Investing in community shares

CO-OPERATIVES UK

DEVELOPMENT TRUSTS ASSOCIATION
transforming communities for good

<u>Update to "Investing in Community Shares"</u>

<u>From Communities UK</u>

Co-operatives and Community Benefit Societies: All Change

What are the most significant features of the new legislation?

Four new pieces of legislation and new regulatory guidance reform the law that applies to co-operative societies and community benefit societies in 2014:

- From 1 August 2014: **The Co-operative and Community Benefit Societies Act 2014** consolidates and brings together all the legislation governing societies and changes their name. It also introduces registration as either a co-operative or a community benefit society rather than as a society which shows it is one or the other.
- From 6 April 2014 six statutory instruments changed the law to facilitate the use of societies for businesses: **The Industrial and Provident Societies and Credit Unions (Arrangements, Reconstructions and Administration) Order 2014 SI 2014/229** used the power granted by section 255 of the Enterprise Act 2002 to apply the insolvency rescue procedures of creditors' voluntary arrangements, administration and schemes of arrangement under the Insolvency Act 1986 and the Companies Act 2006 to societies. This puts insolvent societies in the same effective position as insolvent companies.
- **The Co-operative and Community Benefit Societies and Credit Unions (Investigations) Regulations 2014 SI 2014/574** apply part 14 of the Companies Act 1985 to societies so that the FCA have powers equivalent to those available to the Department for Business Innovation and Skills (BIS) for

companies where they take the view that fraud or other wrongdoing requires the inspection or investigation of a society. This will increase confidence in societies as they are subject to the same investigation regime as companies.

- **The Industrial and Provident Societies and Credit Unions (Electronic Communications) Order 2014 SI 2014/184**, made under sections 8 and 9 of the Electronic Communications Act 2000, permitted the electronic submission of a single registration document to the FCA when an application was made to register a society. Its amendment of the 1965 Act is consolidated by section 3(1)(b) CCBSA 2014. This adds to the ability of societies to use electronic communications. The Industrial and Provident Societies (Increase in Shareholding Limit) Order 2014 SI 2014/210 used the power available to HM Treasury under section 2 of the Industrial and Provident Societies Act 1976 to raise the limit on the amount of withdrawable share capital that a person other than another society can hold in a society from £20,000 to £100,000.

That provision is consolidated from 1st August 2014 by section 24 of CCBSA 2014. This increases the access of co-operatives and community benefit societies to capital.

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Introduction

Have you been invited to buy shares in a community enterprise? Then you are not alone. You are one of thousands taking the opportunity to invest in your local shop, rescue a pub, finance alternative greener energy or even support your local football club. In the past you may have just made a donation but now you have the opportunity to invest in a community share offer. Through a community share offer you can support what is important to you, and help community enterprises become more sustainable.

Buying any type of shares involves risks. You could lose some or all of the money you invest. But it also offers rewards. You become a member of the enterprise, with a democratic say in its social aims and its future success. You may also be offered a financial return on your investment, together with the scope to cash-in your shares at some point in the future.

This guide explains what community shares are, and will help inform your decision on whether you should invest in a community share offer. It focuses exclusively on organisations that are registered with the Financial Services Authority as co-operatives or community benefit societies, which are subject to different legislation from companies, and have their own unique form of shares. At the back of the guide there is an A to Z of technical terms that you might come across in a share offer document.

The guide has been produced by the Community Shares programme, a government-funded project working with ten community organisations in England, all of which are using community shares to finance their work. Further details can be found at: www.communityshares.org.uk

Give, lend or invest?

Many community organisations rely on people who give to good causes; gifts, donations and fundraising events can be very important sources of money. But there is a limit to how much most people can afford to give to good causes. And not all good causes want to rely on charity. There are a growing number of community ventures whose main aim is to provide community, social and environmental benefits, but which rely on trade with their customers as their main source of money.

