



# Mission Investing for Foundations: The Legal Considerations

A Report of Community Foundations of Canada  
and Philanthropic Foundations Canada

by W. Laird Hunter, Q.C., Susan Manwaring and Margaret Mason  
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## FOREWORD

BY CFC AND PFC

This paper is a companion piece to the joint Community Foundations of Canada and Philanthropic Foundations Canada publication, “The State of Community/Mission Investment of Canadian Foundations” by sustainability strategist Coro Strandberg. Foundations considering the potential of mission investing will find in that paper an extremely useful review of the reasons foundations are pursuing mission investing and the benefits – both to the community and to the foundation – that flow from the activity. It also profiles nine Canadian community foundations and private foundations that are engaged in exciting mission investing.

The specific focus of this paper by lawyers Laird Hunter, Susan Manwaring, Margaret Mason and revised for Quebec by François Morin, is the set of legal considerations that foundations should take into account as they move forward in mission investing. It will be most useful for foundation investment committees and boards of directors as they explore integrating mission investing into their current portfolios.

The 2012 edition of this guide has been revised to add references to the Quebec *Civil Code* provisions regarding investments by charities.

## WHAT IS MISSION INVESTING?

Mission investing is a process whereby foundations directly invest some of their assets in community, social or environmental enterprises consistent with their mission. The investments may be program-related investments that anticipate a below-market rate of return, or market-rate investments in mission-related enterprises. They include examples like social housing development and community loan funds.

Mission investing is also referred to as community investing. For community foundations, the term “community investing” may resonate best; for private foundations, whose purview is not always the local community, the phrase “mission investing” may make more sense. For simplicity’s sake, in this paper we use the broader term mission investing.

All foundations invest their financial assets in order to generate new wealth for community benefit. Most have sophisticated strategies and policies for traditional investing that ensure that donor endowments continue to grow philanthropic capital for grantmaking.

A complementary strategy of deploying foundation assets directly in pursuit of its mission allows a foundation to further increase the impact it has on its issue areas or in its community and build on its already-significant grantmaking contribution. On an aggregate basis, \$30 billion in Canadian public and private foundation assets represent a tremendous additional opportunity for Canadian foundations to leverage more of their capital directly in support of their philanthropic missions.

## BENEFITS OF MISSION INVESTING

As early practitioners in this field have noted, there are additional benefits to mission investments beyond their social impact:

- The capital can be reinvested upon repayment.
- The enterprise nature of mission investing may attract donors with a more entrepreneurial bent.
- In some cases, and for example in the 2008 market downturn, assets in mission-based portfolios outperform traditional investment asset classes. In all cases, mission investments can be part of a balanced, diversified portfolio.

## MORE INFORMATION

More observations from this emerging field are outlined in the Coro Strandberg paper mentioned above and on Community Foundations of Canada website: <http://www.cfc-fcc.ca/programs/ri.html> and the Philanthropic Foundations Canada website at <http://pfc.ca/en/resources/mission-related-investing/>.

## INTRODUCTION

What are the legal rules that apply to a foundation when making a mission investment decision? This paper examines the legal elements of whether, when and how investments of this kind can be made. Depending on the number of these investments, these considerations can be made on a case-by-case basis or criteria can be included in a comprehensive statement of investment policies and procedures (SIPP) to supplement a foundation's existing due diligence processes.

### The Usual Caution

This primer is information. It is neither legal advice nor investment advice. The goal here is to give foundation boards and staff a basic review of the relevant law so they can consider what additional information they might need to make appropriate decisions.

While most foundation investment committees will have the necessary experience to consider these questions, in a particularly complex situation a foundation might need to contact its advisors – most probably its investment manager and lawyer – with a list of questions for clarification or to get an opinion about a particular community investment or proposed course of action.

### Are There New Rules to Consider?

It is useful to remember that nothing especially new is involved. A robust legal framework already exists to refer to when answering the questions posed by mission investing. With the exception of Québec, all provinces and territories have some form of “prudent investor” or “prudence” standard found in trust legislation. And although Québec doesn't have specific trust legislation, the *Civil Code of Québec* contains provisions requiring administrators of the property of others to act with prudence and diligence.

The trust statutes generally establish a framework within which the trustee must work when investing or otherwise dealing with charitable property. Many factors assist in determining whether the trust property has been invested prudently. Under the existing rules there are a variety of considerations that can lead to compliance with the applicable duties of prudence and loyalty. The requirement is to vet the potential mission investment against the requirements of prudence that do apply, as a foundation

would do with its other investment strategies. To this extent, the exercise is to see if and how old bottles can take new wine.

As mentioned, the *Civil Code of Québec* has rules regarding managed property. These rules are captured in the Title of the *Civil Code* dealing with the broader concept of administration of property of others. One of them is Article 1309 which sets out the same requirements as those found under the *Trustee Acts* of other Canadian provinces dealing with the administration of trust property. These requirements dictate that one who is charged with such administration “shall act with prudence and diligence. He shall also act honestly and faithfully in the best interest of the ... object pursued”.

