Community Foundation Impact Investing

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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).

Council on Foundations-Commonfund Definitions

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.

Program Related Investments: Examples

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)

Program Related Investments: Examples

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

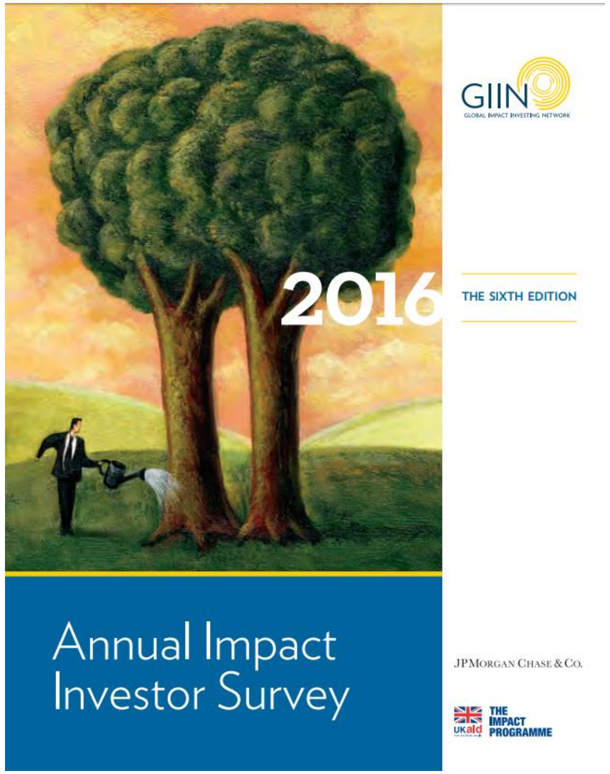
Sizing the field and understanding impediments

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)

GLOBAL IMPACT INVESTING NETWORK

Rate of Foundation Impact Investing

Figure 3.16 Currently Required/Permitted Responsible Investing Practices♦

numbers in percent (%)	Total Institutions		Over $500 Million		$101–$500 Million		Under $101 Million	
	Private	Community	Private	Community	Private	Community	Private	Community
	130	98	24	12	63	34	43	52
Seek to include investments ranking high on ESG criteria								
Yes	15	10	13	25	14	12	16	6
No	84	87	79	67	86	85	84	92
No answer/uncertain	1	3	8	8	0	3	0	2
Exclude or screen out investments inconsistent with institution's mission								
Yes	17	18	25	17	6	21	28	17
No	81	78	71	75	92	73	72	81
No answer/uncertain	2	4	4	8	2	6	0	2
Allocate portion of endowment to investments that further institution's mission								
Yes	28	20	29	50	30	18	23	15
No	69	74	63	42	67	76	77	79
No answer/uncertain	3	6	8	8	3	6	0	6

♦multiple responses allowed

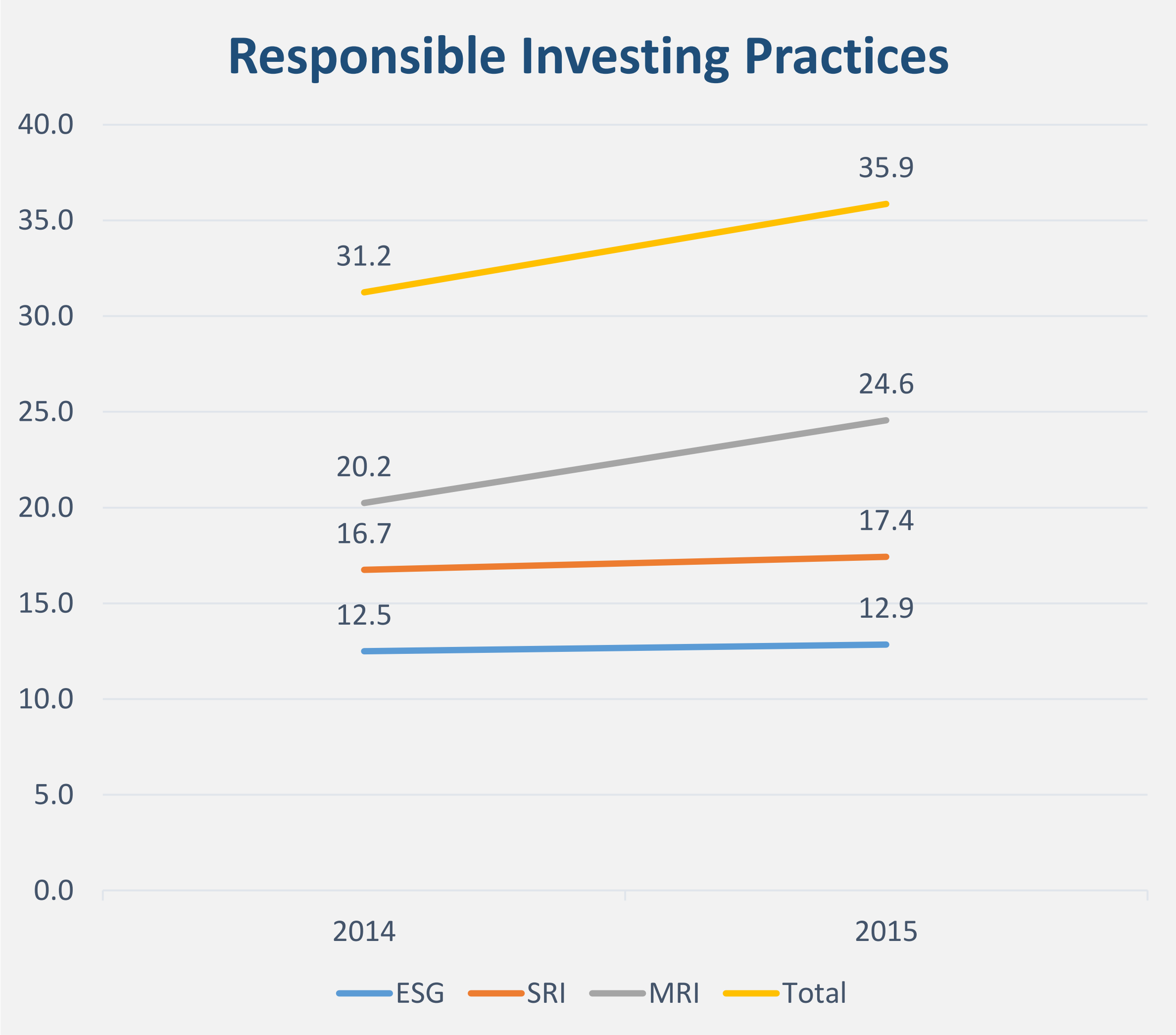
Using One or More RI Strategy:
- 38% of Private Fdns
- 33% of Community Fdns

