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Social Investment by Charities The Law Commission's Recommendations

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THE LAW COMMISSION

SOCIAL INVESTMENT BY CHARITIES THE LAW COMMISSION'S RECOMMENDATIONS

INTRODUCTION

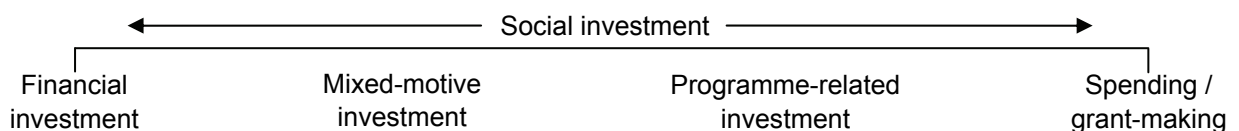
Social investment

- 1.1 Social investment is the use of funds to achieve both a financial return and a social good. For example, some people invest in local credit unions, or buy shares in windfarms, because they want to support the work that the organisation is doing. That might involve either getting a lower rate of financial return than would be available from a mainstream investment, or accepting reduced liquidity. The motivation for making a social investment may be primarily financial, or primarily related to the social good, or a balance of both – and so may the return from the investment. This part of our project relates to the ability of charities to carry out social investment.
- 1.2 Our examination of social investment by charities forms part of a larger project in which we are considering a number of issues in charity law, many of which arose from the review of the Charities Act 2006 conducted by Lord Hodgson of Astley Abbots.¹ The remaining issues will be the subject of a second consultation paper. We are publishing our recommendations concerning social investment by charities at this early stage owing to the heightened interest in this aspect of the project. Our final report on our charity law project will include these recommendations.

Social investment by charities

- 1.3 Figure 1 below shows social investment by charities as a spectrum; it encompasses everything between, but not including, pure financial investment on the extreme left, and pure grant-making on the extreme right. Social investment that is towards the right-hand end of the scale is sometimes referred to as programme-related investment, and the rest as mixed-motive or mixed-purpose investment.

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



¹ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012), hereafter “the Hodgson Report”, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/79275/Charities-Act-Review-2006-report-Hodgson.pdf (last visited 18 September 2014). The full terms of reference for our project are available from the Law Commission’s website: www.lawcom.gov.uk > A to Z of Projects > Charity Law.

- 1.4 The Charity Commission’s guidance explains that programme-related investment (“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 ..., because their decision is about applying assets directly in furtherance of the charity’s aims”.² Mixed-motive investments (“MMI”) are investments that cannot be entirely justified as a financial investment or as a PRI, but have elements of both and are in the charity’s best interests based on “the dual nature of the return”.³
- 1.5 The same social investment can be a PRI to one charity, an MMI to another and even a purely financial investment to another. Much depends on the charity trustees’ intentions when making the social investment and upon the width of their purposes. There are no clear dividing lines along the spectrum. We therefore do not regard the terms PRI and MMI as legally significant⁴ or as precise distinctions, and they can be misleading.

The Consultation Paper

- 1.6 *Social Investment by Charities* (the “Consultation Paper”)⁵ was published on 24 April 2014. The consultation period ran until 18 June 2014. We received 44 consultation responses. Our consultees comprised 15 charities (including representative organisations), 12 lawyers (including a working party formed by the Charity Law Association), 3 academics, 11 organisations making, facilitating or advising on social investment, 1 Parliamentarian, 2 individual members of the public, and the Charity Commission.⁶ We participated in a consultation event on the Consultation Paper hosted jointly by the Charity Law Association and Charity Investors’ Group at Farrer & Co’s offices on 29 May 2014, and a discussion with representatives and members of the Association of Charitable Foundations on 11 June 2014. This engagement built on extensive pre-consultation with the charities sector prior to publication of the Consultation Paper. After the close of consultation, we convened a meeting to discuss the responses we had received concerning the use of permanent endowment to make social investments.⁷ We are grateful to consultees for their engagement with the project, and to those who have hosted and participated in events, all of which has informed and guided our recommendations. We also extend our thanks to Con Alexander and Rachel Tonkin of Veale Wasbrough Vizards LLP for their ongoing assistance and input

² Charity Commission, *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011), p 36, hereafter referred to as “CC14” and available at http://www.charitycommission.gov.uk/media/93859/cc14_lowink.pdf (last visited 18 September 2014). Relevant extracts from CC14 were included in Appendix B to the Law Commission’s Consultation Paper, *Social Investment by Charities* (2014) Law Commission Consultation Paper No 216.

³ CC14, p 48. Some consultees thought that the words “mixed-motive” had negative connotations and preferred the phrase “mixed-purpose investment”. Equally, however, “mixed-purpose” may not be appropriate since charity trustees making social investments have just one purpose, namely to act in the charity’s best interests. It is unnecessary for us to select one or the other term since our recommendations do not distinguish between different categories of social investment.

⁴ They are not referred to in legislation or case law.

⁵ (2014) Law Commission Consultation Paper No 216.

⁶ Consultees are listed in Appendix A.

⁷ Those who attended the meeting are listed in Appendix A.

on the project. Finally, we would like to record our gratitude for the work of Stephen Lloyd, formerly of Bates Wells Braithwaite, and for his involvement with our project; he was instrumental in Lord Hodgson's review, from which our review of social investment originated, and gave helpful advice and encouragement to us. We were greatly saddened by his untimely death in August 2014.

- 1.7 This paper summarises the legal problems facing charities in this context, reports consultees' responses to the proposals and questions in the Consultation Paper, and sets out our recommendations for reform. It is accompanied by a detailed Analysis of Responses, which gathers together the comments made by consultees and sets out a more in-depth analysis of some of those comments than is contained in this paper. In addition, we have produced an executive summary of our recommendations. Both documents are available from the Law Commission's website.⁸

THE PROBLEM: CHARITY TRUSTEES' POWERS AND DUTIES

- 1.8 In Chapter 3 of the Consultation Paper we analysed the current law on the use of charity funds and considered how well it accommodated social investment. We looked in detail at two issues:

- (1) the sufficiency of charity trustees' powers to make social investments; and
- (2) the appropriateness of particular duties currently imposed on charity trustees in the context of social investment.

- 1.9 We also acknowledged the existence of a third issue: the adequacy of the law relating to private benefit. A charity may only act to further its own charitable purposes. It must not confer a benefit on a person otherwise than as a beneficiary of its charitable activities, unless that benefit is an incidental consequence of the furtherance of the charity's purposes. We made no proposals about private benefit; the issue is explicitly excluded from the terms of reference for the project because it is fundamental to the legal definition of a charity.

Sufficiency of powers

- 1.10 Charity trustees have various powers – conferred by their charity's governing document, by statute and by the common law – in order to further the charitable purposes for which their charity is established. Some of those powers relate to the use of the charity's funds, and typically comprise: (1) a power to invest; and (2) a power to spend those funds. Some charities, however, have a "catch-all" power to further their charity's objects. A few may have an explicit power to make social investments.
- 1.11 Social investment is a relatively recent phenomenon. It enables charities to further their purposes while also securing a financial return that can be used to fund the charity's future work. That return might be positive (for example, return of capital with interest) or negative (such as repayment of only part of the initial investment).

⁸ www.lawcom.gov.uk > A-Z of Projects > Charity Law.

