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# The 24<sup>th</sup> Annual *Church & Charity Law*<sup>™</sup> Seminar


Toronto – November 9, 2017

## THE INVESTMENT SPECTRUM FOR CHURCHES & CHARITIES

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## The Investment Spectrum for Churches & Charities

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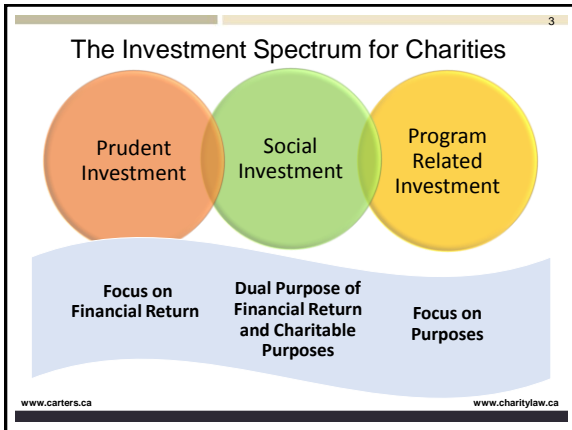
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### A. INTRODUCTION

- This presentation is intended to provide churches and charities with a basic understanding of the spectrum of options available when investing charitable funds
- The options reviewed in this presentation include:
  - Prudent Investments under the *Trustee Act*
  - Program Related Investments under the CRA's Guidance: *Community Economic Development Activities and Charitable Registration (CG-014)* ("CED Guidance")
  - New Social Investments under Ontario Bill 154 amending the *Charities Accounting Act* ("CAA")

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- What is not covered by this presentation includes:
  - "Related business" under the *Income Tax Act* ("ITA")
  - Non-qualified investment rules for private foundations
  - Excess business holding rules for private foundations
- For additional resource materials, see:
  - *Investment Powers of Charities and Not-For-Profits Under Ontario's Trustee Act*, Terrance S. Carter: <http://www.carters.ca/pub/bulletin/charity/2010/chylb192.pdf>
  - *Consideration in Drafting Investment Policies in Ontario*, by Terrance S. Carter: <http://www.carters.ca/pub/bulletin/charity/2010/chylb207.pdf>
  - *Bill 154 to Permit "Social Investments" in Ontario*, by Terrance S. Carter: <http://www.carters.ca/pub/bulletin/charity/2017/chylb407.pdf>

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### B. PRUDENT INVESTMENTS UNDER THE TRUSTEE ACT

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

#### 1. Application of the Trustee Act to Charities

- The reference to "trustees" in this presentation includes directors, governors, council members, deacons, elders, etc. - e.g., whoever is in charge of the church or charity
- 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*

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- 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)
- Situations where the *Trustee Act* will generally not apply:
  - The letters patent or articles of continuance of a charity state that the *Trustee Act* does not apply
  - A special purpose trust in a will or gift agreement establishes a different investment power from that contained in the *Trustee Act*
  - A different investment power is set out in special legislation creating the charity
  - Program related investments under the CRA's CED Guidance (discussed below)
  - New social investments under the CAA (see below)

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### 2. Prudent Investor Standard

- "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*)

### 3. Standard of Care Required

- Standard of care required of a trustee involving the investment of charitable property consists of
  - "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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### 4. Specific Types of Investments Permitted


- Investments in mutual funds are permitted (s. 27(3) of the *Trustee Act*)
  - But no definition of mutual funds
- Investing in pooled funds is specifically permitted
  - But no definition of pooled funds
- Investing in segregated funds under insurance contracts is also permitted
- As well, while there are no specific references to Exchange Traded Funds (ETFs) in the *Trustee Act*, ETFs would generally be considered to be a type of pooled funds and would therefore appear to be permitted



