BATES WELLS & BRAITHWAITE

TEN REFORMS TO GROW THE SOCIAL INVESTMENT MARKET

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Foreword

Social investment is attractive because it emphasises positive social impact as well as financial returns. It shows that it is possible, when investing, to do well and to do good at the same time.

Big Society Capital is the world's first social investment wholesaler and it is already up and running and making investments. Our aim is to use the money we have been given – up to £600million from dormant bank and building society accounts and from additional direct investment by the big four high street banks – to grow the social investment market in the UK.

To do this, we will provide investment funding for social finance and investment intermediaries, including backing social investment funds, to leverage more private investment into charities, social enterprises and social businesses in the UK. We will also seek to support the development of the infrastructure needed to build the social investment market.

I therefore warmly welcome this report as an important contribution to the policy debate. To be able to address the market failure in the provision of finance for social sector organisations, we need a legal and regulatory framework which supports the making of social investment by different categories of investors, including individuals, charities and other institutional investors.

The world is changing quickly and law and regulation need to keep pace. Nowhere is this more apparent than in the context of the growth and development of the social investment market. Unfortunately, at the moment, the legal, regulatory and tax framework predates the notion of social investment and so could do more to incentivise and support investors who are seeking positive social impact alongside financial returns.

The authors, Stephen Lloyd and Luke Fletcher, are two of the leading legal experts on social investment and were instrumental in helping us design the legal architecture of Big Society Capital.
This publication deserves careful consideration by all those interested in the social investment market and, in particular, those policy makers who are thinking about how to create an enabling legal, regulatory and tax environment to make social investment as easy and accessible as possible.

Nick O'Donohoe
CEO, Big Society Capital

Executive Summary

This report sets out ten reforms to grow the social investment market in the UK:

1. A social investment duty should be placed on each of the Financial Conduct Authority and the Prudential Regulation Authority to encourage sensitive regulation.

2. The rules governing financial promotions should be reformed to take account of investors who invest with social or philanthropic motives, crowdfunding and peer-to-peer lending.

3. A specific authorisation regime should be introduced by the Financial Conduct Authority to facilitate crowdfunding, peer-to-peer lending and other online direct investment facilities.

4. The regulatory concept of 'suitability', which undergirds investment recommendations and discretionary management activity, should expressly include investors' social goals.

5. A tax break should be introduced for social investment and community interest companies to level the investment playing field and encourage more social enterprise start-ups.

6. The law concerning the investment duties of charity trustees should be reformed to strengthen and expand the ability of charities to invest for social impact.

7. The law concerning the investment duties of pension fund trustees should be reformed to add to the ability of pension funds to consider environmental, social and governance factors.

8. Company law and co-operative law should be reformed to encourage the formation of more start-up companies with a social purpose and more new co-operatives.

9. A model social investment fund structure should be introduced to enable Government, charities and other investors to more easily invest in structured funds for social impact.

10. The registration of co-operatives and community benefit societies should be moved to Companies House and the CIC Regulator, to create a new Social Economy Commission.

Ten Reforms to Grow the Social Investment Market recommends to the Government that these reforms be introduced in a single item of legislation, such as a 'Social Economy Enabling Act'.

A Social Economy Enabling Act with these ten reforms would enable and incentivise social investment and bring clarity to an area which, in regulatory terms, is fragmented and ill-defined.

Acknowledgements

This report has been made possible through the contributions of a large number of people.

We would like to thank those of our clients who have engaged us on social finance transactions for informing our thinking on the issues set out in this report over a number of years. A special thanks to those who have directly informed the proposals with specific comments and feedback, including especially Charlotte Chung at Social Enterprise UK and Matt Robinson at Big Society Capital.

We would also like to thank officials at the Cabinet Office, especially Rob Parker and Philip Craig, who have asked searching questions and provided constructive challenge over many months.

The proposals in relation to the fiduciary duties of pension fund trustees reflects the work of Christine Berry of Fair Pensions on this issue and the call for a regulated activity category for crowd-funding is informed by the work and thinking of Simon Deane-Johns, co-founder of Zopa.

The proposals on suitability have been shaped by work we have done with Big Society Capital and Gavin Francis of Worthstone Limited on the report 'Advising Clients on Social Investments and Deciding on Suitability'.

The proposals in relation to co-operatives build on the arguments Malcolm Lynch has been making for a number of years and we would like to acknowledge his thinking and advocacy in this area.

We would like to wish Lord Phillips of Sudbury and Baroness Kramer of Richmond Park well in their efforts to have social investment acknowledged appropriately in the Financial Services Bill.

A thank you also to feedback from officials at the City of London Corporation, which is playing a key role in creating a hub of social investment expertise in London, as well as informing the general policy debate, and especially to Katie Hill, the Corporation's principal social investment adviser.

Lastly, we would like to acknowledge our colleagues in the Social Finance Group at BWB who have provided feedback and suggested refinements.

As ever, any errors or omissions remain our own and we take full responsibility for the report.

Introduction

Social investment is investment on the basis of social impact as well as financial returns. In the UK, it is generally understood as involving investment into social sector organisations, such as charities, community interest companies, co-operatives and community benefit societies.

Social investment is to be distinguished from mainstream ethical investment and socially responsible investment, which generally involves the screening out of investments which are regarded as having negative social or environmental impact, such as aerospace, tobacco or heavy industries.

The UK Social Investment Market

Current Size

A study carried out by the Boston Consulting Group and the Young Foundation estimates that total investment inflows into the UK social investment market in 2011 to be only *£165 million* in the financial year 2010-11, with the majority of investment coming from four social banks.

Funding Gap

The 2011 State Aid application of the UK Government in respect of Big Society Capital, estimates that social enterprises are receiving *£0.9-1.7 billion* less finance than they need, when compared to the level of financing of SMEs using information derived from the 2010 BIS SME survey.

Potential Growth

A June 2012 internal study carried out by Big Society Capital estimates that total investment inflows into the UK social investment market has the potential to grow from *£165 million to up to £750 million* by 2015 on the basis of demand for social investment on the part of social enterprises.

A Global Phenomenon

Interest is being shown in social investment by some of the world's most prominent financial institutions and there is debate about whether we are seeing the emergence of a new social investment *"asset class"*. In 2010, JP Morgan released an influential report surveying global social investment opportunities and estimated the global value of the marketplace in excess of $1trillion.

In *"Impact Investments: An emerging asset class"*, JP Morgan argues that "impact investments" – another term for social investment – should be defined as a new asset class. JP Morgan estimates the potential scale of global investment capital and profit from social finance, in selected businesses within five sectors – housing, rural water delivery, maternal health, primary education and financial services – for that proportion of the world's population earning less than $3,000 a year, to be £400 billion-£1trillion in invested capital and $183-667 billion in profit over the next 10 years. These figures are impressive when one considers that this is a bottom of the pyramid analysis in only a small number of sectors. The full potential scale of social investment – which covers investment across business sectors, geographies and social strata – may be significantly in excess of these figures.

