Community Shares

This handbook sets out guidance for professional practitioners who provide advice on community shares, a term used to describe the withdrawable share capital of industrial and provident societies. This handbook has been produced by the Community Shares Unit (CSU), under the supervision of a technical committee composed of representatives from the FCA, HM Treasury, the Charity Commission, and an independent legal adviser.

Anyone can now search and explore the Handbook using the search facility and the navigation provided. However, you will need to register to comment on the handbook sections and receive alerts when guidance is updated. We would very much welcome your comments on any part of the guidance!

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1 Introduction to the handbook

This handbook sets out guidance for professional practitioners who provide advice on community shares, a term used to describe the withdrawable share capital of industrial and provident societies.

The Financial Conduct Authority (FCA) is the registrar of industrial and provident societies in Great Britain. The Mutual Societies Order 2013, which transferred this responsibility from the Financial Services Authority on 1 April 2013, states that *"the FCA must maintain arrangements designed to enable it to determine whether persons are complying with requirements imposed on them by or under the mutuals legislation".* The FCA has the power to cancel the registration of a society if it does not comply with society legislation.

The FCA is also responsible for regulating financial promotions, but industrial and provident societies are exempt from most of these regulations. The FCA has a duty to ensure that community share offers do not transgress the terms of their exemption from regulation, and to encourage good practice in all forms of financial promotion, as part of its consumer protection responsibilities.

This handbook has been produced by the Community Shares Unit (CSU), under the supervision of a technical committee composed of representatives from the FCA, HM Treasury, the Charity Commission, and an independent legal adviser.

The first section of the handbook provides an introduction to community shares for professional advisers unfamiliar with the concept. The remainder of the handbook provides guidance on two main matters:

- The legal requirements of industrial and provident society legislation
- Good practice relating to the promotion of community shares.

The legal requirements guidance addresses matters covered by legislation or case law with which societies must comply. Where appropriate, the handbook highlights these requirements by using the imperative "must", and in some places refers to relevant legislation by name.

The good practice guidance looks at the underlying principles, ethics and standards of behaviour expected from societies offering community shares. The term "should" is used when referring to these voluntary, but desirable, practices.

The CSU and FCA are working together to promote good practice by societies making community share offers. While the CSU has no formal powers to require societies to follow the guidance set out in this handbook, it is exploring ways of working with professional advisers to promote good practice. This could include training and accreditation for community shares advisers and the quality assurance of offer documents. The handbook will be regularly updated, based on comments and feedback from professional practitioners, and will act as a means of sharing good practice.

2 An introduction to community shares

2.1 Equity for social enterprises

All enterprises need risk capital to start, to grow, and to be sustainable. This risk finance has to come from somewhere, usually from shareholders, owners, investors, banks and, of course, from the business itself, reinvesting its profits. Risk capital allows the enterprise to ride the ups and downs of development, which are to be expected when pursuing ambitious, challenging or innovative business objectives.

One of the main reasons why social enterprises can find it difficult to compete with private enterprises is their lack of risk capital. A root cause of this under-capitalisation is the belief that social enterprises cannot, or should not, have shareholders. Equity investment is considered anathema, because shares give legal title, meaning that the enterprise is owned, controlled and run in the interest of investors.

Social investment institutions have developed alternatives: quasi-equity, patient capital, and social impact bonds. But most of these products are, ultimately, a form of debt. And indebtedness is a poor form of risk capital, especially for social enterprises, where the high levels of profitability that are needed to repay debt might be incompatible with their social aims. All debts, however patient, eventually have to be repaid.

Social enterprises are defined as businesses that have "primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners."

The purpose, objectives and behaviour of a social enterprise are enshrined in its legal and organisational form. There are many different forms of social enterprise, including charities, charitable incorporated organisations, not-for-profit companies limited by guarantee, community interest companies, co-operative societies, and community benefit societies. Each of these forms has a distinct approach to social objectives, ownership, control and capital finance.

The term "community shares" refers to withdrawable share capital; a form of share capital unique to industrial and provident society legislation. This type of share capital can only be issued by co-operative societies, community benefit societies and charitable community benefit societies.

Community shares are an ideal way for communities to invest in enterprises serving a community purpose. The remainder of this section explains how community shares work and why industrial and provident society legislation is the preferred legal form for community shares, the business model underpinning community shares, and the many starting points for community share initiatives.

2.2 How community shares work

2.2.1 Origins

The term community shares was coined by the Development Trust Association (now Locality) in its 2008 publication *Community Share and Bond Issues*, which examined how a growing number of community enterprises were raising investment capital from their local supporters. In the same year, Co-operatives UK published a document called *Community Investment: using industrial and provident society legislation*, addressing the same phenomenon, but focusing exclusively on industrial and provident societies. It identified 39 societies that had raised more than £10,000 in share capital through public share offers since the early 1990s, at the rate of three or four new initiatives per year. Later that year, the two organisations set up the Community Shares programme, an action research partnership funded by the Cabinet Office and the Department of Communities and Local Government (DCLG). The programme ran from 2009 to 2011, during which time over 150 new societies were formed with the aim of making community share offers.

The Community Shares Unit was launched in October 2012. It continues as a joint initiative between Locality and Co-operatives UK with funding from DCLG. Since 2009 over 350 new societies have been registered, and more than 130 community share offers have been successfully completed. In total, more than £20m of share capital has been raised from over 20,000 investors.

2.2.2 What are community shares?

Community shares is a term used to describe withdrawable share capital; a form of equity unique to industrial and provident societies. Shareholders have the right to withdraw their share capital, subject to the terms and conditions stated in the society's rules and share offer document. Withdrawability solves a liquidity problem faced by any minority shareholder in a small enterprise. Shares in companies are normally transferable, not withdrawable. Under normal circumstances, companies are not allowed to redeem their shares. Instead, the shareholder must find a willing buyer for the shares, which can be very difficult for minority shareholders, especially if the company is too small to be listed on a stock market.

In solving the liquidity problem for shareholders, societies create a liquidity problem for themselves. A society must plan how it will generate the cash to allow share capital to be withdrawn. The most effective way of doing this is by attracting new members and new shareholders, to replace members and shareholders that are leaving the society. (see Section 3.3)

2.2.3 Shareholder motivation

The motivation for buying shares in an industrial and provident society is wholly different from that of shareholders in companies. This is reflected in the differences between company law and society law, and in how these corporate forms are regulated when they seek to raise capital from the public.

The commonly accepted purpose of private enterprise is to maximise the wealth of owners and shareholders. Shareholders are motivated by the revenues they receive in the form of dividends, and by the capital gains they may achieve through any increase in the value of the enterprise. Company law caters for this by allowing companies to pay unlimited dividends, by giving shareholders full rights over the assets of the enterprise, and by allowing shareholders to sell or transfer their shares to a third party at a mutually

acceptable price.

Social enterprises are motivated by their social objectives and social purpose. For social enterprises registered as industrial and provident societies, this social purpose is either for the mutual benefit of members in a bona fide co-operative society, or for broader community benefits in a community benefit society, which may, in some cases, include charitable objects. These differences in investor motivation are enshrined in society law by means of limits on the financial return on investment, restrictions on the scope for capital gains, and caps on the amount of capital an individual can invest. All of these matters are addressed in more detail below.

The primary motivation for purchasing shares in a society is to support the social purpose and objects of the enterprise. Financial motivation is at best secondary, and any return on capital is better understood as compensation rather than a reward for risk taking.

Because of these differences in investor motivation, industrial and provident societies are normally exempt from financial promotions regulations when promoting the sale of share capital to the public (See Section 8).

2.2.4 Return on investment

Unlike other types of business, it is not the object of a society to maximise profits for members and shareholders. Instead, any interest payable on share capital "*should be no more than is necessary to obtain and retain enough capital to run the business*".

Section 1(3) of the Industrial and Provident Societies Act 1965 states that "*a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person*". To be a bona fide co-operative a society must conform to the Statement on the Co-operative Identity of the International Co-operative Alliance. The Third Principle of this Statement says that "*members usually receive limited compensation, if any, on capital subscribed as a condition of membership*".

Although the 1965 Act makes no equivalent statement relating to community benefit societies, Section 1 (2) makes it clear that *"the business of the society is being, or is intended to be, conducted for the benefit of the community."* This is generally taken to preclude conducting activities with the primary object of making distributable profits.

2.2.5 Capital gains

The scope for a shareholder in a society to make a capital gain is either severely restricted or eliminated by a variety of mechanisms, including the nature of withdrawable share capital, the opportunity for community benefit societies to impose an asset lock, and the requirement for co-operatives to satisfy the FCA that they are bona fide.

Withdrawable share capital cannot be sold or transferred to third parties, except under special conditions where the member has died and the rules of the society allow the shares to be transferred on the death of a member. Instead, withdrawable share capital can be withdrawn from the society, subject to terms and conditions (See Section 3.2.2). This will normally be at the paid-up value of the shares, although some societies have rules that allow them to discount the value of share capital under special circumstances.

Societies can issue transferable shares, which, at least in theory, could be subject to capital gains (or losses). However, transferable share capital is outside of the scope of the Community Shares Unit (See Section 3.2.3).

A capital gain could also be achieved by shareholders if the society were able to distribute residual assets in the event of the society being dissolved. However, the rules of societies usually prohibit the distribution of residual assets. A community benefit society can choose to adopt a statutory asset lock by becoming a prescribed community benefit society (see Section 3.4). This asset lock prevents a community benefit society from converting to a form that would allow it to distribute residual assets to members. A charitable community benefit society is subject to the same asset lock as a registered charity.

The position of co-operative societies is complex. Most co-operative societies have rules that prevent the distribution of residual assets to members. However, there is scope for a co-operative society to convert into a company, which in turn would enable it to distribute residual assets to members.

These restrictions on capital gains may mean that societies have to offer a higher financial return to attract and retain the share capital than they would if capital gains were permitted. This, in turn, could mean that societies reinvest less of their profits in the business. However, in most societies, interest on share capital is credited to members' share accounts rather than paid out in cash, and is thus automatically reinvested in the society until it is withdrawn by members. Although there are no capital gains, there can be growth in the amount of share capital held by members.

2.2.6 Shareholder influence

Shareholders and members of societies are restricted in the amount of influence and control they can exercise individually. This is achieved through two legal mechanisms. Societies are required to state in their rules how decisions will be made at general meetings. Bona fide co-operative societies are required to work to the co-operative principle of one-member-one-vote, regardless of the amount of share capital held by an individual. Industrial and provident society legislation makes no provision for voting arrangements to be allocated on the basis of shareholdings, so the principle of one-member-one-vote also applies to all community benefit societies by default.

The other way in which shareholder influence is restricted is by placing a legal limit on the maximum amount of withdrawable share capital an individual may hold in a society. Currently this limit is set at £20,000. This maximum limit prevents a society from being overly dependent on larger investors. A society can choose to adopt a lower maximum limit in its rules, which may be advisable for smaller societies, where £20,000 could be a significant proportion of the total capital they require.

2.2.7 Community interest companies

Community interest companies (CICs) can, and do, sell shares to investors and raise capital from the communities they serve. But they must do so in a way that is completely different from industrial and provident societies.

CICs are a regulated form of company. As such they are fully subject to company law, plus the specific provisions of the CIC regulations. CIC legislation, introduced in 2005, provided a new regulatory framework governing the three main forms of company: a private company limited by shares, a company limited by guarantee, and a public limited company (plc).

Section 755 of the Companies Act 2006 prohibits private companies from making public share offers. This means that any company planning to make a public offer of its securities must convert to a plc before making the public offer. This includes CICs, which must become CIC plcs. Plcs are required to have a minimum of £50,000 in paid-up share capital, meet more stringent auditing and public reporting standards, and are generally subject to greater levels of regulation and compliance, making this form of company too costly for most community enterprises with a capitalisation of under £5m.

The Financial Promotion Order 2005 (see Section 8.2) requires financial promotions to be overseen by an FCA authorised person, unless the promotion is exempt from these provisions. The Order specifies a range of exemptions, including an exemption for industrial and provident societies, but not for CICs. Other exemptions include high net worth individuals, sophisticated investors, and the 'common interest group' of a company. This could include defined groups such as the members of a company, its employees, customers and suppliers, or other groups with a pre-existing interest in the affairs of the company making the promotion.

In addition to complying with the Financial Promotion Order, larger financial promotions must also comply with the Prospectus Regulations 2005. These regulations apply to promotions made to more than 100 people or where the total being sought exceeds the sterling equivalent of €5m. Societies issuing withdrawable share capital are exempt from these Regulations, as are charities and other non-profit-making bodies or associations, which could be interpreted as including CICs.

To sum up, it is possible for a CIC to make a share offer to the public, but it must be a plc and employ an FCA authorised person to oversee its communications with the public. The costs associated with these requirements can be onerous and out of scale with the capital requirements of most community enterprises.

There are also financial and governance reasons why CICs may not be a suitable form for community shares. Unlike societies, companies cannot issue withdrawable shares; their shares must be either transferable or redeemable, which requires a very different approach to capital liquidity. On the other hand, there are no restrictions on the amount of share capital an individual may hold in a CIC. The dividend cap on

CICs may allow investors a far higher return on capital than can be offered on shares in societies, but because the cap is based on start-up capital, it can have consequences for secondary investors.

Although the CIC form may not be suited to community investment, it is still a suitable form for equity investment by social investors. It may be particularly suited to social investors who want to exercise control over their investment, because CICs work to the principle of one-share-one-vote. The private placement of CIC equity with social investors could be facilitated by social investment financial intermediaries who understand the constraints of the Financial Promotion Orders and have access to sophisticated investors and high-net-worth individuals.

2.3 The business model

Investing in community shares engages communities in a virtuous circle where it is in their interests as members and investors to also be active as customers, as supporters, and as volunteers. The same applies to other stakeholders, including employees and suppliers, giving new meaning to the term multi-stakeholder, where the same person engages with the enterprise through a multiplicity of stakeholder roles.

This is in contrast to the conventional business model, where the interests of shareholders are at odds with other stakeholders. Profit maximisation for shareholders is at the cost of customers, suppliers, employees and other investors. There is no incentive to volunteer, or to become an active supporter of an enterprise that works in someone else's interests.

Community shares promote a different sort of business model, where it is in the interests of all stakeholders to work together to create wealth and to use their democratic rights to determine how that wealth is distributed. It is in the mutual interests of all stakeholders to become members and investors, not just when the society is established, but on a continuing basis as the enterprise grows and develops. New customers, suppliers and employees can be encouraged to become members and investors, to replace the share capital being withdrawn by older members when they leave the society.

Community shares relies heavily on community engagement; the involvement of people in the life of the enterprise. Societies need to define their target communities, and to develop the identity of these communities. Most communities are geographic in nature, but it is not always obvious where the boundaries of geographic communities lie, and whether people within that community have a shared identity.

Community identity can transcend geography and focus instead on shared interests, values, concerns, or beliefs. Examples include a shared interest in renewable energy, local food production, affordable housing, support for a football club, or community services provided by a faith group.

Community shares can provide an enterprise with a competitive advantage by engaging stakeholders in new responses to the causes of market failure. For instance, many small businesses fail because the owner is unable to find a buyer willing or able to purchase the business. Communities can spread the cost and risk of acquisition across a large number of shareholders. A business might be failing through a lack of demand; communities can address this by aggregating demand and ensuring that the business serves the

community. A business might be unable to control costs resulting in unaffordable prices; a community can reduce costs by volunteering, or by providing cheaper capital.

2.4 Starting points

2.4.1 The initial stimulus

Since the inception of the Community Shares programme in 2009, more than 90% of community share offers have been made by new societies. Most of these societies have been formed by communities in response to one or more of the following:

- a community is about to lose a local service, for instance, a pub, shop or post office, or any other community service that is encountering market failure
- a community is being poorly served by an existing enterprise, for instance, supporters of a football club may feel that the current owners do not serve their interests, or a local service is too expensive or fails to address local needs
- a community need or interest is not being met, for instance, there may be no local sports facilities, poor broadband connections, or a lack of flexible workspaces for new businesses
- a community is inspired by new ideas or opportunities to act collectively, for instance, by the scope to establish community renewable energy schemes, local food initiatives, or develop community land trusts for affordable housing.

These stimuli result in new societies being formed as pre-start initiatives, or to act as the vehicle for acquisitions and buy-outs of existing enterprises that are failing in these communities.

2.4.2 Pre-start initiatives

There are four main challenges facing all community enterprise pre-start initiatives:

- developing a robust, competent development team capable of taking the idea forward to start-up
- establishing the business case for the proposed enterprise; testing the business viability of the idea and showing that the enterprise will be profitable; ensuring that the proposed development is in scale with the target community
- identifying the target community for the initiative; establishing contact with this community, and winning their support for the initiative; engaging the community in the development process
- obtaining the resources to pay for the pre-start development costs, which can amount to at least 5% to 10% of the capital costs at start-up.

