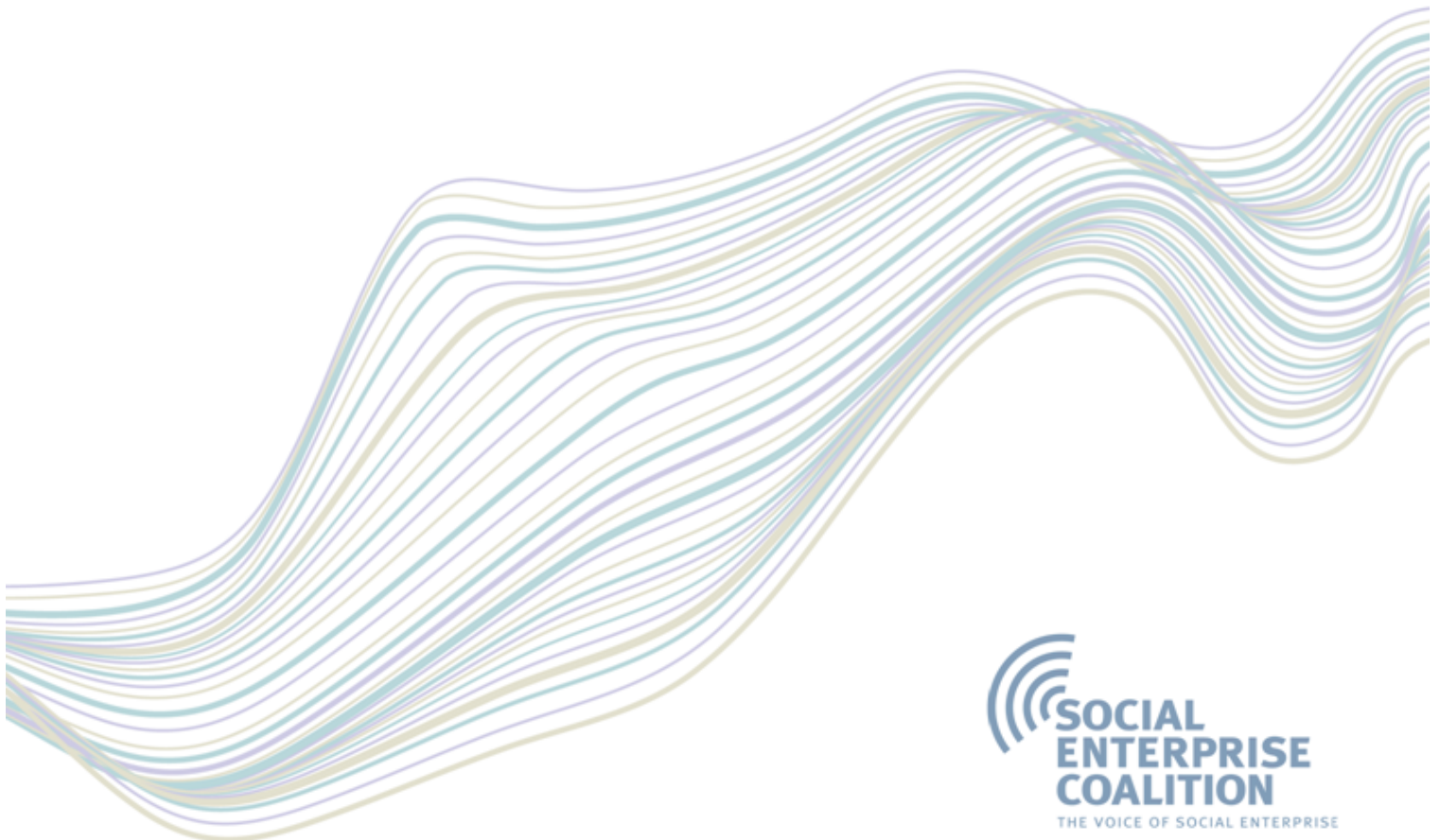


Community Interest Company Regulator Consultation on Dividend and Performance Related Interest Caps

Social Enterprise Coalition Response



The Social Enterprise Coalition response to the Community Interest Company Regulator Consultation on Dividend Caps and Performance Related Interest Caps

