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«Impact investing» in the european legal system: an italian perspective on investors' pro-tection and regulatory compliance

SUMMARY: 1. For profit *vs.* non-profit: the Swan-song of a black and white view on the World. – 2. The overall inadequacy of the Italian regulatory system and the call for legislative reform. – 3. Capitalistic interest and social-impact investment: from financial returns to measurable social impact. – 4. The renewed European legal scenario: equity-based crowdfunding, EUSEF funds (EU Regulation n. 346/2013) and Social impact bond. – 5. Key elements of investors' protection and regulatory compliance: the private benefit doctrine and the legislative ban on public administrations' use of derivatives.

1. The deficit of social impact in the investment process is at the heart of the debate on today's financial crisis.

Looking at the investment-return dynamic, the entire scene reflects a "black and white" view on capitalistic economic operation. Alternatively, capital can be allocated to optimize either risk-adjusted returns with no specific interest in social benefit, or social impact on the basis of social value of production, in this case without any claim to financial return.

For this reason capital has dramatically shaken off its historical function. In the capitalist development model, private economic undertaking justified itself as an engine of economic welfare[1]. Nowadays the concept of profit has been reduced to the mere enhancement of capital within the bounds of financial markets. As a consequence, it no longer could be described in terms of "creative destruction"[2] aimed at changing reality, or a method of doing business which cannot exist without «constantly revolutionising» the instruments of production, and thereby the relations of production, and with them «the whole relations of society»[3].

[1] On this pont see M. LIBERTINI, *Impresa e finalità sociali*, in *Dir. società*, 2009, p. 6 ff.

[2] «Capitalist reality is first and last a process of *change*»: J.A. SHUMPETER, *Capitalism, Socialism and Democracy* (1942), London, 1976; trad it. in ID., *Il capitalismo può sopravvivere? La distruzione creatrice e il futuro dell'economia globale*, Milano, 2010.

[3] «The bourgeoisie cannot exist without constantly revolutionising the instruments of production, and thereby the relations of production, and with them

The crisis of such a model marks an historical gap between the dual nature of money[4]: on one hand, money as just an instrument to measure the value of an asset; on the other hand, money as «an 'asset in re ipsa' capable of generating wealth by itself and more precisely, interest»[5].

Beyond the pure social significance, the recent financial crises have shaken firmly established beliefs dealing with the risk and return profiles of traditional investments[6]. Risk aversion of institutional and

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the whole relations of society. Conservation of the old modes of production in unaltered form, was, on the contrary, the first condition of existence for all earlier industrial classes. Constant revolutionising of production, uninterrupted disturbance of all social conditions, everlasting uncertainty and agitation distinguish the bourgeois epoch from all earlier ones»: K. MARX e F. ENGELS, *Manifest der Kommunistischen Partei* (1848).

[4] For a complete analysis of the role played by money within the economic system see M. SEMERARO, *Gli interessi monetari.* Utilitas temporis, *capitale e scelte di sistema*, Napoli, 2013, p. 11, 22, 136, 140. Acting as the specific "language" of the economic system, money empowers creation of large manufacturing and mass-production, frees human needs from the time factor and lays modern natural science in service of goods production: cfr. M. BARCELLONA, *Diritto sistema e senso. Lineamenti di una teoria*, Torino, 1996, pp. 369 f. and N. LUHMANN, *Grundrechte als Institution. Ein Beitrag zur politischen Soziologie*, Berlin, 1999, tr. S. Magnolo, *I diritti fondamentali come istituzione*, Bari, 2002, p. 173, 176.

[5] For a very interesting analysis of the role played by money in Islamic finance, «a system that has discovered, before the Western-conventional economic system, the so-called ambit of 'ethical finance'», see A.H.A. KHALEQ and T.V. RUSSO, *Introducing islamic banking in Italy. Challenges and Opportunities to diversify funding sources at a time od a crisis*, in *Riv. dir. bancario*, 2014, 6, p. 4 f., who remarks that «in Islamic fi- nance, money is seen just as an exchange of goods and does not represent the asset itself». See also T.V. RUSSO, *Finanza Islamica*, in *Digesto delle Discipline Privatistiche*, Sez. Commerciale, Agg. VI, Torino, 2012, p. 389 ff.; T.V. RUSSO, *Contrattazione Shari'a compliant e meritevolezza degli interessi. Prime riflessioni su un differente approccio al mercato finanziario*, in *Riv. dir. bancario*, 2014, 4 p. 11. All of the above studies should be read being mindful of the need in Italy for the expansion of public and private infrastructures and for growth of the renewable energy sector amidst the continuing money deficiency. The European and Italian banking system should think about the opportunities associated with the issuing of financial products compliant with the principles of *Shari'a*, in order to utilize the surplus wealth readily available in the Middle East. For further analysis see T.V. RUSSO, *I contratti Shari'a compliant. Valori religiosi e meritevolezza degli interessi. Contributo allo studio*, Napoli, 2014.

[6] See, on this point, M. FALKOWSKI and P. WIŚNIEWSKI, *Impact Investment as New Investment Class*, in 1 *Rev. Bus. & Econ.*, 2013, p. 78 ff.

individual investors as well as structural limits affecting the institutional management industry have accustomed us to the idea that markets have a life of their own, adding operations in an almost cybernetic way. So financial markets drain everyday resources from actors which act without "looking inside the box". Investors operate continuous adjustments apart from the social object of funded activities and without a clear propensity towards selection of innovative projects[7]. On such a basis, business which involves social and/or environmental goods are constantly discriminated with advantage of more competitive investments.

