

Mission-Related Investing: Legal and Policy Issues to Consider Before Investing

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Mission-Related Investing: Legal and Policy Issues to Consider Before Investing

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Introduction

The notion that investments should be made not just to earn the best financial return but also to achieve some positive social impact, while not new, is growing in popularity in philanthropy, investment firms and with individuals. Yet for many people there remains confusion about what this practice means, how it should be defined, the legal parameters surrounding it, and how a charitable organization might implement a practice or policy incorporating the approach.² It does not help that there have been a myriad of terms and definitions used and evolving over time.³ Even among the cognoscenti, there is not necessarily consensus about the appropriate language to capture the diversity of practices associated with the concepts. For less experienced people interested in the concept generally and for the stewards of charitable institutions particularly, the jargon and concepts may appear daunting. In addition, there has been a proliferation of new (but untested) legal entities that proponents claim can be effective vehicles to achieve beneficial social impact (such as B-Corps, benefit corporations, L3C companies, flexible benefit corporations, and special purpose corporations).⁴

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² There also remain skeptics who question whether by seeming to mix objectives (social and financial) neither one will be accomplished satisfactorily.

³ The evolution of terms and concepts include socially responsible investing (including the screening of investments and shareholder advocacy), community investing, mission related investing, and impact investing. Investment firms and others are also increasingly using environmental, social, and governance factors to assess investments in particular companies. Program-related investments, as authorized by the Internal Revenue Code as described later in this article, were not initially often thought of as a category of socially responsible investing, but now are generally included under impact investments.

⁴ A description of these entities and additional resources for state-specific legislation is attached as Appendix 1.

The purpose of this paper is to focus on the legal and governance framework surrounding one aspect of the broader universe,⁵ what we are calling for purposes of this paper, mission-related investments (defined below). We describe legal rules applicable to this practice and then suggest an array of issues that a charitable organization⁶ might consider if it chooses to adopt a policy to make mission-related investments. We begin, however, with some context.

A LITTLE CONTEXT

Traditional investment management practices at most private foundations focused solely on generating maximum risk-adjusted returns so that the gains and income can fund the program strategies of the foundation. This practice largely grew out of two core assumptions; first, an assumption by foundation managers that there was a fiduciary obligation to seek the maximum risk-adjusted returns on investments made with charitable dollars; and second, the widely held view by many investment professionals that successful investing was difficult enough without adding to the challenge by using screens, requiring positive social impact or imposing an array of other requirements rooted in the mission of the organization. Many foundations continue this practice today. Over the last five years, however, there have been an increasing number of foundations and other charitable organizations that have allocated portions of their corpus to pursue forms of investing in which one or more aspects involve a social benefit objective.⁷

THE BROADER UNIVERSE OF MISSION INVESTING

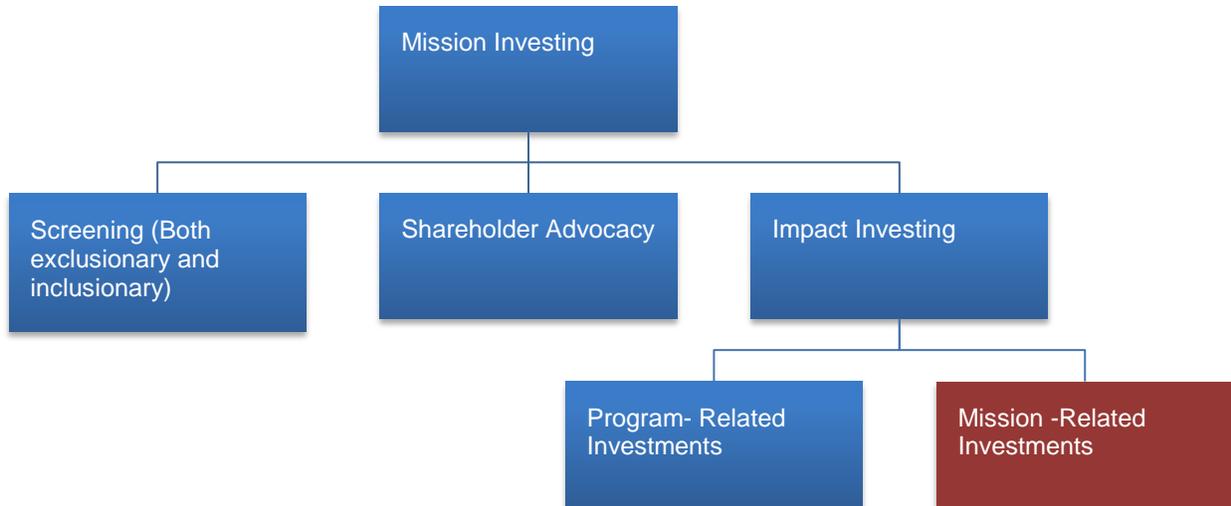
As noted, there are a variety of terms and definitions that seek to capture the various practices falling under the broad rubric of investing for positive social impact. For purposes of this paper, we will use the term “Mission Investing” broadly to include the components reflected in the chart below.⁸

⁵ In the Appendix, we attempt to identify additional sources that will assist readers in becoming more knowledgeable about various aspects of the phenomena. This list is not meant to be exhaustive but a starting point for those interested. See Appendix 3 below.

⁶ We are going to focus primarily on private foundations in this article. Some of the legal rules, such as the jeopardizing investment rules are specific to private foundations. Many of the concepts apply equally, however, to other charitable organizations.

