Investing Into Social Impact Bonds or Maybe It Is Still Time to Wait and See...

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Abstract

Securing the repayment of an investment is one of the key concerns for many investors. This problem is particularly acute with new financial instruments where only limited information and data are available, that would allow investors to appropriately assess the risks and make arrangements that would make their position more secure.

This paper analyzes some of the most interesting problems of a new financial instrument called Social Impact Bond (SIB) that is gaining more and more attention in United States of America. The paper introduces two different areas of concern that can be described as *macro* and *micro* problems. *Macro* problems stem from the potential interference of SIB with the existing legal and economic systems in the United States. They concern the current regulatory void surrounding SIBs and therefore are external in nature to the SIB concept. *Micro* problems are different in that they derive from the very design features of the SIB concept. These are various risks (e.g. financial risk, intermediary risk, etc.) that are inherent in the SIB design.

It is submitted that together *macro* and *micro* problems present a significant obstacle to investors interested in securing the repayment of their investment. The paper argues that because of the uncertainties currently present on the United States' SIB market mainstream profit-oriented investors should wait until the SIB pioneers develop a more standardised and transparent market.

"*Social impact bonds are new and innovative financing mechanisms for social programs in which government agencies pay only for real, measurable social outcomes—after those results have been achieved*." – Center for American Progress[1]

Introduction

In the recent years impact investment seems to have become one of the hottest topics among various governments, philanthropists and investors.[2] In essence impact investments are those that "intentionally target specific social objectives along with financial return and measure the achievement of both."[3] In other words, impact investors try to make profit, while at the same time they strive to improve some aspect of our society. Even though the idea behind social finance seems simple and admirable, it is also controversial. While investors argue that impact investment is an opportunity to make positive social impact that allows them to generate a financial return at the same time, some regard impact investment as unethical profiting from the poor.[4] Regardless of where the truth lies, the field of impact investment is here and growing significantly.[5]

[1] Definition by Center for American Progress - a think tank dedicated to developing and promoting progressive agendas across various disciplines. Note that this definition is by no means exhaustive. It merely indicated the main purpose of SIBs. See Center for American Progress website (CAP website): https://www.americanprogress.org/issues/economy/report/2012/12/05/46934/frequently-asked-questions-social-impact-bonds/ accessed on 15 February 2015

[2] See Deborah Burand, 'Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees Can Scale Development' (2013) 9 N.Y.U. J.L. & Bus. 447, 450; Nick O'Donohoe, Christina Leijonhufvud, Yasemin Saltuk, 'Impact Investments: An Emerging Asset Class' (J.P. Morgan, The Rockefeller Foundation, Global Impact Investing Network, 29 November 2010) http://www.ita.doc.gov/td/finance/publications/JPMorgan%20II%20Report.pdf accessed 28 January 2015

[3] Social Impact Investment Taskforce, 'Impact Investment: The Invisible Heart of Markets' (G 8 Social Impact Investment Taskforce, 15 September 2014) <http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL[3].pdf > accessed 28 January 2015

[4] O'Donohoe an others, 'An Emerging Asset Class' (n 2) 66-69

[5] See Yasemin Saltuk, Ali El Idrissi, Amit Bouri, Abhilash Mudaliar, Hanah Schiff, 'Spotlight on the Market: The Impact Investor Survey' (J.P. Morgan, GIIN, 02 May 2014) <http://www.socialfinanceus.org/sites/socialfinanceus.org/files/Spotlight%20on%20the%20Market%20-%20The%20Impact%20Investor%20Survey.PDF> accessed on 3 February 2015

Lately, a new financial instrument, a novel tool for impact investing,[6] called Social Impact Bond (SIB) has become available to investors in several jurisdictions worldwide.[7] Simply put, SIB is "a new approach for expanding successful social programs. It is a partnership in which private investors – not governments – provide [upfront] capital for nonprofits to scale up. The government pays only if the program succeeds."[8] One report suggested that the volume of the market for this financial instrument in the United Kingdom alone has the potential to grow into one billion pounds by the year 2016.[9] The prognosis for the SIB market in the United States seems also very optimistic.[10] Furthermore, the relatively recent report of the Social Investment Taskforce under the UK's presidency of the G8 suggests that because of political pressure build-up, impact investments (and SIBs) are likely to become a global phenomenon.[11] Even though at present most of the SIBs available around the world are still at early stages of their implementation, the rapid developments of this field connected with the interest of the some of the biggest impact investors such as J.P. Morgan, Rockefeller Foundation, Morgan Stanley, Goldman Sachs and Merrill Lynch hint a promising future for this financial instrument.[12]

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[6] Yasemin Saltuk, Amit Bouri, Giselle Leung, 'Insight into the Impact Investment Market' (J.P. Morgan, GIIN, 14 December 2011) 7 <http://www.jpmorganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf > accessed 2 February 2015; See also: Drew von Glahn, Caroline Whistler,'Social-Impact Bonds/Pay-For-Success Financing' in Lester M. Salamon ed., *New Frontiers of Philanthropy: A Guide to the New Tools and New Actors that Are Reshaping Global Philanthropy and Social Investing* (OUP New York 2014)

[7] The first SIB was launched in the UK in 2010. See Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes, Deirdre Culley, 'Lessons learned from the planning and early implementation of the Social Impact Bond at H.M.P. Peterborough' (2011, RAND Europe) 3 < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/217375/social-impact-bond-hmp-peterborough.pdf> accessed 2 February 2015, Nowadays SIB is becoming a global phenomenon. It is available in the United Kingdom, United States of America, Canada, Australia and has a great expansion potential. See also: Salamon, *New Frontiers of Philanthropy* (n 6) 437-438

[8] McKinsey&Company, 'From Potential to Action: Bring Social Impact Bonds to the US (2012) 7 <http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf> accessed 2 February 2015

[9] The Boston Consulting Group, 'The First Billion: A forecast of Social Investment Demand' (BCG, September 2012) <http://www.bcg.hu/documents/file115598.pdf> accessed 2 February 2015

[10] See: Salamon, *New Frontiers of Philanthropy* (n 6) Chapter 16

[11] Social Impact Investment Taskforce (n 3)

[12] Judith Rodin, 'Innovations in Finance for Social Impact' (The Rockefeller Foundation, 5 September 2014) < http://www.rockefellerfoundation.org/blog/innovations-finance-social-impact> accessed 3 February 2015

The aim of this paper is to examine the nature of SIB as a financial instrument from the perspective of potential investors in the United States of America. It examines the nature of a SIB transaction and contemplates about the risks that endanger the repayment of the SIB investment. In essence the paper explores the extent to which an SIB investor can secure its repayment. The purpose of the paper, however, is not to provide a comprehensive overview of all the problems connected with SIB, but rather to introduce some thought-provoking concepts and ideas that must be taken into account before making an investment into SIBs. The paper introduces two different areas of concern that can be described as *macro* and *micro* problems. *Macro* problems stem from the (potential) interference of SIB with the existing legal and economic systems in the United States of America. They concern the current regulatory void surrounding SIBs and therefore are external in nature to the SIB concept. *Micro* problems are different in that they derive from the very design features of the SIB concept.

The following discussion analyses and evaluates a selection of some of the most interesting *micro* and *macro* problems connected with regulation issues, taxation issues and risks present in SIB investments. It is extremely important for potential SIB investors to appreciate these issues as they could have significant impact on their investment. Actually these problems can be perceived as threats that endanger the overall security of the SIB investment.

First, Chapter I introduces the concept of SIB, provides two case studies and explains the reasons why SIBs should be perceived as an important financial instrument. Chapter II then discusses some of the most interesting *macro* problems. The paper explores the uncertain nature of SIB as a financial instrument and determines that SIB is essentially a strange combination of debt and equity. It is then established that, at least in theory, SIB could be classified as a 'security' and therefore become subject to Securities and Exchange Commission's (SEC) regulatory powers. The regulatory discussion is then developed on two levels – securities and taxation. It is submitted that because of the similarity between SIBs and municipal bonds when it comes to their purpose, parallels could be drawn between these two financial instruments and lessons could be learned from the existing municipal bond markets. It is submitted that even though at present it may be undesirable to regulate SIB, some regulation seems inevitable in the future once the SIB market becomes more developed. When it comes to SIB taxation status, the paper argues that these instruments should be at least partially tax-exempt. Because of the uncertainties surrounding the precise legal and economic position of SIB in the current market the paper suggests that investors should be vigilant and prepare for the potential changes that may occur. Chapter III provides an examination of seven selected *micro* problems. The chapter analyses model risk, service provider risk, political risk, intermediary risk, evaluation risk, financial risk and reputation risk, all of which are inherent in the SIB structure. It is submitted that in the current US SIB market environment it is practically impossible to manage these risks. For this reason the paper argues that mainstream investors should be very cautions and perhaps wait until the market is more developed before investing.

I. SIB Introduced

a) What is a SIB?

SIB is a financial instrument that enables a results-based form of social investment, where private investors provide upfront capital to launch or expand social services that are meant to deliver a pre-determined amount of measurable public benefit at the end of an agreed period of time.[13] If the agreed (or greater) amount of public benefit is delivered by social services by the end of the stipulated period, investors retrieve their capital together with a premium, the amount of which usually depends on the amount of benefit delivered.[14] However, if the pre-determined amount of public benefit is not achieved at the end of the agreed time period the private investors (as opposed to government) lose the entire investment and receive nothing.[15] Even though far from perfect, this definition provides important background information and explains the general pay-for-success philosophy of SIBs. In reality, however, SIBs provide an extremely flexible financial instrument that can be tailored to the particular needs of the very project to which they are applied. For instance, the risk of loss of the entire investment upon failure of the social services to deliver the pre-agreed benefit can be hedged by a use of guarantee.[16] This flexibility, however, comes at a price of relative complexity of SIBs.

