Community Shares

Regulatory Barriers to Social Investments

Final Response by the Community Shares Unit

14 March 2016

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About the Community Shares Unit

The Community Shares Unit (CSU) was established in 2012 as a partnership project between Co-operatives UK and Locality. It is currently funded by the Department for Communities and Local Government (DCLG) and the Department for Energy and Climate Change (DECC). Among its aims are the provision of good practice guidance and the promotion of voluntary regulation by societies issuing community shares. With these aims in mind it produces the Community Shares Handbook and has developed the Community Shares Standard Mark, awarded to share offers that meet good practice standards set out in the Handbook.

Community shares are non-transferable, withdrawable share capital issued by societies registered under the Co-operative and Community Benefit Societies Act 2014.

The FCA has been represented on the Steering Group of the CSU since its inception and was also a member of the Steering Committee for the CSU's predecessor body, the Community Shares Programme, an action-research project funded by the Cabinet Office and DCLG (2009-11)

In 2012 the FCA established a Technical Committee to supervise the production of the Community Shares Handbook, with representation from the FCA, HM Treasury, DCLG, Charity Commission and HMRC, plus mutual society law expert Ian Snaith. In 2014 the remit of the Technical Committee was extended to include the development of the Community Shares Standard Mark.

Structure of this Response

We have structured this response as follows:

Section 1- Observations on the Consultation Document: The first section sets out our overall observations on the consultation document, in light of our work on overseeing a voluntary standards scheme for community share offers. In certain cases we use these general comments to request further clarification from the FCA.

Section 2 – The Investor Perspective: An outline of investor perspectives on the regulatory barriers to social investment within the community shares market. This account is informed by a survey exercise undertaken in February 2016 via the Community Shares Unit's Microgenius platform.

Section 3 – The Enterprise Perspective: An outline of emerging views of enterprises that have undertaken community share offers and have engaged with the CSU by participating in a Standard Mark assessment exercise.

Section 4 – The Case for Co-regulation: Based on our observations of the consultation document and the views of investors and enterprises that characterise the community shares market, this section presents the CSU's position on the regulatory barriers to social investment.

Section 1: Observations on the Consultation Document

1. Defining social investment

In your document, paragraph 1.1 provides an inclusive description of what you consider to be social investment. For the purposes of regulation, we consider this description too inclusive and lacking definition. You make use of terms, such as social enterprise, traditional green and "ethical" investments that have no meaning in law, which is highly problematic from a regulatory point of view. Your infographic on page 7 illustrating the step 1 in forming a social enterprise, compounds this problem by implying that a social enterprise could be any form of company.

In establishing Social Investment Tax Relief (SITR), the government has defined social investment as the investment of securities in three eligible legal forms, charities, community interest companies (CICs), and community benefit societies with a statutory asset lock. We believe this provides the appropriate definition to inform subsequent regulatory considerations.

Additionally, this approach to defining social investment overcomes the limitations of linking any definition to the type of investor. There have been calls to allow investors to self-certify as a social investor, but we believe this would contribute to the ongoing ambiguity of social investment for regulatory purposes as it would rely on unclear circumstances of the investor rather than the clear boundaries of legal form.

2. Conflating social investment with crowdfunding

Although crowdfunding has played an important part in helping some social enterprises to access finance, we are concerned that your document conflates social investment with crowdfunding. This is evident in paragraph 2.3 where you refer to your regulatory practices, and throughout much of the rest of the document where crowdfunding is presented as an option for social enterprises and investors.

Essentially most forms of crowdfunding have little or nothing to do with social investment. Specifically, donation and rewards-based crowdfunding are not forms of investment, let alone social investment. Equally debt-based and equity crowdfunding can only be considered social investment if the recipient is a defined form of legal entity, as outlined by SITR.

3. Conflating public and private promotions

Your infographic on page 8 fails to distinguish between public and private promotions, assuming instead that all social investment is a public promotion. We contend that many social enterprises are financed through the private promotion of investment, based on the exemptions listed in the Financial Promotions Order 2005. This form of private placement social investment needs to be recognised and encouraged. Such investment may be eligible for SITR.

With this, there is an important distinction to be made between a private offer of investment, aimed at specific groups or types of person, and a public offer aimed at the general public. Your infographic on page 9 helpfully informs readers that the Companies Act 2006 Section 755 prohibits private companies from making public offers of securities, but then fails to explain why this does not apply to private companies offering securities through crowdfunding sites.

