

# INVESTING IN CIVIL SOCIETY

A framework for a bespoke regulatory regime

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# INVESTING IN CIVIL SOCIETY

## A framework for a bespoke regulatory regime

### 1. Introduction and summary

To date, there has been no attempt on the part of government to create a tailor-made regime for community and social finance activity. This position paper sets out how a proportionate social finance legal and regulatory regime could be established, to enable the Government to achieve its policy objectives of growing the social investment market and making the Big Society Bank a success.

The activities of social financiers sit uneasily between, on the one hand, the world of charity, social enterprise and community action and, on the other hand, mainstream financial services. In legal terms, social finance is often found in the midst of a regulatory muddle between the law as it applies to charities, social enterprises and community groups and mainstream financial services regulation. Unfortunately, there is currently no such thing as *'the law of social finance'*.

The legal form of the community interest company was made available on 1 July 2005 and addressed the need for a tailor-made, by definition, non-charitable social enterprise in a company form. There has been a rapid take-up – already, over 4,700 have been incorporated – and community interest companies now form an essential part of the social enterprise movement.

In the same way, there is a serious need for law and regulation to recognise the special characteristics of social and community finance investment offerings and activity. At the moment, the cost of compliance with mainstream financial services regulation is often prohibitive and prevents or seriously delays much necessary and important social finance activity from taking place.

This position paper sets out and explains:

- The current community and social finance

policy context.

- The mainstream financial services law and regulation applicable to community and social finance activity.
- The problems and risks associated with existing law and regulation.
- Some guiding principles to consider when designing a new regime.
- Some key conclusions reached during consultation with social financiers.
- An outline of a proportionate social finance legal and regulatory regime.
- A series of recommendations for policymakers.

The primary focus of this paper is on the law of financial promotions but we also discuss other related areas of law and regulation in urgent need of reform.

The principal recommendations we make to Government are as follows:

- The Government should issue a consultation on proposals to establish a bespoke regime for community and social finance, in the form of a stand-alone piece of subordinate legislation to the soon-to-be-amended Financial Services and Markets Act 2000, concerned solely with community and social finance activity (the 'Community and Social Finance Order').
- The proposed Community and Social Finance Order should set out a co-regulatory framework, involving the establishment of new community and social finance standards boards which would include representatives of the community and social finance sectors, to set mandatory and best practice standards for

community and social finance (the ‘Standards Board’).

- A new independent office-holder should be established to oversee the co-regulatory framework set out in the proposed Community and Social Finance Order, to review and approve the practice standards articulated by the proposed Standards Board and to act as a registrar for community and social offer documents (the ‘Social Finance Regulator’).

The co-regulatory regime we propose fits within the existing financial services legislative framework and, critically, would not require significant Government expenditure. The Social Finance Regulator would have a limited but important public function, which could be carried out by a very small team at minimal cost, whilst reducing the regulatory work and costs of the successor organisation to the Financial Services Authority, the Financial Conduct Authority.

The bespoke regime we propose also protects investors by ensuring that a public official is charged with the responsibility for ensuring that practice standards set by the community and social finance sectors are appropriately protective of investors. Investor protection could be achieved by the Social Finance Regulator requiring certain minimum protections, for example:

- Mandatory risk warnings.
- A process of self-certification of risk tolerance on the part of investors.
- Declarations on the part of promoters of community and social finance offerings, to raise the standard and quality of offer documentation.

## 2. Policy context

On 14 February 2011, the Cabinet Office released a strategy paper entitled *Growing the Social Investment Market: A Vision and Strategy*.

The strategy paper sets out the Government’s vision of a thriving social investment market where social ventures can access the capital they need to grow, allowing them to do more to help build a bigger, stronger society.

In the strategy paper, the Cabinet Office announced that it wishes to “seek further

*evidence on the impact of the regulatory framework on social and community investment to assess whether it is proportionate*”, with particular reference to the rules governing the communication of financial promotions and the costs of investment offerings which are communicated by civil society organisations to the public.

Prior to the launch of the strategy paper, as a firm, we participated in discussions with the Cabinet Office, HM Treasury and the Financial Services Authority with respect to ways in which a bespoke legal and regulatory regime for community and social finance could be created, to aid the development of the social investment market.

On 17 February 2011, HM Treasury published a second consultation paper on the reform of the financial services framework entitled *A new approach to financial regulation: building a stronger system*. The Government intends to publish a White Paper with draft primary legislation for parliamentary pre-legislative scrutiny in the spring of 2011. Responses will feed into the Government’s White Paper and draft Bill, which will be published in the spring of 2011. The Government has committed to continue to adopt an open and consultative approach as the reform programme moves into its legislative stages.

## 3. Financial Services Authority

The Financial Services and Markets Act 2000 (FSMA) established the Financial Services Authority (FSA) as the independent regulator of financial services.

Under FSMA, the FSA has as its core statutory objectives:

- Market confidence – maintaining confidence in the UK financial system.
- Financial stability – contributing to the protection and enhancement of the stability of the UK financial system.
- Consumer protection – securing the appropriate degree of protection for consumers.
- The reduction of financial crime – reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

The FSA is guided by a number of principles of good regulation when discharging its functions. These principles of good regulation include:

- Acting in a proportional way.
- Facilitating innovation in connection with regulated activities.
- Facilitating competition between regulated firms.

As well as being the primary regulator of mainstream financial services, the FSA is also the primary regulator of community finance and social finance activity.

It is proposed that, in respect of the regulation of conduct in financial services, the FSA will be replaced with the Financial Conduct Authority (FCA). It is proposed that the FCA will have a single strategic objective of *“protecting and enhancing confidence in the UK financial system”*.

It is proposed that the FCA’s operational objectives will be:

- Facilitating efficiency and choice in the market for financial services.
- Securing an appropriate degree of protection for consumers.
- Protecting and enhancing the integrity of the UK financial system.

It is also proposed that the FCA will be required, so far as is compatible with its objectives, to discharge its general functions in a way which promotes competition.

#### 4. Financial promotions

A financial promotion is an invitation or inducement to engage in investment activity.

Under FSMA, 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.

The exemptions available to the general prohibition on financial promotions are primarily set out in the Financial Promotion Order. A deliberate breach of the general prohibition on financial promotions amounts to a criminal offence.