1. The Social Enterprise Coalition (the 'Coalition') welcomes the opportunity to respond to the Community Interest Company Regulator Consultation on Dividend Caps and Performance Related Interest Caps.
2. The Coalition was established in 2002 as the national body for social enterprise. Social enterprises are businesses trading for social or environmental purposes whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners. The Coalition represents a wide range of social enterprises, umbrella bodies and networks, with a combined membership of over 10,500 social enterprises. These include co-operatives and mutuals, housing associations, leisure and football supporters' trusts and Social Firms. Social enterprises in the UK generate more than £27 billion in turnover, and contribute more than £8 billion to GDP per year. In preparing this response the Coalition consulted widely with its members.
3. The Community Interest Company (CIC) is a new legal form of limited companies set up for those wishing to operate for the benefit of the community rather than private owners. The 'asset lock' and cap on the distribution of profits makes it a legal form specifically useful for social enterprises.
4. The Coalition as the national umbrella body for social enterprise was intimately involved in the development of the CIC legal form. Since its launch we have been monitoring its uptake, liaising with the regulator, facilitating forums to bring together CICs and gathering evidence to understand how the legal form is working and any issues that have arisen.
5. Over the last 3 years the Coalition has gained considerable insight into the needs of CICs for regulatory changes as well as what priorities the CIC form exists to fulfill.
6. We are aware that this consultation is the first step in a broader consultation programme to inform the development of the CIC legal form. The Coalition would like to share its information and work with the Regulator and BERR to engage in developing the regulatory framework to meet these needs and ensure the legal form fulfils its function efficiently.

Questions 1– 4 for Social Enterprises, excluding community interest companies.

Question 1 – dividend cap

Would the maximum dividend per share cap (5% above the Bank of England base rate) have any bearing on your decision to form as a community interest company?

7. Only 26% of CICs have been incorporated as Companies Limited by Shares (CLS) with the majority favouring Company Limited by Guarantee (CLG) structure. We have been informed there are two motivations for this. Firstly a number of CICs have their origins in the charitable sector consequently appealing to grant funding to start up. The CLG structure was better understood by themselves and the providers of the grants as protecting assets and the social purpose.
8. Secondly, feedback from social investors and the wider social enterprise movement indicates that there is limited understanding of using equity and share options as a way of raising finance. As a result, uncertainty about using equity investment is more of a factor in shaping the decision not to form a CIC than the size of the dividend cap.

Central to increasing the uptake of the CIC legal form as CLS is extending the understanding of the CIC as protecting community assets in both CLS and CLG.

Question 2 – dividend cap

Would the maximum aggregated dividend cap (35% of a relevant company's distributable profits) have any bearing on your decision to form as a community interest company?

9. The views above concerning the limitations of understanding of the CIC apply for the aggregated dividend cap also. At previous CIC forums and consultations many CICs and social enterprises of other legal forms have recognised the asset lock and limited distribution of profits as very good to embed the 'social purpose' of the CIC form. The guarantee of benefit for the 'social purpose is a specific and very important value of the legal form and it is necessary to maintain this. Central to this the aggregated dividend cap is considered more important than the cap on individual share dividends. This allows clear evidence and controls that the majority of profits (65%) are reinvested for the benefit of the community.
10. The aggregate cap is not seen as detrimental and is seen as a benefit of the CIC legal form, and therefore should be kept.

Question 3 – dividend caps

Would the interrelation between the dividend per share cap and aggregated dividend cap have any bearing on your decision to form as a community interest company?

11. It has been raised that the need to protect the distribution of profits in favour of the community interest is the valuable part of this legal form. This only really applies to the aggregated dividend cap. The cap on individual shares only dissuades investors who are seeking high returns. Therefore as stated earlier the interrelation seems to be that the aggregate cap clearly maintains the social/community purpose of the CIC, but the cap on dividend per share limits the viability of the investment for investors. There is no interrelation of purpose between the two caps as understood by social enterprises as the aggregate cap is cited as the reason for forming a Community Interest Company, rather than individual share cap, which is understood in only the most limited way.

Question 4 – performance related interest cap

Would the cap on performance related interest (4% above the bank of England base rate) have any bearing on your decision to form as a community interest company?

