



**Law
Commission**
Reforming the law

Social Investment by Charities

Analysis of Responses

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THE LAW COMMISSION

SOCIAL INVESTMENT BY CHARITIES

ANALYSIS OF RESPONSES

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CHAPTER 1

INTRODUCTION

- 1.1 Social Investment by Charities (“the Consultation Paper”)¹ was published on 24 April 2014. The consultation period ran until 18 June 2014.
- 1.2 We received 44 consultation responses. Consultees comprised 15 charities (including representative organisations), 12 lawyers (including a working party formed by members of 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. A list of consultees is at Appendix A.
- 1.3 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 (“the CLA and CIG Seminar”), and a discussion with representatives and members of the Association of Charitable Foundations on 11 June 2014 (“the ACF Meeting”). 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.²
- 1.4 The Consultation Paper generated interest in the sector press, both at the time of its publication and during the consultation period.³
- 1.5 This Analysis accompanies a paper setting out the Law Commission’s conclusions and recommendations for reform in relation to social investment by charities (“the Recommendations Paper”). The Recommendations Paper and an executive summary are available to download from the Law Commission’s website.⁴
- 1.6 In Chapter 2 of this Analysis, we discuss some general themes that emerged from our meetings with, and responses from, consultees. In Chapter 3 we analyse consultees’ responses to the nine provisional proposals and questions in the Consultation Paper. In Chapter 4 we analyse two particular points of detail raised by a few consultees. Appendix A comprises a list of our consultees and Appendix B lists the consultation meetings that we have had concerning social investment by charities.

¹ (2014) Law Commission Consultation Paper No 216.

² Those who attended the meeting are listed in Appendix B.

³ S Shiva, “The Law Commission and social investment”, *Civil Society* (2 June 2014); “Points of law: clarity on social investment”, *Third Sector* (11 June 2014); D Ainsworth, “Statutory power of social investment proposals broadly welcomed”, *Civil Society* (18 June 2014); L Fletcher, “What will a statutory power of social investment mean for charities?”, *Civil Society* (24 June 2014).

⁴ www.lawcom.gov.uk > A-Z of Projects > Charity Law.

- 1.7 In a number of places throughout this Analysis, we have added our response to consultees' comments, particularly in cases where we do not address the comment specifically in our Recommendations Paper.
- 1.8 This Analysis makes frequent reference to the terms "programme-related investment" (or "PRI") and "mixed-motive investment" (or "MMI"). Both terms are used in the Charity Commission's guidance⁵ and are explained in paragraphs 1.4 and 1.5 of the Recommendations Paper.
- 1.9 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 Abbotts.⁶ The remaining issues will be the subject of a second consultation paper.

⁵ 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 Consultation Paper.

⁶ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012), hereafter the "Hodgson Report". The Hodgson Report is 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 at www.lawcom.gov.uk > A to Z of Projects > Charity Law.

CHAPTER 2

GENERAL THEMES EMERGING FROM CONSULTATION

INTRODUCTION

- 2.1 In this Chapter we discuss some general themes in relation to social investment by charities that emerged from consultation.

THE DESIRABILITY OF SOCIAL INVESTMENT

- 2.2 Some consultees commented on the desirability of charities making social investments, and hence whether it should be encouraged by law reform at all.
- 2.3 Sir John Mummery considered that a new power might “have a downside, if the effect was to produce a small financial return on outlay thereby reducing the income of the charity investments available to promote its purposes”. He thought that this might be detrimental to the furtherance by charities of their purposes; it might reduce public support, and increase the risk of challenges to trustee decision-making. This view does not take into account the fact that the reduced income from social investments, as compared with mainstream financial investments, is justified by the fact that the investment itself achieves the charity’s purposes; it merely abridges the traditional process of generating a financial return to be spent at a later date.
- 2.4 Hubert Picarda QC thought that “policy desiderata”, rather than empirical evidence, were being used to suggest “some kind of groundswell or call for reform by charity [lawyers] as a whole or by charities”. He thought that social investment “gets transfusion from the blood supply of Coalition Big Society notions and the predictable interest of political campaigning groups and self styled alleged educational research groups plugging single issue policies...”.
- 2.5 By contrast, Professor Janet Ulph was in favour of reform as it “takes account of the public dimension of a charity’s functions”; law governing trusts and companies concerned with financial benefit ought not automatically to apply to a charity which has a public purpose.
- 2.6 The view of UK Sustainable Investment and Finance Association (“UKSIF”) was that social investment “can be a valuable tool for a wide range of organisations and individuals. This is particularly the case for charities, where social investment products can provide a further opportunity to contribute to their charitable purposes, as well as maximising what are often relatively limited resources.”
- 2.7 The Charity Law Association (“CLA”) Working Party commented that “[s]ocial investment offers innovative approaches to the promotion of [charities’] charitable objects, their primary concern, and an efficient way of recycling funds for later use. It also enables charities to align their finances with their missions.”
- 2.8 The Wellcome Trust explained that it had been making PRI for over 10 years and “[had] found this to be a useful tool in awarding funding to both charitable and for profit organisations”. The Trust could see opportunities to make social

investments that were justified by the combined financial and mission benefits. Similarly, the National Council for Voluntary Organisations (“NCVO”) and Charity Finance Group (“CFG”) said that social investment “can be genuinely transformative in some cases”.

- 2.9 We can see the benefits for charities of their being able to make social investments,⁷ particularly in the light of endorsement of social investment by consultees at the coalface of charities’ activities. We acknowledge the views of those who consider social investment to be undesirable. Ultimately, however, it is for charity trustees to decide whether or not to make social investments; our recommendations are intended to assist charity trustees who wish to make social investments, not to require them to do so.

FACILITATING, NOT IMPOSING, SOCIAL INVESTMENT

- 2.10 Consultees agreed with us that social investment should be facilitated, not imposed.⁸ The Chartered Financial Analyst Society of the UK (“CFA UK”) commented that “if changes to the law do take place, we would hope that this is not interpreted as a signal that all charities must undertake some form of society investment. ... [I]f charities do not wish to undertake social investments then this choice should be respected.” Whilst suggesting that social investment can be “genuinely transformative”, NCVO and CFG said that it “is only likely to impact a small segment of our sector – it is not a panacea to be prescribed as a solution to the sector’s funding challenges”.
- 2.11 Dr Matthew Turnour suggested that the Consultation Paper may “be gliding over the complexity involved in introducing altruism as a concept when it comes to drafting legislation. ... [M]otive addresses the supply side of the equation and law arguably addresses only the demand side”. In response to this consultee, our proposals facilitate social investment by those charity trustees who wish to engage – they do not purport to, and cannot, promote altruism amongst charity trustees and the public at large.

THE DEFINITION OF SOCIAL INVESTMENT

Different meanings of “social investment”

- 2.12 The Social Investment Forum noted that “social investment” can have different meanings. It can be investment in social sector organisations, or investment for a social purpose, or both. Similarly, there are different understandings of whether the anticipated financial return must include a positive financial return, or whether a neutral (in real or actual terms), or negative, financial return is permitted. The various descriptions cause confusion and doubt among charity trustees. They suggested that bringing greater clarity of thought was critical, even though that will inevitably “overturn a minority’s perception of what constitutes social investment”.

⁷ We noted the importance of social investment to charities in paras 1.26 to 1.32 of the Consultation Paper.

⁸ Consultation Paper, para 4.2. This was expressed by Social Finance; Lord Hodgson; Chartered Financial Analyst Society of the UK; the Monument Trust; Churches’ Legislation Advisory Service; the Social Investment Forum; NCVO and CFG; Stone King; the City of London Corporation; and during the ACF Meeting.

- 2.13 Hubert Picarda QC thought “social investment is an unclear concept and capable of being used by a proponent to mean precisely what that proponent wants it to mean”. It is “a misnomer and form of doublethink”. Similarly, “social value” and “social impact” are “suffused with [ethereal] vagueness with similar lack of clarity not least because of the preconceptions of those who bandy these terms about in their espousal of particular causes. ... One man’s social value is to him a tasty refreshing potion for another man it has a nasty taste or is perceived as poison. Social impact is also a vague subjective and unreliable test”.

Possibility of financial benefits

- 2.14 Francesca Quint suggested that the definition of social investment should not necessarily require trustees to anticipate a financial return; it should extend to investments which are only designed to achieve mission benefit, for example, a charity purchasing shares in a housing association where the only intention is to achieve the charity’s purposes, and any financial return would be a bonus. We address this issue in paragraph 1.34 of the Recommendations Paper.

Broad definition

- 2.15 Mercer Investments said that, given the nascent and emerging market, it was important for the definition to be broad. A prescriptive or narrow power “could lead to further confusion for trustees and pose a further barrier to charities making social investments”. The Wellcome Trust said that the definition “should accommodate the evolving nature of social investment and the practical complexities faced by trustees in identifying risk around social investment opportunity”.
- 2.16 The Social Investment Forum supported a definition that made clear that the duty of charity trustees is to seek the best overall return when making social investments, not exclusively a financial return.
- 2.17 We referred to “financial benefit” in the Consultation Paper.⁹ Some consultees preferred the phrase “financial return”. Geldards suggested the following definition of social investment: “expenditure or outlay which will further the objects of the charity and which may give rise to a financial return to the charity”. The Higher Education Funding Council for England (“HEFCE”) considered our definition “to cover satisfactorily the range of activity between ‘pure financial investments’ and outright grants (or direct service provision), although we prefer the phrase ‘financial return’ to ‘financial benefit’.” We agree with these comments and refer to “financial return” in the Recommendations Paper.
- 2.18 Professor Duncan Sheehan said it was important to ensure that an interest-free loan is included as a financial benefit within the definition, but suggested that “return of money which due to inflation has reduced in real value is not a benefit”. St John’s Hospital, Bath made the same point. Similarly, Bircham Dyson Bell said the definition needed to include an investment that was anticipated to yield a negative financial return, “first loss” investments, and high-risk investments. Geldards suggested that the definition ought to be broad enough to cover the giving of a guarantee, as in *Rosemary Simmons Memorial Housing Association*

⁹ Consultation Paper, para 1.13.

*Ltd v United Dominions Trust Ltd.*¹⁰ The definition of “financial return” that we recommend at paragraph 1.35 of the Recommendations Paper is broad enough to encompass all of these transactions; it simply requires charity trustees to expect something better than complete loss of the money invested.

Other points

- 2.19 Bircham Dyson Bell suggested that reference in the definition to a “charity” seeking mission and financial benefit, should be a reference to a “charity’s charity trustees”. We agree, and have incorporated this into the definition we recommend at paragraph 1.35 of the Recommendations Paper.
- 2.20 The Social Investment Forum welcomed Figure 3 in the Consultation Paper,¹¹ but expressed caution about Figure 2¹² insofar as it suggests a “trade-off between financial return and social return”; not all social investments tend to compromise financial returns. We agree, and we emphasise that the lines on Figure 2 represent minima not maxima.

THE POSITION OF SMALLER CHARITIES

- 2.21 The response of the National Association for Voluntary and Community Action (“NAVCA”) drew our attention to the position of smaller charities.

The majority of charities have relatively small incomes and expenditure and are run predominantly or entirely by volunteers. Their small levels of expenditure, often in support of other volunteer led initiatives, can have significant impacts locally, often disproportionate to the amount of money expended. In reading the consultation paper we have a concern that the discussion and proposals appear to presume that charities are of a certain size, have access to significant resources (in terms of staffing and access to legal and financial advice) and make significant investments. In reality the majority of organisations are volunteer led and have very small incomes. These will in general have limited capacity to engage with the detailed legal arguments outlined in the consultation. Furthermore the impact of any misunderstanding of the rules on social investment will be relatively minor, particularly when weighed up against the potential impact of the transaction, so we have concerns that rules designed for major charities with significant investments, could create unnecessary bureaucracy for small charities. We would therefore commend that the Law Commission considers whether any final proposals will be appropriate and proportionate for small and volunteer led organisations, which are making very small investments and which have limited access to financial and legal expertise.

- 2.22 We acknowledge NAVCA’s concerns and have sought to ensure that our recommendations do not place unnecessary burdens on charity trustees. We also make recommendations that the Charity Commission updates its guidance

¹⁰ [1986] 1 WLR 1440.

¹¹ Consultation Paper, para 1.24.

¹² Consultation Paper, para 1.21.

on social investment,¹³ which we hope will be of assistance to smaller charities that do not have access to financial and legal expertise but which nevertheless wish to make social investments.

NON-LEGAL BARRIERS TO SOCIAL INVESTMENT

- 2.23 Chapter 6 of the Consultation Paper, which summarised the non-legal barriers to social investment, was endorsed by Lord Hodgson: “To achieve a level playing field for this new, exciting but as yet not fully charted movement will require more than mere passivity by a number of professional bodies and [HM Revenue and Customs (“HMRC”).”
- 2.24 St John’s Hospital, Bath noted that social investment requires trustees to consider:
- (1) legal advice about their charity’s purposes, their powers and Charity Commission requirements;
 - (2) investment advice including accounting treatment, tax advice, and HMRC requirements; and
 - (3) accounting advice concerning expenditure, including audit and reporting, SORP (Statement of Recommended Practice) and IFRS (International Financial Reporting Standards) and tax.

It said that there needs to be liaison between the different professionals, and lack of charity trustee skill or lack of funds to obtain professional advice will preclude many charities from making social investments.

- 2.25 CFA UK considered that the non-legal barriers to social investment “should be addressed first rather than starting with the legal ones”.

Tax

Aligning the new power with tax legislation and guidance

- 2.26 Tax concerns were raised by several consultees.¹⁴ The Wellcome Trust noted that the tax exemptions given to charities in the tax legislation – and as explained in HMRC guidance – were based on the use of charity funds being either charitable investments/loans or charitable expenditure akin to grants. It is therefore necessary to shoehorn a social investment into one or the other. “It is difficult to see how genuine mixed motive investments can easily fit into this framework.” It commented that HMRC’s guidance suggested that the social element of an MMI could and should be valued, which is not always possible.
- 2.27 The Churches’ Legislation Advisory Service said that, whilst tax may be outside the Law Commission’s terms of reference, the tax implications “will nevertheless have to be addressed and resolved in the evolution of the policy”. UKSIF said any new legislation “must be shaped in consultation with HMRC as there are

¹³ Recommendations Paper, paras 1.87 and 1.88.

¹⁴ NCVO and CFG; Churches’ Legislation Advisory Service; UKSIF; Bircham Dyson Bell; the Wellcome Trust; St John’s Hospital, Bath; CLA Working Party; and attendees at the CLA and CIG Seminar.

significant concerns ... that social investments may be deemed, after the event, to be 'non-qualifying' investments".

- 2.28 Bircham Dyson Bell said that the way HMRC views social investments causes "serious concern" for charity trustees. They suggested HMRC's guidance was extremely limited and, unless HMRC's approach is clear, doubts about the tax position "will remain a significant bar to social investment". They also suggested that confusion may be exacerbated the more that social investment is seen as different from pure financial investment (particularly with the proposed disapplication of the Trustee Act 2000, on which see paragraphs 3.188 to 3.226 below) and hence less likely to constitute an "approved charitable *investment*" under the tax legislation. The tax legislation therefore also "needs to catch up with accepted (and, indeed, Government endorsed) practice".
- 2.29 The CLA Working Party thought that "any review of social investment and/or a discussion around the definition of social investment should be considered in conjunction with HMRC in order to avoid a divergence of views on the subject and thereby avoid any further confusion on the subject. It is the view of the working party that any definition of social investment should have the same meaning both under charity law and tax law and regulation."
- 2.30 The CLA Working Party felt that there is a lack of clarity in relation to the tax treatment of social investments. The current HMRC guidance on MMI unhelpfully implies a need to calculate the value of the "programme-related" element of the investment in financial terms, which is in many cases impossible to do with any confidence. It was felt that "a full exercise would need to be carried out with HMRC to clarify the tax position" and that "more certainty on the tax side could make the difference between the success or failure of the uptake of the new power".

Prior clearance

- 2.31 Bates Wells Braithwaite endorsed the recommendation¹⁵ of Lord Hodgson in his review of the Charities Act 2006 that HMRC should provide prior clearance on the tax treatment of proposed social investments. Alternatively, they suggested that HMRC could publish a detailed list of examples of previously approved social investments (particularly MMI and co-investment) to assist charity trustees and their advisers.
- 2.32 Our recommendations concerning tax are at paragraphs 1.93 to 1.95 of the Recommendations Paper.

Reporting

- 2.33 NCVO and CFG referred to reporting requirements under the new Statement of Recommended Practice ("SORP"). They thought that charities should report on the extent of their mission and financial motivations in making social investments, and that this needs to be separated from reporting the total risk attached to the investment and the risk relationship with the investment portfolio: "If not treated separately and reported accurately there is a danger that a charity might

¹⁵ Hodgson Report, ch 9, recommendation 9.

underplay the risk involved because they can underwrite the risk by transferring the financial risk onto the social risk or vice versa.”