If we take for granted the black-and-white view on the World, it becomes evident that innovative projects are to become the real "adventures" cut out of the market of financial resources.

Such projects are not profitable enough to access traditional financial markets, resulting in a «financial-social return gap»[8]. For all this it is crucial to verify whether Social Enterprises are, either in fact or prospectively, able to yield sufficient returns, adequate not only to cover expenses, but also to further develop its own institutional activities. In fact many social enterprises, at present, are not 'profitable' enough to gain access to traditional financial markets. This causes a gap between financial returns and social benefits. While the social value of offering health care accessible to disadvantaged groups is significant, the cost of private financing to the organization may well exceed the expected and/or achieved gains. For instance, a firm that seeks to employ disadvantaged persons by insufficient qualifications or social or professional problems leading to exclusion and marginalization; a firm that seeks that offer care accessible in favor of disadvantaged groups; a firm that provide a rehabilitation program for ex-prisoners and drug addicts: in any case, the social value of providing social services or goods to vulnerable,

[7] See M. FALKOWSKI and P. WIŚNIEWSKI, *Impact Investment as New Investment Class*, cit., p. 82 f., who underline that «the impact investment universe is evolving as a partial remedy to challenges progressing within the institutional management industry *per se*. These constraints relate to the unhindered expansion of exchange traded funds (ETFs) and index funds, an over-reliance on algorithmic (automated) trading and an ever more potent role of behaviourisms in investment allocations».

[8] A. BUGG-LEVINE, B. KOGUT and N. KULATIKALA, *A New Approach to Funding Social Enterprises*, in 78 *Harvard Bus. Rev.*, 2012, p. 3 ff.

marginalised, disadvantaged or excluded persons is enormous, but the cost of private funding often outweighs the financial return.

From this perspective, the lack of funding opportunities represents one of the main hurdles that the Social Enterprise model is facing. Most non-profit organizations survive thanks to generous state contributions and donations by private individuals, who decide to invest their savings in projects of social interest. The efficiency of this type of organizations depends, in sum, from the amount of capital injected into the organization. This means that they make considerable efforts in order to raise funds. By contrast, it would be more useful if such efforts were directed to the planning and managing of 'general interest' activities.

Therefore it becomes increasingly important to recognize the need for the creation of a systematically sound normative framework, with the object of providing adequate regulation of the several innovations concerning nonprofit organizations fundraising and financing. Such innovations should be read through the lenses of the need for Social Enterprises to explore and exploit broader financial channels than the ones currently available, which are provided by banks, public financing (progressively decreasing), and the simple giving (occasional in nature) by private individuals.

The international debate concerning the need of additional funding sources for social innovation projects[9] now focuses on the feasibility of financial contracts aimed to generate both financial and social returns[10], that means transferring the risk of failure of such projects

[9] The term "social innovation" indicates the development of ideas aimed at solving social, economic and environmental problems through the use of alternative solutions: see R. RANDAZZO, *Finanza ed innovazione sociale: un nuovo glossario*, in *Enti non profit*, 2012, 1, p. 47. Cfr. S. GOLDSMITH, *The Power of Social Innovation: How Civic Entrepreneurs Ignite Community Networks for Good*, San Francisco, 2010.

[10] The term "impact investing" was first coined at a convening hosted by the Rockefeller Foundation in 2007. While all impact investing is united by a dual intent to generate both financial and social returns, the structures within that umbrella are vast: it varies by asset class, the investor's risk tolerance and expectation of return, sector and geographical scope. For previous studies about this phenomenon in economics see A. BUGG LEVINE e J. EMERSON, *Impact Investing*, San Francisco, 2011. See also the J.P. Morgan Report, *"Impact Investments: An emerging asset class"*, in *Global Research*, November 2010; J. FREIREICH and K. FULTON, *Investing*

from the public to the private sector by the issuance of special financial instruments[11].

2. The main problem with the promotion of the so-called «Social entrepreneurship» perspective is the overall inadequacy of the Italian regulatory system governing the non profit entities. In spite of a lengthy legislation careful to tax-relief mechanisms, what is actually missing is a general regulatory framework.

The rules contained in Book I of the Italian Civil Code were in fact conceived in 1942 by reason of activities very different from those carried out today by the enormous variety of non-profit organizations[12]. Conversely, the decree on Social Enterprise (n. 155/06) whereas it provides important theoretical-systematic insights, seems unfit to meet the same need that would justify its use in practice[13]. As regards the definition of 'subjects', in fact, commentators call for a reform that might ensure their suitability to carry out business activity. Under a systematic point of view, the specific provision introduced by the legislature with respect to Social Enterprises still appears incoherent. Overall, there still remain several problems as to the nature of internal and external funding instruments and identification of the interests that justify the giving; such problematic profiles need be solved, also in the light of article 3 of Leg. Decree 24 March 2006 n. 155, which emphasizes the mandatory nature of the non distribution constraint, namely the prohibition for Social Enterprises to distribute dividends and profits either directly or indirectly.

for Social and Environmental Impact. A design for Catalyzing An Emerging Industry, 2009, in www.monitorinstitute.com; the Bridges Ventures Report, *Investing for Impact. Case Studies across Asset Classes* (2010), in www.parthenon.com.

