The next chapter

A new bond linking financial returns to environmental or social goals could thrive. But securities law conditions need to be met first

Shakespeare's Juliet may not have ascribed great significance to a name but for securities lawyers and market participants alike there is significance to nomenclature. Social impact bonds, or investments that are intended to provide funding to achieve a particular environmental or social impact, have not, to date, been structured as debt securities or "bonds". Also, many so-called social impact bonds may not be structured in such a way as to link financial returns and the achievement of observable impact milestones or results. We advise NPX, LLC which has developed the proprietary Impact Security, a debt security that incorporates pay-for-performance elements to expressly condition payments on the attainment of specified metrics. Impact Securities differ from green bonds, which are "use of proceeds" bonds wherein the issuer of the bond commits to deploy the proceeds of the bond issuance to fund certain environmental projects. Instead, payments to holders of Impact Securities vary based on the issuer's success in furthering its goals.

Securities law considerations

From a securities law perspective, assuming the Impact Security is issued by a non-profit entity, the security will be exempt from the registration requirements of section 5 of the US Securities Act of 1933. Section 3(a)(4) of the Act provides an exemption from registration for securities issued by an entity organised and operated exclusively for charitable purposes and not for pecuniary profit. As with other exemptions from registration, the entity availing itself of, or claiming, the exemption is required to show that it is available. A single substantial for-profit purpose will render the exemption unavailable. The entity claiming the exemption must ensure that no part of the entity's net earnings will inure to the benefit of a stockholder, member or individual.

Many non-profits obtain no-action letter relief from the US Securities and Exchange Commission (SEC) confirming that the SEC staff will not take enforcement action if the non-profit issuer issues and offers securities publicly without registration in reliance on the section 3(a)(4) exemption although there is no requirement to do so. The SEC staff, in its no-action letters, often has identified one factor in its analysis regarding the entity's charitable purpose (based on) a ruling from the Internal Revenue Service (IRS) that the issuer qualifies as a tax-exempt organisation under IRS Code section 501(c)(3). However, the exemption from registration is not conditioned on the receipt of the tax ruling. Also, if a tax-exempt issuer serves a "substantial non-charitable purpose," the exemption from registration will not be available. US state securities laws also provide an exemption from registration for "any security issued by any person organised and operated not for private property but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes". The state law exemption is broader in scope than the federal securities law exemption. From time to time, the US Congress has reviewed the exemptions available to non-profits. For example, in 1995, it adopted the Philanthropy Protection Act which amended the section 3(a)(4) exemption to make it broader and provide an exemption for pooled non-profit or charitable vehicles that are excluded from the definition of an "investment company" under the Investment Company Act of 1940 under section 3(c)(10)(B).

An entity's purpose can be established through its organisational documents, including its charter and bylaws. The charter and bylaws should expressly limit the entity's activities and limit the entity's purposes solely to advancing its charitable purposes. In fact, in considering the tax determination, the IRS reviews the language of the charter and the bylaws. Similarly, any descriptions prepared by the entity of its operations should clearly state the entity's charitable purpose. Courts and regulators have looked at other "extraneous" evidence of the entity's purpose. Careful records should be kept by the entity relating to its activities. Beyond looking at organic documents, the most important determinant of charitable purpose is the fact that no part of net earnings can inure to the benefit of a person, stockholder, member or individual. To the extent that the SEC or other regulators have pursued enforcement actions against entities claiming the exemption from registration, most regulatory concern has almost invariably stemmed from profits derived by "promoters" or "sponsors" of the purported non-profit entity.

Form of offering

A non-profit or charitable entity may, therefore, in reliance on the section 3(a)(4) exemption, offer an Impact Security in a public offering. To date, most social impact bonds, which generally have been structured as LLC or LP units, have been offered in private placement transactions. As a result, only certain institutional investors or high net worth investors are eligible to participate in the transactions. In addition, the offerings have not involved the use of general solicitation, so the marketing of the offerings has been limited and quite targeted to seeking capital from foundations, family offices, and governmental or quasi-governmental entities. A broader cross-section of potential impact investors would be able to invest in an offering of Impact Securities made in reliance on section 3(a)(4).

Structure of the instrument

The Impact Security would be offered by a non-profit or charitable entity to investors. The purchasers of an Impact Security are not making a "donation" but rather seeking a potential financial return while furthering through their investment certain environmental or social objectives. The Impact Security is structured as a debt instrument. The proceeds of the issuance, excluding transaction fees, are deployed exclusively to advance the entity's charitable mission. The terms of the security may be structured so as to provide for interest and/or principal or supplemental payments to be tied to a predetermined set of impact outcomes. A donor, or a payer, will guarantee the issuer's payment obligations to the Impact Security holder, or will make the contingent payments to the holder on the issuer's behalf to the extent the impact outcomes are met. An Impact Security holder's return is variable based on impact – as a result, there is a pay-for-performance feature incorporated into the instrument that can manifest itself through varying levels of principal protection or through variable interest payments.

Regardless, the Impact Security will be a debt instrument (a real social impact bond) that is issued pursuant to an indenture or an issuing and paying agency agreement. The offering may be undertaken on a firm commitment or on an agency basis with the participation of a financial intermediary acting as underwriter. Given that the instrument is a debt security issued pursuant to agreements familiar to investors, a higher level of standardisation can be attained, which will promote growth in impact investment generally.

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