinguish between the actual value and the real value of a permanent endowment. The actual value is the original sum given to the charity or held by it at any time. The real value is the actual value adjusted for inflation and changes in the market value of the assets that comprise the fund.

THE PURPOSE OF PERMANENT ENDOWMENT

- 5.6 The purpose of permanent endowment is to ensure that a charity's work continues indefinitely. Permanent endowment restrictions are emotive. Many charity trustees believe that the permanence of their endowment is crucial, taking the view that donors are often only willing to give if they know that a restriction is in place that will preserve their donation for perpetual use; any relaxation of their permanent endowment restrictions would prejudice their fundraising efforts. There is also a view that the basis on which gifts have been given for charitable purposes should be honoured and that it is important to preserve a charity's assets so that it can operate indefinitely. Conversely, others in the charitable sector disapprove of perpetual control over the use of charity property, because it denies charity trustees the freedom to spend charities' capital resources to achieve their aims.⁴
- 5.7 The question of whether the law protecting permanent endowment should be retained or abolished falls squarely outside our terms of reference. During this review, we must therefore respect it. We are instead considering whether permanent endowment restrictions prevent charities from making social investments under the current law and, if so, whether the restrictions should be relaxed to facilitate social investment.

PERMANENT ENDOWMENT AND SOCIAL INVESTMENT

- 5.8 Traditionally, a charity's permanent endowment is used to generate an income, and that income is then spent by the charity on its charitable purposes. If permanent endowment is used to make a social investment, we can say that the process is abridged. The investment itself furthers the charity's purposes, rather than generating money to then be used to further the charity's purposes; the income-generation step falls away.
- 5.9 If a charity has a permanent endowment of £100,000 invested in traditional investments, it may anticipate an income of £3,000 (a 3% return) each year to be spent on its charitable purposes. The charity may instead prefer to use the permanent endowment to make a social investment that is anticipated to generate an income of just £500 (a 0.5% return) each year, which could then be spent on its charitable purposes. The permanent endowment will have generated less income, but the loss of potential income of £2,500 each year is justified by the mission-impact achieved by the social investment. £2,500 has effectively been spent; we can say that a short cut has been taken.

⁴ See R Jenkins and K Rogers, *For Good and Not For Keeps* (2013) pp 5 and 47. The authors suggest that, as good stewards, charity trustees should not simply focus on preserving the value of their investments but should focus on, amongst other things, "doing as much good with all their assets as they can".

- 5.10 Conversely, if the social investment is anticipated to preserve less than the £100,000 initial outlay, the charity's permanent endowment should not be used to make the social investment; this would amount to spending the endowment on the charity's purposes rather than preserving it for future generations.

THE CURRENT LAW

- 5.11 Charities with a permanent endowment cannot spend the capital fund. Charities cannot therefore make a social investment which is intended to diminish the actual value of the permanent endowment.⁵ Put another way, if a social investment is anticipated to produce a negative financial return,⁶ it cannot be made using permanent endowment.
- 5.12 Some charity trustees would go further, taking the view that they should preserve the real value of the permanent endowment,⁷ in which case they cannot use permanent endowment to make a social investment which is not anticipated to preserve its real value. In that situation, charity trustees could not use permanent endowment to make a social investment that was anticipated to produce a low (albeit positive) financial return,⁸ unless that low financial return would preserve the real value of the permanent endowment.
- 5.13 We see no legal argument that charity trustees' powers or duties prevent them from using permanent endowment to make a social investment that is anticipated to preserve the real value of the capital.⁹ Arguably they are entitled to use permanent endowment to make a social investment that is anticipated to preserve only the actual value of the capital. The proviso here is that the word "anticipated" is important. In assessing the potential return, the trustees must consider the risk involved in making the investment. If the return of the capital (in terms of actual or real value) is unlikely then they cannot be said to be anticipating a positive financial return on the investment.

⁵ See paragraph 5.5 above.

⁶ See paragraph 1.13 above.

⁷ In accordance with their duty of even-handedness between present and future beneficiaries: J Warburton, *Tudor on Charities* (9th ed 2003) para 6-027; *Nestle v National Westminster Bank* [1993] 1 WLR 1260 at 1279 by Staughton LJ and 1282 by Leggatt LJ; P Matthews and C Mitchell, *Underhill & Hayton – The Law of Trusts and Trustees* (18th ed 2010) paras 44.1 and following and 49.65.

⁸ See paragraph 1.13 above.

⁹ Whilst we consider that trustees should reasonably believe that the permanent endowment will be preserved by the social investment, there is no absolute requirement that the capital should in fact be preserved when the investment has been made. Given the volatility of mainstream financial markets, charity trustees may lose capital when making a purely financial investment with permanent endowment. There is no requirement that a loss of the permanent endowment in those circumstances be restored. Similarly, if a social investment performs badly, there is no requirement that the permanent endowment be restored. Using permanent endowment to make a social investment is no different from using it to make a mainstream financial investment, albeit that the anticipated return is likely to be lower and the risk of capital loss may be greater. If the trustees have properly assessed the risk and expect the investment to generate a positive financial return, the fact that the return may prove to be negative does not mean that they had no power to make the investment or that they breached their duties.

- 5.14 So any use of permanent endowment in making social investments must be done with the intention and expectation of, at the very least, the return of the capital actually invested – preferably with some increase so that its value is preserved in real terms.
- 5.15 Subject to what we say below about particular requirements that may attach to some permanent endowments,¹⁰ the current law therefore permits charity trustees to use permanent endowment to make social investments which are anticipated to produce a positive financial return,¹¹ but not social investments which are anticipated to produce a negative financial return. In all cases the charity trustees must take account of risk. If the financial return on a social investment is so uncertain that it cannot reasonably be said to preserve the charity's permanent endowment, then it ought not to be made using the permanent endowment. In short, permanent endowment can be used to make social investments that are "investments" in the strict legal sense.¹²
- 5.16 If the new statutory power that we provisionally propose in Chapter 4 is introduced, charities would be able to exercise that power (as an alternative to their power of investment) to make social investments that were anticipated to preserve capital using permanent endowment.

Removing permanent endowment limitations

- 5.17 If charity trustees conclude that their permanent endowment restriction prevents them from engaging in social investment because the terms of the trust deed or other founding document forbid it, or if they want to use their permanent endowment in circumstances where they do not think that there will be a positive financial return, they potentially have three mechanisms available to them under the current law to enable them to make such investments.¹³ Those mechanisms may not all be available and, where they involve an application to court or to the Charity Commission, they may not be successful.

Statutory power to release permanent endowment restrictions

- 5.18 First, charities have a statutory power to release their permanent endowment in certain circumstances under sections 281 and 282 of the Charities Act 2011.

¹⁰ See paragraph 5.28 below.

¹¹ Whether a very low positive return is permitted depends on whether the charity trustees are seeking to preserve the actual or real value of the permanent endowment: see paragraphs 5.11 and 5.12 above.

¹² See paragraphs 3.31 to 3.38 above.

¹³ It may be argued that a fourth mechanism is available. Charity trustees who invest permanent endowment on a total return basis (see paragraphs 5.25 to 5.26 below) have the power to allocate up to 10% of the capital fund to income to be spent on the charity's purposes, subject to its recoupment on a pound for pound basis: Charities (Total Return) Regulations 2013, reg 4. We do not regard this as permitting trustees to use permanent endowment to make social investments which are anticipated to produce a negative financial return. We consider regulation 4 to have been primarily intended as a temporary relief measure where there is insufficient unapplied total return out of which to meet the charity's spending requirements, as where the charity trustees make an investment which has low short-term yields with a view to long-term capital growth: see the Law Commission's Report on Capital and Income in Trusts: Classification and Apportionment (Law Com No 315) paras 8.52 to 8.55.

