NOT YOUR OLDER BROTHER'S BONDS: THE USE AND REGULATION OF SOCIAL-IMPACT BONDS IN THE UNITED STATES

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> For one thing, missions I would thoroughly reform. Missions I would quicken with the Wall street spirit.[1]
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> Herman Melville

I
INTRODUCTION

Of the many pressing issues facing the United States, juvenile delinquency—especially the rate at which juvenile delinquents recidivate—is one of the most troubling. In New York, for example, sixty-three percent of juveniles released from a state corrections facility are rearrested within two years of release.[2] And the long-term numbers are worse: By the time they reach their twenty-eighth birthday, eighty-nine percent of (formerly) juvenile males and eighty-one percent of such females will have been rearrested.[3]

But what is one to do? Recidivism, like homelessness, is a seemingly endemic problem requiring a top-down, comprehensive solution that private charitable donation would likely fail to produce. And, in a stuttering economy, individuals and companies may lack extra capital to donate to charity[4]—especially if the tax benefits of such donations are unavailable.

So, it seems, government must step in to address problems such as juvenile-delinquent recidivism. Indeed, governments have a substantial financial interest in reducing the amount of juvenile crime, which accounted for $7 to $8 billion in U.S. government spending in 2007.[5] Yet governments suffer in recessions too,

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1. HERMAN MELVILLE, THE CONFIDENCE MAN: HIS MASQUERADE 49 (Hershel Parker & Mark Niemeyer eds., 2006).

2. N.Y. STATE JUVENILE JUSTICE ADVISORY GRP., TOUGH ON CRIME: PROMOTING PUBLIC SAFETY BY DOING WHAT WORKS 17 (2010).

3. *Id.*

4. *See* ROB REICH & CHRISTOPHER WIMER, CHARITABLE GIVING AND THE GREAT RECESSION 2 (2012), *available at* http://www.stanford.edu/group/recessiontrends/cgi-bin/web/sites/all/themes/barron/pdf/CharitableGiving_fact_sheet.pdf ("[T]he economic downturn of 2008 has given rise to one of the largest year-over-year declines in charitable giving since the late 1960s.").

5. MCKINSEY & CO., FROM POTENTIAL TO ACTION: BRINGING SOCIAL IMPACT BONDS TO THE US 33 (2012), *available at* http://mckinseyonsociety.com/downloads/reports/Social-Innovation/

and accordingly may lack the resources necessary to adequately address social problems—especially those of politically powerless groups like at-risk youth. Thus, if neither private philanthropy nor the government can afford to fix the problem, are we simply out of options? Perhaps not.

Social-impact bonds (SIBs) may be the answer. SIBs are new financial instruments in which private investors bear the financial risk of social-welfare programs. As will be seen, SIBs provide a mechanism by which governments can infuse private sector social initiatives with powerful financial incentives. In this note, I explore the potential use and regulation of SIBs in the marketplace. I argue that the promising and potentially widespread use of SIBs to fund innovative programs targeted at important social issues poses challenging policy questions about how—if at all—the SIB market should be regulated.

II
SOCIAL-IMPACT BONDS

Like traditional government or municipal bonds, SIBs—also known as pay for success bonds—utilize private capital to fund government projects. Unlike traditional municipal bonds, in which the private investor receives a fixed return on her investment, in a SIB structure the return to the private investor is contingent on the "success" of the program.[6] Moreover, in the case of a SIB, repayment of principal to the investor is also contingent. On the other hand, all parties stand to gain financially and otherwise if the SIB-funded project is successful: Investors might receive a return on their investments, governments might realize net savings, and, most importantly, constituents will (certainly) receive needed social services.

A. SIB Basics

The three parties discussed above—government, private entity, and society—are not the only stakeholders involved in a SIB. Indeed, "[t]here are seven stakeholder groups involved in a SIB: constituents (the direct beneficiaries of the social services), government, nonprofit service providers, investors, intermediaries (responsible for overall SIB project management), evaluation advisors (to help monitor and refine the program), and independent assessors (to determine if SIB targets are met)."[7] Among this group, the intermediary plays perhaps the most important role in a traditional SIB: It "raises capital from investors, selects the service providers, contracts with [the] government, works with the evaluation adviser and the independent assessor to set and measure performance targets, and partners with the evaluation adviser to monitor and analyze interim results and suggest midcourse corrections."[8]

McKinsey_Social_Impact_Bonds_Report.pdf.

6. Success is usually defined by some benchmark of government savings resulting from the program's implementation.

7. *Id.* at 7.

8. *Id.*; *see also* JEFFREY B. LIEBMAN, CENTER FOR AMERICAN PROGRESS, SOCIAL IMPACT

Typically, the intermediary will have experience in the implementation and evaluation of social-welfare programs similar to the one the SIB is financing.[9] The intermediary's experience and expertise thus make it a more efficient option for governments than contracting with parties directly.

If, as a result of the social-welfare program, the government realizes a predetermined benchmark of savings, the investor recoups his or her principal plus some additional amount.[10] Often this percentage can vary depending upon the amount of money the government saves as a result of the program: The more money saved, the higher the rate of return.[11]

B. The SIB Marketplace

Though ever-increasing in popularity,[12] SIBs are nonetheless a relatively new phenomenon: The first one began in Britain in 2010.[13] Indeed, at the time of this note's writing, only a handful of SIB arrangements have been finalized in the United States, none having existed long enough to provide any kind of initial statistical results.

Because of the way SIBs are structured, SIB use lends itself most readily to programs addressing certain types of social problems. Payment to investors in SIBs is contingent upon numerical success rates, so the outcome of any SIB-funded program must be reliably measurable. For example, recidivism is an easily traceable, binary construct that allows for such measurement. Also, to allow for liquidity, results of any SIB-funded program must be available within a relatively short period—usually five years or less.[14] McKinsey & Company

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BONDS 2 (2011), *available at* http://www.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/social_impact_bonds.pdf ("Under the social impact bond model, a government contracts with a private-sector financing intermediary we'll call a 'social impact bond-issuing organization,' or SIBIO, to obtain social services. . . . The bond issuer obtains operating funds by issuing bonds to private investors who provide upfront capital in exchange for a share of the government payments that become available if the performance targets are met. The bond issuer uses these operating funds to contract with service providers to deliver the services necessary to meet the performance targets.").

9. MDRC, for example, is a prototypical intermediary for a SIB. *See About MDRC*, MDRC, http://www.mdrc.org/about/about-mdrc-overview-0 (last visited Oct. 9, 2013).