Like any other business, these community ventures need money to get started, to grow, and to buy the resources they need to be successful and profitable. There are three ways you can help: you can give, lend or invest. Giving will always be welcome. But sometimes these ventures need more money than you and your community can afford to give. This is where lending or investing becomes important.

Lending money, for an agreed period of time, with or without interest paid on the loan, can be a good way of financing community ventures, but it also has its down sides. The venture cannot be sure what interest payments it will be able to afford, and might have to borrow more money in order to repay your loan. Borrowing money from the community will reduce its ability to borrow money from commercial sources. For these reasons, loans are far less attractive to community ventures than shares.

Investing money, by purchasing shares, makes you a part-owner in the venture. It entitles you to have a say in how the organisation is run, and you may also be offered interest on your investment and the scope to cash-in your shares and get your money back. Any organisation offering community shares should explain how you can cash-in your shares, and what their policy is on paying interest. Your money is more at risk than it would be if you lent the money, but if the business is successful, it would be reasonable to expect a higher financial return than you would get for a loan.

However, you should be aware that, unlike companies, there are legal limits to financial returns on shares in co-operative and community benefit societies. Also, unlike company shares, co-operative and community benefit society shares cannot go up in value but they can go down, meaning that you could lose some or all of the money you invest.

What are community shares?

There is no legal definition of community shares. The term is used here to refer to a unique form of share capital called 'withdrawable shares' which can only be issued by co-operatives or community benefit societies registered with the Financial Services Authority. Co-operative societies are for the mutual benefit of their members, whereas community benefit societies are for the broader benefit of the whole community. Both types of society can issue withdrawable shares, and they work to similar principles. A withdrawable share can be withdrawn from investment, subject to the terms and conditions of the society concerned. This provides a straightforward way of getting your money back when you want to cash-in your shares.

Withdrawable shares are very different from 'transferable shares', which are the type of shares normally issued by companies. To cash-in transferable shares you must first find a buyer to whom you can 'transfer' (i.e. sell) your shares, at an agreed price. Shares in larger companies are bought and sold through stock markets, but these markets do not cater for smaller companies where there are very few buyers or sellers. Finding someone willing to buy shares in a small venture can be very difficult. Co-operative and community benefit societies can issue transferable shares, or shares that are both withdrawable and transferable. A few societies do offer these types of shares, and should tell you how you can sell your shares.

The main reason for buying community shares is to support the social aims of the venture concerned. Unlike shares in private companies, where personal financial gain is the main motive, community shares are subject to laws that limit financial gain and emphasise social benefit. The following table highlights the most important differences between community shares and company shares:

Community shares in co-operative and community benefit societies	Company shares
Maximum £20,000 limit on individual shareholdings	No maximum limit – one person can own all the shares in a company
One vote per shareholder, which means that decisions are democratic	One vote per share, which means a majority shareholder can make all the decisions
Can only pay limited interest on shares, "sufficient to attract and retain the investment"	There are no legal limits on the dividend rate paid on shares
Interest on shares is paid gross of tax. It is up to investors to declare this income to HMRC	A tax-credit of 10% is deducted from all dividend payments on company shares
In most cases shares can be cashed-in ('withdrawn'), subject to the rules of the society	Shares cannot be cashed-in. Shareholders must find a buyer to whom they can 'transfer' (by selling) their shares
Shares can go down in value, but they cannot increase in value above their original price	Shares can go up or down in value according to the price the buyer is willing to pay and the seller is willing to accept
If a society is wound up, some or all of the money that is left, after shareholders have cashed-in their shares, will be given to an organisation with similar aims	If a company is sold or wound up, any money that is left is distributed in full to shareholders, according to how many shares they hold

The sale of community shares is not regulated by the Financial Services Authority, because investors are deemed to be investing for social returns, not financial gain. This is good news for community ventures, which would otherwise face prohibitively expensive regulations when marketing community shares. But it comes at a cost to community investors, who have no right of complaint to the Financial Ombudsman Service and cannot apply to the Financial Services Compensation Scheme.