- 5.19 The trustees of unincorporated charities may resolve that the endowment ought to be freed from the restrictions with respect to expenditure of capital that apply to it if they are satisfied that the purposes set out in the trusts to which the endowment is subject could be carried out more effectively if it could be expended as well as the income it produces, rather than just such income.¹⁴
- 5.20 Such a resolution is itself effective to release the permanent endowment restriction if either:
- (1) the charity is small, having a gross income not exceeding £1,000 and an endowment not exceeding £10,000 in value; or
 - (2) regardless of the size of the charity, the endowment does not comprise property entirely given¹⁵ by a particular individual or institution, or by two or more individuals or institutions in pursuit of a common purpose.¹⁶
- 5.21 In the case of a large charity (that is, exceeding the thresholds set out above) whose endowment was entirely given by a particular individual or institution, or by individuals or institutions in pursuit of a common purpose, then the resolution must be approved by the Charity Commission following a statutory procedure.¹⁷
- 5.22 If a charity holds permanent endowment under a “special trust”¹⁸ which is treated as a separate charity by a direction made by the Charity Commission under section 12 of the Charities Act 2011, then equivalent powers are available to release the permanent endowment restriction.¹⁹ This power applies to any charity, whether unincorporated or incorporated.

Expenditure of permanent endowment pursuant to a Charity Commission order or scheme

- 5.23 Secondly, a charity that cannot use the statutory power to release permanent endowment may still be able to request the Charity Commission to sanction the expenditure of permanent endowment under its statutory powers in section 105 of the Charities Act 2011. The restriction on expending investment permanent endowment can be removed by order if the Commission is satisfied that this would be expedient in the interests of the charity.²⁰ The Commission may attach conditions to the removal of the restriction, most notably the requirement that any capital expenditure must be recouped out of income within a specified period.²¹

¹⁴ Charities Act 2011, ss 281(3) and (4) and 282(2) and (3).

¹⁵ One example given by the Charity Commission of permanent endowment that is not entirely given is where the trustees have set aside surplus income to be invested as permanent endowment pursuant to an express power: Charity Commission, *OG545-1 Identifying and Spending Permanent Endowment* (December 2012), section D1.8.

¹⁶ Charities Act 2011, ss 281(2) and 282(1).

¹⁷ Charities Act 2011, ss 282(4), 283 and 284.

¹⁸ Namely property held by or on behalf of a charity under a separate trust for any special purpose of the charity: Charities Act 2011, s 287(1).

¹⁹ Charities Act 2011, ss 288 and 289.

²⁰ Charities Act 2011, s 105(1). See also Charity Commission, *OG545-1 Identifying and Spending Permanent Endowment* (December 2012), section E1.2.

²¹ Charities Act 2011, s 105(6)(c).

Charities may seek an order under section 105 from the Charity Commission to allow them to use permanent endowment to make social investments.

Application to the court

- 5.24 Thirdly, trustees (in the technical legal sense)²² may apply to the court under section 57 of the Trustee Act 1925 to authorise a particular social investment which is not permitted by the trust deed, or to expand the trustees' powers if that would be "expedient". Charities may seek an order under section 57 to allow them to use permanent endowment to make social investments.

Total return investment

- 5.25 Charities may invest their permanent endowment to achieve the maximum overall return, without regard to capital or income, and then allocate the total return between capital and income. Charities now have a simple mechanism to opt in to this process following the implementation of our recommendations²³ in the Trusts (Capital and Income) Act 2013.²⁴
- 5.26 If charity trustees invest their permanent endowment on a total return basis, and also utilise some or all of their endowment to make social investments, the unapplied total return is likely to be lower. Trustees will therefore have to give particular consideration to the proportion of the total return that they wish to allocate to capital and income. It is likely that the proportion allocated to income will be reduced and the proportion allocated to capital²⁵ will be increased so as to maintain the capital's real or actual value and to balance the interests of current and future beneficiaries.²⁶

IS THE CURRENT LAW SATISFACTORY?

- 5.27 We have concluded that there is nothing to stop charity trustees using permanent endowment to make social investments that preserve the real value, and perhaps only the actual value, of the capital. Following the analysis in paragraphs 5.8 to 5.10 above concerning the purpose of permanent endowment in the context of social investments, we see no reason for permitting charities to go beyond these limitations by spending permanent endowment on social investments. If they wish to do so, they have procedures available to them – subject to the oversight of the Charity Commission or the court – to release permanent endowment restrictions:

²² See paragraph 1.38 above.

²³ Capital and Income in Trusts: Classification and Apportionment (Law Com No 315) paras 8.80 and 8.81.

²⁴ Inserting sections 104A and 104B into the Charities Act 2011.

²⁵ By "proportion allocated to capital" we mean the proportion actually allocated to capital by a decision of the trustees and not the unapplied total return pending such a decision: see Charities (Total Return) Regulations 2013, reg 3(4). The amount that can be allocated to capital is capped in line with inflation: see Charities (Total Return) Regulations 2013, reg 5; Charity Commission, *Total return investment for permanently endowed charities* (November 2013), section E3, available at https://www.charitycommission.gov.uk/media/585298/total_return_investment_for_permanently_endowed_charities.pdf (last visited 9 April 2014).

²⁶ Regulation 6(2) of the Charities (Total Return) Regulations 2013 requires the trustees to exercise their powers "in such a way as not to prejudice the ability of the charity to further its purposes now and in the future".

see paragraphs 5.17 to 5.24 above. Charities may consider these to be cumbersome procedures to follow, and where approval from the Charity Commission or the court is sought, consent may be refused. In addition, the first procedure is not available to incorporated charities²⁷ and the third is only available to trustees in the technical legal sense. However, they have the advantage of being subject to proper oversight by the Charity Commission or the court, and we do not think it appropriate to go beyond these as the appropriate mechanisms for charities that wish to remove a permanent endowment restriction.

- 5.28 Having said that, a charity's permanent endowment may be subject to other limitations that prevent the charity trustees from making social investments that preserve capital. For example, the trusts on which the permanent endowment is held may preclude the charity trustees from converting a particular asset (selling the asset and using the proceeds to purchase another),²⁸ or the trusts may stipulate that the permanent endowment must be invested to achieve the best financial return.
- 5.29 Charities precluded from making social investments by such limitations on their powers have procedures available to them to remove those limitations, namely an application under section 105 of the Charities Act 2011 or under section 57 of the Trustee Act 1925.²⁹ It may be that some limitations could be overcome by charity trustees modifying their powers by passing a resolution under section 280 of the Charities Act 2011.³⁰ Again, we see no reason to go beyond these procedures, which are designed to ensure that the intentions of donors are properly respected.
- 5.30 Lord Hodgson recommended that "a legal power [should be introduced] for non-functional permanent endowment to be invested in mixed purpose investments, with the requirement that capital levels must be restored within a reasonable period."³¹ Given our conclusion above that charity trustees already have the power to use permanent endowment to make social investments which are

²⁷ Although incorporated charities may still be able to take advantage of section 281 of the Charities Act 2011 if the permanent endowment is treated as a separate (unincorporated) charity. Alternatively, where an incorporated charity holds its permanent endowment on "special trust", it may use the power to release the permanent endowment restrictions in sections 288 and 289 of the 2011 Act: see paragraph 5.22 above.

²⁸ Whether charity trustees have the power to convert permanent endowment investments into other investments will depend on the construction of the trust deed. For example, in *Oldham Borough Council v Attorney General* [1993] Ch 210, the Court of Appeal held that recreational land held by the Council on charitable trust for the benefit of the inhabitants of the local area could be sold and the proceeds applied in the acquisition of other land to be held on precisely the same charitable trusts without the need for a *cy-près* scheme. The question was whether the exchange would involve a change of purpose: at 222 by Dillon LJ.

²⁹ See paragraphs 3.28, 3.49 and 5.23 to 5.24 above. The procedure under sections 281 and 282 of the Charities Act 2011 (see paragraphs 5.18 to 5.22 above) is unlikely to be suitable because the charity would not be seeking authorisation to remove restrictions on the expenditure of capital, but instead seeking to remove a restriction on how the capital should be invested.

³⁰ See the discussion of section 280 of the Charities Act 2011 in paragraph 3.49 above.

³¹ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012), recommendation 9.3.

anticipated to produce a positive financial return, we do not see the need for such a power to be introduced. If the suggestion is that it should be possible to use permanent endowment to make social investments that anticipate a negative financial return, or where the return is so high risk that the charity trustees cannot reasonably anticipate a positive financial return, then such a social investment would amount to spending permanent endowment and that should not be permitted. The purpose of permanent endowment is that the capital is to be preserved indefinitely; we are not persuaded that there is any reason for creating an exception allowing charity trustees to spend permanent endowment on social investments when they are unable to spend it on other initiatives. Even permitting permanent endowment to be used to make a particularly high risk social investment with a view to it being restored later (in the event that the social investment fails or under-performs so that permanent endowment is lost) would weaken that principle of permanent endowment and jeopardise its permanence. If charities wish to remove the permanent endowment restriction so that capital can be spent, they can seek authorisation using mechanisms that already exist.

