Bates Wells Braithwaite

Co-mingled investment funds
- subordinated investments and charity trustee duties

1. Introduction

1.1 This note sets out high level principles which trustees of charities should consider when deciding whether or not to make subordinated investments in co-mingled funds.

2. Term sheet and structure paper

2.1 The Cabinet Office has published a draft term sheet and structure paper which illustrates how a charity could take a subordinated position in a co-mingled fund.

2.2 The term sheet contemplates one form of subordination, in which a charity investor takes a first loss position but shares equally in income and capital profits. A whole variety of other forms of subordination are possible, including in relation to the investment capital invested, potential income and capital returns and security.

2.3 There may of course be situations in which charities may wish to take senior investment positions, involving higher returns and lower risks, relative to other investors. However, this note only concerns charities taking subordinated positions.

3. Trustee responsibilities

3.1 Ultimately, only the trustees of a charity can decide whether or not it is in the best interests of a charity to take a subordinated position in a co-mingled fund.

3.2 Any such decision will depend on the nature of the subordination, the nature of the proposed activities of the fund and on an assessment of the risks involved.

3.3 In particular, trustees should consider the objects and powers of the charity and the relationship between the objects and the activities financed by the investment.

3.4 Given that subordination of this kind is rare, charity trustees should consider obtaining advice in relation to these issues and compliance with charity and tax law.

4. Investment analysis

4.1 A charity may only take a subordinated investment position which is considered by HMRC to be an approved investment, if it is '*for the benefit of the charity*'.[1]

4.2 This means that the charity must seek:

4.2.1 to obtain a *proportionately* increased financial return in exchange for any higher risk involved in taking a subordinated position; or

4.2.2 to leverage additional private investment into an investment fund and by so doing to advance its objects *in whole or in part* and *to such a degree* as to justify any higher risk involved in taking a subordinated position;[2] or

[1] HMRC guidance: '*Approved Charitable Investments and Loans*'.

4.2.3 to obtain *a combination* of increased financial return and additional leveraged investment into an investment fund to advance its objects in whole or in part, such that the combination of these two elements justifies the subordination.

4.3 Where a higher financial return is the *only* justification, the charity will be engaging in traditional financial investment according to standard investment principles.[3]

4.4 Where a higher financial return is not expected, a subordinated investment position by a charity will only be justified where:

4.4.1 the activities of the fund – *including* the activities of its investees which are supported by the fund investments – are reasonably considered by the trustees to be *advancing or contributing* to the advancement of its objects; and

4.4.2 the subordinated position taken by the charity is *reasonably predicted to leverage* additional investment into the fund and is *proportionate*.

4.5 Where an investment fund will be making investments which are *wholly* in advancement of a charity's objects, the charity may invest on a subordinated basis in the fund even if, on the balance of probabilities, a financial return is not anticipated.[4]

5. Advancing or contributing to the advancement of charitable objects

5.1 Trustees may consider that the activities of the fund are advancing or contributing to the advancement of its objects where the activities of investees produce *positive social impacts* which are related to and fall within the charitable objects of the charity.

5.2 For example, a fund which invests in social enterprises operating in deprived communities may generate a range of social impacts which advance or contribute to the advancement of charitable objects, such as advancing education, advancing health, establishing young people in life, relieving financial hardship and so on.

5.3 Only those social impacts which are *relevant to the objects* of the charity investor may be considered. This means that charities with an '*all charitable purposes*' objects clause are likely to find it easier to take subordinated positions in a wider range of funds than charities with narrow objects which focuses on particular cause areas.

5.4 In assessing the degree to which the charitable objects of the charity investor are advanced, the trustees are entitled to consider not only the social impacts generated by its investment as a share of the total investment fund but also the social impacts generated by *any additional investment which it is reasonable to think has been or will be leveraged into the investment fund* by the subordinated charity investment.

5.5 Trustees should seek to *estimate the* '*value'* of the *relevant social impacts* which the investment is expected to generate, to determine the degree to which the objects of the charity will be advanced in whole or in part. One proxy is to consider the value of any grant which the charity would be willing to make to achieve the same social impacts.

5.6 Any subordinated investment which a charity makes which is not based on increased financial returns must be based on the *estimated value* of these social impacts. A charity must have a *reasonable basis* for its method of estimating value.

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[2] Charity Commission guidance: '*Charities and Investment Matters: A Guide for Trustees (CC14)*'. We use the terms '*advancing*' objects '*in whole*' to refer to programme related investment and '*contributing*' to the advancement of objects '*in part*' to refer to mixed motive investment.

[3] Ibid.

[4] Ibid. This interpretation is consistent with the general principle that a programme related investment is an investment which could otherwise be structured as a grant to the recipient of the investment.

6. Purposeful and proportionate

6.1 A subordinated investment position will be *purposeful* where the trustees reasonably believe that *but for* the subordination, certain investors or categories of investors will not participate and the participation of those investors is desirable for the purposes of ensuring a successful capital raise by the investment fund.

6.2 A subordinated position will be *proportionate* where the trustees reasonably believe that the level and nature of the subordination is such that the charity is *no more subordinated than is necessary* to leverage the other investors or categories of investors whose participation is deemed desirable for a successful capital raise.

6.3 Where a charity makes a subordinate investment which is proportionate in this sense, it can be confident that any private benefit will merely be necessary and incidental.

7. Trustee discretion

7.1 The law generally respects the good faith exercise of trustee discretion, as trustees are invariably best placed to see and determine what is in the best interests of a charity.

7.2 As a result, where charity trustees decide – acting reasonably and in good faith – to take subordinated investment positions in accordance with these principles, taking into account any relevant independent advice, such an investment should be considered under charity and tax law as being '*for the benefit of the charity*'.

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