



Community Shares Unit response to the FCA Guidance Consultation 15/4

Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014

August 2015

This consultation submission begins with offering useful contextual information which informs the views put forward and how it links to other responses. Specifically, Co-operatives UK has developed a response as the key network for Britain's co-operative businesses, representing its members and the wider movement.

Co-operatives UK, along with Locality, also delivers the Community Shares Unit (CSU) - a long-standing initiative to support best practice for societies undertaking community share offers. On this basis, the CSU has submitted a separate response to recognise its specific work on promoting voluntary regulation by societies issuing community shares. Given the differing scope and scale of activity between Co-operatives UK and CSU, separate consultation responses have been submitted, although recognising there are areas of overlap and a shared support for the points put forward.

About the Community Shares Unit

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

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

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

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

The Community Shares Handbook and the Community Shares Standard Mark are dynamic tools for promoting good practice by societies. Through the auspices of the Technical Committee it provides the CSU, the FCA and other stakeholders with an effective and low-cost method of providing guidance to societies, which can be regularly updated, revised and developed as the modern understanding of what constitutes a good practice evolves over time.



Since 2009 over 600 new societies have been registered capable of issuing community shares, making up a significant proportion of all new registrations handled by FCA Mutuals Registration team. The majority of these new registrations are societies for the benefit of the community, including a handful of such societies that have charitable objects. A minority of societies offering community shares are bona fide co-operatives.

Because of our close working relationship with the FCA via the Technical Committee, we did not formally respond to the FCA's earlier Consultation Paper CP14/22. However, given the level of response generated by both the current and earlier consultation paper, we felt it important to formally respond to the current paper. Had we formally commented on the earlier consultation paper, we would have emphasised a number of issues in our opening remarks.

- The CSU market development work has resulted in a significant increase in the number of new community benefit societies, and has popularised this legal form for community enterprises. In line with the Co-operative and Community Benefit Societies Act 2014, community benefit societies are established for the purposes of “carrying on any industry, business or trade... for the benefit of the community”. Only those community benefit societies that have exclusively charitable objects, and are recognised as such by HMRC, can be described as being “philanthropic in character” (contrast with CP14/22 Section 5.4). All community benefit societies work to a business model, which includes the necessity of attracting and retaining sufficient capital for its business purpose. Members invest to support this business purpose, and not for philanthropic reasons.
- We recognise that many community benefit societies offering community shares also meet the ICA definition for co-operatives, and that many of these societies publicly identify themselves with the co-operative movement by, for example, becoming members of Co-operatives UK. The definition of a co-operative in the UK is not restricted to a single legal form, and it is up to Co-operatives UK, as the national representative body on the ICA, to determine what entities it accepts as co-operatives.

Response to the Consultation Questions in GC15/4

Q1: Do you agree with the indicator set out above relating to interest rates, and in particular: what do we need to add, remove or amend?

The CSU has worked closely with the FCA through the auspices of the Technical Committee, to produce the Community Shares Handbook and more recently, the Community Shares Standard Mark. The Handbook contains *Section 6.2 Interest on share capital*, set within the broader *Section 6. The use and distribution of profit or surplus*. In producing this good practice guidance we have already sought the views of the FCA and received the endorsement of the Technical Committee for the contents of the of Handbook.

The Handbook says that “societies should treat interest on share capital as a discretionary expense, which is only paid if the society has accumulated, realised profits.” This mirrors your proposed indicator that “Where a society sets a rate of interest in advance and cannot afford to pay that rate of interest, it pays a lower than indicated rate of interest, or no interest at all”. It would be helpful if the FCA clarified what it means by affordability in this context. The Handbook says that affordability should be based on the society having accumulated, realised profits. We would like the FCA to say what it means by “affordable”.

The Handbook makes it clear that interest on share capital is not a profit distribution, but is a discretionary operating expense, where the discretion should be exercised according to affordability. UK accounting standards and HMRC treat the interest payable on withdrawable share capital as a pre-profit business



operating expense, not as a distribution of profit. Interest paid on share capital in a society is a deductible expense before any liability to corporation tax.

We would like the FCA to clarify what it means by the indicator “the rate of interest paid on shares is set in advance”. The term “set” in this context is ambiguous, and has been interpreted by some societies as meaning a “fixed” rate, whereas the FCA guidance makes it clear that societies should only pay the set rate if can afford to do so, suggesting that it is not a fixed rate.

It would be helpful if the FCA were to refer to the “set” rate as a “maximum” rate, or a rate cap. This could still be determined by individual societies, taking into account their own circumstances and reasons for determining their maximum rate. The FCA should also say whether it expects societies to state this maximum rate or cap in its rules, or at the very least acknowledge that many societies have rules that state a maximum rate of interest.

Section 14(12) of the Co-operative and Community Benefit Societies Act 2014 requires all societies to have rules stating “*the way in which the society’s profits are to be applied*”. Most model rules registered by the FCA interpret this legal requirement as meaning that there should be rule stating a maximum rate of interest payable on share capital. It is usually accompanied by a rule committing the society to reinvest some of the profit in the development of the society, and to use some for the benefit of the broader community. Among co-operative societies there may also be a commitment to distribute some of its surpluses through dividends on transactions with members. We would like the FCA to clarify its position on whether it expects societies to state a maximum rate of share interest as part of the legal obligation under Section 14(12).

