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Impact Investing

A Guide for Philanthropists and Social Investors

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IMPACT INVESTING: A GUIDE FOR PHILANTHROPISTS AND SOCIAL INVESTORS

October 2013

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INTRODUCTION

Many would argue that current global economic and social trends require public charities, philanthropists and social investors[1] to think differently about how to use private resources to address society's intractable social and environmental challenges. Today, societal needs often exceed the capacity of governmental resources and traditional philanthropy, such as subsidies, outright gifts and grants.[2] Even though charitable donations by individuals in the United States rose by 1.9% (adjusted for inflation) last year to $229 billion, this amount is still 11% less than individual giving in 2007, before the economic downturn.[3] The nonprofit sector, in general, and organizations that provide fee-based services to governmental agencies are significantly under-capitalized. Moreover, according to the 2013 State of the Nonprofit Sector Survey results, three out of four U.S.-based nonprofit organizations, given current contributions and financial reserves, could not meet demand in 2012 and 54% of survey respondents probably will not be able to meet demand in 2013.[4]

In recent years, impact investing has emerged as a growing sector and economy and is considered by many experts in the fields of philanthropy and socially responsible investing as one of the most promising approaches to leveraging private resources to create social benefits. In fact, in 2009, the Monitor Institute estimated that the impact investment industry could grow from $50 billion in assets, the estimate at that time, to $500 billion by the year 2020 as more foundations, family offices, high-net-worth individuals and for-profit organizations make impact investments.[5]

The term "impact investing" was first coined in 2007 by the Rockefeller Foundation. Impact investing is essentially an umbrella term used to describe investments that create positive social impact beyond financial returns or an investment strategy that *intentionally* aligns the investments held by an organization, or in its portfolio, with the mission of that organization. In other words, impact investors (individual investors and institutions) seek to create social benefits, such as alleviating poverty and improving the environment, in addition to financial profits.

Over the past several years, advances in technology and communications have presented new pathways for philanthropists, governmental entities and investors to work together to achieve social good. The number of stakeholders and the kinds of products, services and legal entities used to fund impact investments continue to expand. Commentary, articles, reports and scholarly publications on the subject of impact investing are abundant. In fact, impact investing is often headline news in national and global periodicals and news blogs on a daily basis.

Within the context of, and as a complement to traditional philanthropy, this guide includes a high-level overview of the field of impact investing by examining several impact investing practices and strategies, namely, program-related investments, mission-related investments, socially responsible investments and social impact bonds. This guide also includes a high-level overview of the new legal entities that philanthropists and social investors are using to support impact investing strategies, such as low-profit limited liability companies, benefit corporations, flexible purpose corporations and, in the United Kingdom, community interest companies.

Finally, this guide will examine some of the challenges in implementing and evaluating impact investing strategies and explore specific points of entry for individuals, trustees of private foundations, managers of family offices and social investors seeking to be more engaged in this burgeoning field. While a comprehensive review of the field of impact investing exceeds the scope of the guide, a robust reference list has been included in the FOR FURTHER READING section. Citations to these reference materials are included throughout the discussion where applicable.

DEFINING IMPACT INVESTING

As referenced above, impact investments are often described as "investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return."[6] Impact investing is often referred to as "social investing," "impact-first investing," "social impact investing" and "impact finance." Generally speaking, impact investors can be classified in three main categories:

1. **Impact First** – Investors who *primarily* seek to maximize impact while secondarily expect financial returns, if any;
2. **Investment First** – Investors who *primarily* seek market-rate or premium returns and *secondarily* seek a positive social or environmental impact; and
3. **Catalyst First** – Investors who seek to give or invest in collaborations to build the impact investing industry and infrastructure.[7]

Each category of impact investors will necessarily have different motivations and expectations regarding financial and reputational risk, investment time horizons and how financial and social returns are measured. Impact investors include financial institutions, governmental entities, including cities and townships, pension funds, private foundations, family offices, social investors and individual philanthropists. So far, governmental entities and private foundations have been the primary providers of capital for impact investments. Apart from a few early champions, large financial institutions, including banks and pension funds, have been more hesitant to join the effort, although these entities are now gradually beginning to do so.[8]

Impact investments include most traditional asset classes: cash deposits, fixed income, loans, loan guarantees, debt and equity investments, private equity and venture capital. Impact investments are themselves considered to be an emerging, separate asset class.[9] And, as would be expected, the levels of financial and social returns vary significantly depending on the assets that are employed and the social and environmental challenges that are addressed.

Impact investments are commonly structured as: 1) program-related investments (PRIs); 2) mission-related investments (MRIs); 3) socially responsible investments; and 4) social impact bonds or "pay for success" contracts. Impact investments support various missions and program areas, including agriculture, education, health, housing and financial services. Impact investors may use a variety of legal entities to accomplish the goal of "doing well" while "doing good" including private foundations, social enterprises and so-called "hybrid organizations," such as low-profit limited liability companies, benefit corporations, flexible purpose organizations and community interest companies.

This guide will explore these key structures and the legal entities that facilitate impact investment strategies in more detail in the pages that follow.

Impact Investment Funds

The number of impact investment funds has grown dramatically over the last several years. Today, there are estimated to be more than 200 registered impact investment funds with global investments. ImpactAssets, a nonprofit financial services company which itself administers over $100 million in assets, maintains *The ImpactAssets 50*, a publicly available database of experienced private debt and equity impact investment fund managers. The IA50, as the database is often called, is not an index but is considered a "gateway into the world of impact investing" for investors seeking an easy way to identify investment firms and explore potential impact investment options.[10]

One of the largest impact investment funds is Acumen, formerly known as The Acumen Fund. Acumen is a nonprofit global venture fund that raises charitable donations to invest in social enterprises and entrepreneurs who seek to alleviate global poverty. Acumen seeks to build financially sustainable organizations that deliver affordable goods and services for the poor in the areas of health, water and housing. In its efforts to create methods for measuring the social and financial returns of its investments, Acumen helped create the Impact Reporting and Investment Standards (IRIS), which have been adopted by more than 50 impact investing funds. IRIS is a free, online catalog that provides standardized metrics for defining, measuring and comparing impact investments across sectors, including agriculture, environment, health, education, energy and financial services.

While a thorough analysis of impact investment funds exceeds the scope of this guide, philanthropists and social investors are encouraged to begin exploring the breadth of investment options highlighted in the IA50 database. In addition, a generous list of resources for further study has been provided in the FOR FURTHER READING section.

The Globalization of Impact Investing

Much of the growth and interest in impact investing has occurred in developed countries – the United States, the United Kingdom, Canada and Australia – where the capital to support education, health and environmental issues and other philanthropic activities is arguably the greatest. Yet investment opportunities for all categories of impact investors can be found around the globe. In fact, with the help of philanthropic organizations in the United States, impact investing may be growing at an even faster pace in developing countries and continents, such as India and Africa.[11] For example, The Omidyar Network, a philanthropic investment firm co-founded by eBay founder Pierre Omidyar and his wife, Pam Omidyar, plans to invest more than $200 million in for-profit and nonprofit organizations in India over the next three to five years. Similarly, Acumen, Gray Ghost Ventures, a global impact investor, and the Rockefeller Foundation plan to make grants and investments in India to fund social enterprise development programs and provide capital to increase investment opportunities in sectors such as affordable housing, agriculture, education, energy, health and water.[12]

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As the number of high-net-worth individuals and philanthropists increase outside of developed countries, and as philanthropic communities around the world are increasingly focused on achieving financial *and* social returns, impact investing will likely continue to be a global phenomenon.[13]

"In the past, commercial capital and social impact were clearly divided. The traditional approach is that you got rich with commercial capital and then you might do your philanthropy after the fact. You ran your business by any means necessary and then cleaned up the social and environmental problems thereafter. The fundamental idea of impact investing is to align the way a business generates profits with the way it generates positive social impact."

— Amit Bouri, Managing Director of GIIN. Source: *Impact Investing: An Introduction,* The Future of Finance Blog, Capital Institute, www.capitalinstitute.org/node/186.

PRIVATE FOUNDATIONS AND IMPACT INVESTING

Over the last several years, declining economic markets have dramatically reduced the investment portfolios of non-operating private foundations or "grantmaking" foundations.[14] Even as the financial markets have shown relative gains, charitable giving from grantmaking foundations has seen some decline.[15] Yet as the capacity of grantmaking foundations to participate in charitable giving has decreased, the need for the services that are funded by private foundations and governmental resources has steadily increased. Indeed, in the current environment, nonprofit organizations and philanthropists are exploring in earnest alternative funding sources to support their charitable efforts.

Similarly, many philanthropists are evaluating whether their charitable investments and grantmaking strategies are fully aligned or are taking steps to ensure that their investments are at least not working at cross-purposes with their charitable missions and values. For example, private foundations that seek to slow global warming are making grants to environmental nonprofit organizations and investing in clean-energy start-ups.

It is within this economic and social context that individual philanthropists and private foundations have become more engaged in impact investing. Proponents of impact investing maintain that private foundations, in particular, are uniquely positioned to employ impact strategies because these entities have access to pools of investment capital that are by law earmarked for social purposes. Indeed, along with the socially responsible investment and corporate social responsibility movements in the 1980s and 1990s, private foundations have played and will continue to play a vitally important role in building the impact investing market to its current size.

Program Related Investments (PRIs)

Arguably, the earliest impact investors were a small number of private foundations that participated in program-related investments, commonly known as PRIs, in the early 1970s.[16] The following section includes a detailed description of the legal and tax considerations of PRIs, how these special investments can be made and why PRIs are especially attractive to impact first investors.

Tax Considerations

Pursuant to Section 4944(c) of the Internal Revenue Code (IRC) a PRI is a special investment for which the primary purpose is to accomplish one or more of a private foundation's charitable purposes. The investment must lack a significant investment purpose and may not be used to influence legislation or take part in political campaigns.[17] As a special investment, a PRI is not subject to the "jeopardizing investment"[18] or "excess business holdings"[19] rules that would otherwise apply to investments held by private foundations and possibly subject the private foundation and its managers to significant excise taxes.

Complementing these exceptions to investment restrictions, Section 4942 permits a foundation to treat a PRI as a distribution in satisfaction of its minimum requirement. To maintain a tax-exempt status, Section 4942 requires non-operating private foundations to expend 5% of the foundation's prior year's investment assets (determined as a mean of monthly asset values) on a combination of administrative expenses and distributions to qualified charities.[20] To the extent that administrative expenses fall short of the 5%, most private foundations satisfy this requirement by making outright grants to operating charities. However, for purposes of complying with this requirement, a private foundation's PRIs are no different from outright grants.