- 2.34 The Wellcome Trust referred to the importance of the SORP reflecting the flexibility under the new power.
- 2.35 We comment on the SORP at paragraph 1.90 of the Recommendations Paper.

Governance

- 2.36 Social Investment Business noted the consequences of spending and investing often being allocated to separate committees. A social investment is unlikely to further the charity’s mission more effectively than traditional spending, so is unlikely to be adopted by the spending committee. Similarly, a social investment is unlikely to maximise financial return, so is unlikely to be considered by the investment committee (which is looking for financial returns, not mission-related returns). We commented on this issue in paragraph 6.3 of the Consultation Paper.

Experience of social impact bonds

- 2.37 The Monument Trust was concerned that service-delivery charities who were recipients of social impact bond funds¹⁶ were also being expected to participate in the bond as investors in themselves, effectively taking on debt to fund a scheme that triggers public funds, and that “it is unreasonable to ask charities to take the burden of risk to public funds, as the price of assisting in civil society and the delivery of associated aspects of public services”. Additionally, it made criticisms of the Government’s treatment of the Peterborough Social Impact Bond, saying it “[called] into question not only the integrity of the experiment we were asked to support, but also the basis on which we were asked to and agreed to participate”. It concluded that, whilst a change in the law was to be welcomed, it “should be accompanied by a consideration of the safeguards in place, for example, to keep all participants in [social impact bonds], holders and issuers alike, to the originally agreed terms and the social and charitable aims”. These issues fall outside our terms of reference, but we have passed the comments on to Government.

NOMENCLATURE

- 2.38 Lord Hodgson strongly urged us to consider replacing the term “mixed-motive investment” with “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 other term since our recommendations do not distinguish between different categories of social investment, given the social investment spectrum¹⁷ and the absence of clear distinguishing features between them.

¹⁶ See the Consultation Paper, paras 2.11 to 2.18, where we explained social impact bonds.

¹⁷ Recommendations Paper, para 1.3. See also Consultation Paper, para 1.18 and following.

OTHER ISSUES

- 2.39 Simon Cramp was concerned about lack of legal awareness on the part of charity trustees and proposed mandatory training. This falls outside our terms of reference.

CHAPTER 3

RESPONSES TO PROVISIONAL PROPOSALS AND CONSULTATION QUESTIONS

- 3.1 In this Chapter, we analyse consultees' responses to the four provisional proposals and five consultation questions in the Consultation Paper.

QUESTION 1

We invite consultees' comments on whether the current law governing social investment by charities is satisfactory.¹⁸

- 3.2 Most consultees agreed with us that, generally, charity trustees can make social investments under the current law using existing powers and in accordance with their duties. Nevertheless, 33 consultees thought that the law was unsatisfactory or at least agreed with us that the law is not as certain as it should be and would benefit from clarification.¹⁹ Three consultees thought that the law was satisfactory.²⁰ One consultee expressed other views.²¹

The ability of charity trustees to make social investments under the current law

- 3.3 The Charity Commission said "the existing law undoubtedly permits many charities to make social investments very successfully". It appreciated that some charities were cautious about combining the power to invest and to spend, but said this was advantageous in requiring charities to account for the whole transaction, partly as a financial investment and partly as a furtherance of purposes. "We have had cases where a charity has sought to justify an investment by saying it both furthers their purposes and is likely to generate a financial return but where it does neither effectively." Nevertheless, the Charity Commission could "see the advantages of a specific power to make social investments" which would "give charities confidence that they have the power to make such investments".

¹⁸ Consultation Paper, paras 3.110 and 7.1.

¹⁹ Brian Wheelwright, Wates Family Charities; Francesca Quint; Professor Duncan Sheehan; Social Finance; Geldards; Professor Janet Ulph; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; Higher Education Funding Council for England ("HEFCE"); The Monument Trust; the Bank Workers Charity; Churches' Legislation Advisory Service; St John's Hospital, Bath; Bates Wells Braithwaite; UK Sustainable Investment and Finance Association ("UKSIF"); Bircham Dyson Bell; New Philanthropy Capital; the Social Investment Forum; Friends Provident Charitable Foundation; Wales Council for Voluntary Action; Social Investment Business; National Council for Voluntary Organisations ("NCVO") and Charity Finance Group ("CFG"); the Wellcome Trust; Mercer Investments; Joel Moreland; the Nationwide Foundation; Stone King; Big Society Capital; City of London Corporation; Honorary Treasurers Forum; Association of Charitable Foundations; Institute of Chartered Accountants in England and Wales ("ICAEW"); Charity Law Association ("CLA") Working Party.

²⁰ Chartered Financial Analyst Society of the UK ("CFA UK"); Hubert Picarda QC; Sir John Mummery.

²¹ Charity Commission.

- 3.4 The Friends Provident Charitable Foundation had not found the current law presented difficulties in making social investments, but acknowledged that this might be due to it having an expendable endowment, having broad charitable aims, being a recent creation, and having a programme based on “the right use of money” which lends itself to social investment.
- 3.5 The Wellcome Trust said it “[had] not felt restricted in making social investments by the current law” but recognised that its size meant that it had the necessary resources and could bear the risks. It supported reform that would simplify the legal framework for charity trustees, but thought the non-legal barriers to social investment may be more significant.
- 3.6 Matthew Smith agreed that the combination of the power to spend and the power to invest would usually be sufficient to allow charities to make social investments, but supported the creation of a new statutory power.
- 3.7 The Association of Charitable Foundations agreed that in most cases charity trustees will have power to make social investments. The Association said that arguments made to the contrary “have not held sway with many trustees”, but that there is still sufficient uncertainty at present that the introduction of a new statutory power would be helpful.
- 3.8 Two consultees were doubtful about the scope of charity trustees’ existing powers to make social investments; this divergence in consultees’ views as to what the current law permits reinforces the view that the law is uncertain. Peter Crampin QC said that any use of a power “to invest” for a non-financial return “must be an abuse of the power”.²² Sir John Mummery considered that, when exercising an investment power, charity trustees have a duty to maximise the financial return. He said that, whilst a social investment may pursue a charity’s purposes, it cannot be made using an investment power unless it is made to produce income for use in furthering the charity’s purposes. “Legislation would be necessary to confer on trustees an express supplementary statutory power to use funds for the purposes of ‘social investment’ and by providing that the trustees would be deemed not to be in breach of duty in entering into such arrangements.”

Suggestions that the current law is unsatisfactory

- 3.9 The majority of consultees, while agreeing that charities could make social investments under the current law, agreed with us that the law is unsatisfactory.
- 3.10 The CLA Working Party said that the current law governing social investment by charities was “not fit for purpose” and identified three key deficiencies.
- (1) *Lack of clarity in the law.* There is a lack of clarity in the current law, both as to the power of charity trustees to make social investments (where the charity’s governing document does not contain an express power) and as to their duties. “There is a common, if sometimes ill-founded, assumption among charity trustees that, to act in the best interests of the charity, they

²² In paragraphs 4.7 to 4.12 below, we address Mr Crampin’s further argument that the law relating to private benefit effectively prevents charity trustees from making many social investments.

must invest the charity's funds for the best risk-adjusted financial return and that engaging in social investment opens them to risk of challenge."

- (2) *Case law concerns private trusts and pension funds.* It is difficult to fit social investment within the existing legal framework since the case law with respect to trustee investment duties relates in the main to private trusts and pension funds. "[W]hen making investment decisions, private trust and pension fund trustees often translate their duty to exercise their powers in the best interests of the present and future beneficiaries of the trust into a duty to pursue maximum risk-adjusted returns in their investment portfolio. It is generally assumed that [*Cowan v Scargill*]²³ is equally applicable by analogy to charitable trusts. However, the working party's view is that this application is misplaced because of the distinctive nature of charities." The case of *Harries v Church Commissioners*,²⁴ in which the court held that the *raison d'être* of a charity's investments is to generate money "may have limited application to the circumstances of most charities" due to its unusual facts: the Church Commissioners operated effectively as a pension fund for the Church of England clergy.
 - (3) *Out-of-date law.* *Cowan* and *Harries* were decided in 1984 and 1991 respectively. Both the case law and the Trustee Act 2000 "predate the modern socially responsible investment industry, the rise of the social enterprise movement and the emergence of the social investment market in the UK and impact investment market internationally".
- 3.11 St John's Hospital, Bath said "the current law giving trustees power to undertake social investment does not provide trustees with clear principles for this type of investment. This in turn leads to interpretations, which can make trustees nervous".
- 3.12 Big Society Capital said that many charities do not know how social investment should be undertaken to stay clearly within the law, and that advisers are not providing any greater certainty. This has been borne out by its own recent investment experience. "We have made commitments to invest in investment vehicles with plans to set up sector-specific funds. These funds have not been successful in raising co-investment from large charities/foundations where the objectives of the social investment partly overlap with the objects of the charity. In theory, such sector-focused funds could lend themselves to 'mixed motive' investments by charities with funds to invest. However, as far as we're aware, no charity has yet been willing to make mixed motive investments." It may be that the term "mixed-motive" is being used in a particular sense here to mean a social investment which pursues both the investing charity's charitable purposes and other charitable purposes which are not purposes of the investing charity. Insofar as the benefit from a social investment extends beyond furthering the investing charity's purposes – and even if those other purposes would be charitable for another charity – it must be justified by the financial return from the social investment.

²³ [1985] Ch 270.

²⁴ [1992] 1 WLR 1241.

- 3.13 Francesca Quint considered the law to be unsatisfactory, particularly as legislation often “[assumes] that the only type of investment return is financial”.
- 3.14 Social Finance said “[i]t is our ongoing experience that many charities ... cite uncertainty of the legal standing as a major barrier to entering the social investment market. Indeed it is still quite common to hear statements to the effect that ‘the law does not allow charities to make social investments’ both from charities themselves and from their legal or financial advisors.”
- 3.15 Lord Hodgson said that “At present it requires courageous trustees to fight their way past the serried ranks of lawyers, accountants, actuaries, investment advisers for whom “risk aversion” may be the default option”. He wanted the Law Commission’s recommendations to “provide a set of legal protections for those responsible trustees, who so wish, to consider social investment in the round”.
- 3.16 The Churches’ Legislation Advisory Service said “the current law is unsatisfactory simply because of its apparent lack of clarity. ... [G]iven that charity trustees, particularly those of smaller charities, tend to be selected for their commitment to the charity in question rather than for their technical knowledge of charity law, the law needs to be as simple and unambiguous as possible.”
- 3.17 The Monument Trust referred to numerous trustee discussions considering whether social investments should be viewed as grants, despite the possibility of a financial return, or as investment from capital alongside the investment portfolio, saying “it would be helpful for it to be clear that trusts and foundations are permitted to use their funds in this way without fear of failing to meet their fiduciary duty to achieve the greatest possible return, something which cannot always be projected or even expected from balancing the risks versus the prospect of return on a social investment”.
- 3.18 UKSIF considered that the law “provides insufficient certainty for charity trustees”. Whilst some charity trustees are “quasi-professional” with investment and other relevant backgrounds, many are not and “feel uncertain of their duties and the scope of their powers” in making social investments. “[It] is in part the lack of solid case law on social investment issues that deters some trustees and their legal advisors from making social investments.”
- 3.19 The Social Investment Forum said the law was satisfactory in allowing many charities to make social investments, but was unsatisfactory by reason of the uncertainty as to the meaning of that phrase (see above), and also the perceived difficulties created by the decision in *Harries*, given that “one leading law firm ... have publicly declared that [the decision] is suspect”.
- 3.20 NCVO and CFG said “greater clarity will support charities in making decisions around social investment”. Whilst they had “not encountered charities that wish to undertake social investments feeling unable to do so because there is a lack of legal clarity”, they acknowledged the differences of opinion concerning charity trustees’ powers and agreed the law required clarification to remove “perceived barriers” and the need for costly legal advice.
- 3.21 The Nationwide Foundation said that charity law and the law relating to financial investments was often conflicting. “Although we concluded that we are able to make PRIs it took a long time to pick apart the conflicting points to decide if what

we wished to do was possible.” It said that the lack of clarity, and need for expensive legal advice, dissuades charity trustees from making social investments; “it is easier just not to do it”.

- 3.22 Stone King said that the available case law is unhelpful. “That which does exist in particular *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd*²⁵ makes clear the risks involved whilst providing little or no confidence that trustees can further their objects through social investment activities. In particular, the statements by the Judge 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 own actions or through its agents or subsidiaries’ appear to be contradictory with most forms of social investment where charitable outcomes are achieved through the work of third parties.”
- 3.23 Professor Duncan Sheehan said *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd* “raises eyebrows. It seems at best odd that a large grant to enable the work to be completed might have been valid, but a guarantee (which potentially costs the charity nothing) is void. It seems unduly formalistic.” He said that considerations in *Cowan* and *Harries* are not entirely appropriate for social investment, because trustees are not seeking the best financial return, but pointed out that *Cowan* “[does not require] profit maximisation at all costs”.
- 3.24 Bates Wells Braithwaite referred to an “ill-founded and mistaken”, and “very prevalent”, assumption “in relation to charity trustee investment duties ... that charities must invest for a maximum risk-adjusted return” and that social investment is therefore questionable. They believed that this originated from over-reliance on case law concerning private trusts and pension funds. They said that charities are different; they are for the public benefit and are not required to preserve their capital (save for permanently endowed charities). Accordingly, they have “a great deal more flexibility to be creative, innovative and strategic in making investment decisions in pursuit of social investment than is the case with private trusts or pension funds”.
- 3.25 The Charity Law and Policy Unit at the University of Liverpool noted – in relation to *Cowan* and *Harries* – that “dicta around ethical investments can easily be translated across to social investments, even though they are distinct and judges will not have been considering social investment vehicles when making such comments”.
- 3.26 Mercer Investments said that some trustees believe that social investments are inconsistent with their fiduciary duties, and therefore welcomed the review.
- 3.27 Professor Janet Ulph thought that the Trustee Act 2000 investment duties (to consider the standard investment criteria, to consider obtaining advice and to review investments)²⁶ represented “an excellent balance between flexibility in investing and protection of the beneficiaries’ interests” but agreed that there was a lack of clarity for charity trustees making social investments.

²⁵ [1986] 1 WLR 1440.

²⁶ See the Consultation Paper, para 3.68 and following.

- 3.28 Social Investment Business said it was “unsurprising” that social investment was not adequately catered for by the current law, as it is a new and growing area. It said that the current law does not allow charity trustees to take advantage of the social investment opportunities that exist.

Suggestions that the current law is satisfactory

- 3.29 CFA UK did not see the need for statutory reform, considering that “if social investment aligns with the mission of the charity then one would hope that this would be reflected in the instrument. Where the instrument needs to be amended to allow for social investment, such changes should be allowed to be made in the most efficient manner possible.”
- 3.30 In response, we would point out that governing documents will often say nothing about social investment, owing to its relatively recent emergence. Whilst it is often the case that charities can amend their governing document, there are various reasons why they may not do so or may be unable to do so (see paragraph 3.49 of the Consultation Paper), hence the need for a default power that does not require an amendment to the governing document. Bates Wells Braithwaite gave a further reason why relying on charity trustees’ ability to amend their governing documents was insufficient: the proposed power will cater for those situations where “many charity trustees may not realise that a power is necessary or desirable until it needs to be used”. They said that opportunities may be lost if charity trustees then have to go through the process of amendment before they are content to make social investments.

Separating the power to spend and the power to invest

- 3.31 The Association of Charitable Foundations said that “charity trustees are increasingly becoming conscious that – from a strategic perspective and in order to fulfil their obligation to use their resources only for their charitable objectives – it is best to consider the use of their assets through the single lens of their charitable mission”. The Association felt that the analysis in the Consultation Paper of powers to invest and to spend “inadvertently reinforces binary thinking that increasingly good practice has transcended”.
- 3.32 In response to this consultee, a power to spend enables charity trustees to divest themselves of the charity’s assets directly in pursuit of the charity’s purposes.²⁷ When exercising a power to invest, by contrast, charity trustees are not disposing of the charity’s assets but retaining assets which are expected to produce a financial return. Whilst we agree that charity trustees ought to consider the use of their assets for the charity’s mission holistically, if all that the trustees have is separate powers then it is necessary to identify those powers and work within their scope.