A lack of resources is probably the greatest barrier for pre-start initiatives, with some new societies taking three or more years to become investment-ready.

2.4.3 Acquisitions and buy-outs

Acquisitions and buy-outs mainly arise when a community is driven to rescuing a local business threatened with closure or, in exceptional circumstances, where the community feels poorly served by the business. Communities engaged in acquisitions and buy-outs face all the same challenges as pre-start initiatives, but with the extra burden of:

- having to act quickly, especially if there is competition to buy the business or its principal assets
- having to commit to development costs with no certainty that it will be successful in acquiring the business, with the risk of substantial losses
- the difficulty of agreeing a fair valuation for the business, especially when the principle assets are worth more as non-business assets.

The first of these challenges can be moderated by using the powers included in the Localism Act to list Assets of Community Value. This gives communities six months in which to prepare a bid to purchase a listed asset if it is put up for sale.

Compared with a new-start enterprise, the one advantage of acquisitions and buy-outs is that at least the business in question has a track record, which provides a benchmark for planning performance improvements.

2.4.4 Start-ups

Even when a new enterprise has got through the pre-start stage and is able to prove that it is investment-ready, there is still a lot to do before it can launch a community share offer. There are four main documents it needs to have in place:

- a governing document that sets out the rules of the society, defining its purpose, objectives, membership, management and form of share capital
- an offer document aimed at the target community promoting the sale of share capital; community share offers are normally exempt from financial promotions regulations, but are nevertheless bound by contract law to observe good practice and follow guidance on these matters
- a business plan that provides the evidence to support the assumptions and assertions made in the offer document
- a community engagement plan for recruiting members to the society, involving them in the business model, and securing their investment.

Community share offers are markedly different to share offers made by private enterprise, in the following ways:

- Private enterprises usually only make public offers at a relatively late stage in their development, typically as part of an exit strategy for private equity. In contrast, community share offers tend to be made by new enterprises with no proven record of success.

- New private enterprises usually raise share capital from family, friends, business angels and other types of sophisticated investor, whereas community share offers are aimed at people who are unlikely to have had any prior experience, knowledge or competencies in investing in enterprise.
- Start-up private enterprises tend to raise share capital through private placements, which might lead to a handful of investors purchasing stakes in lots of £50,000 to £100,000. In contrast, the average number of investors in a community share offer is 200 and the average amount invested is £1,000 per investor.

2.4.5 Established social enterprises

There are more than 6,000 societies in the UK that are over 10 years old, but only 40 or so of these societies have ever issued significant amounts of withdrawable share capital. Very few established societies actually use the full scope of their legal form to engage the communities they serve, and it may well be that very few of these societies fully appreciate the capability their legal form offers for simultaneously raising investment capital and engaging their communities.

There are approximately 68,000 social enterprises in the UK. According to a recent survey by Social Enterprise UK, their most commonly held objective is community improvement, cited by 25% of respondents. However, only a handful of these social enterprises have taken advantage of what community shares has to offer in terms of capital finance and community engagement. The vast majority of social enterprises are structured as registered charities or community interest companies limited by guarantee, neither of which can issue share capital. However, as Section 3.6 explains, both of these types of organisations can be converted into industrial and provident societies without any change to their objectives.

The long-term market potential for community shares is substantial. Even if only half of the current stock of social enterprises that see themselves as serving their community were to adopt community shares in the next ten years, there could be as many as 8,500 community-financed enterprises by 2023.

3 Industrial and provident society legislation

3.1 Types of industrial provident societies

3.1.1 Introduction

There are three main forms of industrial and provident society: a bona fide co-operative, a community benefit society, and a charitable community benefit society. Industrial and provident society legislation also makes provisions for credit unions, but these are subject to separate legislation and are outside the scope of this guidance. Two other forms of mutual society, building societies and friendly societies, are also subject to separate legislation and are also outside the scope of this guidance.

All three main forms of industrial and provident society can issue the same types of share capital, including withdrawable share capital, which is also known as community shares.

3.1.2 Bona fide co-operative societies

Industrial and provident society legislation refers to a bona fide co-operative society, but the legislation does not define or describe what a bona fide co-operative society is. Instead, it is left to the Financial Conduct Authority, the body responsible for registering societies, to determine whether a society is a bona fide co-operative. It does this by reference to the International Co-operative Alliance's *Statement on the Co-operative Identity 1995*, commonly known as the Rochdale Principles. According to the Statement, a co-operative is defined as "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise." Co-operatives "are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of co-operative founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others."

The Statement also contains seven co-operative principles, which the FCA uses to determine whether a society is a bona fide co-operative, along with the above definition of a co-operative. According to the FCA, a bona fide co-operative must have rules which embody the following characteristics:

- **"Community of interest**: There should be a common economic, social or cultural need or interest among all members of the co-operative.
- **Conduct of business:** The business will be run for the mutual benefit of the members, so that the benefit members obtain will stem principally from their participation in the business. Participation may vary according to the nature of the business and may consist of: buying from or selling to the society; using the services or amenities provided by it; or supplying services to carry out its business.
- **Control**: Control of the society lies with all members. It is exercised by them equally and should not be based, for example, on the amount of money each member has put into the society. In general, the principle of 'one member, one vote' should apply. Officers of the society should generally be elected by

the members who may also vote to remove them from office.

- **Interest on share and loan capital**: Where part of the business capital is the common property of the co-operative, members should receive only limited compensation (if any) on any share or loan capital which they subscribe. Interest on share and loan capital must not be more than a rate necessary to obtain and retain enough capital to run the business. Section 1(3) of the [Industrial and Provident Society] 1965 Act states that a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person.
- **Profits**: If the rules of the society allow profits to be distributed, they must be distributed among the members in line with those rules. Each member should receive an amount that reflects the extent to which they have traded with the society or taken part in its business. For example, in a retail trading society or an agricultural marketing society, profits might be distributed among members as a dividend or bonus on purchases from or sales to the society. In other societies (for example, social clubs) profits are not usually distributed among individual members but members benefit through cheaper prices or improvements in the amenities available.
- **Restriction on membership**: There should normally be open membership. This should not be restricted artificially to increase the value of the rights and interests of current members, but there may be grounds for restricting membership in certain circumstances, which do not offend co-operative principles. For example, the membership of a club might be limited by the size of its premises, or the membership of a self-build housing society by the number of houses that could be built on a particular site."

The second of these points, on "conduct of business" sets out the basis for membership of a co-operative, focusing on participation in the business. This would appear to exclude from membership people who only have an investor relationship with the society, and do not otherwise use the services of the society as a customer, supplier, employee or volunteer. In 2006 the Financial Services Authority (predecessor to the FCA) issued a policy note, stating that a co-operative could have investor-members who are not otherwise users of the society's services, subject to certain restrictions. This is addressed in more detail in Section 3.2.4.

3.1.3 Community benefit societies

A community benefit society (called a *benefit of the community society* by the FCA) is run primarily for the benefit of the community at large, rather than just for members of the society. This means that it must have an overarching community purpose that reaches beyond its membership. An applicant society must specify the geographic community, community of interest, or other group of people it intends to serves. It must state what these activities of benefit will be, and explain how they will benefit the community. It must also state how the surpluses of the society will be used. This latter matter is dealt with in more detail in Section 6.

The FCA normally expects a community benefit society to fulfil the following conditions:

- **"Conduct of business:** The business must be run primarily for the benefit of people who are not members of the society, and must also be in the interests of the community at large. It will usually be

charitable or philanthropic in character. Interest on share and loan capital. It is unusual for a benefit of the community society to issue more than nominal share capital (for example, one £1 share per member). Where it does issue more than nominal share capital or where members make loans to the society, or both, any interest paid must not be more than a reasonable rate necessary to obtain and retain enough capital to run the business.

- **Profits and assets**: The society's rules must not allow either profits or the society's assets to be distributed to the members. Profits must generally be used to further the objects of the society by being ploughed back into the business. Where profits are used in part for another purpose, that purpose should be similar to the main object of the society, for example for philanthropic or charitable purposes. The rules must specify the beneficiary or beneficiaries, if any. Where the rules of the society allow assets to be sold, the proceeds of the sale should be used to further the society's business activities only.
- **Dissolution:** The society's rules must not allow its assets to be distributed to its members on dissolution. The rules should state that on dissolution the assets should be transferred, for example, to some other body with similar objects. If no such body exists, the rules should state that the assets must then be used for similar charitable or philanthropic purposes."

The above reference to it being "unusual" for a community benefit society "to issue more than nominal share capital", reflects the fact that community share offers by community benefit societies is a relatively recent development, and only a tiny number (approximately 250) of the total stock of community benefit societies, estimated to be in the region of 4,000, have raised capital this way. It does not mean that the FCA disapproves of community share offers by community benefit societies.

Unlike a co-operative society, a community benefit society cannot distribute surpluses to members in the form of dividends. A community benefit society can opt to become a prescribed community benefit society with a statutory asset lock, which has the same strength as an asset lock for a charity and for a community interest company. This type of asset lock is not currently available for co-operatives. Section 2.4 examines asset lock provisions in more detail.

Another difference is that the FCA does not require members to participate in the business, which means that, unlike a co-operative society, anyone is able to invest in a community benefit society, subject to its rules. Although a society is required by the FCA to specify the community it serves, membership is not restricted to this community.

3.1.4 Charitable community benefit societies

A charitable community benefit society is a community benefit society with charitable purposes. The Charity Commission provides guidance on what constitutes a charitable purpose, based on the Charities Act 2011, which sets out 12 main charitable purposes plus any other purposes that can be recognised as charitable under existing law. (For further information see: www.charitycommission.gov.uk/start-up-a-charity/setting-up-a-charity)

A charitable community benefit society must only have exclusively charitable objects. This means that a

charitable community benefit society that intends to engage in trading activities that are neither in pursuit of its primary purpose nor ancillary to that purpose, may have to establish a trading subsidiary to carry out this trade.

A charitable community benefit society must have an asset lock. This must take the form of a rule stating that if the society is dissolved, any residual assets must be transferred to another charity with the same or similar charitable purposes. The asset lock rules prescribed by the Community Benefit Societies (Restriction on the use of assets) Regulations 2006 will not suffice, as they do not give exclusive rights to charities. (This matter is dealt with in greater detail in Section 3.4.)

A charitable community benefit society cannot register as a charity with the Charity Commission. Instead it must apply to HMRC to be recognised as an exempt charity for tax purposes. The Charities Act 2006 introduced changes to how exempt charities are regulated, and required all exempt charities to have a principal regulator. However, a principal regulator has yet to be appointed for charitable community benefit societies that are not registered social landlords. (For further information see: Charity Commission*, CC23 Exempt charities.*)

A charitable community benefit society may include the words 'charity' or 'charitable' in its name if it has obtained prior permission from the relevant authorities (see Section 4.2.1). The Charity Commission will only agree to the use of these words by entities it considers to be charitable.

The Charity Commission issued a statement in 2012 acknowledging that charitable community benefit societies may issue community shares and pay members interest on share capital, subject to a number of conditions. (See Section 7.2 for further details.)

Exempt charities are entitled to the same tax benefits as registered charities. This includes relief from income tax, corporation tax and capital gains tax, exemption from inheritance tax and relief from business or non-domestic rates.

When registering a new charitable community benefit society, information must be provided about the charity's trustees. This includes their full name, contact details, occupation, date of birth and signature. The FCA checks that the persons named are not disqualified from acting as charity trustees. However, the FCA does not grant exempt charity status, this is a matter addressed by a separate application to HMRC.

3.1.5 Choosing between society forms

All three types of society have their pros and cons. Co-operatives have the scope to pay members a dividend based on the level of their transactions with the co-operative, which can incentivise member loyalty and strengthen the business model. Prescribed community benefit societies (see Section 3.4) may provide greater reassurance to public funders and grant-giving bodies that none of their money will end up in private hands, while still giving the society greater freedom in their choice of objects and purpose. Charitable community benefit societies enjoy all the tax benefits that apply to charities, but are restricted to exclusively charitable purposes.

Co-operatives might have greater appeal to members who are attracted by the benefits of mutuality and community; community benefit societies might be more appealing to members who put wider community benefit before their mutual interests.

Choosing between a co-operative society or community benefit society structure is important because, while it is possible to convert a co-operative into a community benefit society, it is not possible to convert a community benefit society into a co-operative.

In the UK, a co-operative can take any legal form, as long as its governing document enshrines the co-operative values and principles laid out in the ICA Statement on the Co-operative Identity. Many community benefit societies are co-operative members of Co-operatives UK and refer to themselves as co-operatives; some even use the term co-operative in their trading name, but not in their registered name.

3.2 Share capital in societies

3.2.1 Share typologies

All three types of industrial provident society referred to in the previous sub-section can issue shares that are transferable and/or withdrawable, or non-transferable and non-withdrawable. For the purposes of this handbook, non-withdrawable, non-transferable shares are referred to as membership shares. Currently, there is no legal provision for societies to issue redeemable shares, which are unique to company law.

In addition to there being different types of shares, a society can issue more than one class of share of the same type, with different rights attached to each class, clearly stated in the rules of the society. Membership and voting rights are normally attached to share capital, although some societies with multiple classes of shares, issue shares that do not carry voting rights. This is explored in more detail in 3.2.6.

Regardless of which type of shares a society issues, it is normal for all three types of society to practice member democracy, based on the principle of one-member-one-vote, rather than one-share-one-vote, which is the default position of company law. Democratic member control is a legal requirement for bona fide co-operatives. For community benefit societies and charitable community benefit societies the same legal requirement does not apply, but is usually observed in practice.

3.2.2 Withdrawable shares

Community shares are withdrawable shares. Members are allowed to withdraw this type of capital, subject to the rules of the society. The rules can specify the terms for withdrawal, such as a period of notice of the intention to withdraw, the proportion of total share capital that can be withdrawn at any one time, as well as the right of the board to suspend withdrawal or to offer applicants only a fraction of the value of their share capital.

International accounting standards require that if withdrawable share capital is to be recorded as equity for

accounting purposes, the society must have the discretionary powers to suspend or refuse withdrawal clearly stated in its rules. If a society does not have these powers, then withdrawable share capital must be treated as a long-term liability.

There is a legal limit on the amount of withdrawable share capital that can be held by an individual member, currently standing at £20,000. The purpose of the limit is prevent a member having undue financial influence, or for the society to be overly dependent on a small number of members.

Withdrawable shares are not normally transferable, unless a member dies, in which case their shares are transferred as part of member's estate. Industrial and provident society legislation makes specific provision to allow members to nominate the person or persons who will benefit from their property in the society, including withdrawable share capital.

3.2.3 Transferable shares

Transferable shares are shares that can be traded between buyers and sellers at a mutually agreed price. Any type of society is free to issue transferable shares, as long as provision has been made for this in its rules. Transferable shares cannot be withdrawn from a society, unless the rules state otherwise. As such, transferable share capital is part of the permanent capital of the society, freeing it from any responsibility to make provision for liquidity. Instead, it is the responsibility of the shareholder to find a buyer if they want to realise the value of their shares. Since 2012 there has been no upper limit on the amount of transferable share capital an individual can hold in a society.

The main problem with transferable shares is the lack of any secondary market or social motive for buying such shares after they have been issued by a society. Buying shares when they are first issued, in a society that needs the capital to get started, provides the investor with a clear social motive. But buying those same shares from an existing shareholder only helps that shareholder get their money back; it does nothing for the society; there is no social motive. Of course, it might be possible for a society to create a financial motive by offering high interest rates on transferable shares, but this might be contrary to the purpose of the society, which is primarily social not financial.

Another problem with transferable shares is that they are not exempt from financial promotions regulations if issued by a co-operative society, which means that this type of society must have their communications vetted by an FCA authorised adviser if they do decide to issue transferable shares. It may also need to comply with the prospectus regulations if the amount of share capital on offer is above the minimum level. The only exception to this is a community benefit society, which is exempt from the prospectus regulations when issuing transferable share capital as long as the money raised is used for its business purposes. However, a community benefit society issuing transferable share capital is still subject to Financial Promotion Order 2005 and must have its communications supervised by an FCA authorised person.

For these reasons, transferable share capital is outside the remit of the Community Shares Unit.

It is theoretically possible to issue shares that are transferable and withdrawable, but it is assumed that such

capital would be subject to the £20,000 individual shareholding limit, and at the same time would not be exempt from financial promotions regulations. That is why this type of share capital is also outside of the remit the Community Shares Unit.