Article 1306 sets out the general principle for investments as follows “a person charged with full administration shall preserve the property and make it productive, increase the patrimony or appropriate it to a purpose, where the interest of the beneficiary or the pursuit of the purpose of the trust requires it”. The subsequent article, Article 1307, adds that the administrator with full administration may, to perform his obligations, make any form of investment.

Although the *Civil Code of Québec* does not contain a clear provision that impose upon charities the rules governing the administration of property of others, it is prudent to apply these *Civil Code* rules to charities carrying on business in Québec, whether incorporated or not, because of the special character these organizations have, the trust that is placed upon them by their donors and the resulting obligations they assume in undertaking to fulfill their objects for the benefit of such donors and the public at large.

Article 1339 of the *Civil Code* provides a series of investments presumed to be prudent. However, if a charity did not restrict itself to investments on the list this would not automatically entail liability. The article is simply a safe-harbour provision.

This list includes immovables, most bonds, most mortgages, preferred and common shares of most publicly traded corporations and investments in funds, provided that the funds invest at least 60% of their portfolio in presumed sound investments. It is probable that many investments that would be mission-related investments

would not be included on the list of presumed sound investments.

As under the laws of the other Canadian provinces, it will be important for the person in charge of investment decisions to document the research and analysis conducted to make a particular investment, including observing the constituting documents, the by-laws and applicable investment policy.

## A REVIEW OF THE FUNDAMENTAL CONCEPTS

Although foundation directors and staff are likely to be very familiar with these, it is helpful to review a few fundamental concepts.

### 1. What is an Investment?

The key attribute of a financial investment is that money is used to buy “something”, the predominant purpose of which is an advantage, income or growth, or profit. The “something” is usually called an asset. For our purposes here, it is enough to say that “assets” are the things that are bought; and “asset classes” are the categories of assets that have similar features when it comes to how they behave in generating advantage, income or growth. For example, the equity shares of public companies tend to show similar trading features and are considered a single class of assets. Bonds have similar trading features and are another asset class.

### 2. What Rules Apply and When?

To understand how to approach making a mission related investment it is necessary to understand what rules apply. The law tells us **what** is charitable. The specifics of **how** charity can be undertaken are found in the statutes and the internal documents governing a foundation, including any donor agreement related to the specific transaction.

In Canada, both the provincial governments and the federal government can make laws about the “what” and the “how” of charity. The federal government does this under its taxing authority. Provincial governments tend to focus on what types of corporate organizations are available and, in some provinces, including Quebec, either directly or indirectly, what investments are appropriate for charitable property.

### a) The Provincial Contribution

The provinces have jurisdiction to make rules about charitable property and how it is used. Provincial legislation sets the standards for investments, usually in two places: corporate legislation and the *Trustee Act* or in Quebec, the *Civil Code of Québec*. Generally these two pieces of legislation refer to each other in some way.

Corporate legislation is usually silent on investments or says the rules to be followed are those in the corporation’s internal documents (i.e. the Memorandum of Association, Letters Patent, Constitution, or Bylaws) and, failing that, the applicable *Trustee Act*. Sometimes a foundation is created by a special statute and the particular rules in that legislation must be carefully reviewed. But generally, the primary statute to consider is the provincial *Trustee Act* or in Quebec, the *Civil Code of Québec*. These statutes differ in detail province by province but today the generally applicable standard is that of a prudent investor managing a balanced portfolio (see #6 below).

In Ontario another piece of legislation makes the *Trustee Act* apply. Section 10.1 of the Charities Accounting Act provides that sections 27 to 30 of the *Trustee Act* apply to every charity – however organized – that deals with charitable property in Ontario. The BC Society Act provides that if a society does not explicitly address investments in its by-laws, the relevant sections of the *Trustee Act* apply.

The *Trustee Act* (Ontario) goes on to say that the documents which establish a charitable corporation are deemed to form part of that trust. In other words, if the trust deed or letters patent of an Ontario corporation provide for different investment powers than the *Trustee Act*, the terms of the trust deed or letters patent take priority. And this is true even if the charitable corporation is established federally, or in another province but deals with charitable property in Ontario.

The corporation and trust statutes establish the rules that apply. As a result, the applicable corporate legislation, the *Trustee Act* or in Quebec, the *Civil Code of Québec* and the foundation’s own governing documents must be read together to determine the framework of rules applicable to mission investing.

## b) The Federal Level – The Income Tax Act

The federal government regulates charities under the *Income Tax Act* (ITA). Once registered, a charity is granted the right to issue charitable tax receipts. Foundations – private or public – are charities registered under the *Income Tax Act*. While there are a number of differences between private and public foundations, this discussion of the legal rules about investments equally applies to both types, unless specific differences are noted.

The ITA is concerned to see that charity is done. It asks whether the foundation deploys its resources on charitable activity. Does it make grants to recipients authorized by the ITA? The ITA is concerned about how money and resources are collected, distributed and spent.