Community shares are far more risky than keeping your money in a savings account with a bank or building society, where currently the first £50,000 is fully protected. You can lose everything you invest in a community shares offer. This is why it is important to look carefully at a community share offer before deciding to invest.

What should you look for in a community shares offer?

Here are ten questions to ask about any community shares offer:

01 What community? Are you part of this community? Is it a place (e.g. village or neighbourhood), or a community of shared interests (e.g. green energy, fair trade)? How many other people identify themselves with this community? Will these other people invest? What can the community do together to make sure the venture is a success? How can you get involved?

02 Do you support the social purpose of the organisation? Who will benefit from the work of this venture? How will the organisation know if these benefits have been achieved? Will anyone be adversely affected?

03 Is it a good business proposition? Your investment will only be safe if the venture is profitable and sustainable. Is there evidence that the venture will make sufficient profits to pay you the financial returns it is offering, and to build up enough reserves for you to withdraw your money in the future? Do you have enough information to make a judgement about the offer? A good offer document should provide you with clear enough information for you to be able to understand it without having to consult an expert.

04 Do you know and trust the people making this offer? What is their track record? Do they have the skills and experience needed to make a success of this venture? What personal interest do they have in the venture? How much money have they themselves invested?

05 How much should you invest? What is the minimum and maximum amount you can invest? Do you have to invest it all straight away, or can you invest in instalments? Does the amount you invest affect the interest rate you receive?

06 What will your money be spent on? Some things, like land and buildings, machinery and vehicles may hold their value, but other costs, such as marketing campaigns or researching business plans, are non-recoverable. You also need to know whether your money will stay in the organisation, or whether it will be invested in another organisation over which you will have less control.

07 How can you get your money back when you need it? Is the offer document clear about how long you will have to wait before you can withdraw your investment? For new ventures there may be an initial period of several years before anyone is allowed to withdraw their investment. Does the offer document explain where the money will come from to cover withdrawals? Established ventures usually have a minimum period of notice you must give when requesting to withdraw, and most societies retain the right to refuse your request if the directors think it might jeopardise the finances of the business. Some societies have rules that limit the percentage of shares that can be withdrawn in any one year.

08 Who else is putting money into the organisation? Has it received any grants or public support? Is it borrowing money from commercial sources? If so, what interest rate is it paying? What proportion of the total funding will come from community shares?

09 Is the promised financial return realistic? Some offer documents say how much interest will be paid on shares. If it is a new venture, what evidence do they provide to support these claims? Established ventures should show you their track record, as well as providing evidence that the new investment will be profitable.

10 Is your money safe? Do you fully understand the risks involved, and do you accept these risks? All investments involve some degree of risk, and you might be prepared to take these risks if the social and financial returns are sufficiently attractive. But can you afford to lose some or all of your investment?

Further information

All co-operative societies and community benefit societies are registered with the Financial Services Authority (FSA), which maintains a public register of societies at http://mutuals.fsa.gov.uk/

The FSA has also established an independent body called the Consumer Financial Education Body which has developed a website, Money Made Clear (www.moneymadeclear.org.uk), which provides impartial information and guidance about consumer savings and investment products.

The guide has been produced by the Community Shares Programme, a government funded project working with ten community community organisations in England, all of which are using community shares to finance their work. The programme is delivered in partnership by the Development Trust Association (www.dta.org.uk) and Co-operatives UK (www.uk.coop)

