THE IMPACT SECURITY
Reimagining the Nonprofit Capital Market

Lindsay Beck and Catarina Schwab
NPX

Anna Pinedo
Morrison & Foerster LLP

In recent years, institutional investors, fund managers, and retail investors have expressed increased interest in aligning their investment objectives with furthering social impact. The development of social impact bonds has been an important first step toward meeting this objective. Social impact bonds incorporate pay-for-performance features that bring together donors, governmental entities, and investors to fund a nonprofit organization's achievement of specified impact objectives. Donations and investments are tied to the advancement of the nonprofit organization's initiatives, which promotes accountability and transparency.

The potential of pay-for-performance investments has not been fully realized through existing examples of social impact bonds because they are so complex. Today's social impact bonds are not actually "bonds," but rather bespoke contractual arrangements entered into among institutional investors, philanthropic foundations, governmental entities, and nonprofit organizations.[1] Some of these arrangements have taken the form of loans or credit facilities, while others have been structured as investments in special purpose investment vehicles. The type of players and variety of legal structures for these arrangements has contributed to limiting the universe of potential nonprofit organizations and investors.

THE IMPACT SECURITY SOLUTION

Now, what if the attractive pay-for-performance elements of existing social impact bonds were incorporated into a simpler, more familiar structure that could be readily offered publicly to socially-minded investors, including individuals? The Impact Security approach accomplishes just this.

The Impact Security is a debt security issued by a nonprofit organization, foundation, government or supranational entity featuring variable returns that are contingent on the achievement of predetermined impact metrics. The Impact Security has the following five characteristics:

1. The issuance proceeds, excluding transaction fees, are deployed exclusively to advance an entity's charitable mission;
2. The terms of the instrument specify a predetermined set of impact outcome(s);
3. The terms of the instrument include the public reporting of an objective, predetermined process for third-party measurement and/or evaluation of impact outcome(s);
4. A predetermined outcome payer(s) undertakes responsibility either to guarantee the issuer's obligation to repay investors, or to make payments of the contingent returns to the investors on the issuer's behalf; and
5. A variable financial return based upon predetermined impact outcome(s).

Purchasers of an Impact Security are not making a donation, but rather seeking a financial return while furthering, through their investment in the security, certain social objectives.

TERMS OF AN IMPACT SECURITY

The Impact Security is a debt instrument, or bond. Most investors are familiar with bonds. Large, well-established companies, as well as municipalities and governments, regularly issue bonds. In this case, an Impact Security will be issued by a nonprofit, foundation, government or supranational entity. Like any other bond, the Impact Security represents a promise by the issuer to make certain payments to the holder of the security. The terms of the security may be structured to provide for interest payments and/or principal payments that are tied to, or contingent upon, the issuer's achievement of predetermined impact outcomes.

1 The exception being DC Water's Environmental Impact Bond, which is profiled in this book (Bafford/Kim/Letsinger) and has less of an explicit focus on social outcomes.

A donor, or a payer, either will guarantee the nonprofit issuer's payment obligations to the Impact Security holder or will make the contingent payments due to the holder on the issuer's behalf to the extent that the impact outcomes are met. An Impact Security holder's return is variable based on impact. The nonprofit issuer will deploy the proceeds of issuance of the Impact Security, excluding transaction fees, to advance the entity's charitable mission.

Like traditional bonds, the Impact Security will be issued pursuant to an indenture or an issuing and paying agency agreement and may be marketed by financial intermediaries, acting as "underwriters," to the public. Given that the instrument is a debt security issued pursuant to agreements familiar to investors, a high level of standardization can be attained. The Impact Security will bear a security identifier (i.e., a CUSIP number), can be held in an investor's brokerage account, and can be readily transferred or sold among interested investors.

ASSESSING IMPACT

The hardest part of structuring an Impact Security is not the legal structure itself, but all of the other considerations, namely, impact assessment.

Impact evaluation is often the anticipated red herring; however, it is less daunting than one may imagine given the great advancements made in the impact field over the past decades, including GIIRS, IRIS, GuideStar, and Impact Genome.

The Impact Security can be applied to any intervention with measurable impact. Impact metrics are predetermined by the donor and/or nonprofit organization, laid out clearly with a sliding scale of outcomes each tied to specific payment triggers and audited by an independent third party.