A separate European-level regime applies under the Prospectus Directive in respect of investment offers in excess of €2.5 million unless a relevant exemption applies. An amending Directive will soon increase the Prospectus Directive threshold to €5 million.

Most community and social finance offers will not cross the new €5 million threshold and, as now, will tend to be subject to the domestic UK-wide financial promotions regime. A small number of community and social offers may exceed this threshold and, if not exempt, will need to be compliant with the Prospectus Directive.

##### 4.1 Investor exemptions

Some of the most commonly used exemptions set out in the Financial Promotion Order allow for investment by high net worth institutions, high net worth individuals, sophisticated investors and investment professionals.

These exemptions are focussed on the nature and identity of the investor. In policy terms, these categories of investor are considered sophisticated enough to be able to determine the risks which apply to potential investments for themselves and are not considered to need the protection of the Financial Promotion Order.

These exemptions are not wide enough to enable ordinary members of the public to invest in community and social investment offers, as it is rightly understood that ordinary members of the public are not necessarily sophisticated enough to understand the risks associated with investment and require more protection.

##### 4.2 Legal form exemptions

There are also exemptions which are available to certain types of legal structures, namely industrial and provident societies in their two forms: co-operatives and societies for the benefit of the community.

These are traditional exemptions which focus on the legal form of the investee organisation and date from a different era when there was a much less well developed concept of socially focussed finance.

It seems that the rationale for these exemptions is based on the fact that co-operatives and

community benefit societies have historically been considered to be largely local, community-based organisations and there seems to be a policy assumption that investors will know the risks associated with investment into co-operatives and community benefit societies on the basis that investors will have established personal associations with the relevant co-operative or community benefit society.

Industrial and provident societies are therefore sometimes presented as the preferable social investment vehicle, when this may not be true by reference to a range of factors other than regulatory treatment of investment offerings.

These exemptions do not extend to providing permission to ordinary members of the public to invest in community and social investment offers issued by civil society organisations other than co-operatives and societies for the benefit of the community.

#### 4.3 Common interest group exemption

There is an exemption for a ‘common interest group’, which is defined as *“an identified group of persons who at the time the communication is made might reasonably be regarded as having an existing and common interest with each other and that company in (a) the affairs of that company and (b) what is done with the proceeds arising from any investment to which the communication relates.”*

The common interest group exemption is of uncertain scope, but appears intended to allow a small group of connected persons who wish to embark on something akin to a joint venture to communicate financial promotions to each other without the need for the communication to be authorised. It is close to amounting to a ‘community exemption’ but the requirements that the recipients of the communication be ‘an identified group of persons’ and that there be a connection with ‘a company’ are too narrow to exempt community investment or social investment in settings where it is not possible to say in advance who all the recipients of the offer will be.

## 5. The problem

There is no compelling reason why financial services law should provide exemptions for the legal forms of co-operatives and societies for the benefit of the community but not for charities or community interest companies or other civil society organisations.

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 by means of investment – potentially a less risky form of support, as capital is due to be returned – even if the primary motivation of the investor is to support the organisation and not to obtain a financial return.<sup>1</sup>

Different considerations apply to community and social finance as compared with mainstream finance, as the motivations of investors are usually mixed and so the consumer protection imperative is very different. Social investors will not necessarily be relying to the same extent or in the same way on there being a financial return and will usually have a very different view of the relative level of risk, and so full compliance with mainstream financial services regulation, which does not contemplate social or community investment, will not be appropriate in most cases.

In addition, there is no regulation in the mainstream financial services regime of the community or social claims which may be made in community and social offers.

So, in effect, at the moment, community and social finance activity is either subject to no regulation and/or it is overregulated, when proportionate regulation focussed on the distinctive characteristics of this type of investment is what is required.

#### 5.1 Costs of authorisation

To approve an investment offer, an authorised person will need to review or draft the investment offer, verify underlying statements of fact and challenge and question statements and claims. This involves a process of due diligence and multiple revision of offer documentation, often in consultation with a number of parties. It is very easy for the costs involved to rise into multiples of thousands of pounds in specific cases.

Anecdotally, we have heard colleagues in the legal marketplace in financial services seminars indicating that average law firm costs for approving a financial promotion are in the region of £50,000 plus VAT. Law firms servicing the social sector will invariably have lower costs but there is a limit to the ability of firms to lower costs when one considers the reputational and regulatory risks which attach to approval.

Whilst mainstream commercial organisations may be able to bear the professional fees involved, these costs are usually not justified for social and

community projects conducted by community and social enterprises seeking to raise relatively small amounts of finance from their supporter bases. Specific regulation of community and social investment should lead to proportionate regulation and proportionate cost.

### 5.2 Legal form

Given the range of legal forms available to and adopted by civil society organisations, the majority of existing civil society organisations are unable to take advantage of the exemptions available to co-operatives and community benefit societies and so are often in practice prevented from making community or social investment offers to members of the public, due to the costs of obtaining offer document authorisation.

Choosing the right legal structure is critical to the development of any organisation, particularly community and social enterprises, which often need to think very carefully about how they ought best to engage a variety of stakeholders – often involving more complicated governance structures than is usual in mainstream commerce – and how they will in future access finance to grow and develop.

Many community and social enterprises struggle because they choose the wrong legal structure and are unable to balance the competing interests of different stakeholder groups or to obtain appropriate development finance when the business needs to grow and scale-up. The co-operative and community benefit society forms will be suitable in some circumstances but these legal forms will not be appropriate for all community and social enterprises, particularly where the circumstances require a legal form which is not mutually owned for mutual benefit or there are other technical reasons which require another specific legal form.

As a result, many new community and social enterprises are being established as charitable companies limited by guarantee or occasionally by shares, non-charitable companies limited by guarantee, community interest companies limited by shares and community interest companies limited by guarantee, as well as other legal forms.

### 5.3 Investor motivation

The financial promotions rules do not currently contemplate investors who are motivated by community or social value. It is assumed that the motivation of investors will be exclusively financial and to this extent community and social offers must be fully compliant with mainstream regulation.