In short, PRIs are not treated as investment assets of the private foundation while the investments are outstanding. Thus, PRIs are excluded from the calculation to determine the foundation's 5% annual distribution requirement. Nevertheless, the income generated by PRIs is treated as investment income. When the principal of a PRI is returned to the

foundation, the value of that principal is added to the distribution requirement in the year received, mandating the recycling of these charitable funds either into other PRIs or into outright grants. When a PRI becomes worthless, it has no effect on the foundation's distribution or reporting requirements, since the PRI is treated as an outright grant unless or until it is returned to the foundation.

How PRIs are Made

PRIs as an investment class may include low-interest loans (often in the form of bridge loans) [21], loan guarantees[22], real estate or equity investments. Depending on the size of the foundation and the needs of the PRI recipient charity, a PRI can range from $250,000 to $5 million.

PRIs can be made by private "grantmaking" foundations, as well as public grantmaking charities and other tax-exempt organizations. PRIs can be made to public charities as well as social enterprises and conventional for-profit businesses.[23] PRIs give public charities more flexibility so they do not need to rely solely on grants and private donations. For example, if a recipient charity receives a PRI structured as a loan it may be able to build a credit history and subsequently gain access to additional sources of private (bank) financing.

PRIs are made in a number of programmatic areas including the arts, education, human services, religion, international affairs and the environment. Certain nonprofit organizations and public charities are better-suited recipients of PRIs than others. For example, public charities that focus on housing and economic development usually have greater potential to pay back a loan. By contrast nonprofit organizations that are involved in social services, health care or the arts may not be in the best position to pay back a loan. Examples of PRIs include:

1. Investments in nonprofit organizations that combat community deterioration;
2. Low-interest loans to small businesses owned by members of economically disadvantaged groups that may not otherwise have access to commercial loans; and
3. Investments in nonprofit housing projects for low-income families.

Considerations for Philanthropists and Managers of Private Foundations

Essentially, PRIs allow private foundations to put resources to work to advance charitable missions through means other than grantmaking. Because the goals of making a PRI are primarily about supporting the mission of a foundation and creating social benefits and not making a return on an investment, PRI makers would arguably fall into the category of *impact first* investors, as referenced earlier in this guide. Considering current economic conditions, some foundations have considered using PRIs to more fully leverage charitable assets; gaining even a small return on an investment is considered optimal to making a grant that would provide no financial return.

The complexities relating to complying with the IRS rules and regulations, identifying investment opportunities and evaluating PRIs are significant, though hardly insurmountable. Here are several to consider:

- Foundations that are normally engaged in traditional philanthropic activities may need to hire staff, directors or investment managers who are experienced and comfortable overseeing a portfolio of PRIs.
- PRIs often resemble *charitable* activities rather than traditional investment activities. Designing an investment policy statement to cover such investments will require additional diligence.
- The due diligence that is required to manage PRIs is more rigorous and may require ongoing examinations, much more so than for traditional investments such as marketable securities, bonds or even private equity investments.
- Even before making a PRI, many foundations find it necessary hire legal counsel to evaluate a PRI to make sure it qualifies under the IRS definitions of charitable purposes and otherwise complies with IRS rules. Foundations will often seek a Private Letter Ruling from the IRS that verifies that a particular investment is a *qualified* PRI.
- Making a PRI may require a large investment by the foundation, which may ultimately be tied up for several years.

While the use of PRIs among small- to mid-sized foundations, including community foundations, is expanding. Of the more than 70,000 grantmaking foundations in the United States, only a few hundred of these foundations are engaged in making PRIs or have a formal PRI program. The complexities described above are often cited as the primary reasons why small- and mid-sized foundations use PRIs only on a limited basis, even when making such investments would fall squarely within the foundations' mission.

Indeed, grants may still be the most critical source of funds for countless charitable activities that cannot and should not be expected to repay loans, even at below-market rates. However, given that the current economic environment has put a strain on traditional grantmaking, private foundations may now have the best incentive to consider using PRIs as an impact investing strategy to supplement existing grants programs.

TABLE A includes a list of examples of IRS-approved PRIs. These examples have been acceptable standards since the 1970s when PRIs were first introduced. In response to taxpayer requests and to provide further guidance to private foundations that are engaged in PRIs, the IRS recently issued *proposed* regulations that include nine additional examples of investments that reflect current practices and qualify as PRIs. These examples are based on prior guidance and private letter rulings that have been issued since the regulations were first published. A description of these examples is provided in TABLE B.[24] Briefly, the new examples provide that a PRI may accomplish a variety of charitable purposes, such as promoting the arts, advancing science and combating environmental deterioration. One of the examples demonstrates that an investment that has the potential for a high rate of return does not necessarily prevent the investment from qualifying as a PRI. Another example demonstrates that an investment that funds activities in foreign countries may further the accomplishment of charitable purposes and qualify as a PRI.

TABLE A
IRS REGULATIONS – EXAMPLES OF PRIs

The following examples contained in Treasury Regulation 53.4944-3 apply to the exception for program-related investments for private foundations and give further guidance regarding what types of investments may be characterized as "program-related." These examples reflect an emphasis on the need for PRIs to be primarily in furtherance of the exempt purpose(s) of the private foundation, that no significant purpose should be the "production of income or the appreciation of property" and not influence legislation or a political campaign.

Although PRIs may generate profits – even significant ones – the regulations emphasize that profit may not be the primary objective. Rather, the IRS takes a "but for" approach, meaning that the investments would not have been made "but for" the fact that they are in furtherance of the private foundation's exempt purpose(s). However, changes in the structure of a PRI may reduce the exempt portion of the PRI.

Examples 1-6, 9 and 10 reflect this "but for" approach in the context of loans and other transactions made by financial institutions. Example 7 demonstrates that investing in the common stock of a corporation may not generally constitute a PRI if the work of that corporation does not align with the private foundation's exempt purpose(s). Example 8 provides guidance regarding scenarios in which a change in the form or terms of a PRI may reduce the portion of the investment a private foundation may treat as associated with an exempt purpose.

A SNAPSHOT OF PROGRAM-RELATED INVESTMENTS (PRIs)

REQUIREMENTS

PRI:

- Must be primarily for a charitable purpose
- Must not be used to influence legislation (lobbying) or participate in political campaigns on behalf of candidates (electioneering)
- Typically feature risk vs. anticipated returns ratios that would not meet business standards for a prudent investment (i.e., they lack a significant investment purpose)

TREATMENT

Private foundation investments that are structured as PRIs:

- Will be counted toward the 5% annual minimum distribution requirement
- Are excluded from the "jeopardizing investment" and the "excess business holdings" rules
- Once classified as PRI assets will remain PRI assets

In addition:

- Income from PRIs is treated as investment income by the private foundation
- Repaid PRIs are added to the distribution requirement in the year received
- PRIs that default or become worthless are treated as outright grants to charity

Example 1. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example 2. Assume the facts as stated in Example 1, except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

Example 3. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example 4. X is a business enterprise that is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic wellbeing of a deteriorated urban area because X employs a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration.

No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 5. X is a business enterprise that is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example 6. X is a business enterprise that is owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions that have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 7. X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Example 8. S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under section 4944(c) at the time that it is made. All of T's voting stock is owned by S. T experiences financial and management problems that, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

(a) Sale of stock or assets. The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.

(b) Lease. The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

(c) Management contract. The corporation enters into a management contract that gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944-3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

Example 9. X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 10. Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation and construction of housing for low-income persons. The investment has no significant purpose involving the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

TABLE B
INTERNAL REVENUE BULLETIN: 2012-21 — NOTICE OF PROPOSED RULEMAKING EXAMPLES OF PROGRAM-RELATED INVESTMENTS

The proposed regulations include additional PRI examples that more specifically reflect current investment practices and illustrate certain principles, including but not limited to:

1. An activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States;
2. The charitable purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas;
3. The recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose;
4. A potentially high rate of return does not automatically prevent an investment from qualifying as program-related;
5. PRIs can be achieved through a variety of investments, including loans to individuals, tax exempt organizations and for-profit organizations, and equity investments in for-profit organizations;
6. A credit enhancement arrangement may qualify as a PRI; and
7. A private foundation's acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI.

MISSION-RELATED INVESTMENTS (MRIS)

Another way that a private foundation can be engaged in impact investing is by including mission-related investments (MRIs) in the foundation's investment portfolio. MRIs are often referred to as "socially responsible investments," green investments," "impact investments," "double bottom line" investments (social and financial benefits) or "triple bottom line" investments (social, environmental and financial benefits).[25] Experts in the field often place MRIs under the heading of "mission investments," an umbrella term similar to "impact investments," which may also include PRIs. For purposes of this guide, mission-related investing is used because this term most commonly refers to market- or below-market-rate investments made using a foundation's investment assets.

The key difference between MRIs and PRIs is that the primary purpose of the MRI is to achieve a return on the foundation's investment, whereas, under Section 4944, the primary purpose of a PRI is to further the foundation's charitable aims. Thus, a PRI will generally be made without regard to the expected returns on the investment. Investors in MRIs are focused on achieving investment returns, with the shared or secondary goal of furthering charitable purposes – they are investment first investors.

EXAMPLES OF MISSION INVESTING

- An individual makes an investment in a certificate of deposit at a community development bank. The bank uses the funds to provide loans to local women-owned businesses in an effort to encourage economic development in the community and create jobs. The bank pays the individual (depositor) 1.5% interest and charges a below-market rate of 2.5% to the local business.
- A family foundation with a mission to protect the environment makes a direct investment in a private start-up company that develops clean-fuel technology for automobiles.
- A real estate developer seeking to strengthen her community purchases a building and hires a local management company to rent space to nonprofit organizations at below-market rates. A foundation provides a line of credit to a nonprofit organization to finance the purchase of affordable housing and undeveloped land in an economically depressed community.

Because an MRI (by definition) does not qualify under the Internal Revenue Code as the equivalent of an outright grant to charity, MRIs are not exempt from the rules governing private foundations, including the prohibition under Section 4944 against "jeopardizing investments" or under Section 4943 against "excess business holdings rules." Similarly, MRIs do not count toward meeting a foundation's 5% annual minimum distribution requirement under Section 4942 and are not excluded from the foundation's assets on which its 5% distribution requirement is calculated. Finally, state law requiring fiduciaries to prudently invest the assets of all charities (whether classified by the IRS as a private foundation or as a public charity) does not distinguish MRIs from standard investments.