Regulatory difficulties

- 3.33 The Nationwide Foundation reported a regulatory problem it encountered in relation to social investment. “Often investment opportunities that have a social

²⁷ In the Consultation Paper, we distinguished this 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: para 3.21, n 14.

impact, are structured in a financial investment vehicle, and subject to the appropriate regulations from the [Financial Conduct Authority]. As a social investor this has presented us with a barrier to investing in some social investment opportunities. For example a non-retail investment cannot be promoted to us as we are not considered high net worth. We also cannot be certified as a ‘sophisticated investor’ as we are not experienced at making financial investments. This regulation is there to protect people from losing their money however as the social return is our main driver this is something we don’t need to be protected from. Could a new statutory power allow us to be certified as a ‘social investor’ to be able to invest in such opportunities that currently we are prevented from doing so?” The issue falls outside our terms of reference, and potentially raises some wide-ranging questions on which we have not consulted, but we have passed the comments on to Government.

Other comments

- 3.34 Turcan Connell provided a Scottish perspective, noting that the Office of the Scottish Charity Regulator had not published guidance equivalent to CC14. They suggested that our final recommendations would be of interest to the Scottish Law Commission and the Office of the Scottish Charity Regulator.

QUESTION 2

We invite consultees’ comments on the Charity Commission’s guidance in CC14.²⁸

- 3.35 Consultees expressed a wide range of views, from:

- (1) “a very helpful building block for the development of the [social investment] market”. CC14 is important and, supplemented by legal clarification, will form “a critical platform for charities to more actively consider and use social investment” (Social Finance);
- (2) “a positive development” (Bates Wells Braithwaite);
- (3) “helpful and welcome” (the Social Investment Forum);
- (4) “a positive step” (the Wellcome Trust);

to:

- (5) helpful as “an enabling framework document”, but there is inconsistency across Charity Commission guidance, for example in defining public benefit, which can cause trustee caution (Charity Law and Policy Unit at the University of Liverpool);
- (6) “very helpful in providing a basis for advice to trustees”, but the terminology (for example, PRI and MMI) can have different meanings in the social investment market place (St John’s Hospital, Bath);
- (7) “very useful”, particularly the distinction between requirements and best practice, and the short and long answers. The meaning of MMI is,

however, unclear, and most charities are only making social investments that are justified solely on the basis of furthering their objects (Friends Provident Charitable Foundation);

- (8) overall it is helpful, but some parts are confusing, particularly the provisions relating to MMI “which also appear to be somewhat limited in light of the growth in the social investment market that has taken place since the guidance was published” (Wales Council for Voluntary Action);
- (9) “welcome and helpful” but “doesn’t appear to have significantly impacted on the likelihood of charities/foundations making social investments” (Big Society Capital);
- (10) “pragmatic and permissive” but difficult to apply in practice (Association of Charitable Foundations);
- (11) “helpful to a point but ... could be improved” (ICAEW);
- (12) inadequate, onerous, and in need of clarification (Brian Wheelwright, Wates Family Charities);
- (13) sometimes deficient and inconsistent, and perhaps too mechanistic (Francesca Quint);
- (14) perhaps too detailed and insufficiently flexible (Professor Janet Ulph);
- (15) “difficult for the average lay-trustee to understand” (Geldards);
- (16) the guidance “doesn’t cover the full range of things that are currently implemented or under discussion” (Honorary Treasurers Forum); and
- (17) some parts of the guidance are “too restrictive to encompass the full scope of social investment opportunities which are available for charities” (the CLA Working Party).

General comments

- 3.36 The Charity Commission said that CC14 had been well received and that the sector considers it “a useful and informative piece of guidance”.
- 3.37 Lord Hodgson was less than happy with CC14, commenting that “[o]verall the tone of the guidance reflects ‘are you sure you want to do this?’ as opposed to ‘another way of fulfilling your objectives would be to ...’”.
- 3.38 Big Society Capital considered that CC14 was deficient in three main respects:
 - (1) it “does not offer charities sufficient information as to how to apply the decision making framework in the guidance to social investment opportunities in practice”;

²⁸ Consultation Paper, paras 3.111 and 7.2.

- (2) it is unclear on how charity trustees should evidence their assessment of the anticipated financial and social returns from the investment; and
 - (3) “the emphasis on advice within the guidance is practically difficult to implement given that this is a developing area, and auditors, law firms and other advisers are often unwilling/unable to provide advice to support decision making around MMI as yet.”
- 3.39 Stone King said that while CC14 “provides a degree of clarity and assurance for trustees it is no substitute for the clarity and assurance which could be achieved through changes in the law itself”. Social Investment Business made the same point.
- 3.40 UKSIF said CC14 was less clear and less grounded in case law when dealing with social investment than other investment issues. Bates Wells Braithwaite considered that the legal underpinning document²⁹ that accompanies CC14 places too much emphasis on the case law concerning private trusts and pension funds.
- 3.41 The Bank Workers Charity and Association of Charitable Organisations said that the reference to social investment being permitted if it is “wholly in furtherance of the charity’s stated aims”³⁰ needs clarification. This issue is discussed in paragraphs 4.2 to 4.5 below. In response, we would point out that the section of CC14 to which these consultees referred relates to PRI, not MMI, so it is correct (and in line with the Charity Commission’s definition of PRI) in stating that the use of the charity’s funds should be confined to the charity’s purposes.

Status as guidance

- 3.42 Consultees pointed out that CC14 did not have the force of law and was only the Charity Commission’s view of the law.³¹ It said that this can have a “crucial ‘chilling’ effect on legal advice”.³²

Classification of social investments

- 3.43 Social Investment Business said the explanation and examples of PRI and MMI are helpful, but are not enough to enable charity trustees to make social investments confidently. New Philanthropy Capital said that the PRI and MMI classifications were not recognised by the law, but made no criticisms of the clarity of those classifications or their utility.
- 3.44 Stone King criticised the PRI and MMI classifications, which create a distinction with “no current legal footing in England and Wales”. “It is difficult for trustees to label investment decisions as PRI, MMI or financial investments as per CC14

²⁹ 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 18 September 2014).

³⁰ CC14, section J1.

³¹ Francesca Quint; Social Finance; Bates Wells Braithwaite; the Social Investment Forum; CLA Working Party.

³² Bates Wells Braithwaite.

guidance, since the rationale for such investments is often not as clear cut and may change over time. Furthermore the various approaches taken by HMRC, in the Trustee Act 2000, in the Charities Act 2011 and, indeed, in each individual charity's governing document do not always reflect the terminology used in CC14. This makes it harder for trustees to be certain that they are making acceptable investment decisions."

- 3.45 The Association of Charitable Foundations questioned CC14's distinction between PRI and MMI. "[S]ocial investments exist on a spectrum rather than either as PRI or MMI", which has meant that the guidance has been "difficult to apply" in practice.
- 3.46 The CLA Working Party said that "the suggestion [in CC14] that an investment must be pigeonholed into one category of investment [either PRI or MMI] is unhelpful. Often a social investment may be justifiable within more than one of these categories at the same time, a point which is well illustrated in the diagram at figure 3 on page 7 of the [Consultation Paper]. A clarification of the position along these lines would be a useful addition to CC14."

Expression of the private benefit test

- 3.47 In the Consultation Paper, we suggested that CC14 was inconsistent in its expression of the private benefit test.³³ Bircham Dyson Bell expressed general agreement with our comments. Some consultees wished to see greater clarity in the formulation of the private benefit test in CC14, to overcome the uncertainties faced by charity trustees.³⁴
- 3.48 Bates Wells Braithwaite suggested that the "necessary" test had not been used universally in the case law and that CC14 should not include it as a crucial ingredient of the private benefit test. Stone King said that CC14 "causes confusion because of the differing treatment regarding the issue of private benefit for furthering a charitable purpose, for PRI ("necessary, reasonable and in the interests of the charity") and for MMI ("appropriate" or "acceptable")." The Association of Charitable Foundations thought that the issue of private benefit was "one where CC14 makes different statements".
- 3.49 The CLA Working Party said that CC14 "does not adequately summarise the legal issues and opportunities for trustees when considering private benefit in the context of social investments. This aspect to the guidance should be improved, in particular to include more worked examples of the types of social investments which, in the Charity Commission's opinion, would not typically give rise to private benefit concerns for the trustees."
- 3.50 We consider the clarity of the law relating to private benefit further in Chapter 4 below.

³³ Consultation Paper, para 3.103.

³⁴ CLA Working Party; Stone King; Bates Wells Braithwaite; Association of Charitable Foundations.

Private benefit concerns along the full spectrum of applications of charity funds

- 3.51 In the Consultation Paper, we explained our view that private benefit concerns arise when charities engage in spending or grant-making and pure financial investment (at both extremes of the spectrum)³⁵ as well as when making social investments. This was in disagreement with sections of CC14 which suggest that private benefit is deemed to be incidental when charities are engaged in financial investment.³⁶
- 3.52 Bircham Dyson Bell, Bates Wells Braithwaite, and Stone King expressed agreement with our comments. Stone King said that it “differs from the Charity Commission’s view in its guidance CC14 in which it implies that there is heightened concern about private benefit in social investment that is absent in financial investments. We would suggest that private benefit is capable of being present in both areas and it would arguably therefore make sense that it must only be incidental in both cases. We agree with the Charity Commission that, with certain forms of investment, it may be harder for trustees to satisfy themselves that private benefit is incidental [F]urther guidance is required on private benefit and it seems appropriate to tackle this issue at the same time as reviewing the law on social investment by charities (or immediately afterwards), since trustees must consider the issue of any private benefit when making investment decisions (whether financial or social).”
- 3.53 The City of London Corporation said that “the guidance on when and where private benefit has been deemed to be created and whether it is incidental or not is unclear and needs revising so as to provide consistency across the range of investment decisions taken by trustees”.

Equity investments

- 3.54 A related comment we made in the Consultation Paper was that CC14 was unduly restrictive in its explanation of the extent to which charities can make social investments by purchasing shares in private companies.³⁷ Bircham Dyson Bell expressed general agreement with our comments. Stone King and the CLA Working Party discussed equity investments in some detail.
- 3.55 Stone King highlighted section J9 of CC14 as causing particular problems for charities who wish to make equity investments in non-charitable companies to further their charity’s aims. They said that the guidance “requires [such charities] ... to take a more restrictive approach than may be necessary”.
- 3.56 The CLA Working Party noted that section J2 of CC14 states that equity investments may be made “exceptionally”. “[F]or many charities, having equity as part of their social investment portfolio is no longer, and should not be treated as being, exceptional. In fact, in some areas, equity is the predominant (and in some cases only) means by which many social investments can be made. As well as perhaps being more attractive to the charity investing in some cases, it is often necessary for social sector organisations receiving the investment to manage

³⁵ See Figure 1 at para 1.18 of the Consultation Paper.

³⁶ Consultation Paper, paras 3.96 to 3.98 and 3.104.

their gearing by equity, rather than debt, particularly where they are smaller/newer social sector organisations.”

- 3.57 The CLA Working Party also criticised section J9, which states that investing in shares will usually not be possible because of the financial return to shareholders or because it will further some other non-charitable purpose of the investee. “We consider this statement to be unhelpful and, in certain respects, misleading. It is not necessarily the case that encouraging financial returns for shareholders means that the investment is not supporting charitable aims, provided that private benefit is incidental, reasonable and necessary.”

Quantification of mission benefit

- 3.58 In the Consultation Paper, we said that whilst charity trustees must consider both the mission benefit and financial return expected from a social investment, they are not required to value the mission benefit precisely. By contrast, certain sections of CC14 tend to suggest that this is necessary.³⁸
- 3.59 Bircham Dyson Bell expressed general agreement with our comments. The CLA Working Party recommended that CC14 include a statement to the effect that the law does not require charity trustees to carry out a calculation in order to consider whether a proposed social investment is appropriate and that, instead, it should be a matter of trustee judgement. Some consultees, however, noted that whilst a precise calculation was unnecessary, it was a useful exercise for charity trustees to consider separately the expected mission benefit and expected financial return from a social investment: see paragraphs 3.148 to 3.151 below. Bates Wells Braithwaite suggested it would be useful if CC14 provided guidance as to how such calculations might be carried out.

The decision-making process for MMI

- 3.60 Geldards said it was hard for charity trustees to understand what constitutes an MMI, their duties concerning the review of MMI, and the extent to which diversification of investments is necessary with MMI. Similarly, the CLA Working Party reported that some charity trustees, and advisors, have had difficulty applying the guidance on MMI in practice. “[I]n the absence of worked through examples (which were considered in the consultation process on CC14 but not adopted), it is not easy to understand how the financial “part” and the programme-related “part” of an MMI should be apportioned.” They provided some practical examples to demonstrate how it can be difficult to categorise social investments into PRI, MMI and financial investments.

Reclassification of investments

- 3.61 The CLA Working Party noted that CC14 makes no provision for the reclassification of investments from PRI to MMI, and from MMI to either PRI or a financial investment. It recommended “a more flexible approach to the issue of re-characterising social investments which allows the trustees flexibility to continually re-evaluate a social investment over the course of its lifetime and

³⁷ Consultation Paper, para 3.104.

³⁸ Consultation Paper, paras 3.105 to 3.108.

continue to justify its retention provided that it fits anywhere within the spectrum of permitted application of charitable funds. In this context we would encourage the incorporation into CC14 of a diagram along the lines of Figure 2 on page 6 of the [Consultation Paper] which we found to be a helpful illustration of this area.”

- 3.62 Consultees’ additional comments on reclassifying social investments are set out in paragraph 3.99 below.

Delegation of investment decisions

- 3.63 Stone King said that CC14 lacks clarity on when trustees can delegate PRI or MMI investment decisions.

Future amendment of CC14

- 3.64 Consultees noted that CC14 will need to be reconsidered in light of our observations (discussed at paragraphs 3.47 to 3.59 above) and to reflect any changes to the law that we recommend.³⁹
- 3.65 The CLA Working Party and NCVO and CFG said the revised guidance should be produced in consultation with the charity sector and membership bodies. Joel Moreland (an investment professional and charity trustee with a background in social investment) said the redrafting of CC14 needed to be simultaneous with any statutory reform, to ensure “seamless congruence between law and guidance”.
- 3.66 NCVO and CFG noted that social investment had become more complex since CC14 was published, particularly with the introduction of social impact bonds and the Threadneedle Social Bond Fund, so CC14 should be expanded to reflect these developments.
- 3.67 Big Society Capital encouraged further refinement to CC14, in particular: (1) further guidance around the acceptable parameters of social investment decisions, rather than purely questions for trustees to consider; and (2) more explicit guidance on the meaning of “properly” in the context of what amounts to a decision properly taken and recorded by the trustees (which is of particular concern to charity trustees where the investment performs worse than expected).
- 3.68 The City of London Corporation wanted CC14 to provide guidance on the use of expendable endowment and permanent endowment to make social investments.
- 3.69 Wales Council for Voluntary Action was keen for the revised guidance to be expanded and clarified, so that it is accessible to a wide range of charity trustees.
- 3.70 The Nationwide Foundation found it difficult to locate the guidance on PRI, as it appears in guidance that largely covers mainstream financial investment. Similarly, Bircham Dyson Bell suggested that the guidance on social investment in CC14 might helpfully be put into a separate guidance document.

³⁹ HEFCE; Churches’ Legislation Advisory Service; Bates Wells Braithwaite; Wales Council for Voluntary Action; CLA Working Party.

- 3.71 The Wellcome Trust suggested that it would be useful to include Figure 3 from the Consultation Paper⁴⁰ in CC14. Similarly, the CLA Working Party considered that Figures 2 and 3⁴¹ could usefully be included.
- 3.72 Social Finance suggested that further guidance on how to split an MMI into its “social” and “financial” components would be helpful.
- 3.73 The Association of Charitable Foundations recommended that CC14 “give greater prominence and exploration to the purpose behind the various duties on trustees and powers at their disposal, and how they relate to the single overriding duty ‘to further the purposes of the trust’ (*Harries v Church Commissioners*)”.
- 3.74 Some members of the CLA Working Party recommended that CC14 be amended to insert “regeneration” – that is, the improvement of the physical, social and economic infrastructure and the physical environment – as a specific example of a social investment given its significance to local communities.
- 3.75 Our recommendations concerning the future amendment of CC14 are set out in paragraphs 1.87 and 1.88 of the Recommendations Paper. We will also draw to the attention of the Charity Commission the comments of consultees summarised above.

QUESTION 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?⁴²

- 3.76 Thirty-eight consultees answered this question. Thirty-one consultees agreed,⁴³ three agreed in part,⁴⁴ and four disagreed.⁴⁵
- 3.77 The Association of Charitable Foundations said that only a statutory power “would give trustees of the wide range of charities that exist the discretion they need to blend financial and social return along the spectrum in ways that will best further their specific charitable purposes”.

⁴⁰ See the Consultation Paper, para 1.24.

⁴¹ See the Consultation Paper, paras 1.21 and 1.24 respectively.

⁴² Consultation Paper, paras 4.12 and 7.3.