CONCLUSION

- 5.31 Our conclusion is that charity trustees are permitted to use permanent endowment to make social investments that preserve its real value, and perhaps only its actual value. If consultees disagree, we would welcome their views as to why charity trustees are precluded from making such social investments together with their views as to any reform to the law that they consider appropriate.
- 5.32 We have further concluded that charity trustees who are prevented from making social investments (because they are anticipated to produce a negative financial return, or the financial return is high risk, or the permanent endowment is subject to a requirement that it be invested in a particular way) have satisfactory procedures available to them to release those restrictions where appropriate. If consultees disagree, we would welcome their views as to how those procedures could be improved.
- 5.33 We invite the views of consultees as to whether the current law concerning the use of permanent endowment to make social investments is satisfactory. If consultees consider the law to be unsatisfactory, we invite their views as to how the law should be reformed.**

CHAPTER 6

NON-LEGAL BARRIERS TO SOCIAL INVESTMENT

INTRODUCTION

- 6.1 In Chapter 1, we noted that there were various non-legal barriers to social investment by charities. We comment on those briefly in this Chapter.

CHARITY TRUSTEE AWARENESS AND CAUTION

- 6.2 Social investment is new territory for some charities and, even for charities that are familiar with social investment in one form or another, new opportunities continue to emerge. Because they are new, many charity trustees will not be aware of social investment opportunities, and because they are untested, many charity trustees will be cautious about committing precious charitable funds to social investments.¹ Over time, and as the social investment market develops, charity trustees are likely to become more familiar with social investment opportunities and more willing to engage.

CHARITY GOVERNANCE

- 6.3 There are structural constraints to some charities engaging in social investment. As noted in paragraph 3.7 above, many charities have different committees overseeing spending decisions and investment decisions. Social investment involves an element of both functions. To encourage social investment, those charities need to remove the division between the committees' functions and facilitate not just communication, but collaborative decision-making, between them.²

EMERGING SOCIAL INVESTMENT MARKET

- 6.4 Charities wishing to engage in social investment, or to expand their social investment portfolio, face other constraints which are a natural consequence of an embryonic market. First, many charities will consider that there is a lack of

¹ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) para 9.8; Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) paras 7, 8.2.1, 9.2.2; N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) pp 9 and 17; Social Investment Task Force, *Social Investment Ten Years On* (April 2010) p 9.

² Some charities have established dedicated committees to consider social investment. For example, the Esmée Fairbairn Foundation has a social investment committee, in addition to its spending committee and investment committee, administering its Finance Fund: see <http://esmeefairbairn.org.uk/what-we-fund/finance-fund>. Similarly, the Trust for London has a social investment committee for its "Capital for London" scheme: see <http://www.trustforlondon.org.uk/funding/other-funding/capital-for-london/capital-for-london-faqs/what-happens-once-i-submit-a-proposal/> (last visited 9 April 2014).

investment opportunities.³ When considering mission benefit (as opposed to financial benefit), charity trustees will seek social investment opportunities that align with their charity's objects. For charities with fairly narrow objects, this necessarily limits the social investment opportunities that will be available. Non-charitable investors are not so limited. Secondly, charity trustees may struggle to source appropriate advice on social investments. Charity trustees are familiar with taking advice on their financial investments from traditional asset managers, but these managers may be unable to advise on social investments.⁴ The social investment adviser's task is difficult as their remit spans what was traditionally two roles, namely spending to achieve purposes and investing to achieve the best financial return.

ACCOUNTANCY

- 6.5 Charities can face uncertainty as to how social investments should be treated in their accounts and sometimes consider that the risks of a social investment require it to be written down until its performance is known, thereby potentially presenting an unfairly damaging picture of the charity's financial state and its spending decisions.⁵ A review of *Accounting and Reporting by Charities: Statement of Recommended Practice* ("SORP")⁶ is underway and we understand that a revised SORP, to take effect from 1 January 2015, will be published in June 2014.⁷

TAX

- 6.6 Statute offers tax relief on a range of transactions by charities. Included within this are "approved charitable investments" and "approved charitable loans", the

³ Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) paras 9.2.3 and 10.1; N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) pp 7, 11 and 18; ICF GHK and BMG Research, *Growing the Social Investment Market: The Landscape and Economic Impact* (July 2013) para 4.5.2; Charities Aid Foundation, *Financing the Big Society: Why social investment matters*, A CAF Venturesome working paper (September 2010) p 10; A Brown and W Norman, *Lighting the touchpaper: Growing the Market for Social Investment in England* (2011) paras 3 and 3.1.

⁴ Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) paras 9.1.4 and 10.1; D Gregory, *Angels in the Architecture: building the infrastructure of social investment* (September 2013), ch 7; N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) pp 7, 9, 12 and 18; Social Investment Task Force, *Social Investment Ten Years On* (April 2010) p 9.

⁵ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) paras 9.16 and 9.18.

⁶ Charity Commission and the Office of the Scottish Charities Regulator, *Accounting and Reporting by Charities: Statement of Recommended Practice* (2005), available at <https://www.charitycommission.gov.uk/media/95505/sorp05textcolour.pdf> (last visited 9 April 2014).

⁷ The consultation on a draft revised SORP closed in November 2013. The final SORP will be published after the SORP Committee obtain clearance from the Financial Reporting Council: see <http://www.charitycommission.gov.uk/about-the-commission/our-status/sorp-committee-latest/> and <http://www.charitysorp.org/> (last visited 9 April 2014).

returns from which are exempt from income tax (for unincorporated charities) and corporation tax (for charitable corporations).⁸

- 6.7 The law recognises a number of investments that will automatically be regarded as approved investments and loans for tax purposes.⁹ Concerns have been raised that many social investments do not fall neatly within these recognised categories, which means that they can only be approved on an ad hoc basis by HM Revenue and Customs, causing uncertainty to charity trustees.¹⁰
- 6.8 These concerns may be overstated. Some social investments will fall within the categories of investments that are automatically approved, such as investments in any company (whether listed on a stock exchange or not), investments in land, investments in unit trusts, or loans to beneficiaries of the charity.¹¹ Indeed, those seeking to attract social investment from charities may choose to structure the social investment in such a way as to ensure that the investment is automatically approved. For social investments that are not automatically approved, the charity must satisfy HMRC that the investment or loan is “for the benefit of the [charity] and not for the avoidance of tax”.¹² Quite apart from tax considerations, charity trustees ought to be satisfied that a social investment is for the benefit of the charity before committing to it in any event. If the charity trustees are so satisfied,

⁸ Income Tax Act 2007, ss 521 to 537; Corporation Tax Act 2010, ss 466 to 493. If the investment or loan is not approved, it will be non-charitable expenditure, with the result that the charity will lose tax exemption on an equivalent amount of its attributable income and gains for the relevant tax period. Charities also benefit from exemption from capital gains tax where a gain is applicable and applied for charitable purposes: Taxation of Chargeable Gains Act 1992, s 256(1).

⁹ There are 12 categories of “approved charitable investments”: Income Tax Act 2007, s 558. The first 11 categories are automatically approved simply on the basis of their form. This includes government bonds, shares in open-ended investment companies, shares and debentures issued by listed and unlisted companies, investments in common investment funds and common deposit funds, interests in land (excluding mortgages), units in a unit trust, and bank deposits. The final category of “approved charitable investments” – “Type 12” – is not automatically approved; rather, it is “a loan or other investment as to which an officer of Revenue and Customs is satisfied, on a claim, that it is made for the benefit of the charitable trust and not for the avoidance of tax (whether by the trust or any other person)”. Similarly, there are 4 categories of “approved charitable loans”: Income Tax Act 2007, s 561. An “approved charitable loan” cannot be “made by way of investment”: ITA 2007, s 561(2). Subject to that, the first 3 categories are automatically approved, including a loan to another charity for charitable purposes, and a loan to a beneficiary of the charity pursuant to the charity’s purposes. The final category, again, is not automatically approved and HMRC must be satisfied that it is “for the benefit of the charitable trust and not for the avoidance of tax” in order for the loan to be approved: ITA 2007, s 561(3)(d). As a matter of practice, in relation to investments and loans that are not automatically approved, charity trustees can either (1) tick a box on their annual return stating their belief that the investment or loan is approved, which HMRC may then decide to investigate further, or (2) make a formal claim for approval which HMRC will then determine: see HMRC, *Charities: detailed guidance notes*, Annexes II and III.