Point of clarification 1: *Can you please clarify why private companies offering securities (debt, equity) through crowdfunding sites are not considered to be a public promotion?*

4. Clarity on the regulatory environment for differing forms and investments

Withdrawable share capital is unique to societies and has some special qualities, bearing some of the characteristics of equity and debt simultaneously. When combined with an asset lock, withdrawable share capital provides no scope for capital gain.

The Regulated Activities Order 2001 is careful to distinguish between withdrawable share capital and transferable share capital, including the latter within its scope, but excluding the former. However, your infographic on page 9 does not fully explain what exemptions exist for societies from the financial promotions regulations. It also fails to explain what are, and are not, specified investments under the Regulated Activities Order. In particular, Article 35 of the Financial Promotions Order 2005 relating to the promotion of debentures, loan stock or bonds in a society, does not exempt unsolicited real-time communications – such as door-to-door promotions, but it does cover solicited real-time communications, such as meetings where members of the public have been invited to attend specifically to learn about the offer.

The infographic on page 9 also does not explain that some of the exemptions also apply to charities. Financial promotion regulations already recognise the difference between financial

promotions made by different type of legal entity, with specific exemptions given to charities and societies promoting debt and withdrawable, non-transferable shares.

Charities, unless they are also societies, cannot issue share capital, so must rely on debt securities alone. However, your infographic on page 13 fails to make it clear that charities promoting bonds and other forms of debt security to the public enjoy the same exemptions as societies issuing the same products.

It should be noted that these exemptions are not afforded to CICs; however CICs did not exist when FSMA 2000 and it subsequent financial promotions regulatory orders were drawn up.

5. Unregulated collective investment schemes (UCIS) and societies

We would like you to clarify whether there is any danger that a society could find itself operating an unregulated collective investment scheme by virtue of the fact that it was offering withdrawable, non-transferable shares to the public and using the capital it raised to invest in other legal entities over which it had no overall control.

Point of clarification 2: Specifically, would such activities constitute an "industry, business or trade" for the purposes of Section 2(1) of the Co-operative and Community Benefit Societies Act 2014? Put another way, would the FCA register a society whose main activity was to raise capital to invest in other legal entities?

Section 2: The Investor Perspective

The CSU estimates that almost 100,000 individuals have purchased community shares over the last five years, this is an important cohort of "active citizens" - often first time investors demonstrating tangible support for local community enterprises.

This section provides an insight into the motivations of investors in community shares based on a survey the CSU carried out in February 2016. This investor survey has acted as a refresher on a study the CSU participated the year before, which was led by NESTA and Cambridge University and looked at the wider alternative finance market in 2015. This research investigated the motivations and characteristics of individual investors across a range of alternative finance instruments, including community shares. A full analysis of the 2015 survey can be found in our Inside the Market Report here.

The CSU are now able to give an early insight into this latest community shares investor survey which was distributed to users of Microgenius – the CSU's community shares online platform. As of March 2016, over 30 share offers have been administered through the site receiving investment from over 7,000 investors which were contacted to participate in the survey. In total just more than 360 responded, giving a response rate of almost 5%.

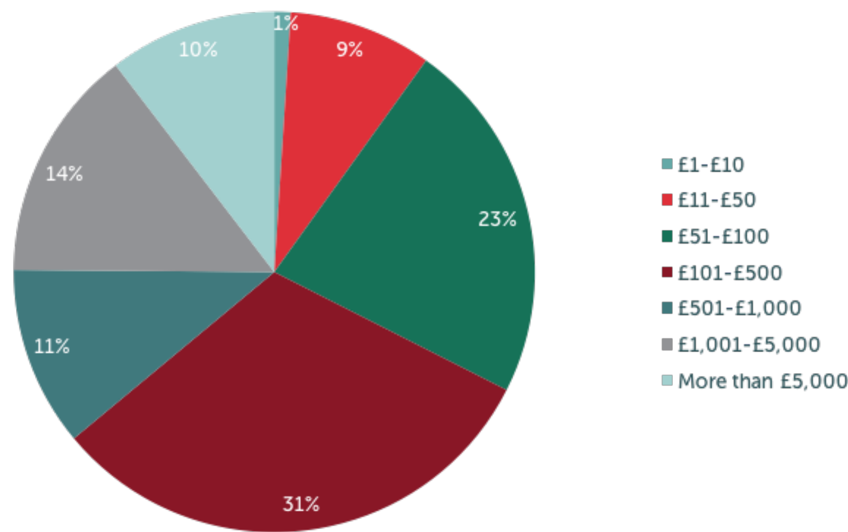
The analysis below provides a snapshot of some of the key areas pertinent to this consultation:

How much do Microgenius users invest in community shares?

