

# THE LAW COMMISSION'S CONSULTATION PAPER ON SOCIAL INVESTMENT BY CHARITIES

## EXECUTIVE SUMMARY

### INTRODUCTION

1. The Law Commission is conducting a review of selected issues in charity law, most of which arose from the evidence given to Lord Hodgson of Astley Abbotts during his review of the Charities Act 2006, published in 2012.<sup>1</sup> The first issue we are considering is social investment by charities, with the remaining issues to be considered in a further consultation paper at a later date.
2. The Law Commission's Consultation Paper, as well as this Executive Summary, can be downloaded from the Charity Law project page on the Law Commission's website ([www.lawcom.gov.uk](http://www.lawcom.gov.uk) > A-Z of Projects > Charity Law). The proposals in the paper do not represent a concluded view; responses to the Consultation Paper will influence our final recommendations to Government and consultees are strongly encouraged to respond to our provisional proposals and consultation questions in the Consultation Paper.
3. The consultation period runs from 24 April 2014 to 18 June 2014.

### SOCIAL INVESTMENT BY CHARITIES

4. Charities occupy a special place in society and in law. They exist for the benefit of the public and they must have exclusively charitable purposes. To achieve those charitable purposes, charities have traditionally both spent their funds in support of their charitable objectives (for example, providing funds to build a hospital), and invested so as to generate further funds for future initiatives (for example, purchasing shares in listed companies to provide an income). A charity making a social investment combines these objectives in one transaction, seeking to achieve both its charitable purposes and a financial benefit.
5. In Chapter 2, we give examples of various social investments made by charities. Social investment has a long history. The Sir Thomas White Loan Charity, founded in 1542, offers low-interest loans to poor young people to enable them to start a business or career, thereby achieving its charitable purposes as well as receiving a small financial return. Further examples of social investment by charities would include:
  - (1) A homelessness charity purchasing empty properties to be renovated and let at a low rent to homeless people, thereby achieving its charitable purposes as well as a financial return from the rental income and any increase in value of the properties.
  - (2) A charity which aims to improve healthcare investing in a medical research enterprise which is in the early stages of developing a potential new treatment. This pursues the charity's objects and may also provide a financial return if the project is successful.

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

- (3) A charity established for the protection of the environment investing in a fund which is used to purchase shares issued by companies that develop green technologies. This promotes the charity's purposes and may also provide a financial return.
6. Some recent examples of collective social investment by charities who invest alongside other investors include:
  - (1) The Big Issue Invest Social Enterprise Investment Fund, which provides loans to, and makes investments in, various social enterprises. Charities have invested in the fund, alongside commercial investors, with the aim of pursuing their charitable purposes as well as achieving a financial return.
  - (2) The Peterborough Social Impact Bond, which was launched to fund interventions aimed at reducing re-offending among short-sentence adult males leaving HM Prison Peterborough, with investors receiving a financial return from Government if the interventions are effective. Charities have invested, alongside commercial investors, to pursue their charitable purposes as well as achieve a financial return.
7. The range of new and emerging social investment opportunities allows charities to pursue their objects in ways that would not, traditionally, have been available and it has the potential to allow charities to make more efficient use of their limited resources by recycling their money.
8. Our terms of reference are to consider charity trustees' powers to make, and duties when making, social investments and to consider whether anything can be done by way of law reform to make those powers and duties clearer.
9. The Charity Commission published revised guidance for charity trustees on the investment of charitable funds in 2011.<sup>2</sup> The guidance refers to:
  - (1) financial investment, the purpose of which "is to yield the best financial return within the level of risk considered to be acceptable";<sup>3</sup>
  - (2) "programme-related investment" ("PRI"), by which a charity "directly further[s] its aims and, at the same time, potentially achieve[s] a financial return";<sup>4</sup> and
  - (3) "mixed motive investment" ("MMI"), which has elements of both financial investment and PRI and is justified based on "the dual nature of the return".<sup>5</sup>

<sup>2</sup> Charity Commission, *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011).

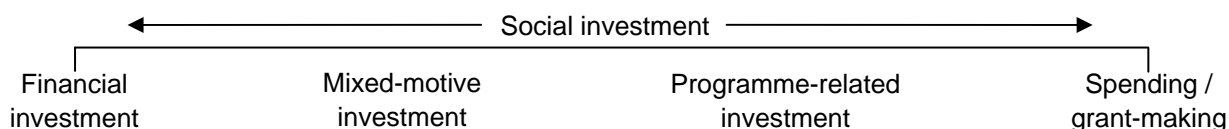
<sup>3</sup> CC14, section B, p 4.