3.2.4 Investor shares

A bona fide cooperative society can recruit investor-only members, but it should do so by creating a separate class of shares called investor shares. The FCA has adopted the following policy on this matter:

> "a) We will wish to be satisfied that a society inviting investors into membership has protections in its rules which ensure that the participation of investors will not prejudice its standing as a bona fide co-operative society; the rules of a society must expressly provide for investor membership and set out the rights and conditions attaching to the shares, including the restriction on voting on a resolution to convert to company status;
>
> b) Shares issued to investors should be known as 'Investor Shares'. Investor Shares may be acquired by both natural and legal persons, subject to the statutory limit on the total interest a person, other than another I&P society, may hold in the shares of a society registered under the Act; a user member should not be permitted to hold Investor Shares;
>
> c) The voting rights of holders of Investor Shares may be restricted as the rules of a society direct, and may include a power to elect one or more Investor Shareholder representatives to the committee; however, we would not register rules which would permit the holders of Investor Shares to vote on a motion to convert the co-operative to company status, as such a power could compromise a society's status as a bona fide co-operative;
>
> d) Investor Shares may be withdrawable or transferable; where transferable, the issuing society should take legal advice as to whether the issue falls within Part VI of the Financial Services and Markets Act 2000 ("FSMA");
>
> e) Investor Shares should only be issued as 'risk capital';
>
> f) The holders of Investor Shares may participate in the distribution of surplus as the society's rules direct; and
>
> g) Co-operatives should not issue Investor Shares without first discussing the risks and consequences with their legal advisors."

Unlike other parts of Europe, where the collective voting power of investor-members is limited to no more than a quarter of the total, the FCA does not specify what restrictions, if any, should be placed on the voting powers of investor-members. The only restriction it does place on investor members is that they cannot participate in a resolution to convert the co-operative into a company.

3.2.5 Membership shares and subscriptions

Non-withdrawable, non-transferable shares are referred to as membership shares in this handbook. All three types of society can issue this type of share capital. If the shareholder ceases to be a member of the society, the share capital is cancelled and transferred to the general reserves of the society. This type of share capital is normally of fixed and nominal value, typically ranging from £1 to £25, although there is no legal limit on the amount. However, a bona fide co-operative society should not have artificial restrictions to open membership, and a highly priced membership share might be seen as such a restriction.

The rules determining how membership is terminated are important in deciding what price a membership share should be. A society can charge a member an annual subscription, and failure to pay this subscription is normally grounds for terminating membership. Where a society charges members an annual subscription, it is normal for the membership share to have a low nominal value, usually deducted from the first year's subscription.

It is reasonable for a membership share to be set at a higher fixed price if the society does not charge an annual subscription, on the grounds that the cost of providing membership services must be covered by the price of the membership share.

3.2.6 Multiple classes of shares

The FCA has registered society rules with multiple classes of shares, including shares that carry no membership rights, shares with different membership rights, and shares with different terms and conditions. Each of these variations is dealt with in turn in this sub-section.

It is unusual for a society to issue shares that carry no membership rights, and where this does happen, it is normal to restrict the sale of these shares to members only. The reason for this is usually that the society already has an established membership, based on membership shares and annual subscriptions, and it wants to maintain the pre-eminence of membership shares over this second type of share. This arrangement might act as a deterrent to investors, who do not want to pay an annual subscription in order to maintain their investment.

The FCA has approved rules for societies with multiple classes of share with different voting rights. If a bona fide co-operative society wants to have multiple classes of shares, it must still uphold the principle of member democracy, although there can be sectional representation on the board of directors, and a class of membership can be excluded from voting on sensitive matters.

Multiple classes of shares can also be used to vary the terms and conditions of each class of share. For instance, a society may incentivise investment in a pre-start society by granting early investors preferential terms for withdrawal and/or preferential interest rates. Or a society may decide to establish a new class of share for a specific investment project, with its own withdrawal terms and interest rates, distinct from the terms applying to the original class of shares. Such arrangements place a duty on the society to maintain transparent financial accounting and reporting procedures.

3.3 Liquidity of withdrawable shares

The liquidity of withdrawable share capital is the main reason why an industrial and provident society is suited to community investment. It provides small investors with an exit route where normally, if the society were issuing transferable share capital in a small enterprise, there would be none.

By comparison, the only way that liquidity can be achieved for a large number of investors with transferable share capital, is for the enterprise to be large enough to be listed on a stock exchange. A stock exchange works when there are sufficient buyers and sellers interested in an enterprise's shares to generate liquidity. Usually, an enterprise needs to have issued between £10m and £25m in share capital before it can be listed on a stock exchange. In smaller enterprises liquidity is usually provided by selling all the shares to another person or enterprise, but such decisions can only easily be taken if ownership of the enterprise is restricted to a handful of shareholders with majority control.

Withdrawable share capital solves the problem of liquidity for investors, but it does so by creating a responsibility for societies to provide liquidity. This is a major difference between a society and a company, which has no responsibility to provide liquidity for shareholders unless it has issued redeemable shares.

There are five main ways in which a society can provide liquidity for members holding withdrawable shares. Before issuing community shares, a society should decide which of these methods it will use, and ensure that this is reflected in its business plan and share offer document. This, in turn, will depend on the starting point of the society, its trading activities, objects and purpose. The methods can be used singly or in combination.

- **Raising new share capital**: this can be achieved through an open offer, enabling the society to recruit new members and raise new share capital. Open offers work best where the community is already engaged as customers, volunteers, employees, or suppliers, making the invitation to become a member and investor all the more appealing. Existing members can also be encouraged to invest additional capital.
- **Reinvestment by existing members**: It is normal practice for societies to credit the share accounts of its existing members with share interest and/or dividend payments, thereby reinvesting this money in the share capital of the society. Depending on the scale of these payments, this can be a significant source of investment. The growth in value of a member's share account is the closest equivalent to a capital gain in a society.
- **Redemption of shares from reserves**: Most societies have rules that allow them to finance withdrawals from reserves, thereby reducing the total share capital held in the society.
- **Capital depreciation funds**: The use of capital depreciation funds as a source of liquidity is only acceptable if the society is planning wind up when the equipment purchased with the share capital reaches the end of its life. This approach has been used by some community energy initiatives. A society adopting this approach should make it very clear to members through its offer documents and general meetings.
- **Replacement with loan capital:** This approach is wholly dependent on securing the agreement of a lender to provide capital for such purposes. In most cases there would need to be special reasons for a

lender to agree to such an arrangement.

A society can manage its capital liquidity in a number of ways. It has the powers to set terms and conditions for the withdrawal of share capital in its rules (see Section 4.2.9). This usually includes rules that require members to give a set notice period, from one week to one year, of their request to withdraw some or all of their capital; rules that cap the total amount of share capital that can be withdrawn in any one financial year; and rules that allow the society to discount the value of its share capital. In addition, a society can adopt a rule which gives the board of directors the power to suspend withdrawals. This rule is mandatory if the society is to present its share capital as an asset on its balance sheet.

Most new societies will defer making provisions for liquidity by suspending the withdrawal of share capital for an initial period of three years or more. Suspension can be justified on the grounds that the investment activity will take time to get established and become profitable. However, there are drawbacks to suspending withdrawals. It may deter people from joining the society and making an initial investment and will also delay the society's progression towards making an open offer.

3.4 Asset lock provisions

An asset lock is a legal device preventing the distribution of residual assets to members. The purpose of an asset lock is to ensure that the public benefit or community benefit of any public funding is maintained, and cannot be of private benefit. Charities and Community Interest Companies are obliged to have asset locks, but industrial and provident societies are not.

The Community Benefit Societies (Restriction on Use of Assets) Regulations 2006 introduced the option for community benefit societies to adopt an asset lock with similar qualities to those available to Community Interest Companies. Community benefit societies adopting this restriction are referred to in the Regulations as 'prescribed community benefit societies'.

This restriction on the use of assets means that any residual assets, after all members' share capital has been refunded according to the rules of the society, must be transferred to one or more of the following: another prescribed community benefit society, a community interest company, a charity, a charitable community benefit society, a registered social landlord (subject to conditions), or any equivalent body in Northern Ireland or a state outside the United Kingdom.

The restriction can be included in the rules of a new community benefit society, or adopted by an existing community benefit society through a special resolution. Schedule 1 of the Regulations specifies the exact wording of the rules that must be adopted.

A charitable community benefit society must have an asset lock that satisfies the requirements of charity law. The 2006 Regulations cannot be used for this purpose because they are not compatible with charity law.

Most other community benefit societies have rules that prevent the distribution of residual assets to

members and specify how these residual assets can be used. The FCA requires all community benefit societies to have rules which prevent the profits or the assets from being distributed to members. However, community benefit societies that have not adopted the restrictions set out in the 2006 Regulations are free to amend such rules, subject to FCA approval.

The position of co-operative societies is less clear. Industrial and provident society legislation has nothing to say about the use of residual assets of co-operative societies. But the FCA does have a duty to ensure that co-operative societies are bona fide co-operatives, and this is usually done by reference to the ICA Statement on Co-operative Identity. The Third Principle on Member Economic Participation is:

> "Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."

Arguably, common property and indivisible reserves can only be secured by the co-operative society having rules that in part restrict the distribution of assets. Most co-operative societies adopt rules which embody the principle of indivisible reserves, even though there is no provision within industrial and provident society legislation to enforce these rules. A co-operative society can convert into a company, subject to the provisions of the Industrial and Provident Society Act 2002, which requires societies wishing to convert into a company to pass a special resolution to that effect, supported by at least a three-quarters majority vote in which at least half the membership has participated.

3.5 Debt

3.5.1 Borrowing

All societies are required to state in their rules the terms and conditions on which they will borrow capital from members and others, including commercial sources. These terms may include details of the security offered to lenders and the maximum amount that can be borrowed. Industrial and provident society legislation makes an important distinction between loans and deposits: loans are used for the business purposes of the society, whereas deposits can be used for other purposes. However, deposit-taking is a regulated activity and most societies adopt rules which expressly forbid it.

There are no legal restrictions on the terms and conditions of the lending arrangements a society enters into. This is treated as a commercial decision of the society. Nor is there any requirement for societies to register secured loans or mortgages. Instead, the annual return made by societies only requires the society to state the amount of its total long term liabilities and the loans from members. This sets societies apart from companies, which are obliged to register any fixed or floating charges secured against the assets of the company with Companies House. These charges are available for public inspection and it is routine for

lenders to inspect such charges as part of their due diligence before making a loan. Commercial lenders may be more reluctant to enter into loan agreements with societies because there is no equivalent public register of charges for societies.

There is no limit on the amount of money a member, or other person, may lend to a society, other than the maximum amount stated in the society's rules. This means that members who want to invest more than the legal maximum for withdrawable share capital could lend additional capital, on terms agreed with the society. These loans can be secured against specific assets, or subject to a floating charge against all assets, or not secured at all. Both parties are free to agree whatever interest rates and repayment terms they choose.

A society seeking to raise capital through the offer of bonds, loanstock, debentures or any other form of debt instrument, is exempt from financial promotions and prospectus regulations, on condition that these debt instruments are non-transferable.

3.5.2 Bonds

A bond is a form of loan agreement between an individual and an enterprise. Capital is loaned in small denominations, typically between £100 and £500, and evidenced by a bond or agreement that the society promises to pay interest and to repay the capital to the bondholder on a set date. Bonds are usually transferable between third parties. Bonds are widely used by public authorities, credit institutions and companies, but are rarely used by smaller community enterprises. Bonds do not confer ownership or voting rights.

Most societies prefer to issue shares rather than bonds. The reasons for this are fairly straightforward. Debt has to be repaid according to a pre-agreed schedule and normally carries a pre-arranged interest rate. Equity, particularly withdrawable share capital, is not subject to any pre-arranged repayment schedule or interest rates.

There are, of course, situations where bonds are appropriate. As they offer greater security and certainty, bonds may be a more attractive financial proposition for investors. Registered charities cannot issue equity that bears dividends, so bonds may be a good alternative. Other organisations, such as workers' co-operatives, might like the idea of raising capital from their supporters without having to compromise their principles of workers' control. Bonds provide a good solution to this problem because no voting rights are attached to them. Bonds may be attractive to members who have already invested the maximum £20,000 that any individual is allowed to hold in withdrawable share capital but still wish to invest more. It is possible that some investors would prefer bonds with fixed interest rates and redemption periods.

Some larger co-operatives and housing associations have turned to the London Stock Exchange bonds market to raise capital, but as these issues are not targeted at the public, they cannot be considered a form of community finance.

Bonds do not provide for community engagement. Bondholders are not members, and they have no voting

rights in the affairs of the society. There is not the same scope to engage bondholders in the business activities of the society as customers, volunteers or elected directors. Bonds do not give legal title to the enterprise or convey community ownership.

There are other disadvantages to bonds. They must be repaid by a fixed date, which means that profits will have to be made and set aside to fund these repayments. Although it may be possible to replace old bonds with a fresh issue, this means re-incurring the cost of raising capital, with the attendant risk that investors may not want to renew their bonds. Bonds can also be more expensive, especially if they are issued with a high fixed rate of interest that turns out to be more than the cost of commercial debt over the same period.

There are other ways of raising loan capital from the public, including the offer of loan stock or debenture stock: the former is fully at risk, while the latter is usually secured against a specific asset held by the enterprise. Selling any form of debt product to the public is a regulated activity, subject to the Financial Services and Markets Act 2000 and its associated Regulatory Orders, unless there are exemptions. Co-operative and community benefit societies are usually exempt.

3.6 Converting legal structures

3.6.1 Converting a company into a society

A company can, by special resolution, convert into a registered society. Additional requirements apply to community interest companies (see Section 3.6.2).

A special resolution is a resolution passed by a majority of at least three-quarters of the voting shares, if it is a company limited by shares, or three-quarters of the voting members, if it is a company limited by guarantee. A copy of this special resolution, signed by the secretary of the company and the chair of the meeting at which the resolution was approved, must accompany the application to convert into a society.

A company can re-register either as a co-operative or a community benefit society, unless the company is a registered charity, in which case it can only convert into a community benefit society, and only then with the express permission of the Charity Commission (see Section 3.6.3). The rules of the new society must be signed by the secretary and three members of the company.

If the company is a company limited by shares, then the nominal value of withdrawable shares held by a member cannot exceed £20,000. This nominal value should be the paid-up value of the shares held, excluding any share premium. If a member of the company holds in excess of £20,000 in paid-up share capital, the excess share capital should be designated as transferable share capital in the society, and there must be provision in the rules for the society to issue this type of share capital.

If the company is a company limited by guarantee, then provision must be made for the members of the company to become members of the society by purchasing the minimum amount of share capital stated in its rules. This also applies to a company limited by guarantee that is a registered charity, which must first obtain the permission of the Charity Commission to de-register as charity.

3.6.2 Converting a community interest company into a society

Section 6A of the Community Interest Company Regulations 2005 allows a community interest company (CIC) to convert into an industrial provident society, but only in the form of a community benefit society that has a restriction on the use of its assets in accordance with the Community Benefit Societies (Restriction on Use of Assets) Regulations 2006 or the associated regulations in Northern Ireland (see Section 3.4). A CIC cannot convert into a co-operative society.

In order to convert, a special resolution must be passed by a three-quarters majority vote in favour. A copy of this special resolution must be submitted to the Registrar of Companies, who will forward them to the CIC Regulator. The special resolution must be accompanied by a copy of the rules of the new society and a statement by an authorised member of the company confirming that, in their opinion, when the new rules take effect, the company will become a community benefit society with the required restriction on the use of assets.

The CIC Regulator must decide whether the company is eligible to cease being a CIC. The company is eligible if, under the Companies (Audit, Investigations and Community Enterprise) Act 2004, it is not under investigation by an auditor, director or manager appointed by the CIC regulator; it is not currently subject to civil proceedings instigated by the CIC Regulator; none of its property is held by the Official Property Holder as a trustee for the company; and it is not subject to any petition to be wound up as a company.

The CIC Regulator must give notice of its decision to the company. If the CIC Regulator states that the company is eligible to cease being a CIC, this notice must be sent to the Financial Conduct Authority (FCA), together with a copy of the special resolution to convert, and the rules of the society containing the restriction on the use of assets. Finally, a certificate issued by the FCA confirming that the society has been registered, together with a copy of the decision by the CIC Regulator, must be submitted to the Registrar of Companies for the conversion to take effect.

It is not possible to directly convert a CIC into a charitable community benefit society. Instead, a CIC would first have to become a registered charity, and then apply to the Charity Commission to become a charitable community benefit society.

3.6.3 Converting a registered charity into a charitable community benefit society

A charitable company can convert into a charitable community benefit society only with the prior written consent of the Charity Commission. Any other sort of charity can only become a charitable community benefit society by winding up and transferring its assets to a charitable community benefit society, again, with the prior written consent of the Charity Commission.