⁷ There is of course a long history of what was initially called, and still is in many quarters, socially responsible investing. For a brief history of socially responsible investing and its evolution, see the articles listed in the “History” section in Appendix 3.

⁸ Other commentators may have used in the past different formulations or charts to capture the universe. See e.g. Mark Kramer and Anne Stetson. *A brief guide to the law of mission investing for U.S. Foundations*. FSG Social



Our focus will be on mission-related investing, but to provide context we briefly describe the other concepts:

- ❖ **Screening:** Typically, this practice consists of an organization screening their investment portfolio either (1) to exclude stocks of or investments in companies that participate in what the investor views as objectionable behavior or antithetical to its mission (such as investments in tobacco, alcohol, armaments, fossil fuels, fire arms, etc.) or (2) to include companies that engage in desirable behaviors (such as alternative energy companies, job creating entities, etc.) Closely related are efforts to divest from a portfolio ownership in companies that become objectionable for one reason or another such as inappropriate conduct or the manufacture of objectionable goods (guns) or because the company is doing business with oppressive regimes.⁹
- ❖ **Shareholder Advocacy:** This practice refers to the efforts of charitable organizations to influence corporate conduct by proposing corporate resolutions to be taken up by shareholders or voting their shares of stock on corporate resolutions that further their charitable priorities, so called proxy voting.¹⁰ Shareholder advocacy can also include using

Impact Advisors (2008). We believe the chart used above is an effective representation of various practices although different names could be used for various boxes (Kramer title “impact investing” as “proactive investments”).

⁹ Mark Kramer and Anne Stetson, *A Brief Guide to the Law of Mission Investing for U.S. Foundations*. FSG Social Impact Advisors (2008).

¹⁰ *Id.*

an ownership position in private entities to push for policy changes of the organizational manager in selecting or divesting from portfolio companies.¹¹

❖ **Impact Investing:** For simplicity and purposes of this Article, we define impact investments as financial instruments designed to support charitable purposes, provide public benefits, and advance social change.¹² There are two types of impact investments which categorized are as follows:

- **Program-Related Investment's (PRIs):** PRIs are explicitly defined in Section 4944 of the Internal Revenue Code (the "Code") as an exception on the jeopardizing investment rules (explained on page 8 infra). To qualify as a PRI, the Code sets out a three part test: (1) the primary purpose of the investment must be to further one or more exempt purposes of the foundation, (2) no significant purpose of the investment will be to generate financial return, and (3) no electioneering or lobbying activity will be supported by it.¹³ PRIs are similar to grants in that they are required to further a charitable purpose and count towards a foundation's five percent 5% payout requirement. However, PRIs seek to generate a return on the funds expended, plus some modest return, differentiating them from a grant. The specific criteria allow PRI's to be easily identified and provide foundations employing this strategy a concrete framework to operate within.
- **Mission-Related Investments (MRIs):**¹⁴ In contrast to PRIs, there is no legal definition of an MRI. For purposes of this paper, we use the term MRI broadly to mean an investment that seeks to generate a reasonable rate of return on capital, while also furthering a social purpose.¹⁵ An MRI is often said to seek a double or triple bottom line in that it earns a financial return (line one) and a positive social

¹¹ *Id.*

¹² As with other phrases, different people or organizations will have different definitions for impact investments. The Global Impact Investors Network (GIIN) uses the following definition: Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate depending on the circumstances. See <http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html>

¹³ I.R.C. §4944(c)

¹⁴ Although MRIs have been used by some foundations for over a decade, the Foundation Center's 2011 report, *Key Facts on Mission Investing*, is thought to be the first to collect aggregate information on the extent to which foundations are using MRIs. MRIs are not limited to private foundations. Public charities can also engage in these strategies. http://foundationcenter.org/gainknowledge/research/pdf/keyfacts_missioninvesting2011.pdf

¹⁵ Trillium Asset Management Corporation - *Mission-Related Investing for Foundations and Non-Profit Organizations: Practical Tools for mission/investment Integration* (2007).

impact arising from the investment (line two and three depending on the investment).¹⁶ MRIs are typically drawn from corpus assets, thereby diminishing the pool available for “ordinary” investments. MRIs can take many forms such as deposits in community development banks, loans or equity investments directly in companies or in intermediaries (like funds or partnerships) that seek to advance one or more social aims, including affordable housing, micro-enterprise development, alternative energy, small business development or job creation, and community development in distressed or low income areas.

MORE ON MISSION-RELATED INVESTING

Organizations may pursue mission-related investing for a variety of reasons and under different philosophical rubrics. Some view impact investing through a programmatic lens, believing that it is most usefully thought of as another tool in the philanthropic toolbox. By selecting this tool, an organization may gain more flexibility in achieving its desired program impact because it can use MRIs where the legal requirements governing program-related investments would prevent the investment from being made or where a grant would be less impactful. Other organizations may view the strategy primarily through an investment lens, believing that such investments can achieve market rate returns while also achieving social impact. Regardless of the philosophical underpinnings for the strategy, an organization should be cognizant of the legal framework (discussed below). We also offer suggested terms for a policy specific to mission-related investments. Not all provisions will be relevant for each organization, but it is prudent for a governing board to consider these provisions while deciding upon the policy and the terms most appropriate for its organization and its philosophical approach.

Legal Framework

The investment decisions of directors of private foundations are generally regulated by the following legal and policy parameters:

¹⁶ An investment that furthers sustainable energy (e.g. wind farms), and also provides for employment opportunities for a disadvantaged class, would be an example of a double or triple bottom line investment if it is financially successful and meets the two social objectives: cheap renewable energy and jobs for the disadvantaged.