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- As well, the CAA/other Acts was amended in 2009 to remove previous restrictions on charities investing in real estate, corporations, partnerships and business trusts
  - However, such investment would still need to comply with the prudent investor standard under the *Trustee Act* and/or the "related business" rules under the ITA, if applicable
  - 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 the ITA can invest in limited partnerships 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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### 5. Mandatory Investment Criteria

- Seven mandatory criteria must be considered in making investment decisions (s. 27(5) *Trustee Act*)
  - 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 would permit a socially responsible investment, or even a social investment separate from the requirements provided for under the CAA for social investments set out below




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### 6. Mandatory Diversification Obligation

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




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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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- Specifically a charity intending to commingle restricted funds with other restricted funds:
  - May only do so if it advances the administration and management of each of the individual restricted funds;
  - Must allocate all gains, losses, income and expenses ratably on a fair and reasonable basis to the individual funds;
  - Must maintain specified detailed records relating to each individual fund; and
  - Must maintain specified detailed records relating to the combined fund




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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 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) 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 a reasonable assessments of risk and return that a prudent investor would adopt under comparable circumstances (s. 28 of the *Trustee Act*)



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#### c) Agency Agreement Requirement (Investment Management Agreement)


- The trustees must have a written agreement (normally referred to as an investment management agreement) in the form of an agency agreement between the trustees and the agent (e.g., an investment manager) (s. 27.1(3) of the *Trustee Act*)
- The agency 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



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- In addition to these statutory requirements, an agency agreement should also
  - Include a definition of conflicts of interest for the agent and the trustees (board members)
  - Avoid the obligation to advise the agent of a change of circumstances
  - Be carefully reviewed to eliminate releases and indemnification of the agent (investment manager) by the charity against damages or losses
  - Be reviewed by legal counsel for the charity to ensure compliance with the *Trustee Act*


Requirements 

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**d) Prudent Selection of an 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*)
- Prudence in the selection requires compliance with regulations concerning who is qualified to act as an agent, but no regulations have been made to date (s. 27.1(5)(a) of the *Trustee Act*)
- Pending the adoption of regulations, it is essential to select agents who have appropriate professional credentials as investment managers




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**e) Prudence in Monitoring of Agents Required**


- The *Trustee Act* imposes a requirement upon the board of a charity to exercise prudence in monitoring the agent's performance to ensure compliance with the terms of the agency agreement (para.27.1(5)(b) of the *Trustee Act*), including:
  - Reviewing the agent's reports
  - Regular review of the agency agreement and how it is being put into effect
  - Regular review of the investment policy and its revision or replacement if necessary
  - Assessing whether the investment policy is being complied with



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- Considering whether directions should be provided to the agent or whether the agent's appointment should be revoked
- Providing, when necessary, directions to the agent or revoking the appointment of the agent
- The above mandatory list is not a complete code of what is required for due diligence and may therefore need to be supplemented as necessary
- As a result, the board of a charity needs to be pro-active in monitoring the agent




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**f) Prohibition on Sub-delegation by Agents**

- 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*)
- This can create problems when the investment manager wants to invest in third party mutual funds or pooled funds as opposed to the manager's own funds
- This limitation is often not recognised by investment managers
- The "work around" involves requiring approval from the charity before the investment manager, as agent, proceeds with investing in third party mutual funds or pooled funds




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**g) Duties of an Agent (Investment Manager)**

- 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
- An agent should carefully review their existing agency documentation (e.g., investment management agreements) to ensure that they comply with the mandatory requirements authorizing delegation under the *Trustee Act*




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### h) Liability of the Agent (Investment Manager)

- 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
- As such, members of a charity and/or other individuals who receive a benefit from the charity could themselves initiate proceedings against the agent for breach of the agent's duty if the directors of a charity do not do so
- It is important for a charity not to contract out of this statutory right




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### i) What Liability Exposure Do Trustees Face From Imprudent Investment Decisions?