⁴³ Brian Wheelwright, Wates Family Charities; Social Finance; Geldards; Professor Janet Ulph; Simon Cramp; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; HEFCE; The Monument Trust; the Bank Workers Charity; Churches’ Legislation Advisory Service; St John’s Hospital, Bath; UKSIF; Bircham Dyson Bell; New Philanthropy Capital; the Social Investment Forum; Friends Provident Charitable Foundation; Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; Association of Charitable Organisations; the Wellcome Trust; Mercer Investments; Joel Moreland; the Nationwide Foundation; Stone King; Big Society Capital; Honorary Treasurers Forum; Association of Charitable Foundations; ICAEW; CLA Working Party.

⁴⁴ Francesca Quint; Matthew Smith; City of London Corporation.

⁴⁵ Professor Duncan Sheehan; CFA Society UK; Hubert Picarda QC; Sir John Mummery.

- 3.78 Social Finance thought that a new power would “be extremely helpful and provide comfort to trustees”. Geldards said “it would be extremely helpful if there were a clear statutory power to use charitable funds to make or retain social investments”.
- 3.79 The Social Investment Forum said “a new power, allied to a better and clearer definition of social investment, could ... bring more certainty and clarity”. The next best option, they said, would be a statutory clarification of charity trustees’ investment duties.
- 3.80 The Charity Law and Policy Unit at the University of Liverpool said a new power “would reduce concerns that such investments are not permissible and would give advisors something concrete to point to, in order to allay trustees’ fears”. But a power alone “would not be enough to discourage negative perceptions about the primacy of financial return as the purpose of investment”. They expressed concern that HMRC might not recognise the wide definition of social investment, given the potential for abuse.
- 3.81 Bates Wells Braithwaite emphasised that charity trustees need absolute confidence about their power to make social investments: “it is essential that any reforms result in lawyers and other professional advisers being able to give straightforward, simple advice without caveats and, as a result, for advisers to be able to produce relatively simple, easy-to-use and inexpensive documentation”. They said that a new power, complemented by HMRC guidance, “will allow charities to engage with the developing social investment market and to innovate and develop new approach(es) to advancing charitable objects”.
- 3.82 UKSIF said feedback from its members indicated a new power and checklist would be helpful, but emphasised that it must be designed “in full consultation with HMRC”.
- 3.83 Big Society Capital agreed with the provisional proposal, but added that the definition of social investment “would need to be carefully considered and consulted on within the social investment market (potentially coordinated by the Social Investment Forum) to ensure that the range of social investments, including the variety of financial and social return expectations, is permitted within this power”.
- 3.84 Stone King supported the introduction of “a new broadly defined power” that eschewed the distinction in CC14 between PRI and MMI. Other consultees also agreed that the PRI and MMI categorisation should not appear in legislation.⁴⁶
- 3.85 The City of London Corporation said that a statutory power would be helpful insofar as it would “provide a single mechanism for accounting for social investments. Given how difficult it is to assess in advance into which category the investment should be accounted for, this would avoid the need to attribute the investment to PRI or MMI.”

⁴⁶ St John’s Hospital, Bath; Wellcome Trust; Social Investment Forum; Social Finance; and the CLA Working Party. See also consultees’ comments at paras 3.43 to 3.46 above.

- 3.86 NCVO and CFG thought the new power would only apply to MMI, and that PRI would continue to be made with charities' power to spend.

The use of a combination of powers

- 3.87 The CLA Working Party observed that “when a social investment is made, trustees tend to ‘cobble together’ the powers available in the circumstances, usually a combination of the investment power and the power to make grants and then rely on Charity Commission guidance to ‘bless’ the proposed steps. It is our experience that trustees often find it unnerving that there is no express power and in some respects this is reflected in the relatively low take-up of social investment products.”

The use of a “catch-all” power

- 3.88 The Wellcome Trust thought that the creation of a default “catch-all” power might be preferable to the creation of a specific power. By contrast, the CLA Working Party said that “it is always preferable to use a specific power, as opposed to a sweep-up power. ... [A] third party is generally unwilling to rely on a sweep-up power to cover particular circumstances – for example, banks are often reluctant to rely on sweep-up powers when a charity grants security.”

Placement of the new power

- 3.89 A majority of Stone King’s members recommended that “careful consideration [be given] as to where any new legislation is placed. If it were to form part of the Trustee Act 2000, it would then only apply to trustees of unincorporated charities and not to incorporated charities (although it does apply to CIO’s⁴⁷ because of a specific reference in the Charity Commission’s model CIO constitutions) and it would suggest that social investment legislation sits alongside financial investments. By contrast, were the new legislation to amend the Charities Act 2011 it might suggest that social investment is more aligned to a charity’s spending or grant making activities. There is an argument to start afresh with new legislation that sets out provisions for all investment and spending decisions and that emphasises neither one nor the other end of the financial spectrum. However, on balance, the Charities Act 2011, as consolidating legislation, seems an appropriate place to insert the new power.”
- 3.90 The CLA Working Party thought that since the new power would be used by all charities (registered, unregistered and exempt), it might be easiest to include it as an additional section in the Charities Act 2011.

Part of the toolbox

- 3.91 The Monument Trust and Bates Wells Braithwaite expressed their agreement with us that a new statutory power should not replace charity trustees’ existing powers, but should form part of the toolbox available to trustees.⁴⁸

⁴⁷ Charitable incorporated organisations; see Part 11 of the Charities Act 2011.

⁴⁸ See the Consultation Paper, para 4.8.

Content and scope of the new power

- 3.92 The CLA Working Party said that a new statutory power would need to be:
- (1) sufficiently clear to distinguish it from the existing powers to make grants and investments;
 - (2) capable of application to all types of social investment and sufficiently widely framed to cover the various types of social investment currently available (and the differing terms used to describe them);
 - (3) separate from the current power to trade;
 - (4) capable of taking into account the need for any geographical restrictions on the exercise of the power;
 - (5) capable of providing sufficient clarity in relation to public/private benefit;
 - (6) subject to any restrictions on the spending of permanent endowment where applicable;
 - (7) capable of use by all charitable vehicles; and
 - (8) certain, from a tax perspective.
- 3.93 The CLA Working Party also considered that the geographical scope of the power should not be limited (but that charities might themselves elect to limit its scope in their own constitutions) since many social investments concern overseas projects.
- 3.94 Matthew Smith's understanding of the new power was that it would only permit a charity to make a social investment in pursuit of its own purposes (or the purposes of any restricted or endowment fund). He thought it was crucial that social investment did not deviate from the charity's purposes. We address this issue in paragraphs 4.2 to 4.5 below. Peter Crampin QC made the same point in his argument, which is addressed in paragraphs 4.7 to 4.12 below.
- 3.95 New Philanthropy Capital suggested that the term "charitable benefit" (which we understand to mean the same as "mission benefit") could be broader to include social benefit generally. We disagree; in so far as a social investment is justified by the social good it is expected to do, only the investing charity's purposes should be relevant. To go further would be tantamount to widening the charity's objects, without formally amending its objects clause. Our conclusion on this issue is set out in paragraphs 1.32(1) and 1.35(1) of the Recommendations Paper.
- 3.96 The Charity Commission could see the advantages of a new power to give charities confidence, but hoped it would be "sufficiently rigorous" to ensure charity trustees only made social investments that were justified by the combination of the financial and mission benefits. Without requiring social investments to be properly accounted for by reference to their mission and financial benefits "may permit the misapplication of charitable funds".

Retrospectivity

- 3.97 Francesca Quint considered that the new power should be retrospective, otherwise “if there were a watershed situation there could be arguments about the propriety of social investments made before the legislation came into effect”. She suggested a provision stating that charity trustees “have, and are to be deemed always to have had, the power to make social investments”, akin to section 1(1) of the Recreational Charities Act 1958.⁴⁹ Geldards agreed, adding that this would “‘legitimise’ social investments which have already been made and protect trustees against allegations that such transactions might be void or made in breach of trust”.
- 3.98 We address this issue in paragraph 1.30 of the Recommendations Paper.

Reclassifying social investments

- 3.99 Bates Wells Braithwaite pointed out that social investments may change their status over time, and “trustees need to be confident that they can review and reclassify such investments”. St John’s Hospital, Bath, however, said that failing social investments should not simply be “converted to a grant” as this sends the wrong message to investees. Similarly, an attendee at the CLA and CIG Seminar said that *ex ante* classification was necessary to prevent charity trustees from reclassifying a poor financial investment as a social investment, in the same way as some fundraising charities write off losses as “awareness-raising”. The CLA Working Party commented on this issue in the context of CC14 (see paragraph 3.61 above).

Sufficiency of revised guidance to address uncertainties

- 3.100 The City of London Corporation thought that a new statutory power was – in principle – to be welcomed, but thought it would not be necessary if the uncertainties and inconsistencies in the current law could be removed through revised guidance. We do not agree that revised guidance would be a solution. First, it can only ever present a view of the law; it is not law itself: see paragraph 3.42 above. Second, guidance cannot help if the underlying law is in fact unclear.

Disagreement with the creation of a new power

- 3.101 Professor Duncan Sheehan suggested that, rather than creating a new power, it should be made clear that the power to invest includes the power to make social investments. He said that a new power would create a dividing line along the spectrum, between financial investment and everything else, and that whilst a dividing line can be drawn between spending and social investment, it cannot easily be drawn between financial investment and social investment. He said that this approach would avoid the problems of overlapping Trustee Act investment duties.

⁴⁹ Section 1(1) of the Recreational Charities Act 1958 provides that “it shall be and be deemed always to have been charitable to provide, or assist in the provision of, facilities for recreation or other leisure-time occupation, if the facilities are provided in the interests of social welfare”.

3.102 In response, we agree that there is no clear dividing line between financial investment and social investment on the spectrum,⁵⁰ but we do consider that the need for a new power only arises between the two extremes of the spectrum. Nor do we want to shoehorn all social investments into the meaning of “investments”. An “investment” is something from which a positive financial return is expected.⁵¹ Some social investments involve only the re-payment (or partial re-payment) of the capital invested. Such social investments do not involve the exercise of the power to invest at all, and could not do so without changing the meaning of “investment”.

Disagreement with any reform

3.103 Sir John Mummery said that a new statutory power would be necessary to allow charity trustees to make social investments, but he did not agree that this was necessarily appropriate given his concerns about the desirability of social investment (see paragraph 2.3 above).

3.104 Hubert Picarda QC said: “I have not been able to descry or discern in the [Consultation Paper] any trace of empirical evidence to support any ground swell for the recited need to reform the law of charities in such a radical way.” He thought reform was unnecessary and undesirable as likely to dissipate charity trustees’ time and energy.

3.105 Stone King reported that a minority of its members disagreed with the need to introduce a statutory power to make social investments. “A minority felt that the introduction of an additional power specifically for social investments would create an unhelpful distinction between financial investments and social investments. This would seem to reinforce barriers in the minds of trustees and charities which was felt to be at odds with a broader aim of integrating social investments into mainstream investment portfolios. In addition, those not supporting the introduction of a new statutory power felt that there was already sufficient authority existing for charities and that undue concern has been caused by the *Rosemary Simmons* decision.”

QUESTION 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?⁵²

3.106 Thirty-four consultees answered this question. Thirty-two consultees agreed,⁵³ one agreed in part,⁵⁴ and one disagreed.⁵⁵

⁵⁰ Consultation Paper, para 1.18.

⁵¹ See the Recommendations Paper, n 10.

⁵² Consultation Paper, paras 4.13 and 7.4.

⁵³ Brian Wheelwright, Wates Family Charities; Francesca Quint; Social Finance; Professor Janet Ulph; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; HEFCE; the Bank Workers Charity; Churches’ Legislation Advisory Service; St John’s Hospital, Bath; Bates Wells Braithwaite; the Charity Commission; UKSIF; Bircham Dyson Bell; New Philanthropy Capital; the Social Investment Forum; Friends Provident Charitable Foundation; Wales Council for Voluntary Action; Social Investment Business; NCVO and

- 3.107 Geldards said “for maximum impact, a new statutory power ... should not normally be capable of modification or exclusion”, although they then stated that this should be the “default position”.
- 3.108 Matthew Smith suggested that, in the rare cases that a governing document does not confer both the power to spend and the power to invest, the statutory power should be taken as having been excluded. We consider that this would go too far; it would perpetuate charity trustees’ uncertainty as to whether they have the power to make social investments, and it would effectively prevent the new power from being used in respect of permanent endowment, since charity trustees never have a power to spend permanent endowment.
- 3.109 Stone King agreed with the provisional proposal, but added that “any exclusion or modification in the charity’s governing document should ideally not have to specifically refer to the new power so that charities with historic constitutions, where it was clearly intended that the trustees would not have similar powers, are not inadvertently given the new power”.
- 3.110 Bircham Dyson Bell referred to the equivalent Trustee Act 2000 investment power, which applies unless it has been restricted or excluded by the trust deed.⁵⁶ Any existing trust deeds which sought to expand the previous default investment power under the Trustee Investments Act 1961 are not to be treated as restricting or excluding the new default investment power under the 2000 Act.⁵⁷ They reported encountering a difficulty with the 2000 Act “where the wording used did not prevent a ‘restriction’ to the 1961 Act power applying, so that additional action was required to ensure the Trustee Act 2000 power could be relied upon”. In response, we would say that since there is no existing default social investment power (equivalent to the default limited investment power under the 1961 Act), it is unlikely that any existing governing documents will contain provisions which seek to expand charity trustees’ powers to make a social investment but which – following the introduction of the new power – would amount to a restriction. Nevertheless, this issue will have to be borne in mind when a Bill implementing our recommendations is drafted.
- 3.111 The CLA Working Party recommended that “[t]he existence of the new power should be highlighted in Charity Commission guidance so that charities can choose to disapply it. It may also be sensible to include a reference to the statutory power in model governing documents published by the Charity Commission.”
- 3.112 Simon Cramp noted that a national umbrella charity may comprise separate charities at local branch level, with different governing documents. We think that

CFG; Association of Charitable Organisations; the Wellcome Trust; Joel Moreland; the Nationwide Foundation; Stone King; Big Society Capital; City of London Corporation; Honorary Treasurers Forum; Association of Charitable Foundations; ICAEW; CLA Working Party.

⁵⁴ Matthew Smith.

⁵⁵ Geldards.

⁵⁶ Trustee Act 2000, s 6(1).

⁵⁷ Trustee Act 2000, s 7(2).

this is not a cause for concern, since the new statutory power would apply to all trustees of all charities (including national and local charities), subject to the terms of the charity's governing document.

QUESTION 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?⁵⁸

- 3.113 Thirty-five consultees answered this question. Sixteen consultees agreed,⁵⁹ sixteen agreed in part or with some qualification,⁶⁰ and three disagreed.⁶¹ Attendees at the CLA and CIG Seminar expressed opposing views on the desirability of a checklist. Some thought it would be helpful; others thought that it would constrain charity trustees.
- 3.114 Questions 5, 6, 7, and 8 all concerned charity trustees' duties when making social investments. Consultees' comments on all four questions therefore overlapped to some extent.

General comments on the desirability of a checklist

- 3.115 The CLA Working Party agreed with the conclusion reached in the Consultation Paper that there should be no attempt to codify charity trustees' duties in statute. "We think that such statutory duties may sit rather oddly where there are no statutory equivalents in the context of grant making."
- 3.116 UKSIF thought a checklist would be helpful. They were aware of concerns that a checklist would "place an unwelcome burden of complexity upon trustees who should be 'trusted' to exercise any statutory powers as they see fit in the best interests of the charity. However, we think that such fears would be outweighed by the potential usefulness of a 'checklist' both in giving confidence to trustees and help ensure they consider a range of relevant factors when deciding their mixed-motive investment strategy."
- 3.117 Social Finance said that it needs to be made clear that a social investment is targeting the best overall return (social and financial), rather than simply the best risk-adjusted financial return. It said that checklist factors would offer charity trustees security ("a safe harbour") and enable them to record their reasons for making social investments; this would provide protection from future criticism,

⁵⁸ Consultation Paper, paras 4.21 and 7.5.

⁵⁹ Brian Wheelwright, Wates Family Charities; Social Finance; Geldards; Professor Janet Ulph; Simon Cramp; HEFCE; Matthew Smith; the Bank Workers Charity; Churches' Legislation Advisory Service; UKSIF; New Philanthropy Capital; Social Investment Business; Association of Charitable Organisations; the Nationwide Foundation; Honorary Treasurers Forum; CLA Working Party.

⁶⁰ Francesca Quint; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; Bates Wells Braithwaite; the Charity Commission; Bircham Dyson Bell; the Social Investment Forum; Friends Provident Charitable Foundation; Wales Council for Voluntary Action; NCVO and CFG; the Wellcome Trust; Joel Moreland; Stone King; Big Society Capital; the City of London Corporation; ICAEW.