- 1) Federal law, most specifically Section 4944 of the Internal Revenue Code containing the jeopardizing investment rules;
- 2) State laws, including the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”), the Uniform Prudent Investor Act¹⁷, and the common law and state not-for-profit corporate law regarding the fiduciary duties of directors in managing charitable assets; and
- 3) Internal governance documents, including articles of association, bylaws or other internal policies including investment and/or ethics policies.

This framework creates the boundaries in which a foundation should construct its MRI program. The following sections briefly describe the legal issues arising from these parameters and then suggest the components of an investment policy for MRIs (“MRI Policy”).

There is scant case law or other authoritative guidance addressing the fiduciary duties of directors or trustees in connection with MRIs. However, most commentators addressing the question have concluded, with caveats, that fiduciaries of charitable assets may, consistent with their fiduciary obligations and applicable law, approve MRIs assuming certain steps and analysis are followed and the investment relates to the charity’s mission.¹⁸ Among other steps, we suggest a governing board undertake and engage in a thoughtful process in evaluating the proposed MRI strategy, carefully assessing the benefits and disadvantages of an MRI strategy for its institution, reviewing the terms to be included in the policy, and understanding the legal rules. Once a well-crafted policy is adopted, a governing board should also ensure there are appropriate mechanisms to monitor the implementation and operations of the policy and MRIs made in accordance therewith.

We first examine the legal platform on which an MRI Policy should be based.

¹⁷ The Uniform Prudent Investor Act applies to charities organized as trusts and UPMIFA applies primarily to charities organized as nonprofit corporations. We will focus primarily on UPMIFA. The rules in the two uniform Acts on investment decision making are almost identical because UPMIFA drew much of its language from UPIA. See Susan N. Gary, *Is It Prudent to Be Responsible? The Legal Rules for Charities That Engage in Socially Responsible Investing and Mission Investing*, 6 Nw. J. L. & Soc. Pol’y 106 (2011).

¹⁸ See Gary, 6 NW J.L. and Social Policy (2011). See also Freshfields, Bruckhaus and Derringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, UNEP FI, (2005). http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf. The “Freshfields report” has played an influential role among responsible investing practitioners. The follow-up report, *Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment* can be found at <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>, and makes an affirmative case for incorporating ESG into investment decision making.

Federal Law

Jeopardizing Investments

MRIs are subject to the jeopardizing investment rules of Section 4944 of the Internal Revenue Code applicable to private foundations. Congress adopted Section 4944 in 1969 to address the concern that foundations created and managed by an individual or family were at risk of possible abuse by those individuals or family members who might allocate all of the foundations assets in a risky investment thereby “jeopardizing” the existence of the foundation.¹⁹ Section 4944 imposes an excise tax on private foundation investments that are deemed to “jeopardize the carrying out of any of its exempt purposes.”²⁰ A tax can also be imposed on foundation managers who approve the investment knowing it might be a jeopardizing investment.

Specifically, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.²¹

There is little authority issued by the IRS or courts addressing the application of the jeopardizing investment rules to MRIs. The applicable Regulations and related authority suggest that fiduciaries of a foundation should carefully consider the following interrelated factors to ensure that an MRI does not violate the jeopardizing investment rules.

Timing. The determination whether an investment is “jeopardizing” is made as of the time that the foundation makes the investment and not on the basis of hindsight if the investment is not successful.

Portfolio View. Under Section 4944, no investment is per se improper. Rather, the determination whether a jeopardizing investment exists is made “on an investment by investment

¹⁹ Gary, *Supra* at 127.

²⁰ I.R.C. §4944(a)(1).

²¹ Treas. Reg. §53.4944-1(a)(2)(i). When the private foundation is subject to the IRC 4944(a)(1) tax, its managers may also be subject to the excise tax under IRC 4944(a)(2) if he/she knowingly participated in the making of that jeopardizing investment.

basis, in each case taking into account the foundation's portfolio as a whole.”²² Certain investments will, however, merit higher scrutiny, such as trading securities on margin, trading commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls and straddles, the purchase of warrants and selling short.²³

Diversification. Diversification is recognized as being one factor to be considered in determining whether a jeopardizing investment is present.²⁴ The most frequently cited reason in IRS private letter rulings for a fiduciary failing to meet the investment standard under Section 4944 is a lack of diversification in the investments portfolio. The amount invested in a particular investment is, however, only one factor to consider in determining whether an investment is jeopardizing and the IRS has confirmed that the percentage of assets invested in one investment should not be the sole consideration.²⁵

No bright line exists for what level of diversification is considered prudent. The IRS has determined that private foundation managers failed to meet the requisite standard of care when the percentage of the private foundation’s assets invested in one company exceeded seventy-five (75) percent.²⁶ Other IRS rulings shed some light on the level of diversification the IRS will find acceptable. For example, the IRS found no jeopardizing investment when only thirty (30) percent of the foundation’s total assets would be in “alternative investments” and no more than two percent of the portfolio would be in any one fund.²⁷ It should be noted that part of the IRS’s determination that the investments were not jeopardizing included the fact that the foundation in this case relied on the advice of two outside investment consultants, all of the funds were limited liability vehicles, and the foundation would incur no debt to make the proposed investments.

