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**The 2018 Ottawa Region
Charity & Not-for-Profit Law
Seminar
Ottawa – February 15, 2018**

**THE EXPANDING INVESTMENT
SPECTRUM FOR CHARITIES,
INCLUDING SOCIAL
INVESTMENTS**

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**The Expanding Investment Spectrum for Charities,
Including Social Investments**

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A. INTRODUCTION

- The presentation provides an overview of the spectrum of options available when investing charitable funds in Ontario
- The options reviewed in the presentation include:
 - Prudent Investor Standard under the *Trustee Act*
 - Program Related Investments (PRIs) under the CRA's Guidance: *Community Economic Development Activities and Charitable Registration* (CG-014) ("CED Guidance"), and
 - Social Investments under recent amendments to the *Charities Accounting Act* ("CAA")
- See recent paper on this topic at <http://www.carters.ca/pub/seminar/charity/2018/oba/OBA Paper Investment Spectrum.pdf>

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The Investment Spectrum for Charities

Ordinary
Investments
under
Prudent
Investor
Standard

Social
Investments

Program
Related
Investments

Focus on
Financial Return

Dual Purpose of
Financial Return
and Charitable
Purposes

Focus on
Charitable
Purposes

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- The reference to "trustees" in the presentation includes directors, governors, council members, and members of the board of trustees, etc. - *i.e.*, whoever exercises direction and control over the affairs of the charity as its directing mind
- What is not covered by the presentation includes:
 - related business rules under the *Income Tax Act* ("ITA") and its comparison to ordinary investments,
 - non-qualified investment rules - private foundations,
 - excess business holding rules - private foundations,
 - restrictions on majority control of corporations by foundations, and
 - the ability of registered charities to invest in limited partnerships

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B. PRUDENT INVESTOR STANDARD UNDER THE TRUSTEE ACT

- Involves a focus on financial return
- Highly prescribed rules under the *Trustee Act*

1. Application of the *Trustee Act* to Charities

- s. 1(2) of the CAA provides that charitable corporations are deemed to be trustees of their charitable property within the meaning of that *Act*
- s. 10.1 of the CAA confirms that charitable corporations must comply with the investment decision making requirements set out in ss. 27 to 31 of the *Trustee Act*
- However, ss. 27(9) and (10) of the *Trustee Act* provide that the *Act* does not require a trustee to act in a manner inconsistent with the terms of the trust (which include the constating documents of a corporation)


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2. Standard of Care Required

- The former *Trustee Act* (pre July 1, 1999) listed specific and very limited categories of legal investments in accordance with the "prudent man" standard
- The prudent investor standard replaced the legal list of authorized investments
 - "[i]n investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments." (s. 27(1) of the *Trustee Act*)




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3. Authorized Investments

- “A trustee may invest trust property in any form of property in which a prudent investor might invest” (s. 27(2) of the *Trustee Act*)
- Investments in mutual funds, pooled funds, segregated funds and common trust funds under insurance contracts are permitted, but no further definitions are provided (ss. 27(3) and (4) of the *Trustee Act*)
- Also, while there are no specific references to Exchange Traded Funds (ETFs) in ss. 27(3) of the *Trustee Act*, ETFs would generally be considered to be a type of pooled funds and therefore should be considered to be an authorized investment



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- As well, Legislation introduced in 2009 to repeal the *Charitable Gifts Act* and to amend the CAA removed previous restrictions on charities investing in real estate or holding more than a 10% “interest in a business”
- However, such investment still need to comply with the prudent investor standard under the *Trustee Act* and, if applicable, the related business rules under the ITA
- As well, if the investment in a corporation, partnership or business trust constitutes a “substantial interest” (e.g. the charity owning or controlling, either directly or indirectly, more than 20% of the applicable voting rights or equity interest), the CAA provides that the Public Guardian and Trustee may require financial statements and other records from the charity and is able to seek court intervention if necessary

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- In addition, as of April 2015, all registered charities under s. 253.1(2) of the ITA can invest in limited partnerships and not be considered to be carrying on a business, provided that:
 - The charity must be a “limited partner” of the partnership (e.g., limited liability) as opposed to a general partner;
 - The charity - together with all non-arm’s length entities - holds 20% or less of the fair market value of all interests in the partnership; and
 - The charity deals at arm’s length with each general partner of the partnership