But the ITA pays little attention to how a charitable foundation invests the assets it acquires with the donations or other money it receives. And while the Charities Directorate of Canada Revenue Agency (CRA) has general views about “program related investments” (PRI) and particular views about certain types of investments that are forbidden to private foundations, the ITA and CRA policies say little else about investments.

But the ITA pays little attention to how a charitable foundation invests the assets it acquires with the donations or other money it receives. And while the Charities Directorate of Canada Revenue Agency (CRA) has general views about “program related investments” (PRI) and particular views about certain types of investments that are forbidden to private foundations, the ITA and CRA policies say little else about investments. The ITA rules allow charities to have assets that are not directly used for charitable purposes. These assets can be held and invested to generate income or grow in value. A **disbursement quota** of 3.5% – the minimum amount that must be spent annually on charitable activity – applies to the average value of these investment assets.

In requiring charities to devote their assets exclusively to charitable purposes, the ITA can be taken to have certain principles that relate to these kinds of foundation investments. These include:

- Implicit rules about investments dealing with rate of return and the nature of the investment. The

question these implicit rules lead to is whether what is being done is a grant or an investment?

- Is the extent of active investing by the charitable foundation of a kind and amount that makes it a business?
- Does the charity own so much of a business through its investments that the foundation has acquired control? (If so, the Act contains various provisions and penalties that might apply if the foundation acquires control of a for-profit entity and receives dividends on the shares it holds. Foundations should be sure to consult their advisors if these circumstances might arise.)

## 3. Qualified vs. Non-qualified Donees

The ITA permits foundations to make gifts or grants to qualified donees, including registered charities. Consistent with this rule, CRA permits a foundation to make investments in registered charities or other qualified donees at below market rates of return ( see section 4 below). The ITA prohibits foundations from making grants or gifts to recipients who are not registered charities or other qualified donees. The CRA is of the view that an investment that yields less than the market return is wholly or partially a “gift” of charitable assets. Since gifts can only be made to qualified donees this means CRA would view this low return “investment”, if made in a non-qualified donee, as offside the rules. If CRA finds a charity has breached this rule it may either impose an intermediate sanction equal to 105% of the amount of the gift or grant or revoke the organization’s charitable status.

If a mission investment is being considered, the issue that will interest CRA is whether the “investment” is in fact an investment and not a way of disguising a grant or a gift to a non-qualified donee. For CRA, the key considerations are whether the “investment” is made:

- in other than a charity or a qualified donee; AND
- at less than a reasonable market rate of return.

If the “investment” is not in a charity or qualified donee AND is at less than a market return, CRA could conclude that it is an unauthorized grant or a gift and not an investment. It might be treated as a prohibited gift to a non-qualified donee. Implicit in this position is the

conclusion that an investment in a non-qualified donee at a market rate of return – whether in Bell Canada or a non-profit housing corporation – is acceptable.

But how can this be? Foundation assets are invested in all manner of non-qualified donees, for example all public companies listed on the stock exchange. Do these investments all have ‘market rates of return? What is the basis for the distinction? Is it that traditional market investments are expected to earn a profit – even if they don’t always do so – while mission investments are presumed to earn lower rates of return than the traditional market? Perhaps. Maybe the reason behind this distinction is that until now there has been no impetus to consider these questions.

**4. When Below Market Investments Are Acceptable Under the Income Tax Act – PRIs**

CRA’s position is that some kinds of investments at less than fair market value are acceptable. These Program Related Investments (“PRIs”) address the two conditions just mentioned. If an investment is made in a charity or other qualified donee it can be at less than fair market value. The less than market yield is treated by CRA as a “gift” of charitable assets to an eligible recipient authorized by the ITA and, by definition, used for charitable purposes.

The CRA position on PRIs is found in the CRA publication that reviews the rules about registered charities and community economic development programs. This guidance was significantly revised and re-released in July 2012.<sup>1</sup>

**5. Investments and Business**

Related to this “permissible” form of what can be described as “charitable investment,” the ITA has rules about charities having business operations. This is important when considering investments because carrying on business in ways that are not permitted by the ITA can result in the loss of charitable status.