However, to the contrary, the motivation of community and social investors is often concerned at least in part with building and developing community or with supporting and furthering a cause as much or more than the expectation or possibility of financial return. There is no provision for investor motivation in the existing rules, which do not focus on the potential community, social or charitable purpose or activity of the investee. The law in this area has failed to keep pace with civil society.

There is no requirement for ‘invitations or inducements to donate monies’ to be approved by a person with regulatory authorisation. It is difficult to see therefore why the law should require full financial regulation of ‘invitations or inducements to engage in community or social investment’, where there is a social motivation, provided the investment risks are clear to potential community or social investors.

### 5.4 Consumer protection

The primary concerns of HM Treasury and the Financial Services Authority with respect to the idea of community and social investor exemptions appear to be related to consumer protection issues and the perceived risk of mis-selling.

To be able to allay these legitimate concerns, which also apply in the context of exempt co-operative and community benefit society offerings, it is imperative that any community and social investor regime includes proportionate protections which effectively remove any material risk of consumer detriment.

## 6. Proportionate regulation and social finance regulated activity

Financial services regulation generally does not contemplate community and social finance activity in a co-ordinated or cohesive way. There is no stand-alone bespoke regime for community and social finance and investment.

In practice, this often means that community and social enterprises and entrepreneurs struggle to understand financial services law as it applies to them and this often necessitates independent legal advice and increases costs, when a bespoke regime could be much simpler to understand. There is also in all probability a significant amount of worthwhile community and social activity which is not fully compliant with the existing ill-fitting and disproportionate regulatory regime.

A bespoke community and social finance regime could be created, for example, by carving out certain forms of community and social finance activity from the Financial Promotion Order and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (Regulated Activities Order).

The Regulated Activities Order sets out certain categories of financial services activity which are regulated and require authorisation by the Financial Services Authority, such as advising on investments and arranging deals in investments.

With respect to community and social investment offers which are exempt from the Financial Promotion Order, it would be possible to articulate certain forms of regulated activity which attach directly to the financial promotions exemptions in such a way as to create a new category of 'social finance regulated activity'.

This would allow the creation of a new category of social finance FSA authorised persons who could, for example, advise on and arrange deals in community and social investments, and would enable recognised intermediaries in the social investment space to advise on and arrange deals in social and community investments without the need for full, mainstream FSA authorisation, reducing costs and aiding market development. It would also be possible in theory to create a new form of social finance authorisation to enable appropriate social finance intermediaries to approve community and social investment offer documentation generally or, for example, in the case of offers over a certain value.

Absent a proportionate regime, there is a risk that intermediaries in the community and social finance space will conduct activity which technically ought to require FSA authorisation, with respect to, for example, advising on investments or arranging deals in investments, without obtaining authorisation, due to the high costs of obtaining authorisation and low regulatory priority given to community and social finance.

There is also a risk that the co-operative and community benefit society forms will be abused, as community and social entrepreneurs may seek to use these forms – and to take advantage of exemptions from the regulated activities of accepting deposits and establishing and operating collective investment schemes – to achieve community and social purposes which cannot be achieved economically using other regulated forms.

There is also a significant reputational risk to the wider community and social finance sector as a result of the poor quality of some of the current community level offer documentation. Without an obligation for the disclosure, for example of conflicts of interest on the part of promoters and of related party transactions, there is a risk of exploitation of the co-operative and community benefit society forms to enable unscrupulous promoters to avoid full disclosure of important information to investors.

The idea of a bespoke category of community and social finance regulated activity is a natural development of the idea of legal form and social investor exemptions, as it is possible for the scope of permission granted by the Financial Services Authority to an authorised person to be limited to regulated activity in relation to such exemptions.

## 7. European law

Beneath the Prospectus Directive threshold of €2.5 million (soon to be €5 million), European law does not impact upon domestic rules concerning financial promotions.

The Markets in Financial Instruments Directive (MiFID) is the overarching piece of European law with respect to financial services activity. It is mandatory and domestic financial services regimes must incorporate its provisions. There are also a number of other pieces of European law which affect specific areas of financial activity.

MiFID contains an optional exemption for pure advisory firms, which would allow the UK to tailor a form of social finance regulated activity with respect to financial promotions and advisory activity.

However, MiFID regulates firms which offer advisory services in addition to other investment services, as well as brokerage, market making, portfolio management, underwriting and placing services and so compliance with MiFID will be necessary in these areas unless exemptions or amendments to MiFID can be negotiated.

## 8. Competing considerations

### 8.1 Community finance v social finance

We are of the view that it is necessary to distinguish, in regulatory terms, between community finance and social finance, although there is some overlap.

In this paper, ‘community finance’ refers to investment contexts where the investors know each other and have personal associations and relationships of a kind which is characteristic of a community, as commonly understood. Often, in community investment contexts, the amounts raised for investment are relatively low.

In contrast, we use the term ‘social finance’ to describe investment offerings of potentially wide public appeal, where there is no necessary pre-existing relationship or connection between potential investors. The risks involved in social offers are arguably higher than in the case of community offers, as investment offerings have the potential to be widely distributed and to come from diverse sources.

The regulatory distinction between community finance and social finance is important, as it would enable distinctive practice standards to be set out over time and with the benefit of experience by a Community and Social Finance Standards Board, in a way that is appropriate to the different community and social finance contexts.

### 8.2 Large-scale v small-scale

We believe that where an investment offering exceeds the equivalent of €5 million, the investment offering is of sufficient size as to make approval of the offer documentation in accordance with the Prospectus Directive desirable.

We do not therefore propose that the creation of a bespoke community and social finance regime should require any amendment to the Prospectus Directive.

### 8.3 General law v bespoke regime

The general law provides a number of protections to investors, even where an investment offer is exempt from regulation under the Financial Promotion Order.

The general law of negligent misstatement, misrepresentation, breach of contract, theft and fraud all act to provide basic protections to investors from persons who might otherwise seek to take advantage of ordinary members of the public.

We believe that, in addition to the general law which provides a number of protections at a high level of generality, a co-regulatory regime including, for example, declarations and risk warnings would provide a high level of investor protection and, combined with the articulation of specific practice standards, would raise practice standards in emerging community and social finance market contexts.