The story of microfinance provides us with a clue as to how social finance more generally can grow and develop. In its report, *"Lessons from the World of Microfinance"*, CAF Venturesome traces the history of microfinance from the pioneering micro-lending work of Muhammad Yunus in Bangladesh in 1976 to today's global industry representing an asset class worth approximately $8.2 billion. As the report shows, this growth was only achievable with the help of significant initial subsidies and state intervention to create a track record of investment and return which could attract large-scale private capital.

Microfinance is a subset of social finance. If other social finance sectors, such as sustainable agriculture or community owned renewable energy, can learn the lessons of microfinance and achieve similar scale, then there is no telling where social finance will stop.

Competition is already emerging for a slice of this developing international market. A report by PWC in Luxembourg called *'The Third Sphere'* sets out how Luxembourg is seeking to build on existing knowledge of microfinance and sustainable finance to win a share of the international impact investment market. In the US, the Jump-Starting Our Business Start-Ups Act 2012 relaxes securities laws to provide a bespoke regulatory regime for crowdfunding small business finance.

To win a sizeable share of the international social investment market and to become a hub for social investment, the UK needs an enabling legal, tax and regulatory regime to support social investment.

Government Policy and Strategy

In July 2012, the Government published *"Growing the Social Investment Market: Progress Report"*, which sets out its progress and its priorities for the development of social investment.

The Government states that the next 12 months will see it focus on *"making it easier to invest in social ventures by reviewing and removing the legal, regulatory and financial barriers to social investment and social enterprise"*.

The Government wants to "make it easier to invest in social ventures, whether that is buying shares in a local community shop, lending to a start-up social venture employing disadvantaged people through a new crowd funding platform, or investing alongside others in a dedicated social investment fund".

Recommendations to Government

The Government is looking carefully at the regulation of and tax environment for social investment.
A HM Treasury review of the financial barriers to social investment was announced in Budget 2012.

The charity law review of the Charities Act 2006 being led by Lord Hodgson has consulted upon and is presently considering the place of social investment by and into charities.

In addition, the Government's Red Tape Challenge initiative has just launched a review of the impact of red tape on civil society, with a particular social investment theme.

The ten recommendations set out in this report are intended to inform Government thinking and the policy development process in relation to each of these Government reviews and beyond.

1. Place a Social Investment Duty on Financial Regulators

A social investment duty should be placed on each of the Financial Conduct Authority and the Prudential Regulation Authority to encourage sensitive regulation

Introduction

The Financial Services Bill is currently going through Parliament. The Bill is a response to the financial crisis of 2007-8 and the breakdown of the tri-partite regulatory system which prevailed at the time between the Bank of England, HM Treasury and the Financial Services Authority.

As well as creating a new overarching Financial Policy Committee in the Bank of England, the Bill will create two new regulators, the Prudential Regulation Authority (PRA), which will be responsible for the prudential regulation of systemically important institutions, and the Financial Conduct Authority (FCA), which will be responsible for protecting consumers.

What is the problem?

Due to the non-profit or low-profit distributing nature of many social sector organisations – charities, community interest companies, co-operatives and community benefit societies – many of the social investment products and structures which are being developed and brought to market are innovative and unusual and do not fit easily within the existing financial services regulatory regime.

It is also the case that social investors are motivated in part by social factors and will be willing to accept lower returns or higher risks, for example, when investing in local community shops, social enterprise shares or charity bonds. The consumer protection issues which apply to social investments are therefore different to those which apply to traditional financial investments. Often, social investment is understood by the investor as an extension of philanthropy.

The social investment market is therefore distinctive: it is not like other parts of the financial markets and should not be expected to fall in with a regime which addresses solely financial factors. The aims and activities of the actors in the social investment market, include investors and investees, are usually not solely financial and so social investment requires sensitive treatment. Regulation needs to balance consumer protection against the social motives of consumers.

At the moment, the FSA does not place any regulatory priority on social investment and so, for example, there is no treatment of social investment in any of its guidance or publications. There is no official or department responsible for social investment and, as a result, it is very difficult to engage with the FSA on social investment related matters generally in a co-ordinated or effective way. It is clear that at the moment that the FSA does not distinguish social investment from other forms of investment, which inhibits sensitive regulation and therefore market development.

If the statutory objectives of the PRA and FCA do not mention social investment, neither of the financial regulators will have a mandate to consider the distinctive features of social investment in the course of carrying out their respective regulatory activities. In such circumstances, the regulators will be inclined and effectively incentivised by virtue of their statutory mandates to treat social investment like other forms of investment, regardless of its unique and often philanthropic features.

What is the solution?

The PRA and FCA require a form of 'social investment duty' to ensure that each considers the distinctive features of social investment and regulates the social investment market appropriately.

A requirement should be inserted into the mandate of each regulator for it to consider the impact of its regulation on social investment and civil society and to take steps to avoid inhibiting the development of social investment and civil society. A social investment duty could be created by an amendment to the Financial Services Bill or set out in an order of HM Treasury under the Bill.

If a social investment duty is created, thought will need to be given to how social investment is defined. One approach would be to anchor the term social investment in the definition of "third sector organisation", as used to define the remit of Big Society Capital as a "social investment wholesaler" under s18 of the Dormant Bank and Building Society Accounts Act 2008.

Ideally, any definition of social investment would also recognise the important role of community development finance institutions in promoting investment into deprived communities and would also recognise the international nature of social investment and the fact that it is possible to invest for social or environmental impact, as well as financial returns, in a whole number of different ways.

A social investment duty of this kind could be very modest in scope. It would not cause the FCA or the Government to incur significant costs. However, it would require more thoughtful and sensitive regulation on the part of each regulator. It would also act as a counterweight to the emphasis which the FCA, in particular, is expected to place on its consumer protection objective.

With a general social investment duty, one could expect the regulators to ask not only "what course of regulatory action is most protective of consumers?" but also "what course of regulatory action is most conducive to the growth and development of the social investment and civil society?".

A change of this kind would have a very significant aggregate effect on regulation over time.

There is no reason why a social investment duty should detract from other measures in the Bill.

What steps need to be taken?

The Bill was introduced to the House of Lords on 24 May 2012 and is currently undergoing its second reading in the House of Lords. A social investment amendment to the Bill has been introduced by Lord Phillips of Sudbury and Baroness Kramer of Richmond Park.

An amendment of this kind to the Financial Services Bill would be consistent with the expressed aim of the Government to grow the social investment market and increase investment into civil society.
We ask the Government to accept a social investment amendment to the Financial Services Bill.

2. Tailor the Financial Promotion Rules for Social Offers

The rules governing financial promotions should be reformed to take account of investors who invest with social or philanthropic motives, crowdfunding and peer-to-peer lending.

Introduction

The financial promotion rules govern how investment opportunities are communicated in the UK. Under the rules, an investment offer or advertisement is called a ‘financial promotion’.

The rules, which are set out in the Financial Services and Markets Act 2000 (FSMA) and in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, state that a person must not communicate a financial promotion in the UK, in the course of business, unless:

- the person issuing the communication is a person authorised by the FSA; or
- the contents of the communication have been approved by an authorised person; or
- the communication is subject to an exemption.

A deliberate breach of the financial promotion rules is a criminal offence.

A separate European level regime applies under the Prospectus Directive in respect of investment offers in excess of €5,000,000, unless a relevant exemption applies. Most social investment offers are beneath €5,000,000 and so tend to be subject to the financial promotions rules.