There are seven stakeholders in a usual SIB structure: "constituents [1] (the direct beneficiaries of the social services), government [2], non-profit service providers [3], investors [4], intermediaries [5] (responsible for overall project management), evaluation advisers [6] (to help monitor and refine the program), and independent assessors [7] (to

[13] A heavily modified definition based on: Ron Davies, 'Social Impact Bonds: Private finance that generates social returns' (Briefing, European Parliamentary Research Service, August 2014) 1 <http://www.europarl.europa.eu/RegData/etudes/BRIE/2014/538223/EPRS_BRI(2014)538223_REV1_EN.pdf> accessed 3 February 2015

[14] Davies (n 13) 1

[15] Social Finance, 'A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good' (2012) 4-5 <http://www.socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL.pdf> accessed 3 February 2015

[16] Kevin W. Humphries, 'Not Your Older Brother's Bonds: The Use and Regulation of Social-Impact Bonds in the United States' (2014) 76 Law & Contemp. Probs. 433, 438

determine whether SIB targets are met)."[17] It is important at this stage to highlight some of the challenges faced by the SIB designers, which concern the different stakeholders in a SIB.[18]

1. **Constituents** – One of the hardest tasks of SIB designers is to define the target population (or constituents), which should benefit from the designated social services. It has been pointed out that some SIB stakeholders might have perverse motivations (i.e. success of the program at any cost) which may cause so called 'cream-skimming' where the provider offers services only to those who are most likely to successfully benefit from the intervention.[19] This is counterproductive to the SIB model because this process excludes individuals who are costing taxpayers the most money.[20] For this reason it is important to carefully demarcate the constituents at the outset of a SIB.
2. **Government** – A key role in a SIB is played by the government because it is ultimately the government who repays the investors for the successful outcome of the programs.[21] If the government does not have the required capacity or indeed the will to honour its commitments under a SIB, the investors might, despite the overall success of the program, lose their investment.[22] SIB investors must be mindful of these possibilities.

[17] McKinsey&Company (n 8) 7
[18] Please note that for a better understanding of this complex financial instrument, the discussion of the different stakeholders in a SIB is followed by two case studies that demonstrate how SIBs work in practice See below
[19] Jeffry B. Liebman, 'Social Impact Bonds: A Promising New Financial Model to Accelerate Social Innovation and Improve Government Performance' (Center for American Progress, February 2011) < http://cdn.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/social_impact_bonds.pdf > accessed 4 February 2015
[20] Benjamin R. Cox, 'Financing Homelessness Prevention Programs with Social Impact Bonds' (2011-2012) 31 Rev. Banking & Fin. Law 959, 977
[21] Burand, (n 2) 473
[22] Burand, (n 2) 473

3. **Non-profit service providers** – Service providers execute the program through which the pre-determined amount of social benefit is to be delivered to the constituents.[23] In order to properly do so, these non-profit organisations need a strong operating model, a good assessment mechanism for social impact and experience in partner work.[24]
4. **Investors** – It has been explained that the 'ice-breakers' in this field are likely to be more philanthropically oriented patrons, who will have to test the ground and pave the way for the mainstream, profit-oriented individuals and entities.[25] This is mainly due to unfamiliarity of the potential investors with the risks involved, as well as the lack of fully developed regulation.[26] Finding investors who are willing to invest into new and not fully explored financial instruments such as SIB could be a challenge.
5. **Intermediaries** – Intermediaries are probably the most important stakeholders in a SIB when it comes to its overall success. It can be said that intermediaries are the glue, between the various parts of a SIB. Intermediaries design and manage the SIB throughout its existence.[27] At the birth of a SIB intermediaries enter into a contract for the provision of particular services with a government.[28] It is typically a long-term, outcome-based contract, where the government pays only at the end and only if the stipulated outcomes are achieved (i.e. a typical SIB model as explained above). The intermediary then has to raise money necessary for the execution of these services from investors and enter into contracts with suitable service providers who will then deliver the agreed services.[29] In the end, if the SIB is successful, intermediaries distribute the money (principal and potentially a premium) they obtain

[23] Social Finance, 'A New Tool' (n 15) 11-12
[24] McKinsey&Company (n 8) 9
[25] McKinsey&Company (n 8) 9
[26] Humphries (n 16); McKinsey&Company (n 8) 9
[27] McKinsey&Company (n 8) 9
[28] Liebman, 'Social Impact Bonds' (n 19) 14
[29] Liebman, 'Social Impact Bonds' (n 19) 14

from the government to the investors.[30] The main concern here is the overall competence of the intermediaries to perform these challenging tasks. It has been pointed out that for a success of a SIB, intermediaries have to "possess expertise in the relevant social issue, financing skills, and project management capabilities."[31]

6. **Evaluation advisors** – Proper evaluation is the only way of how to determine whether the SIB is on the right track and whether the investors will make money on their investment or not. Evaluation advisors work with both intermediaries and service providers to improve the SIB program at the execution stage.[32] In effect this process protects the entire investment. For this system to work, it is critical to find a highly qualified evaluator that possesses the necessary expertise.
7. **Independent assessors** – Independent assessors come into the picture at the end when it is time to determine whether the government will make the payment for the successful outcomes. They pose as 'arm's-length auditors' who decide whether the outcomes of a SIB have been achieved.[33] It has been pointed out that for the assessment to be just, the right methodology must be selected at the very outset of a SIB.[34] Furthermore, there is a risk that the entire assessment process will be subject to inaccuracy, bias and/or fraud.[35]

It is important to note that this list is by no means exhaustive or exclusive and there are SIBs which may involve additional parties and additional concerns.[36] In essence, however, these

[30] Liebman, 'Social Impact Bonds' (n 19) 14
[31] McKinsey&Company (n 8) 9
[32] McKinsey&Company (n 8) 9
[33] McKinsey&Company (n 8) 9
[34] Rebecca Leventhal, 'Effecting Progress: Using Social Impact Bonds to Finance Social Services' 9 N.Y.U. J.L. & Bus. 511, 531
[35] Humphries (n 16) 449
[36] Humphries (n 16) 438

are the most important stakeholders, which can be found in almost all of the currently implemented SIBs.[37]

To conclude, SIB is a relatively new and a fairly complex financial instrument that enables governments to utilize private capital for the provision of social services based on a 'pay-for-success' principle.[38] This model allows the governments to save money and shift the risks connected with the potential failure of the social program on private investors. At the same time SIBs enable investors to profit and deliver a positive social impact.

b) SIBs in the United Kingdom and the United States of America

To better explain and demonstrate the SIB features discussed above, as well as to provide a brief genealogy of this concept and how it arrived in the US, it is useful to provide two case studies, one from the UK and one from the USA. It is important to note that even though the global market for SIBs is gradually developing,[39] the UK and the USA currently happen to belong to the most active SIB markets in the world.[40]

(i) United Kingdom

The UK is the birthplace of SIBs and home to the world's most active SIB-promoting organisation, the mother of the world's first SIB, Social Finance.[41] Social Finance is a non-profit organisation, which cooperates with governments, social sector and investors in order

[37] See examples of case studies in Chapter I (b) below
[38] The term 'pay-for-success' is used by Burand (n 2) 452-453
[39] Social Finance, The Global Social Impact Bond Market (Social Finance, August 2014) <http://www.socialfinance.org.uk/wp-content/uploads/2014/08/Social-Impact-Bonds-Snapshot-2014.pdf> accessed on 14 February 2015
[40] For an overview see: Salamon, *New Frontiers of Philanthropy* (n 6) 437-438
[41] Social Finance, (About Us) < http://www.socialfinance.org.uk/about-us/> accessed 14 February 2015

to provide social services in the UK and abroad.[42] It launched the world's first SIB in 2010 and has been very active on both national and international SIB scene ever since.[43]

The aim of the world's first SIB was the reduction in prisoner recidivism among prisoners leaving Her Majesty's Prison Peterborough over a six-year period.[44] Seventeen investors put together £5 million of upfront capital in form of debt finance to Social Finance acting as an intermediary.[45] Social Finance then forwarded the money onto One Service, a service provider set up by Social Finance to deliver the prisoner rehabilitation program services.[46] The program was expected to serve three cohorts of one thousand prisoners with repayments to the investors depending on the program's partial/overall success.[47] The rules were quite complex. If the reconviction was reduced by 10% or more in any of the cohorts, investors would receive an outcome payment immediately after the relevant cohort data was assessed.[48] If however the 10% reduction in reconvictions was not achieved in any of the cohorts at the end of the SIB lifetime, all three cohorts were to be evaluated together, with the payment trigger at 7.5% reduction of reconviction.[49] The government (from the funds of the Ministry of Justice and the Big Lottery Fund) agreed to repay the investors at a rate of return corresponding to the overall success of the program, ranging from 2.5% to the premium ceiling of 13%.[50] Even though sound in theory and actually quite successful during the implementation stage for the first cohort,[51] the world's first SIB will not be able to fully complete its mission from the investor's point of view. The problem lies with the

[42] Social finance helps with the development of SIBs in Canada, Ireland, Latin America, Portugal, Israel, US and South Africa, See Social Finance, 'Social Finance Global' <http://www.socialfinance.org.uk/about-us/social-finance-global/> accessed 15 February 2015
[43] Social Finance, The Global Social Impact Bond Market (n 39)
[44] Disley and others (n 7)
[45] Social Finance, 'A New Tool' (n 15) 9
[46] Burand (n 2) 454
[47] Disley and others (n 7) 40-41
[48] Disley and others (n 7) 40-41
[49] Disley and others (n 7) 40
[50] Social Finance, 'A New Tool' (n 15) 40
[51] 8.4% reduction in reconviction events. See Social Finance, 'Peterborough Social Impact Bond Reduces Reoffending by 8.4%; investors on course for payment in 2016' (Press Release, 7 August 2014) < http://www.socialfinance.org.uk/news-views/press-releases/> accessed on 15 February 2015

government's decision to implement a new program that deals with the probation and rehabilitation of prisoners.[52] As a result even though One Service continues to provide its services, the funding structure has changed and the outcome payments for the second and third cohort have been removed.[53] As a result, the investors now have to wait until 2016 to have all three cohorts evaluated together with outcome payment trigger at 7.5% reduction.[54] This technicality, however, did not seem to have a huge impact on the UK SIB market. One report indicated that at the end of October 2014 there were 16 SIBs in the implementation stage across the UK.[55] In the meantime, Social Finance has launched three new SIBs aimed at tackling youth homelessness in December 2014.[56] The developments on the UK SIB market therefore suggest a vibrant future for SIBs.