## 9. Recommendations

### 9.1 Consultation

The Government should, as a matter of urgency, issue a consultation on proposals to establish a bespoke co-regulatory regime for community and social finance, in the form of a stand-alone piece of subordinate legislation to the soon-to-be-amended Financial Services and Markets Act 2000, concerned solely with community and social finance activity (a ‘Community and Social Finance Order’).

The final form of the Community and Social Finance Order should be shaped following responses and dialogue with the community and social finance sector and the general public as a whole. The following recommendations outline:

- How a new bespoke regime in the form of a Community and Social Finance Order could be created under the legislative super-structure of the Financial Services and Markets Act 2000, as amended.
- How a co-regulatory regime could be created, involving a Standards Board, articulating practice standards on behalf of the community and social finance sector, and a Social Finance Regulator, to review and approve proposed standards and keep a register of community and social offers.
- Some tentative suggestions for the possible content and scope of a proposed Community and Social Finance Order, subject to consultation in due course.

### 9.2 Additional legal form exemptions

The legal form exemptions available to co-operatives and community benefit societies under the Financial Promotion Order ought to be extended to include charities and community interest companies and wholly owned trading subsidiaries of charities. Once exempt from the Financial Promotion Order, these organisations would be subject to the Community and Social Finance Order.

As charities and community interest companies are by definition public benefit organisations, there is an overwhelming case to say that these organisations should be placed on a comparable footing with co-operatives and community benefit societies by enabling all such organisations to benefit from proportionate regulation. As wholly owned trading subsidiaries exist to generate income for application towards charitable purposes, we believe that these legal forms should also be exempted.

We believe there is also a very strong case to be made for exempting companies limited by guarantee generally, to enable the wider not-for-profit sector to benefit from and have access to a new bespoke community and social finance regime.

In the case of charities and charitable community benefit societies, there should be a requirement for investment offers to be structured in a way which ensures that investment by external or member investors does not result in public benefit organisations being misused for private benefit purposes.

### 9.3 Social investor exemption

A 'social investor' exemption should be set out in the Financial Promotion Order, to enable investment offers targeted at investors who are socially motivated – and who have a relatively high tolerance for risk with respect to the social investment in question – to benefit from regulation under the Community and Social Finance Order.

The exemption would be available to social investors who are investing to promote and finance a civil society organisation or initiative or to advance a purpose or cause for the benefit of society and not exclusively in the expectation of a financial return.

### 9.4 Community and Social Finance Order

The Government should consult with the community and social finance sectors and the public at large as to the ideal scope of the Community and Social Finance Order.

The Community and Social Finance Order could set out certain irreducible minimum requirements for offers made under the Order, for certainty. Alternatively, it may be preferable to give complete freedom to the Standards Board to determine what practice standards ought to be put in place, as this would have the merit of flexibility.

The Community and Social Finance Order could, for example, have the following kinds of provisions, which are given for the purposes of illustration only.

An investor declaration condition – a declaration which could include the following:

- a. Social motivation – if reliance is being placed on the social investor exemption, that the investor is socially motivated in line with the scope of the social investor exemption from the Financial Promotion Order.

b. Risk tolerance:

- i. That the investor is aware that the offer has not been approved by a person authorised by the FCA to approve financial promotions.
- ii. That the investor is in a sufficiently secure financial position to be able to accept the risk of losing the full value of the investment.
- iii. That the investor accepts that the risk associated with the offer may be higher than with investments which are offered pursuant to an offer document approved by an authorised person.
- iv. That the investor has read and is willing to accept the risk factors notified in the financial promotion.

A promoter declaration condition – a declaration on the part of the promoters<sup>2</sup> which could include the following;

- a. Social purpose – if reliance is being placed on the social investor exemption, that the offer is aimed at social investors and/or other exempt investors.
- b. Use of funds – that the funds raised shall be used to promote and finance a civil society organisation or initiative or to advance a purpose or cause for the benefit of society and not exclusively in the expectation of a financial return.
- c. Knowledge and belief – that the offer document is clear, fair and not misleading to the knowledge and belief of the promoters, including regarding any community, social or environmental benefit claims made in the offer.
- d. Reasonable steps – that the promoters have taken reasonable steps to ensure that the offer document includes such information as a reasonable community or social investor would want to know in deciding to make a community or social investment, as the case may be.
- e. Risk factors – that the offer document includes a clear explanation of the material risk factors which the promoters believe a reasonable community or social investor would want to know in deciding to make a community or social investment, as the case may be.

- f. No concealment – that the promoters have not dishonestly concealed any material fact of which a reasonable community or social investor would wish to be aware, including any actual or potential conflicts of interest on the part of the promoters and any actual or potential related party transactions.
- g. Compliance – that the offer document complies with any prevailing practice standards or code of practice issued by the Standards Board.
- h. A registration condition – a copy of the offer document must be lodged with the Social Finance Regulator.

### 9.5 Financial Conduct Authority

The objectives of the FCA should be elaborated to ensure as far as possible, consistent with its objectives, that the general financial services regulatory regime ‘facilitates and enables investment in civil society, community and social benefit organisations’.

An explanation of the place of social finance is needed to ensure that the FCA effectively balances investor enablement against investor protection. The world of community and social finance is largely alien to mainstream financial services and the differing transactional and policy imperatives ought to lead to different regulatory priorities and approaches. The best way to embed an enabling approach within the FCA to community and social investment is to directly set out the importance of social finance in relation to its statutory objectives.

A social finance aspect to its objectives should ensure that the FCA seeks to develop a proportionate, appropriate and tailored approach to the authorisation of social finance authorised intermediaries and would ensure that the FCA takes a constructive approach to its engagement with the Social Finance Regulator.

In contrast, the current proposals for the FCA do not even appear to contemplate the regulation of investment in civil society ventures.

### 9.6 Social Finance Regulator

A new Social Finance Regulator should be created within the FCA. The relationship between the Social Finance Regulator and the FCA should be similar in operation to the relationship between Companies House and the CIC Regulator, a relationship which has proved successful.

The Social Finance Regulator should be an

independent public office holder appointed following an open public recruitment process monitored by the Office of the Commissioner for Public Appointments. The Regulator would be an independent official, with powers set out in the soon-to-be amended Financial Services and Markets Act 2000 and would be required to discharge its functions having regard to:

- What is most likely to encourage growth in investment in civil society?
- What is appropriate to protect investors?