What is the problem?

The financial promotion rules do not consider social investment offers or social investment websites. The rules do contain exemptions for certain types of investor, including high net worth institutions, high net worth individuals, sophisticated investors and investment professionals. However, the rules do not contain exemptions for social investors and do not acknowledge that social investors are often exercising social or philanthropic motives when deciding to make investments.

There are also exemptions available to certain types of legal forms, namely co-operatives and societies for the benefit of the community, which tend to be democratic and community owned. However, there are a wide variety of legal forms which may issue social investment offers and which do not benefit from exemptions, including charities, community interest companies, companies limited by shares with a primary social purpose and social investment funds of varying kinds.

It is also perverse that members of the public are largely free to give donations to charities and civil society organisations but are effectively prevented from supporting the majority of civil society organisations through investment – a less risky form of support, as capital is due to be returned – even if the primary motivation is to support the organisation and not to obtain a financial return.

The financial promotion rules make it very difficult for most charities and social enterprises to raise small amounts of investment from ordinary retail investors. This is because, to get an investment offer approved, a charity or social enterprise will need to pay an authorised person to prepare the offer, verify statements of fact and scrutinise claims made, unless it is able to take advantage of a specific exemption. Investment offer approval involves a process of due diligence and multiple revision. Often, the costs involved make it uneconomic for charities and social enterprises.

In addition, there is a general prohibition on retail investment into collective investment schemes, which prevents retail investors from accessing many social investment fund opportunities.

What is the solution?

The financial promotions rules should be reformed to provide exemptions for social investors and to provide a way for charities and social enterprises to issue small-scale investment offers at a reasonable and proportionate level of costs, whilst still adequately protecting investors.

The rules should expressly recognise that a balance needs to be struck between investor protection and the social and philanthropic motives of many social investors. The Government should consider creating a set of financial promotion rules which apply exclusively to social investment offers.

A new set of "social financial promotion rules" could apply to social investors who self-declare that social impact is at least as important as financial return in the making of the investment in question. It could also apply to all social offers issued by all public benefit or community-owned legal forms, such as charities, community interest companies, community benefit societies and co-operatives.

To protect investors, the rules could require issuers of social financial promotions to self-declare that the social offer complies with minimum standards in relation to quality and accuracy. This could be combined with mandatory risk warnings for investors and it could even be combined with a cap which allows ordinary retail investors only to invest up to a certain amount in any one social offer.

The new rules could require all social offers to be registered with the FCA. The FCA could update the rules in relation to social financial promotions from time to time, to reflect market development. Other jurisdictions, such as the Netherlands, have a regime of this kind.

The financial promotion and other rules which apply specifically to collective investment schemes should be reformed to allow ordinary retail investors to invest, up to a pre-defined cap, into collective investment schemes with a social focus, such as social investment funds like Big Issue Invest or local social impact bond projects, where local retail investors may wish to participate.

What are the next steps?

HM Treasury should consult on proposals to reform and then reform the financial promotion rules in response to the emergence of the social investment market and to make it easier for charities and social enterprises to raise small amounts of investment directly from ordinary retail investors.

HM Treasury should also consult on proposals to reform and then reform the financial promotion and other rules which apply specifically to collective investment schemes, to allow ordinary retail investors to invest small amounts into collective investment schemes with a social focus.

3. Create an FCA Authorisation for Crowdfunding and Peer-to-Peer Lending

A specific authorisation regime should be introduced by the Financial Conduct Authority to facilitate crowdfunding, peer-to-peer lending and other online direct investment facilities.

Introduction

The last ten years have seen an explosion of web-based businesses which offer investors the ability to invest directly over the internet in a range of different investment opportunities.

Where large crowds of retail investors supply small amounts of capital, the process has become known as "crowdfunding". Where a website is used to enable one investor to lend directly to another investor, the process has become known as "peer-to-peer lending". A variety of different models are developing rapidly. Each model holds in common the innovative use of the internet, as the medium through which opportunities are shared and investments are made. Each model tends to be independent and innovative and tends to use social networking as a means to boost interest.

The US is ahead of the UK in the development and regulation of direct finance businesses. The Obama administration has passed the aptly named "Jumpstart Our Business Start-Ups Act" or "JOBS Act", which was passed into law on 5 April 2012 following bipartisan support in the US Congress. The aim of the Act is to reduce financial services regulation to enable more businesses to access start-up capital. When it was introduced to the US Congress, the JOBS Bill exempted crowdfunding intermediaries from registration with the US Securities and Exchange Commission. However, the JOBS Act, as passed, will require crowdfunding intermediaries to register with the SEC.

Examples of crowdfunding and peer-to-peer lending sites in the UK include Abundance, BuzzBnk, Crowdcube, Ethex, Funding Circle, LendwithCare, MarketInvoice, Seedrs and Zopa. There are many more and we are aware of a number of others in development. The market is growing rapidly.

What is the problem?

Financial services law pre-dates the development of direct finance websites. There is therefore no single authorisation which contemplates the way direct finance websites operate. As a result, the majority of direct finance websites have taken advantage of a number of arcane exemptions from financial services regulation, which were created for purposes other than for direct finance.

This situation is far from desirable. The absence of a single authorisation creates significant uncertainty and significant barriers to entry for new entrants to the marketplace, as detailed legal and regulatory advice is needed in relation to whether or not authorisation is required for any particular type of direct finance business and, if so, what type of permission is required.

At present, there are a number of different regulatory analyses which need to be considered when analysing whether or not a direct finance business requires authorisation, including rules relating to accepting deposits, operating collective investment schemes and arranging deals in investments. The legal analysis involved is complex and costly and often does not yield certainty.

In addition, investors are often confused about whether or not FSA authorisation is required. In some but not all cases, where a regulated activity is being conducted, it is possible for FSA authorisation to be sought and obtained. For example, Seedrs has obtained FSA authorisation in relation to the operation of a venture capital business. However, this form of authorisation will not be appropriate or available for most direct finance businesses, which do not conduct such activity.

In the absence of a clear regulatory regime, investors will also continue to lack adequate protection.

What is the solution?

The Government should take a long-term view of the crowd-funding and peer-to-peer lending phenomenon and should aim to harness the movement to improve access to finance for start-ups and for social ventures of all descriptions. The Government should seek to create a clear and cohesive framework in which direct finance platforms can flourish and investors are protected. If regulated appropriately, direct finance is an area in which London and the UK could lead the world.

We believe that the Government should create a new form of regulated activity and therefore a new form of authorisation by the Financial Conduct Authority which relates to "operating a direct finance facility". As a rule, direct finance businesses act as intermediaries bringing together investors and investees and do not take balance sheet risk. The capital adequacy and other prudential requirements for operating a direct finance facility need not and should not therefore be onerous.

The authorisation process should be tailored to fit the nature and profile of direct finance businesses. Instead of being required to seek a form of authorisation which relates to an investment management activity, where there is the significant exercise of discretion and balance sheet risk, the authorisation process should be less burdensome and more straightforward.