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MANDATORY COMPLIANCE

4. Mandatory Investment Criteria


- Seven mandatory criteria must be considered in making investment decisions (s. 27(5) *Trustee Act*) in addition to any others that are relevant in the circumstances
 - General economic conditions
 - The possible effect of inflation or deflation
 - The expected tax consequences of investment decisions or strategies
 - The role that each investment or course of action plays within the overall trust portfolio

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- The expected total return from income and appreciation of capital
- Needs for liquidity, regularity of income and preservation or appreciation of capital
- An asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries
 - Arguably this last criteria may permit socially responsible investments, impact investments, and social investments separate from the requirements provided for under the CAA for social investments as set out later

Eligibility
 Criteria



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5. Mandatory Diversification Obligations

- A trustee must diversify the investment of trust property to an extent that is appropriate to (ss. 27(6) of the *Trustees Act*)
 - The requirements of the trust; and,
 - General economic investment market conditions

6. Investment Advice

- Subsection 27(7) of the *Trustee Act* allows a trustee to obtain advice in relation to the investment of trust property
- As well, a trustee will not be liable for losses to the trust where he or she relies upon such advice, provided that a prudent investor would rely upon the advice under comparable circumstances




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7. Commingling of Restricted Funds

- At common law, restricted charitable funds cannot be commingled with:
 - other restricted charitable funds; or
 - general charitable funds
- In Ontario, however, regulations were introduced in 2001 as part of the *Charities Accounting Act* that permit the comingling of restricted funds with other restricted funds if certain requirements are met




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8. Delegation of Investment Decision Making

a) Power to Delegate

- s. 27.1(1) of the *Trustee Act* permits trustees of a charity to delegate investment decision making to the same extent that a prudent investor could in accordance with ordinary investment practice
- This means that the trustees of a charity are permitted to delegate investment decision making to a qualified investment manager
- However, the mandatory statutory requirements to be able to delegate must be carefully reviewed and complied with, as delegation is only permitted if the statutory requirements are met




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b) Investment Policy Required for Delegation

- Investment decision making cannot be delegated without a "written plan or strategy" (e.g. an investment policy) in place that is intended to ensure that the functions will be exercised in the best interest of the charitable purpose (s. 27.1(2)(b) of the *Trustee Act*)
- An investment policy is optional if there is no delegation, but is recommended in any event
- The investment policy must set out a strategy for the investment of the trust property, comprising reasonable assessments of risk and return that a prudent investor would adopt under comparable circumstances (ss. 27.1(2)(a) and s. 28 *Trustee Act*)




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c) Written Agreement Requirement

- The trustees must have a written agreement (e.g. investment management agreement) between the trustees and the agent (e.g., an investment manager) (s. 27.1(3) of the *Trustee Act*)
- The agreement must include:
 - The delegated authority to make investment decisions
 - A requirement that the agent comply with the investment policy in place from time to time
 - A requirement that the agent report to the trustees at regularly stated intervals
- The agreement should not include a release or indemnification of the agent




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d) Prudent Selection of Agent

- The *Trustee Act* imposes a requirement upon the board of a charity to exercise prudence in selecting an agent (investment manager), in establishing the terms of the agent's authority and in monitoring the agent's performance to ensure compliance with the applicable terms (s. 27.1(4) of the *Trustee Act*)



e) Prudence in Monitoring of Agent Required


- The *Trustee Act* imposes a requirement upon trustees to exercise prudence in monitoring the agent's performance to ensure compliance with the terms of the agreement with the agent (para.27.1(5)(b) *Trustee Act*)

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f) Duties of an Agent

- An agent (investment manager) has a statutory duty to exercise a trustee's functions relating to the investment property (s. 27.2(1) of the *Trustee Act*)
 - With the standard of care expected of a person carrying on the business of investing the money of others
 - In accordance with the agency agreement
 - In accordance with the investment policy



g) Prohibition on Sub-delegation by Agent


- In Ontario, an agent (investment manager) may not sub-delegate the investment decision making authority given to the agent by a board of a charity to another person or agent (s. 27.2(2) of the *Trustee Act*)

