Unlocking More Philanthropic Capital for Social Investment: An Exploration of Best Practice

UnLtd

CAF Venturesome

Shift

Models for delivering social impact are changing with the advent of social purpose organisations as an alternative to traditional charities. This means that charitable foundations need to evolve as well, so that the much needed capital is available in sufficient quantities to support this new wave of impact organisations fulfil their ambition. Unfortunately, a lack of clarity from funders as to how existing UK charity regulations should be interpreted is restricting the flow of philanthropic capital, but there are some exciting examples of best practice from existing funders that we can learn from.

The opportunity

Alongside more traditional charities, a new generation of social purpose organisations has emerged, and the social entrepreneurs behind them are using an ever wider spectrum of business models and legal forms to build sustainable high impact entities. This means that the way philanthropic capital is deployed also needs to evolve to better support these organisations to unlock their full potential.

Institutional charitable giving is booming. In 2017, the top 300 UK charitable foundations made grants totalling £3.2bn[1], an 11% increase on the previous year and 45% higher than 4 years ago. Underpinning the growth is an asset base of £65bn, which itself has grown by 35% over the last 4 years. There is a veritable wall of philanthropic capital, and the managers responsible for it are seeking more innovative opportunities to deploy funds to maximise impact, with an increasing interest in social investment, rather than traditional grant giving.

Methods for delivering impact are changing. Traditional charities, that take donations and deliver services directly to people in need, will always play a hugely important role, but the last 15 years has seen a generation of mission focused entities emerge with innovative new models. Impact is no longer the exclusive domain of charities - the advent of social purpose organisations, and the resulting wide spectrum of business models and legal forms that social entrepreneurs are using to build sustainable high impact entities, means that the way philanthropic capital is deployed needs to evolve to provide the oxygen this new wave requires to flourish.

For example by:

- Broadening the constraints on the types of entities that can be supported beyond traditional charities to include the wide spectrum of legal forms, for example Community Interest Companies (CICs) and Companies Limited by Shares (CLSs), with the focus on measurable impact not legal form.
- Taking a longer term view on delivering impact that sees capital deployed early to fund innovation, and support the high risk early stages of creating new products/services that will grow over time to deliver high impact (e.g. the social accelerator Bethnal Green Ventures).
- Deliberately deploying philanthropic capital to "de-risk" and therefore attract traditional commercial capital (UnLtd.'s Big Venture Challenge programme used predominantly grant funding to leverage external risk capital into social purpose organisations).
- Moving from traditional grants to social investment and returnable grants that drive a change in behaviour for grantees even when they are charities, focusing them on the long term sustainability of their endeavours.

1 www.acf.org.uk/policy-practice/research-publications/foundation-giving-trends-2018

The challenge

A lack of clarity from funders as to how existing UK regulations should be interpreted is restricting the flow of capital from charitable foundations, who are nervous about embracing more innovative models of funding.

At present the existing UK regulatory environment, and particularly a conservative interpretation of charity laws, is inhibiting these new forms of capital deployment. The potential generation of private benefit from charitable activity, and specifically whether it meets the test of being "incidental and necessary", is making charitable foundations nervous about embracing more innovative models of funding. In many instances, the line between a commercial investment and the investment of philanthropic capital in an ultimately successful self-sustaining social enterprise may be difficult to determine. Given that the charitable purpose of philanthropic capital is paramount, it is right that funders, and the Charity Commission, give due consideration to any new proposals. However, this nervousness is limiting the supply of much-needed risk-bearing capital, including equity, to support early-stage social organisations to achieve their significant social impact potential.

What is 'Private Benefit'?

The Charity Commission expects charities to ensure that private benefit generated by their investment is "incidental" to the pursuit of the charity's purposes. "Incidental" has been broken down into the phrase: necessary in the circumstances, reasonable in amount and in the interests of the charity. When considering this, it makes sense to distinguish between:

a) the potential for private benefit to the managers of investee companies, and

b) the potential for private benefit to investors in investee companies.

Social entrepreneurs, starting up a new mission driven entity, will likely fall into both of these categories.

What's the difference between financial and social investment?

When charities make financial investments, i.e. invest solely for a risk-adjusted financial return in established investment markets, there tends not to be a great deal of consideration given to the potential for private benefit or any great regulatory expectation that charities will take any particular steps to limit private benefit. It tends to be expected that "the market" establishes the price and the terms of investment and the salaries and benefits of managers within investees and charities are not expected to upset market norms.