- 1.12 Where charity trustees have a catch-all power, or an explicit power to make social investments, there ought to be no argument as to their legal authority to make social investments.⁹ However, there is some uncertainty as to whether charity trustees can do so where they only have separate powers to invest and to spend the charity's funds. A power to invest is a power to use funds in a way that is expected to generate a positive financial return.¹⁰ Not all social investments do so. Where a proposed social investment is expected to provide a negative financial return, charity trustees would need to rely upon both their power to invest and their power to spend, together. We take the view that charity trustees can combine those powers to make a social investment, but not all lawyers agree.¹¹

Appropriateness of duties

- 1.13 When making any application of the charity's funds, charity trustees owe certain core duties, including the duty to act in good faith and the duty to act with undivided loyalty in the best interests of the charity. We concluded that these core duties did not give rise to difficulties in the context of social investment. However, our analysis of the law concerning charity trustees' duties revealed two potential problems.
- 1.14 First, when making financial investments out of charity funds, charity trustees are obliged to pursue an investment strategy that produces the best risk-adjusted financial return for the charity.¹² Concerns were raised that this might fetter the ability of charity trustees to make social investments that deliver below-market

⁹ Although the Charity Law Association ("CLA") Working Party noted that, in practice, trustees may be cautious about relying on a catch-all power, and third parties may consider it to be inadequate, as a result of the decision in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd* [1986] 1 WLR 1440, where the court decided that a charity with a catch-all power could not guarantee another company's obligations, even to enable that other company to advance the charity's purposes. We discussed the decision in paras 3.17 to 3.19 of the Consultation Paper. The decision was not supported by consultees.

¹⁰ There is a more extreme view (with which we disagree) that the power to invest is simply unavailable where the expected financial return is less than the best that could be obtained. We concluded in para 3.34 of the Consultation Paper that an investment that is expected to produce less than a market rate of return is nevertheless within the legal meaning of "investment". We referred to *Cook v Medway Housing Society* [1997] STC 90, where the court considered whether the Medway Housing Society was an "investment company" under s 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 expected to produce a below-market financial return. Nevertheless, it "was intended over time to produce a profitable capital and income return" and was therefore an "investment".

¹¹ See, for example, J Warburton, *Tudor on Charities* (9th ed 2003) para 6-026, quoted in para 3.46 of the Consultation Paper.

¹² For our detailed analysis of the law relating to trustees' duties when making financial investments, see *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350, ch 6. We concluded that "the primary aim of [trustees'] investment strategy should be to secure the best realistic return over the long-term, given the need to control for risks" (para 6.23), and explained the relevance of "financial factors" and "non-financial factors" to trustees' decision-making.

rates of return.¹³ We think that that concern is groundless; under the current law, charity trustees are not under a duty to seek the best financial return from social investments, but may consider the overall return, comprising both the financial return and the furtherance of the charity's purposes (which we call "mission benefit").¹⁴

- 1.15 Secondly, where the charity is a trust (as opposed to a company or other incorporated body), the trustees will be subject to the provisions of the Trustee Act 2000.¹⁵ Some of these provisions, including the duty to have regard to the standard investment criteria when exercising an investment power, were not drafted with social investment in mind and do not seem apposite to social investment.¹⁶ A particular problem is the duty to consider diversification of investments, as part of the standard investment criteria. A social investment is unlikely to play a part in a diversified portfolio, because it is selected not with a view just to financial return but also for the mission benefit that it will produce. When compared with a mainstream financial investment, a 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), and all the more so where the expected financial return is modest.¹⁷

¹³ This view is based on comments in *Cowan v Scargill* [1985] Ch 270 and *Harries v Church Commissioners* [1992] 1 WLR 1241, discussed in paras 3.58 to 3.67 of the Consultation Paper.

¹⁴ The principal duty is to act in the best interests of the charity. In our view, *Cowan* and *Harries* should not be read as requiring the best financial return from social investments. 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. 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": [1992] 1 WLR 1241 at 1248. The reasoning in both cases 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 Vice Chancellor said that the best financial return was only "the starting point".

¹⁵ We follow the Charities Act 2011 in using the term "charity trustee" to encompass those responsible for the control and management of charities: Charities Act 2011, s 177. Strictly speaking, however, not all of those who govern charities are trustees; for example, charitable companies are run by directors, not trustees. The Trustee Act 2000 applies only to trustees in the technical legal sense (whether the trust is a pension trust, a charitable trust, or a private trust) and not to charity trustees who are not trustees in that sense, such as directors of charitable companies.

¹⁶ Consultation Paper, paras 3.75 and 3.76.

¹⁷ The Social Investment Forum pointed out, however, that social investments do not necessarily compromise financial returns.

PROVISIONAL PROPOSALS AND CONSULTATION QUESTIONS

Trustees' powers and duties

- 1.16 To address the problems above, we provisionally proposed the introduction of a statutory social investment power. We proposed that it should apply unless it has been expressly excluded, or modified, by the charity's governing document.¹⁸
- 1.17 Turning to trustees' duties, we provisionally proposed the creation of a non-exhaustive, optional, statutory list of factors that charity trustees might take into account when making a social investment, and invited the views of consultees as to what that list should contain.¹⁹ We invited consultees' views as to whether the investment duties under the Trustee Act 2000 should be excluded whenever trustees make social investments.²⁰

Social investment of permanent endowment

- 1.18 Some charities have permanent endowment, which is property that cannot be spent in the furtherance of the charity's purposes and which must either be retained as a direct means of furthering the charity's purposes, such as a village hall (sometimes referred to as "functional" permanent endowment) or invested to produce an income ("investment" or "non-functional" permanent endowment).²¹ Our project only considers the social investment of "investment" or "non-functional" permanent endowment, and references hereafter to permanent endowment should be read accordingly.
- 1.19 We concluded that charity trustees are presently permitted to use permanent endowment to make social investments – provided that they are satisfied that the social investment is likely to preserve the value of the invested endowment capital for future beneficiaries – and that the law is satisfactory.²² Accordingly, we made no proposals for reform, but we invited the views of consultees as to

¹⁸ Consultation Paper, paras 4.6 to 4.13.

¹⁹ Consultation Paper, paras 4.14 to 4.22. The factors proposed were: (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 powers; and (8) any other relevant factors.

²⁰ Consultation Paper, paras 4.23 to 4.33.

²¹ Section 353(3) of the Charities Act 2011 provides that "a charity is to be treated for the purposes of this Act as having a permanent endowment unless all property held for the purposes of the charity may be expended for those purposes without distinction between – (a) capital, and (b) income; and in this Act 'permanent endowment' means, in relation to any charity, property held subject to a restriction on its being expended for the purposes of the charity".

²² Consultation Paper, paras 5.11 to 5.16. We discussed whether this was the actual value (the original sum given to the charity or held by it at any time) or the real value (the actual value adjusted for inflation and changes in the market value of the assets that comprise the fund) in paras 5.11 to 5.14 of the Consultation Paper.

whether the current law is satisfactory and, if not, how the law ought to be reformed.²³

The Charity Commission's guidance: CC14

- 1.20 We also invited consultees' views on the Charity Commission's guidance on social investment, which forms part of *Charities and Investment Matters: A guide for trustees* ("CC14").²⁴ The principal difficulty, of course, is that it is guidance and not law, so cannot entirely overcome any fears that charity trustees might have about their powers to make, and duties when making, social investments.