As with the 2015 investor survey results, most people invest £101-500 in community shares, followed by £51-100. Together these make up over half of the 2016 respondents, which is a drop from the 71% of the 2015 respondents. This fall has been caused by a slight increase in the number of supporters investing both lower amounts i.e. under £50 and higher contributions i.e. £500 plus.

However, in comparison to other alternative finance products investments as set out by the NESTA research, community shares are still considerably higher than donation and reward-based platforms but lower than investments in other debt and equity platforms.

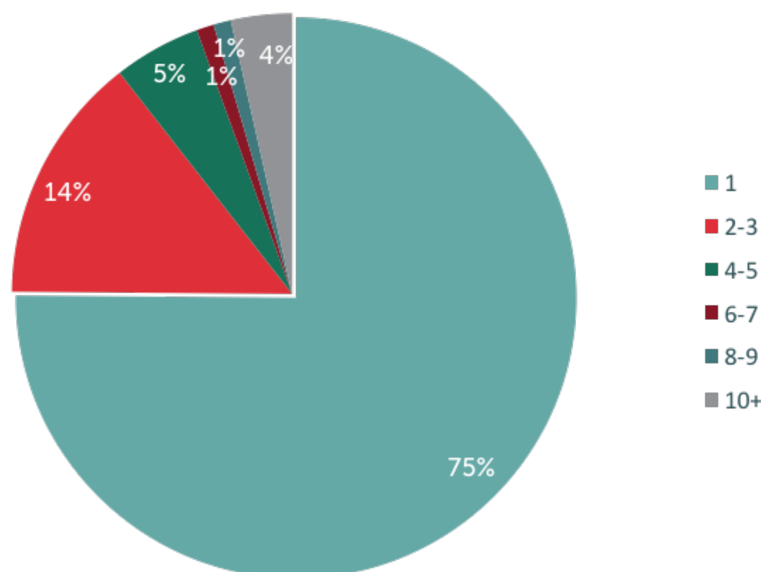
Figure 1: How much money have you used to invest in community shares?



How many share offers do investors fund?

There has been a growth in the number of community share offers that the respondents invested in compared to 2015 results. Although three-quarters still have only invested in one share offer and the number investing in two or three offers has remained static, the percentage of investors investing in four or more offers has grown from 9% to 12% compared to 2015 results. This may be due to the greater visibility and understanding of community shares and/or the growth of the Community Shares Standard Mark as an indicator of good practice, both of which could be increasing investor confidence in community share offers.

Figure 2: How many community shares enterprises have you invested in?



