DIRECTORY OF SOCIAL CHANGE

INFORMATION AND TRAINING FOR THE VOLUNTARY SECTOR

Social Investment by Charities

DSC Response to Law Commission Consultation Paper 216

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About the Directory of Social Change

The Directory of Social Change (DSC) has a vision of an independent voluntary sector at the heart of social change. We believe that the activities of charities and other voluntary organisations are crucial to the health of our society.

Through our publications, courses and conferences, we come in contact with thousands of organisations each year. The majority are small to medium-sized, rely on volunteers and are constantly struggling to maintain and improve the services they provide.

We are not a membership body. Our public commentary and the policy positions we take are based on clear principles, and are informed by the contact we have with these organisations. We also undertake campaigns on issues that affect them or which evolve out of our research.

We view our role as that of a 'concerned citizen', acting as a champion on behalf of the voluntary sector in its widest sense. We ask critical questions, challenge the prevailing view, and try to promote debate on issues we consider to be important.

Summary

The Law Commission is an independent statutory body which keeps the law under review and recommends reform where it is needed. Often the Law Commission's work forms part of a pathway from policy consultation to draft legislation and laws enacted by Parliament.

The aim of the Commission is to ensure that the law is fair, modern, simple and as cost-effective as possible. The present proposals and consultation paper are available from the Law Commission.

This response concerns the Law Commission's consultation on the law around social investment, and how it can be undertaken by charities. Social investment can be broadly defined as an investment which achieves both a financial and a mission-related benefit for a charity. It is in contrast to traditional financial investments which achieve only a financial benefit.

In our response to the consultation DSC puts forward the following points:

- The power to make social investment already exists, both from unrestricted reserves and (to a lesser extent) permanent endowment.
- However, we agree with the Law Commission that this power is not necessarily clear in the law.
- We therefore agree with the proposed new power to make social investments, subject to two important reservations:
    - Firstly, that the new power is introduced only with sufficient safeguards – we do not think the current proposals provide adequate safeguards at present.

    - Secondly, that the new power is not extended to covering permanent endowment. We are in agreement with the Commission on this matter.

- We recommend keeping Charity Commission guidance CC14 under regular review after the introduction of a new social investment power. Social investment remains a relatively new field and reforms to the law may increase participation. It is important the guidance remains relevant and up-to-date with practice.

Background

To a significant extent the legal 'barriers' to advancing social investment have been overplayed. For confident trustees with powers to spend and invest we believe the ability to make social investments already exists. The far greater issues to further adoption are:

- The lack of relevance of many of the proposed or widely publicised investment-types to the vast majority of charities (in particular, Social Impact Bonds)

- An understandable and cultural lack of receptiveness or desire for this type of finance from charity trustees.

Policy around social investment is heavily driven by the Government's policy agenda to pluralise public service delivery and to grow social enterprise. The evidence of need or demand from the charity sector is limited. We therefore question the rationale behind the priority given to consideration of this topic above many other matters in charity law needing reform.

A far greater concern in our view is the ability and willingness of trustees to invest ethically – in particular the confidence to make ethical choices in the context of traditional investing, which may have the possible effect of diminished returns when compared to other non-screened products.

Ethical investment is closely related to social investment but too often receives little attention in relation to the more headline-grabbing and 'innovative' types of schemes and products favoured by Government. Ethically screening financial investments is arguably just as much of a programme-related investment activity as making a social investment.

Questions about the ethical rigour of charity investments clearly speak to the current public interest and to the idea of a charity's public benefit in the round, than the legal technicalities about whether it is possible for a charity to use experimental and evolving social investment products or models.

The Charity Commission's guidance in CC14 is clear on whether a charity is permitted to ethically screen their investments. Yet in the recent media coverage of this issue some organisations alleged that the Commission's guidance was not clear. The fact that self-regulatory action is now being taken within the charitable sector is a promising development, and perhaps one that the Law Commission can help drive forward.

However, for those few charities or charity trustees considering social investment, we appreciate that the current law isn't necessarily straight forward, involves a degree of legal confusion and is likely to engender doubt in the minds of trustees who are unsure whether they have the power or not. Nevertheless, further changes to the law are unlikely to yield the 'sea-change' in social investment sought by its proponents.

Responses to Consultation Questions

Below DSC responds to the Law Commission's consultation questions (which are repeated in bold italics for context.)

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

Consultation Paper, Chapter 3, paragraph 3.110

For confident trustees with powers to spend and invest we believe the ability to make social investments already exists.

However, for those few charities or charity trustees considering social investment, we appreciate that it isn't necessarily straight forward, involves a degree of legal confusion and is likely to engender doubt in the minds of trustees who are unsure whether they have the power or not – which could preclude the use of social investment.

We also agree with the Commission's conclusion that even if trustees understand that they can make social investments and they know how to do so, they do not possess the certainty that their actions will be upheld as legitimate if later challenged. We agree that the case law in this area, as demonstrated by the *Rosemary Simmons* case, has created uncertainty.