CONSULTATION RESPONSES

- 1.21 We had an enthusiastic response to the Consultation Paper and heard that charities have a real interest in social investment. Only one consultee²⁵ queried the desirability of charities making social investments; others regarded it as "a valuable tool"²⁶ and said that it "can be genuinely transformative in some cases" albeit only a small component in a much wider picture.²⁷
- 1.22 Consultation revealed a sense that the law is unsatisfactory, or at least in need of clarification, and a desire for reform that would engender more certainty and would give greater confidence to charity trustees who are currently held back by uncertainty and, many consultees felt, by risk-averse advice.

Private benefit

- 1.23 Consultation also revealed that concerns about conferring unlawful private benefit on third parties loom large for charity trustees when contemplating social investment. Nevertheless, there was broad agreement that the law relating to private benefit does not generally prevent charities from making social investments. Our analysis of the law relating to private benefit is set out in the Consultation Paper, and we stand by what we said there.²⁸ It does not seem to us that it is an obstacle, if properly understood, to social investment done with the aim of furthering a charity's purposes.
- 1.24 Some consultees called for the law relating to private benefit to be reformed.²⁹ Others suggested that, even if the law is not reformed, there is a need for greater clarity about the current legal test for acceptable private benefit.³⁰ As regards the former suggestion, the law relating to private benefit is outside our terms of reference; we therefore did not consult on it nor do we make any recommendations for its reform. The recommendations that we do make can be

²³ Consultation Paper, para 5.33.

²⁴ Consultation Paper, paras 3.101 to 3.111. See n 2 above.

²⁵ Sir John Mummery.

²⁶ UK Sustainable Investment and Finance Association. The Wellcome Trust expressed similar views.

²⁷ National Council for Voluntary Organisations and Charity Finance Group.

²⁸ Consultation Paper, paras 3.82 to 3.100.

²⁹ Lord Hodgson of Astley Abbotts and Bates Wells Braithwaite.

³⁰ CLA Working Party and the Wellcome Trust.

accommodated within the existing law relating to private benefit. As to the latter suggestion, we make a recommendation below that the Charity Commission produce revised guidance on this area of law.

- 1.25 One consultee thought that the law relating to private benefit effectively prohibits social investment by charities unless the investee is a charity or a not-for-profit organisation whose purposes are exactly aligned with those of the investing charity. If correct, this would be a serious restriction on the ability of charities to carry out social investment. We do not agree with this consultee's view, and the social investment practice of a wide range of charities goes against it.³¹
- 1.26 We now turn to a discussion of our specific proposals in the Consultation Paper and our recommendations for reform, after which we consider consultees' comments about accountancy and tax, the latter clearly being an overriding concern.

A NEW STATUTORY POWER TO MAKE SOCIAL INVESTMENTS

- 1.27 Consultation confirmed that there is some uncertainty as to the scope of the power to invest, and about charity trustees' ability to exercise a power to invest and a power to spend concurrently. Consultees felt that even a catch-all power for charity trustees to further their charity's objects can, in practice, be insufficient for them to make a social investment. Consultees agreed with the view expressed in the Consultation Paper that charity trustees' power (if they have one) to amend their governing document so as to confer an express power to make social investments is inadequate to solve the problem, since the procedure can be slow, costly and difficult, and social investment opportunities may be lost before an amendment can take effect.
- 1.28 Consultees almost unanimously agreed with our proposal for the creation of a new statutory power for charities to make social investments. Our proposal that the power should apply unless it has been excluded or modified by the charity's governing document was generally uncontroversial.
- 1.29 Consultees confirmed that the new power should apply to all charity trustees, regardless of the legal form that their charity takes. The new power should supplement, not replace, charity trustees' existing powers. Further, it should facilitate social investment, not impose it; whether charity trustees wish to exercise the new power will be a matter entirely for them to decide.
- 1.30 The new power should apply to existing charities, but some consultees went further by suggesting that the new power should have retrospective effect to avoid arguments about the propriety of social investments made before the statutory power comes into effect.³² This would be unusual, and we consider it unnecessary and undesirable. Charity trustees who already make social investments are likely to be able to do so by using other existing powers, such as the power to spend, or to invest, or a catch-all power (see paragraphs 1.10 to 1.12 above). Nevertheless, charity trustees ought to be acting within their powers,

³¹ We consider the argument in more detail in paras 4.18 to 4.22 of the Analysis of Responses.

³² Francesca Quint, barrister, and Geldards LLP.

and we cannot absolve them from any past breaches simply because they were making a social investment (or indeed any other worthy activity that was, nonetheless, beyond their powers). We do not therefore recommend that the new power should have retrospective effect.

Definition

- 1.31 Consultees emphasised the importance of a broad, but clear, definition of social investment, and agreed that it should not seek to replicate the Charity Commission's distinction between programme-related investment and mixed-motive investment.³³
- 1.32 Consultees also regarded it as important that the definition includes transactions that may yield only a neutral or negative financial return (such as repayment of an interest-free loan, or only partial repayment of the initial investment), or may take the form of giving a guarantee.³⁴ In light of consultees' comments, we consider that the definition should make clear that insofar as a social investment is justified by its expected mission benefit:
- (1) only the charity's objects are relevant; other benefits which do not fall within the charity's purposes are irrelevant (even if they may be charitable purposes for another charity);
 - (2) for a charity with multiple purposes, a social investment need not further each one of those purposes; and
 - (3) the charity's social investment must be expected to cause the mission benefit that is relied on to justify the social investment.³⁵
- 1.33 However, insofar as a social investment is justified by its expected financial return, it need not be used exclusively and directly to further the charity's purposes.
- 1.34 One consultee suggested that the definition should not necessarily require trustees to seek a financial return, giving the example of a charity purchasing shares solely for the sake of voting rights. We do not agree that this is a social investment. In our view, for something to be a social investment, the charity trustees' decision-making must be driven to some extent by the expected

³³ We discuss the meaning of "programme-related investment" and "mixed-motive investment" in paras 1.4 and 1.5 above, as well as in paras 1.15 to 1.23 of the Consultation Paper. We explained that we did not favour legislation replicating this categorisation in para 4.9 of the Consultation Paper.

³⁴ As in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd* [1986] 1 WLR 1440; see n 9 above.

³⁵ By using the word "cause", we do not mean that the charity trustees must be satisfied that, but for their social investment, the mission benefit would not be achieved. In the context of social investment funds, for example, if a particular charity does not participate, the same mission benefit might be achieved by reason of other investors participating in the social investment fund. Rather, there must be a causal connection between the charity's money and the mission benefit on which the charity trustees rely to justify the social investment. Charity trustees can only rely on mission benefit that is expected to be caused by the charity making the social investment.

financial return. To widen the scope as suggested would bring in a potentially very wide and inappropriate range of transactions.

- 1.35 **We recommend that a new statutory power should be created conferring on charity trustees the power to make social investments.**

“Social investment” is any use of funds from which charity trustees seek both (a) to achieve a mission benefit, and (b) a financial return, where:

- (1) mission benefit is the furtherance of one or more of the charity’s objects (and not charitable purposes generally), and is caused by the social investment; and**
- (2) the financial return might include: (i) income, (ii) capital growth, (iii) full or partial repayment of the investment, or (iv) avoiding incurring financial liability at a future date.**

- 1.36 **We recommend that the new power should apply unless it has been expressly excluded or modified by the charity’s governing document.**

CHARITY TRUSTEES’ DUTIES IN RESPECT OF SOCIAL INVESTMENTS

- 1.37 The general law governing charity trustees’ duties must apply to the exercise of the new statutory power in the same way as it applies to their exercise of any other power.³⁶ Accordingly, the power must be exercised in the best interests of the charity, for proper purposes, and in accordance with the charity trustees’ fiduciary duties; charity trustees must consider the Charity Commission’s guidance on public benefit;³⁷ and charity trustees must not confer unlawful private benefit on third parties.

