Mission-Related Investing: A Legal Framework for Integrating Mission Into the Other 95%

INTRODUCTION

Mission-related investing, the practice of aligning a foundation's endowment with its philanthropic goals, has the potential to greatly increase the amount of capital available to address social and environmental challenges. Yet despite growing excitement about and attention to mission-related investing, implementation remains relatively slow. It has been almost two years since the IRS issued Notice 2015-62 (the "Notice"), the much welcomed guidance that many hoped would clear the way for private foundations to integrate mission considerations into their investments. Although some foundations, such as the F.B. Heron Foundation were early adopters in terms of integrating mission across their investment portfolio, many more continue to grapple with whether and how to integrate mission into their investment practices and still comply with applicable regulatory requirements. Even for foundations that have decided to engage in mission-related investing, concern persists among directors and managers regarding the extent to which mission-related investing comports with the highest standards of applicable federal and state laws.[1]

The good news is that with the issuance of the Notice, the legal landscape has become much clearer for mission-related investing and many more tools have been developed in the last few years to help implement such a strategy. What follows is a brief review of the legal framework applicable to mission-related investing, along with some concrete next steps foundations may want to consider before implementing a mission-related investment strategy.

1 Mission-related investments are distinct from program-related investments ("PRIs") which are a creature of the federal tax code whose primary purpose is to accomplish one or more of the foundation's charitable purposes (and not the production of income or the appreciation of property). PRIs are made out of the "minimum investment return" of a foundation (i.e., the 5% of its adjusted gross income that it is required to pay out each year in order to maintain its tax exempt status). In practice, most PRIs generate below-market returns. In contrast, mission-related investments are intended to generate both a positive social or environmental impact, and a reasonably competitive rate of financial return. Mission-related investments are made out of the corpus or endowment of a foundation (i.e., the other 95%).

REGULATORY LANDSCAPE

For a private foundation considering how to manage its investments, there are two principal legal frameworks at play: (i) federal tax law, and (ii) state laws regarding the fiduciary duties of foundation directors (for most states, codified in a version of the Uniform Prudent Management of Institutional Funds Act, known as UPMIFA). Under both laws, foundation managers are required to use ordinary business care and prudence, essentially a prudent investor standard, when making investment decisions regarding the foundation's endowment. Until recently, the challenge has been a lack of clarity about whether a prudent investor can consider mission as part of its investment analysis, and if a mission-related investment results in lower returns than a traditional investment, will the manager or directors be viewed as having violated their fiduciary duties?

Until a few years ago, the situation under UPMIFA, which has been adopted in 49 states, was a bit clearer than under federal tax laws because UPMIFA specifically identifies "the special relationship or special value to the charitable purposes of the institution" as one of eight factors that managers ought to consider as part of their investment analysis. However, under federal tax law, many private foundations were concerned that if they chose mission-aligned investments and those investments resulted in lower returns or increased risk when compared to traditional investments, then those investments could be treated as jeopardizing investments and subject the foundation to excise taxes under the federal tax-exemption laws.[2] When the IRS issued the Notice two years ago making clear that mission-aligned investments would not be considered *per se* jeopardizing investments, it fixed a disconnect between the jeopardizing investment rules under federal law and the state governing rules under UPMIFA. This is good news for foundations interested in implementing mission-related investing, but to ensure compliance with the above rules, foundations must pay careful attention to the processes they use for investment decision-making.

Federal Tax Law

There are several sections of the Internal Revenue Code that apply to mission-related investments. The single most disconcerting is Section 4944, which imposes excise taxes on a private foundation (and its management, for "knowing" participation) in the making of investments which jeopardize the carrying out of the exempt (charitable) purposes of the organization.[3]

An investment jeopardizes 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

2 The desire of foundation managers and directors to avoid jeopardizing investments is well-placed. A jeopardizing investment will be subject to an initial tax of 10% of the amount invested each year in the taxable period. If the investment is not removed from jeopardy within the taxable period than an additional tax is imposed on the foundation for 25% of the amount invested. Furthermore, a foundation manager who knowingly participated in making the jeopardizing investment will be subject to a tax equal to 10% of the amount invested, unless the participation was not willful and due to reasonable cause, with potential for additional penalties if the investment remains uncorrected.