10. MCKINSEY & CO., *supra* note 5, at 7.

11. *See* SOCIAL FINANCE, SOCIAL IMPACT BONDS: RETHINKING FINANCE FOR SOCIAL OUTCOMES 6 (2009), *available at* http://payforsuccess.org/sites/default/files/sf_rethinkingfinance.pdf ("[O]utcome payments may increase with successive percentage point improvements in the target outcome in recognition of the increasing marginal cost (and benefit) of each incremental improvement.").

12. *See* Caroline Preston, *Getting Back More Than a Warm Feeling*, N.Y. TIMES, Nov. 8, 2012, at F1 ("Since [the first SIB], the social impact bond idea has spread at a pace that has surprised some in the slow-moving world of philanthropy.").

13. *Id; see also* MCKINSEY & CO., *supra* note 5, at 11 (noting that, at the time of the report's publication, "the UK pilot [was] the world's one and only SIB").

14. MCKINSEY & CO., *supra* note 5, at 25; *see also Social Impact Bonds: Can a Market Prescription Cure Social Ills?*, KNOWLEDGE@WHARTON (Sept. 12, 2012) ("SIBs are best suited for programs where results can be evaluated in a couple of years. . . . 'If you need to wait 10 years to see if the goal was hit, that is not a good project for a SIB.'"), http://knowledge.wharton.upenn.edu/article/social-impact-bonds-can-a-market-prescription-cure-social-ills/.

suggests that SIBs are "especially well suited to scale interventions focused on behavior change," but recognizes that "all the potential applications have not been fully explored."[15]

In addition to recidivism,[16] SIBs have been proposed or enacted by governments to address homelessness,[17] disadvantaged youth,[18] school attendance and other family-related issues,[19] out-of-home child care,[20] and asthma treatment.[21] Federally, the Obama administration has launched a number of pilot SIBs (called pay for success programs) in the areas of "criminal justice and workforce development."[22] Notably, "[t]he President's 2013 Budget reserves a total of up to $109 million to test this new financing mechanism in a broader range of areas including education and homelessness."[23]

C. SIBs in Action

1. Peterborough, United Kingdom

The world's first social impact bond was launched in September 2010 in Peterborough, Cambridgeshire.[24] The Ministry of Justice contracted with Social Finance, a nonprofit intermediary, to provide a set of interventions over a six-year period to three thousand short-sentenced male prisoners released from the

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15. MCKINSEY & CO., *supra* note 5, at 12.

16. Social-impact bonds aimed toward reducing recidivism have been initiated by a number of countries, cities, and municipalities. *See, e.g.*, Press Release, Mass. Exec. Office for Admin. & Fin., Mass. First State in the Nation to Announce Initial Successful Bidders for 'Pay for Success' Contracts (Aug. 1, 2012), *available at* http://www.mass.gov/anf/press-releases/fy2013/massachusetts-first-state-in-the-nation-to-announce-ini.html (announcing such a program in Massachusetts); discussion *infra* Part II.C.1 (Peterborough, United Kingdom); discussion *infra* Part II.C.2 (Rikers Island, New York City).

17. *See* Press Release, Mass. Exec. Office for Admin. & Fin., *supra* note 16.

18. *See* David Ainsworth, *Two New Social Impact Bond-Style Investments Launched*, THIRD SECTOR ONLINE (Jan. 24, 2012), http://www.thirdsector.co.uk/Finance/article/1113538/Two-new-social-impact-bond-style-investments-launched/?HAYILC=RELATED.

19. *See* Kaye Wiggins, *Office for Civil Society to Trial £40m Social Impact Bond Scheme to Support 'Problem Families,'* THIRD SECTOR ONLINE (Aug. 26, 2011), http://www.thirdsector.co.uk/news/1087083/.

20. *See* Joint Media Release, New S. Wales Treasury, NSW Government Announces Joint Development Phase for Social Benefit Bonds (March 20, 2012), *available at* http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0006/21786/NSW_Government_Announces_Joint_Development_Phase_for_Social_Benefit_Bonds_20-3-12.pdf.

21. *See* Manuela Badawy, *California City Seeks to Cut Asthma Rate via Bond Issue*, REUTERS, (Oct. 19, 2012, 10:50 AM), http://www.reuters.com/article/2012/10/19/us-investing-impactbonds-health-idUSBRE89I0U120121019.

22. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2013, at 45 (2012).

23. *Id.*

24. SOCIAL FINANCE, A NEW TOOL FOR SCALING IMPACT: HOW SOCIAL IMPACT BONDS CAN MOBILIZE PRIVATE CAPITAL TO ADVANCE SOCIAL GOOD 9 (2011) [hereinafter SOCIAL FINANCE, A NEW TOOL FOR SCALING IMPACT], *available at* http://www.socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf; *see also* SOCIAL FINANCE, SOCIAL IMPACT BONDS: THE ONE* SERVICE. ONE YEAR ON (2011) [hereinafter SOCIAL FINANCE, THE ONE* SERVICE], *available at* http://socialfinanceus.org/sites/socialfinanceus.org/files/sf_peterborough_one__year_on.pdf.

Peterborough prison.[25] Social Finance raised a total of £5 million from seventeen investors,[26] including, for example, the Rockefeller Foundation.[27]

The interventions provided to each prisoner—the collection of which Social Finance has termed "One* Service"—are administered by a number of nonprofit social organizations, such as the YMCA, and include "housing and employment assistance, accessing drug and alcohol addiction recovery services as well as mentoring and behavioral support."[28] The arrangement's objective is to achieve a reduction in reconviction among the prisoners and a concomitant savings by the Ministry of Justice as a result of such interventions. If, among former Peterborough prisoners, reconviction events[29]—offenses committed within a twelve-month period following release—fall by 7.5% or more, investors will receive a return on their investment.[30] The size of such return increases as reconviction drops below 7.5%, with a maximum return of 13% per year over the eight-year period of the "bond."[31] Payments are to be made in the fourth, sixth, and eighth years, but are conditioned on meeting the benchmarks based on outcomes achieved from working with the prisoners during the preceding two-year period.[32] This determination is to be monitored and made by an independent, third-party evaluator.[33]

Whereas, in a traditional SIB model, the return paid to investors would be drawn directly from savings realized by the government as a result of the reduction in recidivism, in this case the Big Lottery Fund—responsible for delivering UK lottery proceeds to "good causes"—agreed to fund the outcome payments to the investors.[34] Though interim data for the Peterborough SIB is not yet available,[35] early data suggest that the program is achieving some success.[36]

2. Rikers Island, New York City

The contract for the United States' first social impact bond, also aimed at reducing recidivism, was finalized in late summer 2012 in New York City.[37] This

25. SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 7.

26. *Id.*

27. SOCIAL FINANCE, A NEW TOOL FOR SCALING IMPACT, *supra* note 24, at 9.

28. SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 32.

29. Importantly, the reconviction events "are not being measured by a binary measure (whether the offenders reoffend) but rather by a frequency measure (the combined number of reconviction events)," which "encourages the providers from the One* Service to work with all clients, including those who are the most prolific reoffenders." *Id.* at 10.