- 1.38 Arguably, therefore, it is not necessary for statute to say anything expressly about charity trustees’ duties when exercising the new power. We noted in the Consultation Paper that some charity trustees would prefer the freedom and flexibility that this would offer, but that others would find it too vague and would benefit from direction as to how the power can, or should, be exercised.³⁸

- 1.39 There was general agreement amongst consultees that the duty under the Trustee Act 2000 to consider the standard investment criteria (suitability and diversification of investments) created difficulties for trustees making social investments and should be removed, or at least tailored to suit social investment, but that the duties to review investments and to consider obtaining advice were appropriate.³⁹

³⁶ See para 1.13 above, and para 4.14 of the Consultation Paper.

³⁷ As required by s 17 of the Charities Act 2011.

³⁸ Consultation Paper, paras 4.3, 4.4 and 4.15.

³⁹ See para 1.15 above.

- 1.40 In addition, there is a misconception that the decisions in *Cowan v Scargill*⁴⁰ and *Harries v Church Commissioners*⁴¹ place a duty on charity trustees to maximise financial returns when making a social investment.
- 1.41 Accordingly, we remain of the view that there is a strong case for creating tailor-made duties that apply when charity trustees make social investments.
- 1.42 We now look in detail at consultees' responses to our provisional proposal for the creation by statute of a non-exhaustive list of factors that charity trustees may take into account when making social investments, and to their views as to what that list should contain.

The status of a list of factors

- 1.43 The proposal for a statutory list split consultees. Some consultees agreed with an optional list; others considered that it should be mandatory. Some agreed that the list should appear in statute; others thought that it should feature in non-statutory guidance. Some agreed with the detailed list; others expressed a preference for briefer, high-level, strategic duties. Consultees' views on any one of these points influenced their views on the others. For example, consultees favouring a mandatory statutory list often considered that it should be brief and high-level; but consultees favouring an optional list (in statute or guidance) preferred a more detailed list of factors.
- 1.44 Lists are often useful because they give the decision-maker confidence, but many consultees had a preference for a list of factors to appear in non-binding guidance, rather than in legislation or statutory guidance. This would permit amendments to the list to be made more easily; it would allow the list to be more detailed; it would avoid the risk of the factors listed being treated as mandatory and exhaustive; and it would avoid charity trustees paying lip service to the factors as a "tick box exercise".
- 1.45 Of those consultees who agreed with a statutory list (whether mandatory or optional), many considered that supplementary guidance would in any event be important. The place for this is a revised CC14, as we discuss below, and we make recommendations there for the inclusion of further matters in CC14 that reflect the more detailed matters originally contained in our provisional proposal and some further points raised by consultees.

The content of the list

- 1.46 Consultees stressed that it is important that charity trustees consider both the expected mission benefit and financial return from a social investment, and are satisfied that the social investment is in the charity's best interests.⁴² They also felt that any mandatory duties ought to reflect actions that reasonable charity

⁴⁰ [1985] Ch 270. See para 1.14 above.

⁴¹ [1992] 1 WLR 1241. See para 1.14 above.

⁴² The Charity Commission reported having seen cases where a charity has sought to justify an investment by saying it both furthers the charity's purposes and is likely to generate a financial return but where it was not expected to do either effectively. The duties should seek to prevent this from occurring.

trustees would take in any event. Similarly, they must not be burdensome for charity trustees or restrict their judgement and discretion.

- 1.47 There was general agreement that the duties under the Trustee Act 2000 to consider obtaining advice and to review investments periodically were sensible and ought to apply to social investments. Indeed, consultees felt that the duties attaching to the exercise of the new power should be consistent with the Trustee Act 2000 so that, where a social investment is close to being a pure financial investment, whether the transaction is treated by the trustees as a social investment or a pure financial investment, they are likely to consider similar matters and reach the same decision.
- 1.48 Similarly, it is necessary to consider suitable duties for a wide range of situations; the duties must be appropriate whether charity trustees are considering a social investment that is very close to pure spending (for example, a housing charity purchasing properties for occupation by its beneficiaries at a low rent) or a social investment that is very close to pure financial investment (for example, purchasing shares in a company that is developing a new medical treatment).

Discussion

- 1.49 It is important to note that in many instances of social investment there are currently no specific duties imposed on charity trustees. Where the activity contemplated is at the spending/grant-making end of the spectrum, and is not strictly an investment, the law gives charity trustees a wide discretion. In many cases, of course, social investment is within the legal meaning of investment because a positive financial return is expected; but in such cases there are currently no investment-specific duties imposed on charity trustees of incorporated charities (since the Trustee Act 2000 does not apply).⁴³ We should therefore be cautious about imposing mandatory or detailed duties on charity trustees who are operating between, but perhaps close to, one of the two extremes of the spectrum.
- 1.50 However, having considered consultees' comments, we can see the attraction in creating high-level duties for charity trustees which are tailored to social investment. This would provide charity trustees with some certainty – on the face of the statute – concerning their duties when making social investments, rather than a blank canvas. It will always be important that charity trustees consider the expected overall benefit of a social investment, in terms of both its expected mission benefit and its expected financial return. This need only be a broad assessment; in particular, it should not be necessary for the charity trustees precisely to value the expected mission benefit and financial return from the social investment. In the Charity Law Association's words, charity trustees should look at a social investment through two lenses. We therefore conclude that charity trustees should be under a duty, when making a social investment, to be satisfied that it is in the best interests of the charity, having regard to the expected overall benefit to the charity from the social investment, comprising the expected mission benefit and the expected financial return.

⁴³ Although we have heard that such charity trustees often follow the Trustee Act 2000 investment duties as a matter of good practice.

- 1.51 We agree with consultees who suggested that the Trustee Act 2000 duties to review investments periodically and to consider obtaining advice should also apply to social investments. We have concluded that charity trustees should be under a duty to review their social investments periodically (at such frequency as they decide). This replicates trustees' duties under the Trustee Act 2000.
- 1.52 In relation to advice, we have concluded that charity trustees should be under a duty to consider obtaining advice, but that this duty should not exactly replicate the duty of trustees under the Trustee Act 2000 in two respects.
- 1.53 First, charity trustees should not feel compelled to take advice, and there should be no presumption that they ought to do so. When trustees are engaged in pure financial investment, advice is to be encouraged and can usually be expected. The same, however, should not necessarily be expected in respect of social investments. Social investment by definition involves charity trustees forming a judgement about mission benefit, on which they do not typically take advice. Furthermore, consultees have said that there is a lack of suitable advisers, in which case expecting charity trustees to obtain advice would be unreasonable. The Trustee Act 2000 places a duty on trustees to obtain advice unless they "reasonably [conclude] that in all the circumstances it is unnecessary or inappropriate to do so".⁴⁴ The language indicates that the default position is that trustees should obtain advice. For social investment, we consider that charity trustees should simply be obliged to consider, from a neutral starting point, whether they should obtain advice on a social investment. We anticipate that revised Charity Commission guidance (which we discuss below) will provide charity trustees with further help as to when it will, and will not, be appropriate to obtain advice.
- 1.54 Second, as charity trustees seek both a mission benefit and financial return from social investments, we consider that the duty to consider obtaining advice should apply in relation to both. It may be that one person or organisation can give advice on the social investment holistically, or it may be that charity trustees will want to obtain separate advice on the financial aspects and the mission benefit. They may decide to obtain advice on one aspect only.
- 1.55 The approach set out above creates consistency between the duties that apply to financial investment under the Trustee Act 2000 and social investment, whilst properly catering for their differences. Importantly, in a case where there is genuine ambiguity as to whether a particular outlay is a pure financial investment or a social investment, trustees will not be put at risk by that uncertainty.
- 1.56 The new duties, being tailored to social investment, should apply in place of the duties imposed on trustees by the Trustee Act 2000 (in so far as they apply) and should apply to all social investment by charities, whether or not the trustees in fact need to make use of the new power.⁴⁵ This means that trustees do not have to analyse their constitution so as to decide which power they are using.