⁶¹ Professor Duncan Sheehan (who disagreed, based on his different approach overall); St John's Hospital, Bath; Association of Charitable Foundations.

and a benchmark against which to measure future performance of social investments. Social Finance thought this should not be a mandatory, or exhaustive, list of factors.

- 3.118 Lord Hodgson agreed with a statutory checklist, provided the factors were set out in statutory instrument to allow easier future amendment.
- 3.119 Brian Wheelwright (Wates Family Charities) thought that the factors in the checklist would be considered by charity trustees even in its absence, as part of their due diligence and monitoring.
- 3.120 The Wellcome Trust had misgivings about a checklist.
- (1) Even if expressed as optional, “experience suggests that there would be pressure to treat it as a mandatory list of factors that would each need a positive evaluation”.
 - (2) On their own, checklist factors may not provide much help (for example, what is the effect of a social investment having a long or short duration, or an equity investment having no clear duration?); guidance would be necessary.
 - (3) Charity trustees entering transactions close to the extremes of the spectrum may inadvertently fail to comply with the formal requirements.
- 3.121 The Wellcome Trust noted that there are no checklists when charities simply spend or make grants, which involves far more of their resources; they are trusted to act in accordance with their core duties and there is nothing “inherently more risky about social investment”. The Wellcome Trust therefore favoured non-statutory guidance, which could contain the checklist factors, and could be easily updated.
- 3.122 The Charity Law and Policy Unit at the University of Liverpool expressed two concerns about a checklist.
- (1) Perception is crucial; if taken too seriously, a checklist may constrain effective social investment. Alternatively, charity trustees may pay lip service to a checklist by treating it as a “tick box exercise”.⁶²
 - (2) Without guidance on the weighting of the factors, it would be difficult for charity trustees to make a clear judgement. An analogy can be drawn with balancing the factors in section 15 of the Trusts of Land and Appointment of Trustees Act 1996, which required development through case law. The weighting and structuring of the discretion needs to be addressed at the outset, rather than being left to Charity Commission guidance.
- 3.123 The Association of Charitable Foundations reported that some of its members were concerned that any defined list “might quickly cause real thought to be replaced with a ‘tick box’ approach”. Other members questioned whether a

⁶² A similar point was made at the CLA and CIG Seminar.

defined statutory list reflecting what seems to be best practice today may in future years become outmoded.

- 3.124 Social Investment Business suggested that the factors should be for charity trustees to “discuss” rather than “consider” in order to encourage detailed debate by trustees. The same suggestion was made by an attendee at the CLA and CIG Seminar.

Should the checklist factors be mandatory or optional?

- 3.125 The Charity Commission, Wales Council for Voluntary Action, NCVO and CFG thought the factors should be mandatory, not optional, considerations.

- (1) NCVO and CFG said that “this will ensure that trustees have certainty about the factors they should take into account when considering social investments”. They said that a checklist “should be proportionate and not create unnecessary burdens” on trustees, and believed the proposed checklist to be comprehensive and “universal for all charities and all social investments” whilst providing charities with scope to consider other relevant matters.
- (2) Wales Council for Voluntary Action said that charity trustees need clarity, and that it did not see that an optional checklist would be particularly helpful. It thought the checklist we proposed was comprehensive but, at the same time, it did not want the checklist to be “overly restrictive to those using it”.

- 3.126 Many consultees thought that the factors should be optional considerations.

- (1) A majority of the CLA Working Party thought that any checklist of factors should be optional and non-statutory.
- (2) Social Investment Business thought a mandatory checklist would be dangerous: it could create “a lowest common denominator” approach that does not encourage trustees to consider unlisted factors – it could become “an exhaustive list by default”; it may also create “a box ticking culture”.
- (3) Matthew Smith agreed that a mandatory checklist was unlikely to be workable, but thought that the proposed checklist may lead trustees to forget to ask “the cardinal question: does this investment further the purposes of this charity?”
- (4) Professor Janet Ulph agreed that the factors ought not be mandatory “because one or more might not be relevant”. “In my experience as an [Arts and Humanities Research Council] Fellow working in the museum sector, employees of public bodies find check lists reassuring.”
- (5) The Churches’ Legislation Advisory Service wanted it to be made clear that the checklist was for illustrative purposes only.

- (6) The Social Investment Forum agreed with an optional, non-exhaustive, checklist of factors, but thought that such a list might be more helpful in guidance, particularly to allow easy amendment.
 - (7) The City of London Corporation favoured a non-mandatory checklist. A mandatory checklist “would be counterproductive as it could make trustees more anxious about their decision making process when considering a social investment”.
- 3.127 Other consultees suggested a hybrid approach, with charity trustees being required to take checklist factors into account unless there is good reason not to do so, akin to the requirement to consider obtaining advice under the Trustee Act 2000.
- (1) Francesca Quint thought trustees should take the factors into account unless there was good reason not to do so. Brian Wheelwright (Wates Family Charities) agreed in relation to obtaining advice and reviewing social investments.
 - (2) Bates Wells Braithwaite suggested that charity trustees should be required to consider the relevance of the factors before exercising the power, and have regard to such factors as they reasonably considered to be relevant. They thought that although trustees would be required under this approach to consider the checklist at the outset, this would empower them to develop bespoke investment policies that might deviate from the checklist.
 - (3) Whilst the majority of the CLA Working Party thought that any checklist of factors should be optional and non-statutory, a minority thought that charity trustees should be obliged to demonstrate that they had considered the relevance of the checklist before exercising the investment power. Charity trustees “should be required to have regard to such of the factors listed in the statutory checklist as the trustees ‘reasonably regard to be relevant in all the circumstances’”. It was said that a formulation of this kind “would empower charity trustees to develop bespoke investment policies and approaches which deviate from the checklist, whilst at the same time requiring charity trustees to at least consider the checklist at the outset”. The proponents of a mandatory checklist made two further comments.
 - (a) If a statutory power is created, the Charity Commission would need to revise CC14. A revised CC14 could be helpful to trustees but, critically, as CC14 does not have statutory force, it would not be necessary for trustees to have regard to it to be able to exercise the statutory power with confidence.
 - (b) A statutory checklist should not be accompanied by statutory guidance (that is, guidance to which trustees must have regard pursuant to a statutory obligation). This “would only complicate the decision-making process for trustees”. It would be better for a revised non-binding, non-statutory CC14 to supplement a statutory checklist.

A checklist or high-level strategic duties?

- 3.128 The Friends Provident Charitable Foundation was concerned that a statutory checklist might be seen as, or become, mandatory and exhaustive (rather than optional and non-exhaustive) and that it would be almost impossible to specify correct and useful factors. It therefore only supported a statutory checklist that was “brief, high level and strategic”. Similarly, Joel Moreland preferred high-level guidance to a statutory checklist. He thought any checklist should be in guidance, with examples of best practice.
- 3.129 St John’s Hospital, Bath disagreed with a checklist of factors, suggesting instead that the new power “should include a high-level strategic framework only. This would provide an overview of what trustees are expected to consider when deciding whether social investment is a tool they can validly use to achieve the charity’s charitable purpose and when making a social investment decision.” It considered that charity trustees should simply consider whether social investment was an appropriate tool, and delegate operational matters such as structure, risk strategies and performance management of individual social investments.
- 3.130 The Association of Charitable Foundations suggested that instead of a checklist of factors for charity trustees to consider, the new statutory power could be framed “in such a way as to make its strategic intent explicit, so that trustees are required to consider the appropriateness of the social investment in light of their charitable objectives. We would therefore ask the Law Commission to consider whether the statutory power should have a rider, making it clear that in exercising the power trustees should take into account all factors reasonably understood as necessary to ensure that the social investment will best further the charity’s objectives.” This approach “would achieve the aim of requiring trustees to think carefully about how the investment would achieve their objectives, and that this would be the best grounding for successive iterations of Charity Commission guidance and possible decision-making by the courts reflecting developing good practice”.

Should the factors appear in statute or guidance?

- 3.131 Many consultees expressed a preference for optional factors to appear in guidance, rather than in statute.⁶³
- 3.132 Bircham Dyson Bell said that the guidance “should be regarded as a resource to assist charity trustees in their decision-making, rather than a checklist which risks becoming an administrative ‘tick-box’ exercise”. Non-statutory guidance would also be more flexible to cater for change as the social investment market develops.
- 3.133 Stone King were concerned that “a statutory checklist may be very different from a list of factors which trustees may take in to account, unless it is made very clear that any statutory checklist is only included as an indicative, non-exhaustive list of the sort of factors which trustees are normally expected to take into account”.

⁶³ St John’s Hospital, Bath; Bircham Dyson Bell; Stone King; the Wellcome Trust; Big Society Capital; ICAEW; the majority of the CLA Working Party. The point was also made by attendees at the CLA and CIG Seminar and at the ACF Meeting.

- 3.134 Big Society Capital thought that a checklist would be better contained in guidance “in order to ensure that in practice charities interpret it as guidance rather than mandatory exhaustive provisions. This would also enable further explanatory information to be provided along with this checklist, further increasing the comfort that trustees need with their decisions about making social investments.”
- 3.135 The dominant view amongst members of the CLA Working Party was that a checklist of factors should not be enshrined in statute, for the following reasons.
- (1) Each social investment along the “spectrum” is likely to be slightly different with different considerations applying in each case. Charity trustees “will feel that they need to work through [the checklist] every time they are considering making any social investment”.
 - (2) The checklist might impose additional obligations or constraints on charity trustees already making social investments within the powers currently available to them.
 - (3) Charity trustees may not feel sufficiently confident to deviate from the checklist or consider other factors. It was noted that “a practice has developed in relation to the duty on company directors under section 172 Companies Act 2006 to promote the success of the company, whereby the non-exhaustive list of factors to which directors should have regard are typically set out like a checklist in board minutes. We are concerned that the same may be the case for the proposed checklist of factors for social investments and that it becomes simply a procedure that trustees go through”.
 - (4) A statutory checklist would not remove the need for charity trustees to take professional advice on the implications of the different factors in some cases.
 - (5) It would be difficult to amend the statute for the checklist to keep pace with evolving social investment practice. “The point has been made that this is an area where practice has developed quicker than the law and we agree that the approach taken in relation to the new power needs to recognise that practice will continue to evolve and be flexible enough to cater for that.”
- 3.136 Those in the CLA Working Party supporting a non-statutory checklist thought it should exist in guidance issued by the Charity Commission. Further, it should be non-statutory guidance; charity trustees should not be under a statutory obligation to consider it when making their investment decision.⁶⁴ It was thought that a statutory obligation to consider the guidance “would increase the burden on trustees” when exercising the social investment power and that its requirements “might become onerous, thereby making the power unattractive”.

⁶⁴ Bates Wells Braithwaite similarly opposed statutory guidance.

- 3.137 Even those consultees who agreed with a statutory checklist (whether mandatory or optional) considered that supplementary guidance would be necessary.⁶⁵

Relevance of the investment duties under the Trustee Act 2000

- 3.138 NCVO and CFG thought legal duties should be similar when charity trustees are making pure financial investments and social investments: “This will ensure that the appropriate level of rigour and due diligence is undertaken when charity trustees consider social investments and prevent any temptation for regulatory arbitrage, where investments are classified as ‘social investments’ to avoid more rigorous duties.”
- 3.139 Professor Duncan Sheehan said that, when making social investments, charity trustees ought to consider risk and diversification, because the failure of a large social investment may cause significant loss. “I would not therefore be so ready to remove the requirement to consider the [standard investment criteria] or something similar.” He also thought that reviewing social investments and obtaining advice would be appropriate. He suggested that the provisionally proposed checklist factors were similar to the Trustee Act duties, and that “you make too much of your argument (CP, para 4.25) that the standard investment criteria are based on traditional financial investments not social ones and are (CP, para 4.31) inappropriate.”
- 3.140 If – he continued – social investments are subsumed within the investment power (as suggested), trustees can be required “to consider a list of core issues (such as monitoring, review, risk of failure etc) common to both limbs of investment, but adding that in the case of social investments other considerations concerned with the purposes of the charity may also be relevant and outweigh them”.
- 3.141 The Charity Law and Policy Unit at the University of Liverpool thought that factors (4), (5) and (6) of the proposed checklist replicated the essential features of the Trustee Act duties, but were nuanced to social investment.
- 3.142 UKSIF thought that social investments should be carefully monitored and regularly reviewed and therefore favoured this being given greater emphasis in the checklist.

Tax

- 3.143 The Association of Charitable Foundations reported concerns from its members that HMRC “may take the view that investments will not count as charitable expenditure unless all factors in the list have been taken into account, defeating the point of the list being ‘non-exhaustive’ and non-mandatory”. Conversely, Bates Wells Braithwaite and the CLA Working Party wanted HMRC to recognise that, provided charity trustees had considered the checklist factors at the outset, a social investment made using the statutory power was charitable expenditure.

⁶⁵ Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; the Nationwide Foundation;

QUESTION 6

We invite the views of consultees as to whether the following, or other, factors should be included in such a statutory checklist.⁶⁶

- 3.144 Many consultees expressed general agreement with the factors set out in the Consultation Paper, qualified by their views as to the status of the checklist (see previous question).⁶⁷ Where consultees made comments on the specific factors, they are set out below.

Factor (1): the anticipated overall benefit from the social investment

- 3.145 The CLA Working Party noted that the checklist contained “no specific reference to the impact or the ‘total return’ from the investment which some would find helpful and perhaps this could form part of factor (1)”.
- 3.146 NCVO and CFG thought it important that charity trustees consider the risks of the investment and evaluate the mission benefit that it is anticipated to achieve.
- 3.147 UKSIF thought the checklist should make clearer that charity trustees are required to consider the relationship between a social investment and a charity’s mission, values and purpose.

Separating financial and mission benefit

- 3.148 Francesca Quint suggested that this factor was too vague in two respects. First, it should be limited to benefit *to the charity*. Second, it should recognise that the benefits may be financial and/or related to furthering the charity’s mission. Geldards agreed that this factor was too vague, and should be split into (i) furthering the charity’s purposes, and (ii) the financial return (whether partial return of capital, capital growth or income).⁶⁸ Bircham Dyson Bell suggested that there might be merit in tracking the words of the statutory power by requiring trustees to consider how the social investment “[is] intended to achieve the charity’s purposes and what financial benefit might result.”
- 3.149 The Charity Commission commented on the importance of charity trustees considering both mission and financial benefit (see paragraph 3.3 above): “There are dangers in considering the benefits under one heading rather than separately identifying them.” Similarly, Social Investment Business thought that, in referring to “overall benefit”, it would be helpful for charity trustees to refer separately to

⁶⁶ Consultation Paper, paras 4.22 and 7.6.

⁶⁷ Francesca Quint; Social Finance; Geldards; Professor Janet Ulph; Simon Cramp; Lord Hodgson; HEFCE; Matthew Smith; the Bank Workers Charity; Churches’ Legislation Advisory Service; Bates Wells Braithwaite; UKSIF; Bircham Dyson Bell; New Philanthropy Capital; the Social Investment Forum; Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; Association of Charitable Organisations; the Wellcome Trust; Stone King; Big Society Capital; the City of London Corporation; Honorary Treasurers Forum; ICAEW.

⁶⁸ The same point was made by the Charity Law and Policy Unit at the University of Liverpool, Bates Wells Braithwaite, the Nationwide Foundation and New Philanthropy Capital.

the financial and mission benefit; “separating the benefits out in this way may actually help trustees to consider the holistic benefits of the social investment”.⁶⁹

- 3.150 Bates Wells Braithwaite said that, whilst these calculations are difficult, “nonetheless in our experience this is the best way of trying to get trustees to consider the balance of impact and financial return. A calculation of this kind does not have to be highly calibrated or mathematically detailed; it can only be a rough expectation.” Bates Wells Braithwaite considered these calculations were therefore helpful.⁷⁰
- 3.151 NCVO and CFG agreed that a fastidious quantification of mission benefit should be unnecessary, particularly given the complexity involved in such assessments. They believed that charities were best placed to decide how to measure and report the impact of their social investments, and that this would depend on the administrative burdens, the call for accountability, and the available metrics. The Wellcome Trust agreed that it was often not possible to calculate mission benefit.

Factor (2): the duration of the social investment

- 3.152 The Charity Law and Policy Unit at the University of Liverpool agreed with the inclusion of this factor, but queried whether it added anything to factors (1) and (3).
- 3.153 Bates Wells Braithwaite suggested adding: “the anticipated means of realising or exiting the investment”.
- 3.154 Social Investment Business said that, rather than just noting the duration of the investment, charity trustees ought to consider the appropriateness of that duration.