Case by Case Analysis and Legal Opinions. Determining whether an MRI will be deemed to be jeopardizing requires a case by case analysis based on all the facts. The fact that any particular investment may be small relative to the entire portfolio will be a factor to consider and may, in a particular case, give comfort to fiduciaries that a single small investment will not

²² David A. Levitt, *Investing in the Future: Mission-Related and Program-Related Investments for Private Foundations When It Comes to Private Philanthropy, the Return on an Investment May Not Be Only Financial*, Prac. Tax Law. (2011).

²³ Treas. Reg. §53.4944-1(a)(2)

²⁴ Treas. Reg. §53.4944(1)(a)(2)

²⁵ PLR 200218038.

²⁶ PLR 8631004. See also General Counsel Memo 39537 (Confirming that the investment should be deemed to be a jeopardizing).

²⁷ PLR 9723045. It is also important to note the IRS examined each investment, even those investments representing a mere 2% of the portfolio, to determine if the investment was jeopardizing.

be considered jeopardizing. But given the uncertainty and lack of authority, it would be prudent in the authors' views to analyze each investment based on the facts and consider obtaining an opinion of counsel with respect to each mission-related investment. If obtaining an opinion on each investment is impractical or expensive, it might be possible to obtain an opinion that given the structure of an MRI portfolio and limitations on the amount and kind of individual investments, it is unlikely that any single investment could be considered jeopardizing. Of course, this would all depend on the specific facts and circumstances of a particular portfolio.

State law regarding Fiduciary Duty

UPMIFA

UPMIFA articulates a general standard of care for both managing and investing an endowment and has been adopted, in some form, by 49 states. The Act applies to charities organized as nonprofit corporations, unincorporated associations, and other forms, but does not apply to a charitable trust mandated by a corporate or individual trustee. UPMIFA does not address MRIs directly but an analysis of the statute suggests that the law does not prohibit such investments.²⁸ Many commentators agree.²⁹

UPMIFA revised the prudence standard that applies to the management and investment of charitable funds by effectively merging the laws applicable to private trusts and business corporations. The Act provides that, in addition to complying with the duty of loyalty imposed by general corporate law, each person responsible for managing and investing assets of a charitable institution shall manage and invest such assets in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.³⁰

UPMIFA establishes a list of factors those responsible for oversight should consider, if relevant, when making investment decisions. These factors include:

1. General economic conditions;
2. Effects of inflation and deflation;
3. Tax consequences;

²⁸ Levitt, *Supra*.

²⁹ For a comprehensive analysis of the legal issues associated with MRIs and UPMIFA, among other subjects, see the "Legal Framework Sources" table in Appendix 3.

³⁰ UPMIFA §3(B)

4. The role of each investment in the overall portfolio;
5. Expected total return from income and appreciation;
6. The charity's other resources; and
7. An asset's special relationship or value to the institutions charitable purpose.

The last factor provides support for the proposition that an MRI can be made consistent with UPMIFA as long as the investment is made with the remaining factors in mind. This conclusion is buttressed by the statement from the Uniform Law Commission, which drafted UPMIFA, that the Act “does not preclude a charity from acquiring and holding assets that have both investment purposes and purposes related to the organization’s charitable purposes.”³¹

To ensure adherence to the prudent investor standard, a fiduciary must also consider the cost associated with making MRIs. Mission-related investing combines both investment and programmatic considerations and research. These considerations may result in additional costs.³² Fiduciaries should understand the transactional costs such as investment fees and expenses as well as the time expended in choosing and monitoring the investments.

Additionally, UPMIFA emphasizes diversification of the portfolio and applies the “modern portfolio theory.”³³ This theory provides that decisions about an individual asset are to be made in the context of the portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the organization.

Internal Policies, Governance Structure and Existing Investment Policies

A foundation must also consider whether undertaking a MRI strategy complies with its own bylaws, donor intent, articles of association or other internal policies, including its existing investment policy, which may set additional restrictions for an investment beyond the fiduciary considerations discussed above. For instance, an investment policy may require that an investment fit within a currently existing asset class and permitted allocations that the organization already has established.³⁴ Conversely, if the proposed investment is particularly underrepresented in the portfolio, or might hedge against a decline in other parts of the portfolio,

³¹ See UPMIFA Program-Related Assets Article by the Uniform Law Commission at www.upmifa.org.

³² See Gary, *Supra* at 123.

³³ Levitt, *Supra* at 33.

³⁴ *Id.*

an MRI could contribute to diversification even if not part of an existing asset allocation plan.³⁵ In any event, existing policies can be modified to incorporate MRI or to ensure a companion MRI policy is not inconsistent as explained below.

An MRI Policy – *Governance and Other Considerations*

If an organization is going to pursue mission-related investments, it should, as a matter of good governance and best practices, adopt a written MRI policy. This will help ensure that the Board and management are on the same page in terms of approach and assist the organization in ensuring it is making prudent investments.³⁶ In adopting a policy, an organization should carefully assess the trade-offs associated with its choices. Acting prudently also includes careful consideration of all costs involved with employing a strategy. It is critical for the Chief Executive Officer and the Board to understand fully the implications of an MRI strategy and to be comfortable with the costs associated with achieving the desired results.

