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October 21, 2019

INVESTMENT CHALLENGES AND OPPORTUNITIES FOR CHARITIES, INCLUDING SOCIAL INVESTMENTS AND DONOR ADVISED FUNDS (PLUS A SHORT UPDATE ON THE ONCA)

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OVERVIEW

- This presentation provides an overview of investment challenges and opportunities for charities
  - Prudent Investor Standard under the *Trustee Act*
  - Program Related Investments ("PRIs") under the Canada Revenue Agency's ("CRA") Guidance, and
  - Social Investments under recent amendments to the *Charities Accounting Act* ("CAA")
- The presentation will also explain donor advised funds
- Finally, the presentation will provide a brief update on the Ontario *Not-for-Profit Corporations Act, 2010* ("ONCA")

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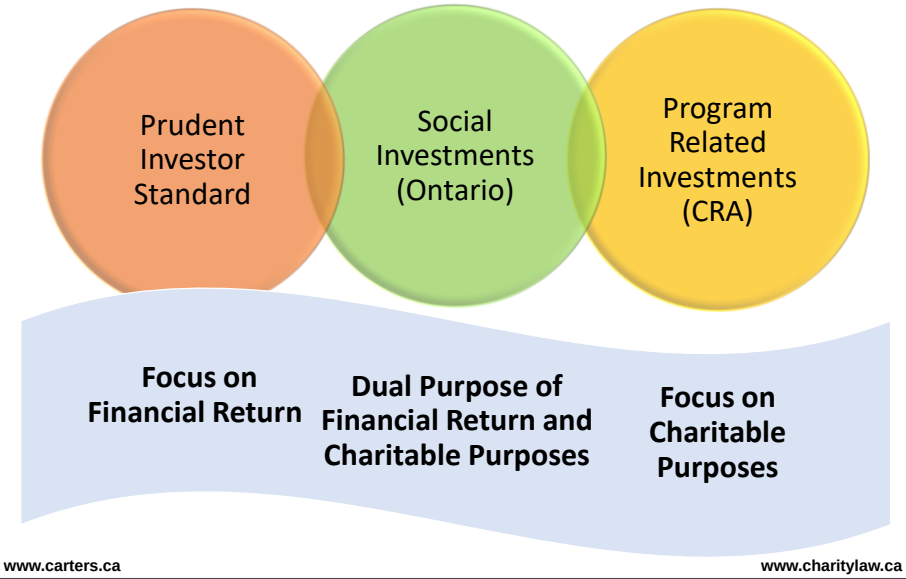
A. THE INVESTMENT SPECTRUM FOR CHARITIES



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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* (Ontario)

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 investor" 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 ("PGT") 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 in this presentation

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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 28 of the *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

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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) of the *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
- The agreement should not include a release or indemnification of the agent

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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 may not necessarily 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 an investment policy to reflect the requirements of the *Trustee Act* and what they need as a charity

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C. PROGRAM-RELATED INVESTMENTS

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

- Focus on charitable purposes rather than financial return
- 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 undertaken 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 as charitable expenditures in meeting the 3.5% DQ

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D. SOCIAL INVESTMENTS

1. Definition of Social Investments

- Charities may also establish a fund or receive gifts intended to undertake "impact investing", also referred to as "social investing"
- The CAA was amended on November 14, 2017
  - CAA applies to all charities in Ontario and under these amendments, charities are now permitted to make "social investments", by applying or using trust property to both: (s.10.2(2) CAA)
    - directly further the purposes of the trust; and
    - achieve a "financial return" for the trust
- "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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- In April 2018, the Ontario PGT released the "Charities and Social Investments Guidance" (the "Guidance")
  - The Guidance clarifies that "financial return" is not required to be at market rates, and, depending on the terms of investment, it may not require the re-payment of the invested capital
  - This suggests that even where the investment results in a partial loss of capital, it may still qualify as a social investment as long as the investment was directly furthering the charitable purpose of the charity

- Before a charity makes a social investment, it is important that the charity understands the legal issues that need to be considered in undertaking social investments, some of which are described below

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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"

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7. Issues Involving Social Investments

a) Identifying Types of Investments and Potential for Overlap

- It would 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 as a social investment, then it would likely need to meet the requirements of a PRI to avoid penalties or revocation of charitable status under the ITA

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b) Issue 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 as when making a PRI or a regular investment, for *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 holding “endowments” need to review their historical gift documentation to determine any limitations on the expenditure of capital, e.g. whether or not capital is to include realised capital gains

