Charity Commission Consultation on
'*Charities and Investment Matters*'

The submission of an expert group on responsible investment convened by the UK Sustainable Investment and Finance Association and Bates Wells and Braithwaite

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The Draft Guidance

Overview

The draft guidance is welcomed by the group as an improvement on previous guidance and the group believes the Commission has made considerable progress in a complex area. However, there are a number of issues of concern and the group is strongly of the view that the draft can be improved and made clearer and more consistent in a number of ways.

The group welcomes the acknowledgement on the part of the Commission of what it describes as "mixed purpose" investment, sometimes known as "blended investment", as this is a developing area of investment practice, but the draft is restrictive and, in its current form, may unnecessarily discourage trustees from mixed purpose investment.

In practical terms, the emphasis in the context of programme related investment on charity funds being invested only to further charitable aims for the public benefit does not acknowledge that social investments often involve a complex mixture of financial return, mission-linked social return, other public benefit and private benefit. A more generous and fulsome treatment of mixed purpose investment therefore appears necessary to provide charity trustees with greater confidence about their freedom to engage in social investment.

Generally, issues surrounding private benefit are emphasised in a way which is not helpful and which in practical terms will discourage investment by charities in social enterprises.

The strongest criticism of the draft voiced by members of the group is that the attempt to definitively categorise different types of social investment still in part reflects a binary approach to charity investment which the group does not believe to be tenable. The group is therefore unanimously of the view that the guidance would be better if it started and finished with the core principle that trustees must seek to make effective use of charitable resources. In summary, a principles-based approach which acknowledges the need for trustees to make judgements in good faith is preferable to the rules-based approach taken by the draft.

Status of Guidance

The guidance represents the Charity Commission's perspective on the applicable legal, tax and accounting issues but it is not binding. Unlike the public benefit guidance, there is no statutory obligation upon trustees to take account of the guidance. However, the guidance is important because, not only does it represent the Commission's view of the law and practice of charity investment but many financial advisors, investment managers and trustees will follow the guidance closely and will not interpret the issues or take an independent view.

The Commission can speak authoritatively about charity law. The same may not necessarily be said for investment related issues particularly as investment thinking and products continually evolve. The guidance should therefore aim to avoid stating binding rules unless the law is settled and clear.

Tax

It is critical that HMRC agrees with the final form of the guidance, as the risk of being taxed on the full amount of a non-qualifying investment is such a significant risk that it has the potential to unnecessarily stymie the development of legitimate social investment practice.

In principle, it ought to be the case that if trustees act reasonably and honestly in the best interests of the charity, in accordance with fiduciary obligations, then there should be no risk of an investment being regarded after the event as a non-qualifying investment. The guidance could provide even greater comfort in this respect – without this comfort, many charities may still feel reluctant or unable to engage in programme-related and mixed purpose investments.

The guidance should also move away from trying to cover all possible tax issues and rather make mention of the fact that investments may be treated differently for tax purposes both in the UK and in jurisdictions outside the UK, and that professional tax advice should be taken where trustees determine is appropriate.

Also, in some instances, it may still be advantageous to a charity to make an investment even if there is a tax consequence and the guidance does not make this clear and appears in some places to actually exclude investments if there is a risk of a UK tax leakage.

Fiduciary Obligations

The guidance should explain more clearly the fiduciary obligations of trustees to consider the environmental, social and governance aspects of investment decisions. The draft is deficient in that it emphasises at a number of points the importance of financial return without mention of the broader fiduciary and stewardship duties of trustees as shareholders and owners of investments. The guidance reflects outdated thinking in this respect, as ethical investment is considered primarily in terms of negative screening and there is little comment on the positive fiduciary obligations of trustees.

The understanding of fiduciary obligations is more highly developed in the context of the investment of pension funds, as compared with charity investment, and the guidance needs to better reflect the latest thinking on these issues. The guidance could be improved by making reference to the 2007 United Nations Environment Programme report "Fiduciary Obligations", which is a key and authoritative document in the area of financial stewardship.