Whether to incorporate the strategy within the existing investment portfolio and investment policy statement or to segregate the funds and craft an independent policy statement is a critical first determination³⁷. Those who view MRIs through a programmatic lens will likely want a separate policy, as may organizations who are seeking to slice a small amount of the corpus from an investment portfolio to manage independently. There is no single correct answer and institutions have done it both ways depending upon their culture, history, and philosophy regarding MRIs. The most important thing is to identify goals and objectives and have a rigorous process for evaluating potential investments. While there are many different approaches to crafting an effective policy, we group the various issues into two main topic areas: (1) Governance and Structural issues and (2) Investment Considerations. While not every topic

³⁵ *Id.* JP Morgan Chase recently issued a paper arguing that MRIs constitute a separate asset class. This suggests such an asset class could be included in the existing investment policy statement as amended. See Impact Investments: An Emerging Asset Class, J.P. Morgan, The Rockefeller Foundation and the GIIN, (2010).

³⁶ Joseph, James and Kosaras, Andras. *New Strategies for Leveraging Foundation Assets*. 20 Tax'n of Exempts 22, 37, WL 3907413 (2008). http://www.arnoldporter.com/resources/documents/TaxationOfExempts_Article_Jul-Aug08_2.pdf (Stating that it is a best practice to employ a written policy when launching MRI's.)

³⁷ Some institutions may choose to devote their entire portfolio to MRIs and therefore would have only one policy statement.

needs to be included in detail, there should be an understanding in the organization on how each topic will be addressed in practice.³⁸

MRI POLICY

Governance and Structural Considerations

1. Statement of Purpose
2. Division of Responsibilities
3. Troubled Assets/Enforcement of Failed Investments
4. Legal Standards
5. Other Policies (UBIT, Conflicts of Interest)

Investment Considerations

1. Investment Objectives
2. Role of Risk
3. Portfolio Diversification/ Asset Allocation
4. Permitted Investments and Criteria for Investing
5. Evaluation and Impact Assessment
6. Miscellaneous Issues (Currency and Hedging)

GOVERNANCE AND STRUCTURAL CONSIDERATIONS

1. Statement of Purpose

This is perhaps the most critical aspect of any sound investment policy, including an MRI policy. An organization needs to be clear why it is pursuing MRI, its underlying philosophy, what it hopes to accomplish, the expected return, how it will know it is successful and the time frame upon which the performance will be assessed.

2. Division of Responsibilities

The MRI policy should clearly specify the roles and responsibilities of the Board, Board committees, staff and consultants if any. The appropriate delegation of responsibility and authority depends on the history, culture, needs, expertise and function of the Board, relevant

³⁸ See also Godeke, S., Pomares, R. et al. *Solutions for Impact Investors: From Strategy to Implementation*. Rockefeller Philanthropy Advisors, Chap. 5 (p.55-77) (2009).

committees and staff. It is important to note that the emphasis on which part of the organization is ultimately delegated a certain task is far less important than the delegation itself. The policy should provide clear guidance of the expectations and responsibilities of each group involved in the MRI process. Setting forth the authority of the respective players in the general investment process is viewed by many to be a best practices exercise that is applicable to mission-related investments to produce a more efficient process internally and externally.³⁹ Appendix 2 contains a more detailed description of the division of duties and responsibilities between Board, Committee and staff.

Board or Committee Oversight

If the organization has a committee with particular expertise in investments and more specifically, mission-related investments, the Board can, consistent with most state law and UPMIFA, appropriately delegate substantial authority and oversight to the committee. An investment committee may not, however, be the most appropriate committee to exercise oversight if it lacks program expertise or an understanding of MRIs. An existing investment or board committee could be augmented by outside advisors with program expertise. If an organization lacks a committee or staff with expertise, the board may decide to retain substantial authority. In any event, as a matter of best practice, the Board should retain ultimate authority for approval of the structure and require periodic reporting to the Board regarding any changes to the MRI policy itself as well as regular reporting on performance or other issues affecting the portfolio.⁴⁰

Staff

The role of staff will depend in large part upon the organizational structure and whether the organization has the requisite personnel to handle the tasks. MRIs require a blend of investment, programmatic, and legal expertise. Some organizations may be fortunate to have a group of individuals who possess these characteristics. Many competent investment professionals, however, may not have the skill set to assess the proposed social impact of an MRI. Similarly, program staff with expertise in their field may not have the necessary investment

³⁹ Recommended Best Practices in Managing Foundation Investments. Council on Foundations. (2011). <http://www.cof.org/files/Bamboo/programsandservices/legalinfo/documents/interinvestmanagetipsresources.pdf>.

⁴⁰ For example, MacArthur Foundation established a PRI Staff Committee to oversee the PRIs made by the Foundation. This consists of the Vice President and Chief Investment Officer, the Vice President and General Counsel, the Vice President and Chief Financial Officer, and the Vice Presidents for the US and International Programs. In accordance with a resolution of the Board, the PRI committee has limited authority to approve certain types of PRIs as well as modifications to existing PRIs.

skills to assess the financial impact. Depending on its resources and personnel, an organization can use a team approach, combining the expertise of investment and program staff, or use outside resources to complement existing resources. While a team approach has appeal on its face, combining very different approaches, expertise and philosophies can be challenging (think program staff are from Mars and investment professionals are from Venus to borrow from John Grey's book of a slightly different title).

Alternatively, an organization may choose to outsource important components of this process. There are an increasing number of organizations or individuals devoting themselves to this field, but the right fit is critical. Legal expertise is more easily outsourced but carries a price tag that must be considered.

