

**BATES WELLS & BRAITHWAITE**

SUPPLEMENTARY SUBMISSION TO LORD HODGSON

**REVIEW OF THE CHARITIES ACT 2006**

SUBMISSION ON SOCIAL INVESTMENT

April 2012



BATES WELLS & BRAITHWAITE LONDON LLP

### **Background to this submission and Lord Hodgson's review**

Parliament built in to the Charities Act 2006 a requirement that the effectiveness of the Act should be reviewed after five years. In November 2011, the Government appointed Lord Hodgson to carry out the review. He is due to report to Parliament by Summer 2012. The terms of reference for Lord Hodgson's review were wide-ranging and included, at a high level, what charities need to have/be able to do in order to carry out their roles. On a more detailed level, the review terms of reference included looking at measures to facilitate social investment or "mixed purpose" investment by, and into, charities

This booklet sets out our submission on social investment. BWB has also submitted two further submissions, one focusing on changes to the rules on disposals of land and the other covering a wider range of issues. Copies of these additional submissions are available on the BWB website: [www.bwbllp.com/updates/Charity-law-reform-review-of-the-Charities-Act-2006-and-Lord-Hodgsons-review.html](http://www.bwbllp.com/updates/Charity-law-reform-review-of-the-Charities-Act-2006-and-Lord-Hodgsons-review.html).

### **BWB's involvement in the review**

Luke Fletcher, an Associate in the Social Finance Group, authored the BWB social investment submission. Luke was recently seconded to the Cabinet Office to advise on the removal of legal and regulatory barriers to social investment. Stephen Lloyd, Senior Partner of BWB, acted as special legal advisor to Lord Hodgson.

**For more information on any of the issues mentioned in this submission, contact your usual BWB lawyer or Luke Fletcher [l.fletcher@bwbllp.com](mailto:l.fletcher@bwbllp.com).**

## **1. Introduction**

- 1.1 This submission is made by Bates Wells & Braithwaite London LLP in response to the consultation issued by the Cabinet Office on 9 February 2012 regarding social investment by and into charities, as part of Lord Hodgson's Charity Law Review.

## **2. Bates Wells & Braithwaite**

- 2.1 Bates Wells & Braithwaite London LLP is a leading law firm in the fields of charity, social enterprise and social finance. As a firm, we have advised clients and maintained a strong interest in socially responsible and social investment by and into charities for a number of years.
- 2.2 We acted for the Bishop of Oxford on the landmark case which, in 1992, established the validity of socially responsible investment by charities.
- 2.3 In 2002, we acted on the establishment of Charity Bank and CAF-Venturesome. More recently, we have acted on the establishment of Social Finance, Social Stock Exchange, Bridges Social Entrepreneurs Fund and Big Society Capital. Today, our Social Finance Group services many of the leading social investment organisations.

## **3. Background to the Submission**

- 3.1 This submission has been informed by:
- 3.1.1 over twenty years of experience of advising charities with respect to socially responsible and social investment;
  - 3.1.2 a roundtable event convened by Social Finance and Social Enterprise UK and hosted by the Esmée Fairbairn Foundation on Monday 19 March 2012 comprising of leading social sector organisations with an interest in social investment, with a view to co-ordinating responses to the consultation;
  - 3.1.3 a BWB client seminar on Wednesday 21 March attended by approximately 50 client organisations active in social investment; and
  - 3.1.4 discussions with and comments from leading social investment experts in relation to the framing of the specific proposals contained in this submission.
- 3.2 We do not seek to respond to each of the specific questions posed by the Cabinet Office in its consultation on social investment. Instead, we set out, in order of importance, the reforms to charity law which we believe are necessary to create a satisfactorily enabling legal and regulatory environment for social investment.
- 3.3 Each of the reforms we propose will require primary legislation to be put into effect. In our view, the reforms we propose should be combined with other important reforms to the legal and regulatory environment for social investment and the social economy, which we have advocated elsewhere and of which the Cabinet Office are aware. This could be achieved by a single 'Charity and Social Economy Bill'.
- 3.4 If the Government fails to implement a package of legal reforms to the social economy in a single item of legislation, we believe that the law and regulation of the social economy will continue to remain fragmented, inconsistent and incoherent. In our view, in the absence of co-ordinated legislative reform, there is a risk that the Government's ambitions to grow the social investment market will not be achieved.

