Social Enterprise UK response to FCA's call for Input: Regulatory Barriers to Social Investments

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socialinvestmentsfca@fca.org.uk

About Social Enterprise UK

Social Enterprise UK was established in 2002 as the national body for social enterprise in the UK. We are a membership organisation. We conduct research; develop policy; campaign; build networks; support individual social enterprises; share knowledge and understanding; support private business to become more socially enterprising; and raise awareness of social enterprise and what it can achieve.

Social enterprises are businesses driven by social or environmental objectives whose surpluses are reinvested for that purpose in the business or in the community. They operate across a wide range of industries and sectors from health and social care, to renewable energy, recycling and fair trade and at all scales, from small businesses to large international companies. They take a range of organisational forms from cooperatives and mutuals, to employee owned structures and charitable models. Our members come from across the social enterprise movement, from local grassroots organisations to multi-million pound businesses that operate across the UK. We represent social investors, social enterprises, and cooperatives – the groups most keenly interested in the FCA's call for evidence.

Executive Summary

Social Enterprise UK very much welcomes the FCA's Call for Input on Regulatory Barriers to Social Investment. In our response we aim to set out the current perspective of social enterprises in what is a fast moving landscape. We are pleased to support the FCA with their timely efforts to ensure the UK benefits from the most appropriate and effective regulatory regime for this increasingly significant field of investment.

Social enterprise and social investment, community shares and crowdfunding have grown rapidly over the last 10-15 years. The sheer pace of change, and the entrepreneurial manner in which legal structures and financial instruments have been used, diversity within the tax and regulatory systems for social sector organisations and inconsistencies between legal forms has resulted in somewhat baffling regulatory environment. The FCA's call for evidence gives a flavour of the complexity.

Social Enterprise UK is therefore supportive of the suggestion that social sector regulation in its widest sense needs to be examined as a whole rather than piecemeal; we also recognise that this goes beyond the FCA's call for evidence on regulatory barriers to raising capital.

The issue

In the UK today, much of the current regulatory regime for investment, including the financial promotion regulations, is founded on assumptions of self-interested, primarily financially motivated investors. Yet critically, both for this FCA call for input and more widely, not all investment is based on these assumptions or follows this logic. Indeed, motivations beyond a narrower conception of purely financially motivated investment *is* occasionally acknowledged in our regulations or by our regulators. For example:

- The FCA already recognizes the distinctive characteristics of the co-operative model, the society legal form and the practice of community shares. The motivations of member investors in societies can include a significant commitment to a co-operative or communal purpose, rather than narrow pursuit of financial returns. The unique characteristics of withdrawable share capital are well understood by regulators and have a long track record. Members and investor-members can withdraw their shares under specific conditions but these shares cannot be traded, and can only ever be withdrawn at par value without the scope for capital gain.

- The FCA recognizes, in the existing Financial Promotions rules, the significance of the idea "common interest" which goes beyond private interests. This exemption from the general rules is based on an identified group of persons who have an existing and common interest with each other, with the company in which they are investing, and with what is done with any proceeds arising from their investment. This subset of investment is defined in the FCA rules terms of how it primarily assists the furtherance of a company's objectives rather than purely financial objectives.

- In the FCA's Occasional Paper No. 1 which explore regulatory approaches in the light of behavioural economics, FCA staff describe how financial decisions can be made for reasons beyond financial logic. For example, stating that "Many financial decisions are emotional… Consumers do not always realise how much their decisions and willingness to pay for a product are influenced by emotions…"

These examples aside, it is evident that many financial transactions take place every day across the UK which are driven by something other than financial motivations - through the very existence of philanthropy, donations, the activities of charitable trusts and foundations, tax relief such as Gift Aid and even financial regulations around charitable fundraising activity.

It is very welcome that the FCA have come to recognise through this call for input that some financial activity combines a mix of motivations. Those making so-called social or community investments intend to use their money differently than if they were making purely financial investments; they have social impact objectives as well as — or in place of — financial objectives. As the FCA says "Social investments aim to provide a wider social benefit than an investment where the primary purpose is a purely financial benefit. They are also different from donations where the donor does not expect to get any money back. Social investors generally either expect to get back their initial investment or they expect the organisation to use the investment for its work and provide a return to investors where it can."