[11] For a first analysis, see J.B. LIEBMAN, *Social Impact Bonds. Promising New Financing Model to Accelerate Social Innovation and Improve Government Performance*, Center for American Progress, 2011.

[12] For a closer examination, see R. DI RAIMO, *Le associazioni non riconosciute. Funzione, disciplina, attività*, Napoli, 1996, p. 131, 143, 253.

[13] For a broad overview on issues and problems see M.V. DE GIORGI (eds), *La nuova disciplina dell'impresa sociale. Commentario al D.Lgs. 24 marzo 2006, n. 155*, in *Le nuove leggi civ. commentate*, 2007, p. 418 ff.

Almost all commentators in Italy call for legislative reform. However, if one wants to appropriately tackle the issue of how to finance social innovation, it is crucial to overcome the traditional conceptual barriers which continue to separate "black" from "white": "profit" from "non-profit".

The need for an all-encompassing study of the aforementioned weaknesses becomes even more imperative if one considers that soon the domestic system will be called to harmonize itself to the new instances fostered by the EU legislature. Unsurprisingly, the EU policymaker, within the *Single Market Act*, has expressly indicated as a way out of the financial crisis the promotion of new measures in support of *social entrepreneurship*. Above all, the study of social finance institutions plays a central role with a view to conveying within our socio-economic system the investments of the European social entrepreneurship funds (EuSEF) recently introduced by the European Parliament with the EU Reg. no. 346/2013.

Likewise, most of the attempts – either public or private – to solve or at least to mitigate the current shortage of liquidity of sovereign finances have heavily relied on the promotion of new financial instruments aimed at diversifying the sources of financing social innovation. Within this framework, the new models of collective 'impact investing' need to be studied from a legal point of view, with respect to: (a) oversight and responsibility in the investment managing; (b) interactions between private and public finance; (c) investors' protection.

3. The fundamental axiom of the non-profit world mirrors the perfect coincidence between the enterprise's social nature and the ban on dividend distribution[14].

[14] About the distinction between "subjective" and "objective" profit and the way it has been widely used by scholars see R. COSTI, F*ondazione e impresa*, in *Riv. dir. civ.*, 1968, I, 1, p. 1; G. MARASÀ, *Le "società" senza scopo di lucro*, Milano, 1984, pp. 76, 165 ff. Critical remarks by R. DI RAIMO, *Date a Cesare (soltanto) quel che è di Cesare. Il valore affermativo dello scopo ideale e i tre volti della solidarietà costituzionale*, in *Rass. dir. civ*., 2014, 4, p. 1087. In the same sense, see also M. D'AMBROSIO, *Partecipazione e attività. Contributo allo studio delle associazioni*, Napoli, 2012, p. 11, 41 ff.

Historically, the capitalist system has assumed that an organization is either a for-profit or a non-profit/charity: the former exists to maximize profit, the latter exists for a charitable purpose. It is therefore plausible to assert that at the center of the black-and-white paradigm is the non-distribution constraint placed on charities, on the one hand, and the duty of for-profit companies to maximize shareholder value, on the other[15].

It is well known that non-profit organizations are entitled to carry out business activities without losing the corresponding "non-profit" qualification insofar as the profits are not distributed, either directly or indirectly, among the participants in the venture[16] (Decree 4 December 1997, n. 469; art. 3, Decree 24 March 2006, n. 155). By this token, common wisdom has thus far stressed upon the fundamental distinction between equity-investment and debt-investment[17]: the former being always forbidden, whereas the latter is permitted on the condition it does not exceed the official interest rate by more than 5% (art. 3, para. 2, Decree n. 155/2006).

The dual concept of investment and returns describes the essence of any capitalistic economic operation, regardless of its legal qualification[18]. Within this framework, the *surplus* generated by enterprises – including social enterprises – has been understood as a simple sum of homogeneous values: the (economic) value of the utility produced, discounting the cost of resources employed along the process. The social goals institutionally pursued by non-profit organizations are of course taken into consideration, but they are by

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[15] Interesting remarks by K. WESTWAY, *Beyond Black and White: The New Paradigm of Social Enterprise*, in 9 *New York Univ. J. Law & Bus*., 2013, p. 441.

[16] It is well known that the *rationale* for tax exemption is based upon the theory that Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds. In other words, nonprofits are able to obtain tax-exempt status because they provide the government with a public benefit by providing resources and services the government would otherwise have to finance with taxpayer money.

[17] On this point see G.F. CAMPOBASSO, *Diritto commerciale*, 2, *Diritto delle società*, Torino, 2002, p. 7; see also G.B. PORTALE, *I «beni» iscrivibili nel bilancio di esercizio e la tutela dei creditori nella società per azioni*, in *Riv. soc.*, 1969, p. 267.

[18] In the same sense, see the interesting considerations of R. DI RAIMO, *Impresa, profitto e categorie dello spirito*, in *Riv. dir. impr*., 2011, 3, p. 603 ff.

and large conceived of as elements which hit the contractual relationship (between the investor and the beneficiary social undertaking) only "from the outside". In other words, it is rare that the significance of such non-economic goals is as high as to condition the search for the applicable law: the economic operation is constantly scanned through the debt/equity lenses and in the light of the non distribution constraints. These are the sole pre-requisites the law mandates in order (for the social enterprise or, else, the investor) to obtain favorable tax treatments or facilitated loans[19].