Under the Charities Act 2011, all charitable community benefit societies are currently exempt charities. The Act provides for the reform of exempt charity regulation, including the appointment of principal regulators or the removal of exempt charity status. The Charity Commission says that:

> "No firm decision has been made on the future regulation of community benefit societies [and friendly societies] as charities. One possibility is that those which are registered social housing providers may remain exempt whilst others may lose their exemption if no suitable principal regulator can be found." (Charity Commission CC23 Exempt Charities, March 2012)

Currently, therefore, a registered charitable company converting to a charitable community benefit society with the consent of the Charity Commission to the changes of its articles would automatically become an exempt charity, and would be removed from the Charity Commission's register. The Charity Commission does not offer any guidance on this matter but will consider applications on a case by case basis. The Charity Commission will not consent if, in its opinion, the conversion would result in a community benefit society that was not charitable. Therefore, by agreeing to the conversion, the Charity Commission is giving its implicit approval to the charitable nature of the new form. It is up to HMRC to decide whether a charitable community benefit society is an exempt charity, but it will always defer to the Charity Commission in determining whether a legal entity is charitable.

In order to be registered as a community benefit society, there is a condition that, in view of the fact that the business of the society is being, or intended to be, conducted for the benefit of the community, that there are special reasons why the society should be registered under industrial and provident society legislation rather than as a company under company law.

3.6.4 Converting a society into a company

An industrial and provident society can convert into a company, except for a prescribed community benefit society, which has a rule restricting the use of its assets (see Section 3.4). A community benefit society with this rule can only convert into a company if its residual assets are transferred to another similarly asset-locked community benefit society, or registered social landlord, community interest company, charity, or equivalent body in Northern Ireland, and would require the prior consent of the appropriate regulator.

The Industrial and Provident Societies Act 2002 introduced new requirements for a special resolution to be passed by members approving conversion. These requirements state that at least half of the qualifying members of the society must vote on the special resolution to convert, either in person, or where the rules allow, by proxy, and at least three-quarters of those members who vote must be in favour of the resolution for it to be passed. A qualifying member is a member of the society who is entitled to vote under the society's rules. A second meeting to confirm the special resolution must be held between two weeks and one month after the first meeting. The resolution to confirm must be passed by the majority of those qualifying members who vote, and the meeting most be quorate under the society's rules.

The wording of the special resolution should indicate whether the society is converting into a company limited by shares or a company limited by guarantee. If the society is converting into a company limited by guarantee, provisions should be made for members to withdraw or cancel any share capital they hold in the society.

A society cannot be converted into a pre-existing company. Prior to registering the special resolution with

the FCA, the society must apply to Companies House to register the company, telling it that the application is being made by an industrial and provident society with the intention of converting into that company. The society should request that the application is not registered until a date for conversion has been agreed by the FCA and Companies House.

3.6.5 Converting a society into a Charitable Incorporated Organisation

There are provisions in the Charities Act 2011 to enable a charitable community benefit society to convert into a charitable incorporated organisation (CIO). However, further regulations are needed to complete the legal framework allowing an industrial and provident society to convert into a CIO. Unless and until these regulations are implemented, it is not possible for a society to convert into a CIO.

3.7 Amalgamations and transfers of engagements

An amalgamation is the merger of one society with another society or company, to form a new legal entity. A transfer of engagements involves the transfer of a society's business to another society, or company. The Industrial and Provident Societies Act 1965 makes provision for both of these actions.

Any two or more societies may be amalgamated to form one new society by means of each society passing a special resolution, supported by at least a two-thirds majority of its members. Members of each amalgamating society will become members of the new amalgamated society and hold shares in that society in place of the shares they held in the separate societies before amalgamation. The property of each society will be vested in the new amalgamated society without the need for any form of conveyance. The special resolutions must be registered and approved with the FCA. In the case of a transfer of engagements from one society to another society, members of the transferring society will be made members and shareholders of the other society and the transferring society will cease to exist.

In the case of a society amalgamating with or transferring its engagements to a company, the special resolution proposing this change must secure a three-quarters majority in favour, with a least half of all eligible members participating in the vote. The special resolution must make provision for the society's members' share capital and voting rights in the company that emerges from this process. The society will cease to exist when the amalgamation or transfer is complete.

Prescribed community benefit societies and charitable community benefit societies can only amalgamate or transfer their engagements to other prescribed community benefit societies and charitable community benefit societies respectively.

3.8 Investments in other legal entities

3.8.1 Guiding principles

Section 31 of the Industrial and Provident Societies Act (1965) allows societies to invest funds in other corporate entities and securities. The Act also requires societies to state in their rules whether, and if so, by what authority and in what manner, any part of their funds may be invested.

A distinction should be made between investing the general reserves of a society, and investing capital raised through a public share offer where the purposes of that offer are to invest in another legal entity. The Financial Services and Markets Act 2000 only gives exemption from regulation to societies making public offers where the "*proceeds of the offer will be used for the purposes of the issuer's objectives*" (see Schedule 11). This is taken to mean the objects of the society as stated in its rules. Section 1 of the Industrial and Provident Societies Act (1965) explicitly prevents co-operative societies from raising capital with the object of making profits to pay dividends, interest or bonuses to members on the money invested. It also restricts community benefit societies to business which is of benefit to the community.

It is permissible for a society to invest some of its general reserves in other legal entities, but it should only do so to further the objects of the society, and in a way that meets the needs of the society to maintain financial liquidity and solvency. This would include normal treasury practices of keeping cash in deposit accounts and other types of liquid investment.

It is not permissible for a society to raise capital with the specific intention of investing in other legal entities over which it has no overall control, or to act as a collective investment vehicle, unless it is authorised by the FSA to do so.

The guiding principles are:

- Investment by a society in other legal entities should only be made when it furthers the objects and business of the society.
- A society must always act within its own rules on investment.
- Capital should only be raised to further the objects and business activities of a society, and not to invest in other legal entities over which it has no overall control.
- Any capital raised by a society through a public offer should only be invested in other legal entities in a way that fully protects the terms of the public offer.
- A society should not raise share capital with the specific intention of investing that capital in another legal entity over which it does not have overall control.

3.8.2 Wholly-owned subsidiaries

A wholly-owned subsidiary is a legal entity over which the parent organisation has sole control. The subsidiary may be structured as a company but not normally as a society. A society cannot be a wholly-owned subsidiary because a society must normally have a minimum of three members, or two members if both these members are societies.

If the subsidiary is a company limited by shares, all voting shares must be owned by the society, or, if the subsidiary is a company limited by guarantee, the society must have the sole power to appoint and dismiss directors.

If a society is investing general reserves (retained surpluses and/or donations), it can use whatever method of investment it chooses, be it in the form of equity, debt or donation, bearing in mind its own rules, its overall level of reserves, and the potentially different tax treatments of these forms of investment. If a society chooses to invest in the form of transferable equity then it must be willing and able to sell the subsidiary if this is in the best interests of the society.

If a society is investing capital raised through a public offer it should only invest in a subsidiary in a way that enables it to honour the terms of the public offer. If the society has issued withdrawable share capital, then this capital should only be invested in the subsidiary either in the form of a loan or, in exceptional circumstances, as redeemable share capital if the subsidiary is a company limited by shares.

Company law imposes restrictions on redeemable shares, only allowing a company to redeem this type of share capital using distributable profits, or newly issued shares, unless it is a private company that adopts special procedures to protect creditors. This makes redeemable shares an unsuitable method for investing withdrawable share capital in a subsidiary, unless there are reasons for believing that the withdrawal terms of the public offer can still be met.

The repayment schedule for the loan must be consistent with the terms and conditions for withdrawal of share capital from the society. For example, if a society is making an open offer (see Section 5.6) and limits the total amount of share capital that can be withdrawn in any one year to 10%, then the capital invested in the subsidiary must be repayable at this 10% rate. If a society is raising capital through a time bound offer, then the forecast business performance of the subsidiary should be used to set the terms of the offer.

Likewise, the interest or dividends payable on any investment must be consistent with any financial returns mentioned in the public offer document. At all times, the society must be minded to manage the subsidiary in the best interests of its members, and be prepared to sell the subsidiary if doing so would serve the society's best interests.

3.8.3 Majority-owned ventures

A majority-owned venture is a legal entity in which a society holds over half of the voting shares, with other persons owning the remainder of voting shares.

If a society owns a controlling majority of the shares, generally taken to be three-quarters of the voting shares, and in the absence of any shareholder agreements that give any special powers to minority shareholders, then for investment purposes, it can be treated in the same way as a wholly-owned subsidiary.

If a society owns a majority of voting shares but does not have full control of the legal entity, then it can still

invest in this legal entity, subject to the following safeguards. The objects of the majority-owned venture should be the same as those of the society. The society should only invest capital in the form of loans or redeemable shares regardless of whether this capital is part of its general reserves or has been raised through a public offer. If the capital being invested has been raised through a public offer, then the terms of the investment should mirror the terms of that public offer. The society should have the power to veto any changes to the governing document of the legal entity, or any associated shareholder agreement.

3.8.4 Joint ventures

A joint venture is taken to mean a legal entity owned by two or more partners on more or less equal terms. These terms may be expressed in a shareholder agreement if the joint venture is structured as a company, or a partnership agreement if it is structured as a limited liability partnership (LLP). Alternatively, the joint venture may be structured as a society if the other members are also societies.

If a society is investing its general reserves in a joint venture, then it should only do so in pursuit of its objects and business. It should only invest in a joint venture where it has influence over the venture that is written into the shareholder or partnership agreement, or by holding at least a quarter of any voting rights. The amount invested should not be so large as to adversely affect its own liquidity or solvency, should the joint venture encounter financial difficulties.

A society should not raise capital through a public offer to invest in a joint venture unless it has overall control of the joint venture (in which case it would be more properly described as a majority-owned venture (see Section 3.8.3)).

3.8.5 Minority stakes

A minority stake is defined as a shareholding in a legal entity which does not provide the investor with sufficient voting rights to protect their interests. This is usually the case where the investor has less than a quarter of the total voting rights.

A society is entitled to invest some of its general reserves in other legal entities, as long as it acts within its rules and the amount invested should not be so large as to adversely affect its own liquidity or solvency, should the legal entity encounter financial difficulties. It should seek to invest in a way that best serves the business interests of the society, typically in the form of secured loans, bonds or debenture. Shares should only be purchased if the legal entity is listed on a stock market, or the shares are redeemable or withdrawable.

A society should not raise share capital to acquire minority stakes in other legal entities.

3.8.6 Investing in other societies

It is acceptable for one society to invest in another society, subject to the above guidance in this section. But care should be taken to avoid cross-investment of withdrawable share capital, where two or more societies invest in each other, which could artificially bolster the balance sheets of each society.

3.8.7 Transparency of investments

As a matter of good practice, a society should declare in its annual accounts and report, details of any investments it has made in other legal entities, along with details of any corporate investment it has received.

3.9 Dissolution of societies

A society can be wound-up under the Insolvency Act 1986 if it is insolvent, or by way of an Instrument of Dissolution, if it is still solvent. Member share capital is fully at risk, and any share capital belonging to a member will only be realisable after all other creditors of the society have been repaid in full. Currently, there is no equivalent to the administrative procedures available to companies, which allow them to enter into a Company Voluntary Arrangement if they are insolvent. However, there is no reason why a society could not try to negotiate a voluntary arrangement with its creditors, including its members and shareholders. Most societies have rules that allow them to discount the value of shares if it is in the best interests of the society.

If a society is insolvent, it will be wound up under the Insolvency Act 1986. Members will lose their share capital, but, under normal circumstances, will not be liable to contribute towards the debts of the society. However, under Section 57 of the Industrial and Provident Societies Act 1965, members who have withdrawn share capital up to one year before the date of the insolvency remain liable for the debts of the society, up to the value of the share capital they have withdrawn.

If a society is solvent and is up-to-date in making its annual returns, it can apply to the FCA for an instrument of dissolution to terminate its registration as a society. An instrument of dissolution must be signed by at least three-quarters of the members of the society, or if it is a dormant society, approved by a special resolution passed by a two-thirds majority vote. The residual assets of the society must be disposed of in the manner prescribed by the society's registered rules. An instrument of dissolution has to be advertised by the FCA in the London or Edinburgh Gazette, giving members of the society three months' notice of their right to ask a court to set aside the dissolution. A society with residual assets of less than £1,000 can request to cancel its registration. This does not require the consent of members or a special resolution, but can be subject to a legal challenge.

4 Governing documents

4.1 Registration processes

Any organisation seeking to become a co-operative society or a community benefit society must register its rules with the Financial Conduct Authority (FCA). This registration function of the FCA is distinct from its role as regulator of the financial services industry in the UK.

There are several matters to consider in deciding when to register a new society. Early registration can give a new enterprise initiative some momentum, provide it with a legal identity, and limit the personal liability of the promoters. It also enables a society to begin the work of community engagement, allowing people to become members of the society. A consideration against early registration is the cost involved. Pre-start groups may simply not have the resources to cover the cost of registration. There is also the danger of adopting rules that will not be fit for the purposes of the society by the time it is ready to trade.

The FCA website has a section devoted to the registration of new societies, which provides all the necessary forms. The application form states that it takes 15 working days to examine each application. There is no provision for the directors of societies to self-certify that the governing document is compliant with society law, as there is for companies.

Applicants are required to submit a set of rules that must cover 14 matters required by law (see Section 4.2). Rules can cover additional matters as long as these matters do not conflict with legislation and are acceptable to the FCA. Once approved, a society is obliged to follow its rules, so it is important that it is committed to implementing all the rules it adopts, including those that are supplementary to the rules required by law. Rules can be added, amended or rescinded, but only with the support of a general meeting of members and the permission of the FCA.

The application form also requires applicants to state whether they are registering a co-operative society or a community benefit society, and to provide additional details if they are registering the latter, including whether it will be a charitable community benefit society. Applications can be made to register new societies, or to convert an existing company, including a CIC into a society, subject to certain conditions. Companies that are registered charities can only convert into a charitable community benefit society, and this must be approved by the Charity Commission. Similarly, a CIC can only convert into a prescribed community benefit society (see Section 3.6.2).

To register a new society, the FCA requires the name, contact details and signature of at least three founder members, including the secretary of the proposed society. Applications to register a charitable community benefit society must provide more extensive details of all the proposed charity trustees so that the FCA can check that the persons named have not been disqualified from acting as a charity trustee.

The FCA has a duty to examine the rules of all applicant societies. This is reflected in the fees the FCA charges to register societies. The fees are lower if the applicant society uses the model rules of a sponsoring body (see Section 4.3). Model rules have been pre-approved by the FCA. It charges an additional fee for

inspecting amendments to model rules made by applicant societies.

4.2 Statutory rules

4.2.1 Name

The FCA has the powers to register the name of a society, and to decide whether a proposed name is acceptable. A name should be unique, memorable, reflect the character of the society, and not be offensive. The FCA says that a name should generally include a reference to the business activity, membership, community of benefit and/or the geographic location of the society. Languages other than English and Welsh cannot be used unless a translation is provided.

The name must not be the same as, or very similar to, that of another existing society, company or charity, unless it is somehow connected or related to this other entity, and has its express permission. The same applies to defunct entities that have traded within the previous 10 years. Exceptions to this principle will only be made if the proposed business activity or the location is very different from that of the defunct entity, or if the defunct entity never actually traded.

The FCA provides guidance on sensitive words in names, which can only be used if there is supporting evidence to justify their use, or the society has obtained the permission of the relevant authority. There are three main categories of sensitive word: words implying the society trades nationally or internationally, words implying an authoritative or representative status, and words implying a specific object or function. Included in the latter category are the words ‘charity’ and ‘co-operative’, which the FCA will only allow the appropriate type of society to use in their registered name.

4.2.2 Objects

Objects describe the purpose of an enterprise and the scope of its operations. Most sponsoring bodies provide standard objects rules that are broad and flexible enough to enable the enterprise to fully engage in all forms of business or trade. Some sponsoring bodies encourage societies to be more specific about their purpose, in order to protect the vision of the founders, and to prevent a society changing its purpose without the consent of at least three-quarters of its membership.

To register as a co-operative society, it is an FCA requirement that the society should be carrying on “*an industry, business or trade, whether retail or wholesale*”. This excludes co-operatives that are set up just as investment vehicles in order to invest in the activities of other societies or companies. This is reinforced by another requirement that “*a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person*”.

To register a community benefit society the objects rules must be consistent with other information required by the FCA to test whether the society is of benefit to the community. This includes information

defining the community of benefit, the activities which are meant to be of benefit to this community, and an explanation of how this activity is of benefit to the community.

The objects of a charitable community benefit society must be exclusively charitable if it is to be recognised as a charity, even though it will be unable to register as a charity with the Charity Commission. It must also comply with the Charity Commission's guidance on public benefit if it is to be recognised as an exempt charity by HMRC. (See www.charitycommission.gov.uk/detailed-guidance/charitable-purposes-and-public-benefit)

4.2.3 Address

The rules must give the address for the registered office of the named society. The FCA must be notified of any subsequent change of address for the registered office.

4.2.4 Admission of members

The rules must state who can (and cannot) be a member, including individuals, corporate bodies, and the nominees of unincorporated bodies. This includes joint members, where one member must be the nominee representing the interests of the joint members. A society must have a minimum of three founder members, or two founder members if both are societies.

