

HKU/HKJC ExCEL3 Forum

Practicing Impact Investing and Responsible Investing in Hong Kong: Legal and Institutional Developments

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Funding sources to address social and environmental problems to create positive impact

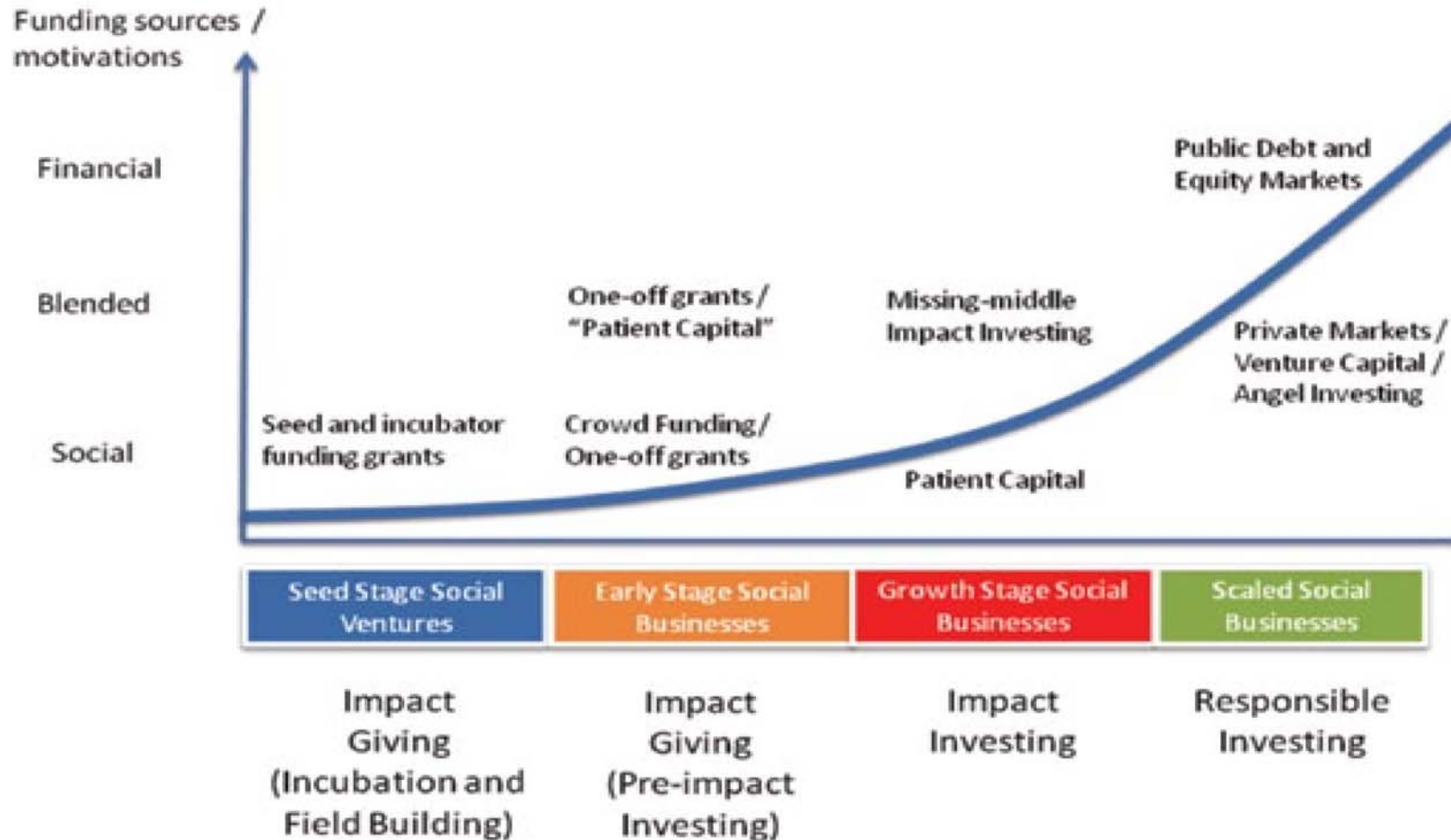
Funding source

1. Government
2. Philanthropy
3. Strategic/venture philanthropy (VP)
4. Impact investing
5. Socially responsible investment (SRI)

Rationale

1. Public welfare
2. Private voluntary funding to charities encouraged by government through tax deductions and exemptions
3. Private voluntary funding to entities motivated by:
 - positive impact
 - entity self-sustainability
 - encouraging innovation
 - certain financial return (“social first” v “finance first”)