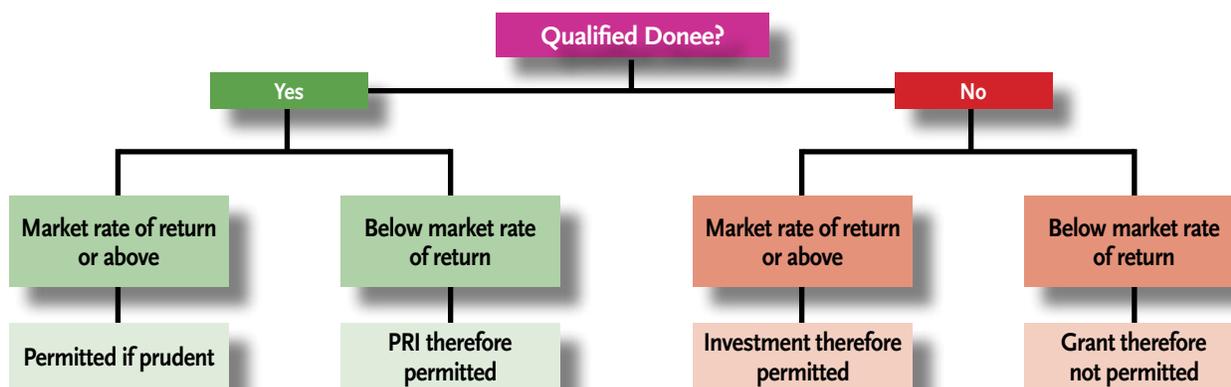
It is crucial that investments be just investments and not an activity that can be seen to describe a business, unless it is a “related business.” The ITA permits charitable organizations and public foundations to carry on a related business, defined as one which is:

- incidental and subsidiary to the charity’s purposes; or
- operated by at least 90% volunteers.

There can be no unrelated business. The CRA does not accept the “destination of funds” test, which would say that money raised through business operations is acceptable so long as it is spent on fulfilling charitable purposes. As a result, if there is a business activity, it must be related to the foundation’s purposes or run by volunteers.

FIGURE ONE:

**Current CRA Rules re Qualified Donees and Rate of Return**



<sup>1</sup> The new guidance, *Community Economic Development Activities and Charitable Registration*, was issued on July 26, 2012 and can be found here: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/cmtycnmcdvpmt-eng.html>

## NB: Private Foundations

The ITA prohibits private foundations from carrying on any business, whether it is related or unrelated. Any revenue generating operation that looks like a “business” activity of the private foundation is a breach of this rule. This prohibition is the basis for the CRA position that private foundations cannot invest in any form of partnership or hold an interest in a limited partnership. The legal definition of partnership is an arrangement under which two or more people come together to operate a business.

These rules give rise to this legal question: if a foundation starts to actively make and manage its mission-related investments, including program related investments, is that investment activity no longer incidental or subsidiary to its purposes and could the activity be considered as an “unrelated” business? If so, it is a problem for the public foundation and an absolute prohibition for the private foundation. If it is a “related business”, it may be permitted for the public foundation but it is still prohibited for private foundations.<sup>2</sup>

## 6. The Prudent Investor and Balanced Risk

As noted previously, the overarching requirement of the foundation is prudent investment of its assets. Most foundations have a diversified portfolio of investments to which a mission investment would be added.

Investment theory today, often called “portfolio theory” is a helpful concept in weighing the prudence of a particular investment. It is based on two assumptions:

- A diversified portfolio is generally less risky than an undiversified one; and
- There is a need to analyse the relationship between different kinds of risk on the one hand, and expected returns on the other.

Different classes of assets have different risks associated with them so risk must be judged across the portfolio as a whole. From these insights has grown the idea of asset allocation and the need to have a balanced risk portfolio in seeking an appropriate return.

What characterizes the prudent investor of a balanced portfolio of investments varies somewhat by province. But the essential features are similar with the standards of prudence applied at the portfolio level, rather than at

the level of each individual investment (as was the case previously). Now, looking at the portfolio as a whole, the *Trustee Act* in Ontario, for example, says that in planning the investment of trust property a trustee must consider the following criteria in addition to any other relevant factors:

- General economic conditions;
- The possible effect of inflation or deflation;
- The expected tax consequences of the investment decision or strategy;
- The role that each investment or course of action plays within the overall trust portfolio;
- The expected total return from income and the appreciation of capital;
- Needs for liquidity, regularity of income and preservation or appreciation of capital; and
- An asset’s special relationship or value, if any, to the purpose of the trust or its beneficiaries.

Portfolio theory says that given a particular choice about acceptable risks, and especially given the other assets in the portfolio, even a very high-risk investment can sometimes be entirely appropriate. For example, a “currency swap” is speculation on the future movement of exchange rates. But if the investor holds bonds denominated in a foreign currency, the swap may allow that investor to eliminate the risk that the value of the bonds will be eroded by an untoward movement of exchange rates. In essence, a swap properly structured is a kind of insurance policy, the hallmark of prudence.

The portfolio approach provides a broader range of options to charities when making investment decisions, including decisions about mission investing.

## 7. Summary

In summary then, mission investments can and should be considered within the overall risks and returns of the portfolio of the foundation. The legal rules that apply flow from the foundation’s internal documents, the incorporating statutes that apply to it, the provincial *Trustee Act* (or in Quebec, the *Civil Code of Québec*) if applicable, and the ITA. Different rules apply depending on whether the investment is to be made in a qualified donee or not, and whether the rate of return is market or below market. Special prohibitions arise if the investment can be seen as a business. The overarching principle is prudence.

