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The Philanthropy Protection Act: A Tool for Charitable Funds

The Philanthropy Protection Act of 1995 (the "Philanthropy Protection Act" or the "Act") is a piece of little-known legislation that provides exemptions from certain federal securities laws to philanthropic entities. Specifically, the Philanthropy Protection Act exempts charitable organizations and qualifying funds maintained by them from the registration requirements under the Investment Company Act of 1940 (the "Investment Company Act"), the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and the Investment Advisers Act of 1940. The Philanthropy Protection Act was initially introduced to facilitate the issuance of charitable gift annuities by charitable organizations without violating federal securities laws. Today, it has become a tool for charitable organizations to organize and offer impact funds, particularly in instances where the charitable organization desires as part of its programmatic goals to crowd-source funds from within the community it is seeking to serve and where potential investors may not meet the typical investor qualifications required under the federal securities laws.

The Origins of the Philanthropy Protection Act

The Philanthropy Protection Act's origins are rooted in a lawsuit involving several Lutheran organizations in Texas and a woman named Louise T. Peters who donated the majority of her $2 million estate to the Lutheran Foundation of Texas (the "Foundation") in exchange for two charitable gift annuities. Additionally, she established a net income charitable remainder unitrust with the Foundation. As Ms. Peters suffered from dementia and Alzheimer's disease, her legal guardians and trustees of her estate sued multiple parties involved in the sales of the annuities and interests in the unitrust, which included alleged violations of the federal securities laws.

At the time of the filing of the claims, charitable organizations were exempt from securities registration requirements if their net earnings did not benefit any individual, private shareholder, or person. This created ambiguity over the applicability of exemption for charities with income funds, as donors received periodic payments from such funds' earnings. Over a 23-year period, the SEC had released a series of no-action letters stating it would not take any enforcement action against organizations maintaining such funds. Congress was therefore motivated to act, and the Philanthropy Protection Act was introduced and ultimately passed unanimously.

In testimony before the Subcommittee on Telecommunications and Finance of the Committee on Commerce of the U.S. House of Representatives, Barry P. Barbash, then director of the division of Investment Management of the SEC stated the following: "The Philanthropy Protection Act (the "Act") is designed to clarify the uncertainty created by the Texas litigation by codifying the approach taken in the staff's no-action letters. **The Act would permit charitable income funds to operate without registration under the Investment Company Act, Securities Act and Exchange Act**. In addition, the Act would exempt charitable organizations that sponsor charitable income funds, and certain persons associated with those organizations, from registration under the Investment Advisers Act of 1940…

Notably, the Act would not affect the reach or scope of the anti-fraud provisions of the federal securities laws…."[1] (emphasis added).

The Act's passage led Judge Joe Kendall to dismiss claims based on Investment Company Act violations in the fall of 1996 (other claims in the litigation continued for another two years).

Philanthropy Protection Act and Private Funds

The Philanthropy Protection Act amended various federal securities laws, creating exemptions for issuances by charitable organizations. Under the Philanthropy Protection Act, a charitable organization may offer securities in a fund that is exempt from registration under the Securities Act pursuant to Section 3(a)(4) thereof.[2] Additionally, the fund itself would be excluded from investment company registration requirements pursuant to Section 3(c)(10) of the Investment Company Act.

The Philanthropy Protection Act also exempts individuals affiliated with funds exempt under Section 3(c)(10) of the Investment Company Act from broker-dealer registration requirements under Section 3(e) of the Exchange Act. This includes charitable organizations and their trustees, directors, officers, employees, and volunteers who are acting within the scope of their employment or duties. To maintain this exemption, individuals involved in fundraising cannot receive commissions or special compensation based on the collected donations.

Under the terms of the Philanthropy Protection Act, it preempts any state securities laws requiring the registration of securities, unless the state has passed a law opting out of that preemption. The states of Arkansas, Connecticut, Florida, Mississippi, Nebraska, Pennsylvania, Tennessee, and Virginia have opted out of this federal preemption. As a result, offers and sales of notes in those states must be made in compliance with the registration requirements of those states' laws.

As noted above, the Philanthropy Protection Act does not affect the applicability of the anti-fraud provisions of the various federal securities laws, such as SEC Rule 10b-5.