Similar to other standardized financial products deployed by different issuers and even by issuers in different industries, there will be some variances among the terms of an Impact Security issued by different nonprofits. By way of example, the terms of a municipal bond issued in connection with a toll road differ from the terms of a municipal bond issued in connection with the construction of a new stadium, which may incorporate different terms and payment features; however, both are still municipal bonds. Similarly, an Impact Security issued for a healthcare project will have different terms and features than one issued to advance an education initiative, but both will have the same basic, familiar structure and documentation.

The donor in an Impact Security can be a private donor (individual, family office, private foundation, corporate foundation, etc.), government, or supranational entity—anyone seeking to make a performance-based donation. Expanding beyond government to include private philanthropy and supranational entities dramatically increases the amount of capital and types of interventions that can benefit from the pay-for-performance model, which is currently limited to those that save the government money.

For example, The Last Mile, a 501(c)(3) nonprofit organization, intends to issue an Impact Security with the support of donors that have pledged amounts that will provide for payment to investors if The Last Mile achieves predetermined impact metrics. The upfront capital will be used by The Last Mile to launch the first-ever web development shop inside a U.S. prison. Highly vetted inmates at San Quentin that graduate from a one-year coding training program are eligible to work inside the "dev shop" where contract work is brought in from the Bay Area's biggest tech firms. The impact metric on the deal is hours worked, which will be audited annually by an independent third party and trigger donation payments from the fund.

ADVANTAGES OF THE IMPACT SECURITY

This novel approach has the potential to transform social impact investing because it promotes:

- **Standardization**—Studies have shown that there are growing numbers of investors committed to making investments that further their social objectives. These investors favor products that are familiar in format, do not require customization, can be readily held in brokerage accounts, and are transferable.
- **Efficiency**—A standardized approach permits many more nonprofit organizations to access the capital markets and replicate an established structure, with appropriate modifications made to the impact metrics, in order to raise funds. This will reduce transaction costs for nonprofit organizations, donors, and payers and also will improve speed of execution.

- **Expanded investor access**—If the debt security is issued by a nonprofit organization, foundation, or governmental or supranational entity, the offering of the security would be exempt from SEC registration. This exemption allows the security to be offered publicly to all investors, accredited and non-accredited, which expands the pool of eligible investors.
- **Transparency**—Using a debt security facilitates public disclosure and reporting, which leads to enhanced transparency and more efficient pricing.
- **Market integrity**—The rigors associated with reporting impact metrics will promote market integrity. Donors and payers will be able to have reliable data, rather than relying on anecdotal evidence, regarding the effectiveness of their sponsored programs and initiatives. Eventually, investment dollars and donations will follow results.

CHALLENGES TO BROAD ADOPTION

Despite these obvious benefits, the Impact Security faces some hurdles to broad adoption. Quite surprisingly, donors (or outcome payers) are the biggest limiting variable to scale despite the novel risk-sharing mechanism built into the performance-driven structure. A donor's best option prior to the Impact Security was to donate and then hope for impact. By contrast, the Impact Security offers a built-in investor match, audited impact evaluation, and the obligation to donate if and only if impact is achieved. Changing donor mindsets and behavior so that capital is explicitly linked to impact is critical to adoption.

Another barrier is getting impact investors to consider alternatives to social impact bonds. Although only 15 social impact bond transactions have been completed to date in the United States, market participants tend to be creatures of habit who find comfort in the familiar, even when presented with a more efficient alternative.

The rigors associated with impact reporting might also discourage some nonprofit organizations and foundations from embracing the Impact Security. One of the key benefits associated with the Impact Security is that it introduces market discipline by aligning dollars with impact achieved. Stakeholders, including foundations and governmental entities, may not agree on the metrics to be reported or the regularity of reporting; they also may be reluctant to share results broadly.

Lastly, fear of the unknown may inhibit nonprofit organizations from offering Impact Securities. Personnel within nonprofit organizations may require the assistance of advisers with the requisite financial and legal expertise to help them evaluate this important alternative.

In our view, success entails mass adoption of a standardized financial product that explicitly links capital with impact, thereby maximizing donor capital, catalyzing investor capital, unlocking impact data, and, ultimately, transforming the way the world finances impact.

LINDSAY BECK *and* **CATARINA SCHWAB** *are co-founders and co-chief executive officers of NPX, where they are working with innovative donors, impact investors, and nonprofit organizations to transform the way that impact is financed in the nonprofit sector.*

ANNA PINEDO *is a partner at Morrison & Foerster LLP in the capital markets group, where she specializes in securities and derivatives, including structured notes and other hybrid and structured products.*