The persons exercising the requisite due diligence in connection with any investment should be spelled out generally in the MRI policy. This could be staff, consultants or some combination. A robust due diligence process can provide support for the conclusion that the investment constituted a prudent investment and give additional comfort to the oversight committees that it is exercising its fiduciary duty by requiring strong due diligence. Due diligence can include, for example, the requirement of organizational visits, discussions with third parties, review of financial and operational aspects of the potential investment entity, confirmation the entity has legal and accounting expertise, background checks (if required), the credit worthiness of prospective entities and similar due diligence matters.⁴¹

Troubled Assets/Enforcement of Failed Investments

The MRI Policy should address generally how investments will be monitored and by whom, as well as who will manage any collection or enforcement efforts if an MRI does not perform as hoped. Regardless of whether it is explicitly stated in the policy, an organization should have a common understanding of how aggressively it will pursue recovery. Enforcement can also create an additional expense which should be considered when evaluating the options.

⁴¹ Various organizations may use due diligence checklists in connection with regular investments or MRIs. Examples of due diligence checklists are available upon request.

Legal Standards

The Policy should specify the applicable legal standards governing investments and how the legal review of the investment will be handled. As noted, consideration should be given to requiring legal opinions with respect to all or specifically identified mission-related investments depending on the amount of the investment and the terms. For example, the policy could require that all investments (or investments above a certain threshold) have a legal opinion that the investment is not jeopardizing or does not run afoul of UPMIFA unless waived by the Committee, Board or other designated individuals.

INVESTMENT CONSIDERATIONS

1. Investment Objectives

The statement of objectives should tie the investment policy to the mission and goals of the foundation. If the focus of the organization is its programmatic impact and objectives and an MRI is viewed as a programmatic tool this should be explained in the objectives. This section may also address the following fundamental questions:

- What is the balance between the social impact objectives and the financial returns for proposed investments?
- What factor will be given greater weight and why?
- What is the return objective for the portfolio as a whole?
- What is the time frame for measurement?
- What definition of MRIs will the organization be using?
- How closely linked to existing charitable programs must the MRI be and/or how significant the social impact if not linked to the existing programs?

2. Risk

Risk can take many forms and, in the context of MRIs, can be particularly challenging since an MRI has both financial and programmatic risk. Risk can be expressed in a number of different ways, both statistically and qualitatively.

The MRI policy should define risk for purposes of the policy, articulate the risk tolerance of the organization, and define how risk will be measured and mitigated. Some organization may choose limits on the amount of risk per investment and with respect to the entire portfolio. However the organization chooses to define risk, there should be consensus with the Board or oversight committee so the organization can adequately monitor and report on the risk.

Investment Risk. In pure investment terms, there is a risk that the investment does not achieve the desired returns or capital is lost. The investment policy should establish performance measurements against clearly defined benchmarks. Tracking error is a measure of how closely a portfolio follows the index to which it is benchmarked. This risk is often defined in terms of standard deviation (volatility) of returns against the benchmark. Various investment formulas such as the Sharpe Ratio⁴² or Information Ratio⁴³ can be used to assess risk and are indicative of whether the portfolio's returns are due to smart investment decision or a result of excess risk. These investment risks can be mitigated through portfolio diversification between securities, strategies, and asset class which should result in a less correlated portfolio. Depending on its underlying philosophy, an organization may decide that such quantitative risk measurements are unnecessary.

Program Risk. In addition to financial or investment risks, the organization also needs to address the risk of not achieving its mission impact by being too cautious or not taking enough risk.

Relation of Investment Risk/Return and Social Return. The organization should also be clear regarding the relationship between the investment risk and return and the potential social or charitable impact. In other words, if the potential social impact is great, should the organization be willing to take on more financial risk. Conversely, if the potential financial return is significant, would a smaller social impact be warranted? These can be challenging issues but it is best to address them in advance of making investments so an appropriate framework is in place should they arise. There is not a right or wrong answer and the outcome will largely depend how the organization views the philosophical approach to MRIs. An organization that

⁴² The Sharpe Ratio measures the excess return (or risk premium) over a risk free asset per unit of deviation in an investment asset or a trading strategy. It measures how well the return of an asset compensates the investor for the risk taken.

⁴³ The information ratio (IR) measures the alpha component of total returns relative to a benchmark, but also attempts to identify the consistency of the investor in achieving returns. This ratio will identify if a manager has beaten the benchmark by a lot in a few months or a little every month.

views the investment as another tool to achieve philanthropic impact will likely place greater emphasis on the potential for programmatic impact.

Reputational Risk. An organization making MRIs can also face reputational risk in making investments in certain types of industries, in following a flawed process or because the investments fail for a variety of reasons. There is also potential reputational risk in pursuing recovery against a company or fund that has a socially beneficial purpose (if the deal ultimately fails).

Legal Risk. As noted earlier, MRIs also carry legal risk within the risk boundaries earlier described. As noted in the section on Legal Standards, the organization should determine to what extent it will seek legal opinions.⁴⁴

3. Portfolio Diversification/Asset Allocation

The MRI policy should ordinarily address portfolio diversification and asset allocation. An organization can decide that due to its mission or the objectives of the MRI portfolio, the type of diversification usually seen in a pure investment portfolio to reduce risk may not be possible, warranted, or appropriate. An organization focused on using MRIs as a philanthropic tool to advance its program work may not want to diversify away from specific program objectives linked to a limited number of program areas. Under such circumstances and in light of the jeopardizing investment rules, it becomes even more important that a careful review of investments be undertaken in light of the portfolio as a whole. Alternatively, an organization taking another approach where a significant portion of its assets may be designated for MRIs may decide to reduce risk by allocating its investments across a spectrum of asset classes. Several recent reports have compiled a list of assets or asset classes that are popular vehicles for MRIs.⁴⁵ Additionally, a foundation may source investments through other means, including current grantees or investment professionals.