The question of whether societies should have a “set” interest rate or a “maximum” interest rate is pertinent to how this rate is communicated in the invitation to subscribe share capital. The Community Shares Handbook (Section 4.2) says that offer documents should state “The society’s rules on financial returns to members, whether as interest on share capital or dividends on transactions should be explained, as should its policy and practices for setting its annual interest and/or dividend rate. Reference should be made to the FCA’s policies restricting financial returns and the good practice requirement that such returns should only be paid from current operating profits.” Elsewhere the Handbook refers to share interest being paid out of accumulated, realised profits or reserves. The society’s rules will normally impose a maximum rate, while the actual rate paid will depend on affordability, and hence long-term profitability.

We recognise the need for a flexible approach to share interest rates, reflecting the different circumstances of societies operating in a diverse range of sectors, and the changing capital demands on societies as they grow and develop. This underlines the utility of another indicator the FCA proposes (see 2.6), which is that “societies can justify a decision to pay interest at a particular rate, and be able to demonstrate the basis for that decision”. The Handbook takes a similar approach to determining what a “fair” interest may be, and proposes the following three benchmarks for determining such a rate:

1. The underlying rate of inflation, which might provide a benchmark for the floor, or minimum share interest rate.
2. Long-term rates of return on other asset classes, such as government bonds, treasury bills and stock market listed equities, bearing in mind the different risk profiles associated with each asset class.
3. Alternative cost comparison, provided by the cost of commercial debt and lending.

Arguably, these benchmarks could result in too low a rate of interest. They do not take into account the differences between withdrawable share capital and other forms of equity investment. Investors in



transferable share capital issued by companies may benefit from both dividend revenue and capital gains in the value of those shares, whereas there is no capital gain to be had from withdrawable share capital in an asset locked society.

Nor do the benchmarks take into account the differences in risk exposure between share capital and other form of investment, especially secured debt. Comparisons with savings rates on deposits protected by the Financial Services Compensation Scheme, or even secured commercial debt, would therefore be unreasonable. We note that the FCA has moved away from the position it adopted in its October 2014 consultation, where it said that a society should normally pay no more than a savings account rate of interest.

We know from research conducted by NESTA and Cambridge University that people buying community shares are not primarily motivated by the prospect of financial gain, but instead want to support the purposes of the society. The risks associated with purchasing shares in an unregulated offer maybe mitigated by the tax relief incentives provided by EIS, SEIS and SISR, where such tax relief is available.

In this context we think our three benchmarks provide a useful basis for determining what a fair interest rate may be. We think that the FCA's proposal that a society could establish the lowest rate sufficient to in order to attract sufficient funds by offering shares through a tendering process is both impractical and counter to the principle that the primary motivation for investing should be to support the purpose of the society, and not the financial return (or lack of it). Some societies do encourage members to waive interest rates or to opt for a lower rate of interest than the society states as a target. But this is predicated on the notion that a society should offer a "fixed" rate of interest, with no regard to its affordability, which we would not support.

We note that the FCA does not currently collect data on the interest rates paid by societies on share capital; the Annual Return (AR30) instead asks societies to declare the total amount of interest paid. Although it is possible to infer an interest rate from this data, by dividing it by members' share capital, this is not a wholly reliable method. We would like the FCA to require societies to state the interest rate paid on share capital as part of the Annual Return. This would provide a better evidence base to inform the policy debate on this matter.

Q2: Do you agree with our approach to the ICA Statement in our application of the 'bona fide co-operative society' statutory test?

Bona fide co-operative societies can and do issue community shares. The Community Shares Handbook promotes the use of this legal form as a suitable vehicle for community share offers. The CSU defers to Co-operatives UK in determining what should be considered to be a bona fide co-operative society.

However, the CSU does set out principles for community shares that determine whether a co-operative society's rules are fit for this purpose. Two principles are particularly relevant and pertinent to how co-operatives are defined. These principles are that:

- membership should be open to all who support the purpose of the society
- the society should be asset-locked, whether voluntarily or statutorily, in order to constrain the scope for capital gains by members.

The first of these principles is consistent with the ICA's definition of a co-operative, while the second principle is consistent with the ICA's Principle 3: Member Economic Participation which states that "at least part of [that] capital is usually the common property of the co-operative". On this basis we support the FCA



proposal to use ICA definition of co-operatives and Principles 1 to 4, as a basis for determining whether a society is a bona fide co-operative.

However, we note that the wording of Principle 3 does not require all co-operatives to have common property achieved through a statutory asset lock. We accept that some bona fide co-operative societies will not choose to have an asset lock, and if they do decide to offer share capital to the public, that this will not be considered to be a community share offer, and will not be eligible for the Community Shares Standard Mark.

Q3: Do you agree with our approach to society names, in particular in our aim to align the naming regimes for companies and societies where possible?

Please refer to the consultation response from Co-operatives UK

Q4: Do any words need adding to or removing from the list at Appendix 1.

We do not consider the approach to society names to be a policy matter for the CSU. The Community Shares Handbook does contain a section on names (3.2.1) where we attempt to summarise the policies of the FCA on this matter. However, we do support the broader policy aim of aligning the naming regimes for companies and societies. With this in mind we would like to propose that the following words are added to the list in Appendix 1:

- society
- community benefit
- community shares
- co-op
- charity