Motivations of investors

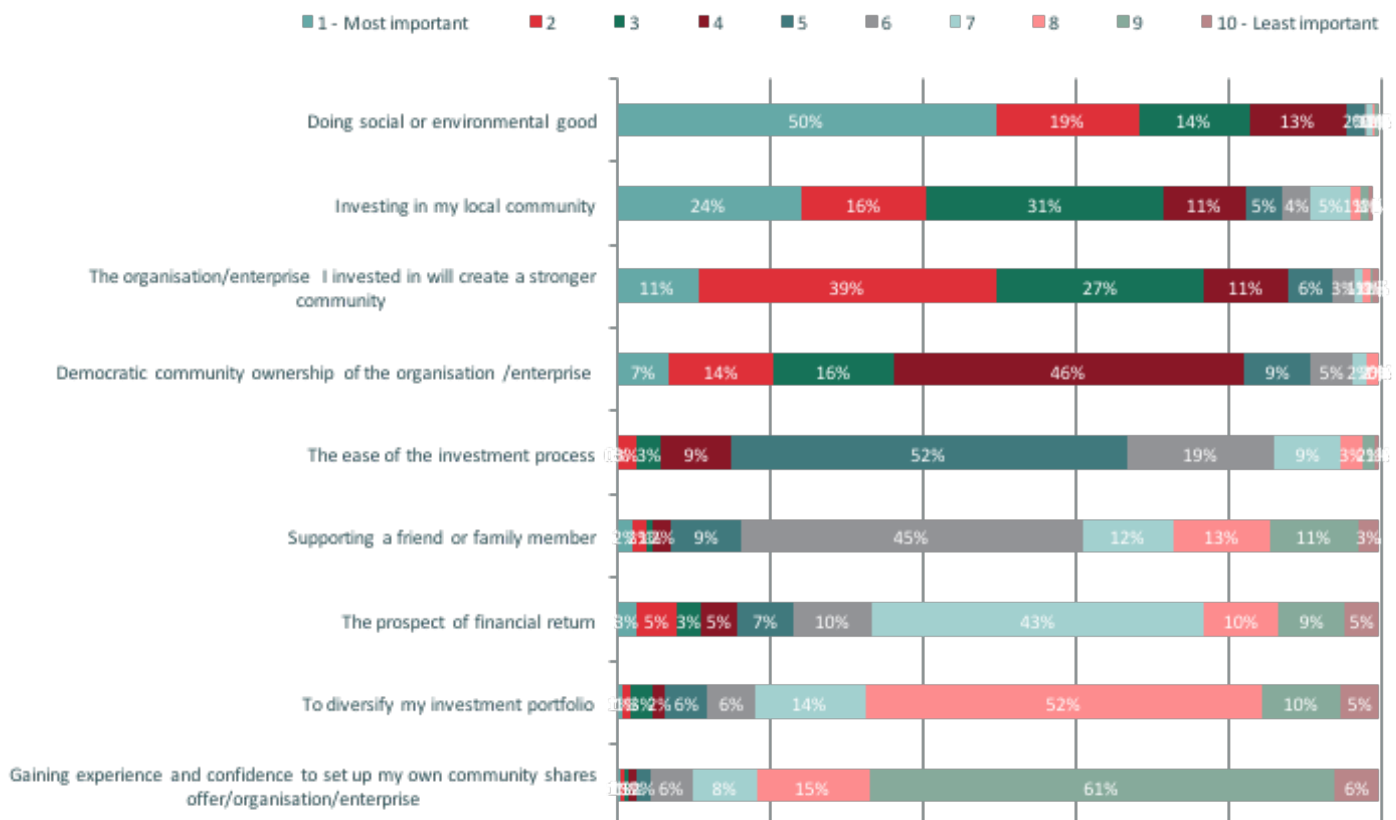
In both the 2015 and 2016 surveys, investors were asked to rank the importance of a series of factors in their decision to invest in organisations. The highest ranking factors for those investing in community shares were *doing social or environmental good, investing locally and creating a stronger community*. Conversely, the prospect of financial return and diversifying their investment portfolio were the least important.

This highlights the principle that community shares are a primarily a socially-motivated investment primarily made for mutual, community, or charitable benefit rather than financial gain.

Investors were also asked about the nature of their connection to the enterprise they had invested in, with over half having a personal connection or association to the share offer(s) they had invested.

Overall the responses indicate investors were motivated by ensuring that the society receiving the investment was able to achieve its goals as a means of securing both personal individual benefits and to provide services or facilities that could be used by other people within and outside their locality. This also reinforces that community shares are not seen as an instrument for achieving personal financial gain, but have mutual and community purpose.

Figure 3: Which are the most important in your decision to invest in organisations/projects through community shares? (Results in order of importance)

