



Colleges and Universities: Investing for Impact

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When making impact investments, colleges and universities should give due consideration to the effect of such investments on the institution's mission and investment portfolio.

Colleges and universities are often early adopters of innovative investment management techniques. In ever greater numbers, they are exploring methods of investing endowment funds to generate investment returns that consider charital impact in addition to providing financial support for their programs. Some institutions use environmental, social, and governance factors (ESG) to screen their investments in response to divestment campaigns waged by institutional stakeholders such as students, faculty, or alumni. Others take a more proactive approach, investing in opportunities that promote environmental sustainability and/or social responsibility. Other ESG activities may arise from student involvement in shareholder advocacy initiatives.

This article provides an overview of different types of impact investments, including investment screens, mission-related investments (MRIs)

and program-related investments (PRIs), and it addresses certain tax and fiduciary considerations that colleges and universities should keep in mind when presented with opportunities involving these investments.

SPECTRUM OF CAPITAL

The spectrum of capital describes how an institution may deploy capital in furtherance of its mission. (See Exhibit 1.) At one end of the spectrum are pure investments, which bear only an indirect relationship to the institution's mission—namely to generate additional capital that may be further deployed in furtherance of the institution's mission. At the other end of the spectrum are pure grants, which directly accomplish the institution's mission, but which typically do not also generate a financial return benefit to the institution (other than goodwill). ESG investments are hybrids of

EXHIBIT 1

Spectrum of Capital

	Financial-only	Responsible	Sustainable	Impact	Impact-only		
	Delivering competitive financial returns						
	Mitigating Environmental, Social and Governance (ESG) risks						
		Pursuing Environmental, Social and Governance opportunities					
			Focusing on measurable high-impact solutions				
Focus:	Limited or no regard for environmental, social or governance (ESG) practices	Mitigate risky ESG practices in order to protect value	Adopt progressive ESG practices that may enhance value	Address societal challenges that generate competitive financial returns for investors	Address societal challenges where returns are as yet unproven	Address societal challenges that require a below-market financial return for investors	Address societal challenges that cannot generate a financial return for investors
Examples:		<ul style="list-style-type: none"> • PE firm integrating ESG risks into investment analysis • Ethically-screened investment fund 	<ul style="list-style-type: none"> • "Best-in-class" SRI fund • Long-only public equity fund using deep integration of ESG to create additional value 	<ul style="list-style-type: none"> • Publicly-listed fund dedicated to renewable energy projects (e.g. a wind farm) • Microfinance structured debt fund (e.g. loans to microfinance banks) 	<ul style="list-style-type: none"> • Social Impact Bonds / Development Impact Bonds 	<ul style="list-style-type: none"> • Fund providing quasi equity or unsecured debt to social enterprises or charities 	

Source: The Bridges Spectrum of Capital: How we define the sustainable and impact investment market (<http://bridgesventures.com/wp-content/uploads/2015/11/Spectrum-of-Capital-online-version.pdf>)

the two, occupying the middle of this spectrum between investments and grants, because they both potentially generate a financial return to the institution and also contribute to some degree to the accomplishment of the institution's mission.

The treatment of ESG investments under tax law and the prudent investor standard of the Uniform Prudent Investor Act (UPIA) and Uniform Prudent Management of Institutional Funds Act (UPMIFA) depends on the attributes of the investment, including the investment's financial return and its relationship to the institution's mission. As discussed below, PRIs are near the grant-end of the spectrum, investment screens are at the investment-end of the spectrum, and other impact investments such as MRIs and socially

responsible investments are in between—they are designed to have more non-financial impacts than pure investments, but unlike PRIs they are not primarily tied to furthering a charitable purpose.