Factor (3): the risks of the social investment failing or under-performing

- 3.155 Francesca Quint thought that this should cover (i) financial risks, (ii) risks that the mission benefit will fail, and (iii) reputational risks (with (iii) possibly being a separate factor).
- 3.156 The Nationwide Foundation made a similar point: trustees should distinguish between failure to achieve the anticipated financial mission and failure to achieve the anticipated mission benefit. “[F]ailure of the financial return may be more acceptable should the social benefit still be delivered, however failure to deliver the social benefit may be a bigger risk and require a different response.”
- 3.157 The CLA Working Party thought that it might be helpful to clarify that this includes other risks (for example reputational risk) as well as financial risk. Professor Janet Ulph suggested a factor which encourages charity trustees to consider enhancing the reputation of the charity.

⁶⁹ Social Investment Business also considered that, in separating out these benefits, charity trustees could identify “incidental benefits” such as “the institutional learning gained from pursuing a new type of investment”.

⁷⁰ See also paras 3.58 and 3.59 above, discussing CC14’s approach to the quantification of mission benefit.

- 3.158 The City of London Corporation suggested that the checklist include “the consideration of what action might be taken by the trustees if the social investment is underperforming (either financially or socially)”.
- 3.159 The Charity Law and Policy Unit at the University of Liverpool thought that this factor would be essential, but said that guidance would be necessary concerning how to assess risk.
- 3.160 HEFCE suggested that trustees using permanent endowment need to consider the risk of the investment yielding a negative financial return.
- 3.161 The Social Investment Forum suggested including other risks associated with the social investment (beyond performance), and the relationship between the financial and social risks.

Factor (4): how the performance of the social investment will be monitored

- 3.162 Bates Wells Braithwaite suggested amending this to: “how the overall benefit is to be measured, assessed and monitored”.

Factor (5): whether and how often the social investment will be reviewed

- 3.163 Brian Wheelwright (Wates Family Charities) said that review ought to be compulsory, for example during the annual audit of accounts, or as part of management accounting. Francesca Quint agreed that review ought to be compulsory, unless the charity trustees think it is unnecessary, with a discretion as to the frequency of review.

Factor (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

- 3.164 Brian Wheelwright (Wates Family Charities) thought that advice ought to be compulsory, particularly on the financial element of a social investment. Similarly, NCVO and CFG said the need to take advice was particularly important, given the complex nature of the social investment market.
- 3.165 Francesca Quint and Professor Duncan Sheehan thought that it should be compulsory for charity trustees to consider taking advice before making social investments.
- 3.166 Professor Janet Ulph thought it important that obtaining advice could include advice on mission benefit. Francesca Quint suggested the advice should extend to the financial aspects of the social investment, achieving charitable purposes, and pursuing the charity’s interests.
- 3.167 Social Investment Business queried the identity of “a suitable person”; a financial adviser regulated by the Financial Conduct Authority might not be a suitable person to advice on a social investment. An attendee at the CLA and CIG Seminar also queried who ought to provide advice on a social investment, saying that lawyers may be best placed to do so. Another attendee said that the type of advice needed would depend on the proposed transaction. The Charity Law and Policy Unit at the University of Liverpool said that charity trustees would need guidance on the level of expertise that advisers should have.

- 3.168 Big Society Capital thought that this factor was out of place “as it considers the process for how factors (1) to (5) should be evaluated rather than the substance. It may also in effect result in the development of a standard practice that trustees will always seek external advice for social investments, which would be unhelpful. Whilst appropriate for some social investments and charities, this will be unhelpful because advice is likely to be disproportionately costly to the investment size, the number of existing relevant advisers is limited at this stage of market development, and many charities currently don’t seek advice for their diligence of investments and grant-making (as they conduct this in-house).”
- 3.169 Similarly, Social Investment Business queried the need for charity trustees to seek advice when making social investments, arguing that they were best placed to decide whether a social investment furthers the charity’s mission. Such a requirement could also place an unnecessary cost on charities.

Factor (7): the relationship between the social investment and the charity’s overall investment portfolio (if any) and its spending or grant-making policies

- 3.170 NCVO and CFG agreed this was important as “social investments are not made in isolation”.
- 3.171 The Charity Law and Policy Unit at the University of Liverpool emphasised that it should be permissible for a social investment to be the dominant investment or spending by a charity, “provided it does not endanger the charitable purposes more widely”.
- 3.172 New Philanthropy Capital said this factor should make specific mention of permanent endowments.

Factor (8): any other relevant factors

- 3.173 Bates Wells Braithwaite suggested that this should be “other factors that the trustees reasonably consider to be relevant”.
- 3.174 ICAEW disapproved of a requirement to consider “any other relevant factors” as part of an optional statutory checklist as this would be “circular and unenforceable”.

Other factors

Proportionality

- 3.175 Lord Hodgson wanted proportionality to be a relevant consideration, referring to a case where due diligence costs were disproportionate to the value of a proposed social investment, and the transaction therefore proceeded as a grant.
- 3.176 We do not see how law reform could address this fact-specific situation. There is no mandated level of due diligence for any use of charitable funds, whether it is outright spending, social investment, or financial investment; what is appropriate will depend on the particular proposed transaction, and the proportionality of the due diligence would be a relevant consideration. We do not consider that it would be helpful to include a specific factor stating this. It might be that an unduly cautious approach to due diligence is a consequence of the relative immaturity of

the social investment market and that advisers will become more comfortable as social investment becomes more mainstream.

Considering alternative options

- 3.177 Matthew Smith suggested including “the ‘opportunity cost’ of the investment (i.e. whether another form of spending would be a more effective means of achieving the objects of the charity: this might ensure that trustees are considering the overall benefit in terms of their own charity’s objects as well as highlighting inappropriate levels of private benefit in some instances).”
- 3.178 Similarly, Bircham Dyson Bell suggested including “how the anticipated overall benefit and risks of the social investment compare with other possible projects/investments available to the charity trustees”, and the Charity Commission suggested a requirement to consider whether the charity’s purposes “could be more effectively furthered” if the outlay were applied directly rather than by way of investment.
- 3.179 We do not agree that this should be a factor appearing in statute. Charity trustees will, of course, consider various possible uses of charitable funds when they make decisions, whether they are spending, making grants, investing or making social investments. But to include this as a specific factor in relation to social investment might tend to suggest that charity trustees should be suspicious of social investment; see Lord Hodgson’s comments on CC14 in paragraph 3.37 above.

Private benefit

- 3.180 Some consultees noted the absence of private benefit from the checklist and suggested that it be included as an explicit consideration.⁷¹
- 3.181 In response, we agree that private benefit will have to be considered by charity trustees, and it will continue to feature in Charity Commission guidance.

Tax

- 3.182 The Charity Law and Policy Unit at the University of Liverpool suggested the inclusion of tax considerations. We agree that this should be addressed in Charity Commission guidance, and we make a recommendation to this effect.⁷²

Permanent endowment

- 3.183 Francesca Quint suggested that the checklist should include consideration of whether the social investment would damage the future efficacy of any permanent endowment used. HEFCE made a similar suggestion in relation to factor (3) above. We agree that this should be addressed in Charity Commission guidance, and we make a recommendation to this effect.⁷³

⁷¹ Geldards; HEFCE; Matthew Smith; Stone King; CLA Working Party.

⁷² Recommendations Paper, para 1.87(5).

⁷³ Recommendations Paper, para 1.88(2).

Financial investment considerations

- 3.184 The Social Investment Forum suggested including other factors that were relevant to mainstream financial investment, such as liquidity, transaction costs, ethics, and reputation. Similarly, New Philanthropy Capital suggested including as a factor the liquidity of the social investment and the charity's ability to sell the social investment before its term date.

The social investment market

- 3.185 Social Finance suggested the following additional factors:
- (1) the extent to which data, metrics and lessons learnt will be captured for use by the charity;
 - (2) whether the social investment provides the best, or a unique, way to address the charity's purpose; and
 - (3) whether the social investment is helping to build the market for more investment or grant-making in the issues related to the charity's purpose.

Other points

- 3.186 NCVO and CFG said that keeping records of trustee decision-making would be important, but that it should be proportionate to the size of the social investment and the size of the charity.
- 3.187 The CLA Working Party noted that it was unclear how the PRI checklist at section J4 of CC14 fits with the proposed checklist, although there is some overlap. "We are conscious of not burdening trustees by imposing several different layers of obligations so this would also need to be clarified."

QUESTIONS 7 AND 8

- 3.188 The answers to these questions overlapped, so we consider them together.

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?⁷⁴

- 3.189 Thirty-two consultees answered this question. Twenty consultees agreed,⁷⁵ seven agreed in part,⁷⁶ and four disagreed.⁷⁷ One consultee expressed other views.⁷⁸

⁷⁴ Consultation Paper, paras 4.27 and 7.7.

⁷⁵ Brian Wheelwright, Wates Family Charities; Francesca Quint; Geldards; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; Matthew Smith; the Bank Workers Charity; Bates Wells Braithwaite; Bircham Dyson Bell; Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; Association of Charitable Organisations; the Wellcome Trust; the Nationwide Foundation; Stone King; City of London Corporation; Association of Charitable Foundations; ICAEW; CLA Working Party.

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.⁷⁹

- 3.190 Thirty-two consultees answered this question. Sixteen consultees considered that the Trustee Act investment duties should be excluded,⁸⁰ nine held that view with some qualification,⁸¹ and five disagreed.⁸² Two consultees expressed other views.⁸³
- 3.191 The majority of consultees agreed that the Trustee Act investment duties should not apply when charity trustees make social investments for two reasons. First, the Trustee Act investment duties are – to some extent – inappropriate for social investments. Second, alternative tailor-made duties should apply in place of the Trustee Act investment duties.

Appropriateness of the Trustee Act investment duties

- 3.192 The Nationwide Foundation strongly supported the removal of the Trustee Act investment duties. “This is one of the main things that creates uncertainty around making social investments.” It acknowledged that there were grey lines between some financial and social investments, but said that trustees’ duties should be tailored to each type of investment, not “shoe-horned into requirements that are not helpful”.
- 3.193 The CLA Working Party identified in detail two problems with the application to social investment of the duty to have regard to the standard investment criteria.
- (1) *Suitability*. In most cases social investments will not form part of a traditional portfolio but will be selected in isolation, based on their individual merits. Suitability would have to be measured against social investment criteria, which could only be set out “in very vague terms”.

⁷⁶ Social Finance; Professor Janet Ulph; HEFCE; St John’s Hospital, Bath; Friends Provident Foundation; Mercer Investments; Big Society Capital.

⁷⁷ Simon Cramp; Charity Commission; the Social Investment Forum; New Philanthropy Capital.

⁷⁸ Joel Moreland.

⁷⁹ Consultation Paper, paras 4.33 and 7.8.

⁸⁰ Brian Wheelwright, Wates Family Charities; Francesca Quint; Geldards; Charity Law and Policy Unit at the University of Liverpool; Lord Hodgson; Matthew Smith; Bircham Dyson Bell; Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; the Wellcome Trust; the Nationwide Foundation; Stone King; Honorary Treasurers Forum; Association of Charitable Foundations; CLA Working Party.

⁸¹ Social Finance; Professor Janet Ulph; HEFCE; the Bank Workers Charity; St John’s Hospital, Bath; Bates Wells Braithwaite; Mercer Investments; Big Society Capital; the City of London Corporation.

⁸² Simon Cramp; Charity Commission; the Social Investment Forum; New Philanthropy Capital; Association of Charitable Organisations.

⁸³ Joel Moreland; ICAEW.

There is no obligation for trustees to set out criteria for their power to make grants, so why should it be necessary for social investments?

- (2) *Diversification*. It would be unrealistic to expect charities to hold a “portfolio” of social investments. In any case, “charity trustees may want to have a concentrated group of similar social investments because they have a high impact (for example, brown site mixed tenure investments in London, or the development of drugs, vaccines, diagnostics or other technologies that address global health challenges that disproportionately impact developing countries)”.
- 3.194 The CLA Working Party felt strongly that the Trustee Act investment duties should be excluded whenever charity trustees are considering making a social investment. Applying these requirements would impose “cumbersome” and “impractical” requirements that were not designed for social investments and would be out of step with the broad discretion conferred on charity trustees to carry out their charity’s purposes by, for example, making grants. The Trustee Act investment duties “are, by their very nature, tailored toward achieving economic rather than social returns, rendering their application unworkable in a social investment context”.
- 3.195 Bates Wells Braithwaite said that “the requirements of suitability and diversification need to be understood, interpreted and applied differently when a charity is making a social investment. ... [I]t is not appropriate to think of suitability or diversification solely in financial terms when a charity is not investing purely for financial reasons.” They acknowledged the uncertainty as to how those duties apply in the social investment context.
- 3.196 NCVO and CFG agreed that charity trustees should not be subject to the Trustee Act investment duties, provided that the statutory checklist accompanying the new statutory power is mandatory. They agreed that a requirement to consider diversification (within the standard investment criteria) was not currently apposite to social investment given the immaturity of the social investment market.
- 3.197 The Wellcome Trust agreed that the Trustee Act investment duties “should not apply to a social investment whether or not made under the statutory power”, though it noted that the boundary between social and financial investment was not easy to identify.
- 3.198 Stone King agreed that the Trustee Act investment duties should not apply to social investments, both because they are as a matter of principle “[inappropriate] for actions which have furthering the charity’s objectives as a primary or equal goal” and because the duties – in particular the duty to consider portfolio diversification – are impracticable for social investments which currently “tend to be of a more bespoke nature”. Stone King also noted that the Trustee Act 2000 does not apply to incorporated charities, and suggested that “the only sensible option” was for the Trustee Act investment duties to be excluded whenever trustees are making social investments to avoid creating a distinction between the statutory power and a power contained in a trust deed. “There may be

confusion as to which duties apply where it is not absolutely clear which power was used”⁸⁴.

- 3.199 The City of London Corporation thought that the duty to consider the standard investment criteria should be excluded whenever trustees are making social investments since the criteria “give no consideration to the social return generated”. It said that the exclusion of the Trustee Act investment duties “is the logical conclusion of creating a statutory power which allows for trustees to take in to account non standard considerations in an investment decision”.
- 3.200 The Charity Commission considered that “applying the standard investment criteria to the financial investment element [of an MMI] is a useful discipline” but was open to the duty being modified to reflect the mixed benefit being sought.
- 3.201 Big Society Capital supported the exclusion of the Trustee Act investment duties insofar as this would give charity trustees more freedom to decide the most relevant process for them at a time when social investment practices are still emerging. However, it suggested that the exclusion of those investment duties might need to be reviewed as social investment practices become more sophisticated.

Retention of the duties to review investments and to consider obtaining advice

- 3.202 Whilst agreeing the standard investment criteria should not apply, Professor Janet Ulph considered that the duties to review and to consider obtaining advice (not limited to financial advice) would be useful, although she accepted that incorporation of these factors into the statutory checklist may be sufficient. “It is always useful to obtain the views of someone outside your governing body in order to stimulate deeper thinking and reflection.” A duty to consider obtaining advice and a duty to review social investments “would provide a flexible restraint”.
- 3.203 The City of London Corporation thought that the standard investment criteria were inappropriate, but considered that the requirements to obtain advice and review investments should remain, saying that this would require new and clear guidance for professional financial advisers so that they would be able to give suitable advice to trustees.
- 3.204 HEFCE considered that the advice and review duties under the Trustee Act 2000 were appropriate for social investment and noted that they were included in factors (5) and (6) of the proposed checklist. It agreed that the standard investment criteria presented difficulties if they required charity trustees to maximise financial return, but said that it was important that charity trustees consider whether the mission benefit from a social investment is sufficient when compared with other ways to use a charity’s resources.
- 3.205 The Bank Workers Charity wished to retain the requirement to carry out periodic reviews and to seek advice in appropriate circumstances.

⁸⁴ This was the majority view; a minority of Stone King’s members took the view that the Trustee Act investment duties should apply, with the exception of the duty to consider diversification.

- 3.206 The Friends Provident Charitable Foundation agreed that the Trustee Act 2000 duty to consider diversification was difficult to apply to social investments, but thought that duties to consider obtaining advice and to review investments were sensible and should be retained as being “consistent with good financial stewardship and use of charitable resources”.
- 3.207 Mercer Investments agreed that the duty to consider the standard investment criteria is not suitable for social investments, but thought that all investments – whether mainstream or social – should be reviewed periodically and that trustees should take investment advice where they think this is necessary. Excluding the Trustee Act investment duties could have “unintended consequences; particularly given ‘social investments’ is not a well-defined term”.
- 3.208 St John’s Hospital, Bath, agreed that the duty to consider the standard investment criteria should not apply, but pointed out that “it is important that as professional approach is maintained to social investment as to main market investments”, and that social investments should be considered “as rigorously as all other investments the charity may make”.
- 3.209 The CLA Working Party suggested that reviewing social investments “should be subject to the same guidelines as those applied to monitoring charitable grants”. It was also said that trustees should not be required to seek third party advice, since “the third party would simply be reviewing and endorsing the charity trustees’ judgement, but for a fee”.
- 3.210 ICAEW noted that trustees’ duty of care “requires them to seek advice on matters that are outside their area of knowledge and experience. However, there is no obvious source of independent, authoritative advice on making social investments so there may be no-one for the trustees to consult. In these circumstances addressing point (6) in the ‘checklist’ above will enable the trustees to demonstrate the proper discharge of their duty of care.”