It is beyond our expertise to say whether or not a non-financial return on an investment would be upheld as legitimate by the courts, if challenged. Navigating competing and overlapping case law judgments would be beyond the reasonable purview of many charitable organisations. The alternative is advice which can be expensive and as the Commission have outlined, not necessarily definitive.

Overall given the lack of clarity and inconsistencies in the current law and the potential pitfalls these entail, it is not unreasonable to consider the current law to see how it could be made more satisfactory.

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

Consultation Paper, Chapter 3, paragraph 3.111

The guidance is clear for the most part and there is much in there which is helpful. In particular points such as J14 which recommends that trustees should consider 'the likelihood of repayment and/or return on the PRI' could be usefully adopted onto the checklist proposed at para. 4.16 of the consultation document. Other recommendations such as those on risk and monitoring are also useful. The emphasis throughout on ensuring that investment decisions are well planned, thoroughly investigated and arrived at after full trustee consideration is also useful.

At the same time the document frequently advises that a particular course of action may or might lead to a certain outcome. This does not offer certainty. A prudent trustee may decide that the risks are too great and opt to avoid social investment or seek expensive legal advice. To an extent this makes the guidance somewhat redundant. However, we realise that there are often no definitive answers given the context-dependent nature of social investments and the guidance has to reflect this.

We recommend keeping CC14 under regular review and updating it with case studies and examples in order to help guide trustee decisions. It could be that the guidance is reviewed every year for an initial period of four years in order to ensure it is relevant and useful.

As noted in the consultation document, trustees may not rely on this guidance in court (para 3.109). This threatens the regulator's ability to uphold their statutory objectives of ensuring trustee compliance with the law and increasing public trust and confidence in charities.

We agree with the Commission's assessment (at para 3.108) that deciding whether a social investment is appropriate "should be a matter of trustee judgement, relying on trustees' expertise and understanding of their own charity's objectives." We have reservations about the extent to which social outcomes can be effectively or meaningfully measured. We would also be concerned if an overly formalistic approach to measurement were included in the guidance. This could lead, as we see it, to one of two outcomes: trustees opt not to pursue social investment because the attendant measurement requirements are too onerous; or instead trustees divert resources to measuring outcomes where these resources may have been more usefully spent directly on the charity's mission, whether through further investment, grants or other spending on charitable activities.

We would hope that any new power is reflected in amendments to CC14 as soon as possible.

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?

Consultation Paper, Chapter 3, paragraph 4.12

Yes. As stated earlier we agree that there is uncertainty in the current law. We would hope that a new power would bring greater certainty and clarity.

However, as we discuss below we believe that the new power must be accompanied by adequate safeguards; otherwise we cannot support the introduction of the power.

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?

Consultation Paper, Chapter 4, paragraph 4.13

Yes. We agree that the new power should apply unless expressly excluded. The fact that the power can still be excluded from a charity's governing document should this be desired is key, in line with the current law on investment powers in the Trustee Act 2000 S6(1)(b).

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?

Consultation Paper, Chapter 4, paragraph 4.21

We would go further than the Law Commission is suggesting here. The proposal is not merely to dispense with a number of factors to be taken into account by trustees – it dispenses with legal duties. While we agree that the idea of a list of factors is an attractive one as it ought to encourage trustees to think widely about their investments, we believe that they are not a strong enough replacement for the Trustee Act duties.

The suggestion that trustees 'may' take into account these factors is wrong. The pendulum has swung too far away from the Trustee Act duties and consequently does not offer sufficient protection for charitable assets.

We suggest that trustees should have a duty to show that they have actively considered the list of factors – if not every factor, certainly those which they judge to be most relevant. It would be absurd if trustees were not expected to consider the risk of any investment, for example. Enshrining a duty to consider such factors would continue to offer protection to charitable assets.

We believe that trustees should have to declare in their annual report and accounts that they have given active consideration to this list of considerations when they have made a social investment.

Further, we would suggest that the factors which trustees should pay attention to should be kept under review given that social investment is still a relatively emergent area. Although the Commission's present exercise is *prima facie* one of legal codification, it will arguably help alter behaviour as well (although we share the Commission's view that law reform alone will not necessarily spark an overnight revolution). By removing barriers to investment, such as legal uncertainty, the Commission's review paves the way for further government policy to promote social investment. Therefore reform of the law may enable a shift in practice which the

Commission should continue to monitor so that any guidance and associated safeguards are adequate and appropriate.

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

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

Consultation Paper, Chapter 4, paragraph 4.22

The list of factors suggested is sensible and by including a catch-all provision at number 8 we are encouraged by the attempt to make trustees think widely about their investments.

We would add two further points for trustees to consider: 'whether a non-financial return would threaten or otherwise undermine the operational viability of the charity' – this is closely linked to the points suggested at K4 in the Charity Commission guidance document CC14, which we think is worth making formally binding by inclusion in this checklist.

Secondly: 'whether trustees have considered any potential reputational damage and how they might mitigate this should the investment fail to recoup any expected return, financial or social.'

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?