The Philanthropy Protection Act's exemptions offer two key benefits. First, these exemptions relieve charitable organizations from the burdensome registration and reporting requirements typically imposed on registered investment companies and public securities offerings. Second, these exemptions broaden the range of individuals to whom charitable organizations can offer, issue, or sell securities. For example, a fund exempt from registration under Section 3(c)(10) of the Investment Company Act may issue interests to investors who are not "accredited investors," as defined in rule 501(a) under the Securities Act.

Eligibility Under the Philanthropy Protection Act

The Philanthropy Protection Act is not universally applicable to all charitable organizations or the funds which they sponsor. To qualify for the Section 3(c)(10) exemption from registration under the Investment Company Act, a company must be organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purpose and either, (i) no part of the net earnings of such company inures to the benefit of any private shareholder or individual, or (ii) such company is or maintains a fund which is a pooled income fund, collective trust fund, collective investment fund, or

[1] https://www.sec.gov/news/testimony/testarchive/1995/spch062.txt

[2] "Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual, or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940."

similar fund maintained by a charitable organization[3] exclusively for the collective investment and reinvestment of one or more of the following types of assets:

1. assets of the general endowment fund or other funds of one or more charitable organizations;
2. assets of a pooled income fund[4];
3. assets contributed to a charitable organization in exchange for the issuance of charitable gift annuities[5];
4. assets of a charitable remainder trust[6] or of any other trust, the remainder interests of which are irrevocably dedicated to any charitable organization;
5. assets of a charitable lead trust[7];
6. assets of a trust, the remainder interests of which are revocably dedicated to or for the benefit of one or more charitable organizations, if the ability to revoke the dedication is limited to certain enumerated circumstances;
7. assets of a trust not described in clauses (1) through (5), the remainder interests of which are revocably dedicated to a charitable organization; or
8. such assets as the SEC may prescribe by rule, regulation, or order.

A fund is considered "maintained" by a charitable organization if the organization serves as a trustee or administrator of the trust or fund or has the power to remove the trustees or administrators of the trust or fund and to designate new trustees or administrators.

In respect of both the exemptions provided by the Philanthropy Protection Act under the Securities Act and the Investment Company Act, charitable organizations must ensure that no part of the net earnings of the investment will inure to the benefit of any private shareholder or individual.

As noted above, the origins of the Philanthropy Protection Act were in the issuance of charitable gift annuities. Charitable gift annuities are contracts between a donor and a charity whereby, in return for a large donation, the donor receives a fixed stream of income from a charity for the rest of their life. This structure of an upfront sum of cash given to a charity in exchange for a predetermined payment has been leveraged by charitable organizations to form, by way of example, private debt funds that can avail themselves of the exemptions provided by the Philanthropy Protection Act. A charitable organization may be able to form a private fund that issues notes or other forms of debt to investors, regardless of their status as an accredited investor under the Securities Act, and such investor may receive a repayment of their note and interest thereon, though no investor may receive a profits interest or otherwise participate in the profits of the private fund. For the avoidance of doubt, the charitable organization may only utilize the capital raised to further their charitable purposes.

Lastly, charitable organizations should note that an exempt fund must provide a disclosure statement to each investor at the time of investment, outlining the "material terms of the operation of such fund."[8] The Act does not specify the exact content of this disclosure statement but a clear record of this statement being provided to each investor should be maintained by the charitable organization.

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[3] Organizations described in paragraphs (1) through (5) of Section 501(c)(3) of the Internal Revenue Code 1986, as amended.

[4] As defined in Section 642(c)(5) of the Internal Revenue Code 1986, as amended.

[5] An annuity issued by a charitable organization that is described in Section 501(m)(5) of the Internal Revenue Code 1986, as amended.

[6] Charitable remainder annuity trusts or a charitable remainder unitrusts, as those terms are defined in Section 664(d) of the Internal Revenue Code 1986, as amended.

[7] Trusts described in Section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B) of the Internal Revenue Code 1986, as amended.

[8] Section 2(b) of the Philanthropy Protection Act.

The Philanthropy Protection Act presents an attractive option for charitable organizations that desire to raise money for their charitable purposes. Charitable organizations should discuss with their professional counsel the availability of an exemption under the Philanthropy Protection Act for purposes of organizing and sponsoring private funds.

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