The aim would be to create a specialist and proportionate regulator charged with encouraging the development of the social investment marketplace both through its engagements within the FCA and with the sector and the outside world. The Social Finance Regulator would be the regulatory point of contact for social and community entrepreneurs with questions about the Community and Social Finance Order.

The Social Finance Regulator and the FCA would have distinct functions and roles but would work together to provide a seamless service. The Social Finance Regulator would be able to hold the FCA accountable to its social finance objective and would have the social finance market expertise to be able work with the FCA to ensure that there is proportionate authorisation for social finance regulated activity.

The Social Finance Regulator could also observe meetings of the Standards Board and would have the power to approve codes of practice formulated and agreed by the Standards Board. Once approved by the Social Finance Regulator, codes would have the force of law under the Community and Social Finance Order and there would be statutory sanctions for breach of the codes on the part of promoters.

There should be a requirement to register all community and social investment offers with the Social Finance Regulator. The Social Finance Regulator should in turn keep an online register of community and social investment offers, to improve the transparency and accountability of the social and community sector.

A new section of the online FCA Handbook should be dedicated to providing guidance and setting out the Social Finance Regulator’s views about the scope of the Community and Social Finance Order and related issues. This could be set-up as a microsite which could be a valuable resource to community and social entrepreneurs.

### 9.7 The Standards Board

The Standards Board should be a body – or one body for the community space and one body for the wider social space – consisting of leading representatives of the community and social finance sectors with appropriate knowledge and expertise to be able to articulate minimum requirements and best practice standards for community and social offers. The Standards Board would be independent of government and representative of the community and social finance sector in the widest sense.

In this paper, references to the Standards Board should be considered to include reference to the possibility of there being two boards, one for the community sector and one for the wider social sector. The shorthand term Standards Board is used for convenience. The detail of the body or bodies which should be charged with the responsibility for setting standards should be a matter for public consultation.

It is important that there is active and wide sector participation in the standard-setting function, to ensure that the Standards Board has a positive role in the development of the social investment market and is not perceived as distorting the market. There may be merit, if it is to be a single body, in the Standards Board having an independent chair and in constitutional checks being set in place to ensure that it is not perceived as overly representative of one section of the community and social finance marketplace over another.

We recommend that the Standards Board articulates differential standards for community offers, as compared with general social offers, as this would enable the Standards Board to build directly upon the work of the Community Shares programme in the case of community offers and would reflect the different regulatory priorities which apply to offers with a community context and those without.

We recommend that Co-ops UK and Locality, as the recognised market leaders in community offers, play leading roles with respect to the setting of standards for community offers, to ensure that the distinct role and potential of member investment on a mutual basis in community contexts is recognised. There are a number of ways in which this could be achieved within an overarching co-regulatory framework, one of which could be by means of a Community Shares Unit within Co-ops UK.

There will be situations in which promoters of community and social offers would be

well-advised to obtain professional legal and accounting advice with respect to offer documentation or aspects of offer documentation or the offer process. Guidance issued by the Standards Board could articulate, through a process of identifying and collating best practice, when this is appropriate and could issue guidance which promoters would be required to observe.

One of the considerations for the Standards Board will be the fact that social offers may involve an element of anonymity which, along with the higher investment thresholds, could expose investors to greater risk and could change the risk profile of social offers as compared with community offers.

The Standards Board could also provide template documentation, to provide a starting point for community and social entrepreneurs in preparing offer documents.

### 9.8 Development of the social investment market

A Community and Social Finance Order would be capable of amendment, without the need to amend wider financial services legislation, as the social finance market develops, on the recommendations of the Social Finance Regulator.

A Community and Social Finance Order could also be adapted, for example, to cater for developing areas of social finance activity, such as crowd-funding and peer-to-peer lending and the growth of social funds and intermediary activity.

A Community and Social Finance Order could also deal with other regulatory blind-spots, such as general invitations to the public to lend money under unsecured loan agreements, which are currently unregulated, on the basis that unsecured loan agreements are not regulated investments. This particular regulatory lacuna is of great significance to the social sector, although this issue is little known or understood.

A new social investment funds exemption to the definition of collective investment schemes could be added to the list of exemptions in the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001. An appropriately tailored exemption could allow for the development of small social funds which would be subject to proportionate social authorisation, avoiding the prohibitive costs of mainstream financial services regulation.