Industrial and provident society legislation has little to say about membership. Section 1 of the Industrial and Provident Societies Act 1965 requires the registering authority, the FCA, to be satisfied that a co-operative society is a bona fide co-operative, which implies that it must meet internationally agreed principles for membership of co-operatives. No similar requirements apply to community benefit societies.

Legislative changes introduced in 2012 scrapped the minimum age for membership of a society, and lowered the minimum age for election as a board member to 16. However, societies are free to set a minimum age for membership, and many societies have chosen to retain 16 as a minimum age for members.

It is generally accepted that the question of whether a society is a bona fide co-operative should be decided by reference to the International Co-operative Alliance (ICA) Statement on Co-operative Identity. The First Principle of this statement is "*Voluntary and Open Membership: co-operatives are voluntary organisations, open to all persons to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination*".

This has been taken to mean that membership of a co-operative should focus on a user relationship, such as customer, employee or supplier. Sponsoring bodies have also registered model rules which include membership for those who support the objects of the co-operative, or who are its intended beneficiaries. This covers community co-operatives that restrict their membership to people residing or working in a defined geographic area, and supporter members, defined as people who support the purpose or objects of

the co-operative. Most co-operatives focus on a single user group, although some sponsoring bodies offer model rules for multi-stakeholder co-operatives.

However, Section 1.3 of the Industrial and Provident Societies Act 1965 excludes from its definition of a co-operative society "*a society which carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person*".

In 2006 the Financial Services Authority (FSA) published a policy note on investor membership of co-operative societies. It concluded that investor membership was acceptable, as long as such members were a separate class of member from user members, and there were restrictions in place that prevented investor members from voting on special resolutions to convert the society into a company.

An alternative interpretation of Section 1.3 of the Act is that the rules must not allow more than half of the operating profits of a co-operative society to be used for the payment of interest, dividends or bonuses to members. This would then allow investors to be accommodated as supporter members of a co-operative society.

Section 1.3 does not apply to community benefit societies, which are free to admit whoever they choose to membership. Most model rules for community benefit societies define members as those who support the objects of the society.

A society can have more than one category of membership, with different rights attached to these categories. However, co-operative societies must ensure that such membership rules are consistent with the International Co-operative Alliance's Statement on Co-operative Identity.

There is also scope to impose an annual subscription fee as a condition of membership. Annual subscriptions are a useful way of covering the cost of providing membership services and can assist the society in maintaining an up-to-date membership list, by requiring members to stay in touch with the society. However, requiring members to pay an annual subscription can be incompatible with encouraging members to maintain their investment in share capital, unless provisions are made to distinguish between the two types of membership, or subscriptions are waived for members holding more than a specified minimum amount of share capital. Others ways of addressing this issue include rules that allow the society to deduct annual subscriptions from the member's share account, or that convert share capital into debt if membership is terminated as a consequence of failing to pay the annual subscription.

The FCA has also approved model rules that allow for nominee shareholdings. This is where an approved nominee holds shares on behalf of their clients, and exercises their proxy votes at general meetings, subject to restrictions. Nominees will normally be independent financial advisers or the managers of investment funds. While such arrangements may make it possible to attract investment from wider sources, they could weaken the community engagement aspects of community investment, and make the society vulnerable to the influence of the nominee.

4.2.5 Conduct of meetings

All societies are required by law to hold general meetings of their members on at least an annual basis to oversee the affairs of the society. The rules of a society set out how these meetings should be conducted. Most societies adopt rules that provide for an annual general meeting, where the annual report and accounts are considered, auditors are appointed, directors are elected, and decisions are taken on the use of profits and any resolutions to change the rules of the society.

The rules will normally set a quorum for general meetings, usually expressed either as a minimum proportion of the total membership, typically 10%, or as a minimum number of members. Some societies have rules that set the quorum as an either/or option, whichever is the lower. Rules may also be adopted to allow for proxy votes, and postal or electronic ballots.

The rules must describe how votes will be conducted in meetings, and the arrangements for deciding between a simple show of hands or a secret ballot. Nearly all societies work to the principle of one-member-one-vote (there are some secondary and federal co-operative societies with corporate membership rules where there is proportionate voting). There is no provision in industrial and provident society legislation for allocating voting rights to shares. The rules must also set the majority required to amend, rescind or add new rules. The Industrial and Provident Societies Act 1965 requires special resolutions with specified minimum majorities for decisions to amalgamate with, or transfer engagements to, another society or company (see Section 3.7), or to convert a society into a company (see Section 3.6.4).

4.2.6 Board members

The FCA requires all societies' rules to state how members of the committee of management, or board of directors, will be appointed and removed, and similarly, how the officers of this board will be appointed and removed, and the arrangements, if any, for paying committee or board members. Under society legislation the minimum age for board membership is 16.

The good governance of a society depends on having an active board of directors, elected by the members, to oversee the affairs of the society. In electing a board, members are delegating their sovereign powers to directors. The directors are accountable to the membership, and are responsible for supervising the managers and executive staff who run the business. Societies, except for charitable societies, can choose to have a mix of executive and non-executive directors on their boards, or opt for an exclusively non-executive board, serviced by executive staff.

Consideration needs to be given to the size of the board, its composition, and the length of service of directors. Usually the size of the board is expressed in terms of a minimum and maximum number of members, typically between three and 12. Some multi-stakeholder societies have rules that reserve a set number of places on the board for different membership categories. Societies may also have rules that allow the board to co-opt individuals with specialist or professional skills. Most societies require directors to either retire or seek re-election after a defined period, typically three years, usually on a rotational basis so

that no more than a third of the board are standing for election, thus allowing for some continuity of membership.

Societies differ widely on the matter of pay and expenses. Some societies will only pay directors out-o--pocket expenses; this is a requirement for charitable community benefit societies. Others will pay directors a fee commensurate with the services they provide.

Societies must have rules to remove directors. Usually this is a power held by a simple majority vote of members at a general meeting. Societies will normally have rules for removing directors who have been declared bankrupt, or are deemed medically incapable of carrying out their duties. Some societies have rules to remove directors if they fail to attend a minimum consecutive number of board meetings.

The rules must also address the appointment of officers. All societies are obliged by law to appoint a secretary. Other officer posts, such as treasurer, chair and vice-chair, are at the discretion of the society. Other discretionary rules include provisions for the proceedings at board meetings, focusing mainly on quora and the role of the chair and the use of electronic media to conduct remote meetings.

The board members of a charitable community benefit society are charity trustees by law, and are responsible for ensuring that the society complies with the requirements of charity law (See Charity Commission CC23 Exempt Charities)

4.2.7 Maximum shareholdings

All societies must have a rule that stipulates the maximum shareholding a member may have. Most societies set their maximum shareholding at the maximum permitted by law for withdrawable share capital, currently £20,000. This maximum does not apply to corporate members that are registered co-operative societies or community benefit societies, where no upper limit applies.

Careful consideration should be given to the proportion of total capital any one individual or corporate entity can invest in a society, in order to limit dependency on larger investors. Smaller societies, seeking to raise less than £200,000 in withdrawable share capital, may choose to set a maximum below the legal limit, typically 5% to 10% of the total capital required by the society. Larger societies may choose to limit the maximum amount that another society can invest in them.

There is no legal maximum limit for transferable share capital issued by a society. For reasons explained in Section 3.2.3, the Community Shares Unit does not advise societies to offer transferable share capital to the general public.

Most societies also adopt rules that set a minimum shareholding for membership. This can vary from a nominal £1 to as much as £1,000 or more. A higher minimum shareholding may be justified if the society does not charge an annual subscription, in order to cover the cost of providing membership services. However, a high minimum shareholding may be a barrier to membership, which could contravene the co-operative principle of open membership, for societies registering as co-operatives. This can be mitigated by

establishing mechanisms to allow members to invest in instalments to reach the minimum level.

4.2.8 Loans and deposits

A society must have rules stating whether it will allow members or others to hold deposits or make loans to the society and, if so, under what terms and conditions. The rules must also state the maximum amount that can be borrowed.

The distinction between loans and deposits is crucial. Deposit-taking is a regulated activity, whereas accepting loans for the purposes of the business is not regulated. Non-transferable debt securities are exempt from prospectus requirements, and a society is allowed to make non-real-time communications about its own debt securities without complying with the financial promotion rules, which would otherwise require an authorised person to approve the material communicated.

Most societies adopt rules that expressly forbid deposit taking, but allow the society to borrow from members as well as from other sources such as banks or commercial lenders. Some societies have rules that fix the maximum amount that can be borrowed and/or the maximum interest rate that can be paid on loans. Borrowing can be an important way of raising additional capital, especially from members who already have the maximum permitted shareholding.

4.2.9 Terms and conditions for share capital

Societies can issue shares that are transferable and/or withdrawable, or non-withdrawable and non-transferable (this type of share capital is cancelled on termination of membership, and the money is transferred to the general reserves of the society). The rules must state what type of share capital the society intends to issue, and the terms and conditions applying to these shares.

Very few societies choose to issue transferable shares, for the reasons explained in Section 3.2.3. Withdrawable share capital is the norm for societies, although there are major differences in the terms and conditions adopted by societies for this type of capital, which in turn affect the liquidity of the shares and the capital flows of the society. These terms and conditions also have a bearing on how withdrawable share capital is treated in the accounts of the society.

Most societies adopt rules that give the board the discretion to suspend the right of withdrawal. This rule is necessary for withdrawable share capital to be treated as equity, not debt, on the balance sheet of the society. Shareholders must be told if the board has the right to suspend withdrawals.

One common reason for suspending withdrawals is the time it takes for a new investment to generate sufficient profits to finance withdrawals. Societies need to plan for the liquidity of their share capital, and reflect these plans in the terms and conditions of their shares. Societies planning to apply for Enterprise Investment Scheme (EIS) tax relief also need to make it clear that withdrawals are at the discretion of the board and are suspended for at least the first three years of trading after investment.

The rules should also state what period of notice a member must give when they ask to withdraw some or all of their share capital. This is usually stated as a minimum period of notice, typically ranging from one week to one year. Some societies also adopt rules that limit the proportion of share capital that can be withdrawn in a year, or that limit withdrawals in some other way, such as linking them to retained profit, or the issue of new share capital.

Another condition sometimes applied to withdrawable share capital is the right of the board to reduce the value of shares. This right is usually linked to an assessment that the net asset value of the enterprise can no longer support the full value of the share capital, justifying a temporary or permanent reduction in share value. Some societies have a rule which allows them to deduct an administrative charge for withdrawals.

The terms and conditions applied to withdrawable share capital have a big impact on the liquidity of share capital and therefore its attractiveness to potential investors. It is very important to ensure that the rules address all the terms and conditions a society may want to place on its share offers.

4.2.10 Audits and auditors

All societies are required to have a rule stating their obligation to appoint an auditor in accordance with the relevant Act. Societies can, if their rules permit it, pass a resolution at their AGM exempting them from a full professional audit, if their turnover and assets are below a prescribed level. Some societies also have additional rules stating their statutory obligation to make annual returns to the FCA.

4.2.11 Terminating membership

Rules governing the termination of membership have important long-term consequences for societies that promote community investment. The rules should enable a society to manage their membership, ensure that members remain in contact with the society, and provide the scope for dealing with dormant or untraceable members.

Provision must be made for the circumstances under which membership of the society may be terminated, and the arrangements for handling terminations. The rules must allow members to cancel their membership, or for membership to be terminated if the member no longer satisfies the criteria for admission. Most societies also adopt rules that allow the board to expel members, for instance, if a member fails to pay an annual subscription, or fails to respond to communications over a period of two years, or is untraceable by the society.

The rules must also state what provisions have been made to handle claims by the representatives of a deceased member, or by the trustee of a member who has been declared bankrupt.

The rules should also make provision for any withdrawable share capital held by a person whose membership has been terminated. Some societies have rules specifying that nominal amounts of share capital are neither withdrawable nor transferable, but are forfeited if membership is terminated. Other

societies have rules that allow withdrawable share capital to be converted into loans upon termination of membership.

4.2.12 Use of profits

The FCA has different approaches to how profits can be used in a co-operative society and a community benefit society. The Charity Commission also has a policy about the use of profits by a charitable community benefit society.

Co-operative societies are established for the mutual benefit of members, and are allowed by law to use some of their surpluses to pay a dividend to members, based on the members' level of transactions with the co-operative. Some co-operative societies have rules that limit the proportion of profits that can be used to pay dividends.

The FCA requires co-operative societies to use profits equitably, but also says co-operatives should not be run primarily to make profits for distribution. This stops short of the ICA Statement on Co-operative Identity, which requires co-operatives to use at least some of their profits to create 'indivisible reserves'. Indivisible reserves are taken to mean reserves that cannot be distributed to members on the dissolution of the co-operative. This matter is addressed in more detail in Section 3.4.

The FCA requirements for community benefit societies are much clearer: "*the society's rules must not allow either profits or the society's assets to be distributed to the members*". Any profits must be used to further the objects of the society by being ploughed back into the business, or by being distributed to beneficiaries with objects the same as, or similar to, those of the society.

Community benefit societies cannot use profits to pay dividends to members, but in common with co-operative societies, they can pay interest on share capital. Interest on share capital is a pre-profit expense for a society, and is therefore not a use of profits. The FCA states that interest rates on share capital should not be more than is sufficient to attract and retain the investment. Most societies have rules which limit the maximum rate of interest payable on share capital. Many societies also have rules that give the board the discretion to set actual interest rates to be paid on share capital only after the operating profit of the society is known.

There are further constraints on how a charitable community benefit society may use profits. The Charity Commission considers that a power to distribute profits is fundamentally incompatible with charity status. It has issued specific policy guidance for charitable community benefit societies with shareholder members, on how these members may be paid interest on their share capital. (See Section 7.2).

4.2.13 Official documents

The FCA requires that the rules state whether the society intends to have a 'common seal', a device for stamping official documents such as share certificates, and if it does have a common seal, to state how it

will be used. Most societies make provisions for a common seal or its equivalent.

The law does not require societies to have a common seal or to issue share certificates, although if a society decides against issuing share certificates it should make alternative provisions so that members know how much share capital they hold.

Societies that intend to pay interest and/or dividends, or that plan to charge members an annual subscription fee, should consider introducing individual share accounts for members. Instead of sending out cheques for interest and/or dividend payments, or share certificates worth the same amount, the society could send members an annual statement of their share account, listing all receipts, withdrawals and charges. This would mean all interest and dividend payments are automatically re-invested, as well as enabling a society to charge an annual subscription fee without having to get members to make an annual payment. In order to manage share accounts this way, a society would need to have a 'lien on shares', which is the right to offset a member's debt against their share capital.

4.2.14 Investments

Section 31 of the Industrial and Provident Societies Act 1965 allows societies to invest funds in other corporate bodies and local authorities. Societies must have rules making provisions for investment. Some societies have rules determining how investment decisions above a set value must be made. Section 3.8 addresses investment in other legal entities.

4.3 Sponsoring bodies and model rules

Sponsoring bodies publish model rules that have been pre-approved by the FCA. The FCA publishes a list of sponsors on its website. Currently, it lists 24 sponsoring bodies, although there are six sponsors that produce rules that are suitable for community investment and are marketed as such by the sponsoring body. These bodies are:

- Baywind Energy Co-operative
- Co-operatives UK
- Plunkett Foundation
- Somerset Co-operative Services
- Supporters Direct
- Wessex Community Assets.

These sponsoring bodies offer a full registration service, which includes offering advice on amendments to their model rules, and will submit applications to the FCA on behalf of their clients. Details of their charges are outlined later in this section.

The alternative to using model rules is to employ the services of a legal professional with knowledge and experience of formulating co-operative and community benefit society rules, or to write rules without

professional support. The FCA does not require applications to be made by a professional person, although, as noted above, it does charge more for examining applications that are not based on model rules, and these fees are non-refundable, even if the application is rejected.

4.4 Amending rules

A society can add, delete or amend its registered rules, subject to the support of a general meeting of its members and FCA approval. The FCA examines applications to register changes to rules to ensure that the proposed changes comply with the relevant legislation, and provides comments on deficient applications. No change to the rules is valid until the FCA has approved and registered the change. A society must follow its own rules for the conduct of meetings (see Section 4.2.5) when seeking the approval of its members for a rule change.

If a society's rules are based on the model rules of a sponsoring body it may be worth contacting the sponsoring body to determine whether changes have been made to the model rules, or if similar changes have been made before.

4.5 Secondary rules

A society may choose to adopt rules that go beyond the matters required by industrial and provident society legislation. Rules that are not statutory may still be registered with the FCA, or they can be maintained as secondary rules by the society, without the approval of the FCA. Most model rules contain rules that go beyond the statutory matters addressed in Section 4.2. However, any amendments to rules registered with the FCA must be approved by the FCA even if the rule concerned does not address a statutory matter.

Secondary rules, which can also be called regulations, standing orders, or bye-laws, are usually developed to improve the functioning of the society. It is a matter of good practice that copies of secondary rules are made available to all members, and changes to secondary rules should be approved at a general meeting.