The introduction of a regulated activity of operating a direct finance facility would enable more investment into direct finance businesses and would enable the market to grow. It would also lead to more direct investment on the part of retail and other investment into social ventures, as investors would be able to access more social venture investment opportunities. It would provide a safe and secure way of bypassing traditional financial institutions which are proving slow to provide the social investment opportunities which retail investors are seeking.

What are the next steps?

Using reforms to secondary legislation, the Government should aim to parallel the effect of the JOBS Act 2012 in the US to achieve an enabling legal and regulatory environment for direct finance.

The Government should reform the Financial Services and Markets Act (Regulated Activities) Order 2001 to introduce a new regulated activity of operating a direct finance facility. Any reform of the Regulated Activities Order should be dovetailed with reforms to the financial promotion rules, to enable ordinary retail investors access to direct investments into social and other ventures.

In response to the crowdfunding movement, the Government should also reform company law to clarify the extent to which private limited companies are able to raise small amounts of share capital through crowdfunding before being required to convert to public limited company status.

This recommendation is informed in part by our client work and in part by the submission of Zopa to the Disruptive Business Models theme of the Red Tape Challenge

4. Ensure Suitability Assessments Consider Social and Philanthropic Goals

The regulatory concept of 'suitability', which undergirds investment recommendations and discretionary management activity, should expressly include investors' social goals.

Introduction

The concept of 'suitability' is a key concept in the regulation of investment advice and investment management services. In regulatory terms, it is the critical test for whether or not a particular investment can be recommended to or made on behalf of a client.

The role of wealth management, put simply, is to enable a client to determine how much money he or she might wish to devote to any discrete area (e.g. retirement planning, giving, social investment) and to make a financial plan which reflects the client's 'lifetime cashflow'. Three constituent parts meet to compose the plan: the client's goals and aspirations, the wealth available to be deployed and the exposure to risk and capacity for loss the individual is prepared to accept. The aim is to enable a client to meet obligations and to meet financial needs as they fall due. In simple terms, assessing suitability in this way is a form of accounting, which also involves the diversification of investments as a tool to optimise a client's reward commensurate with risk.

Suitability is a broad concept which in many ways is deliberately open-ended, so that it can be adapted and interpreted for use and application in a variety of different factual contexts.

What is the problem?

There is a strong latent demand for social investment which is not being met.

An Ipsos Mori poll forming part of the research for Investing for the Good of Society, published by NESTA, revealed that 39% of wealthy individuals had an active interest in the social investment market and that when considering making investments 67% of wealthy individuals would be likely to invest in a financial product that benefits society as well as giving a good financial return.

However, the report Financial Planners as Catalysts for Social Investment, published by NESTA and Worthstone, reveals that the majority of wealth managers and financial planners do not consider or enquire about the amount of wealth clients may wish to give away or use for philanthropy or social investment as part of the financial planning or investment advisory process.

A number of legal and regulatory barriers prevent wealth managers and financial planners from advising on social investments. The regulatory concept of suitability is silent about social investment and encourages suitability to considered through a purely financial frame of reference. This leads to:

- perceptions of social investment as being high risk;
- social investment being excluded from professional indemnity policies; and
- firm compliance and risk policies screening out social investments.

What is the solution?

The FSA/FCA should in due course consider taking the following actions if, as expected, the social investment market continues to develop and grow:

- taking part in a dialogue with FSA accredited bodies and the investment advice profession about the interaction between professional standards with respect to social investment and the financial services regulatory system as a whole, specifically in relation to:

    - the general suitability of social investments;
    - the determination of a client's 'surplus' assets available for social investment;
    - approaches to social investment portfolio construction;
    - the development of model suitability questionnaires which include questions in relation to philanthropy and social investment;
    - the development of training and competence frameworks for advisers;
    - the development of appropriate systems and controls for authorised firms;
    - whether social investment should be seen as being within the meaning of "whole of market" advice for the purposes of the Retail Distribution Review;

- dedicating a new section of the FSA/FCA Handbook to social investment, to provide a regulatory perspective on social investments for the benefit of practitioners; and

- issuing a factsheet in relation to social investment, as a practical tool to aid the development of a basic understanding of social investment amongst practitioners.

What are the next steps?

The FSA/FCA should review its approach to the regulation of the social investment market and in particular in relation to the regulatory concept of suitability, as described above.

In the interests of integrating social investment with the financial services regulatory system across the EU, the European Securities and Markets Association should consider taking steps to clarify and confirm the compatibility of social investment with the overarching Markets in Financial Instruments Directive (MiFID) regime as it applies to a client's investment objectives.

The developing nature of social investment should be considered and appropriately acknowledged as part of the current MiFID review process. This could be done as part of the recitals to the revised MiFID or by incorporating appropriate reference to social investment in the main body of MiFID. This would be a positive development and would be wholly consistent with the agenda of the European Commission's recent Social Business Initiative.

This recommendation is derived in part from the working group report 'Advising Clients on Social Investments and Deciding on Suitability', convened by Big Society Capital and Worthstone

5. Use the Tax System to Incentivise Social Investment

A tax break for social investment generally and for community interest companies specifically is needed to level the investment playing field and encourage more social enterprise start-ups.

Introduction

As well as raising revenue to finance public spending, the tax system is used by Government to encourage positive behaviours and to discourage negative behaviours. It does this through levying tax on negative behaviours and by providing tax reliefs for positive behaviours.

Social investment is a form of investment behaviour which, by definition, is calculated to create positive benefits for society. However, the current tax system does not provide a social investment tax relief and so does not encourage the creation of positive social impact through investment.

The Problem

Unfortunately, the current tax system in the UK does not provide a level playing field for social investment. In fact, the tax system positively discourages social investment in a variety of ways.

Gift Aid rightly creates a strong incentive to give money to charities. However, one side-effect of Gift Aid is that it disincentivises the making of investments into social sector organisations generally.

The enterprise investment scheme (EIS) and venture capital trust (VCT) tax reliefs encourage direct and indirect investment into small and medium sized enterprises. The reliefs are designed, through the provision of relief in relation to a limited list of qualifying trades, to encourage investment for the benefit of the wider economy into businesses which have high growth potential.

However, EIS and VCT are available only for investment by way of purchase of ordinary shares. As the majority of social sector organisations are non-profit distributing, EIS and VCT are not therefore available for the majority of social sector organisations. In addition, there is currently no VCT product in existence which focuses on investment into social sector organisations.

In any event, EIS and VCT are designed to encourage SMEs with high growth potential and not to encourage investment into social sector organisations with high social impact potential.

Community investment tax relief (CITR) exists to incentivise investment via community development finance institutions (CDFIs) into SMEs in deprived communities. However, as currently designed, CITR only incentivises investment into social sector organisations which serve deprived communities and so, like EIS and VCT, it is not available for the majority of social sector organisations.

In summary, the tax system actively diverts finance away from investment into social sector organisations. As a result, as noted in the EU State Aid decision with respect to Big Society Capital, the Government estimates that there is an annual ‘finance gap’ for social sector organisations of £0.9-1.7 billion, when compared with small and medium-sized enterprises based on an analysis of the 2010 BIS Small Business Survey.