That private foundations should use their endowments to advance social change is not a new concept. For example, the F.B. Heron Foundation has included program-related and mission-related investments in its portfolio since the mid-1990s. With the mission of helping people and communities to help themselves, the managers of the F.B. Heron Foundation have used grants, PRIs and MRIs to fully employ the Foundation's corpus, incrementally and proactively, and explore opportunities to fully leverage its philanthropic funds.[26] Other foundations that are leading the way as mission investors include the Annie E. Casey Foundation, the Meyer Memorial Trust, the W.K. Kellogg Foundation, the Skoll Foundation, the KL Felicitas Foundation and the Bill and Melinda Gates Foundation.

Research has shown, however, that the vast majority of foundations are not using their endowments in this holistic manner.[27] For example, it is estimated that in 2011, U.S. private foundations held assets totaling approximately $646 billion, and made grants totaling an estimated $46 billion.[28] If these foundations dedicated even 5% of their assets to these mission investments, there could be an additional $30 billion available for environmental and social programs.

"At the foundation, we see mission-driven investing as an additional tool to go beyond traditional grantmaking [that] enables us to achieve our triple bottom line – social returns, financial returns and learning returns – for the fields of philanthropy and business. When we all share what we know and what we've learned, we multiply the opportunities to get the outcomes we all want."

– Sterling Speirn, President and CEO, W.K. Kellogg Foundation. Source: Said Business School, University of Oxford and W.K. Kellogg Foundation Announce Launch of the Oxford Impact Investing Programme, Press Release, March 4, 2013.

CONSIDERATIONS FOR PHILANTHROPISTS AND FOUNDATION MANAGERS – USING INTERMEDIARIES

MRIs allow governing boards and managers of foundations and endowments to be more strategic in their efforts to advance a foundation's mission and gain access to the capital markets to deepen the impact of the mission. Because MRIs are viewed as conventional investments, albeit riskier investments, MRIs may be more attractive to foundation managers than are PRIs, which often require additional due diligence and ongoing oversight.

Yet, similar to making PRIs, structuring a portfolio of mission-related investments is not without its challenges. Managing MRIs necessarily will require a careful integration of a charitable entity's programs with its investment practices and procedures. Educating the governing board regarding the potential of using MRIs to further the mission, implementing internal controls to find appropriate investment opportunities, training the board and staff on how to source and evaluate investment opportunities, reducing financial and reputational risks, managing transaction costs and identifying the right benchmarks to measure the financial and social returns are all significant hurdles to consider.

Key Considerations for Foundation Managers in Selecting a Mission Investment Approach

Consideration	if low	if high
Amount of staff time available to source and manage mission investments	Investment intermediary	Direct investments
Level of staff investment expertise	Investment intermediary	Direct investments
Level of risk tolerance for potential loss of capital	Investment intermediary	Direct investments
Desire to invest in organizations beyond grantees	Direct investments	Investment intermediary
Desire to invest in asset classes beyond direct loans and loan guarantees	Direct investments	Investment intermediary
Desire for market rate financial returns	Direct investments	Investment intermediary

Source: Cooch, Sarah and Mark Kramer, *Aggregating Impact: A Funder's Guide to Mission Investment Intermediaries,* FSG Social Impact Advisors, November 2007.

Using Intermediaries

Because of these significant hurdles, many foundations will use mission investment intermediaries to help integrate MRIs into an existing portfolio of assets. Mission investment intermediaries are organizations, such as community development banks and venture capital and private equity funds, that collect capital from multiple sources (e.g., private investors, philanthropists and financial institutions) and invest in nonprofit organizations, social enterprises and for-profit businesses that deliver both financial returns and social impact. By using a mission investment intermediary, even modest investors (e.g., an individual or a foundation with a small staff) can support multiple organizations with one investment and have access to specialized expertise to minimize the risk associated with MRIs. Intermediaries allow investors to participate in a variety of investment opportunities in the areas of affordable housing, economic development, education and the environment.[29]

Understandably, whether investing in MRIs directly or through intermediaries, we believe foundations should proceed cautiously when considering shifting endowment funds to MRIs or less conventional investments. Grants are clearly now just one of many tools that foundation managers can use to further an entity's mission and support overburdened and capital-deplete nonprofit organizations. Given current social challenges and market constraints on traditional investments, there may be significant opportunity costs in not including MRIs in an investment portfolio of a charitable endowment or foundation.

TABLE C
A COMPARISON – PRIs AND MRIs

	PRIs	MRIs
Private Foundation Rules		
Minimum required distribution	Count toward foundation's minimum required distribution	N/A
Jeopardizing investment rules	N/A	Subject to jeopardizing investment rule
Excess business holdings	N/A	Subject to excess business holdings rule
Expenditure responsibility	Subject to expenditure responsibility and reporting obligations	N/A
Unrelated business taxable income	N/A	May result in unrelated business taxable income
Investments		
Period of investment	Several years depending on program goals	Several years depending on program goals
Expected investment rate of return	Below-market rate	Market rate
Suitable investments	Variable and subject to IRS regulations	Variable

SOCIAL ENTERPRISES AND HYBRID ORGANIZATIONS

The field of impact investing has been significantly fueled by new and innovative business models and legal structures referred to, respectively, as "social enterprises" and "hybrid organizations" that are enabling for-profit companies, nonprofit organizations, social entrepreneurs[30] and social investors to achieve financial returns while prioritizing social benefit objectives. Proponents of social enterprises and hybrid organizations would argue that conventional corporate structures and legal frameworks significantly hamper the efforts of impact investors who seek double- and triple-bottom line returns.

Given the decline in philanthropic contributions and state and federal subsidies, *nonprofit* organizations must now seek out alternative sources of revenues just to meet current demands for social programs and services. Similarly, directors and officers of *for-profit* companies who seek to prioritize social benefit over maximizing profits for shareholders need legal protections and less restrictive laws to allow them to participate in impact first, investment first or catalyst first investment opportunities.[31] Social entrepreneurs have recognized the limitations of the "not-for-profit" legal form and are increasingly deciding to organize and conduct business through social enterprises.

The following discussion includes a more thorough description of social enterprises and hybrid organizations, such as low-profit limited liability companies, benefit corporations, flexible purpose corporations and community interest companies, and a brief analysis of how these entities are contributing to the advancement of the field of impact investing.

Social Enterprises

A "social enterprise," also known as an "impact enterprise" or an "impact business," is essentially an organization or venture that achieves its primary social or environmental mission using various business models and methods.[32] Here are several characteristics of a social enterprise:

- Uses some or all of its earned revenue (and sometimes governmental subsidies and charitable contributions) to directly address social needs.
- Is different from a traditional nonprofit organization, which primarily relies on governmental and philanthropic support to deliver its products and services to those segments of society that are in need of such products and services.
- Can be distinguished from a "socially responsible business," which seeks to create positive social change indirectly by engaging in corporate social responsibility practices, such as donating a percentage of corporate profits to public charities, paying equitable wages to employees or using environmentally friendly raw materials in manufacturing activities.

An example of a social enterprise would be a business that seeks to advance green energy, where one division of the business functions as a nonprofit organization and is engaged in energy research and the other division functions as a for-profit energy consulting business. Both divisions are trying to advance the environment, share the same purpose and are controlled by the same managing board of directors.

Hybrid Organizations

"Hybrid organizations," otherwise known as "hybrid charities" or hybrid social ventures, are generally organized like traditional limited liability companies or for-profit companies and yet have the characteristics of both for-profit businesses and nonprofit organizations. Simultaneously, hybrid organizations focus on addressing social issues while creating positive investment returns for investors and shareholders.

Hybrid organizations have grown in popularity and use based on the needs of nonprofit organizations and for-profit businesses to raise additional revenues from sources that would otherwise be unavailable to these entities given their legal framework. For example, nonprofit organizations that are seeking to expand globally or improve the quality of their products and services may need to reach out to capital markets for additional sources of revenue. Similarly, for-profit companies that are interested in promoting socially responsible practices may seek to tap the resources of individuals and private foundations. For-profit companies also now have an incentive to reorganize as hybrid organizations to take advantage of the added protections that these entities provide to directors and officers who make impact first business decisions.[33]

In the United States, hybrid organizations include the low-profit limited liability company (L3C), the benefit corporation and the flexible purpose corporation (Flex-C). An equivalent hybrid organization in the United Kingdom is the community interest company (CIC). This guide will examine each of these entities in more detail.

1. Low-Profit Limited Liability Company (L3C)

A low-profit limited liability company (L3C) is a relatively new corporate structure, essentially a hybrid of a nonprofit organization and a for-profit company. An L3C is designed to attract charitable contributions and a wide range of investment resources from private foundations, social investors and social entrepreneurs, for the purpose of investing in economic development activities, social enterprises and for-profit companies that primarily have a charitable purpose.[34] An L3C is equally a hybrid of a for-profit company and a traditional limited liability company (LLC) in that an L3C offers the liability protection of a corporation and the flexibility of a partnership.[35] Profits and losses flow through the L3C to its members and are taxed according to each investor's particular tax situation. An L3C also offers protections for directors and officers from shareholder lawsuits when business decisions prioritize social or environmental benefits at the expense of profits.

The L3C is a new form of limited liability company that combines the best features of a for-profit LLC with the socially beneficial aspects of a nonprofit. It is the for-profit with a nonprofit soul.

Source: Robert Lang, Americans for Community Development. (www.americansforcommunitydevelopment.org).

In addition, most L3C legislation requires that the L3C's operating agreement specifically incorporates all of the federal tax requirements that apply to PRIs. For example: 1) an L3C must be specifically formed to further charitable or educational purposes; 2) no significant purpose of an L3C is the production of income or the appreciation of property; and 3) no purpose is to accomplish one or more political legislative purposes.[36]

As previously discussed, private foundations may not invest in for-profit businesses or social enterprises unless the investment qualifies as a PRI. Making a determination that an investment in a for-profit venture qualifies as a PRI often takes time and may be costly if the private foundation needs to acquire a Private Letter Ruling from the IRS. The primary goal of an L3C is to facilitate and encourage PRIs from private foundations.

L3C entities may be engaged in a variety of social ventures and charitable programs including, but not limited to, alternative energy, arts funding, carbon trading, economic development, environmental remediation, food bank processing, housing for low income and aging populations, medical facilities, medical research, social benefit consulting and media and social services.[37] While these activities are undoubtedly socially beneficial, they may also be financially risky. Thus, proponents argue that in order for an L3C to remain viable and attract philanthropic investments, it should be engaged in a venture that will consistently generate revenues from various sources.