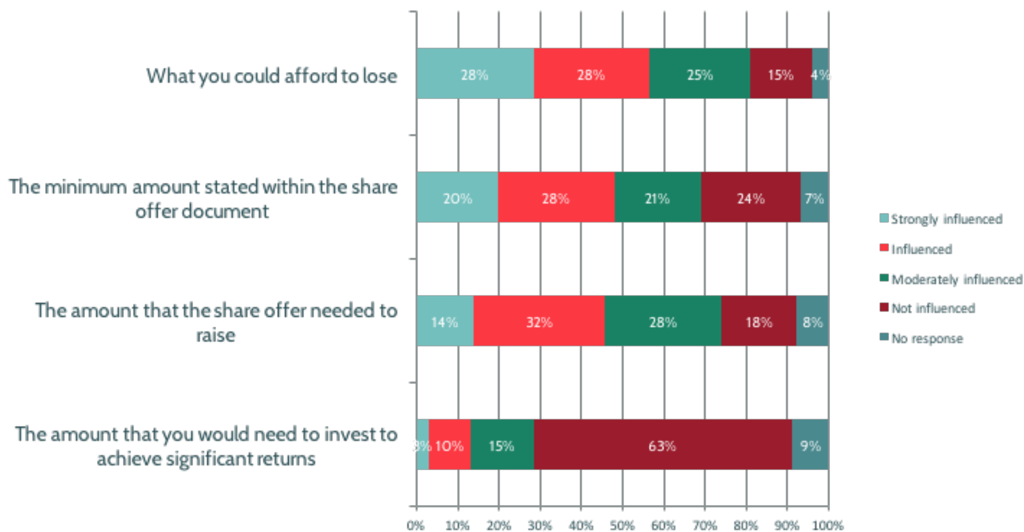


Understanding risk

The majority of community share investors have a good understanding of the risks associated with the investment, with over 80% of respondents stating that their decision to invest is influenced by how much they could afford to lose when they decide how much to invest.

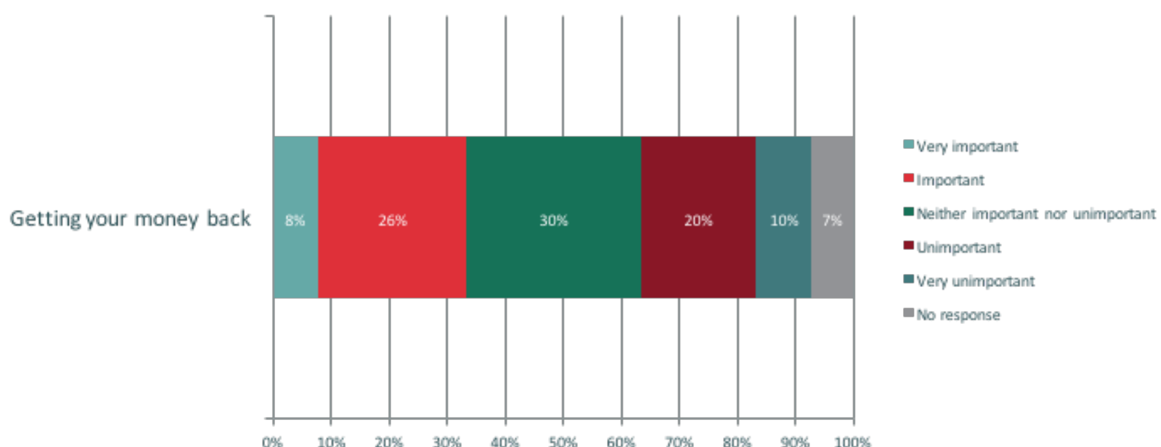
When comparing these results to 2015 responses, there has been a shift in the importance of returns in 2016 - 5% more respondents stated that it was either important or very important to get their money back.

Figure 3: When investing in community shares, which factors influence how much you decide to invest?



In terms of investors getting their money back, over half of investors do not see this as an important factor in their decision to invest, although this consideration is higher than the prospect of financial returns, with over a third seeing this as an important or very important factor, emphasising a greater importance for liquidity than return on investment.

Figure 4: As an investor, how important is the following?



As for understanding the risks in investing in community shares, the majority stated that they felt that anyone would be able to read and understand the risks involved. Similarly, over a third stated that they were not particularly concerned either way over the possibility of losing their money in a community share investment. Only 3% felt that they needed a more experienced family member or friend to help them understand the risks, but this was not a deterrent to them making an investment. This was the same figure in 2015.

In 2016, 23% felt that the risks were upfront and impossible to avoid, up from 18% in 2015. We can infer from this that the share offer documents themselves may be becoming clearer in the way

that they set out and explain the risks involved, even if investors then felt that they needed to discuss these with other people.

This is reflected by the percentage that felt that anyone would be able to read and understand the risks involved, which dropped from 74% in 2015 to 56% in 2016. This could be due to share offer documents becoming more thoroughly developed, and especially in the case of community energy share offers, the added complexity in business plans could have affected this result.

However, the CSU believed that this is not necessary such a negative thing as it could mean that share offers are becoming more transparent to all the intricacies that surround the project that may have not be articulated previously.

Figure 5: How easy or difficult was it to understand the risks involved in investing in community shares?