3 In addition to the jeopardizing investment rules, mission-related investments are subject to the federal tax rules regarding unrelated business taxable income (UBTI). Mission-related investments are not presumed to be substantially related to the exempt purposes of the foundation, and because such investments are expected to make financial returns as well, meeting the substantially related test may be more complicated to demonstrate. In addition, IRC Section 4943 imposes an excise tax on the "excess business holdings" of a private foundation. Typically, the foundation may hold no more than a 20% ownership in a business enterprise. Compliance with the UBTI rules can be complicated, and may require the assistance of qualified counsel.

investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."[4] Traditionally, federal tax law looks to the prudent investor standard codified in state fiduciary law, and to the Modern Portfolio Theory, in making determinations whether investments are jeopardizing (on an investment by investment basis, taking into account the foundation's portfolio as a whole). Therefore, if an investment was not a jeopardizing investment at the time it was made, a subsequent loss related to the investment will not alter the analysis. No category of investment is *per se* jeopardizing, although certain categories of investments will receive close scrutiny (*e.g.*, trading in securities on the margin, commodity futures, oil and gas wells, and the purchase of puts, calls, warrants, selling short; and more recently, investing in junk bonds, risk arbitrage, hedge funds, derivatives). However, Section 4944 was silent on whether taking mission goals into consideration as part of investment decision-making would be considered consistent with the prudent investor standard.

Two years ago, the IRS broke its silence on mission-related investing and issued the Notice. The Notice makes clear that mission-aligned investments will not be considered jeopardizing investments pursuant to Section 4944 as long as a foundation exercises ordinary business care and prudence by analyzing all facts and circumstances, in the same way that it would do for its traditional investment decisions. The Notice goes further to make clear that relevant facts and circumstances can include a foundation's charitable mission.

Specifically, the Notice addressed the most pressing question – whether a foundation director or manager could choose a mission-related investment that advances the charitable purposes of the foundation and is intended to earn a profit, *over* a more conventional investment that might have a potentially greater financial return but does not advance its charitable purposes. In short, the answer is yes.

In this regard, Notice 2015-62: (1) allows foundation managers to "consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes;" (2) does not require foundation managers "to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation's charitable purposes;" and (3) specifies that Section 4944 will not subject foundation managers to tax if they "have exercised ordinary business care and prudence to make an investment that furthers the foundation's purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes." Although the guidance was lauded by some as offering precisely the clarity that had been lacking, its practical effect in boosting mission investing is still pending. From our vantage, foundation managers and directors are still searching for more concrete guidance.

If there is any question whether a particular mission-related investment might be considered a jeopardizing investment, one step foundations may want to consider is whether to obtain a written opinion of legal or investment counsel about the status of the investment. If a manager obtains a reasoned written opinion that a particular investment would not jeopardize the carrying out of any of the foundation's exempt purposes, then the foundation manager's participation in such investment will ordinarily be considered due to "reasonable cause," meaning the manager has complied with the prudent investor

4 Treas. Reg. § 53.4944-1(a)(2).

standard and the manager will not be subject to the jeopardizing investment tax.[5]

State Fiduciary Law and UPMIFA

Although each state has its own investor prudence standards for nonprofit fiduciaries, 49 states and the District of Columbia have adopted the Model Uniform Prudent Management of Institutional Funds Act (UPMIFA) (2006), which governs the management, investment and spending by charitable institutions of their endowments. UPMIFA codifies the modern prudent investor rule as it applies to the directors of foundations and other nonprofit corporations, and articulates in concise terms what conduct is required to make investment decisions in compliance with the rule.

Under UPMIFA, each person responsible for managing and investing institutional funds on behalf of a foundation shall do so in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. UPMIFA provides detailed guidelines for which factors a prudent person should consider when making investment decisions. In considering whether mission-related investments will be deemed prudent under UPMIFA's definition, foundations should make sure that their investment decision-making takes such factors into consideration. Helpfully, one of the factors is "any special relationship or value of the asset to the organization's charitable purpose," which has given much comfort to those seeking to make mission-related investments. Specifically, Section 3 of UPMIFA requires managers and directors to consider the following, all subject to any specific restrictions or requirements by a donor regarding the use of funds:

- general economic conditions
- effects of inflation or deflation
- expected tax consequences
- relation of each investment to the entire portfolio
- expected total return from income and appreciation
- other resources of the organization
- need for distributions and preservation of capital
- any special relationship or value of the asset to the organization's charitable purpose

These factors require a foundation to consider its charitable purposes and the purposes of the endowment in its management and investment decisions. Each of the requirements included in Section 3 of UPMIFA apply to both traditional and mission-related investments. Fiduciaries will want to give careful thought to how their decisions about mission-related investments comply with UPMIFA's guidelines. For example, fiduciaries are required to consider the costs of different investment options and only incur reasonable costs. For mission-related investments, the cost analysis can be a bit tricky because the due diligence and structuring costs of mission-related investments as well as the ongoing management costs may be higher than for some traditional investments. The key for managers is to compare mission-related investments against other mission-related investments in similar markets and make sure the investment costs are in line with each other. To be sure, this is easier said than done because so many mission-related investments are customized and unique. Fiduciaries should follow a thoughtful process for analyzing the investment costs and have

5 Treas. Reg. § 53.4944-1(b)(2)(v); *see also*, Michael J. Huft & Bina Joshi, Jeopardizing Investments by Private Foundations: A Current Overview, 26 J. Tax'n Inv. 76 (2009), citing TAM 200218038 ("A foundation's investment of substantial assets in a company that traded in futures and commodities and which was established by the foundation and its managers, was not jeopardizing in part because the foundation reviewed two separate opinions of counsel which concluded investing in the company was not a jeopardizing investment.").

documents to show that the process was followed for each mission-related investment.