Yet this blend of motivations is only recognised in the FCA's rulebook in one or two places, as outlined above. We therefore find ourselves in a position where a range of potential social investment activities, if not modelled in line with the very specific 'common interest' or societies exemptions above, are inadequately recognised or by the current financial regulations. As has been noted in the House of Lords debates on this issue, it seems counterintuitive that a member of the public could give money to an organisation irrevocably through a donation, but could not without difficulty invest in exactly the same organisation because of the requirements of the Financial Promotions Regime, even if the investor is willing and able to bear the loss and is aware of the risks involved in investment. An individual can give an organisation as much money as she wishes, yet when the possibility of a financial return arises, the current regulatory framework precludes this activity - except under very particular circumstances.

So our financial rules sometimes recognise the non-financial motivations of investors but too often do not. This inconsistency and incoherence is certainly problematic in theory and potentially problematic in practice. What is clear is that the rules do not make it easy for individuals to invest in causes they care about.

In practice

In practice, it seems that most social investment intermediaries (SIFIs) or funds have found ways to navigate the existing regulatory framework, helping channel investment to social enterprises while finding other barriers more significant than regulations. These SIFIs tend to offer finance in larger quantities (last available data put this at £264,000) than those societies who pursue a community share offer (£174,000 and significantly less discounting the energy sector.)

Meanwhile, there is significant anecdotal evidence and a clear logic that it is indeed too costly for many social enterprises to raise investment directly from the public due to the costs of compliance with the Financial Promotion Regime. That certain exemptions from the Financial Promotion Regime for societies has helped support the remarkable success of community shares, while other social enterprise forms have not attracted similar retail investment over the same period is evidence that these other social enterprises face significant and more costly barriers in offering investments to members of the public than their society counterparts. There may be significant untapped consumer demand for small public social offers beyond the current community shares model based on the society form.

So there seems to be regulatory challenge for social enterprises which are not societies – and potential investors in them – when it comes to the promotion of social investment opportunities to the general public for small offer sizes. Whilst there are established routes through the regulatory landscape to raise investment from high net-worth individuals and for larger offers, charities and Community Interest Companies (CICs) find it difficult to raise investment from the general public for small offers under the current financial promotions rules.

Of course, organisations can choose which legal form to take when they incorporate so in theory they can choose a form for which there are already exemptions. However, social enterprises must consider many factors in choosing their governing structure; their ability to finance the organisation is never the sole determinant. Many charities and community interest companies that would be interested in raising investment from the public may not be suited to a society form for various other reasons and nor should they be forced, or even incentivised - to create a new structure or adopt an otherwise unsuitable structure solely to make it easier to seek investment from supporters under the financial promotions rules.

However, we note that in practice, there is no great clamour from our social enterprise members for changes to the regulatory regime. This may, in part, reflect a lack of information about what could be possible if the laws were different. It also surely reflects how enterprises adapt as best they can to existing regulatory frameworks and laws – we and they simply cannot know what might happen if the laws were different. There is also much to be said for the society model which has proved a great vehicle for many community enterprises over the past decade and more.

Recommendations

To address the issues identified above, SEUK believes that the FCA, the Government and others could take a series of steps in order to create a more effective and appropriate regulatory regime for social investment. Such steps should be based on two principles.

First, the FCA's rulebook should be developed over time to ensure greater consistency and coherence in terms of recognising social motivations beyond the purely financial. We are not arguing for preferential treatment for social investment. Rather, we are arguing that regulation should reflect the diverse motivations of investors. Regulation should also be considered more holistically in terms of the interrelation between regulation of financial investments and regulation of philanthropy, for example. Investment than is characterised by blended motivations may fall between two regimes or across both and regulators in both field should be cognisant of the other and consider the incentives which each set of regulations creates for those undertaking activities along this spectrum of motivations.

Second, the FCA should embrace the principle that their regulatory regime should, over time, move towards a more coherent, fairer and more consistent level of treatment across all social enterprises including charities, CICs and societies, while taking into account the peculiarities of each. The FCA should work to support a wide range of social sector organisations to raise investment from the public.

In line with these principles, the FCA should:

- Retain the existing exemptions for societies which have been a great success in supporting the responsible growth of the field of community shares, offering social investments and maintaining appropriate and proportionate investors protections. It can help people reconnect with their finance choices by providing more real choice about where to save and invest their money. The success of Community Shares has shown that it is possible for community organisations to raise investment from supporters in a responsible and positive way.