¹⁰ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) para 9.13; E Finch, “Mixed messages on mixed motives” *Civil Society* (11 December 2013).

¹¹ Being, respectively, Type 1, Type 5 and Type 8 “approved charitable investments” under Income Tax Act 2007, s 558, and an “approved charitable loan” under s 561(3)(b), though in the case of the approved charitable loan there may be uncertainty as to whether it can fall within s 561; if it is “made by way of investment”, it cannot be an “approved charitable loan”.

¹² Income Tax Act 2007, s 558; Corporation Tax Act 2010, s 511.

and provided they can give their reasons as to why the social investment was considered to be appropriate, it is difficult to see how HMRC could say that the social investment was not for the benefit of the charity and therefore does not have approved status. We accept, however, that the possibility of an assessment and determination of this point by HMRC may create some uncertainty for charity trustees and perhaps some additional administrative burden or cost.

- 6.9 Lord Hodgson recommended that HMRC should provide charities with prior clearance as to the tax treatment of proposed social investments.¹³ Such a procedure would assuage many charity trustees' fears, and we think that it would be clearly desirable. Our discussions with HMRC, however, suggest that such a procedure would be administratively burdensome and costly for HMRC and that such a service is unlikely to be provided.
- 6.10 Tax relief – or its withdrawal – understandably looms large in charity trustees' minds when making decisions; they may be reluctant to pursue social investments where they consider the tax consequences to be uncertain.

QUANTIFYING MISSION BENEFIT

- 6.11 When considering the viability of a potential social investment, charity trustees must have regard to the anticipated benefit that it will have to their charity's mission. We concluded in paragraphs 3.105 to 3.108 above that this should not require charity trustees fastidiously to attempt to ascribe a numerical value to that benefit so that it can be compared in a more direct way with the financial benefit of the social investment.
- 6.12 Nevertheless, we acknowledge the growing wisdom in the field of "impact measurement" – the practice of developing standard measures for an investment's social or environmental impact – and the contribution that this is having, and will have, to the decision-making of charity trustees in the social investment arena. For instance, we are aware of the IMPACT Scorecard used by Bridges Ventures to report to its investors on the social impact of their investments, including the two "co-mingling" funds referred to in Chapter 2 above.¹⁴ We are also aware of other techniques being developed by expert analysts, including Investing for Good's methodology for impact analysis and assessment (MIAA)¹⁵ and the Social Impact Tracker produced by Cunamh ICT.¹⁶ We also appreciate that accurate and objective impact monitoring is an essential feature of outcome-based investment, most notably social impact bonds.¹⁷
- 6.13 Despite concluding that charity trustees do not need to perform rigorous calculations to discharge their investment duties, the development of impact measurement may be of assistance to charity trustees in their decision-making. Indeed, we recognise that some charity trustees may want the comfort of a

¹³ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012), recommendation 9.9.

¹⁴ See paragraph 2.10 above.

¹⁵ A Hornsby, *The Good Analyst: Impact Measurement and Analysis in the Social-Purpose Universe* (2012).

¹⁶ <http://www.socialimpacttracker.org> (last visited 9 April 2014).

¹⁷ See paragraphs 2.11 to 2.18 above.

reliable metric before they will be prepared to make a particular social investment. However, many charities will have insufficient resources to be able to engage with these metrics and, in any event, they are at their early stages of development; in some cases a metric will simply not exist or will not have undergone sufficient market testing to gain industry acceptance.¹⁸ This is a barrier that cannot be removed by law reform.

TRANSACTION COSTS

- 6.14 Whilst some collective social investment funds exist, many social investments are unique transactions between a charity and an investee. Such social investments can require detailed negotiation, due diligence exercises, legal advice, detailed contractual documentation and ongoing monitoring. This necessarily brings with it higher transaction costs,¹⁹ particularly when compared to a charity making a mainstream financial investment or making a grant. As charities become more familiar with social investment and streamline their processes, these costs are likely to decrease. However, by entering into tailor-made transactions, charities are always likely to face higher transactional costs.

CONCLUSION

- 6.15 In this Consultation Paper, we consider the legal obstacles that exist for charities seeking to engage in social investment and set out our provisional proposals for law reform. However, in light of the barriers to social investment highlighted in this Chapter, law reform alone will not guarantee a thriving social investment market. Whilst a review of non-legal barriers falls outside our terms of reference, if consultees wish to make any comments on the issues that arise, we will pass them to Government.

¹⁸ Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) para 10.3.2; HM Government, *Growing the Social Investment Market: A vision and strategy* (February 2011) para 4.17; N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) p 12.

¹⁹ Institute for Voluntary Action Research, *Charities and social investment: a research report for the Charity Commission* (March 2013) para 9.1.3; N Jeffery and R Jenkins, *Research briefing: charitable trusts and foundations' engagement in the social investment market* (2013) pp 7, 9, 12 and 18; Lord Hodgson gives an example of a social investment where the transaction costs would have been twice the value of the investment: Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012) para 9.16; Social Investment Task Force, *Social Investment Ten Years On* (April 2010) p 9; ICF GHK and BMG Research, *Growing the Social Investment Market: The Landscape and Economic Impact* (July 2013) para 4.5.2.

CHAPTER 7

SUMMARY OF PROVISIONAL PROPOSALS AND CONSULTATION QUESTIONS

- 7.1 We invite consultees' comments on whether the current law governing social investment by charities is satisfactory.

[paragraph 3.110]

- 7.2 We invite consultees' comments on the Charity Commission's guidance in CC14.

[paragraph 3.111]

- 7.3 We provisionally propose that a new statutory power should be created conferring on charity trustees the power to make social investments, meaning any use of funds from which a charity seeks to achieve both its charitable purposes and a financial benefit.

Do consultees agree?

[paragraph 4.12]

- 7.4 We provisionally propose that the new power should apply unless it has been expressly excluded or modified by the charity's governing document.

Do consultees agree?

[paragraph 4.13]

- 7.5 We provisionally propose that the new statutory power should be accompanied by a non-exhaustive list of factors that charity trustees may take into account.

Do consultees agree?

[paragraph 4.21]

- 7.6 We invite the views of consultees as to whether the following, or other, factors should be included in such a statutory checklist:

- (1) the anticipated overall benefit from the social investment;
- (2) the duration of the social investment;
- (3) the risks of the social investment failing or under-performing;
- (4) how the performance of the social investment will be monitored;
- (5) whether and how often the social investment will be reviewed;

- (6) whether the charity trustees should obtain advice from a suitable person on all, or any aspect of, the social investment and, if so, the substance of that advice;
- (7) the relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies; and
- (8) any other relevant factors.

[paragraph 4.22]

- 7.7 We provisionally propose that, when exercising the new statutory power to make social investments, charity trustees should not be required to comply with the duties under the Trustee Act 2000 to consider the standard investment criteria, to review investments periodically, and to consider obtaining advice.

Do consultees agree?

[paragraph 4.27]

- 7.8 We invite the views of consultees as to whether the requirements under the Trustee Act 2000 to consider the standard investment criteria, to review investments periodically, and to consider obtaining advice, should be excluded whenever trustees (in the technical legal sense) are making social investments.

[paragraph 4.33]

- 7.9 We invite the views of consultees as to whether the current law concerning the use of permanent endowment to make social investments is satisfactory. If consultees consider the law to be unsatisfactory, we invite their views as to how the law should be reformed.

[paragraph 5.33]

APPENDIX A

ACKNOWLEDGEMENTS

- A.1 We are extremely grateful to the following people who, either individually or on behalf of an organisation, have spoken to us, have attended and contributed to group discussions, or have otherwise engaged with us in the course of preparing this Consultation Paper.