30. *Id.* at 7.

31. *Id.*

32. LIEBMAN, *supra* note 8, at 13.

33. SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 10.

34. *Id.* at 7, 31.

35. *See* LIEBMAN, *supra* note 8, at 13 (noting the "four-year lag between the start of the service period and the first potential payment" in order to deliver services, measure recidivism, and analyze the data).

36. *See* SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 16.

37. David W. Chen, *Goldman to Invest in City Jail Program, Profiting if Recidivism Falls Sharply*,

SIB paired Goldman Sachs and the New York City Department of Correction in an effort to reduce juvenile recidivism at Rikers Island, a jail facility in New York City.[38] Goldman Sachs committed $9.6 million to pay for MDRC, the intermediary, to develop and oversee a rehabilitation program for juveniles released from Rikers Island.[39] If recidivism drops by more than ten percent, Goldman will be repaid its principle in full; if recidivism drops even further, Goldman stands to make as much as $2.1 million in profit.[40]

The intermediary for the Rikers Island SIB, MDRC, is a nonprofit group that specializes in implementation and statistical evaluation of social-welfare initiatives.[41] Thus, for example, a private philanthropy might ask MDRC to create, and subsequently evaluate the success of, a program tailored toward that philanthropy's charitable goals. Or, a government body might ask MDRC to evaluate the impact of a certain program it initiated through legislation. MDRC focuses on the areas of education, disconnected youth, work and income security, families and children, and health and disability.[42] The Rikers Island SIB is the first SIB in which MDRC has taken part.[43]

One thing that differentiates the Rikers Island SIB from the traditional SIB model is that whereas in the traditional SIB model *all* of the investor's money is at risk, in the Rikers Island project Goldman stands to lose only up to $2.4 million. Bloomberg Philanthropies—former Mayor Michael Bloomberg's charitable foundation—has guaranteed a $7.2 million loan to MDRC, which will be used to repay Goldman if the program does not meet the ten-percent benchmark.[44] If the program does succeed, however, Goldman will recoup its principle, plus interest, from the New York City Department of Correction, and MDRC may retain the Bloomberg money for future SIB projects.[45]

As in the Peterborough Project, the intermediary (here MDRC) contracted with nonprofit organizations to provide the rehabilitation services, and with an independent third party to provide program evaluation.[46]

N.Y. TIMES, Aug. 2, 2012, at A14.

38. *Id.*

39. *Id.*

40. *Id.*

41. *See* MDRC, *supra* note 9.

42. *Issues We Focus On*, MDRC, http://www.mdrc.org/issues-we-focus (last visited Oct. 11, 2013).

43. *See Social Impact Bond Project at Rikers Island*, MDRC, http://www.mdrc.org/project/social-impact-bond-project-rikers-island#featured_content (last visited Nov. 26, 2013).

44. Chen, *supra* note 37.

45. *Id.*

46. *See Design, Sites and Data Sources, Social Impact Bond Project at Rikers Island*, MDRC, http://www.mdrc.org/project/social-impact-bond-project-rikers-island#design_site_data_sources (last visited Nov. 26, 2013).

III
REGULATORY QUESTIONS

Upon reading the description of the SIB model and considering the Peterborough and Rikers Island examples, any law student who has taken a course in securities regulation might immediately think back to the first few days of class and wonder: Is a SIB a security? And it is easy to see why one might believe it is a security: At first glance, it seems as if the SIB would fit *somewhere* in *some* category of security, be it bond, note, investment contract, or some other type. Yet, since their recent inception, SIBs have not caught the attention of the Securities and Exchange Commission (SEC) or other securities-regulating bodies. Further, upon closer inspection, SIBs do not fit as squarely into any of the aforementioned categories of securities as might be expected. Below, I analyze the threshold question of whether SIBs are securities, and then, having found that they are securities, consider whether SIBs should nonetheless be exempt from regulation.

A. Are SIBs Securities?

1. Investment Contracts

SIBs, despite being called "bonds," are probably actually more like "investment contracts"[47] as that term is used in *SEC v. C.M. Joiner Leasing Corp.*[48] and its progeny. In *Joiner*, the Court held that divided interests in oil rights were securities within the meaning of the securities laws:

> [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"[49]

Three years later, in the seminal case of *SEC v. W.J. Howey Co.*,[50] the Court considered whether tracts of orange trees sold, accompanied by a service contract under which the seller cultivated, harvested, and marketed the orange crop, were investment contracts and therefore within the grasp of the federal securities laws. Holding that the tracts were indeed securities, the Court provided further guidance on the *Joiner* investment-contract category: "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or

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47. SIBs are not "notes" as that term is used in 15 U.S.C. § 77b(a)(1) (2006). Whereas notes memorialize a promise to pay a sum certain, in a SIB structure the private investor is repaid only if the program "succeeds," success usually being defined by some benchmark of government savings resulting from the program's successful implementation. Even if SIBs were notes, however, they may not be covered by the 1933 or 1934 Acts because they do not clearly satisfy the "family resemblance" test developed in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

48. 320 U.S. 344 (1943).

49. *Id.* at 351.

50. 328 U.S. 293 (1946).

a third party."[51] Thus, after *Howey*, an instrument was an investment contract if it met the four criteria of being (1) an investment of money (2) in a common enterprise, and (3) involved an expectation of profit which was (4) derived by the efforts of others.[52] Additionally, as noted above, courts have sometimes considered whether some comparable regulation of the putative security renders application of the federal securities laws unnecessary.[53] Though subsequent cases have occasionally reformulated the *Howey* test in part,[54] and some states apply an altogether different test,[55] the *Howey* rubric remains the basic test for an investment contract.[56]

At first glance, SIBs seem to easily meet all of the elements of the *Howey* test: The traditional SIB structure involves a contract in which investors invest money in a common social-welfare project managed by a third party, through whose efforts the investors expect to make a profit. Even the unorthodox Peterborough and Rikers Island examples, discussed above, arguably meet this test on its face. Yet the *Howey* test has been refined in the nearly seventy years since its inception. In the following parts of this note, I analyze SIBs under each element of the modern formulation of the *Howey* test for investment contracts. I then analyze SIBs under the alternative "risk-capital" test followed by many states.

a. Investment of money and expectation of profit. Normally, it is fairly evident that money has been "invested" in a security. Such was the case in *Howey*, for example, wherein the purchasers were motivated by an expectation of profits to be derived from the sale of the oranges rather than by "a desire to use [the land] or consume the [oranges]."[57] In some cases, however, purchasers may seek not a financial return on their money, but rather some other, nonmonetary, benefit. In these cases, it is less clear that money was invested with the expectation of profit rather than "spent" for the consumption or

51. *Id.* at 298–99.