Also in our regulatory system there were legislative attempts to craft a conceptually independent notion of "private finance" for the Third Sector. Nevertheless those experiments, rather sporadic and haphazard, were almost entirely based on tax incentives and are still awaiting to be duly implemented in practice[20].

Especially the experiment about "solidarity securities" as a source of financing for "social utility" enterprises (as intended by art. 29, Decree n. 460 of 1997) did not work as well. With "solidarity securities" the Italian legislature intended to promote a type of financial instrument issued by institutional/specialized intermediaries and underwritten by under-remunerated investors to the sole aim of financing ONLUS organizations[21]. Issuers (banks and authorized intermediaries) may deduct from business incomes the difference between the charged interest rate and the rate of interest fixed by law.

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[19] This is a way of looking at the non profit sector that some autoritative scholars repute conceptually outdated: R. Di Raimo, *Postulati logici e soggettività degli enti che esercitano l'impresa*, in Atti S.I.S.Di.C., *Il diritto civile oggi. Compiti scientifici e didattici del civilista*, Napoli, 2006, p. 330; ID., *L'impresa non lucrativa*, Atti del seminario di Benevento del 25 settembre 2007. Introduzione, in *Riv. dir. impr.*, 2007, 3, p. 437 ff. See also M. FRANCESCA, *La rilevanza dei fatti di sentimento nel diritto privato: associazionismo, terzo settore e tutela dei diritti sociali*, in *Percorsi di diritto civile. Studi 2009/2011* by R. RAIMO, M. FRANCESCA e A.C. NAZZARO, Napoli, 2011, p. 55.

[20] So far, due to the absence of a relevant market of reference, the civil and administrative provisions pertaining to «products and services qualified as "ethical" or "socially responsible"» (art. 117 *ter* TUF, artt. 89-90 CONSOB Regulation on Intermediaries) have never been applied. Besides, such rules have now been superseded by EU law through the creation of «EuSEF» funds (EU Regulation nn. 346 of 17 April 2013).

[21] For a brief analysis see C. RABITTI BEDOGNI, *Patrimoni dedicati*, in *Riv. not.*, 2002, 5, p. 1125 ff.

The mechanism, apparently simple, is perverse with regard to the consequences. For sure, the lower is the return for the investor, the higher is the tax advantage for issuers but this does not involve automatically that the interest rate for the ONLUS beneficiaries is lower, too.

Some brief reflections are required.

First. Why should the investor settle for an interest rate considerably lower than the market-rate? Well, perhaps the investor renounces to a portion of returns just for the gratification due to supporting an activity generally handled in the form of solidarity.

Second. The required financial support is too generic: the investor has no idea about the organization he actually funds. The option is only up to Government supervision and monitoring. Might in long terms this generic 'call for help' represent a gap?

Third. The structure of 'solidarity securities' is the typical one of a debt instrument: the subscriber gains regardless of a measurable and positive social impact. To put it briefly, it represents a structural combination of the old funding models: private donations and tax breaks.

From a macro-economic standpoint, the model envisaged by Italian legal system – as well as many other European ones – is almost entirely dependent on the persuasive strength of tax benefits in fostering the private pursuit (and management) of public-benefit goals. But, faced with the current public finance crisis, one can easily object that such a model can no longer play the same role as it used to in the past. In the current economic scenario, it is crucial to find «a new start»[22]. A model entirely based on grants and tax exemptions not only loses in attractiveness because of the dire conditions of public finance, but it also becomes a factor of systemic slowdown for social enterprises. In this way, they are unable to make medium- or long-term forecasts on expected cash flows, which hampers sound

[22] M. FRANCESCA, *La rilevanza dei fatti di sentimento nel diritto privato*, cit., p. 55, who said that «just the profitable interest, which is the main "selfish lever," may be subjective and objectified driver in order to stabilize and expand the modulation of an offer, to date, not always consistent with demand».

business-planning, with easy-to-guess adverse effects on the pursuit of their institutional social aims[23].

4. We are therefore on the wave of a new transition from the traditional way of financing the non-profit organization (through private donations and tax incentives) towards an emerging new one: the support from an asset class structured with the aim of generating financial returns and achieving positive social impacts.

The crucial problem to solve is one and still the same: the financial-social return gap. The social benefit, as mentioned, is considerable, but the risk of losing the entire capital is not offset by a sufficient return to make the investment attractive.

The solutions to the problem are various.

The recent regulation[24] of equity-based crowdfunding on web portals[25] allows so-called innovative start-up[26] "with social vocation" to shorten the financial-social return gap easily and cheaply, by "splitting" the risk and raising capital from those investors who are usually less accustomed to assume the default risk.

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[23] In the same sense, see G. BOSI, *Modelli di autoregolazione dell'impresa sociale*, in *Giur. comm.*, 2012, p. 145 ff.

[24] Art. 100 *ter* TUF and CONSOB Regulation no. 18592/2013.