TABLE D
A COMPARISON – LOW-PROFIT LIMITED LIABILITY COMPANY (L3C), LIMITED LIABILITY COMPANY (LLC) AND NONPROFIT ORGANIZATION 501(C)(3) OR OTHER TAX-EXEMPT ORGANIZATION.[44]

Type of Corporation	Organizational Purpose(s)	Potential Rate of Financial Return on Investment (ROI)	Private Sector Resources
Low-Profit Limited Liability Company (L3C)	Financial and mission-related	Between 0% and 5%	Philanthropic source invests with an expectation of lower than market rate of return; philanthropic investment lowers the risk and raises potential ROI for subsequent investors.
Limited Liability Company (LLC)	Financial	5% or greater	Market driven; making money and building wealth.
Nonprofit Organization	Mission-related	0% to negative 100%	Market incentives are inadequate or non-existent.

2. Benefit Corporation

Similar to an L3C, a benefit corporation is a new class of for-profit company designed to generate profits and create a general public benefit for society and the environment.[38]

While the laws relating to benefit corporations vary by state[39], the model legislation provides that a benefit corporation:

- Must exist and operate for the purpose of creating general public benefit (a benefit corporation may identify one or more specific public benefits, but such election does not limit the corporation's obligation to create general public benefit).
- Must publish an annual "benefit report" on the corporation's website detailing how the corporation performed on a social and environmental axis.
- Will be held to a third party's independent assessment to determine its social and environmental impact.
- Are subject to rigorous reporting standards to ensure that the benefit corporation is operating pursuant to socially responsible practices.
- Must provide a right of action to enforce the corporation's stated public benefit.

Directors and officers of benefit corporations:

- Must consider a broad array of constituents and stakeholders when making decisions (e.g., shareholders, employees, customers, community and societal factors, the local and global environment).
- Are not liable for damages for any failure of the corporation to create its stated general or specific public benefit.[40]

Unlike traditional for-profit corporation legislation, benefit corporation legislation expressly permits a corporation's directors to consider and prioritize non-financial interests and the social and environmental impacts of their decisions without fear of breaching any fiduciary duty to shareholders.

3. B Corporation

A B Corporation or "B Corp" is a nonprofit organization, L3C, social enterprise or for-profit business that has been certified by B Lab, a nonprofit organization that assesses organizations, social enterprises and for-profit businesses (which may or may not be organized as benefit corporations) to ensure they are meeting social and environmental accountability, performance and transparency standards, and encourages businesses to engage in activities that will help solve social and environmental problems.[41] B Lab also helps develop tools, advance public policies and provide incentives for businesses that are engaged in impact investing.

Specifically, B Lab certifies passing companies as "B Corps," much like LEED (environmental) certification for buildings, USDA certification for dairy products or Fair Trade Certification for coffee. B Lab is currently the most prominent third-party certifier of benefit corporations. To date, B Lab has certified 782 B Corps in 27 countries around the world and in 60 different industries.[42] And, while the B Corp designation carries no legal status and a benefit corporation need not be certified by B Lab, many benefit corporations find that the certification helps them attract consumers and investors, and overcome perceptions that they are using the socially responsible corporation designation merely as a branding or marketing strategy.

Benefit corporations and B Corps are often confused, understandably. In summary, a benefit corporation need not be certified as a B Corp and some B Corps are not organized as benefit corporations.

According to B Lab, B Corps (which may be legally structured as benefit corporations), are more likely than other kinds of socially responsible companies to:

1. Use suppliers from low-income communities;
2. Use on-site renewable energy;
3. Donate at least 10% of profits to nonprofit organizations;
4. Cover at least some of the health insurance cost for employees; and
5. Have women and minorities in management.

4. Flexible Purpose Corporation (Flex-C)

A flexible purpose corporation (Flex-C), similar to an L3C and a benefit corporation, is organized and incorporated pursuant to state statute. To date, California is the only state with Flex-C legislation[43].

According to the California statute, the Flex-C incorporating documents:

- Must select one or more charitable or public purpose activities or mission (anything that generally benefits its employees, society or the environment) that its directors will pursue, in addition to profits, in the management of the corporation.
- Must articulate the steps that the management will take to achieve the stated purposes.

Flex-C directors:

- Must provide a management discussion and analysis (special purpose MD&A) concerning the Flex-C's stated purpose(s) as set forth in its articles of incorporation.
- Must publish an annual report detailing its progress toward achieving its stated purpose.

Unlike a benefit corporation, a Flex-C can adopt a specific social or environmental goal rather than the broader obligations of a benefit corporation. Similar to a benefit corporation, the statute provides that Flex-C directors may be shielded by the "business judgment rule" for decisions that do not maximize profits. This heightened transparency and accountability requirement is more rigorous than the standard for a benefit corporation.

5. Community Interest Company (CIC)

Hybrid organizations have also emerged in several European countries. In the United Kingdom, for example, an individual or social entrepreneur can invest in a community interest company (CIC) designed to provide social benefits to the public. Every company seeking to register as a CIC:

- Must carry out activities that are for the benefit of the community (a reasonable person test is used to determine if the activities serve the public benefit).
- Will be monitored by an independent regulator charged with, among other things, initiating audits, appointing and removing directors and starting civil proceedings.
- Must limit a shareholder's dividends to a maximum of 20% of the value of her shares at the time of purchase.
- May only distribute up to 25% of the distributable profits.
- Must submit an annual report of its activities and its contributions to the public benefit.

CIC directors:

- Have a duty to the community, the shareholders and creditors.

TABLE E
A COMPARISON – LOW-PROFIT LIMITED LIABILITY COMPANY (L3C), BENEFIT CORPORATION, FLEXIBLE PURPOSE CORPORATION (FLEX-C) AND COMMUNITY INTEREST COMPANY (CIC)

	L3C	Benefit Corporation	Flex-C	CIC
Legal Status	Authorized by state statute. Is not a charity or nonprofit entity.	Authorized by state statute. Is not a charity or nonprofit entity.	Authorized by state statute. California is currently the only state that has legislation for Flex-Cs. Is not a charity or nonprofit entity.	Modeled on traditional company law, the U.K. Company Act. Is not a charity.
Purposes	No significant purpose of an L3C is the production of income or the appreciation of property. L3C model forms lack references to mission that other social enterprise models have.	Need not have as its primary objective a charitable purpose. Legislation requires the benefit corporation to have a "material positive impact" on society.	A specific purpose or mission that generally benefits society or the environment must be articulated in incorporating documents.	To provide social good to the public.
Investors	Allows private foundations to invest in L3Cs as program-related investments (PRIs). May be unattractive for some institutional investors because of tax and due diligence concerns.	Provides protection to investors against any right of action by third parties.	Provides protection to investors from potential shareholder suits, which makes these entities attractive to social entrepreneurs.	The ability of shareholders to buy and sell shares is controlled by a regulator. Shareholder profits are limited to the original investment, not adjusted for inflation.
Transparency	Lack the transparency requirements of benefit corporations and flexible purpose corporation statutes.	Heightened transparency and accountability. Success is held to standards articulated by an independent third-party and must be published on the corporation's website and made available to shareholders.	Heightened transparency and accountability.	Controlled by a regulator who is empowered to set dividend caps, start civil proceedings, initiate audits and do what is necessary to maintain public confidence.

Investing in Hybrid Organizations

Each of the hybrid organizations discussed in this guide – L3Cs, benefit corporations, Flex-Cs and CICs – are explicitly mission – or impact first legal entities. They are arguably more nimble and flexible, and thus, perhaps more appropriate vehicles for for-profit businesses and social enterprises seeking to attract capital from impact investors.

It is expected that the number of states and foreign jurisdictions that recognize hybrid organizations will continue to increase over the next several years. In fact, many experts in the nonprofit sector have envisioned an end to traditional public charities and in its place will be hybrid organizations. As more individuals and private foundations seek to be more engaged in impact investing, hybrid organizations allow the influx of what would be philanthropic dollars and private investments into for-profit businesses that promote social and environmental benefits. Philanthropists who may have spent their careers as entrepreneurs building and managing businesses find the hybrid models especially appealing because they look like the for-profit businesses that they have run.

Whether these new legal structures will significantly change how nonprofit and for-profit businesses, philanthropists and social investors engage in impact investing remains to be seen. For example, opponents of the L3C structure point out that private foundations can otherwise make a PRI into an LLC or other for-profit company that is not an L3C and therefore, L3Cs are not legally necessary and will likely create confusion among PRI investors.

State statutes that provide for the formation of these entities vary dramatically. What may be an acceptable purpose in California may not be appropriate in Vermont. Whether directors, officers and investors are liable for pursuing one social purpose over another, or not maximizing profits over social purpose, also depends on which hybrid model is used and the entity's business plan. Moreover, a director's liability and shareholders' rights vary depending on which "hybrid" is used, as do the rules about reporting requirements, transparency and accountability standards.

Even as more states pass legislation to create hybrid organizations, these entities will undoubtedly be scrutinized by the IRS. Currently, these entities are not recognized by the IRS as being tax-exempt and, therefore, contributions and investments in these entities may not be eligible for an income tax charitable deduction for the donor or investor.

SOCIALLY RESPONSBILE INVESTING (SRI)

Socially responsible investing (SRI) is an investment strategy that considers environmental, social and corporate governance criteria (ESG) to generate competitive and long-term financial returns while having a positive societal impact. Including SRIs in portfolios of personal and charitable assets is another way that philanthropists and social investors can be engaged in impact investing.

SRI is often described using various terms, including "ethical investing," "green investing," "responsible investing," "sustainable and responsible investing" and "values-based investing" to name several. SRI investors include, but are not limited to, individuals (ranging from modest investors to high-net-worth individuals), family offices, nonprofit organizations, private foundations, corporations, public and private pension funds, religious organizations and universities.

As previously defined, impact investing is an umbrella term used to describe an investment strategy that *intentionally* aligns the investments held by an organization with the mission of the organization. Socially responsible investors are quite similar to impact investors in that they seek to build portfolios of assets that *include* companies whose practices are socially and environmentally responsible. Socially responsible investors will also exclude or "screen out" those companies whose products and practices are irresponsible or contrary to the investors' personal goals and values or the mission(s) of their charitable organizations.[45]

While SRI investors are "mission-driven," they generally expect that their investments will return significant profits and are therefore different from *impact first* investors who *primarily* seek to maximize impact and *secondarily* expect financial returns, if any. SRI investors can choose among hundreds of SRI mutual funds and exchange-traded funds. Or, with guidance provided by research firms that compile ESG rankings of companies, investors can create customized portfolios of assets that may include cash, stocks, fixed income, private equity and real estate. Depending on the ESG screens that are used, the investment returns across SRI mutual funds will vary greatly.

Examples of socially responsible investments include: community development loan funds that support housing and social services and job creation, clean technology portfolios, or similar investments that provide significant environmental or societal benefits. These investments are often made in the United States, but there are several SRI funds that include companies whose primary activities are in developing countries.