#### 4. A Statutory Clarification of Charity Trustee Investment Duties

##### *A Confused Picture*

- 4.1 There is a lack of clarity in law about the nature of charity trustee investment duties, which, in our experience, often acts as a significant barrier to innovative and creative investment approaches on the part of charity trustees, including the development of social investment approaches.
- 4.2 The most common default assumption is that charities must invest for maximum risk-adjusted returns. This assumption is ill-founded and mistaken. However, this view is very prevalent. It is also often combined with the view that to engage in socially responsible, programme-related, social or mixed motive investment is in some way questionable and may open the trustees to the risk of challenge.

##### *Case Law Derives from Private Trusts and Pension Funds*

- 4.3 The default approach to investment which emphasises maximum risk-adjusted returns stems in large part from the fact that the case law with respect to trustee investment duties relates in the main to private trusts and pension funds. It is generally assumed that the case law applicable to private trusts and pension funds, which generally emphasises the importance of seeking maximum risk-adjusted returns, is equally applicable by analogy to charitable trusts.
- 4.4 However, private trusts and pension funds are different to charities, as private trusts and pension funds exist for the benefit of specific individuals and so, when investing, private trust and pension fund trustees generally have a duty to balance the needs of present and future beneficiaries and this usually gets translated into a duty to pursue maximum risk-adjusted returns when investing assets.
- 4.5 Pension funds also often have the added burden of being obliged to meet specific liabilities which pension fund trustees know in time will mature.

##### *Bishop of Oxford Case - Of Limited Application and Usefulness*

- 4.6 The leading case with respect to socially responsible investment by charities, which concerns the Church Commissioners, an exempt charity, is also not as helpful as one might expect when considering the freedom of charities to socially invest.
- 4.7 In *Harries v Church Commissioners* [1993] 2 All ER 300 (the “Bishop of Oxford case”), the Church Commissioners operated effectively as a pension fund for Church of England clergy and so, though it concerns a charity, the case is nevertheless unusual and the circumstances of the Church Commissioners can be distinguished from the circumstances of most charitable trusts.
- 4.8 It seems to us that the obligations of the Church Commissioners, which are subject to a strong imperative to maximise return to provide for retiring clergy, are more akin to the obligations of pension trustees than charity trustees in the ordinary course. The court was also looking at the very specific purposes for which the Church Commissioners had been created and considered the approach best suited to achieving the purposes. It is possible that subsequent decisions might therefore regard the case as being, in certain senses at least, limited to its facts.
- 4.9 The case also concerned a challenge to the investment approach adopted by the Church Commissioners, as opposed to a request on the part of the part of the Church Commissioners for the court to uphold a socially responsible investment approach. It is likely that the court felt bound to some degree to defend the Commissioners and to resist the argument that the Commissioners *ought* to invest more ethically.

- 4.10 The Bishop of Oxford case also predates the modern socially responsible investment industry, with the wealth of investment options it provides, the rise of the modern social enterprise movement and the emergence of the social investment market within the UK and impact investment internationally.

*The Distinctive Nature of Charities*

- 4.11 In contrast to private trusts and pension funds, charities exist for public benefit and not to benefit a defined beneficiary class. Charities do not generally have long-term future liabilities which need to be met out of investment assets. With the exception of charities with permanent endowment, charities are also not generally obliged to invest assets and are even able to grant money and to give it away for no consideration provided this is done in advancement of charitable objects.
- 4.12 It follows that the public benefit nature of charities, the primacy of charitable objects and the general absence of any express or implied duty to seek to preserve capital, provides charities with a great deal more flexibility to be creative, innovative and strategic in making investment decisions in pursuit of responsible or social investment than is the case with private trusts or pension funds.