Impact funding source spectrum



Source: Asia Value Advisors

Global social entrepreneurship and impact investment movement

- 1980 - Bill Drayton founded Ashoka Foundation to support social entrepreneurs
- 2006 - Nobel Peace Prize awarded to Professor Mohammed Yunus and Grameen Bank for pioneering the concept of microfinance
- 2010 – JPMorgan and Rockefeller Foundation published research report on impact investing as an emerging asset class worth US\$400 million - US\$1 trillion in the next decade

Key milestones in development of social enterprises in HK

- “Welfare enterprise” (employment driven)
- “Commercial activities by NGOs” (new funding source)
- 2007 - Mention in CE Election Manifesto (focus on promoting poverty alleviation)
- 2008 – Inaugural Social Enterprise Summit, creation of HKCCS-HSBC Social Enterprise Business Center and HK Social Entrepreneurship Forum (HKSEF) (collaborative civic effort)
- 2012 – CE announced HK\$500 million Social Innovation and Entrepreneurship Development Fund (oversight by new Poverty Commission)

Comparative study of social entrepreneurship legal frameworks

Linklaters and Schwab Foundation For Social Entrepreneurship, *Fostering Social Entrepreneurship* (presented at World Economic Forum in Davos, 2006) – examined UK, US, Brazil, Germany, India and Poland

1. Forms of establishment/corporate status
2. Tax regime and benefits
3. Regulatory regime
4. Access to finance
5. Competition issues

1. Forms of establishment/ corporate status in HK

1. Company limited by shares or guarantee under Companies Ordinance
2. Unincorporated society under Societies Ordinance
3. Trust
4. Statutory body by HK legislation

2. Tax regime and benefits in HK

Section 88 Inland Revenue Ordinance – “any charitable institution or trust of a public character”

1. Relief of poverty
 2. Advancement of education
 3. Advancement of religion
 4. Other purposes of a charitable nature beneficial to community
- S.88 charitable institution benefits from tax exemptions regarding profits, stamp duty, estate duty and business registration; donations are tax deductible to donors
 - Jurisdictional nexus – not as narrow as some other countries

2. Tax regime and benefits in HK

Expected governance clauses for S.88 charities by IRD:

- Charitable objects
- Limitation on application of funds
- Prohibition of any income and property distribution to members
- Prohibition of members of governing body from receiving remuneration
- Distribution of assets upon winding up to another charity
- Record keeping of expenditure and financial statements

2. Tax regime and benefits in HK

HK Law Reform Commission Consultation Paper on Charities (2011)

- Expand heads of charity
- Establishment of a Charity Commission (like Charity Commission for England and Wales)
- Some propose that social entrepreneurship should also be examined to encourage innovation and self-sustainable models that address social and environmental needs

3. Regulatory regime in HK

- Treated by reference to the corporate form and industry

4. Access to finance in HK

1. Charitable donations
2. Public Funds/Government Subvention
 - Announced HK\$500 million Social Innovation and Entrepreneurship Development Fund – adoption of UK UnLtd model?
3. Equity investment (including preferred shares; dual class shareholdings)
4. Private debt/hybrid instruments (including convertible bonds, loan plus warrant structures)
5. Venture philanthropy – bridging the gap

5. Competition issues in HK

Not an immediate issue in HK – new
Competition Ordinance enacted in 2012 and not
expected to be in force until 2014

Hybrid innovations from abroad

- **UK Community Interest Company (CIC)**(since 2005) – wider public purpose, 35% cap on dividends, founder/board member can be paid; has a CIC Regulator
- **US Low Profit Limited Liability Company (L3C)** (9 States since 2008) – facilitates tranching of different funding sources
- **Benefit Corporation (B Corp)**(12 US States since 2010) – required general public benefit, branding via certification by B Lab (clients from 19 countries) and required impact reports to shareholders
- **US Flexible Purpose Corporations** (Calif 2012) – public purpose mission change require 2/3 supermajority vote, dissenter's right
- **UK Social Enterprise LLP (SELLP)** – charity on board, have min 30% equity, golden share, and be on management committee

Quick comparison between HK charities and hybrid structures

Charitable Institution

- Charitable objects
- Limit application of funds
- Prohibition of any income and property distribution to members
- Prohibition of members of governing body from receiving remuneration
- Distribution of assets upon winding up to another charity
- Record keeping of expenditure and financial statements

Social Enterprise Hybrids

- Public Benefit/Purpose
- Limit application of funds
- Profit/dividend cap/lock
- Payment to founder/board members permitted
- Distribution of assets upon winding up (varied asset lock)
- Record keeping of expenditure and financial statements