The Six Degrees of Charitability

The tax-exempt status of colleges and universities (and other nonprofit institutions) derives from the fact that they are organized and operated "exclusively" to accomplish educational purposes.¹ In practice, it is nearly impossible to devote 100% of an institution's resources to the direct accomplishment of its mission—it is necessary to use some for administrative overhead, for example, and other activities that further the mission, but only indirectly. As a result, "exclusively oper-

ate" has been interpreted to mean that the institution must "primarily" engage in activities that accomplish its exempt purposes.²

The investment of an institution's own funds is generally considered "passive" activity, with the consequence that it neither helps nor harms the institution's ability to qualify as tax exempt—this is due to the fact that investing one's own funds is generally disregarded as an activity for tax purposes.³ With certain exceptions, most investment returns (e.g. capital gains, dividends, interest, rents, royalties) earned by a nonprofit institution are also generally exempt from the unrelated business income tax (UBIT), despite the fact that the business that generates the investment return is generally unrelated to the mission of the institutional investor.⁴

Do impact investments help an institution qualify for tax-exempt status? Are they neutral? Are they taxable? Can they jeopardize exemption? The answer is, it depends on the rela-

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tionship between the investment and the organization's tax-exempt purpose (i.e., its mission). To assist with the analysis, the following describes what may be called the six degrees of charitability in the context of colleges and universities:

1. Activities that **directly accomplish** the mission—i.e., charitable or educational activities that would be sufficient on their own to enable the organization to qualify for tax-exempt status.⁵
2. Activities that **significantly further** the charitable or educational mission, but which do not directly accomplish the mission—i.e., activities that bear a substantial causal relationship to accomplishing the mission.⁶
3. Activities that are **aligned** with the mission, but which do not further the accomplishment of the mission to a substantial or causal degree—e.g., investment activities that seek to capture positive ESG externalities.⁷
4. Activities that **do not interfere** with the accomplishment of the mission, but which do not otherwise help accomplish the mission—e.g., investment activities that seek to reduce or eliminate negative externalities.⁸
5. Activities that **may interfere** with the mission and are therefore limited—i.e., activities that may not comprise a substantial portion of the organization's overall activities, e.g., unrelated trade or business activity or lobbying.⁹

6. Activities that are **contrary** to the mission and, therefore, prohibited—e.g. political campaign intervention and activities that are illegal or contrary to public policy.¹⁰

As discussed below, PRIs are category 1 or (more often) category 2 activities, while MRIs and investment screens are typically category 3 and 4 activities.

UPMIFA and the Prudent Investor Standard

If the tax law cares about the degree to which an impact investment contributes to an organization's mission, the prudent investor rules have the opposite concern—to what degree does an impact investment affect the risk and expected return of the organization's investment portfolio? More precisely, how does the impact investment fit into the institution's overall investment portfolio using the principles of modern portfolio theory?¹¹ The trouble is, impact investments are different from other investments because they take more into account than simply risk and return. As an economic matter, impact investments are financial products that capture and commoditize goodwill, an economic attribute that modern portfolio theory generally ignores.

In many ways, contemporary concerns about impact investments echo past concerns about new financial products. New investment technologies are always met with skepticism,

at least at first, until the prudent investor standard evolves. Before modern portfolio theory had been widely accepted as the primary method of constructing investment portfolios, the investment of institutional funds was prone to much second guessing by the legal system. The use of now-common financial products like puts, calls, and short sales was considered overly risky for institutional funds, yet under-diversification in "safe" assets like real estate and corporate bonds was a common strategy. The legal uncertainty on what a prudent investor should do led investment managers to adopt investment strategies that were inconsistent with the risk profile of their institutions, and, likely, to lower returns. Later, once modern portfolio theory had been broadly accepted, it became the basis for the prudent investor standard.

The UPIA, which the Uniform Law Commission proposed in the early 1990s and has now been adopted in 45 states, directs trustees to consider the risk and return objectives of the trust and to manage risk across the trust's portfolio for purposes of meeting the prudent investor standard.¹² UPMIFA has a similar prudent investor standard that applies to non-profit corporations.¹³ UPMIFA is a uniform state act that provides guidance for investment management and enumerates rules for investing in a prudent manner. All states have adopted a version of UPMIFA, except for

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¹ See Section 501(c)(3) (describing organizations operated exclusively for charitable, educational, scientific, religious, and other tax-exempt purposes). Note that state colleges and universities may be exempt from federal tax for a second reason, which is constitutional immunity from intergovernmental taxation.

² See Reg. 1.501(c)(3)-1(c)(1) ("An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).")