Investing with a Conscience

Including SRI and integrating ESG issues into investment decisions provides an opportunity for philanthropists to better align mission and values with personal and philanthropic investments, especially when direct investments in PRIs or MRIs, for example, may not be feasible. Modern portfolio theory and current fiduciary practices and standards generally support the inclusion of SRI and ESG investments in portfolios when these investments can be shown to be profitable. While SRI and ESG investment managers continue to develop and test SRI and ESG measuring tools and determine how ESG integration affects either investment returns in domestic and international markets, or the sustainability of portfolios, research has shown a strong link between ESG strategies and long-term financial performance.

And, given recent corporate scandals, more investors view corporate governance issues as important, if not central, to making responsible investment choices. In this case, including SRI among charitable investments may not be a bad idea from a risk management perspective. It is through the screening process that investment managers are able to identify socially irresponsible companies that, according to the company's balance sheet, are profitable but may actually be exposed to lawsuits, boycotts and similar liabilities.

For these reasons and many others, the number of SRI mutual funds has grown significantly over the last decade. It is currently estimated that more than one of every nine dollars held in professionally managed portfolios in the United States – approximately $3.74 trillion – is invested in SRIs or pursuant to SRI strategies.[46]

Today there are more than 300 mutual funds in the United States, including alternative investments funds such as social venture capital and hedge funds that incorporate ESG criteria. [47]

Similar to impact investing, SRI continues to be an evolving capital market. Many SRI funds are relatively new and may lack historical data on performance. Also, like other aspects of impact investing, SRI and ESG investment managers are still working on ways to measure how ESG integration affects either investment returns or the sustainability of portfolios. [48] Not all investment consultants and managers are even familiar with SRI and ESG screening strategies and technologies, and may not know how to incorporate these strategies into a portfolio of assets. They simply may not be convinced that ESG integration leads to financial benefits. Indeed, just as the field of impact investing is just beginning to develop appropriate financial and social impact measures, SRI and ESG measurement tools are still being developed and tested by domestic and international markets.

Shareholder Advocacy

Individual investors and philanthropic entities seeking to better align personal and charitable assets with missions and values may want to become more engaged in shareholder advocacy. Often referred to as "active ownership" of publicly traded securities, shareholder advocacy simply means taking actions to encourage more responsible and progressive corporate behaviors and practices.
Shareholder advocacy practices may include:

- Participating in shareholder resolutions;
- Educating the public about a company's actions and behaviors that may have a detrimental effect on society; or
- Any actions brought by shareholders that seek to encourage the management or board of directors of a company to act as good corporate citizens while ensuring the long-term value and financial viability of the company.

Shareholder resolutions have been quite instrumental in cases where companies are or have been engaged in activities that were harmful to the environment (water management, greenhouse gas emissions and hydraulic fracturing), adverse to workers (employment discrimination, poor labor or human rights conditions) or that promoted unsustainable business practices (excessive executive compensation) or less than transparent governance and oversight (political contributions and activities). Since the 1970s, religious institutions, in particular, have been quite diligent and successful in influencing corporate behavior by filing shareholder resolutions urging corporate management to maintain strong ethical and governance standards.[49]

Interestingly, shareholder resolutions are often withdrawn before they are brought up for a vote among all of the shareholders. In some cases, the resolution may have failed to meet requirements set by the Securities & Exchange Commission. In most cases, however, shareholders were successful in garnering enough support from other shareholders or the public, or have attracted enough media attention that a company's leaders have chosen to take steps to address shareholders' concerns, to change corporate policies and otherwise ameliorate less-than-suitable behaviors and practices. In recent years, shareholder

advocacy activities have led to state and federal legislation and reform efforts requiring publicly traded companies to adopt more transparent policies and otherwise be more responsive to shareholders.

SOCIAL IMPACT BONDS

Historically, in the United States, individuals, private foundations, public charities and the federal government, by offering tax incentives for charitable giving, have been primarily responsible for directing philanthropic resources and subsidies to organizations and programs that would ameliorate society's most intractable social problems. Excluding charitable gifts made by corporate foundations, arguably the for-profit sector has not played a direct or substantial role in funding social benefit programs.

"By bringing in financing from private and philanthropic sources for demonstrated social interventions, social impact bonds offer a win-win-win proposition for governments that can provide well-proven interventions without using tax dollars, for local organizations that can take their programs to scale, and for investors that can get both a social and financial return."

Judith Rodin, president, The Rockefeller Foundation. Source: Press Release issued on April 9, 2013. www3.illinois.gov.

With the emergence of social impact bonds, the number of philanthropic stakeholders has the potential to increase dramatically. Indeed, finding and funding preventative solutions to today's social and environmental challenges often requires more than the efforts and available resources of governments, nonprofit organizations and philanthropists. And many would argue that governmental entities and philanthropists who seek to create positive social change now have an imperative to collaborate with profit-motivated investors.

Within the last few years, governmental entities in the United Kingdom, the United States, Australia, Canada and Israel, at federal, state and city levels, have begun exploring the potential of using social impact bonds (SIBs) to attract much needed private capital to fund social programs. Similar to other kinds of impact investments, SIBs are a new and innovative financing tool that provides an opportunity for impact investors to fund effective social programs and *potentially* earn a profit at the same time.

SIBs are not traditional bonds. They operate over a fixed period of time, but they do not offer investors a fixed rate of return. The rate of return offered to investors may even be below-market. Repayment to investors is contingent upon specified social outcomes being achieved. Generally, the higher the social impact, the higher the expected return to the investor. Therefore in terms of investment risk, SIBs are more similar to that of a structured product or an equity investment.

Here is a brief description of how SIBs, also known as "social innovation financing" and "outcomes-based" or "pay-for-success" contracts, are employed:

1. A governmental entity, such as a city, municipality or state department, identifies a specific social problem to be solved (e.g., reducing crime in an urban community, rehabilitating ex-offenders to reduce the likelihood that they will return to prison, building affordable housing or spurring economic development in poor communities).
2. The governmental entity identifies critical and innovative social programs to address the problem, defines the goals, metrics and outcomes by which success will be measured, and identifies nonprofit service provider(s) with the expertise to address the problem.

3. The governmental entity makes payments to a nonprofit service provider(s) (or to an intermediary(ies) or a bond-issuing organization(s)) that implements and manages the social programs and raises funds from the private investors (foundations, financial institutions and individuals) to fund the program.
4. If the program achieves the desired results, the governmental entity repays the investors (with returns based on the realized savings). The governmental entity utilizes the remaining savings to reinvest in the same program or other critical programs.
5. If the program does not achieve the desired result, the governmental entity does not repay the investor.

In other words, instead of using taxpayer dollars to fund a social program, the governmental entity relies on private investors to provide the capital and take the risk that would otherwise be assumed by the government and the nonprofit service provider if the program is not successful or does not achieve its stated objectives.

"Social innovation financing is not a heartstring puller, but the upside is powerful. With traditional philanthropy, you pay for the program and then the money is gone; this way the money comes back and can be recycled into the program to help more people."

George Overholser, founder and CEO, Third Sector Capital Partners. Source: Pettus, Ashley, *Pay for Progress – Social Impact Bonds*, Harvard Magazine, July-August 2013.

The earliest example of a social impact bond program can be found in the city of Peterborough in the United Kingdom. In an effort to reduce "post-release reoffending by prisoners," the British Ministry of Justice, with support from the Rockefeller Foundation, private investors, philanthropists and four nonprofit organizations, launched an SIB pilot program in 2010. If, after the first six years of the pilot, the program reduces the re-offending rate by 7.5%, the Ministry of Justice will pay investors a share of the long-term savings to the government or a return up to a maximum of 13%. If the re-offending rate does not drop to under 7.5%, investors will lose their entire investment.

In the United States, SIB programs are receiving significant attention and financial backing from philanthropic organizations (in the form of foundation grants), consulting and investment firms, the federal government, states and cities across the country. Well-known and well-heeled supporters include the Rockefeller Foundation, the Kennedy School of Government at Harvard College, McKinsey & Company, Michael Bloomberg and Goldman Sachs, to name several. For example, the Kennedy School of Government, with support from the Rockefeller Foundation, recently established the Social Impact Bond Technical Assistance Lab to state and local governments with technical assistance to develop pay-for-success contracts using SIBs. Colorado, Connecticut, Illinois, Michigan, New York, Ohio and South Carolina have already received SIB Lab support.

Similarly, the Obama Administration has for the last three years set aside funds for "pay for success" bond programs. President Obama has included a $300 million Pay for Success Incentive Fund in his 2014 budget to give incentives to local and state governments who are considering adopting or are using social impact bonds for problems ranging from prisoner recidivism to homelessness to juvenile asthma.

Considerations for Philanthropists and Social Investors

Proponents of SIBs recognize that many of the social challenges that governmental entities and nonprofit organizations are trying to solve cost more to treat than they would to prevent. Proponents also maintain that pay-for-success contracts encourage collaboration among various stakeholders – nonprofit organizations, governmental entities and private investors – and have the potential to more fully leverage the capital markets and create new investment products for social investors, foundations and financial institutions.

Opponents of SIBs suggest that only the safe, low-risk programs will receive funding from SIBs and that the more innovative and perhaps, riskier programs will not be able to attract funding from profit-driven investors. Moreover, opponents of SIBs argue that only those programs that can achieve quantitative, easy-to-measure benchmarks will receive funding while other programs with harder to measure social impacts and quality of life benefits will receive little attention.[50]

Because SIB programs are so new, and financial and programmatic results have not yet been fully reported, it may still be too soon to decide how the capital markets will be attracted to these products and whether this form of public-private partnership will yield the expected social and financial results. Similarly, it is questionable whether investors will want to wait 10 or 20 years to be repaid even though it may take that long to measure the real impact of the social programs that receive funding.

READY... SET... IMPACT!

The field of impact investing is now facing some of the same challenges as the more established microfinance sector experienced in its nascent years and, some would say, even today. When Muhammed Yunis, Nobel Laureate and the "father of microcredit," made his first investments in the form of loans to impoverished Bangladeshi women so they could create small, for-profit businesses, many believed that he was taking a risk that was greater than the potential return he would receive if and when the loans were paid back. Yet within a short time after Yunis made his first investments, individual philanthropists and private foundations stepped in and supplied the seed capital so that his Grameen Bank could make additional loans. These social investors continue to provide capital and philanthropic contributions to the intermediaries and microfinance institutions (MFIs) that manage microloans and a host of other financial products for poor entrepreneurs.