(ii) The United States of America

The US is a follower, when it comes to implementation of the SIB-financing concept. It was the 'ground-breaking work' of Social Finance (UK) that inspired the establishment of Social Finance US in 2011.[57] Social Finance US is a non-profit establishment aimed at mobilising social investors and promoting SIBs in the US.[58]

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[52] Social Finance, 'Changes to Peterborough Social Impact Bond' (Press Release, 13 May 2014) <http://www.socialfinance.org.uk/news-views/press-releases/> accessed on 15 February 2015

[53] Social Finance, 'Changes to Peterborough Social Impact Bond' (n 52)

[54] See Social Finance, 'Peterborough Social Impact Bond Reduces Reoffending (n 51); Darrick Jolliffe, Carol Hedderman, Peterborough Social Impact Bond: Final Report on Cohort 1 Analysis (QinetiQ, 7 August 2014) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/341684/peterborough-social-impact-bond-report.pdf> accessed on 15 February 2015

[55] James Ronicle, Neil Stanworth, Edward Hickman, Tim Fox, 'Social Impact Bonds: The State of Play' (Full Report, November 2014) iii < https://www.biglotteryfund.org.uk/~/link.aspx?_id=38B25B895A86492AAA548D4737DFE302&_z=z> accessed on 15 February 2015

[56] Social Finance, 'Social Finance Launches 3 Social Impact Bonds to Tackle Youth Homelessness' (Press Release, 11 December 2014) < http://www.socialfinance.org.uk/news-views/press-releases/> accessed on 15 February 2015

[57] Social Finance US, 'About Us' < http://www.socialfinanceus.org/who-we-are/our-mission> Accessed on 15 February 2015

[58] Social Finance US, 'About Us' (n 57)

The first SIB in the US is aimed at reducing the recidivism among young man exiting the Rikers Island prison facility in New York between September 2012 and August 2015.[59] Even though very similar to the Peterborough SIB in its aim to tackle recidivism, the arrangements here were quite different. The Rikers Island SIB arrangement provides that MDRC, a non-profit intermediary organisation, manages the implementation of the project by two non-profit service providers.[60] In contrast with Peterborough, here we have two service providers as opposed to just the one. The differences between Peterborough and Rikers SIB only escalate when it comes to investor arrangements. The Rikers SIB is funded only by Goldman Sachs, a sole investor, through a $9.6 million loan to MDRC.[61] The outcome payment, however, does not depend exclusively on the successful outcome of the SIB.[62] The SIB designers have added some extra layers of protection for the sole investor. First, there is a sliding scale of recidivism reduction from 8.5% to 20%, which triggers the corresponding outcome payment by the city of New York between $4.8 million and $11.7 million.[63] Second layer of protection is added by the guarantee from Bloomberg Philanthropies that secures the first $7.2 million of loan repayment.[64] Therefore in the worst-case scenario where the 8.5% recidivism reduction is not achieved Goldman Sachs will not lose the entire investment of $9.6 million, but 'only' $2.4 million. On the other hand, if the ambitious target of 20% recidivism reduction is reached, Goldman Sachs will pocket $2.1 million, which amounts to a staggering 22% return on investment. When comparing this arrangement with the 2010 Peterborough SIB, one starts seeing the extraordinary flexibility and consequently the huge potential of SIBs.

[59] Hanna Azemati, Michael Belinsky, Ryan Gillette, Jeffrey Liebman, Alina Sellman, Angela Wyse, 'Social Impact Bonds: Lessons Learned So Far' 9(1) Community Development Investment Review (2013) 22, 24
[60] Azemati and others, (n 59) 24
[61] Azemati and others, (n 59) 24
[62] Azemati and others, (n 59) 24
[63] Azemati and others, (n 59) 24
[64] Azemati and others, (n 59) 24

However, the Rikers SIB only kick-started the US enthusiasm about SIBs. Harvard University in 2013 observed that SIBs were spreading faster than expected.[65] Thanks to the Center for American Progress, a think tank focused on development and promotion of progressive policy agendas, SIBs are getting much attention from federal, state and local government, media, investors and public alike.[66] Further pioneering work is done by a pro-bono consultancy establishment called Harvard Kennedy School Social Impact Bond Technical Assistance Lab, which offers technical assistance to governments interested in harnessing the power of SIBs.[67] Currently, there are at least five states where SIBs are in use and nineteen which seem to be interested in this financial instrument.[68] Interestingly, a new bill, the Social Impact Bond Act, is presently before Congress. If passed in its present form, a $300 million Treasury Department fund will be created to support SIB projects nationwide.[69] Based on the presently available information, the US SIB market does seem to have a bright future ahead. Much probably depends on the actual outcome of the SIBs that are currently in the implementation stage.

c) Why do Social Impact Bonds matter?

The previous sections introduced the concept of SIBs and enlightened our path for further exploration of this new financial instrument. Now it is important to explain why have SIBs managed to generate so much attention and why they actually matter. There are three important reasons for this.

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[65] Azemati and others, (n 59) 23 - 24

[66] See Jitinder Kohli, Kristina Costa, 'Center for American Progress: Importing Social Impact Bonds' in James G. McGnann, Anna Viden, Jillian Rafferty (eds), *How Think Tanks Shape Social Development Policies* (PENN Press 2014) Chapter 18

[67] See Harvard Kennedy School Social Impact Bond Technical Assistance Lab website <http://hks-siblab.org> accessed on 15 February 2015

[68] The five active states are Illinois, Massachusetts, New York State, Ohio and Utah. See Social Finance, 'Global SIB Activity, The United States, State and Local Activity: A Snapshot' <http://www.socialfinanceus.org/social-impact-financing/social-impact-bonds/history-sib-market/united-states> accessed on 15 February 2015

[69] US Government Website, Congress.gov, (SIB Bill) <https://www.congress.gov/bill/113th-congress/house-bill/4885/all-actions> accessed on 15 February 2015

First and foremost SIBs provide an interesting funding alternative for cash-strapped governments that strive to implement social programs for which they have no money.[70] In particular the unique SIB funding structure, which provides an up-front capital and shields off the risk from the government, has been recommended for preventative and innovative social programs.[71] It has been explained that preventative programs that target specific social outcomes often result in reductions in the use of remedial services and therefore save taxpayers money.[72] However, the typical problem for governments is that preventative and innovative programs are, at least from the political perspective, not a lucrative investment.[73] They are often lengthy and only bear fruit (if any) long after the implementing government is gone.[74] Furthermore, the government may not be willing to assume the risk for a potentially unsuccessful preventative program.[75] Yet, some preventative programs have a proven track record of providing substantial savings for the government if implemented.[76] As Benjamin Franklin put it: "An ounce of prevention is worth a pound of cure."[77] To be precise, there is money to be saved and governments are therefore keen to use SIBs.

Second and a more controversial reason why SIBs are generating so much attention is that there is also money to be made. Investors are usually willing to assume risk of particular investments as long as they obtain some premium in return. The market rule is simple: the higher the risk, the larger the premium must be. As demonstrated above on the Rikers Island SIB example, investing into SIB may be very lucrative and profitable with returns as high as

[70] Humphries (n 16) 433-434
[71] Jeffrey Liebman, Alina Sellman, 'Social Impact Bonds: A Guide for State and Local Governments' (Harvard Kennedy School, Social Impact Bond Technical Assistance Lab, June 2013) < http://hks-siblab.org/publications/> accessed 11 February 2015
[72] Salamon, *New Frontiers of Philanthropy* (n 6) 427
[73] Liebman and Sellman (n 71) 6-7
[74] Liebman and Sellman (n 71) 6-7
[75] Liebman and Sellman (n 71) 6-7
[76] Leventhal (n 34) 513-514
[77] Benjamin Franklin, *The Writings of Benjamin Franklin* (Volume 2 Haskell House Publishers Ltd., New York 1907) 205

22%.[78] Even though it is still unclear whether such high returns will become the norm,[79] this financial instrument is undoubtedly becoming a hot topic for many.

Finally it is the virtually limitless potential of SIBs, which makes it a particularly exciting financial instrument. SIBs show an extraordinary level of flexibility. To start, they are usually tailored to the needs of the specific project and investor.[80] SIB designers can therefore create variations of SIBs that complement the market demand (i.e. more risky and more rewarding SIBs for risk-takers; and more safe, potentially even guarantee-secured SIBs for more conservative investors).[81] Furthermore, while SIBs can be used for the sole purpose of investment, they can also be utilized as a part of a strategic plan. For instance, SIBs could hypothetically be the new frontier for various corporate social responsibility (CSR) programs, which are becoming more and more popular among today's corporations.[82] The plug-in of SIBs into their CSR schemes could, at least in theory, provide a double benefit. On the one hand the corporation would provide a valuable service to the community, which would ultimately save public funds. This, in turn, would enhance the corporation's public image. On the other hand, corporate investors would obtain a return on their investment if the supported program succeeded in delivering the agreed outcome. On top of this, SIBs are scalable devices, which have the potential to go global and beyond their current social scope.[83]

To summarize, the future of SIBs seems to be bright. SIB's win-win model for governments and investors alike connected with their extraordinary potential provides at the very least an incredibly good starting point. It is for this reason that we need to explore the potential issues that might arise in a SIB arrangement and question whether the investors actually can secure the repayment of their investment.

[78] Liebman and Sellman (n 71) 10
[79] Salamon, *New Frontiers of Philanthropy* (n 6) 430-431
[80] See Social Finance, 'A New Tool' (n 15)
[81] See Burand (n 2)
[82] See Kenneth Amaeshi, Paul Nnodim,Onyeka Osuji, *Corporate Social Responsibility, Entrepreneurship, and Innovation* (Routllege 2013, Oxon)
[83] Burand (n 2)

II. Selected *Macro* Problems of Social Impact Bonds

The previous chapter provided both an introduction to SIBs as well as explanation of why SIBs seem to have a bright future. This chapter discusses some of the most pressing *macro* problems present in a SIB arrangement that concern SIB regulation and taxation in the United States of America. As mentioned in the introduction, *macro* problems concern the (potential) interference between SIBs with the existing legal and economic system. Since regulation and taxation can have a significant impact on the SIB investment, it is important that potential SIB investors are aware of issues that can arise. First, this chapter explores the uncertain nature of SIB as a financial instrument. The discussion determines that SIB is essentially a strange combination of debt and equity. Secondly, it is established that, at least in theory, SIB could be classified as a 'security' and therefore become subject to Securities and Exchange Commission's (SEC) regulatory powers. This opens up some regulatory questions. The regulatory discussion is then developed on two levels – securities and taxation. It is submitted that at least during the early development stages SIB should not be heavily regulated or taxed. Alternatively, it is suggested that because of the similarity between SIBs and municipal bonds when it comes to their purpose, a parallel could be drawn between the regulatory treatment of SIBs and municipal bonds. It is submitted that the SIB market should be afforded only a very light (if any) regulatory and taxation treatment similar to the one currently present in the municipal bonds market.

Because of the above uncertainties that surround the precise legal and economic position of SIB in the current United States' SIB market it is concluded that investors should ensure that they make appropriate arrangements before their SIB investment or alternatively wait until the murky waters of the present regulatory regime of SIBs clear out.

a) Is SIB Equity, Debt or Derivative?

Before purchasing a financial instrument is undoubtedly a good practice to understand the true nature of the financial instrument that is going to be acquired. For this reason it is useful to define the true nature of SIB.