[25] This collective funding is implemented through collection of individual investments from the so-called crowdfunders, which may have an interest in cooperating on the project for entrepreneurial purpose, simple appreciation or solidarity. According to the prevailing opinion participation of non-professional investors and use of web platforms distinguish this phenomenon from more traditional funding channels, as well as from venture capital and "business angels". See A. BOLLETTINARI, *Il* crowdfunding*: la raccolta del capitale tramite piattaforme on-line nella prassi e nella recente legislazione*, in *Il Nuovo Diritto delle Società*, 2013, 2, p. 12; P. ALVISI, Equity crowdfunding: *uno sguardo comparatistico*, in *Riv. dir. bancario*, 2014, 3, p. 1; I. CAPELLI, *Brevissime considerazioni sull'*equity based crowdfunding, in *Riv. dir. bancario*, 2014, 3, p. 1; G. GAGLIARDI e A. TONELLA, Crowdfunding*: una nuova frontiera per la raccolta di capitali*, in *Amm. e finanza*, 2013, 11, p. 51; G. NUNZIANTE, Il "Crowdfunding", in *dirittocancario.it.*, agosto 2013, p. 1 ff.; M. PINTO, *L'*equity based crowdfunding *in Italia al di fuori delle fattispecie regolate dal "Decreto Crescita"*, in *Le Società*, 2013, p. 818; E. GIRINO, *Le regole del* crowdfunding, in *Amm. e finanza*, 2014, 1, p. 81.

[26] See the requirements for the new corporate model designed by Art. 25, para 4, Decree 18 October 2012, no. 179.

However, neither management of the portal, nor technical details of the offer are part of the impact investing phenomenon as properly understood. In this case we are talking about a specific way of raising capital, but «Impact investing» is something other. It means that the social impact is not only measurable, but affects the rules applicable to the financial product.

On the contrary, European Social Entrepreneurship Funds, recently covered by reg. EU, April 17 2013, n. 346, are based on a risk diversification strategy. Compared to traditional OICR scheme, this diversification is also established on the basis of the social value of financed undertakings. Under the regulation of the EuSEF funds the investor's interest relates consequently non only to financial returns, but also to the achievement of a measurable and positive social impact.

Pursuing of social goals affects the nature of the portfolio of funds that operate under the «EuSEF» designation, their eligible investment targets and the investment tools they may employ (art. 3 Reg. EU 346/2013).

The EU regulation balances the need of providing capital to social undertakings and the need of maintaining the necessary flexibility in the investment portfolio. To be entitled to use the designation as 'EuSEF' across the Union, managers of a qualifying social entrepreneurship fund have to ensure that at least 70% of their aggregate capital contributions and uncalled committed capital is invested in *target* undertakings; in case of acquiring assets other than qualifying investments, instead, they have to ensure that those investments do not exceed the threshold of 30% (art. 5, 1, Reg. EU 346/2013).

The target undertakings are identified through their articles of association, statutes or any other rules establishing the business, where the undertaking:

i) provides services or goods to vulnerable or marginalised, disadvantaged or excluded persons (such services include access to housing, healthcare, assistance for elderly or disabled persons, child care, access to employment and training as well as dependency management);

ii) employs a «method» of production of goods or services that «embodies its social objective» (in spite of the fact that the activities are «outside the realm of the provision of social goods or services»)[27];

iii) provides financial support exclusively to social undertakings as defined above (such as financial activities of the new social finance companies)[28].

The target undertaking is not admitted to trading on a regulated market. Its primary goal is to achieve measurable positive social impacts not to maximize profits, as well.

Unlike the Italian regulatory system forbids the distribution of net either directly or indirectly, the EU regulation defines social undertaking as «an operator in the social economy», whose «main objective»[29] is to generate a social impact[30] rather than to make a profit for its owners or shareholders. It operates by providing goods and services for the market and uses its profits «primarily» to achieve social objectives.

It seems correct, and fair, to therefore conclude that EU regulation admits distribution of profits, even if on an exceptional basis, according to its articles of association, statutes or any other rules «which determine the circumstances in which profits are distributed to shareholders and owners to ensure that any such distribution of profits does not undermine its primary objective» (art. 3, 1, *d*, *iii* Reg. EU 346/2013).

And so we come to the last model available: social impact bond model, the prototype of the "impact first" investment.

The international debate about funding social innovation focuses on the feasibility and the regulatory compliance of financial contracts

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[27] According to the 'whereas' no. 14 Reg. EU 346/2013 those activities include social and professional integration by means of access to employment for people disadvantaged in particular by insufficient qualifications or social or professional problems leading to exclusion and marginalisation. These activities may also concern environmental protection with a societal impact, such as anti-pollution, recycling and renewable energy.

[28] According to the provision of Art. 3, 1, (d), (ii) Reg. EU 346/2013.

[29] See the 'whereas' no 12 Reg. EU 346/2013.

[30] According to the 'whereas' no. 13 Reg. EU 346/2013 a measurable and positive social impact could include «the provision of services to immigrants who are otherwise excluded, or the reintegration of marginalised groups into the labour market by providing employment, training or other support».

so-called "pay for success", designed for the purpose of transferring the risk of failure of social projects from the public to the private sector through the issuance of Social Impact Bonds.

The cornerstone of SIB[31] is the agreement between the government and the various SIB actors: an external organization to execute the program that delivers the outcome, often known as a non-profit service provider, the bond issuing organization and a neutral evaluator. The bond issuing organization (or an intermediary) is responsible for raising capital from private investors (including banks, foundations, and individuals) and for hiring and managing nonprofit service providers[32]. The government repays the investors or external organization only if the target outcomes are met, with returns based on the savings the government accrues as a result of the program's success[33]. A neutral evaluator, agreed on by both parties, is hired to measure the outcomes and resolve any disputes.