The guidance should make reference to the importance of the UK Stewardship Code produced by the Financial Reporting Council and should make it clear that it is good practice for charities to state in their annual reports how they have considered environmental, social and governance issues in making their investment decisions.

It is essential to understand that the fiduciary duties of pension fund trustees and charity trustees are different. For example, where a charity has no permanent endowment and so no obligation to maintain its capital endowment, it is able to spend down its endowment, which provides greater scope for social investment. Where a charity does not have an obligation to maintain its capital endowment, its obligation is to make best use of its funds in furtherance of its purposes, considering the financial returns available from investment and the social returns available in furtherance of the charity's purposes, whilst taking into account social, environmental and governance factors - i.e. to seek the "best return".

To put this more directly, if in a hypothetical case the financial returns available from financial investment, ethical investment, mission connected investment and programme related investment were identical, trustees would have an obligation to choose the form of investment which would generate the greatest social returns in furtherance of the charity's purposes, which would be the investment generating the "best return".

Seen in this light, the Bishop of Oxford case is distinguishable from cases where charities do not have an obligation to maintain capital endowment, as the Church Commissioners' main obligation is to obtain the best possible long term <u>financial</u> return to generate money to fund the work and pensions of the Church of England. This is a very fundamental distinction which ought to be drawn out very clearly and ought to permeate the guidance.

The term "fiduciary duty" or "fiduciary obligation" ought to be defined in the glossary.

<u>Financial Investment</u>

One of the aspects of the guidance of greatest concern is the frequent reference to "best financial return". As used, the phrase "best financial return" is a very narrow concept particularly as it appears to ignore levels of risk taken.

It should be explained that, where a charity, whether with an obligation to maintain its capital endowment or not, the obligation of trustees is not simply to "obtain the best financial return" but to exercise reasonable care and skill in seeking the best financial return whilst taking into account various risk factors which may include environmental, social and governance issues.

It is not possible to know in advance which investment will yield the best financial return or indeed what best financial return actually involves. Trustees and investment committees can only make decisions on the information available to them and different investments have different risk profiles – we have seen in recent years that even supposedly secure bank deposits and highly rated fixed income products can be risky and may yield negative returns.

Where there is a poor financial return, this may be due to poor fund management or timing issues or default on the part of an underlying investee, as opposed to investment policy.

Terminology

We are concerned that the phrase '*best financial return*' will be generally construed as relating solely to standard investments without taking environmental, social and governance factors or the charity's purposes into account at all.

It is important that the language used by the Charity Commission reflects current industry usage as far as possible, to avoid confusion.

The phrase "minimum good practice" is problematic and should be avoided.

The use of the term "social investment" to refer to a spectrum of investment, as opposed to the usage of social investment in previous guidance to refer to programme related investment, aligns more closely with the way the term social investment is used in Europe, which is helpful. However, the term "impact investing" has increasing currency in the US and internationally and the guidance should therefore also explain the relationship between the investing terms used in the guidance and the term "impact investing".

The term "ethical investment" has lost credibility in recent years and the term "responsible investment" may therefore be a more appropriate substitute, as it is increasingly being used given that it does not have the same implication of avoiding certain types of investments..

Whatever terminology is used by the Commission, the glossary section should not only set out the meanings of the words used *for the purposes of the guidance* but should acknowledge divergent usage and should also more fully explain interchangeability with words in popular currency e.g. "programme related" and "impact-first" or "financial" and "finance-first".

Accounting

The guidance should not attempt to explain how the different categories of social investments should be treated for accounting purposes. Rather the guidance should point the reader to the SORP and relevant Accounting Standards as the accounting for charities is an evolving area and thus the guidance is in danger of being out of date very quickly if it is too prescriptive..