Tailor-made duties to apply in place of the Trustee Act investment duties

- 3.211 Some consultees took the view that the factors in the checklist incorporated the Trustee Act investment duties, properly adapted for social investment – as indeed we intended.
- 3.212 The Charity Law and Policy Unit at the University of Liverpool thought that the Trustee Act investment duties were “replaced and nuanced” by factors (4), (5) and (6). Similarly, Bates Wells Braithwaite considered the checklist was “an appropriate surrogate”. Francesca Quint and Wales Council for Voluntary Action agreed. Social Investment Business said “the specialist checklist ... sufficiently and effectively covers the issues that trustees will need to consider”; it therefore agreed that the Trustee Act investment duties should not apply to avoid “unnecessary repetition of work”.
- 3.213 Bircham Dyson Bell noted that the Trustee Act investment duties were not wholly irrelevant, hence their reflection – duly modified – in the checklist factors. The Trustee Act investment duties are mandatory, and Bircham Dyson Bell considered there was a risk of imprudent trustee decisions without a similar *requirement* to consider the modified Trustee Act investment duties for social investment, but nevertheless preferred an optional checklist of factors in non-

statutory guidance. They said that the non-statutory guidance should refer to the equivalent Trustee Act investment duties and their relevance to assist charity trustees making social investments. They said that this would also assist trustees who were considering and comparing a mainstream financial investment with a social investment, since the Trustee Act investment duties would apply when considering the former.

- 3.214 Similarly, the Churches' Legislation Advisory Service said that, if the law is changed, guidance should make clear that the Trustee Act investment duties should be considered as a matter of good practice, as part of trustees' duty to act in the best interests of the charity.

Other comments

- 3.215 Social Finance thought that, ultimately, social investments should be treated in the same way as conventional investments, but that the standard investment criteria are unrealistic in view of the nascent social investment market. Diversification is difficult, there is a limited supply of advice, and social investments may take time to review. Social Finance suggested that, over time, these limitations will change, and that there should therefore be ongoing reviews as to whether the social investment market has matured sufficiently for the standard investment criteria to be applied.

- 3.216 The Association of Charitable Foundations agreed with the exclusion of the Trustee Act investment duties, but noted that this would not remove the general duty of care on trustees, nor would it remove their overriding fiduciary obligation to use their resources in the best interests of the charity. "[T]here may be considerable merit in making this obligation explicit in the way the [statutory] power is constructed."

- 3.217 Matthew Smith said it would be useful to group together the criteria relevant to financial investment and social investment in one place for charity trustees, whether the charity is incorporated or not.

Creating a loophole?

- 3.218 Some members of the CLA Working Party suggested that there would be "a risk of leaving an unregulated space between either end of the charitable spending 'spectrum' if trustees are making decisions in relation to what are essentially financial investments (albeit with some 'mission' element) without having to go through the usual Trustee Act 2000 considerations". However, these members thought that neither a list of statutory criteria nor a list of factors in non-binding guidance was the answer. Rather, trustees' exercise of their social investment power should be subject to two "key considerations ... built into the power itself", namely:

- (1) whether the social investment furthers the charity's objects (on the basis that any social investment can only be made if it furthers the charity's objects); and
- (2) whether the social investment is suitable as a financial investment (albeit potentially with a different risk/reward profile to pure financial investments).

- 3.219 Bircham Dyson Bell saw the same potential problem, but thought that adequate guidance would address it. “In practice, it will be for the charity trustees to justify their decision in any particular case; the suggested guidance should equip the charity trustees to make a proper decision.”
- 3.220 Similarly, NCVO and CFG said that excluding the Trustee Act investment duties made it “more important that a mandatory statutory framework is put in place to prevent a loophole being created for social investments”.
- 3.221 Bates Wells Braithwaite suggested an alternative approach: the Trustee Act investment duties ought to apply when charity trustees make a social investment without using the statutory power. “It would be unwise to allow social investments to be made without reference to the Trustee Act 2000 investment duties or the proposed statutory checklist.”

Disagreement

- 3.222 Simon Cramp disagreed with the exclusion of the Trustee Act investment duties, but may have misconstrued the question as suggesting that duties on charity trustees be removed altogether, rather than the investment duties under the Trustee Act 2000 being replaced with specific duties.
- 3.223 New Philanthropy Capital disagreed. “Social investment is an emerging market and trustees would do well to take advice, look at the investment in the context of their portfolio and to monitor their investment regularly.” Nevertheless, they said that “the degree to which charity trustees should be required to comply with the [Trustee Act investment duties] will be influenced by the classification of the social investments – which depends on the trustees’ objective in making the investment and the charity’s purposes”. They acknowledged that the need to consider the standard investment criteria “is relevant for *parts* of [the social investment] spectrum” (emphasis added).
- 3.224 The Social Investment Forum was concerned that social investments will often amount to conventional financial investments. All social and financial investments will be driven by a range of factors, and “there is no reason why trustees should not ‘consider’ factors such as the standard investment criteria” and assess investments. However, they supported any move to give trustees more freedom: “the pertinent issue is one of relevance – trustees should consider those aspects (under the Trustee Act 2000 or outside of this) that are relevant and material in relation to social investments; freedom from those that are not relevant is to be welcomed.”

Tax

- 3.225 Stone King suggested that “the tax position should be considered in discussion with HMRC to ensure that, whether or not the Trustee Act duties will apply, trustees can have clarity as to whether the investment constitutes a qualifying investment”.
- 3.226 The CLA Working Party warned that “the proposal to exclude the requirements of the Trustee Act 2000 will not, in and of itself, encourage social investment unless HMRC also revises its interpretation of the tax legislation”. It was said that the guidelines set out on page 10 of the Financial Law Panel’s *Running Your Own*

Company: A Practical Guide to a Director's Duties are applied generally by HMRC as a matter of policy when examining the question of charitable expenditure and whether an investment should be treated as an approved charitable investment for tax purposes.

QUESTION 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.⁸⁵

- 3.227 Twenty-four consultees answered this question. Seventeen consultees considered the law to be largely satisfactory.⁸⁶ Seven consultees regarded the law as unsatisfactory to some extent, and six of those made suggestions for reform.⁸⁷

“Functional” and “non-functional” or “investment” permanent endowment

- 3.228 In the Consultation Paper, we explained the difference between “functional” and “non-functional” or “investment” permanent endowment.⁸⁸ Functional permanent endowment is an asset used for the purposes of the charity which cannot be sold and the proceeds spent on the charity’s activities. An example of functional permanent endowment is a village hall. Investment permanent endowment is capital which is to be used to provide an income for the charity, but which cannot be spent as if it were income.
- 3.229 The scope of our review of the law relating to the social investment of permanent endowment is limited to investment permanent endowment, though it was suggested by Francesca Quint that an asset held as functional permanent endowment may sometimes be regarded as a “social investment”. For example, a painting owned by a charity may be displayed for its charitable purpose, but the charity may also derive a financial return from its ownership and display of the painting (in terms of any appreciation in its monetary value and any income generated from the charging of fees to members of the public to view it).

Suggestions that the current law is satisfactory

- 3.230 Social Investment Business agreed that permanent endowment can be used to make social investments that anticipate a positive financial return, but disagreed with any assumption that social investments tend not to deliver a positive financial return.

⁸⁵ Consultation Paper, para 5.3.

⁸⁶ Francesca Quint; Professor Duncan Sheehan; Social Finance; HEFCE; Matthew Smith; St John’s Hospital, Bath; the Charity Commission; Bircham Dyson Bell; New Philanthropy Capital; the Social Investment Forum; Wales Council for Voluntary Action; Social Investment Business; NCVO and CFG; Hubert Picarda QC; Stone King; ICAEW; CLA Working Party.

⁸⁷ Geldards; Lord Hodgson; Bates Wells Braithwaite; Joel Moreland; Big Society Capital; Association of Charitable Foundations. The Honorary Treasurers Forum said the current law was in some respects unsatisfactory, but did not make any suggestions for reform.

⁸⁸ Consultation Paper, para 5.3.

- 3.231 Matthew Smith said that the social investment power should not be used as a means of evading the restriction imposed on using the funds for the charity's purposes.
- 3.232 HEFCE asserted that "permanent endowment should not be eroded by social investments where there is a high risk of a negative financial return". Francesca Quint agreed that permanent endowment could be used to make a social investment where the mission benefit justifies a lower financial return and where that financial return is of an "income nature". She said that it would be unacceptable to use permanent endowment to make a social investment that involved the loss of capital. She considered that any problem could be remedied by including a further checklist factor: "the effect of the social investment on the future efficacy of any permanent endowment used".
- 3.233 Stone King said that our view of the current law regarding the social investment of permanent endowment accords with that of the Charity Commission, and that these views "are fairly uncontroversial". Stone King thought that "if a permanently endowed charity wishes to make a social investment, which will not provide an acceptable financial return (however that is expressed) then the appropriate course is to use existing powers, primarily those under sections 281 and 282 Charities Act 2011, to lift permanent endowment restrictions. It is primarily through this mechanism that permanent endowment funds could enter the social investment market."
- 3.234 Wales Council for Voluntary Action thought that "further changes to the law ... could cause unnecessary confusion for trustees" and agreed that there were adequate mechanisms to enable trustees to use permanent endowment to make social investments under the current law.
- 3.235 The Charity Law and Policy Unit at the University of Liverpool said that "the legal principles governing permanent endowment do not impact on social investment particularly". Similarly, Bircham Dyson Bell said permanent endowment restrictions "are seen in some quarters as anachronistic today" but the difficulties are not limited to social investment, and therefore extend beyond the Law Commission's remit. They suggested that the use of permanent endowment should be kept under review as the social investment market develops, and if there is found to be caution on the part of charity trustees in using permanent endowment to make social investments, or numerous applications for the release of permanent endowment restrictions are made to the Charity Commission, then reform could be reconsidered.
- 3.236 Hubert Picarda QC said he "[disagreed] with proposals to allow permanent endowment capital to be used as social investment" as being "inimical to the interests of charity and to the usual aspirations of donors".

Express application of the new power to permanent endowment

- 3.237 Social Finance pointed out that charity trustees' general concerns about their power to make social investments existed in relation both to general charitable funds and to permanent endowment. It was concerned to ensure that the new statutory power also applied to permanent endowment on the condition that permanent endowment was only used to make social investments anticipated to preserve capital.

- 3.238 The CLA Working Party, Bates Wells Braithwaite and the Association of Charitable Foundations agreed. The CLA Working Party said that the proposed statutory power should expressly state that investment permanent endowment may be used to make social investments “so that the ability of charity trustees to use permanent endowment for social investment is placed beyond reasonable doubt”. Otherwise, Bates Wells Braithwaite warned, “trustees and advisers will continue to doubt that permanent endowment can be used in this way”.
- 3.239 The CLA Working Party said the power should “make it clear that permanent endowment may only be used to make social investments that it is reasonably believed by the charity trustees will produce a positive capital return, and which balance the interest of present and future beneficiaries”. Bates Wells Braithwaite recommended “a general statement or codification in statute of the way in which permanent endowment may be used to make social investments, which we would expect to refer to the ability to make social investments where a positive financial return is anticipated provided the trustees seek to maintain the real capital value of the endowment in aggregate over time”.
- 3.240 The CLA Working Party added that “due care would need to be taken to consider how the new statutory power ... would impact on other features that one can find in permanent endowment funds”. Two such features were mentioned.
- (1) *Charity expenses charges.* “Some trust deeds and Charity Commission schemes (particularly for older foundations) express charity expenses as a necessary first charge on income out of a permanent endowment fund, before expenditure for charitable purposes. A power permitting the use of income returns to make social investments – which would necessarily involve expenditure for charitable purposes before charity expenses are charged – would seem to be at odds with these provisions.”
 - (2) *Permanent endowment held for the benefit of more than one charitable purpose.* “Some permanent endowment is invested as a single fund but held for the benefit of more than one charitable purpose. This would also make social investment difficult, unless a social investment could be found to suit the purposes of all charities for which the fund is held (and perhaps, with the consent of the beneficiary charities operated by separate trustees). This point will also be relevant where expendable endowments are invested on a pooled basis.”
- 3.241 In relation to (1), in our view the effect of any such trust deed or scheme will depend on its precise terms. We would note, however, that charity trustees are already permitted by the current law to make social investments that do not achieve a market rate of financial return using permanent endowment, since we consider an “investment” to be something from which a positive – but potentially low – financial return is expected.⁸⁹ In any event, we doubt that responsible trustees would make social investments to reduce their income from the permanent endowment in order to evade the first charge on that income imposed by the deeds or schemes.

⁸⁹ See the Recommendations Paper, n 10.

- 3.242 As for (2), we agree that permanent endowment invested on a pooled basis could not be used to make a social investment that involved any element of foregone income unless all charities involved in the investment pool consented.
- 3.243 The City of London Corporation commented that any new statutory social investment power and associated guidance need to be clear in respect of social investments made out of both permanent endowment and expendable endowment.

Charity trustees' understanding of the law

- 3.244 The City of London Corporation criticised CC14 for not providing guidance on the use of expendable endowment and permanent endowment to make social investments (as noted in paragraph 3.68 above).
- 3.245 NCVO and CFG said it was important for charities to consider social investments in the context of the overall investment portfolio and their spending or grant-making policies. In particular, charities that operate a total return investment policy⁹⁰ will need to be reminded by Charity Commission guidance that the use of permanent endowment for social investment has the potential to require a greater proportion of unapplied total return⁹¹ to be allocated to capital, since the unapplied total return is likely to be lower.
- 3.246 St John's Hospital, Bath suggested that many trustees do not understand the law regulating their permanent endowment. In particular, it wanted to see guidance as to how the unapplied total return can be used for social investment or spending.
- 3.247 NCVO and CFG also thought that charity trustees would need guidance on ascertaining whether a social investment is intended to retain real or actual values and on considering risk, interest rates and inflation.⁹²

Seeking Charity Commission authorisation

- 3.248 In the Consultation Paper we noted that there were existing mechanisms available to charity trustees who wished to make social investments that were expected to produce a negative financial return.⁹³ Some consultees commented on those existing mechanisms.
- 3.249 Social Finance considered that the power to seek the Charity Commission's approval to spend permanent endowment ought to be expanded to allow charities to seek such approval on the basis that they wish to make social investments.

⁹⁰ See the Consultation Paper, paras 5.25 and 5.26.

⁹¹ The unapplied total return is the total return from the portfolio, including capital and income gains, before it is allocated to the trust for application (when it can be spent on the charity's purposes) or the trust for investment (when it forms part of the permanent endowment capital to be invested in the future).

⁹² We consider the question of real or actual capital values in the Consultation Paper, para 3.11 and following.

⁹³ Consultation Paper, para 3.17 and following, and Recommendations Paper, para 1.72.

- 3.250 The City of London Corporation thought that while the existing routes of recourse to the Charity Commission to remove the restriction on the expenditure of permanent endowment were “theoretically viable, ... [i]n practice, however, they might prove too big a hurdle for the charity, particularly with reference to the significantly reduced resources of the Charity Commission to support charities to make relevant changes”.

Reform suggestions: (1) spending followed by recoupment and (2) portfolio offsetting

(1) RECOUPMENT

- 3.251 Lord Hodgson remained of the view, expressed in his review of the Charities Act 2006,⁹⁴ that “a general power to use permanent endowment to make social investments would be useful provided that any such proposal contained a plan to ensure that the levels of permanent endowment was restored within an agreed time frame (say 5 or 10 years)”.
- 3.252 Bates Wells Braithwaite additionally endorsed the view of Lord Hodgson and suggested that charity trustees should have “a power to ‘spend’ up to 10% of any permanent endowment on social investments which may be expected to generate a negative financial return provided the trustees seek to replenish any depleted capital within a reasonable period of time”.
- 3.253 Joel Moreland agreed with the suggestion of Lord Hodgson and Bates Wells Braithwaite that there should be a power to spend permanent endowment on social investments, subject to reinstatement within a reasonable time, but he thought that *expected* rather than *actual* losses should be reinstated. Given that a charity’s “investment pot” is significantly larger than the “grant pot”, he thought that access to the former is “crucial” for social investment. He said that access to the grant pot only means that social investment will be by-passed, because it is less likely to deliver the same level of mission benefit as outright spending, yet it often involves the return of the capital invested or better. He provided examples of how permanent endowment could be used for social investment in this way. The more social investments that are made, the more that charity trustees will benefit from diversification, which would reduce the need to reinstate losses.
- 3.254 Joel Moreland thought an alternative option would be to create a simple process under which the Charity Commission can approve the investment of permanent endowment in social investments, “with refusal unlikely”.