³ See generally *Higgins*, 312 U.S. 212, 25 AFTR 1160 (1941) ("managerial attention" investors devote to their stocks and bonds is not a trade or business, "no matter how large the estate [portfolio] or how continuous or extended the work required may be."); Section 512(b) (UBTI modifications exempting most forms of passive income from tax).

⁴ See Sections 511-514 (setting forth UBIT rules), including Section 512(b) (excluding most passive income from UBIT), Section 514 (taxing certain investment returns that would otherwise be exempt in the case of acquisition indebtedness), and Section 512(b)(13) (tax-

ing certain investment returns that would otherwise be exempt in the case of payments received from controlled entities).

⁵ See Sections 170(c) and 501(c)(3).

⁶ This is the standard used to determine if income from a regularly carried on activity is taxable as unrelated business income. See Reg. 1.513-1(d)(2). These activities are not subject to UBIT, even if they are regularly carried on trade or business activities.

⁷ These activities and those in the categories below may be subject to UBIT if they are regularly carried on trade or business activities. As discussed above, the investment of one's own funds is generally disregarded as an "activity" for tax purposes, and is therefore not subject to UBIT. See note 3, *infra*.

⁸ Same comment about passive investment activities.

⁹ See *Better Business Bureau of Washington, D.C., Inc.*, 326 U.S. 279, 34 AFTR 5 (1945) (organization lost tax-exempt status for operating an unrelated business as a substantial portion of its activities); Section 501(c)(3) (no substantial part of the organization's activities may be lobbying). The present author's own view is that

lobbying that is substantially related to the mission should be moved to category 2, leaving only unrelated lobbying in category 5.

¹⁰ See Section 501(c)(3) (denying tax-exempt status to organizations that participate in, or intervene in any political campaign on behalf of or in opposition to any candidate for public office); *Bob Jones University*, 461 U.S. 574, 52 AFTR2d 83-5001 (1983) (university's tax-exempt status revoked for racially discriminatory policy). The present author's own view is that political activity is not antithetical to exempt status, and should be moved to category 5.

¹¹ Nobel-prize winning economist Harry Markowitz defined the mathematical framework for assembling a portfolio of assets that is now called modern portfolio theory in his essay "Portfolio Selection," 7 *The Journal of Finance* 77 (March 1952). The theory uses mean-variance analysis to maximize an asset's expected return for a given level of risk.

¹² See Uniform Prudent Investor Act, section 2(b) (1994).

¹³ See Uniform Prudent Management of Institutional Funds Act, section 3A (2006).

Pennsylvania, which has its own rules.

UPMIFA requires managers of institutional funds to invest in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Specifically, it says that a prudent investor is one who makes investment decisions that consider the following factors:

- General economic conditions.
- Possible effect of inflation or deflation.
- Expected tax consequences, if any, of investment decisions or strategies.
- Role that each investment plays within the overall investment portfolio of the fund.
- The expected total return from income and the appreciation of investments.
- The institution's other resources.
- The institution's needs to make distributions and preserve capital.
- An asset's special relationship or value, if any, to the institution's charitable purposes.

To comply with the standard, financial officers of colleges and universities must take into account the institution's entire investment portfolio when making investment decisions, and the investment strategy should be based on the risk and return objectives reasonably suited to the fund the institution. In addition to determining whether the investment is "prudent," college and university investment managers have an obligation to monitor the financial performance of impact investments.

Given that UPMIFA uses modern portfolio theory to define prudent investment decisions, the question arises: how can an impact investment be "prudent" if it has a lower expected return for a given risk profile than a comparable investment? The answer is that college and university investment officers must rely on the second part of the prudent investor rule under UPMIFA—specifically, how does the investment contribute to the institution's charitable purposes? This leads full circle to the six degrees of chari-

tability discussed above. An impact investment that furthers the institution's mission is not subject to UPMIFA because it is a program rather than an investment. An impact investment that does not further the institution's mission is only prudent if it fits into the institution's overall portfolio on a risk-return basis.