In essence, financial instruments are agreements whereby one party agrees to exchange something of value in return for something else of value and at least in theory they can be divided into three categories: equity-based, debt-based and derivatives.[84]

Equity-based financial instruments allow the issuer to sell a piece of equity (i.e. an ownership in a company) to the purchaser whereby the purchaser becomes a part-owner (i.e. a shareholder).[85] The shareholder is then entitled to payment of dividends when and *if* declared by the board of directors (i.e. dividends can only be declared if the company possesses funds that can be legally used for that purpose).[86] Also, shareholders may obtain voting rights with their shares and so participate in the management of the company.[87] To redeem the principal of an equity-based investment the investor has to sell the shares or the company has to go into liquidation, in which the company has no liabilities that would endanger the repayment of the principal.[88] In other words, if the company goes bankrupt the equity holder may receive nothing if the assets of the company are not capable of satisfying its liabilities. It follows that equity-based investment is long-term with the profit (i.e. dividends) depending on the success of the company and with the principal being locked in for as long as the investor holds the shares or the company remains in business.

Debt-based financial instruments, also known as fixed-income securities, allow the issuer to raise capital by issuing a debt instrument (e.g. a bond) in which the issuer *unconditionally*

[84] See Alan N. Rechtschaffen, *Capital Markets, Derivatives and the Law* (OUP 2009) 17-19
[85] See Rechtschaffen (n 84) 17
[86] Eric A. Chiappinelli, Cases and Materials on Business Entities (Aspen Publishers 2006) 161
[87] Chiappinelli (n 86) 153-159
[88] Chiappinelli (n 86) 161

promises the investors the repayment of their principal investment together with a premium.[89] First, unlike the equity-based financial instruments, debt-based financial instruments are temporary in that the principal has to be repaid by the borrower upon maturity date.[90] Second, debt-based financial instrument holders are creditors of the issuer and have therefore claims to assets of the issuer upon bankruptcy, which are superior to the claims of equity holders.[91] Thirdly, the investors are entitled to an agreed upon premium, in form of interest payments and/or in cases where the debt-based financial instrument is sold at discount by the repayment of the full face value of the instrument (e.g. a zero-coupon bond).[92] In other words, debt instruments are less dependent on the relative fortune of the issuer, because they impose an obligation on the issuer to repay the principal and interest in accordance with the agreed-upon terms.

Finally, derivatives (i.e. forwards, futures, options and swaps) are a special form of financial instruments. Some of the derivatives involve extremely complex arrangements. However, for the purposes of the present analysis it is sufficient to examine the basic concept of derivatives. In essence, derivatives are bilateral contracts or payment exchanges, the value of which derives from the value of an underlying asset, reference rate or index.[93] An example of a derivative is an *option* to buy shares at a predetermined price over a predetermined period of time. In our example the value of the *option* to buy the shares depends on the actual value of the shares when compared to the option price. The most peculiar feature of derivatives is the fact that they are highly leveraged. This means that they require only a little up-front monetary commitment when compared to the price of the underlying asset.[94] In the above shares example the buyer of the derivative (i.e. the option) purchases the right to obtain future

[89] See Rechtschaffen (n 84) 18
[90] Chiappinelli (n 86)161
[91] Rechtschaffen (n 84) 145
[92] See Lester M. Salamon, *Levereage for Good: An Introduction to the Frontiers of Philanthropy and Social Investment* (New York, OUP 2014) 57-63
[93] See Rechtschaffen (n 84) 19
[94] Rechtschaffen (n 84) 164

control over an asset (i.e. the shares) that has not yet been purchased. In other words, it is only the option that gets paid for, not the shares.

Having introduced the basic characteristics of the above financial instruments, the focus can now return to SIBs and their nature as financial instruments. In a SIB there is an incomplete triangular contractual arrangement between government, intermediary and investors where the intermediary shields off government from investors so that the investors do not have a direct claim against the government.[95] The arrangement goes as follows. First, government promises to pay the intermediary a pre-agreed amount of money provided that the intermediary manages to achieve the contractually agreed-upon outcome.[96] The intermediary then uses the government's conditional promise (and 'issues' SIBs) to solicit investors who are willing to provide the upfront capital, which is then used to finance the designated social programs to be delivered by the social service providers. If the outcomes are achieved the government pays the intermediary, which then forwards the money onto the investors. However, if the agreed outcomes are not achieved, the investors may lose their entire investment as there is no obligation on the government to pay. When trying to determine the true nature of SIBs as financial instruments, one starts seeing that they do not squarely fit within any of the above descriptions.

One could argue that SIBs are derivatives in that they depend on the underling 'asset' – i.e. the success of the program in delivering the pre-determined outcome. However, a distinctive feature of derivatives is that they require "little or no good faith deposit to secure the parties' obligations under the contract."[97] In other words, derivatives do not require the investor to provide an up-front capital. In a SIB arrangement, however, the investors are obliged to

[95] Salamon, *New Frontiers of Philanthropy* (n 6) 444
[96] See also a model SIB agreement: Jitinder Kohli, Douglas J. Besharov, and Kristina Costa: Inside a Social Impact Bond Agreement - Exploring the Contract Challenges of a New Social Finance Mechanism (Center for American Progress, May 3 2012) < https://www.americanprogress.org/issues/open-government/report/2012/05/07/11619/inside-a-social-impact-bond-agreement/> accessed on 9 March 2015
[97] Rechtschaffen (n 84) 19

provide up-front capital for the very program upon which the value of the entire investment depends. For this reason, SIBs are not derivatives.

At the same time, SIBs can neither qualify as debt-based financial instruments. Debt-based instruments involve an *unconditional* promise to repay the debt. For this reason holders of debt-based instruments have claims to assets of the issuer upon bankruptcy.[98] In an SIB arrangement, however, the repayment depends on the success of the funded program and is therefore *conditional*. The investors have no right to claim anything if the program fails to deliver the agreed-upon outcomes. For this reason SIBs are not really bonds (i.e. debt-based financial instruments).

Finally, SIBs are also unlikely to qualify as equity. Unlike equity holders, SIB holders do not become owners of the entity (i.e. intermediary), which receives their funds. Therefore SIBs can neither be equity-based.

Yet, there seems to be an exotic subcategory that can accommodate even such a complicated device as SIBs. Salamon argues that SIBs are a so-called quasi-equity - "a strange amalgam of equity and debt".[99] He explains that, like equity, SIBs only generate returns if the funded services achieve certain performance thresholds.[100] If the thresholds are not achieved, then no returns are available. This is similar to equity holders receiving dividends only if the company generates profits, which can be distributed as dividends. Furthermore, if the company or SIB program fails (i.e. bankruptcy occurs or SIB program fails to achieve the outcomes) the investors may not receive anything and their entire investment may be lost. On the other hand, Salamon points out that SIBs are like debt-based financial instruments in that SIBs have fixed maturity terms and the upside return is capped.[101] Coming back to the case studies from Chapter I both Peterborough and Rikers SIB show debt-like features in that the

[98] Rechtschaffen (n 84) 145
[99] Salamon, *Levereage for Good* (n 92) 70
[100] Salamon, *Levereage for Good* (n 92) 70
[101] Salamon, *Levereage for Good* (n 92) 70

SIB arrangement provides for payments to the investors if the pre-agreed outcomes are achieved after a the contractually stipulated periods.[102]

As one can see, SIBs do not squarely fit into the existing legal categories. This in turn causes some problems. As will be demonstrated in the next part the complicated structure of SIBs can cause some confusion when it comes to determining whether SIBs should be subject to the federal regulatory framework of the United States' securities markets.

b) Are SIBs securities?

Financial instruments, be they equity-based, debt-based or derivatives, are used to raise funds on capital markets.[103] SIBs are similar in that one of their main objectives is to connect intermediaries with investors and so allow them to raise money for their designated social programs.[104] Yet, many of the financial instruments that are designed for fundraising are heavily regulated.[105] The aim of this part is not to provide a comprehensive overview of the United States' securities market, but rather to point out a potentially problematic interference between the federal securities regulation regime and the newly emerging SIB market.[106]

In the United States the Securities and Exchange Commission (SEC), established under the Securities Exchange Act of 1934, is vested with extensive regulatory powers over security markets.[107] Most notably the Act equips the SEC with policing powers over the securities market and allows it to discipline entities and persons who engage in certain types of prohibited conduct (e.g. issue misleading statements relating to their securities).[108] The Securities Act of 1933 imposes certain minimum standards on the securities issuers in that it

[102] See Chapter I (b)
[103] See Rechtschaffen (n 84) 13-23
[104] See Social Finance, 'A New Tool' (n 15)
[105] See Rechtschaffen (n 84) 39-73
[106] For a comprehensive overview of the SEC powers and the securities markets see: John C Coffee Jr, Hillary A Sale, *Securities Regulation: Cases and Materials* (12th ed, Foundation Press 2012)
[107] SEC was established by Securities Exchange Act of 1934 15 U.S.C. § 78(d)(a). SEC derives regulatory powers from the Securities Exchange Act of 1934 15 U.S.C § § 78a et seq. and Securities Act of 1933 15 U.S.C. § 77a et seq,
[108] See generally: Securities Exchange Act of 1934 15 U.S.C § 78 et seq.

requires that investors receive financial and other significant information about the securities offered and prohibits misrepresentations and other forms of fraud on the securities market.[109] Also, the Act requires issuers to register their securities in order to make important financial information public, which in turn enables investors to make an informed decision when purchasing securities.[110] The purpose of this regulation is to eliminate serious abuses in the financial markets and to protect of investors by imposing certain disclosure requirements on the issuers of anything that classifies as a 'security'.[111] The obvious question is therefore whether SIB does in fact qualify as a 'security'. Both Securities Exchange Act of 1934 and Securities Act of 1933 define security in a very similar and very broad manner.[112] The Securities Act states that:

> The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary

[109] Securities Act of 1933 15U.S.C. § 77a
[110] Securities Act of 1933 15U.S.C. § 77a, See also U.S. Securities and Exchange Commission, 'The Laws That Govern the Securities Industry' <http://www.sec.gov/about/laws.shtml> accessed on 13 March 2015
[111] *Reves v Ernst & Young* 494 U.S. 56, 60-61 (1990)
[112] Securities Exchange Act of 1934 § 78(c)(a)(10), Securities Act of 1933 15U.S.C. § 77(b)(1)

or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[113]

This complex and open-ended definition is certainly very inclusive. As summarized in one case, security definition is “sufficiently broad to encompass virtually any instrument that might be sold as an investment.”[114]

The crucial questions for the potential SIB issuers and investors are whether SIBs qualify as securities and whether they come within the regulatory powers of SEC. The implications of this are not negligible. If SIBs come within the regulatory powers of SEC, the SIB issuers will have to comply with the relevant statutory requirements that SEC will deem applicable to SIBs. The investors could, at least in theory, benefit from these disclosure requirements that would be imposed on SIB ‘issuers’ (i.e. intermediaries). On the other hand, however, being subject to SEC regulation can impose an undue administrative burden requiring disclosure that unjustly increases the already high transaction costs of this new financial instrument.