4.6 Obligations of registration

Once registered, a society must keep proper accounts, submit an annual return to the FCA, and let the FCA know of any change relating to its registered office. It must also apply to the FCA to amend any of its rules or to change its name. Amendments are not valid until they are registered and approved by the FCA. Societies are legally obliged to be run strictly in accordance with their registered rules, and to inform the FCA if they no longer wish to be registered.

Registered societies are required to make annual returns to the FCA. There is a standard form that should be completed by the society's secretary and returned to the FCA within seven months of the society's financial year end. The form must be accompanied by a set of accounts. If the turnover of the society exceeds £5.6m

(or £250,000 if the society has charitable objects), or its assets exceed £2.8m, these accounts must be subjected to a full professional audit. This also applies to any society that is a subsidiary, any society that has subsidiaries, or any society engaged in deposit-taking activities.

Societies with a turnover not exceeding £5.6m, or assets not exceeding £2.8m, can, if their rules permit it, and a resolution has been passed at their AGM, get exemption from a full professional audit, and instead submit an accountant's report verifying the accounts. Unaudited accounts, verified by the board, can be submitted if the turnover does not exceed £90,000. If the society's turnover and assets are below £5,000, and it has fewer than 500 members, then it can resolve to submit a lay audit, verified by someone who is not a director or officer of the society.

All registered societies also have to pay an annual fee to the FCA, known as a periodic fee. This fee is on a sliding scale, currently ranging from £55 for organisations with total assets not exceeding £50,000, up to £425 for societies with total assets exceeding £1m.

Community Shares

5 Offer documents

5.1 Guiding principles

An offer document is any form of promotional literature that encourages the public to invest in a society. Even though a society is exempt from regulation when offering withdrawable share capital to the public, there is still an obligation on the society and its representatives to be truthful and responsible and to honour the terms and conditions set out in the offer document. This obligation is reinforced by the Misrepresentation Act 1967. It is therefore vital that all information provided in documentation, on videos or websites, at public meetings, and in any other communications with potential investors is accurate, is not misleading, and is the result of careful consideration.

This section of the Handbook provides guidance on four different types of share offer document: membership offers, pioneer offers, time-bound offers, and open offers. It also provides guidance on the application forms that accompany an offer document. The relationship between these different types of offer and the capital finance requirements of a society are explored in Section 2. This classification of offers is based on commercial practice and not on legal definitions.

The guidance in this section applies to the offer of withdrawable and non-transferable share capital by co-operative societies and community benefit societies. This type of share capital is exempt from financial promotion regulations and prospectus directives. The basis of these exemptions, and other regulatory matters, are addressed in Section 7.

The first step in planning a share offer is to identify which of the four types of offer is most appropriate for the society at that time. This will change as the society develops, and in some cases it may be necessary to plan a step-by-step strategy that leads from one type of offer to another. For instance, it is normal to follow up a pioneer offer, designed to raise risk capital to get investment-ready, with a time-bound offer, to implement the investment plan. A time-bound offer may be followed by an open offer, in order to generate liquidity for existing members. Some societies may start out with a membership offer, to engage the community in the enterprise, and to demonstrate how much support there is for their objectives.

An offer document aimed at the general public should explain the reasons why they are being invited to invest in the society, the risks associated with this investment, and the terms and conditions that apply to the offer. It is important to use simple, non-technical language that is engaging to read from beginning to end. Offer documents should be brief, but they should also address the matters identified in the relevant parts of this guidance. More detailed information, supporting the offer document, should be made available wherever this is indicated in this guidance. Section 5.2 outlines the basic information to be presented in all offer documents, regardless of type. The Community Shares Unit has produced a guide for the general public called *Investing in Community Shares*, which explains what community shares are, and is free to download and distribute. The Financial Conduct Authority also provides guidance for the general public on withdrawable share capital, through its online Money Advice Service (www.moneyadviceservice.org.uk).

5.2 Basic information

The following information should be provided in all offer documents, regardless of the type of offer, the only exception being where this information is not relevant to the offer:

Financial risk: All community shares offer documents should make it absolutely clear that anyone buying community shares could lose some or all of the money they invest, without the protection of the government's Financial Services Compensation Scheme, and without recourse to the Financial Ombudsman Service. This warning should be prominently positioned in all offer documents and expressed in plain English.

Share capital: The nature of share capital should be explained, and the full terms and conditions that apply to shares should be provided. If withdrawable share capital is being offered, applicants need to know that the only way of getting their money back is by selling shares back to the society, that notice has to be given of the intention to withdraw share capital, that directors may have the right to refuse requests for withdrawal, and any other restrictions or conditions that have been placed on withdrawal. It should be made clear that shares do not change in value, unless the rules provide for a reduction in share values, in which case the details of such provision should be made clear. If the share capital being offered is non-withdrawable, the scope, if any, for selling or transferring the shares should be explained.

Democratic rights: The society convention of one-member-one-vote should be explained, and contrasted with the company convention of one-share-one-vote.

Investment limits: The upper and lower investment limits should be stated, and the reasons for these limits should be explained.

Restrictions on financial returns: 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 or practices for setting its annual interest and/or dividend rate. Reference should also be made to the FCA's policies restricting financial returns to society members and the requirement that such returns depend on the profitable operation of the business.

Eligibility for membership: The offer document should make it clear who is eligible to become a member of the society and invest in share capital. It should clearly set out any criteria or restrictions expressed in the rules in the society, including minimum age requirements, geographic location, or transactional relationship with the society.

Some societies may also need to include information about the following matters, where these matters are relevant to the offer:

Money laundering: Societies issuing withdrawable share capital are exempt from money laundering regulations; there is no legal obligation on societies to carry out identity checks on applicants. However some societies have adopted the Co-operatives UK Code of Practice in this area, to reduce

the risk of money laundering. Where this is the case, such practices should be outlined in the offer document.

Conflicts of interest: Conflicts of interest can arise in some share offers, particularly those made by new societies where the founders, directors or promoters have a financial interest in the outcome of the offer.

5.3 Membership offers

5.3.1 Purpose

The primary purpose of a membership offer is to recruit members rather than to raise investment capital. Building up the membership can be an important starting point for many community enterprises, especially those hoping to attract significant amounts of public funding. Members can also contribute significantly to strengthening the business model of the organisation, not only by investing capital but also by contributing to the business as customers, volunteers, supporters, activists, and even suppliers or paid workers.

A membership offer is often appropriate for societies at the pre-start stage that need to raise development finance to test and prove the viability of their business proposal. This development finance will usually take the form of gifts, grants and donations; although some societies may find it easier to raise this finance through a pioneer share offer. Members are more likely to donate than non-members, and although donations should never be a condition of membership, people are more likely to be incentivised to donate to a society if they are members.

5.3.2 Structure

Before making a membership offer, it is important to plan how the society's relationship with members will evolve over time. The rules of the society must enable it to make a membership offer without compromising its ability to make other types of share offer in the future. This may mean establishing a distinct class of membership share (see Section 3.2.5) that is neither withdrawable nor transferable. It may require the member to pay an annual subscription. The subscription rate should reflect the cost of providing membership services, and not be used to raise development finance for the society, unless this is explicitly stated in the offer document. Annual subscriptions are an effective way of ensuring that members still support the society and want to be members. Alternatively, the membership rules of the society can include other requirements that ensure only those who express an interest in membership remain as members.

5.3.3 Contents

Compared with other types of offer document, a membership offer document can be fairly brief, typically no more than 500 words or a single side of A4. The document should focus on explaining the purpose of

the society, the benefits of membership, and the benefits it aims to generate for the wider community. It should also provide the basic information highlighted in Section 5.2, bearing in mind the following points:

- The minimum investment required to become a member should be restricted to a nominal amount. Many societies set this as low as £1, although this can be costly for societies because of the expense of servicing members. More typically, the amount ranges from £5 to £25.
- Any requirement to pay an annual subscription to maintain membership should be clearly stated.
- If the shares being offered are non-withdrawable and non-transferable, this should be stated, but it also obviates the need to provide the following basic information: financial risk, withdrawable share capital, and restrictions on financial return.

5.4 Pioneer offers

5.4.1 Purpose

The purpose of a pioneer offer is to raise share capital for a society that will be spent on getting the enterprise investment-ready. Investing in an enterprise that is not investment-ready is a high risk activity, and because of this, pioneer offers should only be made to existing members or known supporters who have already expressed an interest in investing in the society. Pioneer offers should not be promoted to the general public.

Developing pre-start initiatives can be expensive, time-consuming and highly risky. Pre-start development costs may include professional fees for legal advice, financial advice, planning permission, asset valuations, market appraisals, feasibility studies and business plans. The society will be unable to recoup if its plans turn out to be unfeasible, or if the society subsequently fails to attract the investment capital it needs to implement its business plan. If the society is planning to acquire an existing business or property, there is the risk that the society will lose a competitive bid, and will be unable to proceed, even though the proposition is viable and the society has raised the necessary capital.

The best way of financing these development costs is through grants, gifts, donations and other voluntary fundraising methods. However, there is usually a limit to how much money can be raised this way. Members may be prepared to provide more development finance if there is a possibility, however remote, that they could get their money back.

A pioneer offer invites members and known supporters to invest share capital, which will be spent by the society to get investment-ready. If the society is unsuccessful, pioneer investors will lose all that they invest. However, if the society's plans succeed, and it becomes a profitable trading enterprise, then pioneer investors may be able to withdraw their capital in accordance with the terms of the pioneer offer, and subject to any renegotiated terms set out in subsequent offer documents.

Before making a pioneer offer, the venture needs to prepare a development plan that identifies all the costs that will be incurred in becoming investment-ready. Development costs should be kept in scale with estimates of the start-up costs of the venture, and should not normally be more than 5% to 10% of these

start-up costs.

5.4.2 Structure

Because pioneer investors are asked to take far higher risks than subsequent investors, consideration should be given to establishing a separate class of "pioneer shares" with different terms and conditions, such as a higher rate of financial return, or a preferential right to withdrawal ahead of other classes of share. Introducing more than one class of share can have an impact on the attractiveness of future share issues. This matter is dealt with in greater detail in 3.2.6, which focuses on pioneer and preference shares.

The offer document should make it clear that withdrawal of share capital is suspended indefinitely, or until it is superseded by the terms and conditions for the withdrawal of share capital set out in a subsequent offer document.

It is recommended that pioneer offers should only be made to existing members, or to known supporters of the society, who should be required to become members on the same basis as existing members, prior to investing in a pioneer offer.

Pioneer offers should not be promoted to the wider community through websites, social media or at public meetings.

5.4.3 Contents

Because pioneer share offers are targeted at existing members, and not at the general public, the offer document does not have to explain the purpose of the society or provide basic information about the terms and conditions of membership. However, it remains vital that high standards of accuracy, transparency and care are applied to drafting the document because the promoters are still legally liable under contract and civil law. Pioneer offer documents need to address the following matters:

> **Eligibility:** The document should clearly state that the offer is only open to existing members of the society.
>
> **Purpose of the investment**: A brief description of the proposed new enterprise, the reasons why development finance is required, and an estimate of the current amount of development finance available to the society.
>
> **Development costs, targets and contingencies**: An analysis of the development costs, the target amount to be raised, the contingency plans if less than the target amount is raised, and what will be done with the surplus if more than the target amount is raised.
>
> **Terms and conditions**: Details of the type of share capital being offered, and the terms and conditions that apply to this class of share. The indefinite suspension of withdrawal rights should be

clearly stated, as should the reliance of this offer on the success of future share offers for there to be any prospect of pioneer investors getting a return on their investment.

Timetable: The target date for closing the offer, together with a commitment not to spend any of the finance raised by the offer until the minimum targets or contingencies have been met. An estimate of how long it will take to get investment-ready, raise the capital required, and establish the society as a profitable enterprise.

In most cases, pioneer offer documents will be no longer than 1,500 to 2,000 words.

5.5 Time-bound offers

5.5.1 Purpose

Time-bound offers are offers that seek to raise a target amount of capital for a specific investment-ready project within a specified timescale. If the offer fails to achieve its targets, or any of its contingencies, then the money is returned to investors and the investment project does not proceed. Time-bound offers are open to anyone who qualifies for membership, and because these documents promote an investment opportunity to the general public, it is crucial that they meet high standards of probity. Section 6 provides guidance on how offers should be promoted.

The commitment to refund applicants if the offer fails to meet its minimum targets means that measures should be taken to protect the monies received from applicants until the offer has been successful. There are several ways this can be achieved, for instance through the use of escrow or suspense accounts held by trusted third parties, or by payment procedures that are held in suspense until the closing date of the offer. At the very least, a society should hold applicants' funds in a separate account established for this purpose.

Because a time-bound offer is connected to a specific investment proposition, it is normal to suspend the withdrawability of share capital until the investment has been made and the society is trading profitably.

Time-bound offers are most effective when the purpose of the investment is clear. The community purpose of the investment should be attractive to potential investors, enabling them to engage with this purpose through the simple act of investment. Potential investors will have two immediate concerns: Are they at risk of losing some or all of the money they invest? What are the community benefits of the investment project?

Investors will also want to know how the money raised will be used. Will be it be spent on tangible assets that could be sold if the society underperforms and gets into financial difficulties? Or will it be used to provide working capital, covering initial losses, with the inherent danger that continued losses will erode the capital of the society?

There will also be longer-term concerns about the financial returns on the investment. However strong the social motivation may be, financial incentives will always assist the overall motivation to invest. But any

offer of financial returns has to be plausible, and supported by evidence presented in the business plan.

5.5.2 Structure

If a time-bound offer is made by an established society that is already trading and/or has members, three matters need to be addressed. Firstly, if the society has previously made a time-bound offer, sufficient time should have elapsed for that investment to have become operational, and the trading performance known, before the new offer is made. Under normal circumstances at least one year should have elapsed between offers. Secondly, if the proposed terms and conditions of membership in the offer document are likely to be different from those that currently apply to members, then either a new class of membership needs to be created, or members must approve a change to the terms and conditions of membership, which will apply to all members. Finally, if the society is already trading then measures must be taken to protect the funds of applicants from the current liabilities of the society. This can usually be done by bolding the applicants' funds in a third-party escrow account, until the fundraising targets are met.

A time-bound offer should not be made by an insolvent society, unless the stated purpose of the offer is to address this insolvency, and the risks associated with the investment are made very clear.

All time-bound offer documents should be supported by a business plan, which should be made available to potential investors on request. The business plan should contain the evidence that supports any key statements made in the offer document, especially any forecasts for financial returns and the future liquidity of share capital. An established society should also provide details of its financial performance, along with a copy its annual accounts, or interim accounts if insufficient time has elapsed.

A copy of the society's rules should also be made available to applicants. It is important to check that the society's rules allow it to do all the things mentioned in the offer document. Particular attention should be paid to the rules covering the administrative arrangements, membership and investment criteria, and additional charges, including annual subscription fees.

5.5.3 Fundraising targets

Time-bound offer documents should be supported by a business plan that sets out the case for the amount of capital required by the society. The total amount of capital required, from all sources, should be clearly stated in the offer document, together with the following three fundraising targets:

- the **minimum amount** of share capital to be raised, below which the offer will be deemed to have failed, and the investment project will not proceed. Applicants will not be accepted into membership;
- the **target amount** of share capital sought, which will enable the society to proceed with its investment project without any additional fundraising;
- the **maximum amount** of share capital to be accepted, above which some applications will be refused or scaled back, following the terms set out in the offer document.

If the minimum amount is not raised within the time period of the offer, including any extensions, applicants who have transferred funds should be refunded. The offer document should state the terms of the refund, detailing any administrative charge that may be made.

Normally, the target amount of share capital sought will be the same as the total amount of capital required for the investment project. Any shortfall in funding between the target amount and the minimum amount will need to be addressed, either by securing other finance from other sources, or by scaling back the investment plans. Details of these provisions should be clearly stated in the offer document, including details of the cost of these other sources of finance.

The offer document should explain how any additional share capital, between the target amount and the maximum amount, will be used by the society. Acceptable uses include bringing forward longer-term investment plans, outlined in the business plan supporting the offer document. Another use might be to create a larger cash reserve than planned, in order to provide greater liquidity to share capital, or to reduce the length of the initial period of suspension.

The offer document should also explain the basis on which applications may be refused if the maximum amount of capital is raised. There are several different ways of addressing this matter:

- Share capital can be allocated on a first-come-first-served basis
- Applications can be restricted by geographic proximity
- The maximum amount of share capital allocated to individual applicants can be reduced.

5.5.4 The offer period and timetable

All time-bound offers should have an opening date, when the offer is launched, and a closing date after which no further investments can be accepted. There are a number of factors to consider when determining the timing of an offer period.