Programme Related Investment

The guidance should make it clear that, in some instances, a particular form of programme related investment may be expected to yield higher returns than other available types of mainstream financial investment. Programme related investment can therefore encompass expected returns *as well as* potential returns. The JP Morgan report "Impact Investments: An Emerging Asset Class" dated 29 November 2010 bears this out in the research shown in Figure 4 on page 10, which benchmarks impact investments against market investments.

The 'exit mechanism' requirements in the guidance are currently extremely onerous as the ability to exit an investment on demand is very unlikely in the case of many programme related investments due to the nature of the investments themselves (which by their nature involve patient capital and may involve first-tier risk capital in tiered financing arrangements) and so they are not listed and thus illiquid in nature. The ability to exit is of course significant and should be noted in the guidance but only as one of the consideration which trustees ought to be making alongside risk, social and financial return, tax and legal issues.

Mixed Purpose Investment

The guidance should provide a more complete and more confident treatment of mixed purpose investment, an area of investment practice which is developing quickly and the guidance needs as far as possible to be future proofed. Many charities are already legitimately engaging in mixed purpose investment activity in many different areas on the basis of an assessment of total anticipated financial and social return. The guidance ought to articulate more clearly and with greater certainty how and why mixed purpose investment is allowable.

Without a stronger and more generous treatment of mixed purpose investment, the guidance could actually limit, rather than encourage, social investment by charities.

Charities investing in social enterprise funds will often be investing on a mixed purpose basis and not on a programme related basis, as it may not always be the case that all of the funds in a social enterprise fund will be invested in furtherance of charitable purposes. However, social enterprise funds are part of a developing social investment market and there are considerable public benefits to be gained through the development of such funds.

Whilst there are not yet established metrics for the purposes of measuring, comparing and benchmarking social return on investment, trustees should be encouraged to use the best available means to assess and predict social return on investment.

The diagram on page 6 of the guidance should also include mixed purpose investment.

Public Benefit

The guidance does not expressly acknowledge that programme-related investment, and more particularly mixed purpose investment, takes place in the context of a developing market.

Many of the grant-making charities which are active in this area see that there is a significant public benefit in backing innovative projects and initiatives, which are calculated as having the effect of developing the social investment marketplace generally. Seen in these terms, the purpose of advancing the social investment marketplace for the public benefit (as the Government is currently seeking to do with its Big Society Bank) should be acknowledged in the guidance as being in the nature of a charitable purpose which supports programme related investment by charities.

Private Benefit

The tone of the draft with respect to private benefit is not helpful and will unduly discourage social investment unless a more proportionate approach is taken.

The Charity Commission seems to think that private benefit in the context of financial investment is acceptable but private benefit in the context of social investment is prohibitive. In the context of mainstream financial investments, there is often a very significant amount of private benefit involved and there is no requirement for private benefit to be incidental. For example, fund managers frequently fees of up to 10% of the capital value, when the return may be 30%, i.e. 33% of the yield is paid in fees. This is a significant ‘private’ benefit but is not commented upon. The guidance should therefore make it clear that, where there is a social investment, any private benefit ought to be reasonable and proportionate to the expected level of financial return, as opposed to necessary and incidental. The reasonable and proportionate test would allow reasonable judgement to be exercised by trustees and would give confidence to trustees that they can engage in social investment.

The guidance should make it clear that providing first-tier risk capital on a social investment basis may often be justified, even if it permits other commercial investors to commit capital with an improved risk-profile, on the basis that it can be seen as being for the public benefit to leverage in private funds to the social investment marketplace provided that those private funds are not yielding returns materially in excess of available market returns.

Examples

It is important that, where examples are used, there is clarity about the nature of the investment being made and that examples given allow for the development of charity investment practice over time. For example, where investment may be made at present at below market returns, it is possible that investment may be made in future at market returns. Also, reference is made in the examples given to social enterprise funds being a form of programme related investment. However, in many instances, investment in social enterprise funds will be made as a form of mixed purpose investment.

Portfolio Investment

It would be helpful if the final guidance could comment on how social investments can be held as a proportion of total investments as part of an overall portfolio strategy.

On behalf of the expert group
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