⁴⁴ Trustee Act 2000, s 5.

⁴⁵ This mirrors our interpretation of the Trustee Act 2000; it applies whenever trustees make an investment, regardless of whether they are using a power to invest or a different power, such as a catch-all power: see the Consultation Paper, paras 3.72 and 4.28.

- 1.57 As well as the mandatory high-level duties that we recommend above, we can see the benefits of detailed non-statutory guidance for charity trustees making social investments. Consultees generally agreed that the factors in our proposed list⁴⁶ were appropriate matters for charity trustees to consider when making social investments. Some consultees suggested additional factors that should be included. We conclude that the factors in our proposed list, together with some additional matters raised by consultees, should be included within revised guidance from the Charity Commission concerning social investment. We set out our recommendations concerning revised guidance from the Charity Commission below.
- 1.58 **We recommend that the following duties should apply to all charity trustees.**
- (1) **When making a social investment, charity trustees must be satisfied that it is in the best interests of the charity to do so, having regard to the expected overall benefit to the charity from the social investment, comprising the expected mission benefit and the expected financial return.**
 - (2) **Charity trustees must from time to time review the charity's social investments and consider whether they should be varied.**
 - (3) **When making a social investment and when reviewing an existing social investment, charity trustees must consider taking advice.**
- 1.59 **We recommend that these duties should apply to charity trustees in respect of all social investments, and that for trustees in the strict legal sense they should take the place of the trustees' investment duties under the Trustee Act 2000 (to consider the standard investment criteria, to review investments periodically, and to consider obtaining advice).**

PERMANENT ENDOWMENT

Introduction

- 1.60 The purpose of permanent endowment is to ensure that a charity's work continues indefinitely, and the restrictions on spending permanent endowment reflect donors' wishes. Some people may disapprove of perpetual control over the use of charity property, but our charity law project does not consider whether the law protecting permanent endowment should be retained or abolished. Instead, it considers whether those restrictions prevent charities from making social investments and, if so, whether the restrictions should be relaxed to facilitate social investment.
- 1.61 In the Consultation Paper, we concluded that the current law permits charities to invest their permanent endowment in social investments, provided that the investments are expected to preserve the value of the endowment capital.⁴⁷

⁴⁶ See paras 1.17 and 1.42 and following above.

⁴⁷ See n 22 above concerning the retention of the actual or real value. For charities that invest on a total return basis (see paras 5.25 to 5.26 of the Consultation Paper), this limitation applies only to the "trust for investment". Both the "trust for application" and the

Charities are not permitted to invest their permanent endowment in social investments with an expected negative financial return, as this would amount to spending the endowment in furtherance of their charitable purposes contrary to the restriction on capital expenditure. We concluded that the current law was satisfactory and made no proposals for reform, but we invited consultees' views as to whether the law should be reformed.⁴⁸

Suggestions for reform

- 1.62 The majority of consultees who commented on permanent endowment agreed with us that the law was largely satisfactory; permanent endowment can be used to make social investments that are expected to preserve the value of the endowment capital invested.⁴⁹ Of course, the very uncertainties charity trustees face concerning their power to make social investments using unrestricted funds apply equally to charity trustees' use of permanent endowment. Accordingly, consultees said that the new statutory power should expressly apply to permanent endowment.⁵⁰
- 1.63 We agree that this will bring clarity. Permanently-endowed charities ought to be able to participate in social investment, and we make a recommendation below that this is made explicit in the new statutory power.
- 1.64 The new statutory power should not, however, authorise charity trustees to use permanent endowment to make social investments that are not expected to preserve the capital invested. A few consultees were concerned about this and expressed support for reform to enable charities to invest their permanent endowment in social investments that are expected to generate a negative financial return (or are so high risk that the trustees cannot be confident of generating a positive financial return), in order that they can make greater use of their endowment capital. All of these consultees recognised that such a power would have to be made subject to appropriate safeguards, though they differed in their views as to what form these safeguards should take.
- 1.65 There were, broadly, three suggestions.
- (1) Charity trustees should be given a power to "spend" up to 10% of their permanent endowment on social investments which may be expected to generate a negative financial return "provided that the trustees seek to replenish any depleted capital within a reasonable period of time".⁵¹ We

"unapplied total return" are available to be used for any social investments, whether they are expected to produce a positive or negative financial return.

⁴⁸ Consultation Paper, para 5.33.

⁴⁹ As Stone King noted, this reflects charity trustees' duty to have regard to the interests of current and future beneficiaries.

⁵⁰ Social Finance; CLA Working Party; Bates Wells Braithwaite; the City of London Corporation; and the Association of Charitable Foundations. This is particularly pertinent given that charity trustees only have power to invest permanent endowment and, as set out in n 10 above, there is a view that a power to invest can only be used if charity trustees are seeking the best risk-adjusted financial return.

⁵¹ This was Lord Hodgson's recommendation in his review of the Charities Act 2006, on the advice of Bates Wells Braithwaite: the Hodgson Report, ch 9, recommendation 3. Both

understand this to mean that if the social investment generates a loss then the charity trustees must recoup that loss, whether the investment performs better than expected, as expected, or worse than expected. This would protect the endowment capital against the underperformance of a social investment. However:

- (a) it would require some mechanism to ensure that trustees took the necessary steps to recoup any actual losses; difficulties might arise if recoupment became impossible, for example due to unexpected poor performance of the charity's remaining investments;
 - (b) the approach would treat social investments very differently from financial investments (for which there is no requirement to recoup actual losses); trustees would effectively be required to guarantee the performance of social investments, which could run counter to the drive to make social investment more mainstream; and
 - (c) this would require the charity trustees to take a "wait and see" approach in relation to the social investment, which could undermine certainty in the charity's financial affairs.
- (2) Charity trustees should have a power to invest permanent endowment in social investments with an expected negative return provided that they recoup *expected* losses out of other funds within a reasonable period.⁵² We understand this to mean that if the investment performs worse than expected then the charity trustees will only have to recoup the expected (and not actual) losses; however, if the investment performs better than expected then the charity trustees will only have to recoup actual losses (if any). This would allow the charity trustees to know from the outset the maximum recoupment level, so they can manage the charity's finances accordingly. However:
- (a) this approach – like recoupment of actual losses above – would require some mechanism to ensure losses were recovered;
 - (b) this would place significant emphasis on the calculation of the expected loss, which might be an unrealistic basis on which to determine how much permanent endowment should be replenished;⁵³ and
 - (c) we understand that one reason why a specific power to use permanent endowment for social investment is sought is the risk and uncertainty as to how a social investment is likely to perform; yet this suggestion relies on the trustees being able to calculate

Lord Hodgson and Bates Wells Braithwaite repeated this suggestion in response to the Consultation Paper.