Through the issuance of SIB the government could foster innovation without risk the money of taxpayers in starting useless programs[34], the Third Sector could access to new financial channels and citizens could see increasing the supply and quality of social services. By virtue of the conventional SIB structure, the investors

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[31] For further analysis of SIBs structure, see J. LIEBMAN and A. SELLMAN, *Social Impact Bonds. A Guide for State and Local Governments*, Harvard Kennedy School Social Impact Bond Technical Assistance Lab, 2013, in *hks-siblab.org*, p. 9; J. LIEBMAN, *Social Impact Bonds A promising new financing model to accelerate social innovation and improve government performance*, 2011, p. 10; R. LEVENTHAL, *Using Social Impact Bonds to Finance Social Services*, in 9 *New York Univ. J. Law & Bus*., 2013, p. 516.

[32] In most SIB structures, an intermediary plays the largest role: it contracts with the government, raising capital from investors, choosing the external organization or service provider, and working with independent assessors to assure that the project's goals are being met.

[33] Unlike traditional privatization in which the government pays the up-front costs even if the initiative ultimately fails, SIBs insulate the government from such risk by shifting it to private entities. This structure thus mitigates wasteful public spending while also incentivizing organizations to target programs that achieve results: S. BALIGA, *Shaping the Success of Social Impact Bonds in the United States: Lessons Learned from the Privatization of US Prisons*, at 63 *Duke L.J.*, 2013, p. 422.

[34] J. LIEBMAN and A. SELLMAN, *Social Impact Bonds. A Guide for State and Local Governments*, cit., p. 10.

remain exposed to a major loss if the SIB fails[35], standing to lose their entire capital contribution if the non profit organization does not reach the preset benchmarks.

On August 2, 2012, New York City Mayor announced that Goldman Sachs agreed to loan MDRC n7 $ 9.6 million in the first-ever SIB in the United States. The SIB was structured to implement a recidivism prevention program for juvenile prisoners on Rikers Island that aims to reduce reincarceration rates and the associated costs to the government[36]. If the target population's recidivism rate decreases by at least 10 percent over four years MDRC would then repay Goldman Sachs the principal amount plus a variable rate of return up to 20 percent[37]. Goldman Sachs has publicly stated that it views the participation in the Rikers Island SIB as an investment, while according to the majors social finance companies the potential market for SIBs may represent «a multi-billion dollar source of growth capital for the social sector»[38]. True or not, following the announcement of the world's first SIB in the United Kingdom in 2010[39], many countries

[35] Alternatively, investors could seek to add a guarantor, limiting their downside to only a portion of their overall SIB investment: cfr. S. BALIGA, *Shaping the Success of Social Impact Bonds*, cit., p. 445; R. LEVENTHAL, *Using Social Impact Bonds to Finance Social Services*, cit., p. 520.

[36] For a closer examination of Rikers bonds, see P.G. DAGHER jr., *Social Impact Bonds and the Private Benefit Doctrine: Will Participation Jeopardize a Non-profit Tax-exempt Status?*, in 81 *Fordham L. Rev*., 2013, p. 3482 ff.; A. DAMEL, *Second Thoughts on Social Impact Bonds*, in 9 *New York Univ. J. Law & Bus.*, 2013, pp. 504 f., 506; S. BALIGA, *Shaping the Success of Social Impact Bonds*, cit., p. 441 and R. LEVENTHAL, *Using Social Impact Bonds to Finance Social Services*, cit., p. 511.

[37] Even if the program fails to reach the targeted 10 percent reduction in recidivism, Bloomberg Philanthropies, Mayor Bloomberg's own nonprofit organization, supplied MDRC with a $ 7.2 million grant to be held as a guarantee for that portion of Goldman Sachs's investment.

[38] Social Finance, *A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital To Advance Social Good* (2012), in www.socialfinanceus.com.

[39] The United Kingdom pioneered the use of SIBs with the Peterborough Prison Project in September 2010. The NGO Social Finance UK raised £ 5 million in seed capital from investors. The Peterborough SIB aims to rehabilitate short-term prisoners over several years. The recidivism rate of these prisoners will be compared with the recidivism rate of prisoners who are not enrolled in the rehabilitation program. If the recidivism rate among prisoners enrolled in the program drops by 10 percent relative to the control group of prisoners, the government will pay investors

(U.S., Australia, Canada, India, Ireland, Israel) started exploring SIBs for proposed projects that target varied social problems[40].

5. Some final considerations.

It seems that the model focused on social-impact finance paves the way to new instruments capable of linking together, as compound performance, social benefits and economic returns.

In the EuSEF funds and in the *social impact bond* model the most tangible innovation lays in the quality of the investor's interest: as exactly highlighted by art. 3(1)(d) Reg. EU 346/2013, what really props up the investment choice is not simply the pursuit of maximize profits but rather the achievement of a measurable and positive social impact».

Nevertheless, it is correct to start talking about a «new asset class»[41], alternative to the pure dichotomy between profitable and charitable purposes, in so far as certain minimum conditions, which are the basis for the confidence of the investors in the social-investment market, are met.