Further details on the programme can be found at www.communityshares.org.uk

For more information email: info@communityshares.org.uk

A to Z of terms

- **Asset lock:** A rule which prevents the residual assets of the society being distributed to members. A residual asset is any money left over after everyone has been paid what they are owed, including shareholders. If a society has an asset lock, its rules will usually specify what must happen to these residual assets; normally they are transferred to another asset-locked body with similar aims and objectives to the society that is being wound up. (See also: statutory asset lock)
- **Authorised adviser:** A professional who has been approved by the Financial Services Authority to provide advice.
- **Bond:** An 'unsecured loan' agreement which usually states when the loan will be repaid, and how much interest will be paid on the loan.
- **Community benefit society:** A legal entity, registered under the Co-operative and Community Benefit Societies and Credit Unions Acts that aims to serve the interests of the broader community, beyond its own membership. They can use some of their profit to pay 'interest' on share capital but cannot use profit to pay a 'dividend' to members. They can opt to have a 'statutory asset lock'.
- **Community interest company:** A special type of company, subject to different regulations, which pursues a stated community interest. Community interest companies, along with all other types of company, cannot issue withdrawable shares, and are subject to regulation when issuing 'transferable shares' to the public.
- **Co-operative and Community Benefit Societies and Credit Unions Acts:** A body of legislation that, like company law, provides limited liability status to a corporate entity. There are two types of society, a 'co-operative society' and a 'community benefit society'. Both types of society can offer membership through the sale of shares. All members have one vote each, regardless of how many shares they have purchased.
- **Co-operative society:** A legal entity, registered under the Co-operative and Community Benefit Societies and Credit Unions Acts, serving the mutual interests of its members. Membership is usually open to one or more of the following categories of person: customers, workers, suppliers or investors. They can use some of their profit to pay 'interest' on share capital and a 'dividend' to members. They cannot elect to have a 'statutory asset lock'.
- **Debenture:** A type of loan agreement which is secured against a list of specific assets owned by the organisation.
- **Dividend:** A share of the profit paid to members based on their transactions (purchases, sales, wages etc) with the society. Not to be confused with dividends in companies, which are paid to shareholders based on the number of shares held. Only co-operative societies can pay dividends to members; community benefit societies are not allowed to distribute profit in this way.
- **Enterprise Investment Scheme:** A form of tax relief available to investors buying shares in some types of small enterprise. Only certain types of trade activity qualify for this relief, administered by HM Revenue and Customs.
- **Financial Ombudsman Service:** The official independent expert service in settling disputes between consumers and businesses providing financial services.
- **Financial Services and Markets Act (FSMA) 2000:** The legislation that created the 'Financial Services Authority', independent from the Treasury and the Bank of England, and established a new regulatory environment for the financial services sector.
- **Financial Services Authority (FSA):** The body that registers new co-operative and community benefit societies and collects annual returns from existing societies. The FSA also regulates the financial services industry, including the promotion of investment opportunities to members of the public. Societies offering withdrawable share capital are normally exempt from these regulations.
- **Financial Services Compensation Scheme:** A fund of last resort for customers of FSA-authorised financial services firms. If a firm becomes insolvent or ceases trading, the scheme may compensate for losses up to £50,000 for people with deposit accounts, investments or home finance. People buying community shares are not eligible for this scheme, unless they have purchased them through an authorised firm.
- **Industrial and Provident Societies Acts:** The old name for the Co-operative and Community Benefit Societies and Credit Unions Acts, which was removed by Parliament in March 2010. Industrial and provident society legislation dates back to the nineteenth century, and whilst this legislation has been updated, it was felt that the old name was not well understood.
- **Interest:** Interest is the term normally used to describe the money paid to members based on the amount of share capital they have invested. The interest rate payable by societies is subject to limitations; the FSA says that interest rates should be no more than what is "sufficient to attract and retain the investment". Interest payments are not to be confused with 'dividends', which have a different and specific meaning within co-operative societies.
- **Loan stock:** Usually refers to an 'unsecured loan' carrying a fixed interest rate.
- **Member:** A shareholder in a society or company. Members are part-owners of the enterprise and have rights over all its assets, subject to an 'asset lock'. Members also have voting rights.
- **Membership offer:** A type of share offer where the aim is to recruit members, rather than raise money. Shares have a fixed and limited value, usually £1 or £10,

and you may also be required to pay an annual 'subscription' to maintain your membership. The rules of some organisations say that if you stop being a member, you forfeit your share.