<sup>4</sup> CC14, section J1, p 36.

<sup>5</sup> CC14, sections K1 and K2, pp 48 and 49.

10. A social investment may be classified by different charities as a PRI, a MMI or a purely financial investment, depending on the charity's purposes and on the charity trustees' objective in making the investment. We conclude that the use by charities of their funds will fall somewhere along a spectrum, ranging from financial investment at one end, through to spending or grant-making at the other, with PRI and MMI falling between these two extremes. Social investment covers everything between the two extremes of the spectrum: see Figure 1.

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



11. Regardless of how a charity uses its funds and where upon the spectrum the use falls, charity trustees must always act with the sole objective of pursuing the charity's purposes. A charity making a financial investment does so in order to secure the best possible financial return to be used for future spending on its charitable activities. This is indirectly achieving its charitable purposes. A charity's motivation when spending is to achieve its charitable purposes directly. When engaging in social investment, a charity is seeking to achieve both, to differing extents, albeit with the sole overriding intention of achieving the charity's purposes.

### **THE CURRENT LAW**

12. In Chapter 3, we explain the current law and the difficulties that charities face under the current law when making social investments.

### **Charity trustees' power to make social investments**

13. Charity trustees need powers to achieve the charity's purposes. Many charities can, and do, make social investments without having any concerns about the scope of their powers. Some charity trustees, however, are not confident about making social investments because they are unsure whether their powers under the charity's governing document or under the general law authorise such investments. As noted in paragraph 4 above, charity trustees have traditionally either spent or invested the charity's resources. Social investment, between the two extremes of the spectrum in Figure 1, does not fit neatly within either of these two functions, but spans both.
14. We conclude that charity trustees whose governing document gives them a catch-all power (for example, a power "to do anything desirable to achieve the charity's objects") will have the power to make social investments, although we acknowledge that the decision of the High Court in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd*<sup>6</sup> creates some uncertainty on this point.

<sup>6</sup> [1986] 1 WLR 1440.

15. In the absence of a catch-all power, charity trustees will generally have separate powers to spend and to invest the charity's funds, and many social investments can be made by charity trustees exercising one of those powers. Some social investments, however, cannot be made – or there is uncertainty as to whether they can be made – solely using a power to spend or a power to invest; in particular, a power to invest is unlikely to authorise a charity to make a social investment that is not expected at least to return the capital invested. In such cases, charity trustees are likely to be able to exercise the two powers concurrently to make social investments, but again there is some uncertainty concerning that analysis and we are aware that legal advisers provide differing views.
16. Charities may seek to amend their governing document to ensure that they have sufficient power to make social investments, but we consider that these powers are not a complete solution for charities wishing to make social investments.
17. We conclude that the law concerning charity trustees' powers to make social investments is not as certain as it should be, and would benefit from being put on a more solid footing. Although some charities undertake social investment with confidence, the lack of clarity in the law may be a disincentive to others.

#### **Charity trustees' duties when making social investments**

18. When making social investments, as with any application of charitable funds, charity trustees must act with loyalty, in good faith and in the best interests of the charity. We conclude that these core duties do not give rise to difficulties in the context of social investment. However, we identify two reasons why charity trustees making social investments may be, or may feel that they are, in danger of breaching their duties.
19. First, some charity trustees take the view that they are duty-bound to obtain the best risk-adjusted financial return when exercising their power of investment, which prevents them from making social investments that yield a below-market rate of financial return or carry a high degree of risk.<sup>7</sup> We conclude that the duty of charity trustees when making a social investment is to obtain the best overall return from the investment, and that is not limited to a purely financial return; instead, it should be based on the combination of the financial benefit from the transaction and the extent to which the transaction achieves the charity's purposes. Uncertainty on this point may be dissuading some charity trustees from making social investments.
20. Second, under the Trustee Act 2000, particular duties apply to the trustees of charities which are trusts when they exercise a power of investment: they must consider whether investments are suitable for the trust and sufficiently diversified; they must consider obtaining advice; and they must review the investments. The application of these duties to social investments may be confusing. We conclude that, at present, these duties will apply to such trustees if they make a social investment which is, in the technical legal sense, an "investment", that is, a transaction which is intended to preserve the initial capital outlay and provide

<sup>7</sup> The view is based on *Cowan v Scargill* [1985] Ch 270 and *Harries v Church Commissioners* [1992] 1 WLR 1241.

some (even modest) income return or capital appreciation or both. Since these duties were not designed with social investment in mind, they may be inappropriate when trustees are engaging in social investment.