The Solution

A Social Investment Tax Relief

Government should seek to design a social investment tax relief (SITR) to incentivise investment into social sector organisations. The definition of a social sector organisation should, for this purpose, include all charities, community interest companies and community benefit societies. It could also include companies limited by shares and co-operatives which are able to demonstrate according to pre-defined criteria, which could be set out in subordinate legislation, that they operate primarily for a social purpose and only secondarily to provide a return to or benefits for shareholders.

It would be possible to create a SITR by expanding the scope of CITR to allow CDFIs to invest into social sector organisations generally and not only those operating in deprived communities. A reform of this kind would incentivise indirect investment via CDFIs into social sector organisations.

However, it would be preferable for Government to design a SITR which incentivises investment directly into social sector organisations. Government is willing to allow direct investments to qualify for EIS and so there is no reason why SITR should not be available for direct investments. Indeed, most social sector organisations are closely regulated and by definition have a social focus and culture and so present far less of a risk of abuse to the Exchequer than ordinary enterprises. In contrast to CITR, where the tax relief is ringfenced through the accreditation of CDFIs, SITR could essentially be ringfenced by the regulated status of the social sector organisation recipients.

A Tax Break for Community Interest Companies

In addition to a SITR, which is a tax relief for the benefit of the investor, there is also a need to alter the tax system to encourage the establishment of more community interest companies.

A CIC exists primarily for social benefit and not for shareholder benefit. An entrepreneur establishing a CIC accepts a set of restrictions on dividend distribution and on the payment of performance related interest. However, unlike a charity, a CIC receives no fiscal benefits.

To encourage the establishment of community interest companies and in recognition of the social benefit nature of the legal form, community interest companies should be granted a modest preferential corporation tax rate and a mandatory ratings relief which provides a signal and an incentive to entrepreneurs on start-up to choose a CIC structure. Given the fiscal situation, the tax system could be used as a meaningful signal now, with more generous reliefs to follow in time.

These preferential tax breaks could extend to companies limited by shares and co-operatives which operate primarily for a social purpose and therefore qualify, according to pre-defined criteria, as *"third sector organisations"* under the Dormant Bank and Building Society Accounts Act 2008.

Next Steps

The Government should set out proposals for a social investment tax relief and a tax break for community interest companies in the 2012 Autumn Statement for confirmation in Budget 2013.

6. Clarify the Investment Duties of Charitable Trusts

The law concerning the investment duties of charity trustees should be reformed to strengthen and expand the ability of charities to invest for social impact.

Introduction

There is a lack of clarity in law about the nature of charity trustee investment duties, which often acts as a significant barrier to innovative and creative investment approaches on the part of charity trustees, including the development of social investment approaches.

The common default assumption is that charities must invest for maximum risk-adjusted returns. This assumption is ill-founded and mistaken. However, this view is very prevalent. It is also often combined with the view that to engage in socially responsible, programme-related, social or mixed motive investment is in some way questionable and may open the trustees to the risk of challenge.

What is the problem?

The default approach to investment which emphasises maximum risk-adjusted returns stems in large part from the fact that the case law with respect to trustee investment duties relates in the main to private trusts and pension funds. It is generally assumed that the case law applicable to private trusts and pension funds, which generally emphasises the importance of seeking maximum risk-adjusted returns, is equally applicable by analogy to charitable trusts.

However, private trusts and pension funds are different to charities, as private trusts and pension funds exist for the benefit of specific individuals and so, when investing, private trust and pension fund trustees generally have a duty to balance the needs of present and future beneficiaries and this usually gets translated into a duty to pursue maximum risk-adjusted returns when investing assets.

In contrast to private trusts and pension funds, charities exist for public benefit and not to benefit a defined beneficiary class. Charities do not generally have long-term future liabilities which need to be met out of investment assets. With the exception of charities with permanent endowment, charities are also not generally obliged to invest assets and are even able to give away all their assets for no consideration provided this is done in advancement of charitable objects.

It follows that the public benefit nature of charities, the primacy of charitable objects and the general absence of any express or implied duty to seek to preserve capital, provides charities with a great deal more flexibility to be creative, innovative and strategic in making investment decisions in pursuit of responsible or social investment than is the case with private trusts or pension funds.

The leading case with respect to socially responsible investment by charities – the Bishop of Oxford case – which concerns the Church Commissioners, an exempt charity, is also not as helpful as one might expect when considering the freedom of charities to socially invest. The Church Commissioners are much more analogous to a pension fund trustees – given their specific obligations to provide for the financial needs of Anglican clergy. The Bishop of Oxford case also predates the rise of the modern social enterprise movement and the social investment market.

The Charity Commission guidance in relation to the investment powers and duties of charities and charity trustees, known as CC14, acknowledges the place of social investment. However, the guidance only represents the Charity Commission's view of the law. It is not itself the law and so is subject to challenge and may be overturned. As the underlying case law raises a variety of questions of interpretation, it is possible for different legal advisers to take different positions with respect to the investment powers and duties of charity trustees. Some advisers do not feel able to distinguish charities from pension funds or private trusts and do not feel confident enough to advise that social investment is compatible with case law on charity trustee investment duties.

What is the solution?

A statutory clarification of the investment duties of charity trustees, if done well, would yield significant benefit and could change the default mode of charity trustees with respect to investment from an investment modality which involves doing as others do to an intentional and distinctive approach to investment which has as its first point of reference the charitable objects of the charity.

A statutory clarification of charity trustee investment duties should clarify that:

- the investment powers of a charity are subordinate to the charitable objects of the charity;
- due to the primary importance of the charitable objects and the public benefit nature of charities, the investment duties of charity trustees are different to the investment duties of the trustees of private trusts and pension funds, which exist for private benefit;
- charity trustees should consider what exercise of the investment power is likely, in the opinion of the trustees, to best advance the objects of the charity, whether directly or indirectly through the generation of returns to apply to the charitable objects; and
- only charity trustees have the authority and discretion to determine which exercise of an investment power is most likely in the circumstances to best advance the objects.

A statutory clarification should also clarify that the same investment duties apply to all legal forms of charity and not only charitable trusts. At present, case law and the Trustee Act 2000 apply to charitable trusts only and are generally taken to apply by analogy to charitable companies.

Charity trustees should also be given a clear power to engage in social investment where:

- the expected financial returns are lower than available elsewhere on the market; and/or
- the investment risks are higher or less certain than available elsewhere on the market,
  provided that, in the view of the trustees of the charity, the expected social impact justifies the expected financial returns and the investment risks. The social impact of an investment should be understood in this context to mean the degree to which the investment is expected to:
- advance the objects of a charity; or
- support or contribute towards the advancement of the objects of a charity.

What are the next steps?

Lord Hodgson should recommend, as part of his review, that the investment duties of charity trustees should be clarified generally and bolstered with a specific social investment power.

If these recommendations are backed by Lord Hodgson's review of charity law, the Government should implement the recommendations in a Charity and Social Economy Bill.

7. Clarify the Investment Duties of Pension Funds

The law concerning the investment duties of pension fund trustees should be reformed to encourage consideration of environmental, social and governance factors.

Introduction

Pension funds have the ability to take a long-term view of what is in the best interests of their beneficiaries. The fiduciary obligations of pension fund trustees require pension fund trustees to act responsibly and in the interests of beneficiaries, as opposed to acting in their own interests.