52. Though, in *Howey*, the Court says that profits must be derived "solely" from the efforts of others, subsequent cases have removed this stringent requirement, making clear that profits need only be derived "primarily" or "substantially" from the efforts of others. *See, e.g.*, SEC v. Glenn W. Turner Enters. Inc., 474 F.2d 476, 482 (9th Cir. 1973).

53. *See, e.g.*, Int'l. Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (application of securities acts was unnecessary when the Employee Retirement Income Security Act governed the pension plan in question); *see also* Marine Bank v. Weaver, 455 U.S. 551, 558–59 (1982) (application of securities acts was unnecessary when the certificate of deposit was regulated by banking laws and guaranteed by the Federal Deposit Insurance Corporation).

54. *See* William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 322–30 (1984).

55. Namely, the "risk-capital" test. *See, e.g.*, Silver Hills Country Club v. Sobieski, 361 P.2d 906 (Cal. 1961). The application of the risk-capital test to SIBs is taken up in Part III.A.1.d.

56. *See* Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of 'Security': The 'Context' Clause, 'Investment Contract' Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 523 (1987) ("[T]he Court has not abandoned the *Howey* test in the investment contract setting.").

57. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975).

enjoyment of some underlying asset. For example, in *United Housing Foundation, Inc. v. Forman*,[58] the Court held that purchasers of shares of stock entitling the purchaser to lease an apartment in a co-op *had not* purchased securities as defined by the federal securities laws. The purchasers, the Court found, "were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments."[59]

In the case of SIBs, at first it appears fairly clear that investors invest their money expecting to derive profits from their investment. Otherwise, it would seemingly make little sense for investors to so invest; as opposed to *Forman*, in which purchasers could use or "consume" a benefit generated by the underlying assets toward which they had put their money, there seem to be few or no opportunities to consume any similar benefit generated by the social-welfare products in which investors have invested.

Yet, for a number of reasons, this is not always necessarily the case. First, it is at least arguable that *everyone* derives some benefit from the type of social-welfare projects typically funded by SIBs—whether the SIB is aimed at reducing the juvenile recidivism rate, decreasing the number of homeless, or toward some other cause. Second, if the SIB is successful, then investors—as well as the public at large—will also benefit from decreased government spending. Though this government savings will initially be diverted to the investors specifically, the long-term benefits of this savings will be shared by all within the particular government's borders. Third, it is not always entirely clear that SIB investors always *actually expect* to derive a profit from their investment. In the Rikers Island SIB, for example, Goldman Sachs—the principal investor—may have been equally, if not more, concerned with the positive public relations to be derived from its role as the first investor in an "innovative approach to harness private sector financing for important public initiatives."[60] Indeed, even if the Rikers Island rehabilitation program is successful—by no means an assured contingency—Goldman Sachs almost certainly could have invested its money in a safer market, one more disposed to hedging and other risk-avoiding techniques. Put otherwise, were there not public-image points to be scored by investing in the risky Rikers Island SIB, one might question whether Goldman Sachs would have done so at all. Just as the income from the commercial space in *Forman* was deemed too slight to be the dominant motive for the investment,[61] it may be that Goldman Sachs's potential financial gains from the SIB investment were not the company's paramount

58. *Id.* at 859–60.

59. *Id.* at 853.

60. Press Release, N.Y.C. Office of The Mayor, Mayor Bloomberg, Deputy Mayor Gibbs and Corrections Commissioner Schriro Announce Nation's First Social Impact Bond Program (Aug. 2, 2012) (statement of Lloyd Blankfein, C.E.O. of Goldman Sachs), *available at* http://www.nyc.gov/portal/site/nycgov/menuitem.c0935b9a57bb4ef3daf2f1c701c789a0/index.jsp?pageID=mayor_press_release&catID=1194&doc_name=http%3A%2F%2Fwww.nyc.gov%2Fhtml%2Fom%2Fhtml%2F2012b%2Fpr285-12.html&cc=unused1978&rc=1194&ndi=1.

61. 421 U.S. at 853.

concern. Given that conclusions of "investment" versus "consumption" may be grounded on the subjective intent of the purchaser,[62] perhaps these considerations weigh against the Rikers Island SIB being considered a security under this part of the *Howey* test.

Despite the potential alternative motivations and benefits discussed above, however, the fact remains that the SIB structure will always at least facially involve an "investment of money" and "expectation of profits," thus—in all likelihood—satisfying these elements of the *Howey* investment-contract test. And the fact that such profit might be capped or set at a fixed rate does not remove SIBs from the investment-contract category.[63]

b. Common enterprise. Courts have split over what constitutes a "common enterprise" for the purposes of finding an investment contract.[64] Courts differ as to whether multiple investors must pool their assets ("horizontal commonality") or whether a profit-sharing agreement between a promoter and each individual investor ("vertical commonality") is sufficient.[65] Further, cases applying the vertical-commonality standard have differed as to how expansive the test should be.[66] Some courts require only "broad vertical commonality," wherein the success of the investors need only depend on the *efforts* of the promoter.[67] Other courts look to "strict vertical commonality," wherein the success of the investors needs to be tied to the *fortunes* (as opposed to the *efforts*) of the promoter.[68]

Further, some profit-sharing arrangements may not be investment contracts *at all*. Such was the case in *Marine Bank*,[69] in which the Court considered an arrangement pursuant to which the investors, the Weavers, pledged a certificate of deposit in order to secure a bank loan to a separately-owned company (owned by the Piccirillos) in return for a share of that company's profits as well as the right to use the company's facilities and to veto further borrowing by the

62. *See* Teague v. Bakker, No. 96-2186, 1998 WL 168876, at *3 (4th Cir. Apr. 8, 1998) (rejecting plaintiff's claim that jury instructions were improperly based on the purchasers' subjective motivations).

63. *See* SEC v. Edwards, 540 U.S. 389, 390 (2004) ("There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income. Moreover, investments pitched as low risk (such as those offering a "guaranteed" fixed return) are particularly attractive to individuals more vulnerable to investment fraud, including older and less sophisticated investors."); *see also* SEC v. Infinity Grp. Co., 212 F.3d 180, 186–91 (3d Cir. 2000) (finding an investment contract despite investors being promised a fixed rate of return ranging from 138% to 181%).

64. *See* Revak v. SEC Realty, 18 F.3d 81, 87–88 (2d Cir. 1994) (describing the split among courts between the "horizontal commonality" test and "vertical commonality" test).