- Ensure existing rules are better understood, particularly with regard to the "common interest" exemption which, in could perhaps be more effectively exploited by many investors and social enterprises. The FCA should help develop a clearer understanding of the options available to (charity and CIC) social enterprises offering investment to socially motivated investor members of the public up to a total deal size of £100,000 using existing exemptions and rules. The FCA should help clarify the extent to which it may already be possible within existing rules for many charities and CICs to more easily access retail investment, taking into consideration the thresholds and the exemption for targeting under 150 people in the prospectus rules; the restricted investor rules; and through the common interest principle in the Financial Promotions rules. We believe that these existing rules may allow for opportunities to distinguish genuine community-based social investment opportunities for identified retail investors from other more financially motivated opportunities. SEUK would be delighted to support the FCA with developing further guidance (i.e. to clarify "an identified group of persons" and the nature of "common interest"), make any existing case law more widely available and support some pilot action learning studies, for instance, other with any measures to help social enterprises and investors make better use of existing rules in practice.

- Gather further evidence of the scale and nature of the problem in practice, the likely effect of any changes to the rules, the costs and benefits and any unintended consequences. The FCA should commit further policy resource to this increasingly significant field and undertake further market research and gather greater market intelligence. Some are arguing for a new regime or for an extension of the 'restricted investor' model. Some argue that exemptions for societies could be simply extended to charities and CICs. Others are convinced that existing exemptions are sufficient and simply need to be better understood. This disagreement is in itself a demonstration of the lack of clarity in the field and uncertainty around the current rule book and the need for more evidence. This, however, is not a suggestion that nothing should be done. The FCA should seriously consider the scope for a new regime or extending existing regimes in order to meet the principles outlined above. But the potential development of such regulatory changes should be a matter for further serious deliberation by regulators and policy makers.

- Develop any new initiatives, guidance, consultation or new schemes in close consultation with sector bodies and other key stakeholders, the Treasury, the Charity Commission and CIC Regulator, Co-operatives UK, the Community Shares Unit, Social Enterprise UK, the Social Investment Forum, Community Energy England, the UK Crowdfunding Association and other key stakeholders.

Comments on the Call for Input

As a representative body for social enterprises, we have respond directly to questions 1 and 2. But we believe we also have something to offer under question 6. We also have some comments on some specific sections of the Call for Input.

- The paper says "Private Companies and Community Interest Companies that are limited by guarantee have no share capital. They often raise funds through grants or donations because they are not allowed to market their securities to the public." It is not the case that CICs raise funds through grants *because* they are not allowed to market securities to the public. They often raise grants because they are seen to be desirable with a lower cost of capital i.e. none.

- Steps 1 and 2 in the paper are potentially misleading as many social enterprises do not raise finance at all and many raise finance from banks. This does not come across in the paper so may be confusing for many social enterprises.

- "How can I invest" under step 3 is misleading as it is possible to raise finance without being officially approved – under exemptions.

- The sentence which says "This is because social enterprises are exempt from FCA rules for selling their securities" is not true – this perhaps was intended to refer to societies rather than social enterprises more widely.

- In some places the language reverts to assumptions where financial motivations are seen as primary. I.e. where the "social enterprise performs poorly" is making as assumption that success is defined in financial terms.

Q1: Have you experienced any problems trying to establish a social enterprise or raise capital for a social enterprise? If yes, please provide details of the problems, identifying in particular those caused or exacerbated by regulation. Where a problem is caused by FCA rules or policies, please identify the rule and explain why.

Many social enterprises want to raise capital from individuals: this can be for a variety of reasons including wanting to raise their profile, wanting to access more flexible forms of capital (such as unsecured debt), wanting to have access to a pool of investors, and wanting to build connections with their community.

Access to suitable finance has remained a key barrier to growth and sustainability for social enterprises, across all our surveys and across all sectors in which social enterprises operate. Repeatedly, our surveys indicate that access to suitable finance is a greater problem for social enterprises than 'traditional' small and medium sized businesses.