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

Source: 2015 Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations, www.cof.org/2015CCSF

Early Trends on Growth



- 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

Source: 2015 Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations, www.cof.org/2015CCSF; 2014 Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations, www.cof.org/2015CCSF

Specific Interest from Donor Advisors

Figure 3.18 Responsible Investing Practices Made Available to Community Foundations' Donor-Advised Funds♦

numbers in percent (%)	Total Institutions	Over $500 Million	$101–$500 Million	Under $101 Million
	98	12	34	52
Seek to include investments ranking high on ESG criteria	18	58	21	8
Exclude or screen out investments inconsistent with institution's mission	21	42	24	15
Allocate portion of endowment to investments to further institution's mission	20	42	24	13

♦*multiple responses allowed*

"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."

Source: 2015 Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations, www.cof.org/2015CCSF; 2016 Council on Foundations-Commonfund Study of Responsible Investing, www.cof.org/2016RISurvey

Targeting Impact to Key Sectors

POTENTIAL CHANGES TO PORTFOLIO

Likelihood of increasing investments over the next 5 years in companies involved with:

Numbers in percent (%)	Total Institutions	ADOPTERS Total	ADOPTERS Private	ADOPTERS Public	NON-ADOPTERS Total	NON-ADOPTERS Private	NON-ADOPTERS Public
	186	44	27	17	142	74	68
Energy efficiency	3.2	3.4	3.4	3.5	3.1	3.0	3.1
Renewable energy	3.2	3.5	3.5	3.4	3.1	3.0	3.1
Retrofitting existing power plants to reduce greenhouse gas emissions	2.9	3.1	3.0	3.4	2.8	2.7	3.0
Less water intensive operations	3.0	3.3	3.4	3.3	2.9	2.8	3.0
Drought-resistant agriculture	3.1	3.4	3.3	3.4	2.9	2.9	3.1
Efficiency in transportation	3.0	3.3	3.3	3.4	2.9	2.9	3.0
Waste management	3.0	3.2	3.2	3.3	2.9	2.9	3.0
Adaptation and resilience to climate change and other environmental factors	3.0	3.4	3.5	3.0	2.9	2.8	3.0
Community economic development programs	3.4	3.7	3.8	3.3	3.2	3.0	3.5
Sustainable business practices	3.2	3.6	3.6	3.5	3.1	3.1	3.1
Other	3.3	4.0	4.0	0.0	3.2	3.0	3.4

Very unlikely = (1), Unlikely = (2), Neither likely nor unlikely = (3), Likely = (4), Very likely = (5)

- 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.

Source: 2016 Council on Foundations-Commonfund Study of Responsible Investing, www.cof.org/2016RISurvey
NB: Respondents to the Responsible Investing Survey included public foundations not characterized as community foundations as defined by CFNSB.

Challenges to the Growth of Impact Investing

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."

Source: 2016 Council on Foundations-Commonfund Study of Responsible Investing, www.cof.org/2016RISurvey

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?	
Responsible investing practices are consistent with fiduciary duty	19%
Responsible investing practices are NOT consistent with fiduciary duty	22%
Still debating/Uncertain	48%
Did not answer	11%

- **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

Source: 2016 Council on Foundations-Commonfund Study of Responsible Investing, www.cof.org/2016RISurvey

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

	Non-Adopters	*Adopters*
ESG Investing	67% *[30/37]*	*65% [18/57]*
Mission-Related Investing	66% *[26/40]*	*84% [11/73]*

- 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

Source: 2016 Council on Foundations-Commonfund Study of Responsible Investing, www.cof.org/2016RISurvey

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

www.GuideToImpactInvesting.net