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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. DONOR ADVISED FUNDS UPDATE

1. What is a Donor Advised Fund ("DAF")?

- A DAF is a type of charitable giving vehicle, established when a fund is created by a donor through an initial donation to a registered charity ("DAF charity")
- The gift by the donor is irrevocable, and the donor receives a charitable donation receipt from the DAF charity in exchange for the gift
- Donations to DAFs can be cash, securities or other investments, insurance proceeds, or bequests
- Income generated by the capital in a DAF, as well as the capital, is gifted to qualified donees (most often to registered charities)

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- The donor is given the unique opportunity of making non-binding suggestions to the DAF charity regarding distribution of assets from the DAF to other charities
- However, despite this donor advice, all administrative, operational, and governance matters, including compliance with the ITA and the policies of the CRA, are the sole responsibility of the DAF charity, not the donor's
- All parties involved in DAFs should understand how DAFs work, both legally and functionally, in order to avoid unexpected problems or challenges in the future

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2. Who are the Key "Players" in DAFs?

a) Donors

- Various factors determine which charitable giving method is best, *e.g.* source of funding for gift, gift size, timing, and the type of charity the donor wishes to support
- It is generally thought that donors are attracted to DAFs because of their desire for ongoing "control" over DAF assets and their flexibility

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b) DAF Charities (often called "Sponsors")

- All are registered charities
- Community foundations
  - Focused on raising monies from donors in a particular geographical community
- In-house foundations of financial institutions utilized to make DAFs available to clients of the institutions
  - Financial institutions include large banks, credit unions, mutual funds and financial services firms
- Independent DAF charities
  - Registered charities not directly affiliated with a financial institution which are established to exclusively offer DAFs

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- Single issue focused charities
  - Established to receive and hold DAFs for benefit of particular sector, *i.e.* religious organizations, higher education facilities, etc.

c) Registered Charities

- Gifts from the DAF charity must be given to a qualified donee, usually registered charities
- Can be challenging to apply for grants directly from DAFs, but some DAF charities are now developing grant application systems

d) The CRA

- Regulator of registered charities

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e) Others, *e.g.* Financial Advisors and Financial Institutions

- Clients interested in establishing a DAF will often follow advice of their financial advisors on which charitable foundation to use
- Financial advisors may receive bonuses for these initial client referrals, as well as based on the ongoing amount of assets in the DAFs
- Financial institutions (with in-house foundations or partnerships with independent DAF charities) provide investment services for DAF assets held by DAF charities, resulting in management and investment fees

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3. What is a DAF at Law?

- DAFs are distinct funds within structure of DAF charities
- The original gift from the donor establishing a DAF could be unrestricted or, alternatively, subject to one or more donor restrictions, *e.g.* how long capital to be held or how income is to be used
- The uniqueness of a DAF relates to the donor advised "feature" impressed on the gift at its inception, *i.e.* the ability of the donor to offer ongoing "advice" to the DAF charity one or more aspects of the DAF
- However, while the DAF charity may have a contractual obligation to consult the donor on agreed upon DAF issues, the consultation feature is not a donor restriction *per se,* meaning a DAF on its own is not a special purpose charitable trust

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- That said, the DAF charity has both practical and moral obligations to follow donor advice
- For a DAF charity, the key issue is that the ownership of the DAF funds belongs to the charity, not the donor
- Given this, donors must be clearly informed from the outset that their input is advisory only and all DAF fund decisions are made by the charity
- This is imperative to do in order that all DAF donations will be true gifts at law and then properly receiptable under the ITA
- Where there is excessive on-going control by the donor over a DAF, then the CRA may consider the gift(s) to the DAF to be defeated or negated

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4. Are Some DAFs Really Gifts at Law?