Yet, Humphries argues that SIBs do in fact qualify as securities because of their undeniable similarities with investment contracts.[115] As the definition of securities is not an exclusive one, any instrument that contains features which resemble some recognised security, can qualify as a security.[116] Humphries points out that SIBs do in fact qualify as investment contracts under both, the federal *Howey* test and the state *risk capital* test.[117] As the *risk*

[113] Securities Act of 1933 15 U.S.C. § 77(b)(1); The Definition contained in the Securities Exchange Act of 1934 15 U.S.C. §78(c)(a)(10) differs only by its exclusion of notes with maturity of less than nine months. The US Supreme Court however seems to have treated the definitions as equal. See. *Reves v Ernst & Young* 494 U.S. 56, 61 (1990)

[114] *SEC v Infinity Group Co.* 212 F.3d 180, 186 (3rd Cir. 2000)

[115] Humphries (n 16) 439 - 446

[116] *SEC v. C. M. Joiner Leasing Corp*. 320 U.S. 344, 351 (1943)

[117] Humphries (n 16) 439 - 446, The *risk capital* test is the basis for the *Hawaii Market* (485 P.2d 105, 109) test used in many US states. Similarly to the *Howey* test the *Hawaii Market* test consists of four prongs with the only one significant difference. While *Howey* test focuses on commonality (see below) the *Hawaii market* test focuses on risk capital. (See Rechtschaffen (n 84) *61-62)*

capital test is generally more inclusive than the *Howey* test,[118] it is sufficient for the purpose of this analysis to only discuss the later one.

The *Howey* test says that a financial instrument is to be deemed an investment contract, and therefore a security,[119] if there is: "an investment of money [1] in a common enterprise [2] with profits to come [3] [...] from efforts of others [4]."[120] On its face it is clear that the basic SIB structures whereby investors provide money to the intermediary with the expectation that they will eventually profit from the work of the intermediaries and service providers clearly satisfies the *Howey* test. Yet, there are some grey areas.

Firstly, investment in the SIBs does not have to be solely for the purpose of profits to come. Humphries points out that this might pose a problem because cases where money was invested for the purpose of gaining some non-monetary benefit may not qualify as investment contracts.[121] In case of SIBs it is clear that profit is not the sole motivation for the investors and sometimes making a positive social impact and improving the public relations may be far more important.[122] This might therefore become *the* battlefield for lawyers when the Securities Exchange Commission decides that it could regulate SIBs.

Secondly, when it comes to the common enterprise requirement the courts disagree about the very nature of this requirement.[123] One way to approach the common enterprise is the so called '*horizontal commonality*'.[124] This commonality requires ties between "the fortunes of each investor in a pool of investors to the success of the overall venture."[125] Humphries points out that most SIBs will meet this test, as it is likely that they will have more then just

[118] Humphries (n 16) 445

[119] Please see the definition above. Note that some securities are exempt from regulation, for example municipal securities as discussed below in Chapter II c)(ii)

[120] *SEC v W.J. Howey Co.* 328 U.S. 293, 301(1946), See further Rechtschaffen (n 84) 51

[121] Humphries (n 16) 440-441, See also United Housing Foundation, Inc. v. Forman 421 U.S. 837 (1975)

[122] O'Donohoe an others, 'An Emerging Asset Class' (n 2) 66-69

[123] See *Majors v South Carolina Securities Commission* 644 S.E.2d 710, 716-717 (2007), *SEC v SG* Ltd. 265 F.3d 42, 49-50 (2001)

[124] *Deckebach v La Vida Charters, Inc. of Florida* 867 F.2d 278, 282

[125] *Deckebach* (n 124) 282

one single investor.[126] Yet he also points out that arrangements such as the Rikers Island SIB, where there is only one investor (i.e. there is no pool of investors), may not satisfy the horizontal commonality test.[127] Therefore, in courts that adopt the horizontal commonality test it may be the number of SIB investors that will determine their status as securities.

The other method used by courts is called ‘*vertical commonality*’. It requires a commonality as the one in an arrangement between a lender (possibly a single one) and a customer.[128] This commonality is either ‘*strict*’, requiring the success of the investor to be interwoven and dependent upon the *fortunes* of those seeking the investment;[129] or ‘*broad*’, requiring the success of the investors to depend merely on the *efforts* of those seeking the investment.[130] Humphries points out that even though most of the SIBs are likely to meet the broad vertical commonality requirements, as the success of the SIB investments actually depends on the *efforts* of those seeking the investment (i.e. intermediaries), the strict vertical commonality is uncertain.[131] The problem here is that in the SIB structure the promoter (i.e. the intermediary) is a non-profit organisation, the only ‘fortune’ of which is the non-monetary gain of good reputation if the SIB is successful. If the courts accepted this as a ‘fortune’ then even the strict vertical commonality requirement could be satisfied. This might therefore be yet another frontier for lawyers of clients who do not wish that their SIBs become exposed to the regulatory requirements of SEC. It is probably intermediaries, who would not wish to have SIBs regulated by SEC as it would impose on them an additional financial and administrative burden. Nevertheless, in SIB it may actually also be the investors who may wish to exclude the SIB from regulatory requirements. At least at this early stage of the SIB market development it is intermediaries together with sophisticated investors who make substantial

[126] Humphries (n 16) 444
[127] Humphries (n 16) 444
[128] *Deckebach* (n 124) 282 (1989)
[129] *S.E.C. v. Alliance Leasing Corp.* Not Reported in F.Supp.2d, 2000 WL 35612001, 4
[130] *SEC v ETS Payphones, Inc.* 408 F.3d 727 (2005)
[131] Humphries (n 16) 444

efforts to make the SIB market work.[132] Regulatory burden would be yet another unwanted inhibitor that could slow down the development process and increase the already high transaction costs.[133]

To conclude, it seems like SIBs can, at least technically, be classified as securities (i.e. investment contracts) and therefore they are a potential future target of SEC. Nevertheless, as will the discussion below explain, it is probably undesirable to extensively regulate this emerging financial instrument at this stage.

c) SIBs – regulation and taxation regimes

Regulatory questions are definitely an important aspect of every single financial instrument. This does not concern only regulation of securities. What is perhaps even more important from the investor's perspective is the taxation regime of the relevant financial instrument. SIB seem to be problematic on both of these fronts. Not only it is unclear whether SIB is a security, the taxation status of this new financial device is also unsure. This part explores the regulatory and taxation issues and provides arguments based on the lessons that can be learned from the municipal bond markets. First, subsection (i) explains why it is useful to make an analogy between SIBs and municipal bonds. Subsection (ii) then explores the potential regulation of SIBs as 'securities'. Finally, subsection (iii) elaborates on the taxation regime for SIBs.

(i) (Dis)connections between Municipal Bonds and SIBs

Municipal bonds are financial debt instruments issued by state or local governments or any entity that they established.[134] Municipal bonds are issued as a means for financing long-term

[132] Salamon, *New Frontiers of Philanthropy* (n 6) Chapter 16
[133] See Chapter II c)
[134] See Frank J Fabozzi ed., *The Handbook of Financial Instruments* (John Wiley & Sons, Inc. Haboken 2002) 229-250

projects.[135] These include financing of construction of bridges, schools, roads or they provide a means for covering long-term budget deficits that arise from municipalities' operations.[136] There are two types of municipal bonds, tax-backed bonds and revenue bonds.[137] This division essentially refers to the securitization of the respective instruments. While tax-backed bonds, in general, are secured by the *general or specific tax proceeds of the municipality*,[138] revenue bonds are only secured by *income generated by a specific project* being financed by the bonds.[139]

Considering the above details, it seems that SIBs are actually similar to revenue bonds in that SIBs are issued on the basis of municipalities' promises to pay and the return of the investment depends on the success of the very project that is so financed. Yet, municipal bonds are different from SIBs in in their structure. When a municipality issues bonds these are usually rated and sold to underwriters, who then resell them to investors on various secondary markets.[140] In a SIB arrangement, however, a government merely enters into a contract with an intermediary (a SIB 'issuer') pledging a certain amount of money if the intermediary achieves certain outcomes.[141] Intermediary then uses this pledge and 'issues' SIBs to investors.[142] The raised funds are then forwarded onto service providers and if the contractual outcomes are achieved, governments pay the intermediaries, who then repay the investors their principal and possibly also a premium.[143]

The differences are actually quite substantial. Firstly, in a SIB arrangement it is not the government that issues the SIB, but the SIB is 'issued' intermediary. Secondly, SIBs are currently not rated. Thirdly, there are no underwriters involved and (at least currently) there

[135] Fabozzi (n 134) 235
[136] Fabozzi (n 134) 235
[137] Fabozzi (n 134) 235
[138] There are many variations of tax-backed debt, not only bonds. Also, the tax proceeds securing the obligation do not have to come directly from the issuing municipality. See Fabozzi (n 134) 236-240
[139] See Fabozzi (n 134) 240-245
[140] Neil O'Hara, *The Fundamentals of Municipal Bonds* (John Wiley & Sons, Hoboken 2012) 7-8
[141] Social Finance, 'A New Tool' (n 15) 12, See also the SIB model Agreement: Kohli and others (n 96)
[142] Social Finance, 'A New Tool' (n 15)
[143] Social Finance, 'A New Tool' (n 15)

is no resale of SIBs to investors on any secondary market. Fourthly, as was established at the beginning of this chapter because of its unique features SIBs cannot be classified as a purely debt-based financial instrument (e.g. municipal bond).[144] It was established that SIB is a 'strange amalgam of equity and debt'.[145] For these reasons SIBs cannot be perceived as municipal bonds.

Nevertheless, there is a feature of municipal bonds, namely their purpose to raise funds for cash strapped governments, which strongly resembles SIBs. Even though in a SIB arrangement the government is using a proxy organisation (i.e. intermediaries), the functional analysis of SIBs and municipal bonds suggests that they are indeed identical in their purpose. This paper suggests that this very reason justifies the making of analogies between SIBs and municipal bonds when it comes to their regulation and taxation. The following subsections explore these features of municipal bonds and suggest their application to SIBs.