While the microfinance industry continues to attract billions of dollars from social investors, it has not advanced without significant challenges. At the start of the movement, proponents often made bold claims that microfinance would effectively alleviate rural and urban poverty and encourage gender equality and empowerment, in addition to other economic and social benefits. Over time, measuring the social impact of microfinance has proven to be difficult given that, among other things: 1) there is no uniform set of performance measures and standards used by practitioners; 2) there remain "quality gaps" in the financial services offered; and 3) the local nature of MFIs means that many still do not operate under regulatory supervisions.[51]

Similarly, some of the greatest challenges facing the field of impact investing appear to be insufficient legal and regulatory oversight and supervision, high administrative costs, inconsistent investment standards and inadequate criteria for measuring success. It is important to note that while there are generally accepted investment principles for

measuring financial returns, practitioners in the field, led by the Global Impact Investing Network (GIIN), Acumen and B Lab, are just beginning to develop principles and standards for measuring social and environmental impact.

"As impact investing is becoming an established asset class, there is more focus on returns and commercial opportunities. But in order for the sector to grow and have sustainable social impact, we need a full spectrum of capital from grants to returns-based capital."

Sachindra Rudra, India director, Acumen. Source: Singh, Namrata, *India Takes Centre Stage in Impact Investing*, The Times of India, June 10, 2013.

As the field of impact investing continues to evolve, as new and innovative impact strategies continue to be headline-grabbing news and as social benefit programs that are supported by impact investments begin to show results, the extent to which these challenges are addressed will likely influence how stakeholders – philanthropists, governmental entities, nonprofit and for-profit organizations, private investors and the capital investment markets – remain engaged.

Equally significant are the challenges philanthropists and social investors may face while attempting to include impact investments into an existing portfolio of assets or implementing an impact investment strategy alongside traditional investment strategies. For example, to effectively implement the impact investment strategies described in this guide, such as PRIs, MRIs and SRIs, investors may incur administrative and legal fees and other transaction costs. Setting reasonable expectations regarding returns and acceptable levels of risk may also be quite daunting. Finally, investors will need to need to continually monitor these strategies, as they would any non-traditional investment strategy, and this may be time-consuming and require long-term reporting.

However, we believe the benefits of participating in any of the impact investment practices and strategies described in this guide are quite compelling for several reasons including, but not limited to, the following:
Impact investing creates opportunities for philanthropists and social investors to:

1. Align investment strategies with mission(s) and values;
2. Recycle charitable dollars;
3. Achieve "double- and triple-bottom line" returns;
4. Gain access to the capital markets and allocate these resources to further social and environmental benefits; and
5. Engage with new partners and build collaborations to promote social change.

Opportunities to participate in the impact investing community are numerous and expanding every day. Based on our review of the field, here are several tips to help you find opportunities that are most suited to your objectives.

Learn About Impact Investing

A prerequisite to adopting even a modest impact investment strategy is to become familiar with the most appropriate "points of entry," which may depend on whether you are making an investment as an individual or on behalf of an institution such as a private foundation. This guide provides an overview of the most common and widely accepted impact investing practices and strategies. In addition, the FOR FURTHER READING section provides a robust list of educational resources as well as a list of several policy, research and advocacy organizations that support new investors and the impact investing community in general.

It may also be helpful to study the strategies employed and the experiences and successes of other impact investors. There are several individual philanthropists and foundations that have already entered the field of impact investing quite substantially, namely, the Annie E. Casey Foundation, the Bill and Melinda Gates Foundation, the F.B. Heron Foundation, the KL Felicitas Foundation, Meyer Memorial Trust, the Rockefeller Foundation and the Skoll Foundation.

Whether you are an *impact first, investment first or catalyst first* investor, creating a portfolio of impact investments of the kind described in this guide will necessarily require a rigorous and thoughtful analysis of the risks and rewards of allocating financial resources to non-traditional and, in some cases, more risky investments and strategies. Certainly, the time and costs associated with managing a portfolio of impact investments should be factored into the equation. In order to achieve optimal results from these investments, you may need to contribute to pooled investment funds or participate in collaborations and partnerships with nonprofit and for-profit organizations that may be cumbersome to manage.

If you are a member of a governing board and want to begin making impact investments on behalf of your institution, you may first want to fully understand the potential of using impact investments as a tool to further the mission before introducing investment opportunities to other board members. The need for, and extent of, education (for the board) will depend on the culture of the institution, the board's previous investment experiences, risk appetites and the board's openness to exploring innovative strategies where the likelihood of risk-adjusted financial returns may be unproven.

TABLE E
PRIVATE FOUNDATIONS AND ENDOWMENTS – BUILDING AN IMPACT INVESTING PROGRAM[56]

Initial Strategic Work	Organizational Purpose(s)	Potential Rate of Financial Return on Investment (ROI)	Private Sector Resources
■ Identify champions to drive process ■ Assess landscape of impact investing opportunities ■ Determine strategy based on mission, values and program ■ Perform baseline assessment: Where are we now? ■ Determine financial and social goals and metrics: Where are we going? ■ Foster relationship between investment and program "sides" of the foundation	Prepare investment policy or amend foundation's policy to clarify: ■ Target asset classes, deal size, and funding level and source ■ "Credit culture" as specified by pricing performance benchmarks, risk tolerance, collections, intermediary versus direct investing, and positioning	Determine infrastructure – how foundation will staff, partner, or outsource: ■ Internal education ■ Deal sourcing ■ Financial due diligence ■ Legal structuring and documentation ■ Deal negotiating and closing ■ Portfolio monitoring and reporting	Ongoing strategic management: ■ Human resources and systems for financial performance, social impact, innovation, leverage, collaboration, evaluation, learning, reporting and communication

Individuals, directors and trustees of foundations and endowments, and institutional investment managers would do well to consider the following questions before shifting assets that are earmarked for purely charitable purposes, such as grants, to assets that may deliver social and financial returns.

- Does the investment(s) align with my mission (or the mission of the foundation) and values?
- What issue(s) do I want to address, what type of capital is required and what organizational models are best suited to address the issue(s)?
- Does the investment(s) complement my/our existing investment strategies and grantmaking programs?
- What is the expected social or environmental impact?
- What is the expected financial return on the investment(s)?
- How will I/we manage risk and fulfill our fiduciary responsibility as a board member or investment manager?
- How long am I/are we willing to hold the investment(s)?
- How will I/we measure success?

Review Investment Policy Statement

Another prerequisite or a critical first step to adopting an impact investment strategy is to review and possibly amend your investment policy statement or, if you are a director or trustee of a foundation, the foundation's investment policy statement. More often than not, standard investment policy statements only vaguely address socially responsible or ESG investment criteria. Moreover, standard policies rarely have enough "oomph" to address the issues that are inherent with including impact investments, such as PRIs or MRIs, in a portfolio.

Quite simply, if you want to include MRIs in your investment portfolio, for example, you should ensure that the investment policy statement identifies MRIs as acceptable investments. It is also recommended that the statement include specific percentages of MRIs that may be considered and that social and environmental concerns may be taken into account in making investment decisions. You will also want to provide guidelines for how MRI strategies should be structured to meet the foundation's financial risk/return requirements and social goals. If you are investing on behalf of a foundation and the foundation is large enough to have program and finance committees, you'll want to make sure that decision-making is not siloed and finance committee members are well aware of the programmatic goals of the foundation.

Start with an Existing Portfolio

A second step to adopting an impact investment strategy is to thoroughly examine your existing portfolio of assets to determine if the assets are invested in a manner that supports your mission or the mission of the entity making the investments. Research has shown that certain asset classes may be better suited for generating particular kinds of social and financial returns.[52] For example, you might want to place cash and cash equivalent investments in credit unions or community development financial institutions (CDFIs) to support affordable housing in low-income communities.[53] You might also consider reallocating fixed income into corporate or municipal bonds that finance social, economic or environmental projects that are aligned with your mission.

Start Small

Implementing an impact investment strategy will require significant due diligence, time and resources. Of course, you will need to be able to maintain whatever strategy you employ long enough to be able to evaluate the social impact of your financial investments. In practice, impact investors will often make initial impact investments opportunistically and incrementally build larger, more strategic programs over time. You may want to set aside a small portion of assets – perhaps 1-3% – as a "carve-out" for impact investing. Instead of fully diversifying these investments across asset classes, you may want to focus on a particular asset class or, irrespective of class, select impact investments on a case-by-case basis that are compelling from a mission standpoint.

Similarly, many large and small foundations, whether run by family members or non-family staff, have taken a position that while they will continue to make direct charitable gifts and grants, they plan to gradually increase the percentage of impact investments in their portfolios. Grants are the life-blood of many public charities and not all grants can be converted to impact investments nor should they be. If your foundation is currently making traditional grants, you may want to begin exploring opportunities to restructure potential grants as investments. You may also want to talk with grantees about their needs and determine if one or more of your grantee organizations would be a suitable recipient of a PRI, for example, if this kind of special investment would help the organization achieve its mission.

Invest with a Community Foundation

If you are hesitant to include impact investments in an existing portfolio of assets, but want to invest in nonprofit organizations and social enterprises that are working to create social benefits at a local level, making an investment with a community foundation may be the most convenient way to leverage your financial resources. An increasing number of community foundations allow individuals to:

- Make contributions to a community foundation's existing impact investment fund.
- Allocate a percentage of donor advised fund assets to the community foundation's pool of impact assets.
- Co-invest into specific impact investments on an opt-in basis using non-donor advised fund assets.
- Create a separate mission-focused impact investment fund at the community foundation.

These options give donors and investors flexibility to pick and choose among investments based on preferences and ensures that, in most cases, the community foundation will provide the necessary oversight, due diligence and technical assistance on behalf of the donor/investor.

IMPACT INVESTING FOR PHILANTHROPISTS AND SOCIAL INVESTORS

BENEFITS

Impact investment strategies create opportunities to:

- Align investment strategies with mission(s) and values
- Recycle charitable dollars
- Achieve double- and triple-bottom line returns
- Gain access to resources from the capital markets
- Engage new partners and build collaborations to promote social change

CHALLENGES

Impact investing:

- Is often complex, can be time consuming and may entail significant legal fees and transaction costs
- Challenges traditional expectations regarding financial returns and acceptable levels of risks
- Often requires programmatic and financial managers to work together
- May require long-term reporting and monitoring

Engage the Millennial Generation

Some would say that the future of philanthropy and social investing rests squarely on the shoulders of the next generation of leaders and social investors who seek to tackle the world's most challenging social problems. The Millennial generation of wealth inheritors (born from 1981-1995), in particular, expect to "do well" and "do good." They believe that funding a social enterprise rather than making a charitable contribution is a more effective way to achieve social benefits. They are showing great interest in incorporating socially responsible investments in their personal investment portfolios and customizing the portfolios of their families' charitable foundations to be environmentally and socially impactful. According to a recent study conducted by the Spectrem Group, a research and consulting firm in the wealth and retirement industry, nearly half (49%) of Millennials with more than $1 million net worth said that social responsibility is a factor in evaluating investment opportunities.[54]

"The James Lee Sorenson Center for Global Impact Investing will provide unparalleled experiences for our students and faculty to participate directly in solving some of the world's thorniest and most persistent societal problems. The Center will be a global leader in the creation of new knowledge of how to solve widespread structural problems, while training a generation of transformative leaders in social impact investment."