What is the problem?

Unfortunately, the fiduciary duties of pension fund trustees are generally interpreted as requiring pension fund trustees to focus on maximising short-term returns and are often invoked to discourage consideration of wider ownership and stewardship responsibilities, which permit a more rounded and holistic view of the general environmental and social wellbeing of beneficiaries.

This narrow (mis)interpretation of fiduciary duty leads to a "herd mentality" or "groupthink" approach to investing, which involves focussing on financial benchmarks and neglecting other factors which contribute to the quality of life beneficiaries can expect on retirement. In turn, the perception that the fiduciary duties of pension fund trustees require a focus on financial factors only often leads to the view that ethical investment and social impact investment are not permitted.

What is the solution?

A statutory codification of the investment duties of pension fund trustees would set out the responsibilities of pension funds as asset owners to consider and have regard to environmental, social and governance issues generally and would clarify and confirm the power of pension funds to take a rounded view of what is in the interests of beneficiaries.

Any codification should encourage pension fund trustees to consider the impact any investment approach is likely to have on the financial system, the economy and on the quality of life of beneficiaries and should require pension funds to consider the ethical views, if any, of beneficiaries.

A statutory codification should also expressly encourage concerted action between pension funds on environmental, social and governance matters of joint interest, where joint action can make a difference and would be in the joint interests of beneficiaries but individual action by any one pension fund may not be in the interests of its beneficiaries or may be unlikely to make a difference.

A codification would apply, with appropriate qualifications and exceptions, to the different categories of pension funds and would apply to all types of investments owned by pension funds.

What are the next steps?

The Government should codify pension fund trustee duties in primary legislation and should require trustees to ensure that any investment managers act in accordance with such duties.

This recommendation is derived from 'The Enlightened Shareholder' report published by Fair Pensions in 2012

8. Encourage the Growth of a More Social Economy

Company law and co-operative law should be reformed to encourage the formation of more start-up companies with a social purpose and more new co-operatives.

Introduction

In the ecosystem of legal forms, the company limited by shares is the most dominant. Companies limited by shares far outnumber other legal forms within the general economy and are by far and away the largest contributors to gross domestic product. The company limited by shares is the main legal form chosen by entrepreneurs and investors when starting a new business.

The company incorporation process generally assumes that an entrepreneur starting-up a new business and the shareholders investing in it have exclusively financial motivations and interests. There is an opportunity to harness the company limited by shares model to create social value.

The process of incorporating a company at Companies House does not encourage the establishment of companies with an embedded social mission or purpose. Most entrepreneurs starting-up a business will be unaware of the possibilities of incorporating as a community interest company (CIC) or as a co-operative or of incorporating a social purpose into the Articles.

Problem

Entrepreneurs setting-up new ventures will often have a range of motivations and interests, which are likely to be partly financial and partly social and will fall somewhere along a spectrum from a charity at one end of the spectrum to a full for profit company at the other end of the spectrum.

The company incorporation process does not prompt entrepreneurs to consider whether it would be appropriate to embed social purpose in the constitution of the company on incorporation. There are no incentives to embed social purpose and there is no clear menu of options from which to choose. In addition, from the perspective of investors or analysts, the Register of Companies does not provide any means by which 'pro-social' companies can be identified.

There is a lack of options to choose from where an entrepreneur or shareholders wish to embed social purpose in some form but do not wish to accept the asset lock and profit distribution restrictions of a CIC. The CIC is more restrictive than it needs to be and is not an ideal legal form for social investment. The cap on dividends, for example, operates in relation to the initial par value of shares and does not properly account for the potential of the company to grow significantly in value.

A budding social entrepreneur might reasonably expect upside from the personal investment of sweat equity and will often baulk upon hearing that, in the case of a CIC, an increase in the capital value of the business will be captured by the CIC asset lock for a social purpose. Similarly, social investors looking to invest for financial and social returns might find it hard to generate returns in the present UK social economy, as the CIC form limits equity upside.

Without reform, there is a risk that the UK will fall behind other jurisdictions, such as the US, which is developing a range of hybrid legal forms, including flexible purpose corporations, benefit corporations and low profit limited liability partnerships, to harness capitalism for social impact. Each of these legal forms facilitates the pursuit of wider social benefits alongside investor value and none of these legal forms have asset locks or express limits on dividend distributions.

Finally, co-operative law in the UK remains neglected and has not received the attention it deserves. Whilst company law is updated on a regular basis to ensure that UK companies remain competitive in a modern world, co-operative law is based largely on a model which dates from 1948. The Mutual Societies Division of the Financial Services Authority operates on the basis of a paper register which puts the mutual sector at a distinct disadvantage. It is not a modern or efficient registrar and is not a priority area for the Financial Services Authority in the context of its other regulatory functions.

Solution

Company law

The company incorporation process should be re-designed to create a ‘ladder’ of options for entrepreneurs and shareholders setting up new companies with an element of social purpose. The aim should be to shift the default position from the assumption that entrepreneurs and shareholders have purely financial interests to a new default which encourages the adoption of some social purpose alongside profit but which allows entrepreneurs and shareholders to opt-out.

Entrepreneurs and shareholders should be incentivised and nudged into adopting companies with an element of social purpose. One possible incentive would be the availability of a separate designation. Companies which have as one of their principal objects the advancement of a purpose which is for community benefit, broadly defined, should be given a different designation and suffix.

Instead of being simply a “limited company”, a new designation could be used to reflect its hybrid nature, such as a “social benefit company” or a “social value company”. Instead of “Ltd” or “limited”, a different suffix could be used, such as “SBC” or “SVC”. A modest incentive like this would increase the number of companies forming with an element of social purpose. Eligibility for a separate designation could be supported with additional governance requirements, such as reframed directors’ duties, requirements for independent directorship and transparent social reporting. Model articles should be created to make it as easy as possible for such companies to be formed.

Companies with an element of social purpose should be separately identifiable based on a search of the Companies House register, to make it easy for impact investors to identify pro-social companies.

Any such pro-social companies would not be classed as social enterprises according to the standard definitions applied by Government, Social Enterprise UK or the Social Enterprise Mark. However, the growth of more consciously pro-social companies would increase opportunities for finance-first impact investing and would strengthen and deepen the impact investment market as a whole.

Community Interest Company

The Government and the CIC Regulator should review CIC legislation and the operation of the dividend caps for CICs, with the express aim of creating the most social investment friendly legal form possible, one that is a ‘third sector organisation’ for the purposes of the Dormant Bank and Building Society Accounts Act 2008 but is no more restrictive than that definition requires.

Any such review would be likely to involve a relaxation of the dividend cap for CICs limited by shares to allow a higher percentage of distributable profits to be distributed and to allow a percentage of surplus capital (excluding any assets granted to a CIC) to be distributed to shareholders on a winding-up. We would suggest a cap of 40% of distributable profits and 40% of surplus capital on winding-up, to make the form more attractive to social investors whilst retaining a clear social focus. It would also be likely to involve a move away from solely linking the distribution caps to the initial par value of shares to an alternative cap which either removes reference to the initial par value of shares or which permits a substitute reference to the fair value of shares, certified by an accountant. Any relaxation in the dividend caps could be matched with stronger governance requirements, such as a quorum of independent directors and some form of social reporting.