### **Private benefit arising from social investments**

21. As charities exist for the benefit of the public and must pursue exclusively charitable purposes, they cannot confer private benefits on individuals or organisations, unless those private benefits are incidental to the pursuit of charitable purposes.<sup>8</sup> For many charity trustees, private benefit concerns are particularly acute when considering social investments, although we consider that similar concerns will arise in other contexts, such as making outright grants.
22. The law relating to private benefit goes to the heart of what a charity is and it falls outside the scope of our terms of reference. We acknowledge, however, that there is some dissatisfaction with this area of the law.

### **OUR PROVISIONAL PROPOSALS: CHARITY TRUSTEES' POWERS AND DUTIES**

23. By reason of the uncertainties under the current law, charity trustees may be dissuaded from making social investments that would achieve their charity's objects. To address this problem, in Chapter 4 we provisionally propose the introduction of a new statutory power to make social investments. We do not suggest that the new power should replace charity trustees' existing powers, but rather that it should supplement them, forming part of the toolbox available to achieve charities' purposes. Our provisional proposals are intended to facilitate social investment by charities, not to impose it.
24. We provisionally propose that the new statutory power should be accompanied by a non-exhaustive checklist of factors that charity trustees may take into account in deciding whether to make a social investment. The creation of a new power and checklist would make it clear that charity trustees are not required to obtain the best financial return when making a social investment; rather, they can justify a social investment by reference to the combination of its financial benefits and the extent to which it achieves the charity's objects.
25. We do not propose that the checklist be modelled on the duties that apply to trustees under the Trustee Act 2000 (see paragraph 20 above). We invite consultees' views as to whether the duties under the Trustee Act 2000 should be excluded altogether whenever trustees are making social investments, regardless of whether they are exercising the new statutory power or other existing powers.

### **SOCIAL INVESTMENT AND PERMANENT ENDOWMENT**

26. Some charities hold a permanent endowment, meaning that certain assets are subject to a restriction allowing only the income from the assets to be spent, and not the capital. In Chapter 5 we consider whether permanent endowment can be used to make social investments. We conclude that permanent endowment can be used to make a social investment which is anticipated to preserve the capital value of the permanent endowment. In some cases, that value will be the real

<sup>8</sup> Private benefits can, of course, be conferred on those who are beneficiaries of the charity's charitable activities, as where a homelessness charity provides accommodation to an individual, or a medical charity provides treatment to a patient.

value of the endowment (that is to say, the value of the endowment adjusted for inflation); in others, it will be only the value of the initial capital outlay.

27. Some social investments, however, will not be expected to preserve capital (whether the value of the initial outlay itself or the real value of the initial outlay), or the financial return may be so uncertain that the social investment cannot reasonably be said to be likely to preserve capital. Under the current law, permanent endowment cannot be used to make such social investments unless the charity trustees utilise certain mechanisms to release the restriction on capital expenditure. Preservation of capital is the hallmark of permanent endowment, ensuring that donors' wishes are respected and ensuring the indefinite continuation of the charity. Some of those working in the charities sector question the value of the preservation of permanent endowment and might welcome the ability to spend it through social investment. It would, however, be inappropriate to make such a recommendation in this project as it would enable permanent endowment to be denuded indirectly. Charity trustees have been given the ability to expend permanent endowment within prescribed confines; we conclude that there is no case for further provision to permit permanent endowment to be spent on social investment. We ask consultees whether they agree.

#### **NON-LEGAL BARRIERS TO SOCIAL INVESTMENT**

28. The Consultation Paper focuses on the legal barriers to social investment. We are aware, however, that there are various non-legal barriers to social investment, including caution on the part of charity trustees, charity governance structures, and tax concerns, and we comment on these in Chapter 6. These issues fall outside our review because we are able only to focus on law reform, but we conclude that law reform alone is not a guarantee of a flourishing social investment market.

#### **HOW TO RESPOND TO THE CONSULTATION**

29. If you wish to respond to the consultation, please send your responses:
  - (1) by email to: [propertyandtrust@lawcommission.gsi.gov.uk](mailto:propertyandtrust@lawcommission.gsi.gov.uk); or
  - (2) by post to: James Linney, Law Commission, 1st Floor, Tower, Post Point 1.53, 52 Queen Anne's Gate, London SW1H 9AG.
30. An optional template response form is available on the Law Commission's website.
31. If you send your comments by post, it would be helpful if, where possible, you could also send them electronically (for example, by email to the above address, in any commonly used format).
32. For further information about how the Law Commission conducts its consultations, and our policy on the confidentiality of consultees' responses, please see page iii of the Consultation Paper.