(2) PORTFOLIO OFFSETTING

- 3.255 Big Society Capital suggested that “a different interpretation” be applied to the requirement to preserve capital, namely that social investments are permitted “provided that there is a legitimate expectation that the capital from the entire portfolio of the permanent endowment is preserved. By way of example, Big Society Capital is also an organisation mandated by legislation to preserve its capital (its founding principle is ‘self-sufficiency’). It has interpreted this to mean that it can invest in products with varying expectations of the financial return and risk, and such expectations can vary depending [on] the amount of social impact

⁹⁴ Hodgson Report, ch 9, recommendation 3.

the investment is expected to achieve. This approach may improve permanent endowment flexibility to make social investments at this time when it is still a relatively new concept, whilst also ensuring the long-term retention of capital for the permanent endowment”.

- 3.256 The Association of Charitable Foundations agreed with the general principle that permanent endowment ought not to be eroded, but suggested that “it ought to be possible for trustees to make individual social investments that may not maintain their capital value if trustees can anticipate that other asset classes will provide a sufficient financial return so that, overall, the investment portfolio would maintain its value – where, of course, it was in the best interests of the charitable objectives to do so”. The following example was given:

[T]ake the example of a permanently endowed charitable foundation that exists to support the needs of vulnerable young people in a specific geographical area. Then say a local youth service has been given notice to quit their premises by the freeholder who has offered to sell them the property if they can raise the capital within six months, or else he will sell it to developers. The youth service has existed for some years, though always with some degree of future uncertainty because they rely on voluntary donations, grants and income derived from Government contracts. The building is the only suitable place in the neighbourhood for the youth service and so they approach the foundation asking for a loan with a long-repayment period with which to buy the property. Because of the ongoing uncertainty around the youth service’s finances, they cannot access mainstream finances. Indeed the loan would be risky and, in all probability, not maintain the real value of the capital outlay. However the trustees invest under total return and, while they do not immediately have sufficient unapplied total return to make the investment, they are confident that, over time, they could sustain the financial loss on this specific investment while maintaining the real capital value of the portfolio because they anticipate other [asset] classes to make above inflation returns. They believe that securing the future of the youth service is in the best interests of their charitable objectives but there is not enough time to vary the permanent restrictions on their endowment.

- 3.257 The Association of Charitable Foundations thought that a charity in this situation should be empowered to make the social investment in question using its permanent endowment.
- 3.258 Geldards said that permanent endowment should be preserved if being used to make a social investment but “the issue of subsequent capital growth could be considered against the likelihood of capital growth of the overall investments held by the charity (akin to a “total return” approach)”.

Law Commission meeting concerning social investment and permanent endowment

- 3.259 On 9 July 2014, the Law Commission convened a meeting with a small group of consultees – including those who had suggested reform – to discuss further the

use of permanent endowment to make social investments. The following points emerged from discussions at that meeting.

- (1) One attendee noted that, in the majority of cases, charity trustees expect a positive financial return from their social investments, and that therefore they can already use permanent endowment to make those investments.
- (2) Some attendees supported reform to enable charity trustees to use their charity's permanent endowment to make social investments which are expected to generate a negative financial return, provided that any expected losses are offset by expected gains from other investments and/or any actual losses are recouped out of income within a reasonable period.
- (3) Some attendees thought that the existing mechanisms for releasing the spending restriction on permanent endowment were sufficient to enable charity trustees to make social investments which are expected to generate a negative financial return. They pointed out that permanent endowment can be released on the condition that losses are recouped or that the charity trustees will seek to preserve the capital value of the released fund. They suggested that introducing a new power would add a further layer of complexity to the law governing permanent endowment.
- (4) Other attendees thought that there was a perception amongst charity trustees that the release of the spending restriction to convert permanent endowment into expendable capital was complicated and could only be achieved in exceptional circumstances. Some attendees suggested that the solution to charity trustees' misconceptions is law reform; others said that it is education.
- (5) Some attendees expressed general concerns about the mechanisms for releasing the spending restriction on permanent endowment and suggested that they could be simplified. One attendee argued against general reforms that would undermine the permanence of permanent endowment.

3.260 We address the use of permanent endowment to make social investments in paragraphs 1.60 to 1.83 of the Recommendations Paper.

CHAPTER 4

RESTRICTIONS ON THE USE OF CHARITABLE FUNDS

- 4.1 In this Chapter, we analyse two issues concerning private benefit raised by a small number of consultees.

THE USE TO WHICH A SOCIAL INVESTMENT IS PUT

- 4.2 Must the entirety of a charity's social investment be used to pursue that charity's mission?
- 4.3 Our view is that, insofar as a social investment is justified by the mission benefit, it must, of course, be used to advance the charity's mission. Conversely, however, insofar as a social investment is justified by the financial return, that return need not be generated from advancing the charity's mission. That is exactly what happens to the money a charity uses to make a pure financial investment; the investee is extremely unlikely to pursue the charity's purposes. This issue is considered in paragraph 3.25 of the Consultation Paper, and paragraphs 1.32 and 1.33 of the Recommendations Paper.
- 4.4 In addition, as Bates Wells Braithwaite pointed out, the exercise of charity trustees' general powers will often not directly advance the charity's objects: many activities of a charity will advance its objects indirectly and over a period of time. Such activities include financial investment, spending money on fundraising activities, and buying goods which will then be used to advance the charity's objects. Similarly, a social investment need not wholly, exclusively, and directly pursue the charity's mission.
- 4.5 Two consultees suggested that a social investment can only ever be made if it will be used solely to pursue the investing charity's mission.⁹⁵ Most consultees, however, seemed to share our view (or did not disagree with it). Some consultees made comments that indicated that they shared our view that social investments need not be used solely to pursue the investing charity's mission.⁹⁶ Others were clear that that was the case.⁹⁷
- 4.6 The Bank Workers Charity and Association of Charitable Organisations raised a related point: can a charity with purposes X and Y make a social investment which pursues only purpose X? In our view, the answer must be "yes" since charities cannot be expected to achieve all of their charitable purposes through each grant or social investment taken in isolation. Rather, charity trustees can seek to achieve their purposes by a combination of activities.

⁹⁵ Peter Crampin QC (with whom Hubert Picarda QC expressed his substantial agreement – see n 100 below) and Matthew Smith.

⁹⁶ Bates Wells Braithwaite; Big Society Capital; the City of London Corporation; Stone King; and the CLA Working Party.

⁹⁷ The Association of Charitable Organisations and the Bank Workers Charity.

THE LAW RELATING TO PRIVATE BENEFIT

- 4.7 The law relating to private benefit is explicitly excluded from the terms of reference for our project because it is fundamental to the legal definition of a charity and is likely to be politically controversial and give rise to significant fiscal consequences. The issue was, however, raised by consultees, and we therefore summarise and comment on their views below. We have already set out consultees' views on private benefit in the context of CC14's explanation of the law: see paragraphs 3.47 to 3.49 above.

Is the law relating to private benefit tantamount to a prohibition on social investment?

- 4.8 Peter Crampin QC provided a detailed argument 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, and one whose purposes are exactly aligned with those of the investing charity. Mr Crampin was particularly concerned that the introduction of a new statutory power "may have the unfortunate effect of encouraging the erroneous view that legislation has disposed of all doubts".
- 4.9 Permeating his argument were two contentions. First, that a power to invest can only ever be used to enter into a transaction from which a market rate of financial return is expected. We disagree; an investment is something from which a positive financial return is expected – it need not be a market rate of return.⁹⁸ Second, Mr Crampin contended that a charity can only make a social investment where the entirety of the funds invested will be used to advance the charity's own mission. As explained above,⁹⁹ we do not see that as a requirement.
- 4.10 Relying on these contentions, Mr Crampin argued that a charity cannot make a social investment in a commercial company. He had two principal arguments, as follows.
- (1) The purpose of a commercial company is to generate profit for the investors. A social investment by a charity must be used exclusively for the benefit of the public, but the purpose of an investment in a commercial company would be to generate profits for private investors, not for the public. We disagree; in our view, what matters is the purpose of the charity trustees in making the social investment (and not the purpose either of the investee or of other investors). The mere fact that a social investment is in a commercial company does not mean that private benefit to other investors is a purpose of the charity in making the social investment. Provided the private benefit is incidental (so far as the charity is concerned) to the furtherance of the charity's purposes, it is acceptable.
 - (2) Mr Crampin's other principal argument was that such a social investment would be possible if it could be divided into two parts – one buying a financial investment and one buying the mission benefit – provided each was acquired for "full value". But that, he said, would require the

⁹⁸ See the Recommendations Paper, n 10.

⁹⁹ See paras 4.2 to 4.5 above.

valuation of mission benefit, which could rarely, if ever, be done. We agree that private benefit concerns may be overcome if a charity pays “full value”, whether it is spending, investing or making a social investment; the fact that full value is paid suggests that any private benefit is incidental. We do not agree, however, that private benefit concerns disappear simply because a charity receives full value for its investment. In our view, it is necessary to look at the benefit to third parties caused by the transaction and the reason for conferring that benefit, not just the value of what has been paid; put another way, a charity may pay or receive “full value” yet still confer more than incidental private benefit. In any event, even if charity trustees must ensure that they receive full value, the same would apply to their spending or grant-making activities, and they would – presumably – similarly be required to quantify mission benefit; any difficulties faced by charity trustees in the context of social investment would therefore be no different from the difficulties they already face when spending or making grants.

- 4.11 Charities may pay a third party for the provision of goods or services that the charity needs to carry out its mission, and may pay a third party to do work in furtherance of that mission itself. That is so notwithstanding that the payment contributes to the turnover and profit of the third party. Nor does the private benefit rule prevent a charity from investing in a third party notwithstanding that the investment benefits the third party by providing working capital. In our view, charities are permitted to do both at the same time. The fact that a social investment has a lower financial return than a financial investment does not mean that unlawful private benefit is being conferred.
- 4.12 If correct, Mr Crampin’s view would be a serious restriction on the ability of charities to carry out social investment. For the reasons set out above, we respectfully disagree. No other consultees¹⁰⁰ expressed this view. Those that mentioned private benefit considered it to be an important consideration for charity trustees, but not effectively prohibiting social investment. We also note the comment of the Charity Law and Policy Unit at the University of Liverpool that, whilst private benefit may cause concerns, “the sector has had experience of dealing with such situations before and have not found any difficulties insurmountable e.g. in charitable involvement in urban or neighbourhood regeneration schemes”.

Reforming the private benefit test

- 4.13 Stone King regarded the exclusion of the law relating to private benefit from the terms of reference as “a missed opportunity”.
- 4.14 Lord Hodgson repeated the recommendation in his report¹⁰¹ that the word “incidental” in the private benefit test should be replaced by “proportionate”. This was endorsed by Bates Wells Braithwaite, who referred to charities investing in

¹⁰⁰ Aside from Hubert Picarda QC, who – having read Mr Crampin’s analysis – expressed his “substantial agreement” with Mr Crampin’s qualms, though noted that some points – which he did not identify – may call “for qualification or reanalysis if not rebuttal”.

¹⁰¹ Hodgson Report, ch 9, recommendation 5.

the USA on a first-loss basis¹⁰² to bring in commercial investors, expressing concern that retaining the current law on private benefit would not allow this sort of social investment to flourish. Bates Wells Braithwaite referred to the Oxford English Dictionary definition of “incidental” as “occurring as something casual or of secondary importance not directly relevant to”, and said that the financial benefits conferred on commercial investors as a result of a charity acting as a cornerstone investor were not “casual or of secondary importance” but nevertheless ought to be permitted.

- 4.15 Our comments on the current law relating to private benefit are in paragraphs 3.82 to 3.100 of the Consultation Paper and paragraphs 1.23 to 1.25 of the Recommendations Paper. We are unconvinced by the suggestion that the law be reformed to permit “proportionate” private benefit since the meaning of the term would be uncertain, and it may even be more restrictive than the current law in some cases. It would also involve a change in the definition of a charity, with unknown implications.

Clarity in the law relating to private benefit

- 4.16 The Wellcome Trust said that private benefit “plays an important part in the assessment of whether a particular social investment is appropriate for a charity”. Whilst not suggesting reform, the Wellcome Trust said that it would be helpful to provide clarification of the private benefit test under the current law, and said that this was necessary “if the review is to succeed in its aim of reducing legal barriers to social investment by charities”.
- 4.17 The CLA Working Party regarded the current law’s treatment of private benefit as “complex” and thought that clarification of the law is necessary as to: (1) whether the treatment of private benefit is different for purely charitable activities, financial investments and social investment; and (2) the level of private benefit which is acceptable in relation to social investment. “This issue becomes more acute if MMI is removed as a category of social investment. This is because MMI covers ventures which are neither wholly charitable (and therefore fall outside the strict rules of incidental private benefit) nor wholly aimed at producing a market financial return. Currently, private benefit in relation to MMI must be ‘appropriate’ or ‘acceptable’ – this is arguably a more flexible test than ‘incidental’. Clarification of the private benefit issues should be provided as part of the introduction of a new statutory power and could be dealt with as part of the [Charity] Commission’s public benefit guidance and its functions relating to public benefit (see section 17 of the Charities Act 2011).”
- 4.18 Bates Wells Braithwaite said that, even if the private benefit test is not reformed to consider whether private benefit is “reasonable and proportionate”, the next best thing would be for CC14 to remove its emphasis on “necessary” and “incidental”, and for the test to be explained in line with the authorities set out in the Consultation Paper. We set out consultees’ comments on CC14’s expression of the law relating to private benefit at paragraphs 3.47 to 3.49 above.

¹⁰² A “first loss investment” involves an investor taking a subordinated position compared with other investors; any losses from the venture are to be sustained by the subordinated investor before the other investors. This provides a means of encouraging other investors to participate, since their investment carries a lower risk.

APPENDIX A

LIST OF CONSULTEES

CHARITIES

Association of Charitable Foundations

Association of Charitable Organisations

Bank Workers Charity

Charity Finance Group (“CFG”)

Churches’ Legislation Advisory Service

Friends Provident Foundation

Higher Education Funding Council for England (“HEFCE”)

The Monument Trust

National Association for Voluntary and Community Action (“NAVCA”)

National Council for Voluntary Organisations (“NCVO”)

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 (“CFA UK”)

City of London Corporation

Honorary Treasurers Forum

Institute of Chartered Accountants in England and Wales (“ICAEW”)

Mercer Investments

New Philanthropy Capital

Social Finance Ltd

The Social Investment Business Group

Social Investment Forum

UK Sustainable Investment and Finance Association (“UKSIF”)

Lawyers

Bates Wells Braithwaite

Bircham Dyson Bell

Charity Law Association (“CLA”) Working Party:

Jonathan Brinsden, Bircham Dyson Bell

Alexandra Casley, Bond Dickinson

Neasa Coen, Berwin Leighton Paisner

Edward Collier, Children’s Investment Fund Foundation

Rachel Collins, Trowers

Andrew Crawford, Devonshires

Luke Fletcher, Bates Wells Braithwaite

Rebecca Fry, Farrer & Co

Rachel Holmes, Farrer & Co

Hannah Kubie, Stone King

Sabien Khan, Wellcome Trust (Chair)

Sylvie Nunn, Wrigleys

Nicholas Pell, Macfarlanes

Lucy Rhodes, Bates Wells Braithwaite

David Russell, Harpur Trust

Joss Saunders, Oxfam

Andrew Studd, Russell-Cooke

Rachel Tonkin, Veale Wasbrough Vizards

Peter Crampin QC

Geldards

Sir John Mummery

Hubert Picarda QC

Francesca Quint

Matthew Smith

Stone King

Turcan Connell

Dr Matthew Turnour

Academics

Charity Law and Policy Unit at the University of Liverpool

Professor Duncan Sheehan

Professor Janet Ulph

Parliamentarians

Lord Hodgson of Astley Abbots CBE

Members of the public

Simon Cramp

Joel Moreland

Charity regulator

Charity Commission for England and Wales

APPENDIX B

LIST OF CONSULTATION EVENTS AND STAKEHOLDER MEETINGS

Charity Law Association and Charity Investors' Group seminar, hosted by Farrer & Co (29 May 2014)

Association of Charitable Foundations focus group meeting (11 June 2014)

Law Commission meeting to discuss social investment and permanent endowment (9 July 2014), attended by:

Adrian Broomfield, Charity Commission

Richard Jenkins, Association of Charitable Foundations

Joel Moreland

Francesca Quint

Stephen Roberts, Charity Commission

Kate Rogers, Cazenove Capital Management and Charity Investors' Group

Danyal Sattar, Big Society Capital