Consultation Paper, Chapter 4, paragraph 4.27

We understand the Commission's reasoning for excluding the Trustee Act duties in question – that they were designed for traditional financial investments and do not readily apply to social investments; this is not disputed by us. However as we argued above we could not support the introduction of a new power without requisite safeguards – we do not feel that adequate safeguards are currently offered by the present checklist of recommended factors.

If trustees were exempted from these duties there may be potential for abuse stemming from two interlinked factors: social investment is not defined rigidly (para. 4.10). That it is not is right given the fact that any such definition would become either too prescriptive or too confusing. Secondly, if the current proposals are made law trustees are only advised, not obliged, to consider a non-exhaustive list of criteria when making social investments. The combination of both of these factors could potentially enable abuse, as suggested at para 4.30.

For example if a trustee board made an overly risky investment which in practice resembles a purely financial investment. They may subsequently add a tokenistic Mixed Motive Investment or Programme Related Investment element in order to help them classify the investment as a social investment, rather than purely financial investment. To do so would allow them to avoid the stringent duties attached to S4 TA 2000. They would also not have to show that they considered the factors contained in the proposed non-exhaustive list as it is not proposed that consideration of this list is mandatory. We are worried that the removal of this duty is not being replaced with an adequate safeguard.

This potentially enables the abuse of charitable assets either through wilful misconduct or negligent conduct (whether through overly risky practices or something else). This would set the law in conflict with the Charity Commission's statutory objectives of promoting public trust and confidence and in promoting the effective use of charitable resources.

This also raises the associated question of whether trustees will have to formally state in advance when exercising the new social investment power - in meeting minutes, resolutions, etc.?

We would also seek clarification on whether the exclusion is limited to these Trustee Act duties only. It is important that the general trustee duty of care in Section 1, for example, continues to apply to trustees making social investments.

In summary, if trustees were exempted from considering the Trustees' Act 2000 duties we would recommend the introduction of some new duty along the lines discussed here: a duty to consider the non-exhaustive checklist.

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.

Consultation Paper, Chapter 4, paragraph 4.33

As expressed above we feel that there is a great deal of uncertainty in this area. Therefore any reforms to the law should ensure that achieving certainty is a high priority.

With this in mind it makes sense to remove the Trustees' Act 2000 obligations on trustees making social investments, whether they are exercising a new statutory power or not.

However, as stated above we feel that in the absence of the duty enshrined under the Trustees' Act 2000 there is a lacuna in the law. We do not feel that it is enough to replace a duty with a recommendation.

Trustees ought to have a duty to consider the non-exhaustive list of factors proposed at para. 4.16.

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.

Consultation Paper, Chapter 5, paragraph 5.33

We firmly support the Commission's view that the law should not be altered on permanent endowment. We are particularly interested in grant making trusts with permanent endowments. We refer to 'Investment' permanent endowments here. The defining feature of permanent endowment is its permanency. To extend a new general power of social investment to include permanent endowment would erode this permanency and disregard the wishes of settlors and donors. We believe that this would be unacceptable.

We also believe that if any such change were introduced it could have potentially unforeseen consequences. For example, it is arguable that social investment, if it is suitable for charities at all, is only suitable for larger and mid-sized charities. To enable permanent endowment to be eroded through social investment would ultimately have a deleterious effect on smaller charities which would lose out twice – in the present, having no use or capacity for investment and in the future because the overall grant making capacity of charitable trusts using endowments for social investments has been eroded. This is not inconsequential given that the majority of charities are small – 42% have an income of less than £10,000 per annum, 75% below £100,000 (*Charity Commission, June 2014)*.

As the consultation document discusses there are some ways in which permanent endowment can already be used for social investment. These are subject to fairly rigorous procedures which we believe is correct.

Therefore we argue that the current law is largely satisfactory. Contrary to Lord Hodgson's proposal – and in support of the Commission's position - we agree that (as per para. 5.30) 'charity trustees already have the power to use permanent endowment to make social investments which are anticipated to produce a positive financial return, we do not see the need for such a power to be introduced.'

We would be of the opinion expressed in paragraph 5.12 – that any permanent endowment investment should at least provide a real return, not just actual return. However, we feel that the law at present is unclear on the matter of what level of return (actual or real) should be achieved when making investments from permanent endowment.

This is acknowledged in the discussion in the consultation document. We would urge the Commission to use this opportunity of reform to promote certainty here. As social investment is a relatively new and emergent field it is arguable that risk weighting and assessment is more of an art than a science at present. Indeed the recent economic collapse in the financial sector illustrates how contested the issue of risk is even in sectors where it is supposedly a central and well-established concept with a developed industry backing.

It is arguable, therefore, that it would be preferable for the law to err on the side of caution and only permit social investment from permanent endowment where the real value of the endowment is preserved. This could potentially act as a buffer against investments which fail to meet their financial performance target by excluding more risky investments which cannot realistically promise to deliver even a real return.

At the least, such an approach should help preserve more of the original value of any endowment used for investment, provided the investment does not fail outright. The corollary is of course that fewer investments will be made if the threshold is higher. We see this as a fair trade-off in accordance with trustees' duty of even-handedness between present and future beneficiaries.