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h) Liability of the Agent

- If a charity suffers a loss because of the agent's breach of duty, then legal action can be commenced against the agent (s. 27.2(3) of the *Trustee Act*) by:
 - The trustees, e.g., the charity through its directors
 - A beneficiary, if the board does not bring action within a reasonable period of time
- It is important to ensure that agents not be allowed to contract out of the statutory requirements




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i) Liability Protection for Trustees

- The *Trustee Act* provides that a trustee will not be liable for losses from the investment of trust property if the conduct that led to the loss conformed to a plan or strategy that a prudent investor would adopt under comparable circumstances (s. 28 of the *Trustees Act*)
- If a trustee is liable to the charity for losses arising from investment decisions, the court assessing damages may take into account the overall performance of the investments (s. 29 of the *Trustee Act*)




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9. Contents of an Investment Policy

- An investment policy should be a document created by the charity to guide the charity and its board of directors in complying with the high fiduciary duty that applies to the management of charitable property
- Utilizing a *pro forma* investment policy from a financial institution will not reflect all of the legal obligations that apply to investing charitable property
- As a result, the charity should work with their legal counsel in reviewing and preparing a customised investment policy to properly reflect the requirements of the *Trustee Act*



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C. PROGRAM-RELATED INVESTMENTS

1. What are Program-related Investments (PRIs)?


- Involves a focus on charitable purposes
- PRIs are defined by CRA as investments that "directly further" the charitable purposes of the charity
- PRIs may generate a financial return, though they are not made for that reason
- PRIs are not available for advancement of religion
- PRIs usually involve the return of capital within a period of time, but this is not required, and yields of revenue from the investment, if any, can be below market rates
- A charity can make a PRI with a Qualified Donee ("QD")
- A charity can also now make a PRI with a non-QD if there is direction and control and private benefit is incidental

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2. Requirements of Charities Engaging in PRIs

- Charities conducting PRIs must have
 - A policy describing how the charity will make decisions regarding PRIs
 - Documentation explaining how each PRI furthers its charitable purpose
 - In the case of PRIs to non-QD, the charity must also maintain direction and control ("own activities" test) and ensure that any private benefit is incidental (e.g., necessary, reasonable and proportionate)
 - Exit mechanisms to withdraw from a PRI or convert it to an ordinary investment if it no longer meets the charity's charitable purposes
 - Must also meet all applicable trust, corporate and other legal and regulatory requirements
 - Maintain books and records to prove compliance




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3. Types of PRIs

- Loans and loan guarantees - to another organization to allow that other organization to pursue the charitable purpose of the investor charity
- Share purchases - in a for-profit company to accomplish the charitable purpose of the investor charity
 - However, foundations face restrictions on acquiring a controlling interest in a company
 - Private foundations are also subject to excess corporate holding rules and prohibition on carrying on any business activity
- Leasing land and buildings - buying a building and leasing it to an organization to accomplish a charitable purpose, e.g., for education purposes



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4. Accounting for PRIs


- Charities must account for their assets contributed to PRIs and loans in their financial statements and annual T3010 information returns
- PRIs are not included in the asset base for the calculation of the 3.5% disbursement quota ("DQ")
- PRIs, though, are not considered by CRA to be a charitable expenditure in meeting the 3.5% DQ, except in limited circumstances, such as loss of capital or lost opportunity costs resulting from a PRI's low return
- However, since PRIs must further a charity's charitable purposes, the assets contributed to the PRI arguably should be seen charitable expenditures in meeting the 3.5% DQ

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D. SOCIAL INVESTMENTS

1. Definition of Social Investments




- Involves achieving a dual purpose of financial return and charitable purposes
- Amendments to the CAA in Bill 154, came into force on November 14, 2017, permit charities to make "social investments" where the trustee applies or uses trust property to:
 - directly further the purposes of the trust, and
 - achieve a "financial return" for the trust (s.10.2(2) CAA)
- "Financial return" is defined as an "*outcome in respect of the trust property [that] is better for the trust in financial terms than expending all the property*" (s.10.2(3) CAA)

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2. The Power to Make Social Investments