<sup>2</sup> The current view of CRA on “business activities” is found in CPS-019 - *What is a Related Business?* [www.cra-arc.gc.ca/tx/chrts/plcy/cps-019-eng.html](http://www.cra-arc.gc.ca/tx/chrts/plcy/cps-019-eng.html)

## AN APPROACH TO DECISION-MAKING FOR MISSION INVESTING

A “decision tree” follows, summarizing the kinds of questions – derived from the familiar principles we’ve just reviewed – which a foundation should bear in mind when dealing with mission investment opportunities. Three case examples then illustrate the decision tree.

The case examples and decision tree assume two things:

- First, the foundation has decided that it wants some rate of return on its investment. Therefore – though the outcome might be a program related investment – it is not making a grant where no monetary return is expected or intended.
- Secondly, the foundation either has not developed a Statement of Investment Policies and Procedures (SIPP) or has not addressed mission investing as part of its SIPP.

## QUESTIONS TO ASK ABOUT A MISSION INVESTMENT

Based on the overview just given, any investment decision is guided by two sets of related questions: what rules apply and what is the nature of the investment.

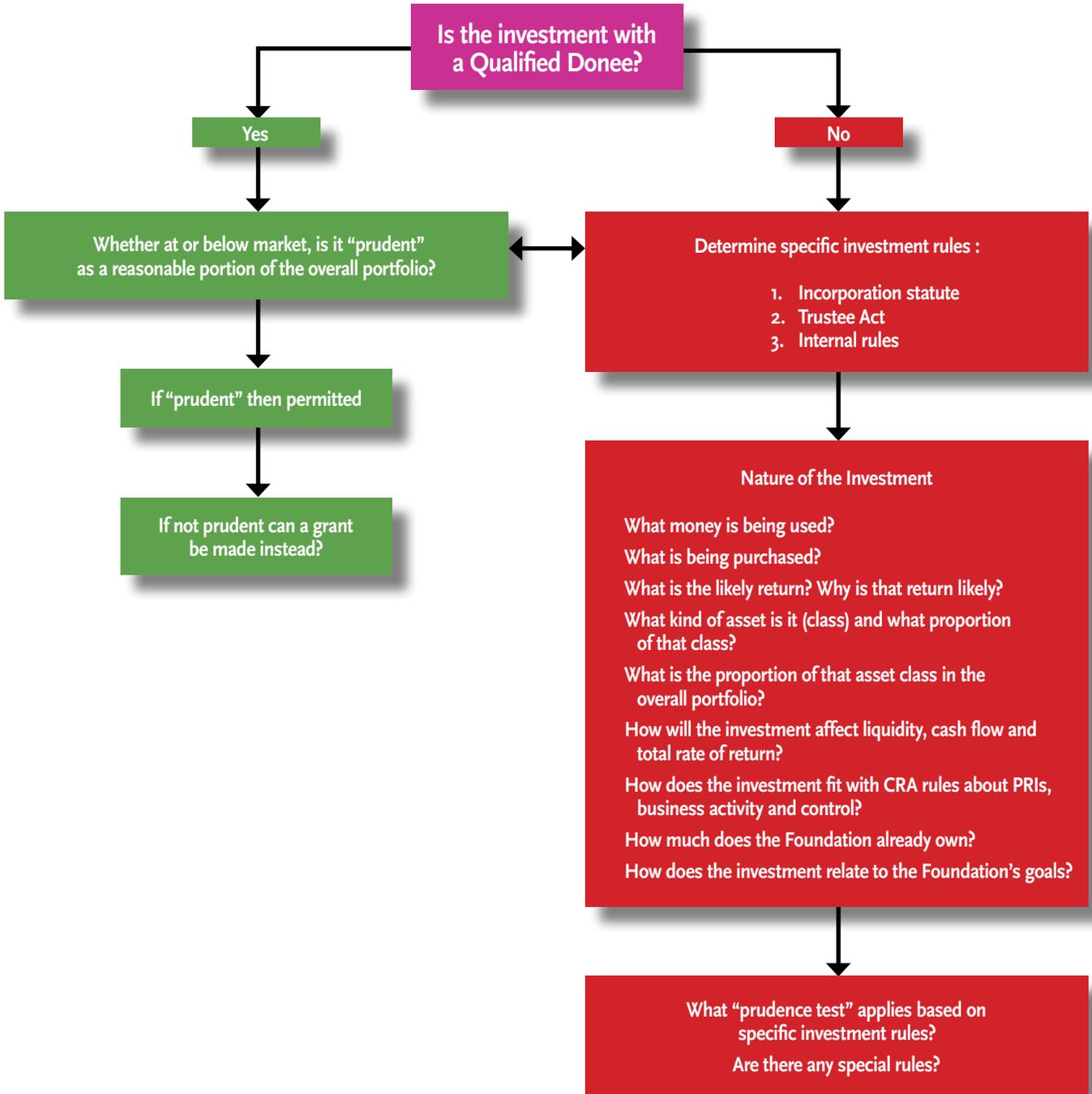
Generally, you must canvas the “prudence” considerations of whatever rules apply to your foundation. The rules that apply to investing, as we’ve seen earlier, will be determined by provincial statutes that apply to your foundation, any statutory (external) documents that address investing powers, and your internal documents (bylaws). If these are silent or incomplete in their guidance, your province’s *Trustee Act* will most certainly apply (*Civil Code of Québec*, in Quebec).

