Community Foundation
Impact Investing

April 6, 2017
John Cochrane
Terms of Law and Art

What we mean when we say impact investing
Why Vocabulary Matters

• The field is moving towards more opportunities for co-investment or parallel investment. It is important to understand the differing, and perhaps competing, expectations of different investors.

• The MRI/PRI distinction has less legal relevance for public foundations, but is a useful framework for understanding the primary purpose of an investment (return first or impact first).
Socially responsible investing (SRI) A portfolio construction process that attempts to avoid investment in certain stocks or industries through negative screening according to defined ethical guidelines.

Environmental, social and governance (ESG) An investment practice that involves integrating the three ESG factors into fundamental investment analysis to the extent that they are material to investment performance.

Impact investing (MRI) Investment in projects, companies, funds or organizations with the express goal of generating and measuring mission-related economic, social or environmental change alongside financial return. Also commonly referred to as Mission-Related Investing (MRI).

Divestment of fossil fuel A type of exclusionary screening strategy through which investors actively exclude companies involved with fossil fuels from their investment portfolio.
Program Related Investment

Initially conceived as an exception to Section 4944(a) of the Internal Revenue Code, which imposes an excise tax on investments that jeopardize the charitable purpose of a private foundation. Legally it must meet three standards:

1. That the primary purpose of the investment is to accomplish one or more of the foundation’s charitable purposes;
2. That no significant purpose of the investment is the production of income or the appreciation of property; and,
3. That the funds not be used for politicking, lobbying, or other prohibited political activity.

A public foundation can also apply the term to describe an investment made to advance charitable purposes, in spite of its potential to lose money.
Ten examples were used to illustrate what a PRI can and cannot be used to do. The examples describe the facts and circumstances that can characterize permissible PRIs. These original examples focused on economic development funded through concessionary debt finance.

- X is a small business enterprise located in a **deteriorated urban area** and owned by members of an **economically disadvantaged minority** group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. (Example 1)

- X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an **interest rate below the market rate** in order to induce X to establish a new plant in a **deteriorated urban area** which, because of the high risks involved, X would be unwilling to establish absent such inducement. (Example 5)
The original examples were not meant to be limiting, and through PLRs the scope was broadened. Beginning in 2011, the IRS began work on new examples to codify this through generally applicable examples.

- An activity conducted in a foreign country furthers an exempt purpose if the same activity would further an exempt purpose in the United States. (Examples 12, 13, 15, and 16)

- The exempt purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas. (Examples 11, 17, 18, and 19)

- The recipients of PRIs need not be within a charitable class if they are the instruments for furthering an exempt purpose. (Examples 11—16)

- A potentially high rate of return does not automatically prevent an investment from qualifying as a PRI. (Examples 12 and 13)

- PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations. (Examples 11—19)

- A credit enhancement arrangement may qualify as a PRI. (Examples 18 and 19)

- A private foundation’s acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI. (Example 13)
Mission Related Investment

• Not formally defined in any Treasury Department or IRS regulation
• Understood to described investments made out of the endowed funds of a foundation with an expectation that they will produce charitable and economic returns
• Notice 2015-62 clarifies treatment with respect to Jeopardizing Investment Rule
  • “When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation’s charitable purposes.”
• Meant to align Federal regulations with UPMIFA standard of care and prudence
Department of Labor ERISA Guidance

• Not directly applicable to grantmaking or investing of a foundation, but signals possible entry of significant new flows of capital to mission-related investments.

• More narrowly construed than foundation guidance

• Allows ERISA fiduciaries to include “economically targeted” investments in the portfolio
Current Research
Sizing the field and understanding impediments
Council on Foundations–Commonfund Research

- 2016 Study of Responsible Investing
  - 123 Private Foundations
  - 77 Community Foundations
- 2015 Study of Investment of Endowments for Private and Community Foundations
  - 130 Private Foundations
  - 98 Community Foundations

www.cof.org/Research
Global Impact Investing Network (GIIN) Research

- 158 Investor Institutions
  - 60% Fund Managers
  - 13% Foundations
  - Banks, DFIs, Family Offices, and Pensions represent the remainder
- $15.2 B Committed in 2015
- $17.7 B Planned for 2016 (16% Projected Growth)
Using One or More RI Strategy:
- 38% of Private Fdns
- 33% of Community Fdns

Considering Adopting ESG:
- 12% of Private Fdns
- 16% of Community Fdns

Consider Use of Proxy Voting Essential in Selecting a Manager:
- 8% of Private Fdns
- 5% of Community Fdns