David Pershing, president, University of Utah. Source: School Creates the James Lee Sorenson Center for Global Impact Investing, University of Utah Press Release, January 29, 2013.

In addition, Millennials are choosing to work in fields to ensure that their efforts will contribute to positive societal outcomes. To that end, billionaire philanthropists around the globe are contributing millions to fund student learning centers to promote the fields of social innovation, responsible investing and impact investing. Several universities and colleges in the United States and the United Kingdom, in partnership with private philanthropies and investors, now offer degrees, certifications and other opportunities for students and entrepreneurs to gain practical experience in impact investing and social entrepreneurship.[55]

As more "next generation" wealth inheritors are encouraged and trained to be transformative leaders and active participants in shaping policies, building sustainable businesses and social enterprises that create large-scale societal change, the rapid growth of the impact investing industry will surely continue.

CONCLUSION – THE FUTURE OF PHILANTHROPY?

Philanthropy has historically been an essential catalyst and the primary tool by which individuals and institutions have addressed economic, environmental and social challenges. Arguably, impact investing is one of the most innovative solutions to address these challenges in the 21st century and beyond. As private, public and philanthropic assets continue to flow into social impact bonds and socially responsible investments, and as the number of social enterprises and hybrid organizations continues to increase, there will be even more opportunities for philanthropists and large and modest investors to "do well" while "doing good."[57]

"Social investment can be a great force for social change on the planet. It can help us to build bigger and stronger societies. That power is in our hands. And together we will use it to build a better future for ourselves, for our children and for generations to come."

David Cameron, prime minister, United Kingdom. Source: Speech presented at the G8 Social Impact Investment Forum, June 6, 2013.

For as many proponents as there are, there is an almost equal number of critics who believe that impact investing will likely not achieve the financial and social returns investors expect.[58] Whether you are approaching impact investing based on your experiences as a philanthropist, as a trustee of a charitable foundation or as a social investor, the success of your impact investments will be contingent upon identifying the appropriate investment vehicles and models and aligning your goals with the right structure. You will want to establish a process and a discipline around your investing, and consult with advisors along the way.

Given the scope of the economic, social and environmental challenges facing the social sector, local and national governments and our global community, it is imperative that philanthropists and social investors use whatever tools are available to address these challenges. While every social challenge may not be solved by impact investing strategies, effective philanthropy means leveraging resources as fully as possible to drive social change. As a set of tools, the impact investments strategies described in this guide, offer individuals and institutions tremendous power to shape, accelerate and scale desired results.

Impact investing may not be appropriate for every investor. Depending on your tolerance for risk, your investment time-horizon and your expectations for achieving positive social outcomes, you may be more comfortable focusing on making direct charitable gifts, investing in microfinance equity funds or socially responsible investments to advance your mission. Undoubtedly, however, the field of philanthropy is evolving and impact investing may just be its future.

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IMPACT INVESTOR NETWORKS AND RESEARCH ORGANIZATIONS

Confluence Philanthropy (www.confluencephilanthropy.org) Confluence Philanthropy is a nonprofit network of private, public and community foundations that provides technical assistance to foundations that seek to align the management of assets with organizational mission, specifically in the areas of environmental sustainability and social justice.

GIIRS (www.giirs.org) GIIRS is a comprehensive and transparent system for assessing the financial, social and environmental impact of developed and emerging market companies and funds with a ratings and analytics approach analogous to Morningstar investment rankings and Capital IQ financial analytics.

Global Impact Investing Network (www.thegiin.org). GIIN is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing.

Global Reporting Initiative (www.globalreport.org). The Global Reporting Initiative (GRI) is a nonprofit organization that promotes economic, environmental and social sustainability. GRI provides all companies and organizations with a comprehensive sustainability reporting framework that is widely used around the world.

ImpactAssets (www.impactassets.org). ImpactAssets provides impact investment products, including a donor advised fund and impact investment notes, and educational resources to support individuals and advisors looking to engage in impact investing.

Impact Reporting and Investment Standards (IRIS). (www.iris.thegiin.org). IRIS is a set of standardized metrics that can be used to describe an organization's social, environmental and financial performance. IRIS' independent and performance measures help organizations assess and report on their social performance.

Mission Investors Exchange (www.missioninvestors.org). Mission Investors Exchange is a "go-to" place for individuals and foundations who are interested in mission investing, both program-related and mission-related investing to exchange ideas, tools, and experiences to increase the impact of their capital.

Resource Generation (www.resourcegeneration.org). Resource Generation organizes young people with financial wealth to leverage resources and privilege for social change.

Social Venture Network (www.svn.org). Social Venture Network connects and supports business leaders and social entrepreneurs who seek to build a just a sustainable economy.

Toniic (www.ussif.org). Toniic is a global network that provides feedback, education, investor tools and support to social entrepreneurs.

US SIF – The Forum for Sustainable and Responsible Investment (www.ussif.org). US SIF – The Forum for Sustainable and Responsible Investment is the U.S. membership association for professionals, firms, institutions and organizations engaged in sustainable and responsible investing. US SIF and its members advance investment practices that consider environmental, social and corporate governance criteria to generate long-term competitive financial returns and positive societal impact.

ENDNOTES

1 Social investing is the general practice of considering social or environmental factors in investment decisions. Social investors include individuals, charitable foundations, pension funds, corporations and institutional endowments.

2 A grant is a donation of funds with no expectation of repayment or financial returns. Typically grant-makers are charitable foundations, governmental entities and private sector entities. Grant recipients are charitable and nonprofit organizations, non-governmental organizations (NGOs), educational and health-related institutions and in some instances, individuals and social enterprises.

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6 See The Global Impact Investing Network (GIIN), *About Impact Investing*, http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html. GIIN is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing.

7 See Lauren Agnew, *Impact Investing for Small, Place-Based Fiduciaries: The Research Study Initiated by the United Way of the Bay Area*, Center for Community Development Investments, Federal Reserve Bank of San Francisco, December 2012, Working Paper 2012-05. *See also* Monitor Institute, *Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry*, 2009:31.

8 One of the most prominent players in the field of impact investing is the Rockefeller Foundation. Over the past several years, the Rockefeller Foundation has invested more than $40 million in organizations and networks that encourage impact investing. In addition, the Rockefeller Foundation has invested more than $140 million of its own endowment into impact investments. See Quinton, Sophie, *The Hottest Trend for Wealthy Do-Gooders*, National Journal, May 7, 2013.

9 *See* Global Impact Investing Network (GIIN), J.P. Morgan and the Rockefeller Foundation, *Impact Investments – An Emerging Asset Class*, November 2010. According to this report, an emerging asset class: 1) requires a unique set of investment/risk management skills; 2) demands organizational structure to accommodate this skill set; 3) is serviced by industry organizations and associations; and 4) encourages the development and adoption of standardized metrics, benchmarks and/or ratings.

10 See http://www.impactassets.org/impactassets-50.

11 According to estimates provided by JP Morgan and the Global Impact Investing Network, impact investments in the developing countries and continents will grow to $400 billion – $1 trillion worth of capital. See, Ghosh, Debojyoti, *Impact Investments Lend Social Businesses Helping Hand*, The Financial Express, Bangalore, India, March 25, 2013.

12 Singh, Namrata, *India Takes Centre Stage in Impact Investing*, The Times of India, June 10, 2013. According to research conducted by the Rockefeller Foundation, impact investing has already generated approximately $100 million of capital in India and may grow at a rate of 30% per year.

13 In East Asia and the Pacific, for example, there is estimated to be more than $10 trillion in combined assets among high-net -worth individuals in the region. Judith Rodin, president of the Rockefeller Foundation, argues that mobilizing even just 1% of this wealth through impact investing could make a tremendous difference to the hundreds of millions who lack access to education, clean water and health care. Rodin, Judith, *The Human Face of Impact Investing*, http://www.rockefellerfoundation.org/blog/human-face-impact-investing.

14 Estimates show that the recent economic crisis cost foundations close to one-fifth of the value of their assets. See Lawrence, S. and R. Mukai, *Foundation Growth and Giving Estimates: Current Outlook*, Foundation Center, New York, 2009.

15 Interestingly, grantmaking by family foundations has risen substantially over the last several years. Many wealthy donors will establish family foundations rather than make gifts directly during their lifetime or via bequests upon their deaths. Giving by individuals, bequests and family foundations is estimated to be $273.48 billion in 2012 or 86% of total giving.

16 With the passage of the Tax Reform Act of 1969, PRIs became a legally recognized form of private foundation distribution.

17 The regulations under Section 4944(c) define a program-related investment as an investment: (1) the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B) (i.e., religious, charitable, scientific, literary or educational purposes or to promote national or international amateur sports competition or toward the prevention of cruelty to children or animals, in short, for "charitable purposes"); (2) no significant purpose of which is the production of income or the appreciation of property; and (3) no purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(D) (i.e., attempting to influence legislation or participating in or intervening in any political campaign).

An investment is made primarily for charitable purposes if it significantly furthers the private foundation's exempt purposes and would not have been made but for the investment's capacity to further the private foundation's exempt purposes. In determining whether a significant purpose of an investment is the production of income or the appreciation of property, §53.4944-3(a)(2)(iii) provides that it shall be relevant whether investors who are engaged in the investment solely for the production of income would be likely to make the investment on the same terms as the private foundation.

18 Section 4944(a) imposes an excise tax on a private foundation that makes an investment that jeopardizes the carrying out of any of the private foundation's exempt purposes. Section 4944(a) also imposes an excise tax on foundation managers who knowingly participate in the making of a jeopardizing investment. Section 4944(b) imposes additional excise taxes on private foundations and foundation managers when investments are not timely removed from jeopardy.

Generally, under §53.4944-1(a)(2), a jeopardizing investment occurs when, based on the facts and circumstances at the time the investment is made, foundation managers fail to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation. The determination of whether an investment is a jeopardizing investment is made on an investment-by-investment basis, taking into account the private foundation's entire portfolio. In exercising the requisite standard of care and prudence, foundation managers may take into account the expected investment return, price volatility and the need for portfolio diversification.

19 §53.4943-10(b). Section 4943 imposes an initial excise tax on a private foundation that holds, in conjunction with all "disqualified persons," more than a certain percentage of a business enterprise, defined as an entity deriving more than 5% of its revenues from something other than passive investments or brokerage services.