What is being purchased, with what funds, the asset class of the investment and expected rate of return, etc. are the kinds of questions you will ask about the nature of the investment and its impact on your overall portfolio.

Moreover, it is important that the detailed requirements of the particular set of rules are followed and the **reasons should be documented** as the investment decisions are made. A foundation is acting most prudently when it documents its reasons in detail.

At some points on the decision tree, the answers will not be a simple yes or no. In the end, the final decision about making an investment will be a judgement made in the context of what the foundation wants to achieve and what assessment criteria legally apply. The exercise of dutifully considering the investment in the structured way the law requires, and documenting the basis for the decision, is a critical element in arriving at an appropriate answer to these complex exercises of judgment.

FIGURE TWO:  
A Decision Tree



## THE CASE EXAMPLES

### CASE EXAMPLE #1

A foundation is interested in making a mortgage loan or directly owning real estate to support affordable housing. The project is being developed by a non-profit development organization associated with a newcomers' drop-in centre. It has no track record but a strong volunteer base of knowledgeable people. The group is neither a registered charity nor any other kind of qualified donee.

#### The Financial Facts

The land is located in a run-down part of the city where there is little affordable housing. The land has been on the market a very long time. There are many empty buildings in the area, most recently re-zoned for development. All conventional sources of financing have turned the group down. There is an urgent need for this type housing in the area.

The group wants the foundation to loan it \$500,000 to buy the land and another \$700,000 to build the building. It is not clear given the location what the resale value might be when built. The group wants a loan at 2% below prevailing mortgage rates.

The loan would be 10% of the foundation's endowment, secured by a first mortgage at a fixed rate for 10 years. The return would be 2% below prevailing mortgage rates and 3% below the current combined return of the foundation's portfolio. Depending on the redevelopment and outcome of the project, the value of the property should appreciate over time.

The likely total return from anticipated income is expected to lower the overall return for the foundation's portfolio (assuming the rates of return on other investments are maintained at expected rates) but the return would still be within an acceptable range given the proportion of the portfolio involved and the other benefits achieved by fulfilling the charity's purpose.

The investment (10% of the overall portfolio generating a fixed return for the 10 years) could reduce liquidity, though income would be regular. Making the mortgage loan is in keeping with the foundation's mission to reduce poverty in the area. The most significant risk is the potential loss of capital due to the unproven experience and capacity of the

operator. But with the proposed security the foundation would have the ability to foreclose on the property, if necessary.

#### The Applicable Legal Rules

The foundation is established by Letters Patent and is registered as a private foundation. Its purposes include direct charitable activity to relieve poverty. The governing act is silent on investment powers but says the foundation's by-laws apply and failing that the provincial *Trustee Act (Civil Code of Québec, in Quebec)*. The by-laws are silent. There are no other internal documents that apply.

#### Comments

Is the investment to a qualified donee? No. Because this loan would be with an organization that is not a registered charity or qualified donee, the loan cannot be considered a Program Related Investment. Therefore the questions that need to be considered are those on the right side of the decision tree. We start with what do the governing statutes and internal documents say. In this case, they are silent so we know that the provincial *Trustee Act (Civil Code of Québec, in Quebec)* is the only set of provincial rules that apply.

We can estimate that the overall size of the foundation's existing portfolio is about 12 million dollars. We know the terms of the loan and the likely rate of return. But we don't know the amount of money the foundation needs to operate its current and projected programs. What if it is currently spending capital because of a desire to maintain long-standing programs? How balanced is the portfolio? Is there a reasonable distribution of equities, bonds with short and long term maturities? What is the overall portfolio return? What if it has been reduced by a fall in value of the equity portion given recent conditions?

Until the larger financial facts are known, the prudence of this proposed investment cannot be determined. And without that information, it would be imprudent to make the loan.

### CASE EXAMPLE #2

A foundation has set aside a fund of \$5,000,000 for community based investing. It is considering making a mortgage loan to a registered charity so the charity

can buy its own building. The registered charity that wants the mortgage is an umbrella group that offers services and represents many members, all of whom are registered charities. It offers accounting services, human resource information, fundraising expertise and in certain circumstances, space to organizations at various stages of development.

The building is located downtown in a developing neighbourhood. It is an ideal location for the charity because its members are located in the near vicinity. The building is a bit awkward to sell because of its physical structure but the varied space available makes it ideal for this charity which will house its own staff in the facility as well as offering space to others. The building was recently renovated structurally and has updated services.

