Impact Investing Under the Uniform Prudent Investor Act

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Impact investing is a process designed to align environmental, social, governance and faith-based goals with an investment portfolio. Most of the activity is in the endowment and foundation space, where a dual mindset (financial returns and social values) is part of the mission-related culture. Families and trust beneficiaries are increasingly interested in being more thoughtful with their investment capital. Glenmede has identified three converging trends making it easier for investors to implement impact investment programs that deliver competitive returns: an increase in data available to support investors; a shift from negative to positive screening; and the proliferation of investment options across asset classes and international borders. Impact investing in the US now represents $8.72 trillion, or one-fifth of all investments under professional management.[1] We expect the trend to accelerate.

The purpose of this article is to define impact investing and to consider whether it might work in an irrevocable trust under the Uniform Prudent Investor Act ("UPIA"). The UPIA includes, among other things, the prudent investor rule, the duty to diversify, and the duty of loyalty. Our conclusion is that impact investing can be consistent with the UPIA if undertaken with (1) a sufficient amount of diversification, (2) a selection process designed to not sacrifice economic returns and (3) at a similar or lower cost relative to other prudent investments. However, some fiduciary concerns linger in connection with the duty of loyalty. Specific drafting can resolve the issue initially or with a modification under the Uniform Trust Code's decanting or non-judicial settlement agreement provisions. Obtaining beneficiary consents is another way to proceed if "fixing" the instrument is not possible or pragmatic.

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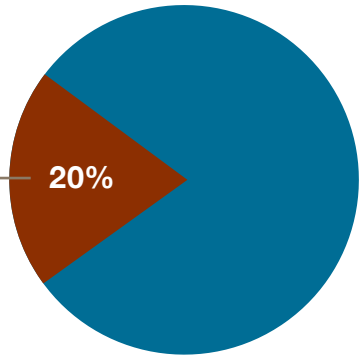


Our conclusion is that impact investing can be consistent with the Uniform Prudent Investor Act (UPIA), however, some fiduciary concerns linger.

WHAT IS IMPACT INVESTING?

The term "impact investing" is still being defined by industry standards. However, some common themes are emerging and "impact investing" as used herein means (1) tilting or aligning a portfolio towards companies with exemplary environmental, social or governance factors using positive screens ("ESG" integration), (2) excluding industries or companies deemed objectionable with negative screens (divesting), or (3) emphasizing thematic issues such as women in leadership or climate change. For fiduciary investments, the ESG integration approach is probably the best form of impact investing to consider in light of comments to Section 5 of the UPIA. However, before analyzing the comments, let's focus on ESG integration: how it works as an investment process and how it is different from other forms of impact investing.

1 *"Impact Investing, Entering the Golden Age," Glenmede Annual Review (2016), citing SIF Foundation, "Report on Sustainable, Responsible and Impact Investing Trends".*

With an ESG integration process, finding appropriate companies to select often involves the simultaneous application of (1) traditional financial analysis and (2) "positive screens" to align or tilt the portfolio towards companies with high or improving ESG scores. ESG data is either reported by the companies or gathered by third parties who then organize and sell the data to investment firms. Investors focused on environmental factors try to address our planet's challenges by focusing on, among other things, carbon emissions, renewable energy, water stress, pollution and waste. Investors who emphasize "social" factors can focus on diversity, inclusion, labor, employee welfare, human rights, product safety and data security. Governance factors include business ethics, independent directors, high audit standards and executive compensation.

Environment
Carbon emissions, renewable energy, water stress, pollution and waste

Society
Diversity, inclusion, labor, employee welfare, human rights, product safety and data security

Governance
Business ethics, independent directors, high audit standards and executive compensation

Impact investing evolved from what was commonly referred to as Socially Responsible Investing ("SRI"), which generally relied on negative screening (i.e., the intentional divestment of capital from certain sectors). Impact investing can include some negative screening but more commonly focuses on ESG integration. The distinction between ESG integration and the historical approach to SRI (negative screening only) is critical. SRI evolved by creating more and more negative screens to help achieve specific social goals. Tobacco, gun companies, oil, liquor, casinos and other so-called "sin" or "vice" stocks were frequently avoided. Excluding these stocks made certain investors feel better about how their capital was deployed. However, from an investment perspective, the "sin" or "vice" stocks outperformed the market.[2]

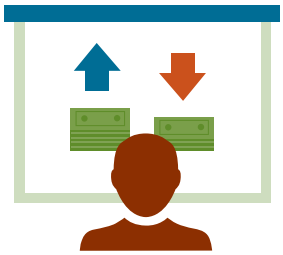
ESG integration does not necessarily exclude any industry or company, but rather tilts the portfolio toward companies that have above average ESG profiles.