*Charities and Investment Matters: CC14*

- 4.13 In October 2011, the Charity Commission issued revised guidance in relation to the investment powers and duties of charities and charity trustees, known as CC14. The guidance acknowledged the place of 'mixed motive investment' for the first time and was generally welcomed for its constructive approach to social investment.
- 4.14 The guidance only represents the Charity Commission's view of the law. It does not represent the law. As we have seen with the public benefit guidance, guidance issued by the Charity Commission is subject to challenge and may be overturned.
- 4.15 In addition, the legal "underpinnings" document issued with the revised guidance places emphasis on case law regarding private trusts and pension funds and does not clearly or adequately elaborate upon the distinctive nature of charities. As the underlying case law raises a variety of questions of interpretation, it is possible for different legal advisers to take different positions with respect to the investment powers and duties of charity trustees. There are likely to be some advisers who are very cautious and are unwilling to distinguish charities from pension funds or private trusts and who do not feel confident enough to advise that 'mixed motive investment' is compatible with case law. A statutory clarification could therefore reinforce CC14.

*A Statutory Clarification of Investment Duties*

- 4.16 In our view, a statutory clarification of the investment duties of charity trustees, if done well, would yield significant benefit and could change the default mode of charity trustees with respect to investment from an investment modality which involves doing as others do to an intentional and distinctive approach to investment which has as its first point of reference the charitable objects of the charity.
- 4.17 A statutory clarification or restatement of charity trustee investment duties should clarify that:
- 4.17.1 the investment powers of a charity are subordinate to the charitable objects of the charity;
- 4.17.2 due to the primary importance of the charitable objects and the public benefit nature of charities, the investment duties of charity trustees are different to the investment duties of the trustees of private trusts and pension funds, which exist for private benefit;

- 4.17.3 when exercising an investment power, charity trustees should consider what exercise of the investment power is likely, in the opinion of the trustees, to best advance the objects of the charity, whether directly or indirectly through the generation of returns to apply to the charitable objects; and
- 4.17.4 only charity trustees have the authority and discretion to determine which exercise of an investment power is most likely in the circumstances to best advance the objects.
- 4.18 The precise formulation of any clarification of investment duties of this kind should of course be subject to consultation.
- 4.19 In our view, exercising an investment power should be understood to include not only the making of a specific investment decision but also the setting of an investment policy or strategy or the delegation of investment functions to an investment committee or an investment manager.
- 4.20 A statutory clarification of this kind would need to amend the Trustee Act 2000 to make it clear that the duties under the Trustee Act 2000, including the duties to exercise reasonable care and skill, to diversify investments and to ensure that investments are suitable should in each case be interpreted and understood in the case of a charity by reference to the charitable objects of the charity in question.
- 4.21 The proposed changes would still empower trustees to invest to achieve maximum risk adjusted return, if that is what the trustees consider best for the charitable objects.
- 4.22 A statutory clarification should also clarify that the same investment duties apply to all legal forms of charity and not only charitable trusts. At present, case law and the Trustee Act 2000 apply to charitable trusts only and are generally taken to apply by analogy to charitable companies.

*Dispelling Charity Investment Myths*

- 4.23 As the distinctive nature of charities is rarely properly interpreted or well understood in investment contexts, there are a number of myths about the nature of the investment duties of charity trustees which adversely influence charity trustee investment behaviours and impede the development of social investment approaches.
- 4.24 This state of affairs is compounded by the fact that charity investment assets are dwarfed by other institutional investment assets and so the investment advisory services available for charities are in the main shaped by the needs and demands of other institutional investors, a situation which in turn serves to perpetuate the view that charities should invest in the same way as other institutional investors.
- 4.25 A statutory clarification of charity investment duties would confirm that charities are unique amongst investors and that charity trustees have the freedom and authority to pursue responsible and social investment, as one among a range of means of advancing charitable objects.