The tax law further supports the view that an impact investment is prudent if it is charitable. Recently, the IRS issued Notice 2015-62, 2015-39 IRB 411, which updated the standards for determining when a private foun-



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ation's investment is made for charitable purposes. The Notice aligns the tax rules with UPMIFA and state law standards, stating specifically that investment managers of nonprofit foundations may consider, as one factor, whether the investment furthers the foundation's charitable purpose. The Notice cites UPMIFA investment standards, stating: "a private foundation will not be subject to tax under Section 4944 if foundation managers who have exercised ordinary business care and prudence make an investment that furthers the foundation's charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes."

The bottom line is that college and university investment managers may consider the implications to their institutions when making impact investments, but if they conclude that the charitable implications are minimal, they should make the investment only if it has an appropriate risk-return profile using the principles of modern portfolio theory.

Some practical advice that nonprofit investment managers should consider:

- **Size matters.** Impact investments that are particularly large in rela-

tion to the institution's overall portfolio should be evaluated carefully to determine whether they are appropriate.

- **Document the reasoning.** The best way to protect an investment advisor concerned about whether or not an impact investment is prudent, particularly a large impact investment, is to carefully document the advisor's reasons for making the investment. Such analysis should include the impact investment's relationship with the institution's mission as well as its relationship to the institution's investment portfolio. If neither relationship is compelling, the institution should take a pass on the investment.
- **Amend existing investment policies.** It may be necessary to update the institution's policy to include the refreshed UPMIFA standards, including consideration of compatibility of investments with charitable purposes.
- **Develop an impact investing policy.** Colleges and universities should establish clear policies and procedures for making impact investments to ensure that investments over a certain size or duration are approved after due consideration by those with the most responsibility. The impact investment policy should have clear goals and success measures. It should spell out how investment and program staff will collaborate. The policy should also define how to identify, review and approve impact investments.
- **Monitoring and evaluation.** Integrate review and approval of impact investments into regular investment review and approval process. Determine the process for monitoring them and for

measuring their impact on the institution's mission.

- **Consult counsel.** In some cases, it may be appropriate to consult in-house or outside advisors to determine whether a large, long-term, or controversial investment is prudent.

TYPES OF IMPACT INVESTMENTS

Under impact investing, investors consider not only the private economic return of an investment but also the positive or negative externalities it is likely to generate (i.e., its "impact"). Institutions should be mindful of tradeoffs between the investment return and the impact of the investment to ensure that the tradeoff is reasonable. For example, if the prospective impact is minimal, and the investment also generates a significantly lower return than comparable non-impact investments, or has other undesirable features as an investment (e.g. is more risky, requires

a lengthy holding period, is difficult to value or sell, etc.), it may not be a prudent investment for the individual investor, even if it benefits the community at large, which may raise fiduciary issues for the directors and officers overseeing the investment management of the institution's endowment.

Impact Investments typically come in three varieties: socially-responsible investments; mission-related investments; and program-related investments. Each of these shares the same quality of helping to align an institution's investment activities with its mission, while also providing the opportunity for a financial return, the proceeds of which further advance the mission. The following provides an overview of each type of investment.

Socially-Responsible Investments

A common type of socially responsible investment (SRI) is to apply positive or negative screens to select investments, reflecting predetermined criteria. Positive screens typically help to identify

investments compatible with the institution's objectives. For example, a positive screen might guide an institution to invest in companies that engage in sustainable environmental practices or apply fair labor standards. Negative screens are exclusionary and guide the institution's investment managers away from certain investments. For example, a college or university investment manager applying a negative screen might not invest in companies that sell tobacco, exploit their workers, or pollute the environment.

Mission-Related Investments

MRIs are investments typically made for the primary purpose of achieving a financial return but that also further a college or university's educational and charitable mission.

For example, a college or university may invest in a for-profit technology company that provides educational software that assists at-risk students to stay in school and complete a higher education degree. The invest-

Golden Gate University

1/2 page, 4 color

ment may yield market returns after a relatively long period of illiquidity. As such, this investment may be riskier than a comparable investment that is not an MRI. A college or university may consider the extent to which this investment furthers the institution's educational and charitable mission when determining whether the investment is prudent.