65. *See id.*

66. *See id.* at 87.

67. *See, e.g.*, SEC v. ETS Payphones, Inc., 408 F.3d 727, 732 (11th Cir. 2005).

68. *See, e.g.*, SEC v. Alliance Leasing Corp., No. 89-CV-1810-J (CGA), 2000 WL 35612001, at *4 (S.D. Cal. Mar. 20, 2000), *aff'd*, 28 Fed. App'x. 648 (9th Cir. 2002).

69. Marine Bank v. Weaver, 455 U.S. 551 (1982).

company.[70] The Court held that "this unique agreement, negotiated one-on-one by the parties, [was] not a security."[71] In so holding, the Court stressed the fact that "[t]he unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction."[72] The Court cited its language in *Joiner* positing that "a security is an instrument in which there is 'common trading.'"[73] The Court further differentiated the securities in *Joiner* and *Howey* with the putative security in *Marine Bank*:

> Here, in contrast, the Piccirillos distributed no prospectus to the Weavers or toother potential investors, and the unique agreement they negotiated was not designed to be traded publicly. The provision that the Weavers could use the barn and pastures of the slaughterhouse at the discretion of the Piccirillos underscores the unique character of the transaction. Similarly, the provision that the Weavers could veto future loans gave them a measure of control over the operation of the slaughterhouse not characteristic of a security. Although the agreement gave the Weavers a share of the Piccirillo's profits, if any, that provision alone is not sufficient to make that agreement a security.[74]

Despite the language in *Marine Bank* suggesting otherwise,[75] a profit-sharing arrangement need not necessarily involve multiple investors to meet the horizontal-commonality test and thus to be considered an investment contract.[76] In *SEC v. Lauer*, for example, the Seventh Circuit held that an investment scheme that initially contemplated multiple investors remained a security despite there ultimately being only one investor in the scheme:

> [I]t is the character of the investment vehicle, not the presence of multiple investors, that determines whether there is an investment contract. Otherwise a defrauder who was content to defraud a single investor . . . would have immunity from the federal securities laws. That would not make any sense, and is not contemplated by any of the cases that require horizontal commonality.[77]

In *Lauer*, the court's decision was influenced by the promoters' original intent to involve multiple investors in the scheme.[78] It is unclear whether a scheme that contemplates only one investor from the beginning could meet the horizontal-commonality test.[79]

SIBs seem to meet the vertical-commonality test, at least in its broad formulation. The typical SIB involves an investment by individual parties in which the success of the investment is dependent upon the efforts of the promoter. In circuits that apply the "strict-commonality" test, it is less clear

70. *Id.* at 552–53.

71. *Id.* at 560.

72. *Id.* at 559.

73. *Id.* (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).

74. *Id.* at 560; *see also* Carney, *supra* note 54, at 356 (arguing that the Court's decision not to bring privately negotiated agreements within the securities act can be justified because "[o]ne-on-one negotiations provide no scale advantages for either party in the transaction").

75. *See id.* at 559.

76. *See* SEC v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995).

77. *Id.*

78. *Id.*

79. *See* JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 39 (6th ed. 2009).

whether or not SIBs would be considered to involve a common enterprise. Even in such circuits, it might still be said that the investors' success is tied to the "fortunes" of the promoter—or at least the particular government entity receiving the SIB funding—in that it is the entity's *financial savings* on which such success depends.

Most SIBs will clearly meet the horizontal-commonality test. In the Peterborough SIB, for example, seventeen different investors "pooled" their money to invest in the prisoner-intervention program.[80] It is less clear whether or not SIBs composed of only one investor, like the Rikers Island SIB, have the requisite common enterprise to constitute an investment contract.[81] Still, the fact that any given SIB *could* involve multiple investors—and likely will involve multiple investors as SIB use continues to become more widespread—militates in favor of categorizing all SIBs as meeting the horizontal-commonality test.

Even more unclear is the extent to which *Marine Bank* weighs against *any* SIB being considered an investment contract. The Rikers Island SIB, a "unique agreement, negotiated one-on-one by the parties," is seemingly the type of agreement the *Marine Bank* Court was seeking to exclude.[82] Yet there are important differences between the agreement at issue in *Marine Bank* and the Rikers Island SIB. One key difference is that, whereas in *Marine Bank* the investor also received personal use of facilities in return for his investment, Goldman Sachs ostensibly received no such direct nonfinancial benefits.[83] Thus, whereas the *Marine Bank* agreement, because of the lack of "equivalent values" of some of its provisions, was seemingly "not designed to be traded publicly,"[84] the agreement in the Rikers Island SIB could easily be valued and traded on the open market.

Unlike the Rikers Island SIB, not all SIBs will have only one investor, and not all will be "negotiated one-on-one by the parties."[85] Indeed, even the Peterborough SIB—the first SIB ever created—involved seventeen different investors of different size and financial prowess.[86] And, as SIB use continues to become more frequent and widespread, it is easy to envision expanded SIB participation and a wider secondary market for SIBs. If, for example, the next SIB contemplates 500 different investors, or if SIB investment becomes open to the general investing public, can it still be said that SIBs categorically fall under the *Marine Bank* typology?

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80. SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 7.

81. *See Lauer*, 52 F.3d at 671 (holding that a scheme with one ultimate investor, but that initially anticipated multiple investors, was an investment contract).

82. *See* Marine Bank v. Weaver, 455 U.S. 551, 560 (1979). Note also that although parties' sophistication and one-on-one negotiation may not remove the SIB itself from the definition of a security, it may provide evidence that there is a transaction exemption available to the parties.

83. *But see supra* Part III.A.1 (discussing putative public relations and societal benefits derived by Goldman Sachs as a result of the Rikers Island SIB investment).

84. *Marine Bank*, 455 U.S. at 560.