(ii) Municipal Bonds Regulation and SIBs

As discussed above, the SEC has extensive regulatory powers over the securities market.[146] Having established that SIBs can, at least in theory, be classified as securities,[147] it is important to determine the extent to which they should be subject to such regulation. Since SIBs are at present *not officially classified as securities,* this subsection is based merely on a hypothetical *assumption* that SIBs *will be classified as 'securities'.* The potential of SIBs being classified as securities can have some positive implications for investors, as they would be by law entitled to certain minimal disclosure standards as discussed above.[148] Nevertheless, this regulation might put an undue financial and administrative burden on

[144] See Chapter II a)
[145] See Chapter II a)
[146] See Chapter II b)
[147] See Chapter II b)
[148] See Chapter II b)

intermediaries and so increase even more the already high transaction cost of SIB.[149] As a consequence the investors may potentially be worse of in a market where SIBs are regulated. To improve the certainty about the status of any particular SIB transaction in the currently unregulated SIB market, issuers should request a no-action letter from SEC, which will give the issuers limited assurances that SEC will take no action with respect to the specific transaction.[150]

The aim of this subsection is to explore the most appropriate regulatory regime for this new instrument by utilizing the lessons learned from the municipal bond market.

As explained above, the ultimate aim of regulation of securities is to protect investors by imposition of certain disclosure standards on security issuers.[151] However, the degree of regulation across the various types of securities is not the same. Municipal bonds for instance have a lower regulatory burden than others. They are exempt from all provisions of Securities Exchange Act of 1934 and Securities Act of 1933, except for the anti-fraud provision in 15 U.S.C. §77q, 15 U.S.C. § 78j(b) and the Rule 17 CFR § 240.10b-5 declared thereunder.[152] The municipal securities market is regulated by a self-regulatory organisation called Municipal Securities Rulemaking Board (MSRB), which is under the supervision of SEC and which is empowered to develop rules for the municipal securities market.[153] Yet, because of the exemptions, the regulatory powers of SEC and MSRB are quite limited. The absence of registration and reporting requirement for the municipal securities *issuers* forced the SEC and

[149] See Chapter III f)

[150] U.S. Securities and Exchanges Commission, 'No-Action Letters' <http://www.sec.gov/answers/noaction.htm> accessed 25 March 2015

[151] See Chapter II b)

[152] See Securities Act of 1933 15 U.S.C. § 77c (a)(2), 15 U.S.C. § l (a) (2), Securities Exchange Act of 1934 15 U.S.C. § 78c (a) (12) and 15 U.S.C. § 78c (29) For a comprehensive overview of the municipal securities market regulation and challenges see U.S. Securities and Exchange Commission, 'Report on Municipal Securities Market' (31 July 2012) http://www.sec.gov/news/studies/2012/munireport073112.pdf accessed 13 March 2015

[153] Securities Exchange Act 15 U.S.C. 78o-4a

MSRB to regulate these securities through a sort of 'backdoor' regulation of *underwriters,*[154] "SEC interpretations,[155] enforcement of the anti-fraud provisions of federal securities laws, and Commission oversight of MSRB".[156] The result is a patchwork of principles that decrease the transparency of this market, which has been highly criticised.[157]

The basic justification for the lowered regulatory standard is that municipal securities are relatively safe in that it can be supposed that "governments typically do not lie or default on their debt obligations".[158] Furthermore, it has been submitted that typical municipal securities investors are sophisticated (i.e. capable of dealing with the lower regulatory standards) and that the imposition of registration requirements would introduce an unjust burden on municipalities and so impair their ability to raise funds.[159] One can definitely sympathize with the reasons behind the lax regulation. Nevertheless, the validity of these arguments has proven to be highly questionable. Firstly, the presumption that municipalities do not typically default on their debt obligation has long been rebutted. Even municipalities can (and indeed do) go bankrupt,[160] which can endanger the repayment of municipal bonds. Secondly, as data shows the sophistication of investors in the municipal securities market is very uncertain as

[154] SEC Rule 15c-12(b) This rule "requires dealers, when underwriting certain types of municipal securities, to ensure that the state or local government issuing the bonds enters into an agreement to provide certain information to the Municipal Securities Rulemaking Board about the securities on an ongoing basis." These include for instance financial information and operating data and audited financial. Importantly, this rule in NOT applicable if the entire issue is less than $ 1 million. See: MSRB,'SEC Rule 15c2-12: Continuing Disclosure' < http://www.msrb.org/msrb1/pdfs/SECRule15c2-12.pdf> accessed on 14 March 2015

[155] See examples given in U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) Footnote 154: Exchange Act Release No. 26100, "Municipal Securities Disclosure" (Sept. 22, 1988), 53 FR 37778 (Sept. 28, 1988); Exchange Act Release No. 26985, "Municipal Securities Disclosure" (June 28, 1989), 54 FR 28799 (July 10, 1989); Exchange Act Release No. 33741, "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others" (Mar. 9, 1994), 59 FR 12748 (Mar. 9, 1994)

[156] U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) 28

[157] See: U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152)

[158] Humphries (n 16) 447

[159] See Humphries (n 16) 448 (citing Robert W. Doty, John E. Petersen, 'The Federal Securities Laws and Transactions in Municipal Securities' 71 Northwestern University Law Review 283, 325 (1976); Bruce N. Hawthorne, 'Note, Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation, 28 Vanderbilt Law Review 561, 583-585 (1975))

[160] In 1994 Orange County in California filled for protection under Chapter 9 and in 2008 another Californian city, Vallejo, filled for bankruptcy. See: O'Hara (n 140) 174; More recently Detroit in Michigan defaulted on more than $ 600 million of unsecured bonds. See: Washington Post, 'Detroit Defaults on $ 600 million of unsecured bonds' (1 October 2013) <http://www.washingtonpost.com/business/economy/detroit-defaults-on-600-million-of-unsecured-bonds/2013/10/01/543f36f0-2aea-11e3-b139-029811dbb57f_story.html> accessed on 14 March 2015

more than 50% of municipal securities in 2011 have shown to be held by households.[161] Lastly, it is questionable whether the imposition of disclosure requirements (in conformity with the present ones that are imposed on *underwriters*)[162] would impose any additional burden on the *issuers* of municipal securities. Actually issuers are already, albeit indirectly, supposed to provide official statements with relevant financial information about the issued securities to the underwriters.[163]

The municipal securities market at present has therefore an underregulation problem. The SEC currently lacks enforcement powers that would allow it to police municipal securities issuers and there is a general lack of uniform standards to be applied when disclosing information about municipal securities.[164] The result is an inconsistent market where individual players cannot act with any great certainty. It is for these reasons that the 2012 SEC Report on Municipal Securities Market recommended that uniform standards be applied to municipal securities and suggested an enhancement of SEC policing powers when it comes to policing municipal securities *issuers*.[165]

It is more than helpful to use these valuable lessons from municipal bonds market and apply them to SIBs if they are to be treated as securities. At present there may be good justifications for *completely excluding* SIBs from regulation, as it may inhibit the expansion of this new phenomenon. Firstly, as a new financial instrument, SIBs are now virtually exclusive to sophisticated investors who are capable of understanding the risks involved and who can properly protect themselves.[166] Secondly, the imposition of an additional administrative and

[161] U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) 14
[162] See above (n 154)
[163] U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) 134 - 135
[164] See: U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) 134 - 150
[165] U.S. Securities and Exchange Commission, 'Report on Municipal Securities' (n 152) 133-150
[166] Currently only sophisticated investors such as Goldman Sachs, Bank of America and numerous large foundations such as Bloomberg Philanthropies and the Rockefeller Foundation are involved in the SIB market. See Jane Hughes, Jill Scherer, 'Foundations for Social Impact Bonds: How and why Philanthropy is Catalyzing the Development of a New Market' (Social Finance, 2014) < <http://www.socialfinanceus.org/pubs/foundations-social-impact-bonds-how-and-why-philanthropy-catalyzing-development-new-market> accessed on 14 March 2015

financial burden on the SIB pioneers in form of various regulatory requirements might discourage potential participants. Lastly, since SIBs are a new phenomenon, it is quite unclear as to what the regulations should be like. As explained above,[167] SIBs has very distinct features that result in very unique risks (e.g. payment conditional upon the successful outcome of the project with evaluation methods that are still being developed) that are yet to be fully understood. Furthermore, the flexibility of the SIB arrangements suggests that SIBs can be quite different from case to case. As our examples from Chapter I suggest, the risk of the Rikers SIB investor who has a guarantee in place is quite different from the risk of Peterborough SIB investors that have no guarantee of repayment.[168] These distinctive features of SIBs suggest that SIB regulation might be quite challenging.

Nevertheless, the positive predictions about the future of SIBs make some sort of future regulation almost inevitable. The lessons from the municipal securities market are clear. Firstly, any regulation of securities should involve uniform standards that promote transparency across the market. Secondly, the regulator should have powers to regulate the conduct of *issuer* (as opposed to an underwriter) as only the issuer can provide the relevant financial and other information about the particular security. It is these principles that have to be considered when developing a regulatory regime for SIBs.

To conclude, the SIB issuers and investors should be vigilant about the changes on the market that influence the SIB regulation. Requesting a no-action letter from SEC before the relevant SIB is issued may bring more certainty into the whole transaction. Even though at present it seems undesirable to regulate the new SIB financial instrument, it is likely that tools can be developed, which will enable imposition of certain minimum disclosure

[167] Chapter 2 b)(i)
[168] See Chapter I b)(ii)

standards on the SIB market.[169] Consequently, a regulated and a transparent SIB market could benefit both investors and issuers alike.

(iii) Taxation

The tax status of US SIBs is currently unclear as none of the publicly available sources contain any information about their taxation regime.[170] Nevertheless, taxation is yet another field where SIBs could utilize the lessons from the municipal bonds market.