Section 3 also requires fiduciaries to: (i) make reasonable efforts to verify facts relevant to the management and investment of such funds; (ii) make decisions about an individual asset in the context of the endowment portfolio as a whole and as part of an investment strategy that is reasonably suited to the endowment and the institution; (iii) consider the role of diversification in the portfolio and the requirement to diversify unless the institution reasonably determines the purposes of the fund are better served without diversification (diversification is considered prudent because it minimizes the risk associated with any one individual investment); (iv) review and rebalance the endowment in a timely manner after newly acquired assets to ensure compliance with the purposes, terms and distribution requirements of the endowment and as required by UPMIFA. How an institution will apply each of these requirements to its decisions about mission-related investments should be reflected in its investment policy statement ("IPS"), or in a separate mission-related investing rider to the IPS, as discussed more fully in the next section.

In addition to the factors in Section 3 of UPMIFA, Section 5, which addresses delegation of management and investment functions, can take on added importance in the mission-related investing space. Where directors and managers of private foundations who undertake mission-related investing do not possess the relevant skills and expertise, serious consideration should be given to the use of outside investment and legal experts with specialized knowledge in that area.

BEST PRACTICES AND STRATEGIES FOR IMPLEMENTING MISSION-RELATED INVESTING

Revising Governing Documents

The legal landscape for enabling mission-related investments has improved dramatically over the past few years. To benefit fully from these legal developments, foundations will want to make sure that their discussions and decision-making about whether and how to implement mission-related investing closely tracks the guidelines and requirements outlined above, based on both federal tax law as well as UPMIFA. Specifically this means reexamining a foundation's investment policy statement and other governing documents that provide the processes and procedures by which the foundation makes investment decisions and manages those investments. Although such documents are unique to each foundation, below are a few key steps foundations may want to consider taking:

Update Investment Policy Statement: Update the foundation's investment policy statement or develop separate guidelines for mission-related investing that run in parallel with the foundation's overall investment strategy. One form these guidelines could take is as a mission-related investing rider to the foundation's existing investment policy statement. The mission-related investing guidelines may want to address target size of mission-related investments, sector or industry focus, method of implementation (direct investing or commingled fund) and costs, among other issues. One example of a responsible investing rider to a foundation's investment policy statement is the Commonfund sample investment policy statement rider. The Rockefeller Brothers Fund Investment Policy Statement and Heron Foundation Investment Policy Statement are good examples of how some foundations have integrated mission-related investing into their investment policy statements.

Obtain Board Input: Document the Board's consideration of mission-related investments demonstrating that the Board has reviewed mission-related investing practices and determined that such practices (i) are consistent with the directors' fiduciary duty; (ii) do not violate the foundation's governing documents nor any restrictions on donor gifts; and (iii) can be evaluated on the eight factors required under UPMIFA, in the same way that traditional investments are evaluated.

Consider Hybrid Entities: Consider the benefits and challenges of investing in newer hybrid entities such as B Corporations, public benefit corporations, and L3Cs.

Define Impact: Define how the foundation will think about the impact sought by any one mission-related investment and methods of monitoring and evaluating such investments as well as the foundation's mission-related investment progress in general.[6]

Negotiating Mission-Related Investments

Once a foundation has done the hard work of deciding to engage in mission-related investing and has created the policies and procedures discussed above, the challenge becomes how to structure those strategies to effectively achieve the agreed-upon mission and comply with the foundation's policies. Fortunately, there are many strategies and tools available to integrate mission-related investments into a foundation's portfolio. Whether through screening investments for exposure to particular issues, adopting a proxy voting policy that reflects certain mission goals, or investing a portion of a portfolio in companies focused on creating solutions to environmental or social issues (*i.e.*, impact investing), the tools available to effectively implement these strategies will depend on how an investor holds its investments (through commingled funds or directly). Investors need to look across their portfolio and work with their investment managers and legal counsel to reflect those mission goals in an accurate and meaningful way in the documents that govern their investments. Whether an investor holds its investments directly or through commingled funds, or most likely, through a combination of both, the following are a few examples of mission-related investing strategies and some terms foundations may want to consider when negotiating its investments:

Negative Screening: Negative screening is one of the oldest mission investing strategies and has been known by many names, including socially responsible investing. For example, a foundation may decide it wants to minimize its exposure to companies that manufacture weapons or tobacco. Other investors may decide that they do not want to have exposure to coal companies. In order to implement this strategy effectively, investors need to work with their investment managers to see what is possible across their portfolios – for example, it may be relatively simple to screen out certain equity investments in companies but much more complicated to screen out investments held through hedge funds. When putting together a screening strategy, foundation managers and directors should consider some of the following questions:

- Is your goal to have zero exposure to certain types of companies, or is ensuring that less than X% of your portfolio is invested in those companies enough?
- How do you define what gets screened (*i.e.*, how far up and down the supply chain do you go)? Does a company that manufactures parts that are used in both weapons and cars get screened out? Is a screen based on a certain percentage of a company's operations that are related to the activity you are screening out?

6 *Id.* at 18.

- Under your internal investment policy statement and other governance documents, are there specific parameters for screening to which you need to adhere?
- What type of reporting can your investment manager provide to reflect the screening?

Proxy Voting: Whether a foundation holds investments directly or through commingled funds, the amount of control the foundation may have over proxy voting will vary. If shareholder engagement is part of a foundation's mission-related investing strategy, it is important to ensure that proxy voting practices are reflected clearly in the relevant investment agreements. For commingled funds where there is not much room to get varied terms, foundations will want to review the fund manager's proxy voting policy. Some fund managers may be amenable to certain proxy voting requests and can offer some assurances either in the main fund documents or in side letter agreements. For example, foundations may request that fund managers support proxy provisions that would require a company to "consider the environmental, social and governance impact of their operations." Foundations will also want to pay close attention to reporting on proxy voting to ensure that managers are actually voting proxies and voting them in a way consistent with whatever policy has been agreed upon. A foundation that holds certain investments directly will have a greater ability to implement its own proxy voting guidelines but if holding those investments through a separate account with an investment manager, it will be important to reflect the specific proxy voting requirements in the investment management agreement governing the separate account.

Impact Investments: Impact investments are "investments into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return."[7] For investors in the impact space, it is important to ensure that the impact sought is clearly defined in the investment documents and that strong provisions are included to provide the reporting and information rights that are necessary to ensure impact goals are being accomplished. Because impact goals can often be difficult to predict with any certainty, it is important to balance the need to protect against mission drift in these investments with the need to allow for some flexibility in impact goals. Foundation managers and directors may want to consider the following terms:

- What rights, if any, do investors have in the event of mission drift? Do they have a redemption right?
- Are management teams incented to achieve the stated mission goals by distribution or other provisions triggered by impact milestones?
- Is it important that the company or fund in which you are investing be a public benefit corporation, L3C or certified as a B Corporation?
- What type of impact reporting will be provided by the company and how often?

The above are some general considerations when making mission-related investments but such investments often require customized terms in investment documents. In general, foundations may want to consider adding covenants that prevent the investee or investment manager from engaging in activities that could create jeopardizing investments and provide appropriate remedies that give the foundation, for example, the right to recover its investment or work with the investee or manager to bring the investment back into compliance or restructure the

7 Definition adopted from the Global Impact Investing Network. *See* Global Impact Investing Network, What you Need to Know about Impact Investing, https://thegiin.org/impact-investing/need-to-know/#s1 (last visited Nov. 30, 2017).

investment to find a workable solution.[8] Foundations will also want to work closely with investees on the form and frequency of impact reporting once the investment has been deployed. It is important to work efficiently with any mission–related investee so that the additional covenants or other provisions do not overwhelm the negotiations, both in transaction costs and time. A foundation should be upfront with potential investees about what covenants it might want to include and should collaborate with any co-investors to make sure various pre-existing covenants align with new ones.[9]

Similar to any investment, after a mission-related investment is made the work is not done. Foundations should continue to monitor both the financial performance of its investments as well as its mission impact. Any sign of mission drift should prompt discussion with the investee or investment manager and consideration of how to bring the investment back into alignment with the particular mission goals of the foundation.

CONCLUSION

While IRS Notice 2015-62 left many practical questions unanswered, the industry has continued to mature. Today, there are numerous opportunities in the mission investing space that could satisfy applicable standards of prudence and other state and federal laws for most private foundations. With a well-developed mission-related investment strategy, and the requisite processes and procedures reflecting that strategy in place, we are hopeful that the trend toward mission-related investing as a routine component of a foundation's overall portfolio will continue to expand.

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FURTHER INFORMATION

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8 *Id*.

9 *Id*.