⁵² This was suggested by Joel Moreland.

⁵³ For example, as the volatility of a social investment increases, the *expected* financial return becomes increasingly unlikely to be the *actual* financial return; using the risk-adjusted return may therefore be an unrealistic measure.

the expected loss at the outset. If they can do that, then it simply becomes a matter of timing; arguably trustees should be required to find the expected loss from their unrestricted funds before making the social investment, rather than effectively spending the permanent endowment (or future income from the permanent endowment) with an intention to replenish the expected loss (if it arises).

- (3) Charity trustees should be permitted to invest permanent endowment in social investments with an expected negative return, or where the return is high risk and uncertain, provided that the charity's permanent endowment as a whole is expected at least to maintain its overall value in the long term.⁵⁴ We refer to this as "portfolio offsetting". This option would treat social investments in the same way as mainstream financial investments by looking to the expected overall returns, rather than requiring recoupment of individual losses. Portfolio offsetting is, initially, attractive, but it is difficult to identify exactly how it would operate in practice. It would require the creation of a statutory scheme to regulate what would have to be a very broad discretion conferred on trustees. It would, for example, be necessary to deal with the fact that a portfolio of investments will change constantly, and there should be a safeguard to ensure that the investments serving an offsetting purpose could not be changed in a way that put that offsetting at risk, but without artificially petrifying the investments in the portfolio.

1.66 We discussed these options – and the need for reform in this area – with a number of experts at a meeting after consultation responses had been received. This was a useful discussion which has helped us reach some conclusions about reform. There was, however, no consensus view among those who attended our meeting or the others we have contacted about the need for – or the shape of – reform. Several of those present who wished to promote social investment advocated the introduction of a simple legal power to enable the trustees of permanently endowed charities to undertake the full range of social investment.⁵⁵ Others opposed that view, and there was no conclusion on how simple reform might be achieved.

⁵⁴ This was suggested by the Association of Charitable Foundations and Big Society Capital.

⁵⁵ We do not believe that any such power could be simple. Merely permitting charity trustees to use permanent endowment to make any social investment could be simple. But all suggestions for reform would involve safeguards, which would have to be set out in legislation. Those safeguards would have to strike a balance between imposing a defined recoupment or offsetting condition, whilst affording sufficient discretion to charity trustees. There would be complexity, for example, in ensuring that investments that play a recoupment or offsetting role are kept (without being too prescriptive and petrifying the portfolio); in addressing the regular changes that are made to an investment portfolio over time; in setting appropriate limits on the period over which recoupment or offsetting must take place; in setting appropriate limits on the proportion of the endowment fund that could be invested in social investments (without also – and inadvertently – preventing charity trustees from being able, in principle, to use the *entire* permanent endowment to make social investments from which a positive financial return is expected under the current law); and in addressing how recoupment or offsetting should function when there are general market failures.

- 1.67 We are therefore left with conflicting stakeholder feedback. As noted above, the majority of consultees agreed with us that the law as it stands is satisfactory. It was suggested to us that that may be because most foundations, including those currently engaged in social investment, have an expendable endowment;⁵⁶ those with permanent endowment were therefore less likely to engage with our consultation, particularly as we did not make proposals for reform in relation to permanent endowment in the Consultation Paper.
- 1.68 That may well be true. It is, however, also important to recognise that the pressure to facilitate social investment by permanently endowed charities has come largely from those who wish to promote social investment rather than from permanently endowed charities themselves. The impression that we received from the consultation was that permanent endowment, as a means of ensuring that a charity's work continues indefinitely, is highly prized, and that any reform that would relax the protections afforded to it should be approached with extreme caution. That matches our wider experience of discussions concerning the investment of permanent endowment.⁵⁷ So the picture on the merits of reform is mixed.
- 1.69 Consultation responses and our engagement with expert stakeholders since the close of consultation have also failed to present us with any clear evidence of the extent of the perceived problem. Stakeholders have confirmed that most social investments will not be expected to produce a negative return; indeed we have not heard from any permanently endowed charities that have been prevented from making social investments which they would otherwise have liked to make. It has been put to us that this may be an emerging issue as permanently endowed charities engage more in social investment in light of our reforms and other developments; but nevertheless it is not clear how far the scenarios we are considering are likely to arise in practice.

Conclusions

- 1.70 In considering the proposals for reform summarised above, we have reached the following conclusions.

Using permanent endowment to make most social investments is permitted

- 1.71 We have been told that, in the majority of cases, charity trustees will expect a positive financial return from their social investments. Any problem is therefore, to a large degree, overcome because charity trustees are already permitted to use permanent endowment to make social investments that are expected to generate a positive financial return, even if that is a below-market rate of return. Insofar as there is any doubt about that, our recommendation that the new statutory power should apply to all charity trustees, including those of permanently endowed charities, will remove that doubt. That, we think, will be a significant contribution to facilitating social investment by permanently endowed charities.

⁵⁶ An expendable endowment is one which the charity trustees have power to convert to income.

⁵⁷ See *Capital and Income in Trusts: Classification and Apportionment* (2009) Law Com No 315, Part 8; (2004) Law Commission Consultation Paper No 175, Part VI.

The use of existing mechanisms to make social investments that would not otherwise be permitted

1.72 Charity trustees who wish to use permanent endowment to make social investments that are expected to generate a negative financial return have available to them mechanisms under the existing law to allow them to do so.

- (1) Charities have a statutory power to release their permanent endowment in certain circumstances under sections 281 to 284 of the Charities Act 2011.⁵⁸ Small charities can do this simply by resolution; larger charities require Charity Commission approval.
- (2) Charities can seek an order from the Charity Commission under section 105 of the Charities Act 2011 sanctioning the expenditure of permanent endowment.⁵⁹ Such an order can direct the charity trustees to recoup any spent endowment capital out of income within a specified period.⁶⁰
- (3) Charities that have adopted a total return investment approach⁶¹ have the power to allocate up to 10% of the endowment for expenditure, subject to its recoupment on a pound-for-pound basis over a period to be reasonably determined by them.⁶² It should be noted, however, that the purpose behind this latter provision is not to permit social investment, but rather to allow charities to continue spending during times of poor market performance. Trustees may therefore – understandably – be reluctant to use this power to make social investments.

1.73 The first two mechanisms are most likely to be used by charity trustees. If the charity trustees consider that making social investments with a negative (or high risk) financial return is in the charity's best interests, and they explain their reasoning, we would expect these mechanisms to provide charity trustees with the power to do so.

1.74 A number of stakeholders have urged us to be cautious about recommending legal reform where there are already legal mechanisms available. We agree. The routes to spending permanent endowment – with or without recoupment – described above are not designed specifically for social investment; rather, they are intended to provide the trustees of permanently endowed charities with flexibility to spend their endowment to further the charity's purposes. That is wholly in line with the principles of social investment, which involve an element of spending alongside investment. The mechanisms above will allow charity trustees to adopt any of the three investment strategies summarised in paragraph 1.65 above. We therefore do not consider that there is a technical need for a

⁵⁸ See paras 5.18 to 5.22 of the Consultation Paper.