Any reforms introduced should be engineered to be capable of being compatible with modest tax breaks for CICs, which should be designed in part to encourage more CICs to be established.

Co-operative law

The law relating to co-operatives and community benefit societies should be reviewed and updated. Entrepreneurs and investors wishing to establish a new company should be presented with the option of establishing a co-operative or a community benefit society, to raise awareness and to encourage the adoption of these mutual legal forms, where appropriate. As far as possible, the process of establishing a co-operative or community benefit society should be made as easy as the process of incorporating a company and it should be one option on a menu of available choices.

Instead of the proposed Co-operative Consolidation Bill, which will simply bring the law as it applies to co-operatives and community benefit societies into one place and clarify minor anomalies and inconsistencies, the Government should aim to update and modernise the law of co-operatives and community benefit societies, with the aim of making a co-operative or a community benefit society as attractive as possible, by making the forms as easy to set-up and run as a company legal form and by making the Register of Mutual Societies as accessible as the Register of Companies.

Next Steps

The company incorporation process should be re-designed to create a 'ladder' of options for entrepreneurs and shareholders setting up new companies with an element of social purpose.

The Government should provide a new company designation and a new company suffix to incentivise the creation of more start-ups with an embedded social purpose. The aim should be to create a new default position which encourages the adoption of some social purpose alongside profit in new companies but which allows entrepreneurs and shareholders to opt-out.

The Government and the CIC Regulator should review CIC legislation and the operation of the dividend caps for CICs, with the express aim of creating the most social investment friendly legal form possible, one that is a 'third sector organisation' for the purposes of the Dormant Bank and Building Society Accounts Act 2008 but is no more restrictive than that definition requires.

The Government should replace plans for a Co-operative Consolidation Bill with plans for a Co-operatives Reform Bill which would both consolidate legislation and update co-operative law.

9. Create a Social Investment Fund Structure

A model social investment fund legal structure should be created to enable Government, charities and other investors to more easily invest in structured funds for social impact.

Introduction

Investment fund structures can take a wide range of legal forms, from limited partnerships, limited liability partnerships, unit trusts, open ended investment companies and many others.

At this point in the development of the social investment market in the UK, all the major social investment funds in existence or in development – Big Issue Invest, Bridges Social Entrepreneurs Fund, the Peterborough Social Impact Bond – are structured as limited partnerships. Not one of those limited partnerships is established as a structured fund.

At present, there is no bespoke legal form for a social investment fund. As a result, the roughly £60-100 billion of assets held by charitable trusts and foundations in the UK are not being deployed by charities to leverage more private investment into the social economy.

What is the problem?

There is no existing legal form which permits charities to invest capital in the same investment fund as more commercial sources of finance but on a subordinated basis for differential returns. Existing fund structures do not allow charitable funds to leverage non-charitable funds.

There are a number of specific barriers to the establishment of structured funds for social impact. These barriers include:

- Charity law – which prevents charities from providing private benefit to individuals or businesses. However, the law on private benefit is ill-defined and creates uncertainty.
- Tax law – which does not clearly define the boundary of qualifying investments for charities.
- Transaction costs – to create a structured fund with charitable and commercial sources of finance, extensive negotiations with HMRC and the Charity Commission and significant professional services costs are likely to be required. A ‘white labelled’ structure is needed.
- Risk – the lack of regulatory clarity prevents structured funds from being established.

There is also a risk that there will be a serious conflict of interest between investment monies chasing a financial return in social contexts and the social enterprises which receive the investment. A social enterprise does not exist to maximise returns to investors and yet traditional investment fund structures and management arrangements generally do exist to maximise returns to investors.

What is the solution?

A bespoke social investment fund legal structure (a “Social Investment Fund”) should be created, through the adaptation of existing fund partnership law, which would allow for the compliant and low cost co-mingling of charity, public and private investment in a manner that respects the public benefit obligations of charities and which therefore places appropriate limits on private benefit.

A Social Investment Fund would allow charities to take subordinated positions in investment structures in a way that satisfies Charity Commission and HMRC requirements by placing appropriate fiduciary obligations on managers to protect and implement the social mission of the fund. A structure of this kind would be a white labelled product which would automatically enable charity investors to comply with charity law requirements and so remove tax and regulatory uncertainty.

A Social Investment Fund would enable charity and public monies to leverage more private monies into the social economy for social impact. It would reduce transaction costs for social investment fund establishment and social investment and would be the first and only bespoke social investment fund structure in the UK. If designed well, it would also have the potential to give the UK a comparative advantage over other jurisdictions and could be the foundation of a new social investment fund management industry centred on the UK.

A Social Investment Fund would have a number of key characteristics. It would exist for the purpose of generating social as well as financial returns. It would be a variant of an existing fund partnership structure, such as a limited partnership or a limited liability partnership, as these fund partnership structures are tax transparent. A Social Investment Fund could be regulated by an expanded CIC Regulator with respect to its social purpose.

If a Social Investment Fund is created, it would have the potential to help outcome-based finance, including social impact bonds. It would also facilitate investment in public sector spin-outs and mutuals and would support the localism agenda, especially community right to buy and community right to challenge. It would generally encourage investment in social enterprises and it would have the potential to strengthen the UK as a global hub for philanthropy and social investment.

Importantly, the interests of the managers of a Social Investment Fund would be more closely aligned with Government than traditional financiers, as the managers of a Social Investment Fund would be expressly tasked with generating positive social impact as well as financial returns. Social Investment Funds would have application in local contexts by local authorities and other public spirited investors, such as for the financing of schools and hospitals, as well as in development contexts, such as in relation to private sector investment funds sponsored by development agencies.

In summary, a Social Investment Fund would be the first social enterprise fund structure.

What are the next steps?

The Government should establish a high-level working group including funds lawyers, tax experts, investment managers, charity and social investment experts and development professionals. The working group should be tasked with devising the ideal social investment fund structure for investment on a structured basis for social impact in a range of national and international contexts.

The Government should act on the specific technical recommendations of the working group to amend either the Limited Partnerships Act 1907 or the Limited Liability Partnership Act 2000 to create a bespoke social investment fund structure with the general characteristics described above.

The idea of a bespoke social investment fund vehicle, which has been described as a 'Social Enterprise Limited Liability Partnership', is the inspiration of Stephen Lloyd, Michael Webber and Arthur Wood

10. Convert the CIC Regulator into a Social Economy Commission

The registration of co-operatives and community benefit societies should be moved to Companies House and the CIC Regulator, to create a new Social Economy Commission.

Introduction

The Government is searching for ways to grow the 'social economy', meaning that part of the economy which is characterised by social purpose or which is democratically or community owned.

The social economy is incredibly diverse in legal status and legal form. The social economy comprises charities (which in turn come in a number of legal forms), co-operatives, community benefit societies, community interest companies, companies limited by guarantee, companies limited by shares with a social purpose, unincorporated associations and many others.

There is neither one Government department nor one registrar or regulator of legal forms which has responsibility spanning the range of organisations in the social economy in the UK.

What is the problem?