James Brooke Turner, Nuffield Foundation

Adrian Broomfield, Charity Commission

Andrew Brown, Church Commissioners

Claire Brown, Esmée Fairbairn Foundation

Geoff Burnand, Investing for Good

Philippa Charles, Garfield Weston Foundation

Charlotte Chung, Social Enterprise UK

Sir Ronald Cohen

Andrew Cossar, Wellcome Trust

Peter Crampin QC, 3 Stone Buildings

Frank Cranmer, Churches' Legislation Advisory Service

Sir Stuart Etherington, National Council for Voluntary Organisations

Nicola Evans, Charity Law Association

Edward Finch, Buzzacott LLP

Luke Fletcher, Bates Wells Braithwaite

Rebecca Fry, Farrer & Co

Douglas Gunn, Trust for London

Lord Hodgson of Astley Abbots

Richard Jenkins, Association of Charitable Foundations

Tim Joss, Rayne Foundation

Philip Kirkpatrick, Bates Wells Braithwaite

Stephen Lloyd, Bates Wells Braithwaite

Daniel Nelki, Wellcome Trust

Debbie Nunn, Charity Commission

Andrew O'Brien, National Council for Voluntary Organisations

Mark O'Kelly, Barrow Cadbury Trust

Leigh Pearce, Nationwide Foundation

Robert Pearce QC, Radcliffe Chambers

Nicholas Pell, Macfarlanes

Nick Perks, Joseph Rowntree Charitable Trust

Ann Phillips, Charity Law Association

Francesca Quint, Radcliffe Chambers

Laetitia Ransley, Farrer & Co

Stephen Roberts, Charity Commission

Simon Rowell, Big Society Capital

Julian Smith, Charity Law Association

Whitni Thomas, Triodos Bank

Dr Matthew Turnour

Danielle Walker Palmour, Friends Provident Foundation

Simon Weil, Bircham Dyson Bell

Brian Wheelwright, Wates Family Charities

Brian Whittaker, Lankelly Chase Foundation

Penny Wilkinson, Northern Rock Foundation

Fiona Young, Tudor Trust

APPENDIX B

EXTRACTS FROM CHARITY COMMISSION GUIDANCE CC14

- B.1 In the pages that follow, we reproduce sections B, J and K of the Charity Commission's guidance *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011).¹

¹ Available at http://www.charitycommission.gov.uk/media/93859/cc14_lowink.pdf (last visited 9 April 2014).

Charities and Investment Matters: A guide for trustees

CHARITY
COMMISSION



B Executive summary

Charities invest so that they can further their charitable aims.

They can invest in a number of ways to achieve their aims, and there are specific legal duties and decision making processes attached to each.

If trustees have considered the relevant issues, taken advice where appropriate and reached a reasonable decision, they are unlikely to be criticised for their decisions or adopting a particular investment policy.

In this guidance we have concentrated on financial investment and programme related investment. We have also included some guidance on mixed motive investment (section K). This is another approach to investing and is an emerging area of interest for some charities.

Financial investment

The purpose of financial investment is to yield the best financial return within the level of risk considered to be acceptable - this return can then be spent on the charity's aims.

In order to act within the law, trustees must:

- know, and act within, their charity's powers to invest **L**
- exercise care and skill when making investment decisions **L**
- select investments that are right for their charity. This means taking account of:
 - how suitable any investment is for the charity
 - the need to diversify investments **L**
- take advice from someone experienced in investment matters unless they have good reason for not doing so **L**
- follow certain legal requirements if they are going to use someone to manage investments on their behalf **L**
- review investments from time to time **L**
- explain their investment policy (if they have one) in the trustees' annual report **L**

We also recommend that trustees should:

- decide on the overall investment policy and objectives for the charity
- agree the balance between risk and return that is right for their charity. This may include a wide range of factors that will impact on return including environmental, social and governance factors.
- have regard to other factors that will influence the level of return, such as the environmental and social impact of the companies invested in and the quality of their governance
- be aware that some investments may have tax implications for the charity
- invest any permanently endowed funds in a way that helps them to meet their short and long-term aims
- decide whether to adopt an ethical, socially responsible or mission related approach to investment and ensure that it can be justified.

An example of financial investments

A medium sized local arts charity receives its income mainly from grants and ticket sales. Surplus funds not needed in the short or medium term are invested in a common investment fund designed for longer term investment, while grants received in advance are invested on the money market. The charity also owns a block of garages which it rents out at the market rate. Some or all of the return on these investments is spent each year on the charity's beneficiaries.

Programme related investment (PRI)

The aim of a PRI is to use a charity's assets directly to further its aims in a way that may also produce some financial return for the charity. PRI is different from financial investment in that the justification for making a PRI is to further the charity's aims: this means that charities are not bound by the principles or law for investment (see section J).

In order to fulfil their duties and act within the law, trustees:

- must be able to show that the PRI is wholly in furtherance of the charity's aims **L**
- should make sure that any benefit to private individuals is necessary, reasonable and in the interests of the charity
- should consider reasonable and practical ways to exit from a PRI if it is no longer furthering the charity's aims.

An example of PRI

A charity that works to help and advise the unemployed usually makes grants to charities and other organisations that help unemployed people back into work. However, it has decided in certain cases to make loans instead of grants. It expects that loans will be repaid, potentially with some interest, enabling the charity to spread the work it does among more beneficiaries.

Mixed motive investment

Where an investment cannot be wholly justified as either a financial investment or a PRI, it may be possible to justify it as a mixed motive investment. Considerations for trustees should include:

- the justification for making the mixed motive investment that will need to be established before making the investment
- the suitability of a mixed motive investment for the charity
- whether there is a need to take professional advice before making the investment
- whether any private benefit arising from the investment will be acceptable.

J Programme related investment (PRI)

J1 What is PRI?

The short answer

PRI allows a charity to directly further its aims and, at the same time, potentially achieve a financial return. In making a PRI, trustees are not bound by the legal framework for financial investment (see C2 above), because their decision is about applying assets directly in furtherance of the charity's aims.

In more detail

PRI uses charitable resources to finance charitable and other organisations in a way that:

- is wholly in furtherance of the charity's stated aims
- is for public rather than private benefit; and
- is expected to produce some financial return for the charity (but this is not the main reason for doing it).

Example

A charity that works to relieve poverty may give a loan to another charity that helps unemployed people back into work.

This will:

- relieve poverty (wholly in furtherance of the charity's aims)
- be for the public benefit
- be expected to achieve repayment of the loan and a financial return from interest payments on the loan.

Successful PRI can enable charities to:

- increase the help they can provide. If the investment is recouped and/or yields a return for the charity, then the resources can be reused to support a greater number of projects
- employ a wider range of funding methods. For example, sometimes loans and equity are better suited to particular projects than grants
- make a long term, flexible investment that directly furthers the charity's aims ie at low interest rates, interest free or involving repayment (partly) through in-kind services
- improve the terms on which charities are offered finance, enabling finance to be accessed at a lower cost.

The difference between financial investments, PRI and grants

A PRI is different from a financial investment or a grant although it may look similar in form.

The difference between a financial investment and a PRI lies in the primary intention of the investment. The main reason for making a PRI is to further the charity's aims, not to generate a financial return. The main reason for making a financial investment is to generate a return which can then be used to further the aims of the charity. Usually the charity will be seeking the best financial return on their investments within the level of risk they consider appropriate for the charity. The intention is important because it allows trustees to show how they are acting in the interests of the charity.

PRI also differs from grant making because a grant is made to further the charity's aims with no expectation of a financial return. However, some charities might choose to make a grant alongside a PRI, for example to help build an organisation's management capacity thus helping to ensure loan repayment.

Financial investment targeting the best rate of financial return given the level of risk considered appropriate

PRI furthering a charity's aims, with the expectation of some financial return

Grants directly furthering a charity's aims

J2 What form can a PRI take?

The short answer

PRIs can take a wide range of forms and can be made to both charities and other types of organisation. They can range from:

- relatively small sums of money provided as loans to another organisation or individual, for example a housing deposit, buying new equipment or renovating a property, to
- large sums invested in complex high profile projects, for example regeneration projects.

In more detail

PRIs often take the form of loans, equity investments or pooled funds more commonly associated with financial investment. PRIs may also be made through intermediaries.

Common examples include:

Loans

The key characteristic of a loan is that the borrower should repay the amount of the loan with or without interest.