85. *Id.*

86. *See* SOCIAL FINANCE, THE ONE* SERVICE, *supra* note 24, at 7.

c. By the efforts of others. Because SIBs typically involve little-to-no effort on the part of the passive investor, the investors' success is usually wholly dependent on the efforts of others. Barring the development of some hybrid SIB in which the investor also plays a role in administering the social-welfare program, SIBs seem to easily meet this element of the *Howey* test.

d. Risk-capital test. In deciding whether a particular instrument is a security, many states do not employ the *Reves* or *Howey* test, opting instead for the so-called risk-capital test. Although "[r]isk capital means different things to different courts,"[87] some common elements of the test can be summarized. The "risk" element of the risk-capital test generally requires that the money invested by investors be at substantial risk.[88] Accordingly, "[t]he existence of collateralization or other security may negate the possibility that a transaction involves a security."[89] "Capital" generally refers to "economic capital which is placed subject to the risk of loss through operation of the scheme in question."[90] Thus, in the case that created the risk-capital test, *Silver Hills Country Club v. Sobieski*,[91] transferable country club memberships, the cost of which was used to finance improvements in the club in order to increase membership cost, were deemed to be securities despite giving holders no rights to the assets or income of the club. In the *Silver Hills* decision, Justice Traynor distinguished the memberships in question from traditional club memberships:

> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labeled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.[92]

The risk-capital test is generally more inclusive than the *Howey* test. For example, as opposed to the *Howey* test, the risk-capital test can be satisfied without the presence of a common enterprise.[93] Further, whereas the *Howey* test requires that the expectation of *profit* be a substantial or primary motivation of the investor,[94] the risk-capital test generally requires only that a substantial benefit—monetary or nonmonetary—be expected by the investor.[95]

Whereas SIBs are probably securities under the more restrictive *Howey* test, they are almost certainly securities under most formulations of the risk-capital

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87. COX ET AL., *supra* note 79, at 27.

88. *Id.*

89. *Id.*

90. 12 JOSEPH C. LONG, BLUE SKY LAW § 2:80 (2013).

91. 361 P.2d 906, 908–09 (1961).

92. *Id.* at 908.

93. *See* 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.6[3] (6th ed. 2009) (citing King v. Pope, 91 S.W.3d 314 (Tenn. 2002), for the proposition that despite a lack of common enterprise, a sale–leaseback arrangement is a security under the risk-capital test).

94. *See* Teague v. Bakker, No. 96-2186, 1998 WL 168876, at *2–3 (4th Cir. Apr. 8, 1998).

95. *See, e.g.*, *Silver Hills*, 361 P.2d at 908 (holding that the benefit of club membership was a sufficient benefit under the risk-capital test).

test. In the traditional SIB model, investors place capital at substantial risk with the primary motivation of deriving a profit from that investment. That investors may also receive some secondary benefits such as positive public relations, improved social welfare, or a more efficient, lesser-spending government, serves to reinforce the substantiality of the benefits potentially received by the investor.[96] Further, whereas the common-enterprise element of the *Howey* test seems to weigh *against* SIBs like the Rikers Island SIB being considered securities under federal law, under the risk-capital test such SIBs need not employ a common enterprise to be considered securities.[97] Though the Rikers Island SIB, because of Bloomberg Philanthropies' guarantee of the majority of Goldman Sachs's at-risk capital,[98] may lack sufficient risk to be considered a security under the risk-capital test, it is unlikely that many future SIBs will include this type of guarantee. Thus, regardless of which category they are put in or which test is applied, SIBs seem to constitute securities under both federal and state securities laws.

B. Are SIBs, Seemingly Securities, Exempt from Registration?

1. Municipal Bonds

If SIBs are indeed securities under federal and state securities laws, then, because they are always issued by government entities, they would likely be considered a special form of securities commonly known as "municipal bonds." Though "[t]he term 'municipal bonds' embraces a multi-faceted, complex array of state and local public debt,"[99] it primarily refers to "bonds issued by state, local or other political subdivisions or their agencies."[100]

Municipal bonds can be either "general-obligation bonds" or "revenue bonds." General-obligation bonds are backed by the issuing government's pledge of full faith and credit, including its taxing power. Today, less than half of securities issued by governments are general-obligation bonds.[101] Revenue bonds, however, are secured only by the revenue created by the *particular* project being financed. Thus, whereas investors' returns on general-obligation bonds are nearly guaranteed, their returns on revenue bonds are far less secure. As demonstrated by New York City's near default on its obligations in the 1970s,[102] however, even general-obligation bonds may involve an element of

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96. It is interesting to consider whether or not such nonmonetary benefits alone would be sufficient to satisfy the "benefit" element of the risk-capital test. Though cases like *Silver Hills* allow for nonmonetary benefits, the members' enjoyment of the club facilities seems to be a more directly felt benefit than the incidental nonmonetary benefits potentially received by SIB investors.

97. *See* HAZEN, *supra* note 93, ("[T]he elements of the risk capital test can be satisfied even though the investment does not involve a common enterprise.").

98. *See* Chen, *supra* note 37 (noting that Bloomberg Philanthropies guaranteed $7.2 million of Goldman's $9.6 million investment).

99. HAZEN, *supra* note 93, § 14.6[1] n.1 (quoting S. REP. NO. 94-75, at 3 (1975)).

100. *Id.* § 14.6[1].

101. COX ET AL., *supra* note 79, at 435.

102. *See generally* SUBCOMM. ON ECON. STABILIZATION OF THE COMM. ON BANKING, FIN. &

risk.

Section 3(a)(2) of the 1933 Securities Act exempts from the Act's registration requirements "[a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories."[103] Accordingly, such securities need not be registered with the SEC prior to issuance, though the antifraud provisions of section 17 of the 1933 Act[104] and section 10(b) of the 1934 Act[105] still apply. Furthermore, pursuant to SEC Rule 15c, a complex regulation enacted in 1975, brokers and dealers in municipal securities must provide some disclosure when initially offering municipal securities of over $1 million to the public.[106] Though ostensibly providing some regulation of municipal securities, these disclosure obligations "ha[ve] been criticized as inadequate."[107] And issuers of municipal securities need not make any disclosures in offering securities.[108]

There are a number of different justifications for the exemption of government securities from the 1933 Act's registration requirements. Some are based on suppositions that governments typically do not lie or default on their debt obligations. Additionally, it is has sometimes been argued that registration

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URBAN AFFAIRS, HOUSE OF REPRESENTATIVES, 95TH CONG., SECURITIES AND EXCHANGE COMMISSION STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1977) [hereinafter SUBCOMM. ON ECON. STABILIZATION OF THE COMM. ON BANKING, FIN. & URBAN AFFAIRS, STAFF REPORT]; Final Report in the Matter of Transactions in the Securities of the City of New York, Securities Act Release No. 6021, 16 SEC Docket 951 (Feb. 5, 1979) [hereinafter Final Report].

103. Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (2006). This provision also exempts from registration requirements "industrial development bonds," which, in some ways, are like SIBs. *See Industrial Development Revenue Bond Program*, CAL. INFRASTRUCTURE AND ECON. DEV. BANK, http://www.ibank.ca.gov/industrial_dev_bonds.htm (last visited Nov. 26, 2013) ("Industrial Development Bonds (IDBs) are tax-exempt securities issued . . . by a governmental entity to provide money for the acquisition, construction, rehabilitation and equipping of manufacturing and processing facilities for private companies.").

104. *Id.* § 77q.

105. *Id.* § 78j.