Primary consideration should be given to the requirements of the investment project itself. When will the capital be used for the stated purpose? How certain is it that the investment project will be able to proceed according to plan? If the society is planning to purchase an existing business, property or asset, there may external deadlines to be met. Alternatively, the society may be planning a development that requires permissions, approvals or contractual agreements, and it cannot proceed until these are in place. The offer document should include details of the investment project timetable, highlighting any uncertainties that may affect it. If the investment project is unlikely to proceed within twelve months of the share offer being completed, then members should be given the option of withdrawing some or all of their capital.

The timing and length of the offer period should also take into account the impact on potential investors. The length of the offer period has to be sufficiently long for the publicity and marketing campaign to be successful, but not so long that early applicants have their money held in suspense for extended periods. Offer periods vary in length from six weeks to six months, with a norm of three months. People often wait until near the end of the offer period before investing, partly to ensure that their money is not held in suspense for too long, and partly to see how successful the offer is before committing their money. So there

is a danger with long offer periods that potential investors do not respond to the initial publicity, delay their decision to invest, and then forget to make a decision before the deadline.

It is important to get the timing right by, for example, avoiding major holiday periods, when people may not be thinking about investment, or may have other calls on their money. During the months preceding and following the HMRC financial year-end in April, many people make decisions about the most tax-efficient use of their savings and investments.

Offer periods can be preceded by promotions, including invitations to register an interest in the offer, make a non-binding investment pledge, or even to pay a deposit towards the investment. Any deposits should be held in an escrow account and be fully-refundable on demand during the offer period.

Most time-bound offers experience a surge of investment at the beginning of the offer period, followed by a lull, and then a final surge in the last few weeks or days of the offer. At the end of the offer period the society should stop actively promoting the offer, although it can continue to accept late applications if the stated maximum amount has not been exceeded. Active promotion would include making the offer document and application form available to enquirers, or continuing to allow online applications.

An extension to the closing date can only be made if the terms of this contingency are outlined in the offer document. Alternatively, an extension can be made if the society contacts all applicants informing them of the extension, and allowing them the option of withdrawing their application.

Offer periods, including extensions, should not exceed twelve months.

5.5.5 Minimum and maximum investment

Currently, the maximum amount an individual can invest in the withdrawable share capital of a society is £20,000. A society is free to determine its own maximum amount below this legal limit, as long as this is stated in the offer document. A society that is seeking to raise only a small target amount, typically less than £200,000, may decide to reduce the maximum individual investment to between 5% and 10% of the target amount. This will reduce the risk of the society being dependent on larger investors, or experiencing liquidity problems when a larger investor wants to withdraw share capital.

It is up to the society to determine what the minimum investment should be. The minimum investment required by time-bound offers in recent years has ranged from £50 to £1,000. A low minimum investment makes investment more affordable to people on low incomes, and will encourage more people to invest because the stakes are lower. This will also increase the level of community engagement, by increasing the proportion of the target community that can afford to invest. Alternatively, setting a high minimum investment threshold may result in more capital being invested, by fewer people, thus reducing the administrative cost of servicing the membership.

Higher minimum investment thresholds can be made more affordable by offering people the opportunity to invest by instalments. Investment by instalments could be incentivised by financial intermediaries

offering bridging loans to allow the investment activity to proceed as soon as sufficient investors are identified.

5.5.6 Contents

Offer documents are aimed at people who may not be sophisticated investors so they should be written in an accessible and engaging style. It is important to get the balance right between writing a marketing document that clearly communicates the investment proposition, and a non-technical document which nevertheless provides accurate financial and legal information.

The length of a time-bound offer document should reflect the size of the offer. Small offers, of less than £100,000, may typically be shorter than 2,000 words, whereas medium-sized offers of between £100,000 and £500,000 may warrant a document of up to 4,000 words. Offers seeking to raise larger amounts should be commensurate in length, but not so long as to deter applicants from reading them. The use of small print, technical language, unnecessary details, or other devices to discourage applicants from fully reading the document, should be avoided.

There are eight main elements to all time-bound offer documents:

> **The purpose of the investment:** This describes the purpose of the enterprise and how it will benefit members and/or the broader community. It should explain how the capital raised will be used, distinguishing between expenditure on physical assets and working capital. If the capital is to be used to purchase an existing business or property, evidence of an independent valuation should be made available. A summary of any significant risks facing the investment project should also be provided.
>
> **Business plan:** The document should provide a summary of the projected income, expenditure and profitability of the society for at least three years after investment. A copy of the business plan with evidence supporting these projects should be available to all applicants.
>
> **Fundraising targets:** The total amount of capital required should be stated, along with the minimum amount, target amount and maximum amount of share capital sought. If the targets include capital from other sources, these should be stated, along with details of the cost of this capital. Details should also be given of what will happen if the offer is under- or over-subscribed. Any administrative charges for investments and/or refunds should also be clearly stated.
>
> **The offer period:** The opening and close dates of the offer should be stated, along with any contingency arrangements for extensions to the offer period. The timetable for implementing the investment project should also be outlined, together with an estimate of when the society will start trading.
>
> **Minimum and maximum investments:** The minimum and maximum amount that can be invested by an individual applicant should be stated, along with any provisions for buying shares in

instalments.

Financial returns: There should be a statement of the society's policies regarding interest on share capital, dividends on transactions (if relevant), together with any forecasts for future interest and dividend rates, if relevant. Details of any negotiated tax incentives should also be included.

Track record: The offer document should summarise the track record of the society, its board and senior managers (if any). It should also identify any personal interests board members may have in the offer, and explain what actions have been taken to address potential conflicts of interest. If the offer is made by an established society, it should include a summary of the previous three years of trading and its current financial position, along with links to its full annual reports for the same years, including any social performance data.

Basic information: This should include any information listed in Section 5.2 which has not been provided elsewhere in the document, and may include statements on:

- Financial risks
- Type of share capital being offered
- Democratic rights of members
- Eligibility for membership
- Money laundering
- Conflicts of interest.

5.6 Open offers

5.6.1 Purpose

Open offers are integral to the capital flow of established societies, enabling people to join or terminate membership, and as members, to invest or withdraw share capital. Open offers should not be made by societies if the directors have suspended the right to withdraw share capital.

There are two main reasons why a society may make an open offer of membership and investment. The first is to provide liquidity for its share capital, with new investment generating the funds to cover withdrawals. This is appropriate where the society has a trading relationship with its members and it is normal to expect a turnover in membership and investment. The second reason for making an open offer is to stimulate and support the organic growth of the enterprise through increased membership and investment.

Societies planning to make an open offer need to consider the impact it may have on existing member investment. As well as potentially improving the liquidity of share capital, new investment could possibly have a diluting effect on the ability of the society to maintain its current level of financial return. It may be necessary to limit the investment of new members to prevent dilution, while still allowing open membership, in which case a membership offer might be a better option.

5.6.2 Structure

An open offer is not time limited or linked to a specific investment plan, which means it is not subject to the same information requirements as a time-bound offer. An open offer should normally be restricted to societies that can demonstrate that their share capital is fully withdrawable. Any initial period when withdrawals were suspended should be over, and withdrawal notice periods should be no longer than six months. If there is a restriction on the proportion of total share capital that can be withdrawn it should not be greater than the anticipated inflow of share capital resulting from the open offer. The rules of many societies have set this restriction at 10% of share capital in any one financial year.

If a society has suspended the withdrawal of shares, then an open offer to invest should be restricted to existing members, and the open offer should not be promoted to the general public. This practice can be justified where a society is, or might become, reliant on expensive external sources of capital, and members are willing to provide a cheaper source of capital.

5.6.3 Contents

An open offer document should explain why the society is recruiting new members and/or encouraging new investment, and how any additional capital raised will be used by the society. The document should focus on the broader principles guiding investment decisions by the society, rather than provide details of any specific investment plans.

In comparison with a time-bound offer document, an open offer document should focus on the track record of the society rather than predictions about its future. It is, as ever, vital that high standards of accuracy, transparency and care are applied to drafting the document, as the board remain legally liable under contract and civil law. Open offer documents should contain the following information:

Purpose: The document should provide a brief description of the aims, objectives and purpose of the society, and its reasons for making an open offer of investment. It should also outline the investment policies of the society.

Returns on investment: A summary of the interest paid on share capital and the social impact of the society over at least the last three years.

Capital position: A simple description of the capital position of the society, detailing how the level of share capital, reserves and long term debt have changed over the last three years, accompanied by information about how many members have joined and how many have left.

Supporting documents: The document should explain how readers can obtain copies of the annual accounts and social reports of the society for at least the previous three years, as well as an up-t--date copy of the society's rules.

Other basic information: This should include any relevant information listed in Section 5.2 which has

not been provided elsewhere in the open offer document.

5.7 Application forms

All offer documents, of whatever type, should include an application form. Application forms can be very simple, requiring no more than the name and address of the applicant, and the amount of share capital they are purchasing. But most societies will ask for additional information, to provide them with greater legal protection, to improve the membership administration processes, or to gather other personal information about the applicant. Societies should ensure the form is fully compliant with the requirements of the Data Protection Act.

The application form should always be attached to the offer document, to encourage applicants to read the document. This can be reinforced by asking applicants to sign or acknowledge a statement saying they have read the offer document and understood the terms and conditions of the offer.

Some societies use application forms as a marketing tool. For instance, the form might contain a series of tick boxes to encourage applicants to invest more than the minimum amount, or it might invite applicants to nominate a beneficiary in the event of their death, encouraging them to think of the offer as a long-term investment.

A society's rulebook will normally specify who can and cannot become a member of the society. Even though legal restrictions on the minimum age at which a person can join a society have been removed, some societies still have rules setting a minimum age for membership, and if this is the case, the application form should make this clear. Some societies restrict applications to people who live or work in a specific geographical area, or do not allow applications by people who live outside the UK.

Societies should be aware of the potential for offers to be used for money laundering. Withdrawable share capital is exempt from money laundering regulations, so there is no legal obligation on societies to carry out identity checks on applicants. However, societies planning to make online offers or accept applications from people living outside the UK, may want to put secondary measures into place to check the identity of investors. These can include restrictions on methods of payment, or restricting investment to applicants with a UK bank account. Co-operatives UK has a Code of Best Practice for member societies issuing withdrawable share capital that addresses these matters.

Some societies have developed online application and payment systems. Putting aside the set-up costs of establishing these systems, and concerns about online security, societies may find this a very efficient way of administering an offer, although it may exclude some potential investors. It may also affect the geographical spread of applications, with a consequent effect on the identity of the community. These issues are addressed in greater detail in Section 6.6 of the Handbook.

6 Promoting offers

6.1 Introduction

The promotion of withdrawable share capital in an industrial and provident society is exempt from regulation (see Section 8), but this does not release a society from its responsibilities to apply best practice to its promotional activities. There are a number of considerations to take into account when promoting withdrawable share capital.

An investment in a society is primarily made for mutual, community, or charitable benefit, rather than private financial gain, so it is important that these benefits are prominent in all promotional materials and take precedence over any financial rewards offered to investors. This matter is dealt with in more detail in Section 7. Community share offers are aimed at people with little or no knowledge of equity investment, or the risks associated with such investment. Most potential investors are unlikely to understand complex financial or legal explanations, or have ready access to expert professional advice. This means that all promotions must be simple, transparent and not overly long.

Offer documents should be the centrepiece of any promotional campaign. Section 5 provides guidance on the contents of offer documents and application forms. The promotional campaign and associated application processes should be designed to encourage potential investors to read the offer document before investing. All promotional activities and materials form part of the contract with the investor and member, so it is important that these activities and materials present consistent information about the offer.

The success of a community share offer is strongly influenced by the quality of the promotional campaign. The campaign should engage the intended community and involve them in the affairs of the society, above and beyond the act of investment. People should be seen not just as potential investors, but also as potential customers, suppliers, employees, volunteers, supporters, and most importantly as active members who will participate in the business and ensure its success.

The use of electronic media and communications is central to most promotional campaigns. Any society planning to use this form of communication must understand their obligations under the Data Protection Act and the Privacy and Electronic Communications Regulations. This is particularly important if a society plans to use more than one form of electronic media to promote its community share offer.

A society making a share offer needs to plan how the shares will be sold, including the application process and the method of payment. Online methods, including crowdfunding, are becoming increasingly prevalent, and are subject to distinct forms of regulation. Other matters, such as the purchase of shares by non-UK residents, shares as gifts, and the use of incentives, need to be carefully considered before the share offer is launched.

6.2 Community engagement

A community share offer should be targeted at a defined community, be it a geographic community, a community of interest, or a combination of the two. The rules of the society should include a definition or description of the community it aims to serve. In an increasingly complex world most people inhabit many different communities and may occupy many different stakeholder roles within those communities.

The benefit of defining the target community is that it should then be possible to estimate the size of the community, describe its demography, select appropriate promotional strategies, and test the viability of the proposed business model.

Capturing the attention, interest and support of people within the defined community requires careful planning and execution in order to build community identity. It means communicating the purpose and activities of the society in a way that relates to people's personal, mutual and community interests. Attracting an audience is the first step in community engagement. There are a wide range of methods for doing this including the use of websites, social media, email and text campaigns, public meetings, events, door-to-door leafleting, public media coverage and, if budgets allow, advertising.

The next step is to recruit supporters from this audience. A supporter is someone who has expressed an interest in the initiative, provided contact details and consented to receive future personal communications. Each method of attracting an audience has its own ways of recruiting supporters; social media is especially good at making it easy for people to express interest in an initiative and to establish contact. Other methods may require more effort from the audience: signing petitions, filling in surveys, responding to emails, registering on websites, and so on. Building up a contact list of known supporters is invaluable for new societies planning a community share offer. It enables direct communication with the people most likely to invest in the offer, and provides the society with intelligence about the scale of its community. However, care must be taken to ensure that these contact lists comply with current legislation on direct marketing (see Section 6.3).

The next step in community engagement is to convert supporters into members. For new societies it is important to decide whether membership will be offered prior to, and separately from, an investment offer. Section 5 describes four different types of community share offer, including a membership offer and a pioneer offer, both of which normally precede a time-bound offer to raise investment capital for a specific initiative.

Community investment is at its most effective when members are more than just investors, but are also engaged as customers, service users, volunteers, employees, activists, experts, advocates, and/or suppliers. Engaging members in multiple ways strengthens the competitive advantage of the business. Members who have invested are more likely to volunteer or to become loyal customers. This can reduce costs and increase turnover. Member-investors, who support the community purpose of the enterprise, may be prepared to accept lower financial returns if the social value of the enterprise is clear. Multiple forms of member engagement also help the longer-term sustainability of the enterprise, by offering many reasons for people to become members and to invest in the enterprise. This can also help to maintain the long term liquidity of withdrawable share capital (See Section 3.3).

6.3 Data protection, privacy and electronic communications

All societies must comply with the Data Protection Act 1998 and the Privacy and Electronic Communications (EC Directive) Regulations 2003 when promoting share offers. Any organisation keeping personal data on individuals is obliged to be registered with the Information Commissioner's Office (ICO), which is responsible for enforcing both the Act and the Regulations.

The Data Protection Act sets out eight principles relating to the use of personal data by organisations. In the context of community shares, these principles require that personal data obtained from supporters and/or members should only be used for the purposes for which it was originally acquired. This personal data should be accurate and up-to-date, should not be excessive, and should be disposed of when no longer necessary for the original purpose or purposes. The organisation is responsible for ensuring the protection of this data from unauthorised or unlawful use, either by design or by accident.

The Data Protection Act gives individuals the right to prevent their personal data from being used for direct marketing purposes. An individual can, at any time, give written notice to stop receiving direct marketing communications from an organisation. These communications have to stop within a reasonable period, taken to be within four weeks for electronic communications and up to two months for postal communications.

The Privacy and Electronic Communications Regulations provide rules about direct marketing or advertising by electronic means such as automated phone, email, fax, text and picture messaging. It also has rules about website cookies, traffic data, location data and security breaches. These rules apply not only to the promotion of goods and services, but also to campaigning activities by not-for-profit organisations.

The ICO is responsible for enforcing the law and regulations, and has the power to impose fines of up to £500,000 for serious breaches.

Among the more serious breaches is the use of personal contact details for a different purpose from that for which they were obtained. This includes using the membership lists of a community organisation that supports the aims and objects of the society, but where the members have not consented to their details being passed on to other related organisations.

There is no restriction on sending marketing materials to people who have specifically requested such materials. So, if a person completes an on-line form requesting the organisation to send them a newsletter, offer document or some other form of community shares marketing materials, then it is free to do so.

The principle of consent is central to good practice in direct marketing communications. If a person has freely given their prior consent to a specific method of communication on a specific topic or matter, then it is usually lawful and acceptable. Prior consent to specific methods of communication is especially important if the society plans to make phone calls, because this will allow the society to call numbers registered with the Telephone Preference Service without committing a breach of the rules.

According to ICO "implied consent can also be valid consent in some situations – in other words, if it is

reasonable from the context to conclude that the person consents, even if they have not said so in as many words." For instance, if a person provides their personal contact details on an application form to purchase community shares, this implies consent to further communications about the share offer and subsequent share ownership.