However, in social investment contexts, where the intended social impact is an important driver and the investment is often bespoke, private and illiquid, there is an expectation that charities will take active steps to ensure that any private benefit is necessary, reasonable in amount and in the interests of the charity.

The issue of subsidising private gain comes into play here. There is often a deliberate decision made by charities when they invest to support a promising new social venture to advance its objects or to enable a more established venture to raise additional capital elsewhere. It is in these situations, where there is the potential for the charity to directly or indirectly subsidise or support the returns to other investors, who consequently either benefit from a de-risked investment or from a priority position in the capital structure or payment waterfall relative to the charity.

Example

Shift (an innovation charity) set up a non-incorporated trust through which they intended to establish new mission focused ventures, standard companies limited by shares, to take to market the impact focused products/services they were developing. Ventures like BfB Labs, which had a mission to improve the mental health of young people by building video games that teach vital emotional self regulation skills. As a new start-up, BfB Labs was by definition early stage and pre-revenue, and therefore best suited to risk-hungry equity capital, which Shift was looking to raise from philanthropic seed investors who seek a financial return commensurate with the risk profile of the investment. To guarantee the mission focus of this new trust, and the ventures it formed, Shift applied to the Charity Commission to register it as a charity.

The Charity Commission asked Shift to find a way to restrict the potential financial returns of investors into the new ventures it establishes. The Commission deems the potential returns to be unacceptable private benefit from charitable activity, but Shift believes that without the potential for these returns, investors will not make an investment as the financial risk is too great.

Shift has not yet been able to address the Commission's concerns and so has not yet been able to register the trust as a charity. Shift continues to explore how best to launch new ventures that can satisfy both the interpretation of the existing legislation but also meets the return needs of early stage investors.

Examples of best practice

A number of charitable foundations are developing interesting and innovative approaches to this challenge, building robust and defendable models for making social investments, despite the ongoing regulatory uncertainty.

Seeking to surface and build out best practice on how to use philanthropic capital in these circumstances, CAF Venturesome, UnLtd. and Shift hosted a roundtable attended by a dozen grant-making trusts, social investment funds and legal experts. The purpose was to share our experiences of using philanthropic capital to make social investments in various types of social organisations, to illustrate best practice, and to identify any instances where greater legal clarity would be welcomed to establish a more conducive investment environment and greater flows of capital in future. A number of interesting approaches and examples emerged from the discussions.

These examples can be best categorised under the following:

1. **Assessment of mission and impact** Assessing mission, impact and public benefit when considering social investments
2. **Capital and legal structures** Establishing public benefit is primary and private benefit is "incidental and necessary" through capital and legal structures
3. **Governance, monitoring and operating models** Maximising public benefit through governance, monitoring and operating models

1) Assessment of mission and impact

Establish a robust method to assess the charitable purpose of the investee, if the investee is not a registered charity. For example, CAF has a Validations team which checks the charitable purpose of the social enterprises supported by its social investment fund CAF Venturesome.

Demonstrate that private benefit has been actively considered as part of the investment decision. For example, UnLtd. is wary of private gain that is in danger of not being deemed necessary or incidental to the creation of social impact. In response they have developed an internal risk register process to ensure social impact is embedded into the core of any business supported. That includes a mission statement and operational commitment to social impact in the articles of association.

Focus on demonstrating the public benefit created is sufficient to justify any potential private benefit. Some attendees felt that this was the real question the Charity Commission was asking with the "incidental and necessary" private benefit test.

2) Capital and legal structures

Explicitly justify private benefit and whether it can be argued to be "incidental and necessary" when establishing investment principals. Some funds are co-investing on a pari passu basis with a commercial investor in a high-risk early stage social venture. The commercial investor may be necessary to provide the capital needed. If the social venture performs well – generating significant social impact – the philanthropic funder and the commercial investor may both make a significant financial gain. The potential financial gain by the commercial investor is not the purpose of the philanthropic funder making the social investment so can be deemed incidental. For example Fair by Design (managed by Ascension Ventures – another for-profit impact investment fund) was set up using two mechanisms to resolve private benefit concerns: i) reasoning – private benefits created are necessary to attract, grow and scale capital in order to tackle the social issue; ii) excuse right – the investors have the right to not to participate in a specific investment made by the fund, if the investment doesn't satisfy their charitable mission test.

Note that some funders argued there would be no private benefit when investing alongside commercial investors on a pari passu basis (i.e. on the same terms), as this would be investing at "the market rate" - not all funders agreed with this approach.