First condition: it should be drawn a «*clear demarcation line*» between collective investments recognizable as part of the social investment market emerging in the EU and alternative financial instruments that engage in other, less specialised, investment strategies, as already stated in the «EuSEF» designation rules[42]. It should be encourage the classification of assets in "impact first" or

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a return of 7.5 percent. If the rate drops more, the government will pay a higher return of up to 13 percent. If the outcomes are not met, investors will receive no return and will lose their entire investment. Additional SIB projects are now in operation in the U.K., including efforts to tackle a variety of family problems, reduce homelessness (known as the Street Impact Project, 2012), and provide increased support for at-risk youth.

[40] For an account of these experiences see J. LIEBMAN and A. SELLMAN, *Social Impact Bonds. A Guide for State and Local Governments*, cit., p. 10 ff.; H. AZEMATI, M. BELINSKY, R. GILLETTE, J. LIEBMAN, A. SELLMAN and A. WYSE, *Social Impact Bonds: Lessons Learned So Far*, in *Comm. Development Invest. Rev.*, 2013, 9, p. 21.

[41] M. FALKOWSKI e P. WIŚNIEWSKI, *Impact Investment as New Investment Class*, cit., p. 78.

[42] See the 'whereas' no 13 Reg. EU 346/2013.

"financial first"[43] according to the incidence of the social or profitable objective on the rules concerning management and investment strategy[44]. The abovementioned classification calls for a specific regulation of fairness and contractual transparency with specific regard to the financial operation's *social core*[45].

The impact investor, as traditional one, should be able to operate a comparison between different investment vehicles. Currently impact investors collate information on the extent to which social undertakings achieve the outcomes or impacts they are targeting. Because there are a wide range of social outcomes, different ways of iden-tifying and measuring the impacts have been developed. For instance, a firm that seeks to improve the rehabilitation of prisoners may assess its performance in terms of recidivism rates; a firm that seeks to employ disadvantaged persons may report on the numbers of

[43] According to the taxonomy adopted by J. FREIREICH and K. FULTON, *Investing for Social and Environmental Impact*, cit., p. 31 f.

[44] Financial first investors seek to balance out financial returns with social/environmental impacts. This group tends to comprise investors searching for investment vehicles offering returns implicating the opportunity cost of capital, while yielding some social/ environmental benefits. On the contrary, "impact first" investors seek to combine a high proportion of social effects with a spectrum of satisfactory returns from mere principal protection to beating predefined "hurdle rates". After that the insight is that you can treat the funding of a social enterprise as a problem of financial structuring. In the "layered structures" (also termed "Yin-Yang" investments[44]) two types of investors join forces, «amalgamating» capital from the "impact first" and "financial first" segments. "Impact first" investors accept a sub-market, risk-adjusted rate of return enabling other tranches of the investment to become attractive to "financial first" players. This symbiotic relationship permits "financial first" investors to achieve market rate returns, and "impact first" investors to leverage their investment capital, thus producing significantly «more social impact than they would if investing singlehandedly»: see M. FALKOWSKI e P. WIŚNIEWSKI, *Impact Investment as New Investment Class*, cit., p. 80

[45] Historically, the impact investment business has been relatively opaque, which has hampered its growth. Under the regulation of the EuSEF funds requirements concerning proper management, conduct, organization and transparency of managers (art. 7, 13 Reg. EU 346/2013) ensure the confidence of investors wishing to invest in such funds. This information includes not only the investment strategy and objectives of the qualifying social entrepreneurship fund, but also the types of qualifying portfolio undertakings in which it intends to invest and the positive social impact being targeted by the investment policy. The information about social outcomes and impacts must be «fair, clear and not misleading, kept up-to-date and reviewed regularly where relevant» (art. 14, para. 2, Reg. EU 346/2013).

such persons employed who would not otherwise have been employed.

It's obvious that, while information about social outcomes and impacts is very important for investors, it is difficult to compare between different social undertakings (and different "EuSEF" funds), because of both the differences in social impacts targeted and the variety of approaches. In order to encourage the impact investors' growing appeal to public and private capital providers, our regulatory system should be able to empower consistency and comparability of such information concerning social and investment performance. That said, the process of "composite reporting" requires common metrics for social impact measurement in the EU market[46].

Second condition: the most critical aspect in the impact investing operations is to identify the remedies to neutralize the potential conflicts of interests between financial and social goals. For instance, managers of EuSEF funds have to conduct their business activities in such a way «to promote the positive social impact of the target undertakings in which they have invested, the best interests of the qualifying social entrepreneurship funds that they manage, the investors therein and the integrity of the market» (art. 7, 1, *c*, Reg. EU 346/2013). What happens if fund's manager provides a satisfactory financial return, fully respecting the threshold of 30% for non-qualifying investments, but succeeds only betraying the fund's ethical investment strategy (for instance, giving space inside the "free" *quota* to securities that finance the weapons industry, risk breaches of human rights or entail hazardous waste-dumping)? He, for sure, betrays the ethical strategy and commits abuse. Affective provisions about conflict of interests in this peculiar side of financial system become

[46] GECES Sub-group on Social Impact Measurement has been appointed to support European Commission in developing a minimum standard process of evaluation and a standard set of criteria (that will serve to facilitate the implementation of EuSEF regulation also): for further information see http://ec.europa.eu/internal_market/social_business/expert-group/social_impact/index_en.htm. With regard to the valuation of assets, the EU Regulation entrusts ESMA to develop guidelines and common principles on investments in such undertakings, especially taking into account «their primary objective of achieving a measurable positive social impact and the use of their profits first and foremost for the achievement of that impact» (art. 12, para. 3, Reg. EU 346/2013).

inescapable. In fact, it will be necessary to identify the notion of conflict of interest compared to the social impact, and then to select the appropriate remedies in view of the overall function of such investment.