106. *See, e.g.*, Dennis L. Holsapple & Curtis L. Christensen, *SEC Rule 15c2–12 and Ongoing Disclosure Obligations on Municipal Securities*, 27 URB. LAW. 943 (1995). Pursuant to section 15B of the Exchange Act, municipal securities brokers and dealers must register with the SEC. *See* 15 U.S.C. § 78o–4 (2006). A "municipal securities dealer" is "any person . . . engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise." 15 U.S.C. § 78c(a)(30) (2006). A "municipal securities broker" is "a broker engaged in the business of effecting transactions in municipal securities for the account of others." 15 U.S.C. § 78c(a)(31) (2006).

107. HAZEN, *supra* note 93, § 14.6[1]; *see also* Lisa M. Fairchild & Nan S. Ellis, *Municipal Bond Disclosure: Remaining Inadequacies of Mandatory Disclosure under Rule 15c–12*, 23 J. CORP. L. 439, 461 (1998) (arguing that "a number of weaknesses" in the regulations "impede the achievement" of the goal of disclosure).

108. 15 U.S.C. § 78o–4(d)(1) (2006). Various attempts at requiring disclosure by issuers of municipal securities have been made, however, including the Municipal Securities Full Disclosure Act of 1976, which was introduced by Senator Harrison Williams first in February 1976 and again in 1977. *See Mun. Sec. Full Disclosure Act of 1976: Hearings on S. 2969 and S. 2574 Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous. and Urban Affairs*, 94th Cong. (1976).

is unnecessary because of the sophistication of the typical investor in municipal bonds,[109] that imposing registration requirements on governments or municipalities would impose an undue burden on them that would impair their ability to raise public funds for specified purposes,[110] and that municipal securities are less subject to speculation because they are usually held for investment, rather than speculative, objectives.[111]

Yet these explanations sometimes fail to justify the exemption of particular municipal securities. For example, in 1996 the SEC brought enforcement actions against the then bankrupt City of Orange County, California, alleging fraud in its sale of over $2 billion in municipal securities.[112] Similarly, in 2002 and 2003 the SEC brought action against the City of San Diego, alleging fraud in its failure to disclose underfunding of its pension plan in connection with the sale of $260 million in municipal bonds.[113]

Even absent fraud, there are many instances of municipalities defaulting on bonds offered to the public. In the mid-1980s, the Washington Public Power Supply System defaulted on more than $2 billion in its securities.[114] A decade earlier, New York City nearly defaulted on its own debt obligations thanks, in part, to questionable accounting by city officials.[115] Most recently, bankrupt Detroit defaulted on more than $600 million of unsecured general-obligation bonds.[116]

Further, the perception that investors in municipal bonds are largely sophisticated is false. As of 2009, approximately one-third of municipal debt was held by individual households.[117] This figure does not take into account the municipal bonds individuals hold indirectly through their ownership of mutual funds or money-market funds.[118]

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109. *See* Robert W. Doty & John E. Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U. L. REV. 283, 325 (1976) ("At the inception of securities regulation, it had been argued that municipal bonds were bought primarily by sophisticated investors, who had little need for protection against the abuses that had occurred in the corporate area.").

110. *See* HAZEN, *supra* note 93, § 14.6[1] (citing Bruce N. Hawthorne, Note, *Municipal Bonds, and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 583–85 (1975)).

111. *See id.*

112. County of Orange, California, Exchange Act Release No. 36760, 61 SEC Docket 310 (Jan. 24, 1996); Report of Investigation, County of Orange, California, Exchange Act Release No. 36761, 61 SEC Docket 382 (Jan. 24, 1996).

113. City of San Diego, Exchange Act Release No. 54745, 2006 WL 3298665 (Nov. 14, 2006).

114. DIV. OF ENFORCEMENT, U.S. SEC. & EXCH. COMM'N, STAFF REPORT ON THE INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES 1 (Sept. 1988).

115. *See* SUBCOMM. ON ECON. STABILIZATION OF THE COMM. ON BANKING, FIN. & URBAN AFFAIRS, STAFF REPORT, *supra* note 102; *see also* Final Report, *supra* note 102.

116. *Detroit Defaults on $600 Million of Unsecured Bonds*, WASH. POST, Oct. 1, 2013, http://articles.washingtonpost.com/2013-10-01/business/42577887_1_u-s-bank-kevyn-orr-debt.

117. COX ET AL., *supra* note 79, at 435–36.

118. *Id.* at 436.

Like other securities, it is clear that municipal bonds (especially revenue bonds) subject investors (who are often unsophisticated individuals) to a high degree of risk. And SIBs, which are not really bonds contemplating a fixed return, but rather a sort of investment contract typically contemplating a contingent return, are no different. A number of factors make SIBs especially risky: The infancy of the SIB model provides both investors and issuers with little guidance as to the SIB's administration; the social-welfare projects being funded, inherently risky, are often relatively untested before the SIB is implemented; and evaluation of the success of the SIB depends on mathematical analysis by third-party evaluators and is subject to bias, inaccuracy, and fraud.

Although there are similarities between SIBs and municipal revenue bonds, certain differences between the two instruments present additional questions about how SIBs would be regulated under current law. For example, SIBs, at least in their current makeup, do not include a role for underwriters (though that role could easily develop) and instead depend on intermediaries such as MDRC to solicit investors and oversee the social-welfare program. The extent to which SIB intermediaries are subject to regulation is extremely unclear. SIB intermediaries would appear to fall under the definition of "municipal securities broker[s]" in section 15B of the 1934 Act, which defines that term as a "broker engaged in the business of effecting transactions in municipal securities for the account of others."[119] Such brokers must register with the SEC[120] and are governed by the Municipal Securities Rulemaking Board (MSRB).[121] Further, the MSRB has promulgated a number of important rules governing securities brokers. For example, rule G-2[122] requires that municipal securities brokers meet certain qualification standards set out in rule G-3.[123] These qualifications are nuanced, but include certain personnel and expertise requirements[124] as well as net-capital requirements.[125] It is unlikely that SIB intermediaries such as MDRC—primarily concerned with implementation and statistical evaluation of social-welfare projects and largely unfamiliar with securities laws—would ever meet these complex and stringent standards. One might question the extent to which such financially disinterested intermediaries should be subject to the disclosure obligations imposed by SEC Rule 15c2–12.[126] Yet, because issuers of

119. 15 U.S.C. § 78c(a)(31) (2006).

120. *Id.* § 78o–4.

121. *Id.*

122. *See* MUN. SEC. RULEMAKING BD. R. G-2, *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-2.aspx.

123. *See* MUN. SEC. RULEMAKING BD. R. G-3, *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-3.aspx.