- Relief from technical breaches of trust under s. 35(1) of the *Trustee Act* is not available for losses resulting from investment of a charity's trust property
- However, the *Trustee Act* does provide 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 an investment plan or strategy that a prudent investor would adopt under comparable circumstances (s. 28 of the *Trustees Act*)
- Therefore, it is very important for the board of a charity to adopt an investment policy



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- Failure to comply with mandatory requirements for delegation will preclude liability protection under the *Trustee Act* and will expose trustees to liability for breach of trust by unauthorized delegation of investment decision making
- 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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### C. PROGRAM-RELATED INVESTMENTS (PRIs)

#### 1. What are PRIs?

- Involves a focus on charitable purposes
- PRIs are defined by CRA as investments that "directly further" the charitable purposes of the charity
- PRIs are not investments in the conventional financial sense because, while PRIs may generate a financial return, they are not made for that reason
- According to CRA's CED Guidance, PRIs may further charitable purposes that relieve poverty, advance education, benefit the community in other ways the law regards as charitable, but not advancement of religion on its own without another charitable purpose




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- 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 make a PRI with a non-QD, provided the charity maintains ongoing direction and control and any private benefit is incidental

#### 2. Types of PRIs


- Loans and loan guarantees - to another organization to allow that other organization to pursue the charitable purpose of the investor charity, e.g., making a loan to a third party so that the third party can acquire job training equipment for eligible beneficiaries of the investor charity



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- Leasing land and buildings - buying a building and leasing it to an organization to accomplish a charitable purpose, e.g., for education purposes
- Share purchases - in a for-profit company to accomplish charitable purpose, e.g., operating an apartment complex for the poor
  - However, foundations cannot acquire a controlling interest in a company
  - Private foundations are also subject to other restrictions, such as divestment obligations resulting from holdings above 20% of any class of shares in a company, under the excess corporate holding regime




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### 3. Requirements of Charities Engaging in PRIs

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



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### 4. Accounting for PRIs and Loans

- 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")
- Unfortunately, though, PRIs are not considered by CRA to be a charitable expenditure in meeting the 3.5% DQ
  - Unless, if a charity does not meet its disbursement quota, CRA *may* consider the lost opportunity cost of the charity's PRIs as equivalent to expenditures
- However, since PRIs must further a charity's charitable purposes, the assets contributed arguably should qualify in meeting the 3.5% DQ

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### D. SOCIAL INVESTMENTS

- Involves achieving the dual purpose of financial return and charitable purposes (dual purposes)
- Amendments to the CAA in Bill 154, which passed third reading on November 1, 2017, (to come into force on Royal Assent) will 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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- Bill 154 imposes a limitation on social investments with regard to using funds that are subject to a limitation on the expenditure of capital (e.g. endowment funds):
  - "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)
  - It is not clear how this provision will be interpreted
- Also, must not contravene any restrictions or exclusions in the trust document, which would include the constating documents of a corporation, e.g. the letters patent or articles of incorporation or continuance (s.10.3(4) and s.10.2(6) CAA)



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- Need to check whether the constating documents of a charity may preclude the ability of the charity to invest in 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 (s.10.4(1) CAA)
- But no guidance in Bill 154 concerning who the charity should seek advice from
- Therefore, prudent to ensure that the advice sought is in writing and that the board of the charity records having received and considered the advice



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- Bill 154 provides protection from liability for losses to the trust 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" (s.10.2(7) CAA)
- The proposed amendment for social investments will now require charities to decide whether the proposed investment is to be:
  - A prudent investment under the *Trustee Act*,
  - A program related investment under the CRA's CED Guidance, that requires significant evidence of "direction and control" and an exit strategy to avoid revocation, as discussed above, and/or
  - A social investment under the CAA



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**E. CONCLUSION**

- Investments of charitable funds by churches and charities need to be carefully considered given the complexities that are involved
- It is important to understand the spectrum of options that are available when investing charitable funds as outlined in this presentation
- It is advisable that churches and charities develop and implement an appropriate investment policy to reflect the specific type of investment that the church or charity intends to embark on before investing

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