Be careful to build a robust and defendable rationale when philanthropic social investor has a junior place in the "capital stack" of an investment. If the philanthropic capital is subsidising others' financial gains, can the private benefit be deemed necessary, i.e. is there a sufficiently strong case that "but for" the philanthropic capital the commercial investors would not participate? For example UnLtd.'s Big Venture Challenge programme used a blend of pure and repayable grant to leverage in external investment for social ventures. Funded by the Big Lottery Fund, the programme was set up to test how UnLtd. could use philanthropic capital to offset the risk and high cost of early stage social investment. In doing so UnLtd. ensured that a) the investment would not have happened if it were not for the use of the grant, b) any social venture had some form of commitment to their social impact (mission lock), and c) that any private benefit would be necessary and incidental to the impact being delivered. See also the co-mingling social investment funds paper from the Cabinet Office[2].

Be more confident about the role of philanthropic capital, and be more innovative about seeking better terms. For example, deliberately structuring early-stage grants as convertible loan notes, and including stronger negotiations at the outset.

Negotiate the best commercial terms appropriate to supporting social mission. If a charity investor is investing on the same terms as other non-charity investors, then there is arguably no restriction on the level of returns the charity investor or other investor can receive. This is because the charity is not contributing by its investment to the benefit derived by the other investors and it is itself benefiting. However, if a charity is taking greater risk or is accepting lower aggregate returns, then "super returns" to other investors would raise the question of whether the charity investor, by accepting differential terms, is directly or indirectly contributing to private benefit. Where there is a risk of this happening, charity investors should seek to negotiate with the other investors for the best commercial terms possible, given the charity's bargaining power and its motivations for making the investment, and to seek rewards which appropriately reflect the level of risk taken.

At the same time, it is vital that charities do not lose sight of their impact motivations of making social investments - and particularly that the social organisation receiving investment is treated fairly. This is particularly the case when investing in early-stage social organisations without experience of taking on investment. In some cases this may mean that the charity investor is regarded amongst the investors as the "guardian" of the mission - and some of the governance best practice outlined below may be helpful in formalising this role.

Guard against a "shift in purpose" of some social ventures at the "second financing round" and in some cases new investors effectively "buying out" the social purpose with their capital. This may be the case when, for example, a charitable foundation has provided high-risk social investment to support a start-up social organisation which then successfully grows, and subsequently needs to raise more investment in a second financing round. Charitable foundations could potentially guard against this by retaining an enduring golden share in the investment to guarantee mission.

3) Governance, monitoring and operating models

Establish "excuse rights" at a social investment fund level for philanthropic social investors giving them the right to not participate in an investment which does not fit their charitable mission. For example the Joseph Rowntree Foundation has invested in the Fair by Design fund. It monitors the mission alignment of investees through observing investment committee minutes, which thereby means it is in a position to exercise its excuse rights, if necessary.

Establish active monitoring and controls over investees that aren't Charities or CICs to limited private benefit and ensure public benefit is maximised. For example:

- Mission lock for the term of the social investment – for example, ensuring that the Mem & Arts of the investee cannot be changed for the term of the social investment, and requiring that funds be used for a particular purpose, such as an agreed business plan
- Dividend cap for the term of the social investment
- Social investor signs off management pay
- Prohibitions on the transfer of assets other than for market value
- Social investor has a golden share (Hogan Lovells report on these[3])
- Active monitoring of social impact as well as financial performance
- Governance rights, such as the right to observe board meetings or appoint to the board.

It's notable that the most experienced funders are consistently doing this with their social investments.

2 www.bigsocietycapital.com/sites/default/files/attachments/Co-mingling%20Social%20Funds.pdf
3 www.hoganlovells.com/~/media/hogan-lovells/pdf/publication/4878744v1golden-share-report-final-formlwdlib01_pdf.pdf

A call to action

Undoubtedly some challenges remain – not least around philanthropic funders taking equity in social purpose organisations. As social investment becomes (we hope) mainstream, there is an opportunity to use valuable philanthropic capital to support new non-traditional social business models to create lasting social impact. By identifying the challenge, and highlighting examples of how some philanthropic funders are addressing it, we are leading a broader conversation on what can be done to encourage more social investments using philanthropic capital.

For more information on what's next and how you could be involved please see **shiftdesign.org.uk/portfolio/philanthropic-capital**

We welcome comment from fellow philanthropic funders and social ventures on other ways of addressing this challenge.

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