The policy context and regulatory framework for the social economy is fragmented and incoherent.

Departmental interest in the social economy span a number of Government departments, including the Office for Civil Society in the Cabinet Office, the Department for Communities and Local Government, the Department of Health, the Department for Education, the Department for Business, Innovation and Skills, the Department for Work and Pensions and HM Treasury.

There are also a number of principal regulators or registrars for organisations operating in the social economy, including the Charity Commission, the Office of the Regulator of Community Interest Companies, Companies House, HM Revenue and Customs and the Financial Services Authority.

The fragmentation of Government departmental interest and responsibility leads to ad hoc and piecemeal policymaking which fails to account for the diversity or complexity of the social economy. It also means that Government departments are often failing to fully co-ordinate policy agendas for the social economy or, at worst, are pursuing conflicting agendas for the social economy.

The absence of any one regulator with a full social economy brief means that there is a critical absence of deep regulatory or policy knowledge or understanding of the issues and needs of the social economy as a whole. This means that the interaction between the regulatory function and the policy development process is also seriously weakened, as Government departments receive conflicting messages or partial pictures from each of the regulators.

Each regulator is also incentivised to take a narrow view of what is part of its regulatory brief and no regulator is incentivised with taking steps to assist Government to grow the social economy. It is also the case that the registration of co-operatives and community benefit societies is a very low priority for the Financial Services Authority and does not fit well with its wider objectives.

What is the solution?

The Government should convert the Office of the Regulator of Community Interest Companies into a 'Social Economy Commission', as the principal regulator of the social economy, with a policy and regulatory brief spanning as far as possible across the social economy.

The Social Economy Commission should be the registrar and regulator of community interest companies, co-operatives and community benefit societies. In time, the Social Economy Commission could also be given responsibility for the registration and regulation of Social Investment Vehicles and of Social Purpose Businesses or other social purpose organisations, if introduced.

It would be a repository of deep and wide regulatory and policy knowledge with respect to the social economy as a whole. The Social Economy Commission would provide Government departments and other regulators with an authoritative view of what is in the best interests of the social economy. It would be able to liaise with, for example, the Prudential Regulation Authority and the Financial Conduct Authority with respect to financial services regulation, including any revision of the financial promotion rules or regulated activities, and with HM Revenue & Customs with respect to tax, including the administration or refinement of the form of any future social investment tax reliefs.

The Social Economy Commission would also be able to provide impartial information and guidance about the different legal forms which are available for organisations wishing to operate in the social economy, including new public service mutuals and new social enterprise start-ups. It would be obliged to be neutral on the question of legal form and would not promote one legal form over another. However, it would be in a position to set out in a dispassionate way the advantages and, most importantly, the disadvantages of different legal forms.

This ability to discriminate between different legal forms would be invaluable for entrepreneurs and public servants setting up new mutuals and social enterprises and would be an important resource for policymakers and public authorities engaging with the social economy generally.

The Social Economy Commission would exist alongside the Charity Commission, which would continue to register and regulate charities as it does currently, but there would need to be a close interaction between the two regulators. An obligation should be placed on the Charity Commission and on the Social Economy Commission to work together to grow the social economy generally.

What are the next steps?

As a first step, the Government should transfer the responsibility to register co-operatives and community benefit societies from the Financial Services Authority to Companies House and the CIC Regulator. The CIC Regulator should be given expanded powers for the registration and regulation of co-operatives and community benefit societies, to create a new Social Economy Commission.

Policy responsibility for co-operatives and community benefit societies should be moved from Treasury to BIS, which would be able to ensure all social economy legal forms operate on as level a playing field as possible. The Financial Conduct Authority and Prudential Regulation Authority would continue to regulate the financial services aspects of social economy organisations.

Selected Further Reading

Advising Clients on Social Investments – Deciding on Suitability
Big Society Capital and Worthstone, 2012

European Commission State Aid Decision regarding Big Society Capital
SA33683, 2011

Financial Planners as Catalysts for Social Investment
Anthony Elliot, Gavin Francis and Geoff Knot, published by NESTA and Worthstone, 2012

Growing the Social Investment Market: A Vision and Strategy
The Cabinet Office, HM Government, 2011

Impact Investments: An Emerging Asset Class
Nick O'Donohoe, Christina Leijonhufvud and Yasemin Saltuk, JP Morgan, 2010

Investing for the Good of Society: Why and How Wealthy Individuals Respond
Anthony Elliot, published by NESTA, 2011

Investing in Civil Society: A Framework for a Bespoke Regulatory Regime
Luke Fletcher, published by NESTA, 2011

Lessons from the World of Microfinance
CAF Venturesome, 2011

Lighting the Touchpaper: Growing the Market for Social Investment in England
Adrian Brown and Will Norman, 2011

Review of the Charities Act 2006: Submission on Social Investment
Bates, Wells & Braithwaite, 2012

The Enlightened Shareholder: Clarifying Fiduciary Duties
Christine Berry, Fair Pensions, 2012

The Third Sphere: How Impact Investing Could Become the Next Big Opportunity for the Luxembourg Finance Industry
Price Waterhouse Coopers, 2011

About the Authors

Stephen Lloyd

Stephen Lloyd is the Senior Partner of Bates Wells & Braithwaite, the leading charity, social enterprise and social finance law firm. Stephen has advised organisations engaged in social finance related transactions and activities for over 15 years, including CAF-Venturesome, Bridges Ventures, UnLtd, NESTA, ClearlySo the Esmée Fairbairn Foundation and most recently Big Society Capital.

He came up with the idea of the community interest company, of which there are, at the time of writing, approaching 7,000. Amongst Stephen's many pursuits, he is on the board of BuzzBnk, the social crowdfunding website, and is a director of the Social Stock Exchange. In 2012, Stephen was appointed by the Cabinet Office as the charity law advisor to Lord Hodgson for the review of the Charities Act 2006 and as a civil society champion for the Government's Red Tape Challenge.

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Luke Fletcher is a Senior Associate at Bates Wells & Braithwaite and co-ordinates the firm's Social Finance Group. Luke specialises in advising charities, co-operatives, community development finance institutions, credit unions, social investors, social enterprises and social businesses on a wide range of social finance structures and transactions. He recently advised on the structuring and establishment of Big Society Capital and is the company secretary of the Social Stock Exchange.

Luke is the author of the policy paper *'Investing in Civil Society: A Framework for a Bespoke Regime'*, commissioned and published by NESTA. In 2011, Luke was seconded to the Cabinet Office to advise the Government on steps it could take to remove legal and regulatory barriers to the growth of social investment. In 2012, Luke has been appointed a civil society champion for the Government's Red Tape Challenge and a social investment advisor to the City of London Corporation.

About Bates Wells & Braithwaite

Bates Wells & Braithwaite is a leading law firm in the fields of charity, social enterprise and social investment.

BWB has a long history of advising upon the full range of social investment related activities and transactions, including secured and unsecured lending, equity investments, fund establishment and operations, intermediary activity, financial services and public investment offerings.

Clients include investment advisors and intermediaries, charities, social enterprises, co-operatives, credit unions, community development finance institutions, banks, social lenders, social investors and venture philanthropists. For more information visit www.bwbllp.com .

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