12. Debt finance is an incredibly important method of finance for social enterprises. This is because of several issues. Mirroring earlier points about understanding, newcomers to business understand the simplicity of debt compared to equity, and lack knowledge of the implications of exit strategies and dividends of equity. Equally, offering a personal guarantee on a loan that is time limited is preferable to giving away permanent ownership in one's business. Maintaining full ownership and control is therefore equally relevant in ensuring the social mission of the organisation. Therefore limitations to debt finance disproportionately affect social enterprises ability to start up, and to grow.
13. One issue that has come to light is that the 4% base rate cap on performance related interest is was considered by consultees as actually for the entire loan value regardless of how long the loan is. As a result it was considered that financiers would prefer to shortest loan term. Over longer term loans the annual return is actually reduced significantly dissuading debt financiers away from long term loans. Whether this effect was a result of the regulations or not seemed unclear.

14. Considering the importance of debt finance for social enterprises, and the high proportion of CLG CICs it is necessary to address this lack of clarity. The regulations need to ensure that the performance related interest cap is linked to the Bank of England rate and then compounded to act as an annual cap at whatever level the regulator sees as necessary.

Questions 5 & 6 for Social Enterprises and community interest companies.

Question 5 – dividend cap

Do you consider that the double cap on dividends unduly restrict your ability to raise adequate financing of business start-up and growth?

15. The double nature of the dividend cap was seen as providing excessive limitations on profit distribution. The aggregate cap was generally seen as necessary to provide sufficient protection of profits. The understanding of the CIC form by banks and investors is a greater barrier than the specifics of dividend caps. It was identified that for some CLS CICs the approach to investors was aggravated by the existence of the dividend cap, but mainly a lack of understanding and the subsequent uncertainty was communicated.

Question 6 – performance related interest cap

Do you consider that the cap on performance related interest unduly restricts your ability to raise adequate financing of business start-up and growth?

16. As described above, debt finance is an important tool for social enterprises to raise finance. At present the performance related interest cap is perceived as only viable for only short term financing. Whereas in this time of limited access to credit it is not as problematic, as we move into periods of more accessible long term credit this may become a serious barrier of the legal form. Given the large proportion of CLG CICs the CIC form will be disproportionately affected by limitations on debt finance resulting from these restrictions.

Questions 7 - 11 for Equity Investors and Debt Financiers

Question 7 – dividend cap

Do you consider that the maximum dividend per share cap (5% above the Bank of England base rate) unduly limits incentive to those who might make an equity investment?

17. There are reports from investors such as Futurebuilders, the London Rebuilding Society and others that monies are available but a lack of investment readiness among social enterprises is the barrier. In consultations the 5% above BOE base rate seems unduly limiting for the dividend per share for investors given that the aggregate cap protects the majority of profits from distribution to private owners.
18. The point was made by social investors that they are more interested in the capital gains from shares than the dividend over a period. Therefore the relevance of the need for a dividend per share cap is questioned. Even if the dividend per share cap was removed it is difficult to see how capital gains could be made on a CIC that is asset locked and therefore cannot liquidate its assets to pay the shares back for more than they were sold for. The Social Enterprise Coalition is interested supporting the Regulator in examining how this might be pursued in the future in terms of creating a tertiary market of tradable shares in social purpose companies.

Question 8 – dividend cap

Do you consider that the maximum aggregated dividend cap (35% of a relevant company's distributable profits) unduly limits incentive to those who might make an equity investment?

19. Social investors report that as they are interested in social benefits as well as financial returns the 35% aggregate cap on dividends is seen as positive affirmation of the social purpose and the dividend per share cap is more of a concern.
20. It has been suggested that many social investors are trusts and charities that exclusively invest to achieve social or community purposes. A CIC can distribute profits for community purpose, which a social investor, charity or trust could be considered to achieve. This could constitute returns on the investment for these organizations outside of the aggregate cap. It is therefore a matter of publicising and developing understanding of this route for exclusively social purpose funding vehicles, before an amendment of the aggregate caps is necessary.

Question 9 – dividend cap

Do you consider the interrelation between the dividend per share and aggregated dividend caps unduly limit incentive to those who might make an equity investment?

21. It appears from the feedback described above the double cap unduly restricts the flexibility and opportunities for investment in CICs. Even with this limitation the largest single problem is the lack of understanding among social enterprises of investment and equity and the lack of understanding among investors and Banks of the CIC form. The Social Enterprise Coalition is willing to support the regulator in addressing this issue.