⁵⁹ See para 5.23 of the Consultation Paper. It is also possible for the expenditure to be sanctioned by the court under s 57 of the Trustee Act 1925, though the circumstances in which charity trustees would invoke the jurisdiction of the court under this section, rather than the jurisdiction of the Charity Commission under s 105 of the Charities Act 2011, are greatly limited by s 115 of the Charities Act 2011.

⁶⁰ Charities Act 2011, s 105(6)(c).

⁶¹ See the Consultation Paper, paras 5.25 to 5.26.

⁶² Charities (Total Return) Regulations 2013, reg 4.

specific statutory scheme to enable charity trustees to make social investments using permanent endowment that are expected to generate a negative financial return.

Concerns about existing mechanisms and guidance

- 1.75 We have, however, heard concerns about the use of general mechanisms to enable the spending of permanent endowment in the context of social investment. We have been told that there is a lack of awareness on the part of charity trustees concerning their ability (a) to use permanent endowment to make social investments that are expected to yield a positive financial return, and (b) to use existing mechanisms to release permanent endowment restrictions in order to make social investments that are expected to yield a negative financial return. There is perhaps also reluctance on the part of charity trustees to do so, for fear of being accused of “selling the family silver”. This need not be the case, given that any “release” of the restriction can be on condition that the charity trustees pursue a particular investment strategy which aims to preserve the capital in the long term, or on condition that any actual losses are recouped.
- 1.76 Whilst we have concluded that the existing law is satisfactory insofar as it regulates the use of permanent endowment for social investment, we consider that the Charity Commission’s guidance should be amended to make clear to the charity trustees of permanently endowed charities that they can engage in social investment and how they should do so. We recommend below that CC14 be amended to make clear that permanent endowment can be used to make social investments that are expected to produce a positive financial return. In addition, we recommend that the Charity Commission revise its guidance on the mechanisms for releasing permanent endowment restrictions⁶³ to make clear that they can be used to allow charities to operate the investment strategies summarised in paragraph 1.65 above.
- 1.77 We think that such guidance will provide comfort to charity trustees and help facilitate social investment by permanently endowed charities where that is appropriate.

Regulation of the expenditure of permanent endowment

- 1.78 Our work on social investment and permanent endowment has uncovered wider issues surrounding the regulation of the expenditure of permanent endowment. There is a variety of reasons why charity trustees may wish to spend part or all of their charity’s permanent endowment, not all of which relate to social investment.
- 1.79 During our discussions, some stakeholders expressed concerns about use of the existing mechanisms leading to a perception that charity trustees are disregarding the importance of their permanent endowment and willingly depleting it, when in fact trustees using those mechanisms to pursue the approaches outlined in paragraph 1.65 above are intending to preserve the value of the permanent endowment overall. In addition, some considered the existing

⁶³ Charity Commission Operational Guidance OG545-1 “Identifying and Spending Permanent Endowment” (2012) and OG545-2 “Expenditure and Replacement of Permanent Endowment” (2012), available at <http://ogs.charitycommission.gov.uk/g545a001.aspx> and <http://ogs.charitycommission.gov.uk/g545a002.aspx> (last visited 18 September 2014).

mechanisms enabling the expenditure of permanent endowment to be inadequate owing to what they saw as bureaucratic requirements which, they thought, would be slow, expensive and off-putting for trustees. That complaint chimes with other debates about the regulation of trustee decision-making, some of which we are considering in the remainder of our project.⁶⁴

- 1.80 It may be that consultees' concerns about the use of these powers to enable social investment could be allayed by more general reforms to the existing procedures by which restrictions on permanent endowment can be released. This wider question concerning the general law of permanent endowment and charity trustees' existing powers to use it flexibly and to best effect is of significant practical import to all permanently endowed charities in England and Wales, many of which have considerable endowments. Any proposal to adjust those powers – for example, by expanding charity trustees' powers to resolve to use permanently endowed funds without prior Charity Commission clearance – would have wide ramifications, and could be controversial.⁶⁵ Reform could not be contemplated without full consultation; and does not currently fall within our terms of reference. Nevertheless, we think that the debate on the use of permanently endowed funds in social investment demonstrates the need for wider work on permanent endowment. We therefore would like to include this wider question, not limited to its implications for social investment, in the terms of reference for the remainder of our charity law project.
- 1.81 **We recommend that the new statutory power to make social investments (and the duties in paragraph 1.58 above) should be available to be used in respect of permanent endowment, provided that the charity trustees expect that the capital invested will be preserved.**
- 1.82 **We recommend that the Charity Commission revise its guidance on the mechanisms for releasing permanent endowment restrictions to make clear how they can be used to allow charities to operate an investment strategy that includes social investments on a recoument or offsetting basis.**
- 1.83 We will discuss with Government the inclusion within our terms of reference of a review of the circumstances in which permanent endowment restrictions can be released and the procedures that must be followed.

CC14

- 1.84 Consultees expressed a range of views about CC14, but it was generally considered to be helpful. Many consultees, however, thought that aspects of it were onerous, unclear, inconsistent or difficult to understand, and that it would therefore benefit from amendment. Lord Hodgson thought that the guidance was unduly cautious about social investment, and others suggested that it had fallen

⁶⁴ For example, our consideration of disposals of charity land: see para 3(1) of our terms of reference.

⁶⁵ There is a power, under s 285 of the Charities Act 2011, to amend the financial thresholds in s 281 of the Charities Act 2011 (see para 1.72(1) above) by secondary legislation, potentially expanding the number of permanently endowed charities that could release permanent endowment restrictions by passing resolutions rather than requiring Charity Commission approval. Any such amendment would not, however, involve changing the general legislative framework governing the release of permanent endowment restrictions.

behind developments in the social investment market since it was published in October 2011.⁶⁶ Consultees agreed with our view⁶⁷ that CC14 is inconsistent in its expression of the private benefit test, and that it is unduly pessimistic about the ability of charities to make social investments by purchasing shares in private companies.

- 1.85 In the Consultation Paper we said that, in determining whether a social investment would be in the interests of a charity, charity trustees must assess both the expected financial return and the expected mission benefit from the investment. We noted that certain sections of CC14 tend to suggest that this requires charity trustees to calculate, in money terms, the precise value of the expected mission benefit. We expressed the view that it is unnecessary (and in some cases impossible) for charity trustees to perform such a calculation, and that the assessment of a proposed social investment is a matter of trustee judgement.⁶⁸ Some consultees expressed their agreement with our view. In deciding whether to make a social investment charity trustees will, of course, need to assess, as best they can, the likely cost of doing so⁶⁹ and this will necessarily involve a comparison with other courses open to them. But this does not require precise valuation of the expected mission benefit or financial return from a social investment.
- 1.86 Accordingly, we think that certain amendments should be made to CC14 – and in any event CC14 will have to be revised if the law is changed in accordance with our recommendations. We also take the view, as discussed above, that CC14 should include further matters that charity trustees may take into account when making social investments.
- 1.87 **We recommend that CC14 be revised to reflect the changes to the law that we recommend, to explain the duties set out in paragraph 1.58 above, and to advise charity trustees to consider the following additional matters when making a social investment (in addition to any other factors that they consider to be relevant):**
- (1) the duration of the social investment and how (and when) funds might be withdrawn;**
 - (2) the risks of the social investment failing to deliver, or under-performing in the delivery of, the expected mission benefit and financial return;**
 - (3) how the performance of the social investment will be measured, assessed and monitored;**

⁶⁶ The National Council for Voluntary Organisations and the Charity Finance Group.