If making a loan, a charity should ensure that the terms of the loan set out:

- how it will be used to further the charity's aims
- a rate of interest. Trustees should consider the impact on their charitable aims and the rate that the borrower might be able and willing to pay
- the timescale and terms of repayment. Trustees can be flexible in considering these arrangements

A charity can also guarantee loans on behalf of organisations or individuals that will further the charity's aims. With loan guarantees, trustees are promising a third party that they are responsible for the obligations of the recipient should it not be able to meet those obligations. The trustees should ensure that they have, or can access, sufficient resources to meet any call under the guarantee. In the meantime they retain use of their organisation's funds.

Equity investments

Exceptionally, PRI can take the form of an equity investment where a charity buys shares in a company and provides it with start up capital. Ownership usually gives a right to a dividend if paid and a right to vote at the Annual General Meeting. However trustees should be aware that there are particular risks involved. They will need to consider what processes can be put in place to ensure the funding will continue to be used to further the aims of the charity. For example this could take the form of shareholder agreements, buy back positions and convertible loan stock.

For more information on equity investments in non charitable companies, see J9.

Charities can also engage in the following:

Revenue participation or quasi-equity

This means that the charity as an investor gets a financial return based on the share of revenue/profits made by an organisation in return for providing capital for the development of a particular initiative. The initiative must be in furtherance of the charity's aims in order for this to be a PRI. The return the investor receives is linked to the financial success of the venture. Investments of this kind do not involve the issue of shares and do not generally confer ownership on the investor.

Outcomes-based finance

Investors in outcomes-based finance structures receive a financial return that is fully or partially linked to the social and/or environmental outcomes generated by the services delivered using the investment. A Social Impact Bond is an example, and describes a contract which is typically between a public sector body and investors where the former commits to pay for an improved social outcome. Investor funds are used to pay for a range of interventions to improve the social outcome. The social and/or environmental outcomes must be in furtherance of the charity's aims in order for this to be a PRI.

It's possible that this type of investment could be viewed as a financial investment if the likely financial return justifies it. It could also be made as a mixed motive investment. Charities will need to take advice where appropriate on this.

J3 What is the trustees' role when making a PRI?

The short answer

When making a PRI, trustees must act in the best interests of their charity and ensure that:

- their charity's funds are only used to further its stated aims
- any private benefit arising from the investment is necessary, reasonable and in the interests of the charity (see J8 below).

Before making a PRI, they should:

- be clear that it contributes to the charity's strategic aims
- compare PRIs with other ways of advancing the charity's aims in terms of effectiveness and risk
- consider whether they need to take advice, given the level of risk to the charity, and any knowledge or expertise that they have in the charity.

Trustees are unlikely to be criticised for their decisions if they have considered the relevant issues, taken advice where appropriate and reached a reasonable decision. The PRI checklist at annex 2 is intended to guide trustees through the decision making process.

In more detail

The trustees have overall responsibility for PRI decisions. They should put in place the appropriate governance arrangements for managing their PRIs. The governance structure and level of delegation will be different for each charity depending on its internal resources and expertise and they should consider the following points:

- Trustees do not need to have specialist project and financial knowledge themselves. However charities with significant funds invested may find it helpful to have a trustee with specialist financial and project knowledge on its board, or co-opted to its board.
- Charities with substantial sums invested in PRIs or that have invested in complex or high profile PRIs may find it helpful to establish an internal PRI committee or a sub committee of trustees or staff to advise the board on the more detailed aspects of PRIs.
- Trustees may delegate decisions about individual PRIs to a third party or to staff within the charity if they have the power to do so in their governing document. However, they will need to:
 - ensure that they provide a clear direction, in writing, about the nature and type of PRIs they consider will further the charity's aims
 - ensure they have procedures in place for monitoring and reviewing PRI performance.

J4 What risks should trustees consider in connection with PRI?

Trustees should consider the following risks and make decisions for their management appropriate to the size and activities of their charity and proportionate to the scale of the PRI in relation to the activities of the charity:

- Will the PRI be used to fund aims other than those intended, for example if the recipient made a significant change to its activities or if the objectives of the PRI are achieved earlier than expected?
- Will there be an unacceptable level of private benefit to the recipient or other investors (see J8 below)?
- Are there risks to the charity's reputation, for example arising from private benefit?
- What will happen if the project is not successful?
- What will happen if the charity is dependent on a financial return that is then not recouped?
- What if real return levels are lower than expected because of changes in inflation or exchange rates?

J5 Should trustees take advice when making PRIs?

The short answer

There is no legal obligation to take advice. Much will depend on whether the trustees feel comfortable and competent enough to make decisions on PRIs.

In more detail

The issues that might influence the need for advice are:

- the size and scale of the PRI and level of risk involved
- the complexity of the legal and financial issues
- whether a particular professional evaluation is called for

and whether the charity has in house expertise in:

- assessing projects
- undertaking due diligence checks
- determining appropriate levels of return
- assessing viability prospects.

J6 Can a charity make a PRI in a project that falls outside its charitable aims?

The short answer **L**

No, a charity can only make a PRI that supports its charitable aims. However, trustees can explore new and innovative ways of using PRIs to further their aims bearing in mind the principles set out in this guidance.

In more detail

It is important that trustees understand the full scope of their charity's aims and can demonstrate how the intended outcomes of the PRI will further these.

Some large charities, often trusts and foundations or charitable intermediaries providing financial support to other charities, have been set up with general charitable aims and will therefore be able to make a wide range of PRIs from their income and expendable endowment that support any charitable purpose they select.

J7 What if the PRI ceases to further the charity's aims?

The short answer

Charities should consider at the outset how they would manage situations where the PRI funded activities cease to further its aims. The terms of the PRI agreement should reflect what is possible and practical to end the PRI and, if feasible, the return of funding which can no longer be used to further the charity's aims.

In more detail

Loans

Where the PRI takes the form of a loan directly from the charity to the organisation it is funding, the agreement may include a condition requiring repayment of the loan or the conversion of the loan to commercial terms in the event that the investment is no longer being used to further the charity's aims.

Equity investments

The position is more complicated where the PRI takes the form of equity investments because of the requirements of company law concerning the reduction of the capital of companies. However, it is possible to put other arrangements in place. For example, a company might agree conditionally to purchase its own shares, or to issue shares which are redeemable in such circumstances.

Intermediaries

Where the PRI is made through an intermediary, the furtherance of the charity's aims may be complicated by the intermediary's relationship with the ultimate recipient. While the principle that the PRI needs to wholly further the charity's aims remains, the trustees should take into account that practical considerations may limit the intermediary's ability to agree how to end an arrangement with its charitable investors.

Risk management

The charity will need to consider, when the investment is first proposed, the risk that the charity might find itself locked into a PRI which has lost any connection with its aims. Trustees may decide that, where the risk is small, the benefit to be obtained by making the investment justifies taking that risk. However, where the amount invested represents a significant part of the charity's resources, the risk becomes greater and will be more difficult for the trustees to justify taking.

J8 When is some private benefit acceptable?

The short answer

Some private benefit flowing to other investors is acceptable if the trustees are satisfied that the private benefit is:

- necessary in the circumstances
- reasonable in amount; and
- in the interests of the charity.

Trustees must have regard to our guidance on private benefit in *Charities and Public Benefit* when making PRIs.

In more detail

A charity's aims must be for the public benefit. However, sometimes, the best way for a charity to help its beneficiaries may result in individuals or businesses making a private benefit. Where there is an unacceptable level of private benefit it can affect charitable status.

Trustees will need to use their judgment to determine whether the private benefit is acceptable. They must always act in the best interests of the charity. They can include the charity's enhanced ability to further its aims (as a repaid loan can be lent to others) in their assessment of the project's public benefit. In some cases the assessment required will be relatively simple, in others it will be complex, based on multiple factors, and the decision will be finely balanced. Trustees should make decisions based on what is reasonably known at the time of making the PRI and ensure they have a record of their decisions.

Where trustees consider that individuals or businesses are making a private return in PRI which is beyond what they consider as necessary, reasonable and in the interests of the charity, they should ensure that the private benefit is recoverable by the charity by some other means. For instance, the person receiving the private benefit may choose to pay it to the charity. If there is continuing unacceptable private benefit, the charity should consider its options for exiting the PRI.