Third and last condition: ensuring that the social-impact investment phenomenon will not contribute to the development of systemic risks. Just think to rules of EU legislation that forbid the use of any method which could increase the exposure of the EuSEF fund beyond the level of its committed capital, whether through engaging in derivative positions or by any other means. Just think, above all, to the opinion of some commentators who have raised an argument against SIBs, as they may collide with the ban on the use of derivatives by municipalities and by public administrations in general: such contracts are deemed null and void by art. 1, para. 572, Law n. 147 of 2013[47]. Another line of scholarship fears that the "quasi-equity" nature of such instruments may lead the service provider (the non-profit organization) to disregard its non-distribution constraints, hence jeopardizing its eligibility for tax exemptions and other types of facilitations[48].

These are nothing but misinterpretations: the opportunities in the new economic models outweigh their shortcomings.

As regards the compatibility of SIBs with domestic public finance regulations, in particular the aforementioned ban on derivatives, it can be noted that performance of derivative contracts is by definition mostly grounded on probabilistic assumptions. It is not the type nor the name of a contract, but rather its content that may or may not

[47] D. DAL MASO, D. ZANONI e M. BOCCIA, *I* social impact bond. *La finanza al servizio dell'innovazione sociale?*, Quaderni dell'Osservatorio della Fondazione CARIPLO n. 11/2013, p. 8, 39 f. About derivatives of governments see R. DI RAIMO, *Dopo la crisi, come prima e piú di prima (Il derivato finanziario come oggetto e come operazione economica)*, in *Swap tra banche e clienti. Le condotte e i contratti* by D. MAFFEIS, in Quaderni di *Banca borsa tit. cred.*, nuova serie, 2013, pp. 61 ff., 69 ff.

[48] For a closer examination, see P.G. DAGHER jr., *Social Impact Bonds and the Private Benefit Doctrine*, cit., p. 3486 ff. who examines social impact bonds from a nonprofit's perspective and raises the question whether the profit margin that the private investors may achieve would qualify as an impermissible private benefit that would allow the IRS to revoke a participating nonprofit's tax-exempt status.

comply with the public interest laws[49]. The rationale for the legislative ban on derivatives, as is widely understood, can be found in the operation's intrinsic uncertainty, on the assumption that negotiating in derivatives may induce public administrations to take on a «financial burden that was unforeseeable at the time the contract was concluded»[50], thus impairing the pursuit of public interest goals.

Social impact bonds' performance doesn't relate to an uncontrollable underlying asset. On the contrary, SIBs' performance seems to be more closely related to a real and foreseeable activity, capable of generating social value, which can be measured in terms of cost savings for the government. Cleary stated, those who oppose SIBs, lending themselves to theorize a parallel with derivatives (as well as the consequent ban on their use by municipalities), mix up the "normal" degree of uncertainty underlying *any* entrepreneurial undertaking with "pure betting", totally unrelated to rational predictions, lacking power of oversight upon the underlying economic activities, which was the main cause of the financial crisis that broke out in 2008.

As regards the alleged contradictions of SIBs as compared to the so-called *private benefit doctrine*, the inner dynamics of impact-investing operations can be duly understood only by focusing on the complex nature of the investor's interest, and not solely on the structure of the investor's power. From this viewpoint, two tasks need to be carried out: (a) to amend the *private benefit doctrine* so as to promote SIBs in the European legal system; (b) while waiting for the abrogation of all bans on profit-sharing, to structure SIBs in such a way as to comply with the *private benefit doctrine*, for the purposes of safeguarding – for the moment – the service provider's chances to enjoy all tax benefits accessible to a "social enterprise"[51].

For the reasons stated above the market for social investment, to become a new strings-attached source of funding, requires also a

[49] R. DI RAIMO, *Dopo la crisi, come prima e piú di prima*, cit., p. 46

[50] Cfr. Italian Constitutional Court, decision. no. 70 of 2012, in *Giur. cost.*, 2012, 2, p. 919.

[51] See the interesting considerations of P.G. DAGHER jr., *Social Impact Bonds and the Private Benefit Doctrine*, cit., p. 3486 recommending how and why the private benefit doctrine should be modified to promote SIBs and finally suggesting methods to structure SIBs in a manner that could mitigate the private benefit threat.

timely reform of national legal systems. However such an expected reform cannot be limited to the removal of non distribution constraint. Regulation has the burden to solve the inevitable overlap of social benefits and financial returns, by means of safety and 'structural' provisions apt to manage the risks that are inherent in this phenomenon, in terms of: a) unprecedented effects onto the relationship between investment, risk and profitability affecting oversight and responsibility in the investment managing; b) fraud and conflicts of interest in financial intermediation and the appropriate and proportionate remedies; c) danger of «mission drift»[52], having regard to the funded organizations' statutory social aims.

[52] Conceived as the cultural shift from a nonprofit purely motivated by charitable ends to one driven by profitable means: see B.K. BUCHOLTZ, *Doing Well By Doing Good and Vise-Versa: Self-Sustaining NGO/Nonprofit Organizations*, in 17. *J.L. & Pol'y*, 2009, p. 411.