### The Financial Facts

The building is listed for sale for \$500,000. The charity has raised \$250,000 and is looking for a mortgage for the balance. If the foundation invests it will have first priority against the land as security. The charity would like the foundation to advance the mortgage for 20 years on an open basis at the prime rate of interest – on the condition the interest rate would cap at 6% (which is 2% above the current bank prime rate). Payments would be interest only.

### The Applicable Legal Rules

The foundation is established under a special purpose statute. It is registered with CRA, as a public foundation. One of its purposes is to undertake direct charitable activity to relieve poverty. The Act says the foundation's by-laws must follow the provincial *Trustee Act* about investments, subject to internal policies. The foundation has a policy that no more than 15% of its overall portfolio can be in securities of more than 5 years duration without a special resolution. The by-laws are silent. The foundation's corporate statute permits mortgage investments and the loan would fit within the Investment Policy approved by the Board of Directors, which specifically contemplates community related investing.

### Comments

The loan is being made to a qualified donee. The issue becomes whether the investment is prudent as a reasonable portion of the portfolio. If not, could this be

made as a grant within the charitable purposes of the foundation?

The money to be loaned (\$250,000) would be 5% of the foundation's community investing fund. The loan would be secured by a first mortgage and the interest rate would fluctuate with prime, subject to being capped at 6% if interest rates go higher.

The return is 2% below prevailing mortgage rates but the real estate is located in an up and coming neighbourhood and as a long term investment the expectation is that overall returns will match or surpass the portfolio. The long-term prospects of the property are relevant to the long-term security of the investment.

The risk to the foundation is low although there is a limited risk of decrease to property values. Urban property values in large cities in Canada however have not to date seen a decline that would take the value of this property below the mortgaged amount and thus the risk of loss in the long term is low.

We have no detailed financial information about the foundation. As in the first situation we don't know the amount of money the foundation needs to operate its current and projected programs. Is its portfolio balanced? But in spite of that lack of information, the investment clearly could qualify as a Program Related Investment. As such, it would be acceptable to CRA even if CRA took the position that the terms were favourable enough to cause CRA to consider all or part of it to be a grant rather than an investment. But is it prudent? In the absence of facts that suggest otherwise, the answer seems to be yes.

### CASE EXAMPLE # 3

The foundation is exploring the opportunity of a 10-year investment in a private equity fund, the purpose of which is to finance social and environmental ventures. The fund is targeting an 8% return.

The foundation has \$5,000,000 of unrestricted funds set aside for what the board of directors refer to as mission based investments. The board is considering a \$500,000 investment in the Fund.

This social venture capital fund intends to make investments in businesses critical to a sustainable economy, such as organic foods and products, green

consumer products and green building. The projected rates of return on the units purchased by the foundation are 10% based on past performance of similar funds offered by this social capital venture firm. It is expected that the investment will be for the long term – at least 10 years.

The directors are of the view that the investments proposed to be made by this fund are consistent with the mission of the foundation.

### The Financial Facts

The investment would be in Units of the Fund. To date the Units have yielded a 6% dividend. The expected 10% rate of return on the investment is generally 3% higher than the overall yield of the portfolio. The issue of value of the units is somewhat more difficult. The value of the units has fluctuated with the markets and there is no guarantee of long term preservation of full value. There is also a question about the liquidity of the investment. It is not clear that the foundation could easily dispose of the investment at the time it chose to do so. It might take some time to sell.

### The Applicable Legal Rules

The foundation is established by Letters Patent and its charitable purposes include supporting environmental and social community projects. The bylaws are silent about the nature of investments and there is nothing in the foundation's investment policy that would prohibit this investment. There is nothing outside of those documents that has an impact other than the prudent investor rule in the *Trustee Act* or the *Civil Code of Québec*, in Quebec), which applies the prudent investor standard at the portfolio level.

### Comments

The investment in the social fund is not an investment in a qualified donee notwithstanding that the social fund may very well invest in qualified donees, so this investment would not qualify as a PRI. It will therefore be necessary to look at the specific investment rules that apply and determine the nature of the particular investment and whether it will qualify as an investment that is prudent for the foundation to make. And then it will be necessary to work through the various questions to be posed as required by the prudence test.

Here the investment is in pooled fund units. This social venture company has operated similar funds over the past ten years and the anticipated rates of return proposed are consistent with performance to date. The rates of return reflect the fact that the underlying investments would be considered riskier than public market investments. The foundation has assets in other pooled funds which are primarily publicly traded investments and which have generated an average return of 6% over the last 10 years. A \$500,000 investment would represent 10% of the foundation's portion of its portfolio available for mission related investments and represents 2% of the foundation's \$25,000,000 portfolio.

The investment in the social fund relates to the foundation's goals directly and that is why the Board is so interested in proceeding with this investment.

The rates of return are good and consistent with other similar funds. While the foundation may not be able to liquidate as quickly as might be desired, the percentage within the total portfolio of this investment is reasonable. It would not be imprudent for the foundation to make this investment.