**5. A Statutory Power of Social Investment**

- 5.1 There are some responsible or social investment opportunities where the expected returns are high and where the investment risks are relatively clear and relatively low. Where this is the case, charity trustees may feel very confident about making responsible or social investments on a traditional risk adjusted return analysis.

- 5.2 However, at the present stage of market development, most social investments will involve investment into unlisted social enterprises or other unlisted funds or products. As a result, most social investment opportunities currently available to charity investors are likely to have the following features:
- 5.2.1 illiquidity - most social investments offer no clear exit from the investment;
  - 5.2.2 lack of price discovery - there are no established primary or secondary markets;
  - 5.2.3 information asymmetry - there is limited market research and analysis;
  - 5.2.4 track record - as it is a young market, there are few established products; and
  - 5.2.5 risk - it is usually difficult to determine investment risk with certainty.
- 5.3 Taken alone, these factors would tend to suggest that a charity investing for purely financial reasons should avoid social investments. However, this would be to ignore the social impact and associated benefits social investments are able to generate. Indeed, more than any other category of investor, it should be clear that charities are able to invest for social impact with confidence and assurance.
- 5.4 To put the issue beyond any doubt, charities could be given a clear power to engage in social investment where the financial returns may be low or the investment risks are uncertain or high.

*A Statutory Power of Social Investment*

- 5.5 We propose that there should be a statutory power to facilitate social investment.
- 5.6 A statutory power is needed to confirm that charities are able to make social investments where:
- 5.6.1 the expected financial returns are lower than available elsewhere on the market; and/or
  - 5.6.2 the investment risks are higher or less certain than available elsewhere on the market, provided that, in the view of the trustees of the charity, the expected social impact justifies the expected financial returns and the investment risks.
- 5.7 The social impact of an investment should be understood in this context to mean the degree to which the investment is expected to:
- 5.7.1 advance the objects of a charity; or
  - 5.7.2 support or contribute towards the advancement of the objects of a charity.
- 5.8 Where an investment wholly advances the objects of the charity, it will be what the Charity Commission currently refers to as a programme related investment. Where an investment does not wholly advance the objects of the charity but does 'support or contribute' towards the advancement of the objects of a charity, it is likely to fall into the category of investments currently referred to by the Charity Commission as 'mixed motive investments'.
- 5.9 The power should be expressly extended to charities which hold non-functional permanent endowment assets, with the proviso that charity trustees must continue to balance the needs of present beneficiaries against the needs of future beneficiaries in respect of permanent endowment. There may also be benefit in clarifying that, in the same way that charities with permanent endowment are able to allocate capital growth towards income as part of a total return approach, where charity trustees are subject to a duty to maintain capital, trustees are able to allocate capital growth towards social investment as part of a social investment strategy.

- 5.10 An investment power of this kind would end once and for all the idea that charities are unable to invest for social impact and must invest on a purely financial basis alone.

## **6. Clarify Private Benefit**

- 6.1 There are often concerns about “private benefit” in social investment transactions - private benefit involves benefit to any person other than as a beneficiary of a charity. In reality, private benefit will exist in almost all charity transactions, as, for example, a charity's employees and its suppliers will receive payment for goods and services supplied to the charity and so will receive private benefit.
- 6.2 The revised CC14 guidance states that private benefit must be “necessary, reasonable and in the interests of the charity” in the case of programme related investment and that it must be “appropriate” in the case of mixed motive investment. This phraseology is not however reflected in the legal underpinnings document, which requires that any private benefit is “legitimately incidental” to the furtherance of charitable purposes, a narrower test which reflects that used in grant-making contexts.
- 6.3 We do not believe that it is appropriate in an investment context to require private benefit to be “necessary, reasonable and in the interests of the charity” or “legitimately incidental” in the ordinary senses in which these phrases are used, for example, in grant-making contexts. In a social investment context, a charity investor is expecting to receive a return on its investment and so it would be more appropriate for private benefit to be “reasonable and proportionate” in all the circumstances.
- 6.4 The paradox is that “private benefit” does not get raised in mainstream financial investment contexts, even though there is widespread concern in society at large about the rewards available to executives in listed companies, banks, investment management firms and the financial services industry generally. The effect of this unjustified dichotomy is that charities are disincentivised from investing in unlisted social enterprises, where executive rewards are lower and social impact is higher.
- 6.5 We therefore propose that any statutory reform of the investment duties and powers of charity trustees should clarify that any private benefit arising from a charitable investment must be “reasonable and proportionate” in all the circumstances. A reform of this kind would ensure that the law does not inadvertently discourage charities from investing in unlisted social enterprises which create positive social impact.