- **Money Laundering Regulations:** Laws requiring businesses that handle deposits and investments to make identity checks to prevent money laundering. Co-operative or community benefit societies offering withdrawable share capital are exempt from these regulations, although some societies may still carry out identity checks, especially if they are accepting overseas or on-line investments.
- **Nominations:** A practice found in some share offer documents where investors are invited to nominate a person who will inherit their shares in the event of their death. This is a voluntary arrangement, although every society is legally obliged to keep a record of all members' nominations.
- **Nominee accounts:** An arrangement where investors purchase shares through a third party, or nominee, who holds the shares and may vote on their behalf. This type of arrangement is used by investment funds who are managing their clients' funds.
- **Offer document:** A term used to distinguish community shares marketing materials from an approved 'prospectus' that companies must produce under the Prospectus Regulations 2005.
- **Open offer:** A type of share offer that should only be made by organisations that have been trading for at least three years. Unlike a 'time-bound offer' there is no target amount or timescale. However, you should be told about the investment policies of the organisation and why they want you to invest. In particular, you should be offered copies of their annual reports for the previous three years, so that you can study their past social performance and financial performance.
- **Pioneer offer:** A high-risk type of share offer which should only be made to existing members or known supporters of the venture. The aim of this type of offer is to raise cash to cover the research and development costs entailed in getting the organisation investment-ready.
- **Reinvestment:** Instead of sending out annual interest or dividend payments to members, some societies add this money to the members' share accounts, effectively reinvesting the money in the business.
- **Rules:** The name given to the governing document of a co-operative or community benefit society, equivalent to the Memorandum and Articles of Association (Mem & Arts) of a company, setting out the purpose of the society and how it will be governed. Rule changes must be approved by members.
- **Secured loan:** Similar to a 'debenture', where the borrower has provided a guarantee or title to an asset in the event of their default on the loan.
- **Social return:** The benefit received by members in return for their investment in the society. Social returns usually encompass community, social and environmental benefits. Offer documents should say what social returns the society aims to deliver and their annual reports should outline what social returns have been achieved.
- **Statutory asset lock:** An asset lock which is backed by legislation (statute); once in place it cannot be removed even with the consent of members. It is possible to include an asset lock rule in any type of society, although only a statutory asset lock in a 'community benefit society' is absolutely watertight. Charities and 'community interest companies' also have statutory asset locks.
- **Subscription:** This term can have two distinct meanings: some societies charge members an annual membership fee, which they call a subscription; or it can refer to the practice of members buying shares in instalments over a period of time.
- **Time-bound offer:** This refers to an offer that seeks to raise a target amount of money by a target date, in order to finance a major investment project. A time-bound offer might be made by an organisation that needs start-up funding, or an established organisation with plans to grow. If the fundraising targets are not met, the organisation should offer to refund your money, and not use it for other purposes. You should also be offered access to their business plan and their legal constitution.
- **Transferable shares:** Transferable shares cannot normally be withdrawn from a society; instead, the member must find a willing buyer, at a price acceptable to both parties. Some societies issue shares that are both transferable and withdrawable, subject to terms and conditions, which should be clearly stated by the society issuing the shares.
- **Unsecured loan:** Usually refers to a debt agreement where the borrower has not offered any assets or guarantees in the event of them defaulting on the loan.
- **Withdrawable shares:** A type of share capital unique to co-operative and community benefit societies, where members are allowed to withdraw their share capital, subject to terms and conditions set out in the society's rules. This will usually include a minimum period of notice of withdrawal, and provision for the directors to prevent withdrawal if, in their judgement, it would jeopardise the finances of the society. Withdrawable shares cannot go up in value, and some societies have rules that enable societies to reduce the value of their shares if the enterprise is performing poorly.

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