20 Section 4942. Qualified charities include public charities and private operating foundations that are not controlled by the distributing foundation. A controlled public charity or operating foundation and any private foundation will be treated as a qualified charity if it distributes the entire grant no later than the end of the year following the year in which it was received, and provides adequate documentation to the granting private foundation that such distribution has been made.

21 Most PRIs are below-market-rate loans made to nonprofit organizations with interest rates between 0-3%.

22 Loan guarantees will be counted toward a private foundation's distribution requirement only to the extent that funds are actually disbursed.

23 Private foundations can make PRIs to for-profit businesses or entities that are not 501(c)(3) public charities if the investment proceeds are used for charitable purposes and the foundation exercises "expenditure responsibility." The private foundation must demonstrate the charitable purposes of the PRI in advance and monitor the use of the PRI for the life of the investment. See IRS, "Grants to Organizations," http://www.irs.gov/charities/foundations/article/0,,id+137611,00html; and IRS, "Expenditure Responsibility," http://www.irs.gov/charities/foundations/article/0,id=137613,00.html.

24 Taxpayers may rely on the examples provided in the proposed regulations §53.4944-3 until final regulations are published.

25 See *Triple Bottom Line: It Consists of Three Ps: Profit, Planet and People*, The Economist, November 17, 2009. The term "triple-bottom-line" was first coined by John Elkington in 1994, who argued that business should consider people, planet and profit instead of pure profit as the bottom line of a business.

26 See Swack, Michael, *Expanding Philanthropy: Mission-related Investing at the F.B. Heron Foundation*, School of Community Economic Development at Southern New Hampshire University and the F.B. Heron Foundation, 2009.

27 See Kramer, Mark R. and Sarah E. Cooch, *The Power of Strategic Mission Investing*, Stanford Social Innovation Review, Fall 2007.

28 Lawrence, Steven, *Foundation Growth and Giving Estimates*, The Foundation Center, June 2012.

29 See Cooch, Sarah and Mark Kramer, *Aggregating Impact: A Funder's Guide to Mission Investment Intermediaries*, FSG Social Impact Advisors, November, 2007.

30 There may not yet be a concise definition or a clear consensus in the field of the term "social entrepreneur." However, in an article published in the *Stanford Social Innovation Review*, authors Roger L. Martin and Sally Osberg define a social entrepreneur as an individual "who targets an unfortunate but stable equilibrium that causes the neglect, marginalization or suffering of a segment of humanity; who brings to bear to this situation his or her inspiration, direction, action, creativity, courage and fortitude; and who aims for and ultimately affects the establishment of a new stable equilibrium that secures permanent benefit for the targeted group and society at large." *Martin and Osberg, Social Entrepreneurship: The Case for Definition*, Stanford Social Innovation Review, 9 Spring 2007.

31 See *DEFINING IMPACT INVESTING* section of this guide.

32 See *What is Social Enterprise?*, Social Enterprise Alliance (www.se-alliance.org).

33 Fiduciary duties of care and loyalty, "shareholder primacy" and what is often referred to as the "business judgment rule" often make it difficult for a for-profit company to consider community and environmental interests and the effects of the company's actions on the well being its employees and the community. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)(A director's decisions must be "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.")

34 Robert Lang of Americans for Community Development introduced the concept of the L3C in 2005. The first L3C legislation was passed in Vermont in 2008. As of the date of this guide, eight additional states and two federal jurisdictions – the Oglala Sioux Tribe and the Crow Indian Nation of Montana – have enacted L3C statutes: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah and Wyoming. An L3C that is formed in these jurisdictions and states, similar to a Delaware corporation, will be recognized in any state. To date, more than six hundred and thirty L3Cs have been formed in states with laws that allow for this structure.

35 In most states that recognize L3Cs, the legislation is generally enacted as an amendment to the existing laws for LLCs.

36 Specifically, the Vermont L3C statute provides:
(A) The company (i) significantly furthers the accomplishment of one or more charitable or educational purpose with the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(D). *State of Vermont, Act of the General Assembly, No. 106*.

37 Pon, Sandy, *Have your Heard about the L3C Nonprofit/For-profit Hybrid?*, Foundation Center, Philanthropy Front and Center-Washington, D.C., July 6, 2009; see generally Community Wealth Ventures, Inc., *The L3C: Low-Profit Limited Liability Company*, Research Brief, July 2008. *For a more comprehensive analysis of L3Cs, see* Phen, Roxanne, *The Future of Philanthropy – Hybrid Social Ventures*, Claremont McKenna College, April 26, 2010.

38 The Model Benefit Corporation Legislation defines "a general public benefit" as a "material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation." Examples of "specific public benefit" include, but are not limited to: 1) providing low-income or underserved individuals or communities with beneficial products and services; 2) promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business; 3) preserving the environment; 4) improving human health; 5) promoting the arts, sciences, or advancement of knowledge; 6) increasing the flow of capital to entities with a public benefit purpose; or 7) the accomplishment of any other particular benefit for society or the environment. Model Benefit Corporation Legislation, Version 12.21.12.

39 As of the date of this guide, 18 states and the District of Columbia, have benefit corporation statutes: Arkansas, Arizona, California, Colorado, Delaware, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Nevada, New Jersey, New York, Pennsylvania, Oregon, South Carolina, Vermont and Virginia. Twelve more states have legislation pending.

40 See Clark, Jr., William H. and Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors, and Ultimately, the Public*, January, 2013.

41 B Lab has also developed a system for benchmarking an individual company, a portfolio of companies and impact investment funds called the Global Impact Investing Rating System (GIIRS) which is based on the Impact Reporting and Investment Standards (IRIS). (www.iris.thegiin.org). IRIS is a set of standardized metrics that can be used to describe an organization's social, environmental and financial performance. IRIS' independent and performance measures help organizations assess and report on their social performance.

42 www.benefitcorp.net. A partial list of founding Certified B Corporations and recognizable companies include, Ben & Jerry's, Dansko, Etsy, Guayakí Sustainable Rainforest Products, King Arthur Flour Company, Mosaic, New Leaf Paper, Numi Organic Teas, Patagonia and Seventh Generation.

43 Corporate Flexibility Act of 2011, Cal. Corp. Code 2500-2517 (West 2011). The state of Washington became the first and only state to recognize the social purpose corporation (SPC) as a corporate entity. Briefly, SPCs are organized: "in a manner intended to promote positive short-term or long-term effects of, or minimize adverse short-term or long-term effects of, the corporation's activities upon any or all of: (1) the corporations' employees, suppliers or customers; (2) the local, state, national, or world community; or (3) the environment. Substitute House Bill 2239, §1. 62d Leg., Reg. Sess. (Wash. 2012).

44 Source: Americans for Community Development, www.americansforcommunitydevelopment.org.

45 An SRI strategy typically uses one or more methods to screen companies for inclusion in an SRI portfolio: 1) a *negative* screen is used to exclude companies that are involved in a particular sector, such as alcohol, gambling, pornography, tobacco or weaponry; 2) a *restrictive or best-in-class* screen is used to permit investments in companies where a relatively small amount of the companies' activities are involved in less than desirable sectors; and 3) a *positive* screen is used to include companies that are involved in practices that contribute to social and environment benefits. Negative screens may not necessarily result in investments that advance the entity's charitable mission. Positive screens, such as targeting companies that have strong environmental records, may result in mission-related investments being included in the portfolio if the screening criteria are also tied to the entity's mission.

46 US SIF The Forum for Sustainable and Responsible Investment, 2012 Report on Sustainable and Responsible Investing Trends in the United States, (www.ussif.membershipsoftware.org/trends). According to the US SIF 2012 Report, assets under management using one or more sustainable and responsible investing strategies increased from $3.07 trillion at the beginning of 2010 to $3.74 trillion at the beginning of 2012, a growth rate of more than 22%. Total assets under management, as tracked by Thomas Reuters Nelson, was $33.3 trillion. SRI investments represent 11.23% of total assets.

47 US SIF The Forum for Sustainable and Responsible Investment, 2012 Report on Sustainable and Responsible Investing Trends in the United States, (www.ussif.membershipsoftware.org/trends). According to the report, as of 2012, there were 333 mutual fund products with assets of $640.5 billion. In addition, the report identified an estimated $132 billion in capital under management at the start of 2012 compared to just $37.8 billion identified at the start of 2010.

48 See Carter, Drew, *Making Sure ESG Works is Next Step in Its Evolution*, Pensions & Investments, January 23, 2012.

49 See *The Impact of Sustainable and Responsible Investing*, for more information about how sustainable and responsible investors have influenced the investment industry and public policy. US SIF, The Forum for Sustainable and Responsible Investment, SRI Impact Paper, March 2012 (www.ussif.org/files/Publications/SRIImpactOverview.pdf).

50 See Kriesberg, Joe, *Op-Ed: Will Social Impact Bonds Improve Nonprofit Performance?*, The Nonprofit Quarterly, March 8, 2011, originally published on the MACDC (Massachusetts Association of Community Development) blog on March 2, 2011.

51 See Griffin, *Marguerite, Microfinance: A Primer for Donors and Investors*, Northern Trust, September 2008.

52 See Trillium Asset Management, *Total Portfolio Activation: A Framework for Creating Social and Environmental Impact across Asset Classes*, 2012.

53 CDFIs include, but are not limited to: banks, credit unions, loan funds, bond funds and venture capital funds. According to the 2013 USSIF Trends report, approximately $61 billion has been invested in CDFIs.

54 See Liebenson, Donald, *Investors with a Cause: Millennials Champion Socially Responsible Investing*, Spectrem's Millionaire Corner, July 10. 2013. By comparison, 43% of Generation X (born from 1965 -1980), 34% of Baby Boomers (born from 1946-1964) and 27% of those born during World War II indicated that they consider social responsibility when making investment decisions.

55 E.g., a partial list of colleges and universities that have created centers focused on impact investing include: American University (Centre for Global Impact Investing); University of Utah (James Lee Sorenson Center for Global Impact Investing); and University of Oxford (Oxford Impact Investing Programme).

56 Grantmakers in Health, *Guide to Impact Investing*, May 2011, p. 10, adapted from Bernholz, Lucy and Lisa Richter, Blueprint Research & Design for Philanthropy, *Equity Advancing Equity: How Community Philanthropy Can Build Racial and Social Equity Through Mission Investing*, September 2009.

57 Interestingly, practitioners in the field of impact investing believe that future investors will likely come from financial services firms and the pension investors such as TIAA-CREF and CalPERS.

58 See Brest, Paul and Kelly Born, *When Can Impact Investing Create Real Impact?*, Stanford Social Innovation Review, Fall 2013.

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