A non-fiduciary can make a personal choice to sacrifice returns in exchange for a greater positive impact. Should a trustee of an irrevocable trust make the same choice? The comments to Section 5 of the UPIA (discussed below) suggest that doing so can be a breach of the duty of loyalty. However, ESG integration is fundamentally different than the initial iterations of SRI (negative screening only). ESG integration does not necessarily exclude any industry or company but rather identifies otherwise prudent investments and then tilts the portfolio towards companies that have the best ESG scores, without sacrificing risk-adjusted returns. Recent commentary even suggests that ESG integration can produce "alpha" (returns in excess of the risk undertaken) by giving an investor access to relevant data not captured by traditional financial indicators.[3] Additionally, focusing on ESG factors could reduce the overall risk of the portfolio by helping the fiduciary avoid companies whose operations could be disrupted by environmental scandals, labor relations and governance policies (e.g., avoiding Volkswagen because of its poor governance score in advance of the emissions scandal).

2 *Casey C. Clark, "Investing Alongside of Your Values,"Glenmede (2014). Please note that terms "sin" or "vice" stocks as used herein generally means the Vice Fund (VICEX). For more information, please refer to the fact sheet for VICEX.*
3 *Susan N. Gary, "Feel Good Doing Good: Impact Investing When Settlors and Beneficiaries Want to Do More Than Make Money" 51st Annual Heckerling Institute of Estate Planning (2017), pages 14-10 and 14-11.*

THE PRUDENT INVESTOR RULE

The concept of today's prudent investor rule is rooted in the seminal case of Harvard College v. Amory. Trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[4] After Amory, the obligation of fiduciaries to act as prudent investors was adopted in §227 of the Restatement (Second) of Trusts (1959) as the so-called "prudent man rule". Various courts then began applying and interpreting the prudent man rule with inconsistent results. What evolved was a patchwork of "generalizations" about investing tied to specific fact patterns.[5]



Two legal developments modernized fiduciary investing in the early 1990s. First, the prudent man rule was replaced with the "prudent investor rule" set forth in §§ 227-229 of the Restatement (Third) of Trusts (1992). Second, the National Conference on Commissioners on Uniform State Laws (NCCUSL) released the UPIA, which was generally consistent with the prudent investor rule.[6] The UPIA has been adopted by 46 US jurisdictions and is generally considered the law of the land (although some state-specific nuances exist). The UPIA embraces modern portfolio theory and a total return approach to fiduciary investing. Asset allocation is more important than individual security selection and diversification is critical to enhancing risk-adjusted returns. Fiduciary investment decisions are now made in the context of the risk and return of the "whole portfolio" rather than isolating individual investments for scrutiny. From a liability perspective, "this new approach puts to rest concerns that [trustees] may be surcharged for the failure of one or a small number of individual investments even when the overall portfolio earns a reasonably positive return."[7]

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There is no case law on whether impact investing (as defined herein) is consistent with the prudent investor rule. However, from a return perspective, an academic case is developing that a company with a high ESG rating is more efficient and successful over time than a similar company with a low ESG rating.[8] One commentator summarized the academic studies as follows:

> In very general terms, the studies show that the use of ESG factors in analyzing stocks independently or in building portfolios may improve investment results and that performance of [impact investing] funds compared with [non-impact investing] funds has been, in most cases, neutral or positive. Few of the studies show negative results when comparing [impact investing] funds with [non-impact investing] funds, and none of the empirical studies support the idea that [impact investing] necessarily leads to lower returns.[9]

4 National Conference of Commissioners of Uniform States, Uniform Prudent Investor Act, Comments to Section 1, Prudent Investor Rule (1994).
5 Introductory note to Chapter 17, Restatement (Third) of Trusts (1992).
6 Alberts and Poon, "Derivatives and the Modern Prudent Investor Rule: Too Risky or Too Necessary?" Ohio State Law Journal Volume 67, Number 3 (2006).
7 Alberts and Poon, page 529.
8 Gary, page 14-10.
9 Gary, pages 14-9 and 14-10.