## **7. Social Investment into Charities**

- 7.1 It is also possible for charities to raise social investment from the public by way of loans. It would be possible in legislation to explain in what circumstances a charity may be used for charitable social investment projects, such as a community renewable energy project financed by loans from the local community.
- 7.2 Any statutory clarification would need to cover:
- 7.2.1 the basis on which levels of return to investors may be determined;
  - 7.2.2 whether quasi-equity arrangements, such as contingent capital repayment and/or performance related interest arrangements, are permissible;
  - 7.2.3 how the Charity Commission would expect conflicts of interest to be managed.

## **8. Charitable Companies Limited by Shares**

- 8.1 A small but increasing number of charities are structured as charitable companies limited by shares. There is currently a lack of consensus as to the extent to which such charities can pay dividends and otherwise distribute assets to members, such as to operate in certain FSA-regulated areas which require both share capital and for that capital to have certain distributive characteristics.
- 8.2 Our view is that the case law relating to this issue is clear that charitable share companies should be able to make distributions to members, including distributions to members upon dissolution proportionate to capital investment, provided that those distributions must be used for charitable purposes. However, the Charity Commission currently takes a different view.
- 8.3 We therefore propose statutory clarification of the law relating to distributions by charitable share companies. This would make clear that such charities are able:
- 8.3.1 To pay dividends to members in the same way as other companies; and
- 8.3.2 To distribute surplus assets on a winding up *pari passu* to members' shareholdings, provided that such amounts must be used exclusively for charitable purposes.

## **9. Structured Investment Funds**

- 9.1 The law should also clarify and confirm the ability of charities to take positions in structured funds with other categories of investor, particularly where charities wish to take junior positions and choose to rank behind other investors in priority but in return have the right to a greater return in the event that the fund performs above expectations. We anticipate seeing more structured funds of this kind with both national and international applications, as charities are likely to have a greater tolerance for risk than certain other categories of investors, where the fund is delivering a social impact related to charitable objects, and may be able to reduce the risk profile of certain investments to encourage other private investors to take part in an investment opportunity. We expect that structured funds of this kind will be necessary to encourage more investors to invest, for example, in social impact bonds.

## **10. Social Impact Methodology**

- 10.1 Any reform of charity law should clarify that it is a charitable purpose to advance social impact methodology and to promote social impact measurement for the public benefit. This is a key area of innovation which is in the public interest and there is presently no catch-all charitable purpose under which it is able to fall.
- 10.2 The absence of a catch-all charitable purpose is likely to mean that organisations involved in this field will need to fit their work into other charitable purposes, such as advancement of education and research and promotion of the voluntary sector, which in turn may inhibit the development of social impact methodology in areas which do not fit squarely within existing charitable purposes, such as, for example, assurance or social audit activities, which are important to the development of social reporting.

## **11. Tax**

- 11.1 With respect to each reform we propose to charity law, reforms should be undertaken in parallel in relation to the underlying tax framework to ensure that it is as supportive as possible of responsible and social investment by charitable trusts and companies.

**12. Conclusion**

- 12.1 The law in relation to charities and social investment requires clarification. The reforms we propose to charity law would remove key barriers to social investment, would avoid the use of prescriptive limits or thresholds and would give freedom, confidence and authority to charity trustees to engage in social investment.

**Bates Wells & Braithwaite London LLP**  
**April 2012**



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