⁴⁴ A well-reasoned legal opinion can protect Foundation managers against the imposition of penalties. A written legal opinion is considered "reasoned" even if it reached an erroneous conclusion, provided that it addressed relevant facts and applicable law. See Reg. 53.4944-1(b)(2)(v).

⁴⁵ In general, capital intensive areas such as housing are easier candidates for mission-related investing than human service organizations. There are an increasing number of funds in various asset classes that purport to meet MRI qualifications. In 2011, the GIIN launched ImpactBase, an online global directory of impact investment funds and products. Subscribers can search across impact themes, asset classes, geographies, and other criteria via the online platform. For more information see <http://www.thegiin.org/cgi-bin/iowa/impactbase/index.html>. A list of assets can also be found on the Mission Investors Exchange website.

4. Permitted Investments and Criteria for Investing

Even within identified asset classes, an organization should specify the types of investments that are permitted under the Policy.⁴⁶ The range of permitted investments may depend on the expertise of staff and availability of resources. There can be a broad range of types of investments to consider, including marketable debt and equity securities traded on public exchanges (nationally and internationally), private debt and equity securities, private equity and venture capital partnerships, investments in commodities, derivatives, swaps, real estate investment trusts, deposits in community banks, and financial accommodations, such as guarantees or letters of credit.

The MRI policy should also address whether direct investments in single companies or entities will be permitted (as opposed to pooled investment vehicles such as funds or partnerships) and if so under what circumstances. Direct investments have appeal in certain circumstances because the investments can link more directly to a foundation's mission. Direct investments are however more difficult to do consistently well and generally require more resources to monitor the investment and enforce a foundation's rights. Alternatively, permitted investments can be limited to intermediaries or pooled funds that then make the more specific investment decisions.⁴⁷

Lastly, the Policy should address the role of newer hybrid entities such as B-Corps, benefit corporations, L3C, flexible corporations and other special purpose vehicles.⁴⁸

5. Evaluation and Impact Assessment

The MRI policy should describe what the organization would consider a successful investment or policy result so the Board and oversight committee can evaluate progress. The

⁴⁶ The MRI Policy may also establish criteria stating when an investment within the category of permitted investments may be made. This can vary depending upon the nature of the proposed investments. Criteria can include the nature and type of co-investors, the credit worthiness of the target investments, the size of the target funds etc.

⁴⁷ In its report on intermediaries, FSG Social Impact Advisors defined a mission investment intermediary as “an entity that accepts investment funds and re-invests them in other organizations in order to achieve social impact and some level of financial return for its investors. Intermediaries typically focus on one issue area (e.g., affordable housing, the environment, economic development) and build specialized portfolios of investee organizations addressing that issue. By placing capital in an investment intermediary, a foundation can impact multiple organizations within the portfolio. See Godeke, S. & Bauer, D. *Philanthropy's New Passing Gear: Mission-Related Investing: A Policy and Implementation Guide for Foundation Trustees*. New York: Rockefeller Philanthropy Advisors, 71 (2008). <http://rockpa.org/document.doc?id=16>

⁴⁸ A description of these entities and additional resources for state-specific legislation is attached as Appendix 1.

MRI portfolio should be assessed periodically to determine whether the initiative should continue or be modified. Success can be determined by performance against benchmarks for financial returns and also evaluated for social or charitable impact, the latter of which may be more difficult to quantify. A number of organizations have now proposed different standards and benchmarks for the social impact of MRIs.⁴⁹ While these standards remain the subject of debate, they do provide an option that was not available ten years ago.⁵⁰

Choosing an appropriate financial benchmark can be challenging, but depending on the asset class there are a myriad of possibilities. In any event, benchmarks should be identified in the policy statement and any changes approved by the Board or oversight committee.

Other Possible Areas to Explore

Unrelated Business Taxable Income (“UBTI”). MRIs can give rise to unrelated business income so the policy may address the organization’s stance on incurring UBTI. Some organizations do not want the headache of reporting UBTI so will not pursue investments that might give rise to it or require structures that effectively “block” UBTI. Other organizations may just consider the after tax returns in assessing whether to proceed.

Proxy Voting. Investments in particular types of entities may give rise to the right of the organization to vote on shareholder resolutions. The policy should describe the process by which the organization will cast its vote (staff, investment committee or Board and what criteria should be used).

Conflicts of Interest and Ethics. The Policy should be clear that the organization’s conflict of interest policy applies to MRIs or craft a suitable policy if the existing policy does not address these issues.

Currency Risk. If the organization is going to make investments overseas the organization should address its policy on currency risk and whether any of the risk would be hedged.

⁴⁹ For example, GIIN created Impact Reporting and Investment Standards, also known as “IRIS”, which is a common framework for defining, tracking, and reporting the social and environmental performance of impact investments. There is also a project of the independent non-profit, B Lab, called the Global Impact Investing Ratings System which will assesses the social and environmental impact (but not the financial performance) of companies and funds using a ratings approach analogous to Morningstar investment rankings or S&P credit risk ratings.

⁵⁰ Jackson & Associates, *Accelerating Impact: Achievements, Challenges, and What’s Next in Building the Impact Investing Industry*. New York, NY: Rockefeller Foundation, 32 (2012) http://www.rockefellerfoundation.org/uploads/images/fda23ba9-ab7e-4c83-9218_24fdd79289cc.pdf

Conclusion

An increasing number of foundations are exploring the utility of MRIs. This article is intended to help provide a framework for the careful consideration of the issues. MRIs may not be for every foundation, but they can function as an additional tool for a foundation to have desired charitable impact while also earning an investment return. A MRI Policy can be useful both as a reference for the board and staff members of a foundation and as a tool to ensure that the legal and implementation issues associated with MRIs are addressed.