- One of the more pressing concerns regarding DAFs is how much ongoing control a donor can have over the DAF after the gift is made
- A "selling point" of DAFs in some marketing communications is that they allow the donor to have the perception of ongoing "control" over who receives disbursements from the DAFs, the amounts and timing of disbursements, and even how the assets are to be managed or invested
- There can be a "disconnect" between how DAFs legally work versus how they work functionally
- Too much donor control over the DAF after the gift has been made begs the question of whether there is legally a gift, and if it is receiptable under the ITA

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5. Properly Establishing and Managing DAFs

- Documents creating a DAF must clearly state that
  - It is the DAF charity which administers the fund
  - The DAF charity reserves the right to not follow advice of the donor regarding how monies in the DAF are to be distributed or applied
- Gifting agreement could also address:
  - Minimum initial amount required to establish the DAF
  - Amount of time that donor has to contribute gifts to reach this minimum amount, and what happens if the minimum is not achieved by donor
  - Frequency of gifts made from the DAF, and the minimum amounts for gifts per year

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- General parameters for the types of QDs to be recipients of DAF gifts
- Frequency of and how donor's advice will be sought
- If and how donor is permitted to appoint a successor advisor to the DAF
- Any special investment powers that charity has in relation to the DAF assets
- A requirement that donor's advice (but not approval) be sought if the charity decides to transfer the DAF to another charity under the *Trustee Act*

• Gifting agreement should originate from the DAF charity, be thoroughly reviewed with the donor who should also obtain independent legal advice, and then signed by both parties

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• The charity must properly manage the DAF, which involves the following steps:
  - Compliance with donor restrictions, as well as donor advice and reporting requirements as set out in the gift agreement
  - Ensure that the DAF is tracked and managed separately from other DAFs or donor restricted trust funds
  - Ensure that the investments of DAF assets are done in accordance with the gift agreement or, if not set out in the agreement, then in accordance with the charity's general investment powers

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- Ensure that DAFs and restricted funds are not commingled with general funds for investment purposes
- Be aware that proceeds from a sale of charitable property held in the DAF are impressed with the original donor restrictions imposed at the time the DAF was established, if any, as well as the donor advised "feature"
- Ensure that any transfer of a DAF to another charity must be done using written appointment pursuant to s. 3 of the *Trustee Act*

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F. ONTARIO NOT-FOR-PROFIT CORPORATIONS ACT ("ONCA") UPDATE

1. Status of ONCA

- ONCA will hopefully be proclaimed in 2020!!
- Ontario *Corporations Act* ("OCA") has not been substantively amended since 1953 - Part III of OCA governs non-share capital corporations
- New ONCA will apply to Part III OCA corporations
- Key timeline of ONCA
  - October 25, 2010 - ONCA received Royal Assent
  - November 14, 2017 - Ontario Bill 154, *Cutting Unnecessary Red Tape Act, 2017* received Royal Assent to amend the OCA, ONCA and OBCA
  - See Charity & NFP Law Bulletin No. 409 at carters.ca

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2. Overview Of ONCA Transition Process

- ONCA applies automatically upon proclamation, except where overridden by existing corporate documents
- Optional transition process within 3 years of proclamation in order to make the necessary changes to their governing documents
- Prudent to go through the transition process by adopting new by-laws and articles of amendment
- If no transition process taken in 3 years, then
  - Corporation will not be dissolved
  - LP, SLPs, by-laws and special resolutions will be deemed amended to comply with the ONCA - will result in uncertainty
- Share capital social clubs under the OCA will have 5 years to continue under the ONCA, OBCA or the *Co-operative Corporations Act*

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3. Overview Of Some Key Elements Of The ONCA

- Removes ministerial discretion to incorporate - incorporation will be as of right
- Default by-law will apply if no by-laws adopted within 60 days after incorporation
- All corporations categorized into Public Benefit Corporations ("PBCs") and non PBCs with consequences concerning financial statements
- Minimum 3 directors
- Articles may provide a maximum and minimum range of directors
- Can have ex-officio directors
- Directors may appoint directors between AGMs - 1 year term, 1/3 cap

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- Directors are no longer required to be members
- Directors must consent to take office (all consents must be in writing)
- Objective standard of care for directors and officers
- Reasonable diligence defence for directors
- Optional proxy voting, voting by mail, voting by telephonic or electronic means
- Members may remove directors by simple majority vote (but not ex officio directors)
- Members have extensive rights and remedies similar to that of shareholders in some respects

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RESOURCES

- Terrance S. Carter, The Investment Spectrum for Charities, including Social Investments: http://www.carters.ca/pub/seminar/charity/2018/oba/OBA%20Paper%20Investment%20Spectrum.pdf
- Jacqueline M. Demczur, Primer on Donor Advised Funds and Current Issues: http://www.carters.ca/pub/seminar/charity/2019/Paper-Primer-or-Donor-Advised-Funds-and-Current-Issues-Jacqueline-Demczur-2019-05-06.pdf

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