It is generally advisable to document the rationale for making the investment, including a comparison between a traditional investment and the MRI to show that the investment decision was undertaken with due care and the trade-offs were judged to be reasonable. In addition to monitoring the investment's financial performance, institutions should also monitor the mission impact of the MRI.

Program-Related Investments

Unlike SRIs and MRIs, which are investments dressed as grants, PRIs are grants dressed as investments. In other words, SRIs and MRIs are investment activity but PRIs are program service activity.¹⁴

As a technical matter, PRIs are investments with sufficiently grant-like features that they meet the requirements of a regulatory safe harbor available to private foundations seeking to avoid the "jeopardizing investment" excise tax. Valid PRIs also qualify as eligible distributions to meet the foundation's annual payout requirement.¹⁵ While colleges and universities, as public charities, are not subject to the restrictions on jeopardizing investments and the minimum-distribution requirements applicable to private foundations, applying the PRI rules in the public-charity context can be helpful for distinguishing investments that qualify as programmatic activity from investments that do not.

PRIs enable institutions to use their funds for grant-like distributions while using the financial rigor of the investment form, which can be a desirable means of achieving specific educational and charitable objectives. Also, unlike grants, PRIs allow institutions to recycle funds for potentially unlimited future distribution to other recipients. On the other hand, unlike MRIs, whose primary purpose is the financial return, PRIs have the primary purpose of significantly furthering the institution's educational and charitable purposes. A PRI cannot be made with a significant purpose of receiving a financial return.¹⁶ In other words, the investment must significantly further the accomplishment of the institution's exempt purposes, and, but for the relationship between the investment and the accomplishment of those exempt purposes, the investment would not otherwise be made.

To determine whether a significant purpose of the investment is the production of income, an important question is whether investors solely engaged in the investment for profit would make the investment on the same terms. However, the fact that an investment produces significant income or capital appreciation will not by itself bar the investment from qualifying as a PRI. Thus, an investment made to accomplish a college or university's exempt purpose that also results in a market-rate return will not automatically disqualify the investment as a PRI, provided that other factors show that the prospective return was not a significant purpose for making the investment.

PRIs can be used to fund many different types of projects and often take the form of a loan bearing interest at below-market rates. For example, a college or university located in or near a deteriorated urban area may seek to make a below-market loan to a business enterprise owned by an economically disadvantaged minority group located in the area as a program-related loan when conventional lenders are unwilling or unable to provide financing.¹⁷ Other

examples of PRIs include loan guarantees (including guarantees of loans by commercial lenders), real estate mortgages, and equity investments in public or private companies, convertible debt or equity. PRIs can be made to public charities, private foundations, public and private companies, LLCs and limited partnerships, and investment funds.

On 4/25/16, the IRS issued final regulations regarding PRIs that contain nine new examples of qualifying investments.¹⁸ These examples show that PRIs can fund a wide range of charitable programs, including commercial businesses that serve as intermediaries to reach the intended charitable beneficiaries. The charitable purposes of the recent examples include funding the scientific research and development of drugs to treat diseases that predominantly affect the poor; funding a recycling business to combat environmental deterioration; funding a failing business that employs a large number of poor individuals; funding small businesses started by the poor in a developing country; educating poor farmers about advanced agricultural methods; and others. The examples also describe the form that the investments must take to qualify as a PRI. For example, requiring the recipient of the investment to distribute drugs to the poor at affordable prices or requiring the recipient to publish research results.

CONCLUSION

The market for PRIs and other impact investments has exploded in recent years. The tax rules and prudent investor rules are flexible enough to permit colleges and universities to engage in most forms of ESG investments. That said, ESG investing should not be undertaken casually, without due consideration for the effect of the investment on the institution's mission and investment portfolio. Investment advisors should develop proper procedures for the selection and evaluation of investments, and document the rationale for each investment. ●

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¹⁴ When made by a private foundation, PRIs are eligible for special tax treatment.

¹⁵ See, e.g., Sections 4942 (failure to make qualifying distributions), 4944 (jeopardizing investments), and 4945 (taxable expenditures).

¹⁶ See Regs. 53.4944-3(a)(1)(i) and (2)(i).

¹⁷ See Reg. 53.4944-3(b), Example (1).

¹⁸ TD 9762, 4/25/16.