Rate of Foundation Impact Investing

<table>
<thead>
<tr>
<th>Figure 3.16 Currently Required/Permitted Responsible Investing Practices*</th>
<th>Total Institutions</th>
<th>Over $500 Million</th>
<th>$101-$500 Million</th>
<th>Under $101 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private</td>
<td>Community</td>
<td>Private</td>
<td>Community</td>
</tr>
<tr>
<td>Seek to include investments ranking high on ESG criteria</td>
<td>130</td>
<td>98</td>
<td>24</td>
<td>12</td>
</tr>
<tr>
<td>Yes</td>
<td>15</td>
<td>10</td>
<td>13</td>
<td>25</td>
</tr>
<tr>
<td>No</td>
<td>84</td>
<td>87</td>
<td>79</td>
<td>67</td>
</tr>
<tr>
<td>No answer/uncertain</td>
<td>1</td>
<td>3</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Exclude or screen out investments inconsistent with institution’s mission</td>
<td>17</td>
<td>18</td>
<td>25</td>
<td>17</td>
</tr>
<tr>
<td>Yes</td>
<td>81</td>
<td>78</td>
<td>71</td>
<td>75</td>
</tr>
<tr>
<td>No</td>
<td>2</td>
<td>4</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>No answer/uncertain</td>
<td>28</td>
<td>20</td>
<td>29</td>
<td>50</td>
</tr>
<tr>
<td>Allocate portion of endowment to investments that further institution’s mission</td>
<td>69</td>
<td>74</td>
<td>63</td>
<td>42</td>
</tr>
<tr>
<td>Yes</td>
<td>3</td>
<td>6</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>No</td>
<td>74</td>
<td>74</td>
<td>63</td>
<td>42</td>
</tr>
<tr>
<td>No answer/uncertain</td>
<td>3</td>
<td>6</td>
<td>8</td>
<td>8</td>
</tr>
</tbody>
</table>

*multiple responses allowed
General trend upward is reflected across foundation type and asset size.

Particular growth in MRI comes alongside new guidance from the IRS (Notice 2015-62).

Remember: These figures only reflect the written investment policy statement as it applies to endowed funds of the foundation.

Several community foundations noted specific or custom options for DAFs not reflected in these figures.
“We have a number of donors who have specific ESG or SRI requirements that must be met before investing with the community foundation. This has led our staff and investment committee to look more closely at our offerings.”

Among public foundations not yet using responsible investing strategies, community economic development was the most appealing impact area to potentially pursue.

Energy efficiency, renewable energy, and to a lesser extent climate resilience also scored highly among both adopters and non-adopters.

### Targeting Impact to Key Sectors

<table>
<thead>
<tr>
<th>Impact Area</th>
<th>Total Institutions</th>
<th>ADOPTERS</th>
<th>NON-ADOPTERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community economic development programs</td>
<td>3.4</td>
<td>3.7</td>
<td>3.3</td>
</tr>
<tr>
<td>Sustainable business practices</td>
<td>3.2</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Other</td>
<td>3.3</td>
<td>4.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>


NB: Respondents to the Responsible Investing Survey included public foundations not characterized as community foundations as defined by CFNSB.
1. Concern about fiduciary duty

“We instruct investment managers to achieve risk-balanced reward without handcuffing their recommendations. Our responsibility is to maximize our ability to fund our interest areas, which do not reflect these investment strategies.”

2. Concern about return

“We have faith that the market will reflect a proper balance [of] social, environmental, governmental issues without handicapping ourselves in meeting our investment goals. If a policy proves to be helpful the investors in the market will follow it. The market is now and will continue to lead us in the right direction.”

3. Lack of knowledge among board and staff

“Honestly, our foundation has never even considered any of these investing practices. This survey is the first exposure we have had that this should even be considered. It will be discussed at our next investment committee meeting.”

## Concern About Fiduciary Duty

With respect to the question of whether responsible investing practices are consistent with your fiduciary duty [... with or without the assistance of counsel ...] what conclusion has been reached on this question?

<table>
<thead>
<tr>
<th>Responsible investing practices are consistent with fiduciary duty</th>
<th>19%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responsible investing practices are NOT consistent with fiduciary duty</td>
<td>22%</td>
</tr>
<tr>
<td>Still debating/Uncertain</td>
<td>48%</td>
</tr>
<tr>
<td>Did not answer</td>
<td>11%</td>
</tr>
</tbody>
</table>

### Important

- This survey was begun prior to the finalization of IRS Guidance (Notice 2015-62)
- Worth noting that in parallel study of institutions of higher education, only 9% said practices are consistent with fiduciary duty
- 38% of non-adopters cited concern about violating fiduciary duty as a significant or moderate impediment to pursuing these strategies

Concern About Financial Return

Percentage of respondents who consider “Concern about the possibility of lower investment performance” a significant or moderate impediment to implementing a given strategy

<table>
<thead>
<tr>
<th></th>
<th>Non-Adopters</th>
<th>Adopters</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG Investing</td>
<td>67% [30/37]</td>
<td>65% [18/57]</td>
</tr>
<tr>
<td>Mission-Related Investing</td>
<td>66% [26/40]</td>
<td>84% [11/73]</td>
</tr>
</tbody>
</table>

- With both strategies, private foundations were more likely than public foundations to view potential sacrifice to returns as an impediment.
- Worth noting that even among adopters of responsible investing strategies, concern about returns remains high, though less substantial.

Strategies to Get Your Board on Board

1. Frame your argument positively
2. Showcase current investments
3. Engage with potential detractors
4. Use external experts
5. Provide evidence of success
6. Phased approach