Working within existing HK legal framework

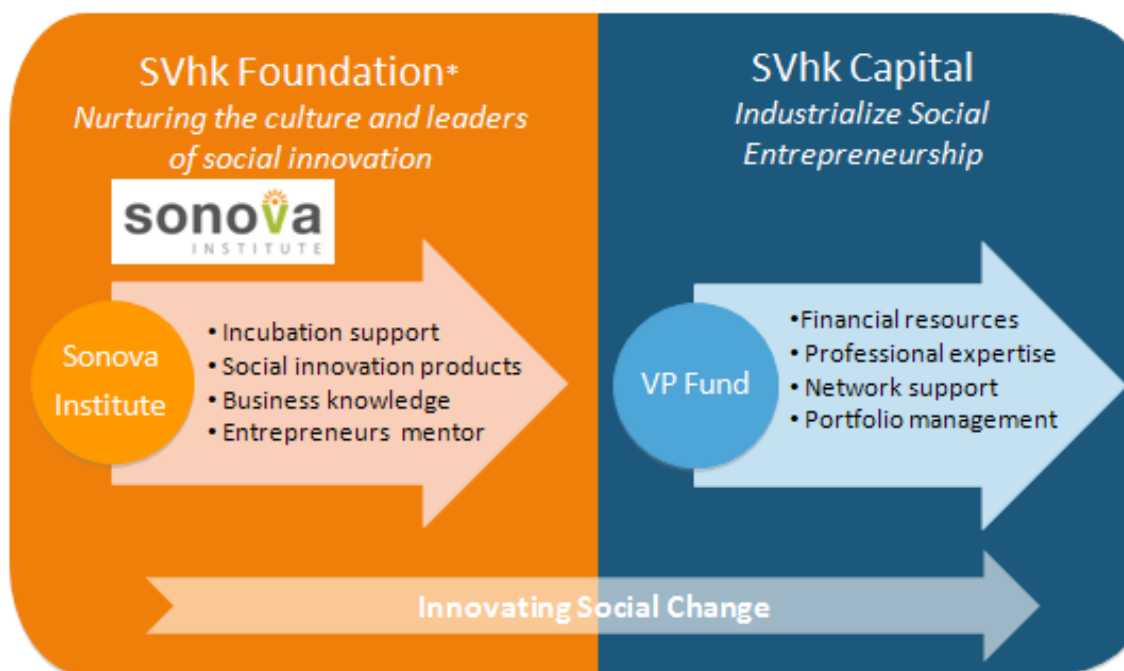
1. Innovative Dual Engine Set-up

- (i) Charitable foundation (company limited by guarantee) for education and capacity building
- (ii) Investment company for funding social enterprises
 - E.g., Social Ventures Hong Kong (portfolio includes Dialogue In The Dark HK, Diamond Cabs)
 - E.g., SOW Asia (portfolio includes GIGABASE, SolarLEAP)

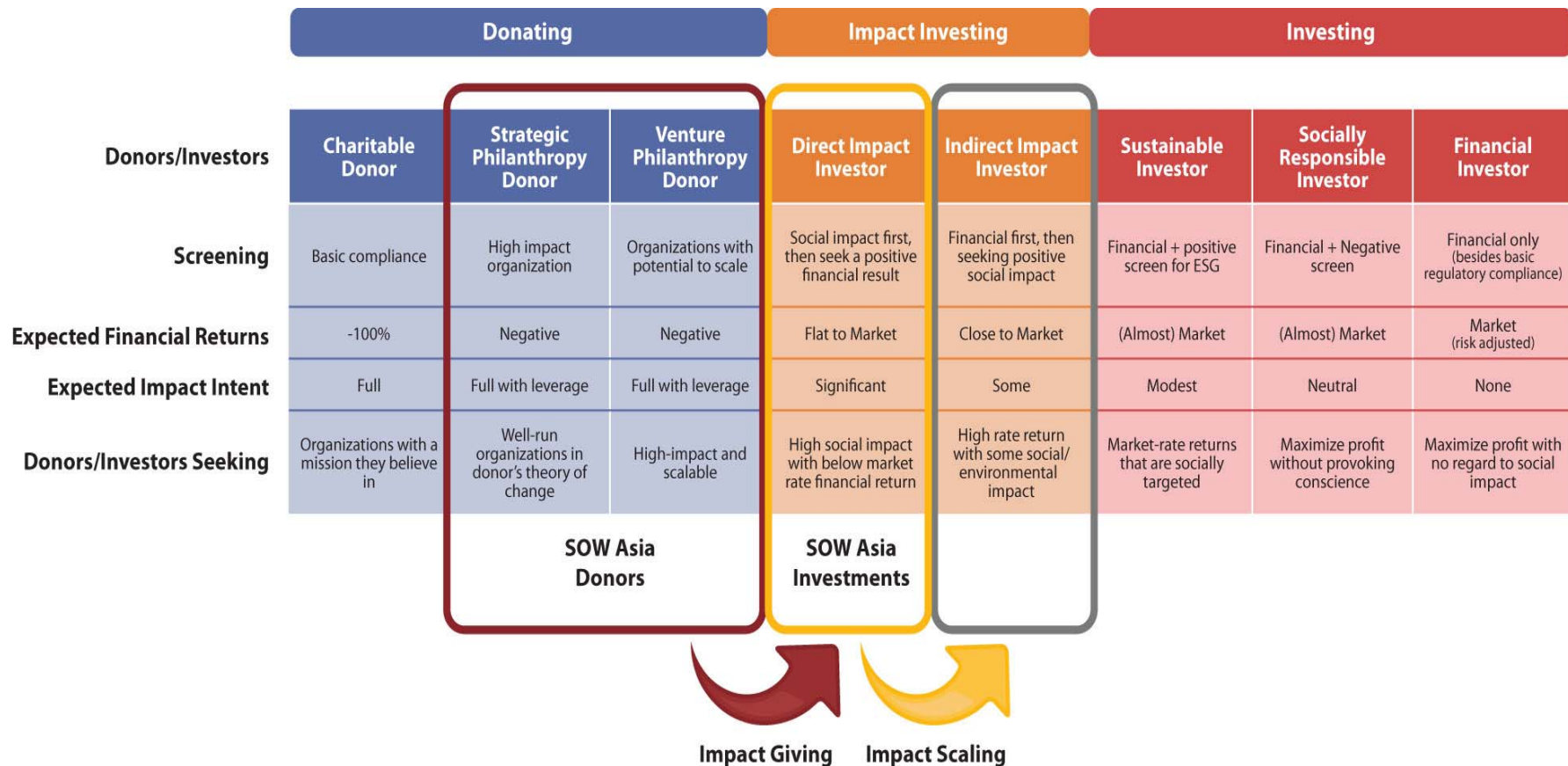
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Dual-Engine Set-up for One Ultimate Goal of Impact