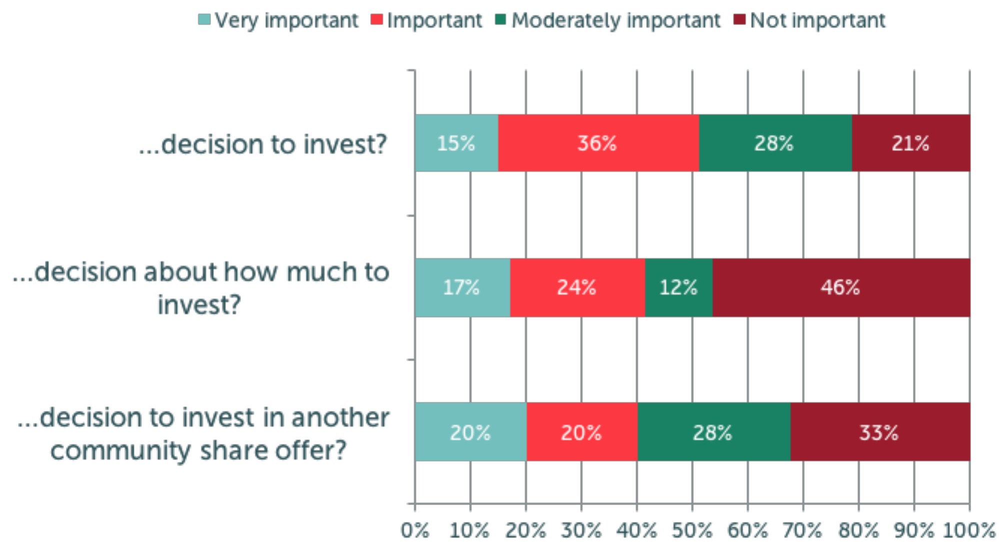
Investor perceptions of the Standard Mark

The Standard Mark was launched in June 2015 following a significant amount of work by the CSU to co-design good practice standards for community share offers. The rationale for all this work has been to ensure investor protection as the community shares market grows through a voluntary approach working closely with the sector. Based on the findings below, the approach appears to be generating positive results and may provide a positive way forward for new social investment markets as a way of promoting good practice in public offers.

In terms of the survey responses, the respondents may have been investors in share offers that were hosted on Microgenius before the official launch of the Standard Mark, which is why the response to the question 'Did a share offer you invested in have the Community Shares Standard Mark awarded to it?' had over three-quarters state 'I don't know'.

At the point of the survey going live, only 10 share offers with a visible Standard Mark had been hosted on Microgenius and so that 14% stated 'Yes' to this question is encouraging, in that these investors had registered the fact that an offer they invested in had a Standard Mark.

Figure 4: How important was the Community Shares Standard Mark in your....



Even if some investors were not aware if they invested in an offer that had been awarded the Standard Mark, none of the respondents stated that they didn't understand what the Mark relates to, which suggests that there is good understanding among the public as to what the Mark means for investors and societies. Overall, 79% of respondents stated that the Standard Mark was moderately important, important or very important in their decision to invest.

Additionally, over half of respondents also stated that the awarding of the Standard Mark was moderately important, important or very important in their decision about how much to invest.

The Standard Mark can also be seen to positively impact on the investor's decision to become a serial community shares investor, with 68% respondents stating that the Standard Mark was moderately important, important or very important in their decision to invest in another community share offer.

Summary of investors survey

Two types of alternative finance model can be broadly distinguished based on the wider NESTA study: higher value loans and equity investments in which financial return is a relatively high priority, although not the only priority (particularly when compared with investor motivations in standard financial products), and lower value crowdfunding models in which the connection to and involvement in the project is of higher importance and the prospects of a return on investment may be low.

Investors in community shares appear to sit somewhere between these two types: differing from both the equity and lending investors in the importance attached to a direct connection to the project being funded and their motivations for investing, but investing larger amounts per transaction than the crowdfunders with similar motivations.

Importantly investors seem to understand the unique features of community shares in their approach to risk and decision making. In particular, they invest what they can afford to lose and based on careful reading of the offer documentation and knowledge of the individuals and organisations involved. The introduction of the Standard Mark is contributing to this growing awareness and understanding of the risks and also improving the quality of offers themselves.

This would suggest that the current regulatory environment is appropriate for the community shares market, recognising that introducing voluntary good practice standards is supporting the current arrangements.