## CONCLUSION

There are many ways that Canadian foundations can make mission investments and more foundations across the country are doing so. While reaching a conclusion about whether a particular investment makes sense for your foundation is not simple, as is demonstrated by this material, it is a process that relies on familiar principles, prudence and careful judgement.

Because this is a relatively new area of emphasis for the foundation sector in Canada and one in which many foundations are keenly interested, it is likely to evolve quickly. The sector will need to work closely with regulators to ensure a full understanding of the issues, opportunities and risks.

For any foundation the first hurdle is to understand the current legal and regulatory issues which must be considered and to know when to consult with outside advisors before proceeding. We hope this primer assists your foundation in overcoming that hurdle.

## GLOSSARY

**Assets** are things that are bought with a view to enhancing return or securing an advantage.

**Asset Allocation and Asset Classes** – allocation refers to the strategy of choosing amongst the various kinds of possible investments (asset in one or more classes) to select where the foundation wants to invest, given risk tolerance, among other matters. Common asset classes include:

- cash (i.e., money market accounts)
- Bonds: investment grade (high yield); government or corporate; short-term, intermediate, long-term; domestic, foreign, emerging markets
- stocks: value or growth; large-cap versus small-cap; domestic, foreign, emerging markets
- real estate
- foreign currency
- natural resources
- precious metals
- Real estate investment trusts
- International Investments: foreign or emerging markets

Underlying the notion of asset classes is the observation that there are categories of assets that have similar features when it comes to how they behave in generating income or growth. For example, equity shares of public companies tend to show the same trading features as do corporate bonds.

**Balanced Portfolio Analysis** – there are a variety of goals in investing. The safety of principal, achieving reasonable income, and growth are central components of any money management strategy. The use of a portfolio balanced across asset classes increases the likelihood of these goals being achieved, while managing the volatility of the economic cycle. Balanced portfolios involve having assets from various asset classes. Conventional asset allocation divides capital between stocks, bonds and cash. But alternative investments include commodities, limited partnerships and derivatives and other emerging classes. Sophisticated investors diversify alternative investments because these assets have demonstrated less correlation to the overall economic cycles.

**Endowment** – the funds a foundation invests to support its charitable purposes.

**Incorporation Statute** – the statute under which the foundation is established.

**Mission investing** seeks opportunities to align a foundation's financial investments with the mission of the organization, while maintaining long-term targeted financial returns. At its core, mission investing is driven by investor intent, and focuses on the dual objectives of furthering programmatic goals and earning financial returns. The term Mission Investing covers two distinct categories of investments: market rate mission-related investments (MRIs) that support program goals; and Program Related Investments (PRIs) structured to create specific program benefits while earning a below-market return.<sup>3</sup>

**Program related investment (PRI)** – a PRI is, in CRA's view:

- an investment rather than a grant, most often in the form of an interest-bearing loan but also the purchase of shares in an enterprise
- made to an organization that is a charity or a qualified donee
- funded with money from a foundation's endowment funds; and
- for the primary purpose, not of income-generation, but of furthering the foundation's charitable purposes.

**Qualified Donee** – under the *Income Tax Act*, the term qualified donee means:

- registered charities
- registered Canadian amateur athletic associations
- registered national arts service organizations
- housing corporations in Canada set up exclusively to provide low-cost housing for the aged
- municipalities in Canada;
- under an amendment that received Royal Assent on December 15, 2011 legislation, for gifts made after May 8, 2000, municipal or public bodies performing a function of government in Canada
- the United Nations and its agencies
- universities outside Canada with a student body that ordinarily includes students from Canada (these

<sup>3</sup> Thanks to *More for Mission: The Campaign for Mission Investing* ([www.moreformission.org](http://www.moreformission.org)) for this definition.

universities are listed in Schedule VIII of the Income Tax Regulations)

- charitable organizations outside Canada to which the Government of Canada has made a gift during the donor's taxation year, or in the 12 months immediately before that period; and
- the Government of Canada, a province, or a territory

**Responsible Investing (RI)** – the integration of environmental, social and governance factors in the selection and management of investments.

**Securities** – defined in many pieces of legislation but generally securities are considered to include stock, debentures, bonds, shares and guaranteed trust or investment certificates.

**Statement of Investment Policies and Procedures** – a document that provides an overview of the foundation's investment objectives and considers current income, growth, and capital preservation. It provides a summary of the responsibilities of the various stakeholders in the investment process: the Board, the Investment Committee, Fund Managers and the Investment Consultant. It should provide an overview of the asset mix for the fund's benchmark portfolio, a summary of the benchmark returns for each asset class, an indication of the discretion allowed the fund with respect to the asset mix and consider matters like conflict of interest policy, proxy voting issues, etc.

**Trustee Act** – provincial statute of general application about matters relating to investments made by trustees and those deemed by the legislation to be trustees.

In Quebec, these matters are dealt with in Title Seven of the *Civil Code of Québec* entitled the "Administration of the Property of Others" (section 1299 and following).