J9 What are the duties of trustees if investing in the equity capital of a non-charitable company in order to further the charity's aims? **L**

In general, investing in the equity of a private company will mean a financial return for the shareholders or will further some other non-charitable purposes of the company. This will usually mean that the charity's investment is not supporting wholly charitable aims and, therefore, a charity can only make a PRI in such a company in exceptional circumstances. These circumstances are only likely to arise where there is a clear correlation between the social purposes that the company will achieve and the aims of the charity.

Therefore, the trustees must satisfy themselves that:

- there is correlation between the charity's aims and the social mission of the non-charitable organisation in which the trustees wish to invest
- any private benefit derived from the PRI is necessary, reasonable and in the interests of the charity
- any private benefit will not be excessive and the investment is clearly for the public benefit.

Where there is potential for considerable economic gain by the company, the trustees should take all reasonable steps to ensure that the charity benefits from this gain. Otherwise, they could not demonstrate that any private benefit is necessary, reasonable and in the interests of the charity. There should be adequate safeguards in place to ensure that any unacceptable private benefit does not arise. For further information see *Legal Underpinning: Charities and investment matters (section 5)*.

Example

Equity investment in a commercial organisation

A charity set up to help people with disabilities find employment might be interested in buying newly issued shares in a commercial organisation run by and employing disabled people. The success of the company will deliver benefits to shareholders. The more successful the company, the more disabled people it is able to employ and train.

Points to consider

- The key question here is the match between the charity's aims and the general activities of the non-charitable organisation. Trustees must ensure that when providing general loans or buying shares in a commercial organisation, the general activities of the commercial organisation should directly further the charity's aims.
- Trustees should also carefully consider at the outset how they would manage a situation where the commercial organisation changes its activity or employment policy. In particular, they should ensure they would be able to exit from the PRI in such circumstances.
- Trustees would need to be satisfied that the private benefits (including to shareholders) are acceptable.

Example

A loan to a commercial organisation for a specific aim.

A commercial organisation providing vocational training requests a loan to enable it to provide training facilities for the unemployed in a disadvantaged area. These new facilities will enable the company to train fifty local unemployed people each year under a local authority contract.

A local charity set up to relieve unemployment considers making the loan on the basis that it furthers its charitable aims. The contract offered by the local authority enables the commercial organisation to cover costs and make a small profit margin. However, this margin is not sufficient to support a loan at market rates.

The commercial organisation needs this loan to develop and equip training premises. It could not operate in the disadvantaged area without the charity's loan which is offered at below market rates. The loan provided by the charity may make an indirect contribution to the company's profitability because it may, for example, win more contracts of this kind with larger margins.

Points to consider

- This sort of evidence of market failure to deliver employment, goods or services to disadvantaged people is sometimes the basis for justifying PRI in non-charitable organisations.
- Trustees have a duty to use their charitable assets to further the charity's aims. The loan should be made on the basis that it will be used by the commercial organisation only to carry out activity that will directly further the charity's aims. The loan could not be used to fund any other activity. Trustees would need to be satisfied that the private benefit is necessary, reasonable and in the interests of the charity.
- The terms agreed should allow for the loan to be repaid in full should the commercial organisation cease to carry out those specific activities.

J10 Can a charity invest in and through intermediaries?

The short answer

Yes. If investing in and through intermediaries, trustees need to be assured that:

- the charity's funds are only used to further the charity's stated aims
- any private benefit arising from the investment is acceptable

In more detail

Some charities and non-charitable organisations specialise in PRI and act as intermediaries. They finance, or facilitate the financing of, other charities and non-charitable businesses. This approach can:

- reduce the transaction costs associated with loans or the purchase of equity
- sometimes provide expertise in assessing and managing the financial risks associated with the projects they support
- provide knowledge about the communities and markets in which they are investing and mitigate risk

- allow charities to pool risk across a large number of investments thus reducing their exposure
- make it easier for charities to recover their investments.

Examples

1. Buying shares in a loan fund

A charity which aims to protect the environment by supporting the development of renewable energy sources might invest in a loan fund set up to finance new green technologies. Given that the fund can continually make loans, the investment by the charity will have a considerable impact on the number of new green technologies supported.

Points to consider

- The PRI can only be made on the basis that it will be used to carry out activity that will directly further the charity's aims.
- The private benefit to those who receive start up funding must be considered to be necessary, reasonable and in the interests of the charity in the circumstances.

2. Investing in a Social Impact Bond

A Social Impact Bond typically describes a contract between a public sector body and investors where the former commits to pay for an improved social outcome. Investor funds are used to pay for a range of interventions to improve the social outcome.

A charity that works to help the unemployed back to work might invest in a social impact bond that funds a project or multiple projects that aim to improve an individual's chances of finding work. This could be a direct investment in the project or be managed through an intermediary. Upon completion of the project, if the targets set out are met, then the charity will recoup its investment and receive a return. (Some charities may choose to make this type of investment as a financial investment).

Points to consider

- the PRI can only be made on the basis that it will be used only to carry out activities that aim to help the unemployed back to work.
- any private benefit must be deemed to be necessary, reasonable and in the interests of the charity in the circumstances.

J11 Can charities use their permanent endowment to make PRIs?

The short answer **L**

In general, permanent endowment involves funds held on trust to be invested to provide a financial income which can be spent on furthering the charity's aims. This will not usually permit permanently endowed funds to be used for PRI.

In more detail

A charity might be able to use its permanent endowment for a PRI by:

Using the income

A charity can use part or all of the income from the permanent endowment to make a PRI.

Justifying it as a financial investment

A PRI is one where the financial return is not the primary reason for making the investment. Trustees can use permanent endowment held on trust for financial investment if the risk profile and financial return sought enable it to be justified as an investment.

Trustees can take account of ethical investment considerations or make mission connected investment when investing permanent endowment.

There may be some occasions when an investment generating less than a market return might be justified because of the extent to which the investment furthers the charity's aims. In this case, the justification has to show that the extent to which the charity's aims are furthered is roughly equivalent to the reduction of income. This is one type of mixed motive investment (see section K).

Adopting a total return approach

Trustees managing permanent endowment can consider adopting a total return approach. This means that part of the capital growth on the endowment can be allocated to their income fund and spent on the charity's aims. This can be spent on the PRI. A permanently endowed charity that want is to adopt a total return approach to investment may use the power in the Charities Act 2011 and the Charities (Total Return) Regulations 2013 to adopt a power to adopt the approach.

Removing restrictions on permanent endowment

Trustees may be able to remove the restrictions from some or all of any permanent endowment their charity holds. They can do this if they decide that it will allow them to carry out the charity's aims more effectively.

The trustees will need to pass a formal resolution that the restrictions on the permanent endowment should be removed from all or part of the fund concerned. If the market value of the permanent endowment is over £10,000, they may also need our approval. This would enable trustees to use the capital in any PRI scheme that furthered the aims of the charity concerned.

Further information on permanent endowment is set out in *Permanent Endowment: What is it and when can it be spent?*

J12 How should PRI be reported in the trustees' annual report and the charity's annual accounts?

Where the trustees must prepare an annual report and are subject to statutory audit, the report must include an explanation of the charity's policy for making a PRI and how any material PRI has performed against the objectives set for it.

In the annual accounts, the balance sheet must show investments held primarily to provide a financial return for the charity (financial investments) and PRI separately. PRI should generally be included at the amount invested less any impairment and, in the case of loans, any amounts repaid. Impairments should be charged as an expense of charitable activities in the Statement of Financial Activities. Where a gain is made on the disposal of a PRI then it should either be set off against any previous impairment loss or included as a gain on disposal of fixed assets for the charity's own use and recorded under 'other operating resources' in the SOFA.

For more information, see *Accounting and Reporting by Charities, SORP 2005*

J13 How can a charity account for a PRI that no longer fulfills the charity's aims?

If a PRI no longer furthers a charity's aims or the trustees' motive for holding the investment changes so that it is held primarily for a financial return, then it will be necessary re-classify the investment as a financial investment in the charity's balance sheet.