Section 3: The Enterprise Perspective

Since the lauch of the Standard Mark in July 2015, 28 share offers have been awarded the new quality mark, which are outlined below:

Organisation	Sector	Region
Lewes Community FC	Sport	South East
Styal Community Shop	Community retail	North West
Community Energy Warwickshire	Energy and Environment	West Midlands
Big Bath City Bid	Sport	South West
Hayfields Sustainable Transport	Transport	North West
Sunart Community Hydro	Energy and Environment	Scotland
Clevedon Pier	Regeneration and Heritage	South West
Drovers Inn Gussage	Pubs and Brewing	South East
Fair Trade Balls (Bala)	Sport	Scotland
Benenden Community Shop	Community retail	South East
Cultybraggan Heritage Self-Catering	Regeneration and Heritage	Scotland
Portpatrick Harbour	Regeneration and Heritage	Scotland
Shared Interest	Finance	North East
Biddulph Youth & Community Zone	Other	West Midlands
South East London Community Energy	Energy and Environment	London
MaidEnergy	Energy and Environment	South East
Harborough Energy	Energy and Environment	East Midlands
Exeter Community Energy	Energy and environment	South West
Sutton Community Farm	Food and Farming	London
Broadmayne Community Shop	Community retail	South West
Penicuik Co-operative Alliance	Community retail	Scotland
Sandford Talking Shop Ltd	Community retail	South East
Fibre 4 Rural Nottinghamshire	Broadband	East Midlands
Maid Energy - 2nd offer	Energy and Environment	South East

TriCE (Tring Community Energy)	Energy and Environment	South East
Ynni Pabarn Peris Hydro	Energy and Environment	Wales
Ynni Ogwen Hydro	Energy and Environment	Wales
Teign Energy Communities Limited	Energy and Environment	South West

Value of the Standard Mark for societies

The CSU has sought feedback from all these enterprises to determine whether the award of a Standard Mark is a valuable exercise for the societies undertaking share offers.

Overall, the majority of societies have confirmed that the Standard Mark is an important factor in encouraging supporters to invest, as it increases the credibility of the offer itself. Equally enterprises suggested that explaining the meaning of the Standard Mark to investors is a manageable process.

Interestingly, enterprises suggested the Standard Mark was not having an influence on how much supporters were investing, which may suggest that this decision is mostly informed by how much investors can afford to lose, which was emphasised in the investor survey.

Wider motivations for undertaking a community share offer

At the same time as receiving feedback on the Standard Mark, the CSU sought to understand the motivations behind why enterprises undertake a community share offer. The responses that came back highlighted that the overwhelming rationale for undertaking a community share offer was that the nature of the project and venture required community participation.

Similarly these organisations confirmed that it was particularly important that their investors were engaged in the society, emphasising the value of investors getting directly involved in the running of the enterprise through attending AGMs, volunteering and promoting the campaign.

Many enterprises also highlighted that the relative ease, speed and cost of undertaking a community share offer was a factor in choosing this option, and equally indicated that the Standard Mark was a manageable exercise that did not impact on the feasibility of raising finance in this way.

Section 4: The case for co-regulation

Background

The Community Shares Unit (CSU) has pioneered the development of co-regulatory practices to promote and disseminate good practice when making public offers of investment in co-operative and community benefit societies. It has been able to develop this form of voluntary regulation because promoting community shares – withdrawable, non-transferable share capital exclusive to societies – is not a regulated activity.

Co-regulation is a regulated form of self-regulation, where a sector of activity works closely with government and regulatory bodies to establish voluntary standards and guidance which is adopted by the sector. In the case of the CSU, it has worked with the FCA, DCLG, DECC, HMT, HMRC and the Charity Commission to establish voluntary standards and guidance for community share offers, expressed in the Community Shares Handbook. It has also established the Community Shares Standard Mark, which is awarded to share offers that meet the criteria, by a national network of licensed practitioners. This has been achieved without any amendment to regulatory statute, keeping costs down, while simultaneously driving standards up.

One of the other key achievements of co-regulation is that it has helped practitioners develop the confidence and competencies to raise social investment from the public. This is evident with the growth in community shares offer over the period in which the CSU has been active.

Alongside this market growth, there is the still the commitment to raising standards with the investor survey indicating that the Standard Mark is having a positive impact on influencing the public on whether to invest, alongside most investors having a good understanding of the risks.