“Leverage the dual-engine set-up to build an ecosystem of Engaged Giving in HK.”



* SVhk Foundation is a charitable organization registered in Hong Kong since 2009.



Adapted from: "Markets for Good" Brian Walsh, Liquidnet

Working within existing HK legal framework

2. Contractual CICs

- No legal framework unlike UK, so founders incorporate into Articles of Association
 - E.g., L plus H CIC (2008)
 - E.g, Education For Good CIC (2012)
- Purely privately funded social enterprises impose own cap on dividends
 - E.g., Dialogue In the Dark HK and Fair Taste HK impose own 33% dividend cap

Working within existing HK legal framework

3. Funding legal structures inspired from abroad
e.g., Acumen Fund (s.501(c)(3)), Gray Ghost Ventures, Unitus Group, LGT Venture Philanthropy

- Longer term (say 10 years), offshore closed-end corporate or GP/LP funds

e.g., Avantage Ventures Impact Fund

- proposed GIIRS rated fund
- focused on Asian social investments in healthcare, education, clean energy, rural development and disenfranchised communities
- IRIS aligned impact measurement reporting principles

Key governance and funding issues for social entrepreneurs/impact investors

1. Transparency
 - Disclosure of layering of funding (grant v financial); conflicts
2. Accountability
 - Measuring and reporting impact v returns – benchmarking
 - Fiduciary duty of board members
3. Mission drift concerns
 - Investor expectations of ROE (equity, debt)
 - “Exits” (e.g., SKS Microfinance IPO)
4. Transactional costs
5. Branding
 - Definition of “social enterprise”; legacy image; accusations of “profiting from the poor”
 - Importance of ecosystem building (eg, Asia Venture Philanthropy Network (AVPN) since 2011; forthcoming Rockefeller Foundation conference to catalyze collective action)

From Private to Public Side of Spectrum... environmental, social and governance (ESG)

According to Association for Sustainable and Responsible Investment in Asia (ASRIA), as of 2011YE, over 130 investment managers in Asia use sustainable investment approaches, with US\$74bn of identified sustainable investment assets under management (AUM) in the region

- However, relatively few dedicated Asian SRI funds

Key Issues faced by SRI sector

1. Fiduciary duties owed by fund managers

- UN Environment Programme Asset Management Working Group 2005 Report by Freshfields and 2009 Follow Up

2. Measuring and pricing externalities and good governance

- Performance benchmarks - sustainability indexes
- Portfolio balance

3. Industry themes and risks

- Themes often dependent on regulation and/or government subsidies (e.g., climate change and carbon)
- Risk of bubbles (e.g., cleantech solar)

Developments promoting ESG in HK

- UN Principles for Responsible Investment (PRI) signatories number is growing amongst asset owners and fund managers
- HK Stock Exchange issued an ESG reporting guide commencing 31 December 2012 which is recommended practice, with the hope to extent the obligation to “comply or explain” by 2015