Hybrid Entities

Benefit Corporation

- A Benefit Corporation is required to have as its purpose creating general public benefit, which may be in addition or a limitation to general corporate purposes. "Benefit corporation" is a legal status administered by the state. Benefit corporations do NOT need to be certified as a "B Corp" (See below). To date, 12 states have enacted legislation to create Benefit Corporations. For a list of these states as well as those with pending legislation in this area see the following online resource: <http://benefitcorp.net/state-by-state-legislative-status>

B-Corp

- Although often confused with Benefit Corporations, the "B Corporation" label is a certification conferred by the nonprofit, B Lab. B Corporations have been certified as having met a high standard of overall social and environmental performance, and as a result have access to a portfolio of services and support that Benefit Corporations do not. For more information visit the Benefit Corporation Information Center at <http://benefitcorp.net/what-makes-benefit-corp-different/benefit-corp-vs-certified-b-corp>

L3C (Low-Profit Limited Liability Corporation)

- The L3C is a variant form of the popular Limited Liability Company (LLC). The L3C is a hybrid structure in that it is a for-profit entity organized to engage in socially beneficial activities. Because L3Cs build on the LLC foundation, the L3C offers a legal and commercial comfort level concerning liability. To date, Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming have passed legislation to establish the L3C form as an entity. For more information on the specific provisions of each state statute see the following online resource: <http://www.americansforcommunitydevelopment.org/legislation.html>

Flexible Benefit Corporation

- Benefit Corporations and Flexible Benefit Corporations are, by and large, similar legal structures. However there is one primary difference between these two pieces of legislation: The Flexible Benefit Corporation allows a corporation to select a specific mission, in addition to profits, that it will pursue. Just like the Benefit Corporation, a Flexible Benefit Corporation broadens the duties of its board of directors, from solely maximizing shareholder value to also pursuing an additional purpose that is clearly stated in the Flexible Benefit Corporation's organizing documents. To date, California is the only state that offers this entity type. For additional information see the following online resource: <http://venturebeat.com/2011/10/11/benefit-corporations-californi/#ODDguDtkoAsBXClq.99>

Appendix 2

Example of Delegation Framework related to MRIs⁵¹

Board Duties	Committee Duties	Staff <i>(or consultants)</i>
<ul style="list-style-type: none">• Approving philosophical approach and providing overall oversight of the program• Ensuring alignment with mission and values;• Approving the delegation of authority to approve investments and creating more specific oversight committee, if any• Approve MRI Policy and material changes to it;• Reviewing performance of MRI Policy (at least once a year).	<ul style="list-style-type: none">• Obtaining relevant information in order to quantify investment objectives and risk;• Approving individual investments and material modifications thereto;• Facilitating portfolio design (asset allocation) and implementation process;• Recommending changes to the MRI Policy;• Monitoring the asset allocation of the overall portfolio relative to the MRI Policy;• Reviewing and monitoring investment expenses periodically including fee structures (cost of an MRI);• Reviewing in general due diligence process and guidelines• Supporting the board in the effective evaluation process of MRIs;• Approving settlement of claims associated with enforcement.	<ul style="list-style-type: none">• Propose MRIs for consideration and make investments;• Identify potential collaboration efforts with peers and networks to enhance and leverage mission-related investment activities;• Support impact assessment and evaluation in due diligence and reporting process including possible site visits;• Monitor and report on investments.

⁵¹ This example is based in part on KL Felicitas Foundation's Impact Investing Policy. See KL Felicitas Foundation. Impact Investing Policy. Sonen Capital. (2012).

Appendix 3

Sources for Relevant Topics when Employing MRIs

Defining Mission Investing and Mission-Related Investment Sources

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Anne Simpson, *The Greening of Global Investment: How the Environment, Ethics, and Politics are Reshaping Strategies*, 27 (1991). (Summarizing the history of ethical investment in the U.S. dating back to 1928 when religious organizations began to engage in social investing).

Ralph Earle. *Socially Responsible Investing: A Guide for Trustees of Charitable Organizations*. TIFF Foundation and the Assabet Group (2009).

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David Wood & Ben Thornley, *Impact Investing: A Framework for Policy Design and Analysis*, Pacific Community Ventures & Initiative for Responsible Investment (2011).

Godeke, S., Pomares, R. et al. *Solutions for Impact Investors: From Strategy to Implementation*. Rockefeller Philanthropy Advisors (2009).
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<http://www.rockefellerfoundation.org/uploads/images/fda23ba9-ab7e-4c83-921824fdd79289cc.pdf>

KL Felicitas Foundation, *Impact Investing Policy*. Sonen Capital (2012).

Mission Investors Exchange Website. See <https://www.missioninvestors.org/>

Measuring Impact Sources

The Global Institutional Investors Network (GIIN) at <http://www.thegiin.org/cgi-bin/iowa/home/index.html>. Specifically, see Impact Investing and Reporting Standards (IRIS) Project of GIIN at iris.thegiin.org.

Correlation Consulting, *Insights and Innovations: A Global Study of Impact Investing and Institutional Investors* (2012). <http://impactinvestingconference.com/wp-content/uploads/2012/04/Insights-and-innovations-full-report.pdf>

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