A distinguishing feature of municipal bonds is their tax-exempt status.[171] According to 26 U.S.C. §103(a) unless otherwise indicated, interest on any state or local bond is excluded from federal income taxation.[172] In 2011, over 90% of municipal debt issued was tax-exempt.[173] This feature is one of the primary factors that influence the demand for these securities.[174]

Yet, the state tax treatment of municipal bonds may vary depending on whether they are classified as ‘in-state’ or ‘out-of-state’ issued bonds and whether the investor is individual or corporation.[175] In most states the in-state issued municipal bonds are exempt from state income taxation, while out-of state issues are subjected to some taxation.[176] This asymmetric treatment usually drives investors away from out-of-state towards in-state bonds.[177] As a

[169] See Hughes and Scherer (n 166) 42-43

[170] Even though the US taxation regime is unclear, the developments in the UK suggest that, at least for individual investors, SIBs will be tax-exempt. See Social Investment Tax Relief <https://www.gov.uk/government/collections/social-investment-tax-relief> accessed on 14 March 2015

[171] Craig L. Johnson, Martin J. Luby, Tima T. Moldogaziev, *State and Local Financial Instruments: Policy Changes and Management* (Edward Elgar Publishing Ltd., 2014) 21

[172] Note: Tax-exemption of municipal securities applies to income interest, not capital gains. See: Fabozzi (n 134) *230-235*

[173] Johnson and others (n 171) 21

[174] Johnson and others (n 171) 24

[175] States typically treat the income interest in one of three following ways: (1) taxation of interest from municipal securities regardless of their in-state or out-of-state issue, (2) exempt interest from all municipal issues regardless of their in-state or out-of-state issue (3) exemption of interest taxation on in-state issues, but some taxation on out-of-state issues. See: Johnson and others (n 171) 230-233

[176] Johnson and others (n 171) 24

[177] Johnson and others (n 171) 24

result the investors have narrower investment opportunities and issuers and underwriters have a narrower pool of municipal investors.[178]

Even though it is questionable whether SIBs 'issued' by an intermediary organisation would qualify as 'any state or local bond' for them to be exempt from federal income tax, the SIBs should, because of their functional equivalence with municipal bonds, be also exempt from tax. The reason for this parallel is the identical purpose of tax-exempt municipal bonds and SIBs – namely to "finance basic governmental functions for which there is a clear public purpose [...] and from which the debt service is being paid from governmental funds."[179]

Furthermore, as a new and risky investment instrument SIBs need a broad support from both federal and state institutions. Similarly to promoting municipal bonds, the federal government should stimulate SIB investments. The federal tax exemption would undoubtedly provide incentives for investors looking for a legal tax shelter.[180]

On the state level, the states should approach the taxation of SIBs with utmost caution. In assessing the tax treatment of SIBs it will be useful to consider the downsides of market segmentation (different treatment for in-state and out-of-state SIBs) and the effects it could have on their SIB projects. Yet it would probably be desirable to afford different tax treatment to large institutional and individual investors. However, this remains to be determined.

Only one thing is certain at this stage of the SIB development – some concessions will have to be made for the SIBs to really take off. Taking into consideration the recent move of the UK's Cabinet Office to push SIBs by providing income tax and capital gains tax relief for individuals on certain qualified social investments, tax-exemption seems to be the right way forward.[181]

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[178] Johnson and others (n 171) 24
[179] Johnson and others (n 171) 23
[180] See Johnson and others (n 171) 24
[181] See (n 170)

To conclude, because of the overall uncertain tax-status of SIBs, investors should enquire about the tax-status of the individual SIB investments. In any case, at this stage of the SIB market it is probably much wiser to wait, until the pioneers sufficiently develop the market and establish standards that promote certainty.

III. Selected *Micro* Problems of Social Impact Bonds

The previous chapter dealt with a selection of *macro* problems that are present in the United States' legal and economic system in which SIB as a new financial instrument operates. This chapter explores a selection of *micro* problems. These problems stem from the very design of SIB and they can profoundly influence investors and their willingness to participate in SIB investments. These problems essentially amount to a complex set of heavily intertwined risks. To make things even more complicated because of the dual-purpose of SIBs, namely to generate both positive social impact and profit at the same time, these risks endanger potential investors on two fronts. First, they threaten the success of their investment. Second, they endanger investors' public image. It is these two underlying issues that steer the discussion in this chapter. The focus is on seven significant risks: (a) model risk, (b) service provider risk (c) political risk, (d) intermediary risk (e) evaluation risk (f) financial risk and (g) reputation risk.[182] The challenge for any SIB investor is clear – to mitigate risks, secure (as much as possible) the return of both investment and profits and to protect their relations with the public. This chapter explores the investors' options.

(a) Model Risk

Model risk concerns the very essence of the program that is funded through SIBs. Investors essentially invest into a model program, which when up-scaled should deliver the agreed upon outcome. However, if the selected intervention model is not properly selected, it may not deliver the desired outcome.[183] This in turn threatens the investment and contributes to the reputation risk (discussed below). It has been suggested that a "due diligence process should provide an understanding of the intervention model, project cash flows, and the

[182] Extended risk categorization based on: Burand (n 2) 468-480
[183] Social Finance, 'A New Tool' (n 15) 20

capacity of the nonprofit providers."[184] Also, it has been suggested that using only proven programs can lower this risk.[185] Nevertheless, it is still too early in the development of SIBs for a proper understanding of what will and what won't work. For instance, some programs may generally not be suitable for being scaled-up.[186] Moreover, as revealed by a 2014 survey of SIB market participants, for privacy and competition reasons, there are no reliable and transparent data on the market, which could help others to design successful models.[187] Consequently, it is extremely hard for investors to verify whether the selected model will work. Probably the only way to improve this situation is to increase the transparency of the market and ensure open dissemination of data.[188] At present, however, investors are heavily exposed to this risk.

(b) Service Provider Risk

Service provider risk is closely connected with the model risk but it is different. It refers to the execution of the model program by the selected service provider(s). Firstly, service providers may be unable to deliver the model program due to their lack of capacity (e.g. lack of leadership talent, staff problems, inadequate information management systems etc.).[189] In this case it has been pointed out that due diligence may not be sufficient, as it is hard to predict how well will the selected social providers cope with the expansion of their services.[190] For this reason it has been suggested that a supporting system that would allow service providers to better cope with any potential issues should be put in palace (e.g. using external consultancy firm that would help with the administration of data).[191]

[184] Social Finance, 'A New Tool' (n 15) 20
[185] McKinsey&Company (n 8) 19
[186] Burand (n 2) 468
[187] Hughes and Scherer (n 166)
[188] See recommendations in: Hughes and Scherer (n 166) 42-43
[189] See: Burand (n 2) 469
[190] Burand (n 2) 469
[191] Burand (n 2) 469

Secondly, there is a risk that service providers may take inappropriate actions in order to ensure meeting performance targets.[192] For instance, a service provider involved in a SIB designed to reduce the number of children in orphanages may be tempted to place children into foster families without adequately checking the family backgrounds.[193] Burand suggested three solution to this problem: (1) rigorous due diligence to be conducted before the service providers are hired to examine financial schemes, staff training, code of conduct and reputation of the service providers; (2) include provisions in the contract with the SIB intermediary that provide for termination, replacement or penalty rights if selected service provider fails to meet the designated standards; (3) establish an independent supervisory organisation that constantly ensures that service providers comply with the terms of the contracts.[194]

Nevertheless, the most important problem with Burand's approach is that this is only a 'protection by proxy'. All the above features of a SIB arrangement can only be negotiated and executed between the intermediary, the government and service provider(s) involved in SIB.[195] The investor therefore has to rely on the diligent work of the intermediary. Consequently, a thorough examination of the intermediary itself connected with the performance of due diligence on contracts and service providers' track record seem to be the best solution for any potential investor.

(c) Political Risk

It has been pointed out that political risk entails two components. On the one hand, the investors have to consider the government's *capacity* to undertake its obligations, however,

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[192] Burand (n 2) 470

[193] Burand (n 2) 470

[194] Burand (n 2) 471-472

[195] The initiative to bring a SIB program into existence usually starts at the government level and or by an intermediary to be. For this reason the design of SIB is likely to be heavily influenced by these two actors. See: Liebman and Sellman (n 71)

on the top of that it is necessary to make sure that the government also possesses the *will* to honour its obligations in accordance with the SIB arrangements.[196] Political risk can materialize in various forms such as “interference with SIB measurement tools, forced renegotiation of SIB contractual terms, manufactured delays (or creation of obstacles) to passing appropriate authorizing legislation to permit the government to meet its SIB obligations or even nonpayment of SIB obligation”.[197] In a 2014 survey of the United States’ SIB market participants seems to have confirmed this problem in that certain participants *expressed a specific concern* that reliance on government over a number of years might pose a risk that politics may interfere with the SIB project over time.[198]

The handling of this risk is probably more complicated than managing any of the other risks. This is clearly something that is completely out of reach of investors. Political risks involve the whole legal and political system of the place where the relevant SIB is to be executed. The only solution that can improve the investor’s position seems to be the passing of specific legislation enabling SIBs and expressing commitments of the government to honour its obligations.[199]

To conclude, it will be quite important for investors to make sure that the government involved has indeed the capacity and the will to commit to SIB arrangements.

(d) Intermediary Risk

The role of intermediary in a SIB arrangement is crucial. Among other things, intermediary is responsible for most of the research, service provider selection, government assistance and contracting, financial and technical structuring of the SIB program, conducting due diligence,

[196] Burand (n 2) 473
[197] Burand (n 2) 473
[198] Hughes and Scherer (n 166) 36
[199] Hughes and Scherer (n 166) 36

raising funds from investors, documentation, monitoring and reporting.[200] As a consequence of this complex set of responsibilities, it is important for SIB investors to ensure that the intermediary organisation is fit for its purpose. It has been suggested that one effective way of hedging this risk is to provide a clause that enables removal and substitution of intermediary in the various contracts between government, intermediary and investors.[201] Though perfect in theory, it is highly questionable whether this would work in practice. From a practical perspective, it is likely to be a significant challenge to define the triggering event in the intermediary removal clause. The complex arrangements of SIBs will definitely provide some interesting challenges for legal counsels. Furthermore, SIB market is a very new playground with virtually no intermediaries that have a proven track record and therefore it may be difficult to find an adequate substitute.

To conclude intermediary risk an inevitable by-product of the SIB arrangement. To deal with it, it is probably more beneficial to invest into *prevention* in form of proper examination of the intermediary, rather than *cure* in form of a very difficult replacement procedure of underperforming intermediary.

(e) Evaluation Risk

SIBs provide a way to finance pay-for-success programs.[202] As the name implies payment only comes if the agreed outcome is successfully achieved. The problem however is to ensure that the outcome is well defined and that performance indicators and targets are properly set. An improper evaluation methodology might for instance not capture the impact of the social services or it can make investors accountable for unmanageable risks.[203] It is possible that in some SIB arrangements the projected outcomes will be overly optimistic or that the

[200] Bank of America Merill Lynch, Social Finance, ‘Pay-for-Success Financing Playbook’ (April 2014) <http://www.socialfinanceus.org/pubs/pay-success-playbook-release> accessed on 16 March 2015
[201] Burand (n 2) 473
[202] Hughes and Scherer (n 166) 11
[203] Leventhal (n 34) 531

evaluation methodology will fail to take into account some important factor with a substantial impact on the actual outcome. Furthermore, to make things for investors even more complicated, because this market is only emerging, there are no market standards in place.[204] It has been pointed out that for the SIB market to really take off it is important to develop a unified "normative outcome measurement methodology, replicable pricing models, and cash-flow schedules".[205] Moreover, all of these will be useless if the quality and quantity of data is not unimpeachable.[206] Therefore it is also the data collecting methods that will have to be standardized. Until these features are in place it is likely that investors will have to be very cautious and will have to carefully examine the evaluation methodology as well as data collection and processing methods in the SIB arrangement.

(f) Financial Risk

One of the most intricate risks of an SIB arrangement for investors is the presence of a very peculiar financial risk. As explained above SIB is a strange amalgam of equity and debt.[207] This feature in connection with the relative newness of this instrument causes some challenges for investors who want to secure the repayment of their investment.