- Subsection 10.3(1) of the CAA establishes the specific power of trustees to use or apply trust property to make a social investment
- Subsection 10.3(4) provides that the terms of the trust may exclude or restrict the power to make social investments
- However, subsection 10.2(5) provides that a social investment is not, for that reason alone, an investment for any other purpose
- This means that an investment power clause referencing the *Trustee Act* in the constating documents of a charitable corporation will not preclude the charity from making social investments

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3. Limitation on Availability of Endowment Funds



- Section 10.3(2) of the CAA states that:
 - "social investment may not be made in relation to trust property that is subject to a limitation on capital being expended for the purposes of the trust, unless the trustee expects that making the social investment will not contravene the limitation or the terms of the trust allow for such an investment" (s.10.3(2) CAA)


4. No Delegation of Power to Make Social Investments

- While charities may make social investments in mutual funds, pooled funds, segregated funds and common trust, charities may not delegate general decision-making power with regard to social investments as section 27.1 of the *Trustee Act* has not been extended to social investments (s. 10.1 of the CAA)

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5. Duties of Trustees in Making Social Investments




- In making social investments, trustees must:
 - ensure that "it is in the interests of the trust" before making a social investment
 - review the investment periodically, after making a social investment; and
 - both before and after making a social investment, determine whether, in the circumstances, advice should be obtained and, if so, obtain and consider the advice (ss.10.4(1)(a) and 10.4(3) CAA)
- Reliance on advice received does not constitute breach of trust (s. 10.4(4) CAA)
- However, there is no guidance concerning who the charity can or should seek advice from
- Therefore, prudent to ensure that if advice is sought, it is in writing and that the board of the charity records having received and considered the advice

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6. Liability Protection for Trustees

- s.10.2(7) of the CAA provides protection from liability for losses to the trust arising from a social investment, but only if in doing so "the trustee acted honestly and in good faith in accordance with the duties, restrictions and limitations that apply under [the CAA] and the terms of the trust"
- This provision was not in the original draft of Bill 154 and was added in third reading



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7. Issues Involving Social Investments

a) Identifying Types of Investments and Potential for Overlap

- It will be important for a charity to determine whether a proposed investment falls into one or more of the three investment regimes available to charities in Ontario
 - An ordinary investment under the *Trustee Act*
 - A social investment under the CAA, and/or
 - A PRI under the CED Guidance
- It is possible for an investment to be in one or all three investment regimes, which may result in unintended consequences
- For instance, if a proposed investment is with a non-QD, then a social investment may also need to meet the requirements of a PRI to avoid penalties or revocation of charitable status under the ITA

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b) Issues for Foundations

- In making a social investment in the form of a share purchase, private foundations will need to be aware that the same issues apply to them when making a PRI or a regular investment (e.g., limits on controlling a corporation for public foundations, excess business holding rules, and no business activities for private foundations)

c) Limitations on Expenditure of Capital

- Charities that hold “endowments” will need to review their historical gift documentation to determine if there are any limitations on the expenditure of capital, including whether capital is to include realised capital gains or not

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- Need to carefully document decisions by the board of trustees concerning possible use of endowment funds in making a social investment, including why they expect that a social investment will not result in an encroachment on capital

d) Issues of Liability Protection for Trustees

- Liability protection for trustees under s. 10.2(7) of the CAA is different and not as practical as provided for under s. 28 of the *Trustee Act*
- Unlike s. 28 of the *Trustee Act*, s. 10.2(7) of the CAA does not provide a methodology of what needs to be done in order to ensure protection from liability (i.e. no reference to a “plan or strategy”)

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e) Trustees’ Duty Regarding Advice

- If the trustees or board of a charity must consider whether they need to obtain advice, this will likely mean that trustees will generally seek advice in order to be cautious
- However, the amendments to the CAA should not be so complicated that obtaining professional advice becomes the norm as a matter of due diligence

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E. CONCLUSION

- Investments of charitable funds by charities will need to be carefully considered given the complexities that have now arisen because of the introduction of social investments under the CAA
- It is important for charities to understand the spectrum of options that are available and the corresponding requirements when investing charitable funds
- It is advisable that charities develop and implement an appropriate investment policy or policies to reflect the specific type of investment that the charity intends to embark on before investing
- Although not intended, charities will likely need more legal assistance than they have had to in the past in order to navigate their investment options

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