As such, evidence suggests that incorporating ESG factors does not lead to below-market returns. From a diversification perspective, the universe of permissible investments across all asset classes is now broad enough to ensure risk is not concentrated in a few holdings even after ESG scores are considered. Fees should be at least the same, if not lower, than traditional approaches.[10] As such, impact investing can arguably be done consistently with the prudent investor rule since returns, diversification and fees are competitive with more traditional approaches that are considered prudent. Does that mean a trustee can conclude an ESG integration approach to impact investing is consistent with the UPIA? The last (and perhaps highest) hurdle is the duty of loyalty.

DUTY OF LOYALTY

The duty of loyalty requires a trustee to administer the trust solely in the interests of the beneficiaries.[11] Comments to the UPIA suggest that "social investing" might violate the duty of loyalty:[12]

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.

Negative screening was the dominant form of values-aligned investing when the comment above was published. If entire sectors were per se eliminated and the expenses were higher, how could one construct a prudent portfolio? The UPIA comments were on target given the forms of "social investing" prevalent at the time. However, ESG integration is fundamentally different. Positive screens have largely replaced negative screens and otherwise prudent portfolios are now being aligned with environmental, social or faith- based values. Investors can now use an ESG framework to build a competitive, diversified portfolio, including stocks, bonds and some private investments that is fee neutral when compared to traditional fiduciary investments.[13]

A POTENTIAL WAY FORWARD

How should a trustee proceed (or not) with an impact-investing framework? For the reasons stated above, a trustee could conclude that impact investing is different than the "social investing" discussed in the comments to Section 5 and otherwise consistent with the UPIA. However, the case is largely academic and it is unlikely to be tested in court unless someone experiences a dramatic financial loss. Specific drafting, modifications and/or beneficiary consents can resolve the issue and provide a path forward.

Most instruments do contain general investment provisions and some waive the duty to diversity. Some of these existing provisions might be broad enough to entirely waive the application of the UPIA.[14] For example, a provision that says the trustee's investment powers are not limited "by any restrictions on types of investments, statutory or judicial, applicable to trustees or other fiduciaries" gives the trustee a considerable amount of flexibility.

10 John F. McCabe and Nina A. Farran, "Impact Investing for Trustees," Trusts and Estates (June 2015).
11 UPIA Section 5.
12 UPIA (1994), comment to Section 5.
13 Ibid; please note that options in the hedge fund and commodities categories are still developing and might be somewhat limited.
14 UPIA Section 1(b).

However, taking the position that the UPIA does not apply and therefore impact investing is "OK" probably misses the point. Trustees should either be confident with their investment approach or seek authorization (or direction) in the agreement.

For new agreements, drafting counsel might consider adding impact provisions to their standard investment powers. For existing agreements, a non-judicial settlement agreement or a decanting could be viable alternatives to "add" impact provisions.[15] If a particular document cannot be modified (or as a potential "short cut"), the trustee could simply request consents from the beneficiaries under the Uniform Trust Code Section 111.

CONCLUSION

Impact investing can be consistent with the UPIA if the trustee uses an ESG integration process that is designed to be at least equal to traditional fiduciary investments from a return, fee and diversification perspective. Other forms of impact investing (in addition to ESG integration) may also work from a fiduciary perspective, but should be considered in the context of the specific strategy at issue. However, in light of the comments to Section 5, a trustee might consider specific provisions authorizing impact investing (either initially or with a modification) or obtaining consents and then partnering with a firm with a well-defined impact process.

15 For some drafting ideas, see Benetta P. Jenson, "The Fiduciary Issues, Strategies and Drafting Considerations Related to Impact Investing" 51st

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