- "Funding and finance remains a key barrier for social enterprises of all sizes: the demand for smaller-scale, simpler, unsecured investment remains constant. Barriers to accessing social investment are more likely to be about navigability, accessibility and confidence than cost of capital or legal structure."[1]

- "44% of social enterprises sought funding or finance in the last 12 months and 39% believe its lack of availability is a barrier to their sustainability. Just 5% of SMEs think access to finance is a barrier."[2]

These questions about finance have become more in-depth and nuanced primarily because social enterprises continue to identify access to finance as the main barrier at both start-up and when more mature; and this is at a significantly higher rate for social enterprises than SMEs.

But broadly, the message is a consistent one: the average amounts asked for are £100,000 or below, with an average across our last three reports of £70,000. CICs are much more likely to be seeking smaller amounts of finance.

There is some evidence that rural organisations may be slightly more successful in raising the full amount they apply for; which may be partly explained by the success of the community shares model in rural areas, encouraged by specialist support.

It is recognised that the costs of working with an authorised intermediary can be prohibitive for a charity or social enterprise seeking to raise smaller amounts (i.e. less than £50,000-£100,000) from individual investors. This is largely due to fixed costs which do not vary depending on the size of the transaction. Given that the median capital raise for social enterprises is £60,000, and there are at least 10,500 community interest companies and thousands more charities, the potential is significant.

Q2: How are you interested in raising capital? Who is your target client base for the products you will sell to raise capital?

SEUK's State of Social Enterprise survey 2015 suggests that social enterprises are, as one might expect, entrepreneurial in seeking capital. Overall, there is a fairly consistent picture in the types of funding and finance that social enterprises are seeking. More than a third apply for some type of grant each year, whilst those applying for loans (10%-12%) and equity (1-2%) have varied little over this time period. Given the limitations of many social enterprise legal structures around equity, this is unsurprising. Our evidence very strongly suggests that social enterprises seek finance from the range of sources.

Q6: Do you have any evidence (e.g. figures, case studies or other practical examples) of the appetite retail investors have for social investments and related products?

There is significant evidence that charities and social enterprises are interested in raising investment from the general public and the public has shown willingness to provide the

[1] State of Social Enterprise 2015 Exec Summary
[2] SoSE 2015 page 5

investment needed. This is evident not just from research[3] but has also been practically demonstrated by the growth of community shares in the last five years. Between 2009 and 2014, 246 share offers from co-operatives and community benefit societies raised over £60m worth of capital; this involved 60,000 individual investors, with 74% of these investing £500 or less[4]. Alongside this, SIFIs have been raising capital directly from individual investors – for example, £45m of the £72m of capital raised by Triodos Bank since 2011 is from individual investors[5]. More recent activity in connection to angel networks by ClearlySo, platforms like Ethex, and Social Investment Tax Relief funds by Resonance demonstrate this appetite spreads across a broad swathe of potential investors.

The reasons for this growth in social investment are highlighted by responses to surveys with individuals saying that they want to 'do social or environmental good', 'create a stronger community' and 'invest in my local community' highlight a real commitment to social purpose and investing in local community. Responses to surveys suggest strong motivations of 'doing social or environmental good', 'create a strong community' and 'investing in my local community.'[6]

Many members of the general public are already interested in investing for social as well as financial returns: this can be traced back to the 'mutual' history of many banks and building societies, as well as more recent developments like 'community bonds'. There are already approximately 55,000 people that hold a social savings account[7] and the amount saved and invested 'positively' has grown by 11% in the past year[8].

The reasons members invest in community shares highlight a real commitment to social purpose and investing in local community. Responses to surveys suggest strong motivations of 'doing social or environmental good', 'create a strong community' and 'investing in my local community.'[9]

Contact

Dan Gregory, Head of Policy
Social Enterprise UK
dan.gregory@socialenterprise.or.uk

[3] For example, Marketing Social Investment (Social Investment Research Council, 2014); Ethex Positive Investing Report (Ethex, 2015)
[4] Community Shares: Inside the Market report (Community Shares Unit, 2015)
[5] Corporate Finance Five Year Review (Triodos Bank, 2016) www.triodos.co.uk/cfreview
[6] Community Shares: Inside the Market report (Community Shares Unit, 2015)
[7] The Ethex Positive Investing Report (Ethex, 2015)
[8] The Ethex Positive Investing Report (Ethex, 2015)
[9] Community Shares: Inside the Market report (Community Shares Unit, 2015)