124. *See id.*

125. *See* 17 C.F.R. § 240.15c3-1 (2008).

126. Notably, Rule 15c2-12 does allow for some exemptions based on the size and duration of the offering and the expertise of the investors. *See* 17 C.F.R. § 240.15c2-12(d).

municipal securities are free from disclosure requirements,[127] exempting SIB intermediaries from disclosure requirements would result in no mandated disclosure regarding SIB issuances.

2. Nonprofit and Charitable Securities

Like municipal bonds, securities of nonprofit issuers are exempt from registration requirements. Section 3(a)(4) defines such a security as "[a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual."[128] Though not explicitly stated in the statute, the second part of the exemption regarding the inurement of benefits refers to persons, stakeholders, or individuals *who have a stake in the organization* or are somehow connected with the organization, not to the purchasers of securities.[129] Thus, for a security to be exempt under section 3(a)(4), it must be issued by a nonprofit organization and its net earnings cannot inure to anyone who has a stake in that organization.

There are two primary policy justifications for the nonprofit exemption. First, subjecting nonprofit organizations to the rigors of registration may limit their ability to raise capital for their objective. Second, the nonprofit-issuer exemption is based on the assumption that "[a]rguably, individuals do not 'invest' in eleemosynary organizations and therefore are not in need of extensive disclosures about the economic aspects of the operations of such issuers."[130] Although the first policy justification applies equally to SIBs as to traditional municipal securities, the second justification—that investors in securities of nonprofit organizations do not have the same investment concerns as investors in securities of for-profit issuers—does not withstand scrutiny under the SIB model, which is designed to attract investors primarily by the potential for profit to be earned.[131]

First, however, is the tricky question of whether SIBs are indeed nonprofit securities as defined in section 3(a)(4). Because they are exempt under a separate subsection of section 3(a), municipal securities are not expressly covered by section 3(a)(4), and courts have not considered whether a security issued by a governmental entity but somehow not qualified for exemption under section 3(a)(2) might qualify for exemption under section 3(a)(4). But,

127. HAZEN, *supra* note 93, § 14.6[4].

128. 15 U.S.C. § 77c(a)(4) (2006).

129. *See* SEC v. Children's Hosp., 214 F. Supp. 883, 890–91 (D. Ariz. 1963) ("The clause . . . must be construed to encompass profit . . . whether such profit inures to anyone directly or indirectly connected with the corporation.").

130. COX ET AL., *supra* note 79, at 432.

131. As SIB use becomes more widespread and less notable, the nonpecuniary benefits of investing in a SIB, such as the favorable public relations ostensibly sought by Goldman Sachs in the Rikers Island SIB, *see* discussion *supra* Part III.A.1.a, are likely to become secondary to the potential financial gain SIBs promise.

because the municipal-securities status of SIBs is questionable, this may be the exemption path that SIB issuers would need to take. In assessing the applicability of the nonprofit exemption to SIBs, one must consider both the nature of the issuing entity and the nature of those to whom revenues from the security inure.

Were they not also typically government entities, SIB issuers would seemingly qualify for exemption as nonprofit issuers under section 3(a)(4). Indeed, the essence of government is that it is organized for the purposes of those whom it governs and "not for pecuniary profit." That the capital raised by the securities typically goes to a specific purpose—be it prison reform, healthcare, or something else—reinforces the nonprofit or charitable aspect of the SIB and more closely aligns it to the traditional nonprofit securities exempt under section 3(a)(4).

More difficult is the question of whether the benefits of a SIB "inure" to members of the issuing party. In *SEC v. Children's Hospital*,[132] a seminal case on the nonprofit exemption, the court deemed bonds issued by a to-be-built hospital *not* eligible for the nonprofit exclusion because the promoters of the bonds (who were also directors of the hospital) stood to receive profits from construction of the hospital. Although the benefit to be received by the promoters in *Children's Hospital* was large, a benefit of any size and type may disqualify a putative nonprofit security from exemption. For example, in 1988, the SEC refused to issue a no-action letter requested by a Christian ministry seeking to offer bonds to fund a building renovation.[133] The SEC based its decision on the fact that one of the buildings to be renovated housed (free of charge) members of the organization who provided drug rehabilitation and other services to patrons of the ministry.[134] Thus, the SEC reasoned, the members might inure a benefit (renovated housing) from the earnings of the security.[135]

In the SIB model, the revenues of the SIB arguably *always* go to stakeholders of the issuer. This is because those for whom the social-welfare projects are designed are citizens of, and therefore stakeholders in, the very governments issuing the securities to fund the projects. Thus, in the SIB model, the recipients of social-welfare initiatives such as drug rehabilitation and housing assistance are somewhat like the members of the Jesus People Ministry, having derived benefit from the funds being financed.[136] Further, *every* citizen of a SIB-offering government arguably receives an indirect benefit of reduced taxes from reduced government spending. Obviously, because of the governmental nature of the SIB issuer, the section 3(a)(4) test for nonprofit

132. 214 F. Supp. 883.

133. *See* Jesus People U.S.A.—Full Gospel Ministries, SEC No-Action Letter, 1988 WL 235026, at *1, *3 (Oct. 13, 1988).

134. *See* COX ET AL., *supra* note 79, at 465–66.

135. *See id.*

136. *See id.*

securities is an inappropriate test for assessing the nonprofit nature of the SIB. Consequently, in the event that a SIB issuer fails to qualify for the municipal security exemption, it should seek a no-action letter before relying on the section 3(a)(4) exemption.

IV
CONCLUSION

SIBs are promising new financial instruments that infuse a for-profit ethos into important, but often underfunded and inefficient, social-welfare programs. Yet precisely because of the great potential for more widespread use of SIBs, some regulation of the SIB marketplace is necessary. It is unclear which category of securities—if any—SIBs fit in: SIBs are unique in that they have characteristics of investment contracts, municipal securities, and nonprofit securities, each of which has its own set of regulations and requirements. Despite SIBs' security-like characteristics, application of the stringent securities fraud provisions that govern the trade of traditional securities seems inappropriate in the SIB context, where issuers and intermediaries often lack securities-law experience and expertise. Thus, SIBs may require a new, light-handed set of regulations that will simultaneously ensure the optimization of public SIB investment *and* reduce the likelihood of fraud in the offering of SIBs and the implementation of the projects that they fund. Such regulations would add an air of legitimacy to the SIB marketplace and encourage responsible utilization of the SIB vehicle.

Perhaps, in a future world, sufficient SIB regulation will enable novice, small-scale, investors to safely invest in SIBs as an alternative to making charitable donations or other philanthropic expenditures. In such a world, the general investing public will gain a new interest in the development and success of social-welfare projects for those in need, and everyone will benefit as a result.