### 9.9 European law exemptions

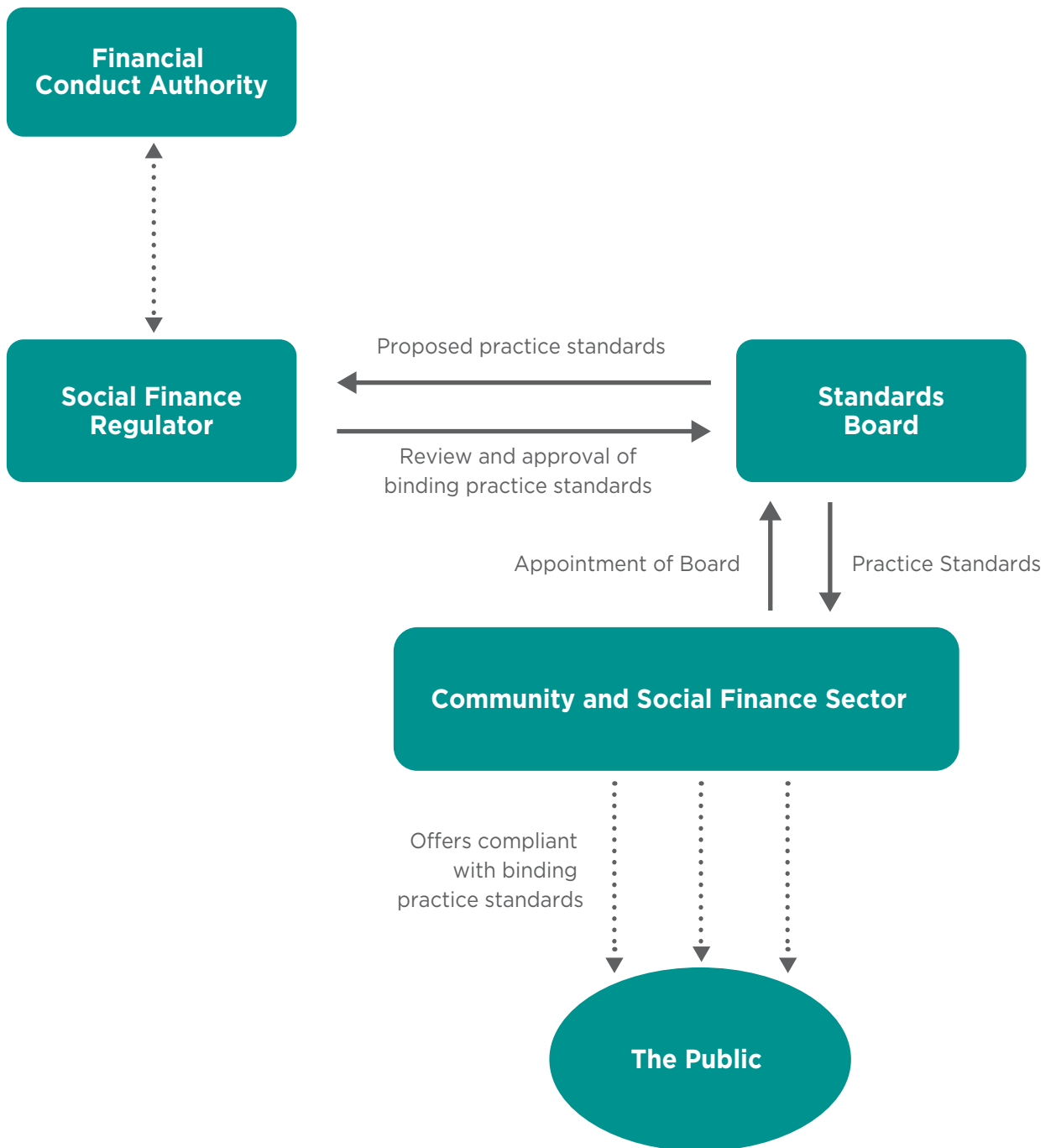
The Government should seek to negotiate at a European level to maintain existing optional

exemptions from MiFID and should consider on an ongoing basis whether further amendments to MiFID may be required to enable a domestic social finance regulated activity regime to develop further over time.