Question 10 – performance related interest cap

Do you consider that the cap on performance related interest (4% above the bank of England base rate) unduly limits incentive to those who might consider debt financing?

22. Debt finance is at present a very important source of finance for social enterprises. There is confusion over whether the performance related interest cap guarantees the 4% above BOE base rate annually for the loan, or just against the value of the loan over its entire period. As a result the cap could act as a disincentive to long term loans, which could then detrimentally effect the decision to finance CICs. The lack of clarity could equally act as a disincentive.
23. There needs to be clarity around the performance related interest cap to ensure that it is understood by financiers and that if the cap is not annually calculated that this is addressed in the regulations as it will dissuade financiers.

Question 11 – performance related interest cap

Do you consider that the 1% more by way of return on equity (under the dividend cap) than on performance related loans unduly limits incentive to those who might make equity or loan investments in a CIC to choose equity rather than a loan?

24. At the present time it appears the drivers for taking loans as opposed to equity is that the CIC form is new and most CICs are start up small and medium sized enterprises that use debt finance to a higher degree because they are not in a development phase.
25. There is also a lack of understanding among social enterprises of the safeguards and implications of equity. Loans are used commonly among personal finance and as such among growing social enterprises. They are relied on by those individuals who aren't comfortable with their understanding of equity. Also there is the issue of ceding

ownership of social enterprise early in their development that can dissuade people away from equity. There is no clear evidence that the caps act as an incentive toward either. Firstly we must address the lack of understanding of equity and investment across the entire social enterprises sector.

26. As discussed above the performance related cap could significantly affect the ability to access debt finance. This needs to be addressed

Questions 12 – 17 for all

Question 12 – dividend cap

Do you consider the limit to the level of return on investment to **equity investors** (the dividend caps) provides adequate protection of community assets?

27. The 35% aggregated dividend cap is generally considered to be enough protection of community assets as it is clear majority of the profit is reinvested into the CIC. The aggregate cap should be maintained to ensure the protection of assets within the CIC is maintained as an attractive element of the legal form.

Question 13 – performance related interest cap

Do you consider the limit to the level of return on investment to **debt financiers** (the performance related interest cap) provides adequate protection of community assets?

28. It provides a more than adequate level of protection. Over the longer term the cap will act as a significant barrier to loans and therefore is ensuring that community assets are not liquidated.

Question 14 - general

Do you consider the Bank of England base rate should be the preferred option for calculating the caps?

29. For the dividend cap the Bank of England base rate gives a good way to link the interest rate and make it comparable for ease of understanding. For the performance related cap the Bank of England rate should be kept but there needs to be development of this cap into a compound interest based mechanism that ensures better annual returns over the longer term.

Question 15 – dividend cap

What principles should be used to set the dividend cap?

30. The principles for the dividend cap should be to preserve the primacy of reinvesting the majority of profits for the community interest.

Question 16 – performance related interest cap

What principles should be used to set the performance related interest cap?

31. Ensuring returns over longer term loan facilities to ensure there is not a barrier to accessing finance for start up and growing social enterprises is important. Although maybe we need to rethink whether the pressure away from debt finance over equity in the CIC is appropriate? One principle for evaluating the return on CIC finance would be to relate it as a reasonable market value of a long term savings account. This would make it comparable for many investors who are low level but would like a return on their investment

Question 17 – general

Please tell us anything else from your own experience that you consider can add to a body of evidence about the dividend and performance related interest caps.

32. CICs also identified that investors that they had approached, private or social, were specifically interested in individual projects of the CIC rather than the entire CIC. As many CICs will operate with several different projects, each project might represent a small share of the entire CIC's turnover. It could be possible for a private investor to invest in one project and be awarded a higher proportion of those single projects' profits than the equivalent 35% aggregate cap or the 5% above BOE rate per share cap for the entire CIC. This is a potential tool to be used by investors which any review of the caps or regulations needs to consider.
33. To develop a tertiary market in shares of CICs the review of regulations need to review how the regulations encourage exit strategies for investors to be remunerated for their shares while maintaining the protections of assets for the social purpose. It must also take into account how the regulations might limit the potential gains on shares under the present regulation, discouraging capital gains for investors and undermining the potential tradability of equity in CICs. The Social Enterprise Coalition is willing to be involved in the any development in this area

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