The opportunity

Following the planned expansion of Social Investment Tax Relief (SITR) the stage will be set for the rapid growth of retail social investment through the public promotion of social investment offers. This growth could be facilitated by extending the co-regulatory practices developed by the CSU to other forms of social investment. SITR applies to three eligible forms of social enterprise; charities, community interest companies (CICs) and community benefit societies with a prescribed asset lock.

The growth of retail social investment depends on social enterprises being able to overcome the regulatory barriers to this form of investment. The CSU is broadly aware of two options being considered; to create a new social investment promotions regime, or to place retail investment in social enterprises outside the scope of regulated activities.

The approach: extending co-regulation

This paper presents the case for the for concentrating efforts on the second of these options – and investing in the development of co-regulatory practices for retail social investment in the three forms of social enterprise recognised by SITR. This option requires the minimum of statutory intervention.

Withdrawable, non-transferable share capital is not a specified investment under the Regulated Activities Order 2001, so the promotion of this capital is not subject to statutory regulation. Debt securities offer by societies are exempt from most forms of regulation under the Financial Promotions Order 2005. Community benefit societies and charities are also generally exempt from the regulations covering prospectuses. It would be relatively straightforward to grant the same exceptions and exemptions in these regulations to registered charities and CICs as currently enjoyed by societies. Charitable companies and CICs would also need exemption from Sections 755 and 756 of the Companies Act, which prohibits private companies from making a public offer of securities.

Application of co-regulation for wider retail social investment

A co-regulatory standards setting regime for retail social investment would need to recognise the diversity of form and function represented by the three types of social enterprise eligible for SITR. They have one common characteristic; a statutory asset lock. Otherwise, they are different forms, especially in the areas of community and member engagement, and the principal type of financial security they offer.

As well as the different legal forms, the difference between equity and debt investment both from the perspective of the investee in terms of risk, ability to exit, and return and for the recipient organisation need to be well understood.

CICs can be structured as private companies limited shares, issuing transferable share capital to members on the basis of one-share-one-vote. This is in contrast to societies that issue withdrawable, non-transferable shares that work to the principle of one-member-one vote. Charities cannot issue share capital unless they are structured as charitable community benefit societies. Instead they must rely on issuing debt instruments that are detached from membership rights. These different approaches to membership generate very different forms of community engagement and involvement in the enterprise, which in turn shapes investor motivation, and the matters that need to be communicated to the investing public.

The type of financial security offered by the three forms is also significantly different, especially in terms of liquidity and financial return. Here liquidity refers to how the investor exits from the investment and liquidates their capital investment as cash. Societies issuing withdrawable shares are required to allow members to withdraw their share capital, subject to terms and conditions that include the discretionary right to refuse withdrawal. CICs issuing transferable share capital have no obligation to provide liquidity to shareholders, and the creation of secondary markets dealing in CIC shares is, as yet, an undeveloped area. Charities issuing debt securities are free to design the terms of capital repayment, determined by what they think will attract public investment, ranging from fixed term debt through to perpetual bonds.

Charities and community benefit societies have a similar approach to financial return, in that returns are treated as an operating cost, and should be restricted to a rate that is only sufficient to attract and retain the investment. In contrast, CICs can distribute profits to shareholders through dividend payments. This is subject to dividend cap, which restricts CICs to distributing no more than 35% of its profits to shareholders.

Taken together, these differences mean that each form of social enterprise needs its own dedicated guidance and standards setting for promoting retail social investment. This is why a co-regulatory approach would be better than trying to establish a social investment promotions regulatory order catering for such diverse forms of social enterprise. The CSU has demonstrated that co-regulation works best when standards, guidance and good practice are based on experience in the field, working closely with practitioners to identify what works best. It provides a dynamic mechanism for practitioners to address the fine detail of structure, form and process, without having to rely on legislative reform, which can be costly, slow and unresponsive.

Next steps

From a CSU perspective, we would welcome the opportunity to work alongside co-regulatory standards setting bodies for retail social investment in charities and CICs, sharing the knowledge and process expertise we have acquired in co-regulatory matters relating to social investment promotions.

This comes at a time when the infrastructure support fundraising standards in the charity sector is in a state of flux, and retail social investment in CICs remains largely undeveloped. The expansion of SITR in 2016 will provide the platform for raising the profile of retail social investment and the perfect opportunity for developing a co-regulatory social investment promotions regime.