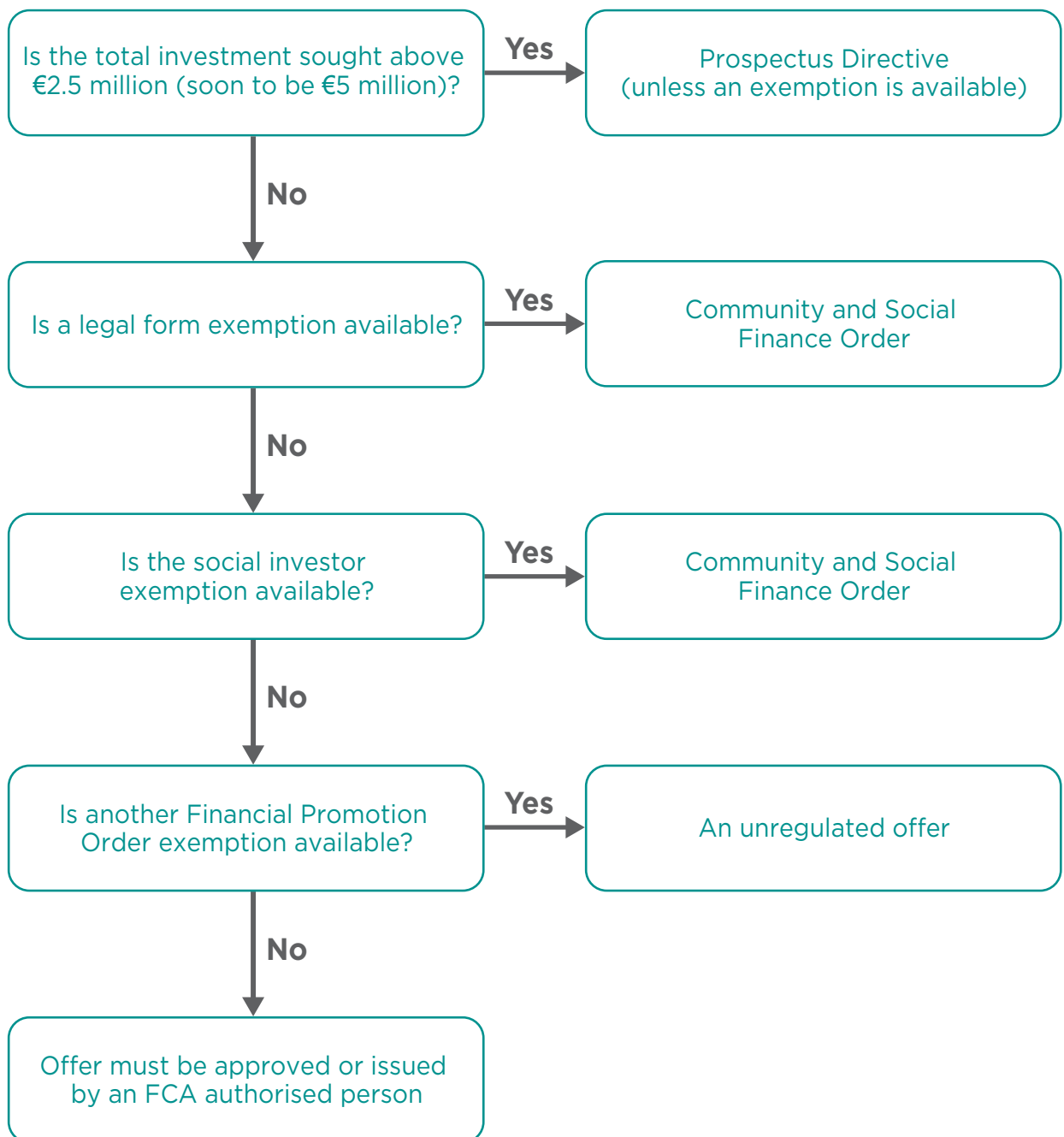
# APPENDIX A: RECOMMENDATIONS

1. The Government should, as a matter of urgency, issue a consultation on proposals to establish a bespoke co-regulatory regime for community and social finance
2. Exemptions under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 should be extended to include offers by charities, community interest companies, wholly-owned trading subsidiaries of charities and companies limited by guarantee and offers to social investors
3. A new Community and Social Finance Order, dedicated to community and social finance, should be issued under the revised Financial Services and Markets Act 2000
4. A new independent Community and Social Finance Standards Board(s) should be established to articulate practice standards for community and social finance offers
5. A new office of the Social Finance Regulator should be established under the revised Financial Services and Markets Act to review and approve standards issued by the Standards Board and to act as the registrar of community and social finance offers
6. The Community and Social Finance Order should:
  - Set out a co-regulatory regime for community and social investment offers.
  - Set out a new category of 'social finance regulated activity'.
  - Treat community and social finance activity in a co-ordinated and unified way.
  - Be updated and adapted from time to time to ensure proportionate regulation of a developing social investment market, including with respect to peer-to-peer lending, online and social media activity, crowd-funding and the development of social funds.
7. Consideration should be given to the place within a bespoke regime for the following:
  - Differential treatment of community and social investment offers.
  - Self-certification for community and social investment offers.
  - A social motivation test for social investors.
  - Risk warnings.
  - Declarations for investors and for promoters of investment offers.
  - Practice standards for community and social offers issued by the Community and Social Finance Standards Board(s).
8. The FCA's objectives should be elaborated to note the importance of social finance.
9. A new section of the FCA Handbook should be dedicated to the work of the Social Finance Regulator and the scope of the Community and Social Finance Order.

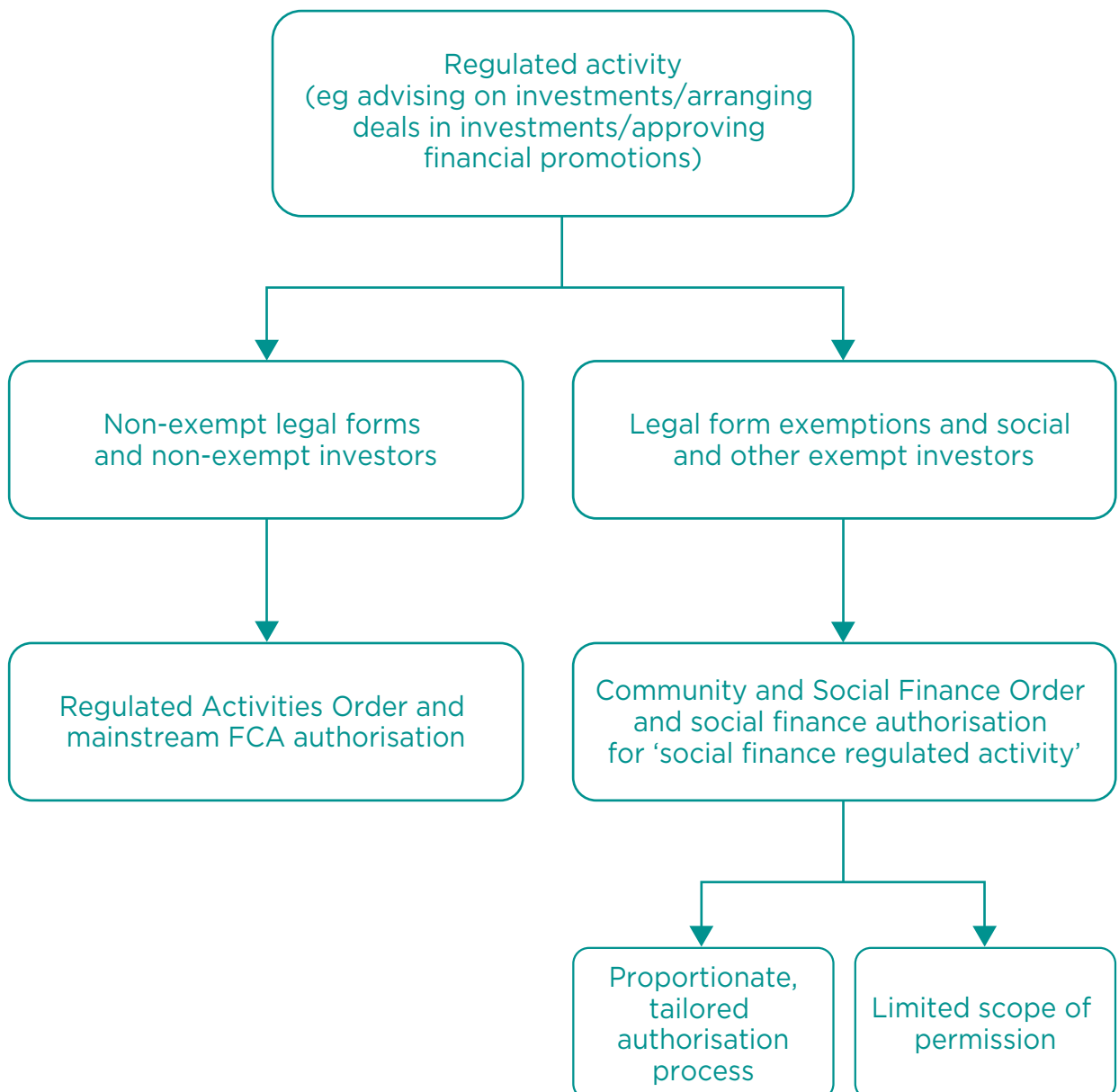
# APPENDIX B: CO-REGULATION OF COMMUNITY AND SOCIAL FINANCE



# APPENDIX C: COMMUNITY AND SOCIAL FINANCE ORDER



# APPENDIX D: SOCIAL FINANCE REGULATED ACTIVITY



# APPENDIX E: SECTOR ROUNDTABLES

## Attendees

In preparing this paper, we held roundtable events attended by the following sector experts and community and social finance practitioners:

- Allastair Ballantyne, Adviser, Portland Place Capital
- Jim Brown, Principal Consultant, Baker Brown Associates
- Sara Burgess, Regulator of Community Interest Companies
- Mark Campanale, Co-Founder and Director, Social Stock Exchange
- Paul Cheng, Senior Investment Manager, CAF-Venturesome
- Will Dawson, Senior Sustainability Adviser, Forum for the Future
- Jeff Dober, Head of Debt Funds, Finance South East
- Greg Fisher, Chief Economist, ResPublica
- Harry Glavan, Policy and Research Manager, CDFA
- Dan Gregory, Founder and Director, Common Capital
- Jamie Hartzell, Co-Founder of Ethical Property Company
- David Hutchison, CEO, Social Finance
- Jonathan Jenkins, Director of Ventures, UnLtd
- Stephen Lloyd, Senior Partner, BWB (Chair)
- Joe Ludlow, Public Services Lab, NESTA
- Caroline Mason, Chief Operating Officer, Charity Bank
- Nick O'Donohoe, Government Adviser on the Big Society Bank and former Global Head of Research at JP Morgan
- James Perry, Trustee, Panahpur Trust
- Annika Tverin, Director, Social Finance
- Louise Wilson, Product Director, Abundance Generation

## Conclusions

The roundtable discussions revealed broad agreement on the following key issues:

- There is a need for a bespoke and proportionate financial promotions and financial services co-regulatory regime which takes account of the special characteristics of community and social finance.
- The detail of the co-regulatory regime should be set out in a regulatory order beneath the soon to be amended FSMA 2000.
- A single regulator should be responsible for approving sector proposed standards for both community and social finance.
- Differentiation is required between community and social finance.
- Co-ops UK/Locality should lead on standard-setting for community finance.
- A new representative organisation should be established to set standards for the wider social finance space.
- A co-regulatory regime should be wide

enough to enable retail investment in the full range of civil society organisations.

- The content of the relevant regulatory order should reflect and be sensitive to different legal forms and different types of offers.
- Great care and consideration needs to be taken in shaping any final form proposals for a bespoke regime, to minimise the risks of market distortion, market segmentation and investor detriment.
- Any new bespoke regime should be the product of a collaborative and consultative process with input and feedback from representatives of the community and social finance sectors.
- A new bespoke regime could, if well shaped:
  - a. Help ordinary investors and investment professionals to better understand community and social investment.
  - b. Reduce transaction costs.
  - c. Raise the standard and quality of community and social investment offerings, particularly at the lower levels of investment raise.
  - d. Put community and social investment on the legal and regulatory map.
  - e. Reduce the risks of market distortion, abuse of exemptions and bad practice.
  - f. Help to catalyse retail investment into community and social ventures.
  - g. Allow for the development and differentiation of social finance intermediaries, social finance regulated activity, social funds and new social finance products.

## Guiding principles

The following guiding principles emerged during roundtable discussions:

### The need for differentiation

The social investment space is in need of greater definition.

There is a need to make social investment simpler for ordinary investors and advisers to understand.

### Avoiding market segmentation

There is a need to respect and acknowledge the existence of a spectrum of community and social offers of different sizes, promising differing levels of financial and social return and to seek to minimise boundary issues when shaping a bespoke regime.

A bespoke regime must avoid the segmentation of community and social investment and should seek to connect community and social investment with mainstream finance and institutional investment.

A bespoke regime should not make it more difficult for finance-first or triple-bottom line organisations to raise finance.

At the same time, it is important to create space for social-first finance activity, which is at risk of being impeded by over-regulation.

### Investor protection

Investor protection must be a critical feature of any bespoke regime and is essential to the reputation of the social investment marketplace but it must be balanced against the need for investor enablement, a current economic imperative and policy priority.

There is an imbalance in favour of investor protection as against investor enablement, which needs to be addressed.

Investors ought to be given freedom to take risks, to democratise finance raising and minimise professional and other transaction costs.

### Legal form exemptions

There is merit in the existing exemptions for co-operatives and community benefit societies, due to the special nature of withdrawable share capital and the democratic and social benefit characteristics of co-operatives and community benefit societies.

There is a strong argument for equal treatment of community interest companies and charities, due to their public benefit and asset lock characteristics.

Financial promotions exemptions based on defined public benefit legal forms have the merit of clarity and certainty and are a good starting point to facilitate community and social investment.

Exemptions which focus on defined public benefit legal forms will not facilitate community and social investment in civil society organisations which have adopted other legal forms, such as companies limited by shares or limited liability partnerships and so do not provide a complete solution.

### **Investor exemptions**

A wider test focussing on investor motivation could be used to exempt offers targeted at socially motivated investors from full mainstream regulation.

A social investor exemption could enable socially motivated investors to invest directly into civil society organisations not benefiting from legal form exemptions and ‘lifestyle businesses’ which are not run to maximise profit, which form a wider part of civil society.

An investor motivation test may be complex to define.

Thought should also be given to expanding existing financial promotions exemptions, such as the sophisticated investor exemption and the common interest group exemption, to facilitate community and social investment.

### **Distinction between financial promotions and regulated activities**

A distinction needs to be made between financial promotions and regulated activities, as financial promotions may be issued by ordinary social enterprises whereas regulated activities involve financial services related activity and will be conducted by a smaller number of social finance intermediaries.

### **Distinction between venture capital and deposit capital**

A distinction needs to be made between venture capital in social enterprises and deposit capital with social banks, as investors placing deposits with a bank will expect the same level of protection as in mainstream financial services,

whereas investors may be willing to accept higher levels of risk when investing in social ventures which they would wish to support and further.

### **General policy considerations**

Exemptions from financial promotions rules should not mean that community and social finance offers are completely unregulated but should be a gateway to proportionate regulation.

Any proposed investment caps ought to be rationalised and made consistent with any investment caps applicable to the underlying legal forms.

A form of social finance ‘authentication’ by authorised social finance intermediaries, short of formal approval, could help to protect investors.

A general review of financial promotions rules is overdue, considering the capital needs of small and medium-sized enterprises, the current restrictions in the supply of credit and the need to boost employment.

# ENDNOTES

1. See [www.frsb.org.uk](http://www.frsb.org.uk) for an explanation of the self-regulatory regime for charitable fundraising activity.
2. The promoters would be the directors of a company, the trustees of a trust or the management committee of an LLP, unincorporated association, co-operative or community benefit society seeking investment.



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Published: June 2011

ISBN 978-1-84875-127-9



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