⁶⁷ As set out in the Consultation Paper, paras 3.103 to 3.104.

⁶⁸ Consultation Paper, paras 3.105 to 3.108.

⁶⁹ In terms of any foregone financial return (if the money were instead used to make a financial investment) and/or any foregone mission benefit (if the money were instead spent directly on the charity's purposes).

- (4) the relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies; and
- (5) the tax treatment of the social investment.

1.88 We also recommend that the revised CC14 should:

- (1) explain that, in determining whether a social investment would be in the best interests of the charity, charity trustees must assess—
 - (a) the expected financial return and the expected mission benefit from the investment; and
 - (b) the likely cost of making the investment (in terms of any foregone financial return and/or any foregone mission benefit);

however, charity trustees are not required to attach a precise monetary value to either the expected financial return or the expected mission benefit as part of that assessment (though they may choose to do so);

- (2) explain that, if using permanent endowment, the trustees must anticipate that the social investment will preserve the capital for future beneficiaries;
- (3) reframe its explanation of the law concerning private benefit, setting out the test consistently and acknowledging that social investments can be made by purchasing shares in private companies; and
- (4) provide worked examples of social investment decisions made by charity trustees.

NON-LEGAL BARRIERS TO SOCIAL INVESTMENT

1.89 In the Consultation Paper, we noted that law reform alone would not guarantee a flourishing social investment market, since there were various non-legal barriers to social investment.⁷⁰ We summarised the non-legal barriers in Chapter 6 of the Consultation Paper. Many consultees expressed their agreement with those comments. Government is already taking numerous steps to stimulate the social investment market,⁷¹ and many of the other non-legal barriers we commented on might be difficult for Government to solve. In light of consultees' comments, however, there are two particular issues which merit further consideration here.

⁷⁰ Consultation Paper, para 1.34.

⁷¹ HM Government, "Growing the social investment market: 2014 progress update", available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/321483/2014_Social_Investment_Strategy.pdf (last visited 18 September 2014).

Accountancy

- 1.90 Consultees explained that the accountancy treatment of social investments can be problematic for charities. In July 2014, the Charity Commission and Office of the Scottish Charity Regulator published two new Statements of Recommended Practice (“SORP”) for charities, taking effect in January 2015.⁷² Both SORPs specifically address social investment.⁷³ Consultees noted the importance of charity law being aligned with accountancy practices and reporting standards. Future reviews of the SORP and International Financial Reporting Standards (“IFRS”) should therefore include consideration of whether they cater properly for charities’ social investments. We emphasise the importance of engagement between charities, their advisers, the Charity Commission, the Office of the Scottish Charity Regulator, the Financial Reporting Council and the International Accounting Standards Board on the implementation of the new SORP and on the future development of the SORP and IFRS as regards social investment.

Tax

- 1.91 Several consultees raised concerns about the tax treatment of social investments, in particular the fact that tax legislation does not align with social investment (in much the same way as charity trustees’ powers do not align with social investment, as set out above)⁷⁴ and that the guidance issued by HM Revenue and Customs (“HMRC”) is brief.⁷⁵ Some consultees suggested that the utility of reform to charity trustees’ powers and duties would be significantly undermined without corresponding reform of the tax legislation and revision of the tax guidance.
- 1.92 Consultees explained that charity trustees are uncertain as to how HMRC will treat social investments and are therefore concerned about the risk of adverse tax consequences, which can dissuade them from making social investments. Some suggested that a procedure for obtaining prior clearance from HMRC as to the tax treatment of a proposed social investment would therefore be helpful. We reported in the Consultation Paper that our discussions with HMRC had “[suggested] that such a procedure would be administratively burdensome and

⁷² Charity Commission and Office of the Scottish Charity Regulator, “Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard for Smaller Entities (the FRSSE)” (“FRSSE SORP”); and “Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102)” (“FRS 102 SORP”) (effective 1 January 2015), available at http://www.charitySORP.org/media/619092/frsse_complete.pdf and http://www.charitySORP.org/media/619101/frs102_complete.pdf (last visited 18 September 2014).

⁷³ FRSSE SORP, ch 21; FRS 102 SORP, ch 21.

⁷⁴ The concern is whether social investments are “approved charitable investments” or “approved charitable loans” under the Income Tax Act 2007, ss 521 to 537 and Corporation Tax Act 2010, ss 466 to 493. If not, a social investment will be non-charitable expenditure, resulting in the charity losing tax exemptions. We explained the tax concerns in more detail in paras 6.6 to 6.10 of the Consultation Paper.

⁷⁵ HM Revenue and Customs, *Charities: detailed guidance notes*, Annexes II and III, available at <http://www.hmrc.gov.uk/charities/guidance-notes/intro.htm> (last visited 18 September 2014).

costly for HMRC and that such a service is unlikely to be provided”.⁷⁶ Nevertheless, in light of consultees’ comments, we consider that such a procedure would be extremely useful and has the potential to remove charity trustees’ caution about making social investments.

- 1.93 **We recommend that HM Treasury review and seek to amend the legislation concerning approved charitable investments and loans to reflect the definition of social investment in paragraph 1.35 above and the new statutory power to make social investments.**
- 1.94 **We recommend that HMRC produce revised guidance to reflect the changes to the law that we recommend, any amendment of the tax legislation following our recommendation in paragraph 1.93 above, and our recommendations in paragraphs 1.87 and 1.88(1) above. It would be helpful for that guidance also to include anonymised details of social investments that have previously been approved, or not approved, as charitable investments or loans. The guidance should be consistent with the Charity Commission’s revised guidance.**
- 1.95 **We recommend that HM Treasury introduce a procedure by which charities can obtain prior clearance from HMRC as to the tax treatment of a proposed social investment.**

⁷⁶ Consultation Paper, para 6.9.

APPENDIX A

ACKNOWLEDGEMENTS

RESPONSES TO THE CONSULTATION PAPER

- A.1 We are grateful to the following individuals and organisations from whom we received consultation responses:

Charities

Association of Charitable Foundations

Association of Charitable Organisations

Bank Workers Charity

Charity Finance Group

Churches' Legislation Advisory Service

Friends Provident Foundation

Higher Education Funding Council for England

The Monument Trust

National Association for Voluntary and Community Action

National Council for Voluntary Organisations

Nationwide Foundation

St John's Hospital, Bath

Wales Council for Voluntary Action

The Wellcome Trust

Brian Wheelwright, Wates Family Charities

Organisations making, facilitating or advising on social investment

Big Society Capital

Chartered Financial Analyst Society of the United Kingdom

City of London Corporation

Honorary Treasurers Forum

Institute of Chartered Accountants in England and Wales

Mercer Investments

New Philanthropy Capital

Social Finance Ltd

The Social Investment Business Group

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UK Sustainable Investment and Finance Association

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Simon Cramp

Joel Moreland

Charity regulator

Charity Commission for England and Wales

MEETING TO DISCUSS PERMANENT ENDOWMENT

- A.2 We would like to record our thanks to the following individuals who attended a meeting on 9 July 2014 to discuss the use of permanent endowment to make social investments:

Adrian Broomfield, Charity Commission

Richard Jenkins, Association of Charitable Foundations

Joel Moreland

Francesca Quint

Stephen Roberts, Charity Commission

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