To recapitulate like equity SIBs only generate returns if the funded SIB project achieves certain predetermined outcomes. On the other hand SIBs are like debt-based financial instruments in that SIBs have fixed investment terms and the upside return is capped. In essence therefore the repayment depends on (non)-materializing of all and any the above-mentioned risks. As explained above, considering the generally low availability of reliable data on the current United States' SIB market it is extremely hard for investors to manage those risks. Furthermore, there are other financial risk related problems.

[204] See: Hughes and Scherer (n 166) 42
[205] Hughes and Scherer (n 166) 36
[206] Hughes and Scherer (n 166) 42
[207] See Chapter II a)

First, and probably the most important problem, is the overwhelming exposure of SIB investors to losses. In a traditional borrowing market, investors prefer to obtain a security (i.e. a collateral) of some sort in order to secure the investment.[208] The basic purpose of security is to give lenders the power to take security over a determined asset and then sell it if the lender is in default and to apply the proceeds against amounts owed under the loan arrangement.[209] In a SIB arrangement this is impossible to accomplish because there is no collateral, but only a *conditional* promise to repay the investor upon successful outcome of the SIB project. As already explained, even though on first sight it might seem that a SIB is similar to a typical municipal bond, this is certainly not the case.[210] In a municipal bond, a bondholder upon default (i.e. municipal project failure or municipal bankruptcy) becomes a creditor of the municipality and can attempt to recover at least some of its initial investment in the bankruptcy proceedings.[211] SIBs are different in that the *conditionality* of the promise to pay is ultimate. In other words, it means either the SIB project achieves the pre-determined outcome and payment is made or the investor loses the entire investment.[212] Furthermore, even if the SIB program achieves the pre-agreed outcomes, the investor has no direct claim against the government if the government fails to repay the investor. This is caused by the incomplete triangular contractual arrangement between government, intermediary and

[208] In the social sector risk-based financing is not new. 'Asset based' financing has been a traditional way for developing affordable housing, healthcare facilities and similar projects where the funded object becomes the security. See Salamon, *New Frontiers of Philanthropy* (n 6) 429; There are various types of security: proprietary security, personal security, quasi-security or creditors' position enhancing devices, procedural security and security function of complex transactions. See Tibor Tajti, *Comparative Secured Transactions Law* (Akademiai Kaidó, 2002) For an overview of the multitude of security devices in United States, England, Germany and Hungary see Tibor Tajti, *Comparative Secured Transactions Law* (Akademiai Kaidó, 2002) 402-404

[209] Graham Vinter, Gareth Price, David Lee, *Project Finance* (4ed Sweet & Maxwell 2013) 269, Note that there are also other 'less aggressive' purposes for taking security – a defensive purpose (i.e. ranking ahead of unsecured creditors), a management purpose (i.e. entitlement to use the collateral as opposed to a mere sale of it) and control on insolvency purpose (i.e. secured creditor may have a stronger influence over collective insolvency proceedings. See Graham Vinter, Gareth Price, David Lee, *Project Finance* (4ed Sweet & Maxwell 2013) 269

[210] See Chapter II c)(i)

[211] Municipal bonds are secured either by some sort of tax revenue (tax-backed debt) or by the revenues generated by specific projects (revenue bonds). See Fabozzi (n 134) 235-245

[212] As explained in Chapter I this is the backbone of the whole SIB system in that the risk for the successful outcome of a project is shifted from the government to investors. For a good overview see: Hughes and Scherer (n 166) 9-13

investors where the intermediary shields off government from investors so that the investors do not have a direct claim against the government.[213]

Yet, there might be a solution to this exposure problem. To mitigate the investors' risks, some SIB arrangements provide investors with an external guarantee or loan subordination schemes that significantly lower investors' exposure.[214] For example, as discussed in Chapter I, Bloomberg Philanthropies guarantees to Goldman Sachs the repayment of the first $7.2 million of the whole $9.6 million loan if the New York Rikers Island SIB fails to achieve the contractual outcomes.[215] More recently in Utah, a philanthropist J. B. Pritzker together with Goldman Sachs put together $7 million for a SIB project that aims to increase enrolment in a high-quality preschool program.[216] Pritzker provides a subordinated loan of up to $ 2.4 million to reduce the financial risk of Goldman Sachs, which plans to invest up to $ 4,6 million.[217]

Although these quasi-security devices provide a substantial benefit for the SIB investors, it is questionable whether these devices will be broadly available on the SIB market. Also, a concern has been expressed that "presence of large guarantees makes SIB transactions appear far riskier than they really are."[218] Nevertheless, it is probably important to provide at least some sort of security for the investors who decide to explore the presently murky waters of the SIB market. A quasi-security at this initial stage of the SIB market development can only encourage investors to participate. However, once clear rules, practices and standards are established on the SIB market there will be less need for these devices.

[213] Salamon, *New Frontiers of Philanthropy* (n 6) 444
[214] See Hughes and Scherer (n 166) 30-31
[215] See Chapter I b)(ii)
[216] For more information about this SIB see Nonprofit Finance Fund, 'Goldman, Pritzker & United Way Team up for Latest SIB Pilot' < http://payforsuccess.org/resources/goldman-pritzker-united-way-team-latest-sib-pilot> accessed on 18 March 2015
[217] See (n 216)
[218] Hughes and Scherer (n 166) 38

Second financial risk is the illiquidity of the SIB investment.[219] Currently there is no such thing as a secondary market for SIBs and it is therefore unlikely that it will be easy for investors to exit the market before the maturity of the SIB investment. Nevertheless, it has been suggested that as a result of the overall growth on the social investment market, "it is likely that a secondary market for SIBs may emerge offering primary investors liquidity and exit and secondary investors, such as pension funds, a potentially attractive asset class within a diversified (and socially aware) portfolio."[220] The second financial risk might therefore only be a temporary one.

Thirdly, the overall transaction costs may overwhelm the actual financial returns from the SIB arrangement.[221] Taking account of all the above risks it is undeniable that a potential SIB investor will have to do a substantial amount of due diligence procedures before purchasing a SIB. It has been admitted that early-stage projects can carry a high transaction cost.[222] However, the reality may not be so bleak. The lessons from Peterborough suggest that in SIB arrangements smaller investors can utilize the due diligence carried out by the large foundations.[223] Another possibility to deal with the high transaction costs would be to pay them (by foundations or other philanthropic organizations) at the start of the SIB to encourage investors to enter this market and then if the outcomes are achieved, a certain proportion of the profit would be deducted to cover this initial cost.[224] Even though this is not

[219] See Burand (n 2) 478
[220] Alex Nicholls, and Emma Tomkinson. 'Case Study: The Peterborough Pilot Social Impact Bond' (2013) Oxford: Saïd Business School, Oxford University 42 <https://emmatomkinson.files.wordpress.com/2013/06/case-study-the-peterborough-pilot-social-impact-bond-oct-2013.pdf> accessed 18 March 2015; Similar development for the SIB market is projected in Salamon, *New Frontiers of Philanthropy* (n 6) *454* (Projection that by 2020 the scale of SIBs will be large enough to support independent rating agencies, clearing houses and specialist firms. Note that in Salamon SIBs are called PFS – 'pay-for-success'.)
[221] Burand (n 2) 479
[222] Hughes and Scherer (n 166) 28
[223] See Disley and others (n 7) 13 (One investor into the Peterborough SIB explained that they actually used the materials developed by another larger investor in order to decrease their costs.)
[224] Hughes and Scherer (n 166) 28-29

going to decrease the initial high cost, it definitely lowers investors' financial risk, by effectively leveraging a part of their investment with some external funds.

To conclude, the financial risk present in an SIB arrangement is relatively high. Yet, most of the problems can be attributed to the newness and the unique structure of the SIB financial instrument. What is needed, probably, is more time and data that will enable investors to better understand the SIBs so that they can more competently manage the various risks.

(g) Reputation Risk

The ultimate 'umbrella problem' of SIB that brings all the above risks together is the negative publicity effect that an SIB investment may have once things turn out badly. Negligent intermediary, service provider that mistreats clients, rigged metrics of the SIB that enable payment despite the failure to deliver the agreed-upon outcome. These are just some things that can significantly affect public image of an SIB investor. Furthermore, it is not only the isolated investor who needs to worry about these poorly executed SIBs. As Burand pointed out, one negative SIB project experience can spoil the positive momentum of the entire SIB market.[225] Even though this risk *per se* is extremely hard to eliminate, following the steps discussed in the preceding subsections can significantly reduce this risk. Yet, at this stage of the SIB development it is difficult to properly assess reputation risk.

To conclude, the discussion of the seven significant *micro* problems suggests, that due to lack of transparency, uniform standards and data in the current United States' SIB market it may be extremely hard for investors to properly manage the various risks. Consequently, it is extremely hard for the investors to secure the repayment in a SIB arrangement. Yet, this is unlikely to significantly influence philanthropically oriented investors who are predominantly

[225] Burand, (n 2) 480

interested in a positive social impact of their investment. However, it is submitted that because of the above uncertainties profit-seeking investors should wait until the pioneering work of philanthropists produces a more transparent and predictable market, that will allow profit-oriented investors to better evaluate and manage their potential exposure to investment failure.

Conclusion

The United States' SIB market is booming and there seems to be promising future for this new financial instrument. The paper has explored this new financial instrument through the lenses of various *macro* and *micro* problems.

The *macro* perspective dealt with problems that are external to the SIB. The discussion focused on the present regulatory void surrounding the SIB concept in the United States of America. After showing that the present legal and economic regulatory environment is quite unclear the paper suggested that SIBs should, at least initially, be unregulated and tax-exempt. After the SIB market develops, however, the economic as well as legal regulation of SIBs should be adjusted accordingly. It was concluded that investors should beware of any potential changes that the developing SIB market may bring.

The *micro* perspective dealt with problems that are inherent in the SIB design. The paper presented and analysed seven risks that are present in a SIB arrangement on the United States' SIB market. Even though it was shown that some of the risks are less significant than others, as an aggregate these risks pose as a serious problem for any potential investor. Furthermore, because of the newness of the SIB market, some of the risks are extremely hard (if not impossible) to manage. The SIB investments are, at least at the present stage of the SIB development, an inherently risky venture. Because of these reasons it may be better for investors to wait until the pioneering work of philanthropically oriented investors is done and standards are settled, before profit-oriented investors decide to invest into SIBs. In any case more research, case studies and data collections are necessary for the development of proper risk mitigation strategies and market standards that will allow SIB investors to make informed investment decisions. For now SIBs remain 'the wild west' of capital markets...

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