One of the key characteristics of a PRI is the expectation of repayment and/or a financial return for the charity, although the primary aim of a PRI is to further the aims of the charity. Therefore a PRI is an asset but one which, like any other asset, can reduce in value. If the PRI is no longer worth what it is valued at in the balance sheet, it should be included at its recoverable amount. Alternatively, provided the aims of the charity are still furthered by the investment, the charity may choose to convert the PRI into a grant.

J14 How should trustees monitor and review a PRI?

Trustees will need to review their charity's PRIs regularly. The approach to, and frequency of, this review will depend on the nature and size of the charity's PRIs and on its need for resources which may change over time. Trustees will need to consider:

- the use which the recipient makes of the resources the charity has provided to ensure that they are being used to further the aims of the charity
- emerging methods of impact reporting or 'social return on investment' to measure, manage and communicate how the PRI furthers the charity's aims
- the likelihood of repayment and/or return on the PRI. This will vary depending on the form of the PRI. For example, for loans and equity investments this may involve ongoing reports on the progress of the project with regular assessment of the prospects of loan recovery and financial returns. The relevant terms should be built into any funding agreement.

J15 What are the tax implications of PRI? **L**

There may be tax implications for PRI which depend on the structuring of the investment and the tax treatment of any return - charities should be aware of this and take advice where appropriate. As long as charities apply the income and gains arising from a PRI charitably they will normally be exempt from UK tax.

Charities risk losing their tax exemptions if they incur non-charitable expenditure. This can include making investments or loans that are not 'approved charitable' investments or loans. Some categories of loans and investments are automatically treated as 'approved charitable' loans and investments. HMRC will consider claims for other loans and investments to be treated as 'approved charitable' as long as they are made for the benefit of the charity and not for the avoidance of tax. HMRC will normally accept claims for PRIs to be treated as 'approved charitable investments'.

For more information see the *HMRC Charities website*

K Mixed motive investments

The previous sections have concentrated on two different forms of investment – financial and programme related. However, some new and developing investment opportunities do not fall entirely within just one or the other of these categories, but can still be justified as being in the interests of the charity. We refer to these as mixed motive investments.

We recognise that this new approach to investment could be an appropriate way for some charities to respond to the changing environment in which they work. We intend this basic legal and good practice framework to help charities consider whether mixed motive investments might be an option for them and to describe the decisions involved.

K1 What is a mixed motive investment?

The short answer **L**

A mixed motive investment is one which trustees make on the basis that it has elements of both financial investment and programme related investment. The investment cannot be wholly justified as either one or the other.

In more detail

Generally, trustees must be able to show that investments they make are in the best interests of the charity. They do this by justifying them as either:

- financial investment - seeking the best financial return given the level of risk considered to be appropriate; or
- programme related investment (PRI) - furthering the charity's aims directly in a way that might generate a financial return.

Separate legal requirements apply to both.

However, sometimes trustees will want to invest in a way that they consider to be in the best interests of their charity but not **entirely** justified on just one of these grounds alone. In this situation, they may be able to justify the investment as a mixed motive investment if they are satisfied that:

- the investment can be justified by the dual nature of the return - part financial and part justified by the investment's contribution to the charity's aims; and
- there is no other reason for making the investment, including:
 - creating unauthorised private benefit to some or all of the trustees or people connected with them; and
 - creating unacceptable private benefit to other individuals.

As mixed motive investments are a developing area, professional advice may be required on specific proposals.

K2 Why might a charity want to make a mixed motive investment?

Where an investment cannot be wholly justified either as a financial or a PRI, but the trustees still consider that it is likely to be in the best interests of the charity, it may be possible to justify it as a mixed motive investment. However, trustees should bear in mind that:

- they should be satisfied **before** proceeding that the mixed motive investment can be justified by the combination of the anticipated financial return and the contribution the activities funded will make to the charity's aims; and
- any private benefit arising from the investment must be appropriate.

Sometimes a subsidiary trading company can be set up both to further a charity's aims and to generate a financial return. It is important that trustees are able to justify an investment either on the basis of the financial return or the extent to which it furthers its aims. Where the subsidiary trading company is doing both, it is a mixed motive investment and the criteria set out in this section will also apply.

For permanently endowed charities, there may be some occasions when an investment generating less than a market return might be justified because of the extent to which the investment furthers the charity's aims. In this case, the justification has to show that the extent to which the charity's aims are furthered is roughly equivalent to the reduction of income.

K3 What should the trustees consider when thinking about making a mixed motive investment?

The short answer

They should carefully think through the justification for a mixed motive investment before it is made and be satisfied that it is in the best interests of the charity. It should also keep a record of the decision and the reason for it.

In more detail

A charity should ask the following questions when considering making a mixed motive investment:

- Will we be considering the extent that the mixed motive investment supports our charitable aims or the financial investment aspect first? Both could be appropriate ways to approach a mixed motive investment (see *Legal Underpinning: Charities and investment matters (section 6)*).
- Do we know how much of our investment can be justified by the PRI's contribution to our aims and how much can be justified by the financial return? This may not be easy to quantify, but to try to do so could be a useful analytical exercise in justifying the total mixed motive investment before it is made.
- How are we proposing to monitor the mixed motive investment?
- Are we satisfied that, taken as a whole, the mixed motive investment can be justified as being in the interests of the charity?
- Will this investment be suitable for our charity looking at its activities and financial position as a whole? This should include consideration of the size of the mixed motive investment in relation to our charity's overall investment portfolio, and our charity's attitude to risk.
- Have we applied the decision making criteria to both financial investment and the PRI?

- Have we considered whether any private benefit arising from the mixed motive investment is acceptable taking into account the contribution the activities funded make to the aims of the charity (see section J8)?
- Have we considered the risk of the charity's resources being used for purposes that are inconsistent with charitable status and the law on investing charitable funds?
- Do we need to take professional advice on the proposed investment? We might need advice on:
 - the fit with the charity's overall business plan
 - whether the investment contributes to the charity's aims
 - the legal issues attached to the proposed investment as a whole
 - any tax implications for the charity

K4 When is a mixed motive investment not justified?

A mixed motive investment is not justified where:

- it is made for purposes other than furthering the charity's aims and securing a financial return
- one or more of the trustees (or persons connected with them) will derive an unauthorised private benefit
- the level of private benefit to other individuals is not appropriate
- the risks involved do not justify the level of resources to be invested.

K5 How should a charity monitor a mixed motive investment?

A mixed motive investment should be monitored both as a financial investment and as furthering the charity's aims and different criteria apply to each. In addition, the charity needs to bear in mind that the balance between the two elements may change.

Trustees should monitor and review:

- the extent to which their charity's resources are being used to further its aims. Trustees may find it helpful to look into and apply emerging methods of reporting on impact or the social return on investment to measure, manage and communicate how the investment furthers the charity's aims
- the expected financial return on the investment and whether it continues to be a suitable one for their charity.

K6 What happens if a mixed motive investment is unsuccessful?

If an investment falls in value or becomes irrecoverable then there will be a financial loss. However, provided that the trustees have taken and recorded their decisions properly, then they are likely to be able to address questions or challenges about their actions.

K7 How should mixed motive investments be dealt with in a charity's annual accounts and the trustees' annual report?

The short answer **L**

The Charities SORP does not currently directly address accounting for recent developments in mixed motive investments which can take many different forms.

In more detail

Where mixed motive investments are material, the trustees should consider their separate disclosure within the balance sheet or within the investment notes to the accounts. The trustees should explain their investment policy in relation to such assets within their annual report and assess their performance.

In so far as the investment seeks a financial return, trustees should consider whether fair value or transaction cost approaches are appropriate to their year end accounting for such assets. As this is an emerging area, we anticipate further consideration will be given to accounting issues as practice develops.

For more information about accounting for investments, see *Accounting and Reporting by Charities, SORP 2005*



Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, Telephone, Fax & E-mail
TSO
PO Box 29, Norwich NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Order through the Parliamentary Hotline Lo-Call: 0845 7 023474
Fax orders: 0870 600 5533
Email: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Houses of Parliament Shop
12 Bridge Street, Parliament Square
London SW1A 2JX
Telephone orders: 020 7219 3890/General enquiries: 020 7219 3890
Fax orders: 020 7219 3866
Email: shop@parliament.uk
Internet: <http://www.shop.parliament.uk>

TSO@Blackwell and other accredited agents

£21.25

ISBN 978-0-10-856042-2



9 780108 560422