The principle of implied consent may also extend to other methods of obtaining personal contact details, such as sign-in sheets at public meetings, signatories to a local petition, or participating in surveys, as long as it is made clear that these personal details will be used for direct marketing purposes. Such notices should be prominently displayed and not hidden in small print.

The clearest way of obtaining consent is to include an unticked opt-in box on marketing materials, including websites. These are preferable to opt-out boxes which, even if they are pre-ticked, might be deemed to be confusing and hard to understand. The use of indirect, third-party consent, where a person has consented to their personal details being passed on to third parties, is not allowed under the privacy regulations for electronic communications in the form of emails, texts or automated calls.

Consent to direct marketing communications does not last forever. There are no prescribed time limits for consent, but it is deemed to be linked to the specific topic or matter. In the case of a community shares offer, consent is linked to a particular offer and does not automatically extend to new offers made by the same society at a later date. Direct marketing materials should always include information on how to cancel or unsubscribe from the communications.

The burden of proof that consent has been given is borne by the organisation not the individual, so it is important that societies keep records of all consents it obtains.

6.4 Communication methods

6.4.1 Advance publicity

Any form of publicity that refers to a society's intention to sell community shares forms part of the contract with the purchaser of those shares. All public communications, at all stages of a promotional campaign, should be consistent with the contents of the share offer document. These communications should not provide supplementary or additional information that changes the material nature of the offer, or implies different terms and conditions.

At the early stages of planning a community share offer, a society should restrict its public communications to more general matters, and avoid giving details that it might later want to alter when it is ready to launch the offer. As plans develop, care needs to be taken to ensure the consistency of communications across all the forms of media used to promote the share offer, including websites, social media, and public meetings, as well as the published share offer documents.

6.4.2 News coverage

It is beyond the scope of this handbook to provide detailed guidance on how to manage media campaigns. From a community shares perspective, accurate factual reporting of the details of any community share offer is vital. Advance publicity should focus on the purpose of the offer, rather than on the offer itself. So, for instance, if the purpose of the offer is to save the last retail outlet in the community, then this should be the news story. Details of the community share offer should only be released when the share offer document is ready for distribution.

Local, regional, and national news coverage is welcome and achievable. Community ownership, community investment and community shares are novel concepts and may attract media interest. Several community share offers have attracted national news coverage, but this did not appear to significantly alter the geographic distribution of investors. Instead, national coverage tends to bolsters local support, perhaps by reinforcing the sense of pride and identity within the target community.

6.4.3 Websites

All but the smallest of societies need to have their own websites in order to communicate with members and prospective members. Electronic communications are far cheaper and easier to administer than paper-based communications, and a website forms the hub of an electronic communication system. A website enables a society to provide members and prospective members with full information about the society at low cost. It also provides a vehicle for people to express an interest in the society and to consent to future communications, enabling the society to build a contact list of supporters (see Section 6.2). To do this, the website needs to elicit contact. Invitations to receive newsletters, email bulletins, or make pledges should comply with the requirements of the Privacy and Electronic Communications Regulations (see Section 6.3), and as a matter of good practice should require people to opt-in to communications for each of the formats the society intends to use in its direct marketing efforts. If the website uses cookies, it should also be compliant with the EC Directive 2013 on this matter.

6.4.4 Email and text communications

Email and text communications count as electronic communications for the purposes of the Privacy and Electronic Communications Regulations, and the electronic storage of this personal data is also covered by the Data Protection Act (see Section 6.3). A society should only email or text people who have consented to receive direct marketing materials from the society on the specific matters being addressed via the particular medium concerned. This applies to existing members, prospective members and supporters who have expressed an interest in a community share offer.

6.4.5 Phone calls

If a society plans to communicate with members, prospective members and supporters via phone calls it should first obtain their consent. But it can make unsolicited calls, as long as any phone lists it uses have been screened for people registered with the Telephone Preference Service (TPS). A society can only call someone registered with TPS if the person has consented to such communications. When making calls a society must always say who is calling, and provide a contact address or Freephone number if asked.

6.4.6 Doorstep materials

Unsolicited mail and hand-delivered promotional materials are allowable, although if these deliveries are being made using an electronic database, then the Data Protection Act still applies (See Section 6.3). Door-to-door leafleting, used by many community share offers targeting small target communities, is fully allowable under almost all circumstances, especially when it does not involve the electronic storage of personal data.

6.4.7 Social media

Social media campaigns to draw attention to community share offers are a well established practice. It is beyond the scope of this handbook to state how the Privacy and Electronic Communications Regulations applies to all the various forms of social media. The main issue here is whether the electronic message is directed at and can be stored by an individual, in which case prior consent may be required. Where the communications are not directed at or designed to be stored by individuals then the Privacy and Electronic Communications Regulations may not apply.

6.4.8 Published documents

Published share offer documents, including printed media and electronic documents, form part of the contract between the society and its potential and existing members. As soon as such documents are distributed, or placed in the public domain, they should not be altered or changed without communicating these changes to all existing members and applicants. This means that care should be taken to ensure that all the details of the offer document are correct before publication. If any substantive changes are made to an offer document after it has been published, and before the offer is closed, then all applicants and existing members should be contacted to inform them of the changes and to allow applicants the option of cancelling their application.

6.4.9 Public meetings

Public meetings are an excellent campaigning tool for societies seeking to engage communities in their objects, purpose and projects. Care has to be taken at such meetings to ensure that anything that is said about an impending or live community share offer is consistent with the share offer document, the society's

rules and its business plan. If these meetings are used to collect personal data from supporters, the guidance in this Section relating to the Data Protection Act and the Privacy and Electronic Communications Regulations must be followed.

6.5 Selling shares

6.5.1 Advance selling and pledge campaigns

Advance selling refers to the practice of inviting a person to pay a deposit towards the future purchase of share capital. A pledge is a non-binding statement of intent to buy community shares at some point in the future.

Pledge campaigns can be a useful way of gauging the level of community support ahead of a community share offer. It will provide a society with a contact list of supporters that will be invaluable when the share offer is ready to be launched. But it also runs the risk of failing to attract significant support and undermining confidence in the share offer. Pledges must be non-binding and supporters should not be repeatedly urged to honour their pledge.

Advance selling that asks investors to pay a deposit before the launch of a community share offer is only acceptable in special circumstances. These include circumstances where the society is competing with third parties to purchase a going concern, or proof of support is need to raise other sources of capital, or there is some other significant reason justifying the use of advance selling. Any money received from supporters should be held in a secure place, such as an escrow account, or by an independent third party who guarantees any money held on deposit (see Section 6.6). The terms and conditions of the investment must be clear and prominent. This should include the right to a refund at any time up to the closing date of the community share offer itself. There should clear information about when the community share offer will be launched or the factors that will determine the launch date. Investors should be informed of any delays to the launch date and reminded about their right to a refund. When the share offer is launched, investors should be sent the share offer document and invited to complete their investment or accept a refund. Any administrative charge applied to refunds should be reasonable and clearly stated in the advance selling literature.

6.5.2 Paper-based applications

Section 5.7 provides guidance on what should be in an application form. Most societies require applicants to return an application form that is attached to the end of the offer document. Paper-based applications are administratively burdensome, but may be more secure and less expensive for smaller offers seeking to raise less than £100,000, where the cost of establishing online application and payment systems could be prohibitive.

6.5.3 Online applications

For community share offers above £100,000 or where the offer is being made by an established society, it may be worth establishing systems that allow people to make online applications and payments. Online payment methods are dealt with in the next sub-section. However, it should never be possible to purchase shares online without first completing an online application form. The contents of an online application form should be the same as for paper-based applications. Access to the application form should be at the end of the share offer document, and applicants should be encouraged to read the document before submitting an application.

6.5.4 Payment methods

The simplest way of accepting payment is by cheque. Payment by cheque restricts investment to UK residents and minimises the risk of money laundering. Societies that cash cheques before the share offer closes should place the money in an escrow account (see Section 6.6).

Payments using debit or credit cards require the society to establish a dedicated merchant account, and to establish systems that meet the Payment Card Industry Data Security Standards. However, the cost of establishing a merchant account may be prohibitive for smaller societies, or simply not an option for new societies without a financial track record.

Remote transactions (by mail or online) are allowed by most card payment processors, although the risk associated with such transactions is generally perceived to be greater than that of face-to-face transactions. However, the risk of fraud is comparatively low because it is impossible for a purchaser to resell withdrawable shares to anyone other than the society itself.

There are a number of online payment options. Debit and credit card payments can be processed through a dedicated merchant account, although the cost of security arrangements for online payment may be prohibitive for smaller offers.

BACs and Faster Payments allow people with internet banking arrangements to make one-off payments and to transfer money from their account to other bank accounts, quickly and easily. Faster Payments was introduced in 2008 and allows funds to be transferred within 24 hours, whereas BACs transactions take three days to complete. The main problem with these methods of payment is the potential difficulty of identifying the payee because there is no facility for them to provide their contact details. This problem can be addressed by ensuring that the application form has (or generates) a unique reference number so that applications and payments can be matched. The other problem with using these methods of payment is their reliance on the applicant correctly entering the society's bank details when making the payment; any mistake may make it difficult to retrieve the funds.

PayPal is an online payment service that allows organisations and individuals to make and receive online payments without the need to exchange bank account details. Applicants do not have to have a PayPal account to use the system, or to make a complaint to the PayPal Resolution Centre. But its payment

protection policy does not extend to property, so does not apply to the purchase of shares. A society selling shares through PayPal will need to establish a PayPal account, which will allow it to generate invoices, and to collect the name and address of the purchaser. There is a flat rate transaction fee, payable by the seller, currently 3.4% of the transaction value plus 20p. PayPal supports international payments in 24 currencies with the payment automatically converted into the recipient's desired currency. There is no scope to block international PayPal payments, so a society needs to make special arrangements to ensure that it complies with its policies on applications by non-UK residents (see Section 6.8).

6.6 Receiving funds

When a society makes a time-bound community share offer, the transaction to buy and sell shares is not complete until the share offer is closed and the society can be certain that the offer has achieved its minimum target for issuing shares (see Section 5.5). Until the society issues the shares, any money it has received from investors needs to be protected from the liabilities and contingent liabilities of the society.

There are a number of ways of providing this protection. The safest way is for the society not to receive payment for the shares until it is in a position to issue them. This could be achieved by requesting that cheques should be post-dated, or by using any other payment method that allows payment to be postponed to an agreed date. An alternative to this is to establish an escrow account to receive funds. An escrow account is where money is held by an independent and trusted third party. It is normal for organisations offering an escrow service to administer the offer: receiving and processing all payments, and concluding the transactions when the offer is closed. Ideally, the escrow service provider should indemnify the funds it holds from any liabilities, including bank failures.

A new society making a share offer should endeavour to keep its liabilities and contingent liabilities to a minimum until it knows that the share offer has been successful. This means not entering into advance agreements on sales or purchasing, or limiting such agreements to levels that can be covered by existing reserves.

6.7 Crowdfunding

Crowdfunding is an increasingly popular fundraising tool. The FCA has identified five main types of crowdfunding: donation-based, reward-based, loan-based, investment-based, and exempt. Community share offers fall into the last of these categories and are exempt from the need for FCA authorisation or regulation.

Donation-based and reward-based crowdfunding may be attractive fundraising options for a new society, especially one at an early stage of development that needs to raise money to meet pre-start costs. Donation-based crowdfunding can generate risk capital for a society, free from any obligation to provide a financial return to the donor. Reward-based crowdfunding is more onerous in the sense that the recipient of such funds enters into a contract to provide a reward in the form of a product or service. Both these forms of crowdfunding are unregulated activities and do not need FCA authorisation.

Loan-based and investment-based crowdfunding are regulated activities. Loan-based crowdfunding, also known as peer-to-peer lending, is a part of the consumer credit market and is currently regulated by the Office of Fair Trading, although this responsibility will be transferred to the FCA on 1 April 2014. The FCA intends to introduce a disclosure-based regime to regulate loan-based crowdfunding, and ensure that investors have information that is fair, clear, and not misleading, upon which to base their investment decisions.

Investment-based crowdfunding is a regulated activity. All investment-based crowdfunding platforms require FCA authorisation to carry out regulated activities. In October 2013 the FCA launched a consultation paper outlining proposals to change its approach to the regulation of investment-based crowdfunding, with the aim of encouraging competition, and making this market more accessible to retail clients while ensuring that only investors who understand and can bear the risks participate in the market.

Community share offers are exempt from regulation, and crowdfunding platforms promoting community share offers need to reflect the unique characteristics of this form of share offer. A crowdfunding platform can ease the administrative burden of making a community share offer by providing a means for processing investment applications online. For larger community share offers involving hundreds or thousands of applications, this is a significant benefit. But crowdfunding has its drawbacks: it excludes people without access to websites and online payment methods; it may be more difficult to aim the offer at the target community; and it may undermine efforts to engage members in the day-to-day activities of the society.

6.8 Applications by non-UK residents

With the advent of the internet and international payment systems such as PayPal, it is possible for any society that promotes a share offer through its website to attract applications from non-UK residents.

Community engagement is central to community share offers. Many societies rely on the active involvement of members, not only as investors but also as customers, volunteers, supporters, employees and suppliers. It may be much harder to maintain the active engagement of members who reside outside the geographic community served by the society. On the other hand, people located anywhere in the world may have strong personal reasons for identifying with the community served by the society.

Unless the rules of a society state otherwise, there is no legal restriction on where a member of a society resides; applications by non-UK residents are allowable. But there may be laws in other countries that restrict or prevent individuals from directly investing in UK registered corporate entities.

The sale of withdrawable share capital in a society is exempt from UK money laundering regulations (see Section 8.4). However, a society may still want to satisfy itself that it is not receiving investments that are the proceeds of criminal or terrorist activities by carrying out identity checks on non-UK resident applicants. The identity of UK resident applications is usually secured by the bank, credit or debit card provider.

6.9 Shares as gifts

It is acceptable to promote the sale of shares as gifts to third parties, subject to the active agreement and eligibility of the gift recipient to become a member of the society. The gift recipient must confirm that they are eligible and agree to become a member before the shares are issued. A deadline should be set for receiving this confirmation, together with a statement made to both the giver and the recipient that if the confirmation is not received by that date, or if the recipient is not eligible or willing to become a member, then the giver will be refunded. As with all refunds, any administrative charges should be clearly stated and be reasonable.

In the case of time-bound share offers, the shares are not normally issued until the closing date of the share offer, and this date can be used as a deadline for receiving confirmation from gift recipients. But if a society decides to extend this deadline beyond the closing date of the offer, then the funds should be held in suspense either until confirmation is received or the deadline has passed. Additionally, the society should make both the giver and the recipient aware of the difference between the closing date and the confirmation deadline, explaining the consequences for the recipient if the offer is over-subscribed prior to them confirming their application for membership.

Eligibility for membership is set out in the rules of a society (see Section 4.2.4). The most common restriction on membership is a minimum age requirement. Even though there is no legal minimum age for membership of a society, many societies have rules stating a minimum age, typically 16 or 18. If the society has a minimum age rule, it must make this clear in its share offer document and in any associated literature relating to shares as gifts.

6.10 Purchasing shares by instalments

Some societies, especially those with a high minimum shareholding requirement, may invite applications from people to purchase shares by instalments. There are several matters to be addressed when establishing such arrangements. If the society is making a time-bound offer and any purchase by instalments is likely to extend beyond the closing date of the offer, then it will be necessary to decide how such purchases count towards the fundraising targets, and how the society will meet its cashflow needs.

One solution is for the society to borrow additional capital from a third party, to be repaid by the instalment purchases. Another solution is to treat instalment purchases as an additional investment, so they do not count towards the minimum target but do count towards the maximum target, and thus are limited to the range between the minimum and maximum fundraising target (see Section 5.5.3).

Making arrangements so that applicants can borrow money to pay for shares is not considered to be good practice, unless the liability is borne by someone other than the applicants.

A society offering shares by instalments also needs to decide at what point the person acquires membership rights. Normally this will not be until the minimum shareholding has been purchased. Arrangements also have to be made to address the possibility that a purchaser might fail to maintain or

complete all the instalments. A society would be within its rights to refuse membership and to deduct administrative charges from any refund, as long as these terms are clearly stated on the application form.

6.11 Incentives

The use of incentives to promote the purchase of community shares is acceptable as long as the incentives are consistent with the rules of the society. A distinction should be made between incentives that are linked directly to share capital, for instance, offering interest payments in kind (a community pub paying interest in beer, or a community bakery paying interest in baked goods) and incentives that are linked more broadly to membership, such as discounts on the society's products or services. As long as the latter type of incentive is not associated with either how much share capital the member has invested, or their level of transactions with the society, then such incentives should be treated as a marketing cost for the society and not a reward to the member. A society should ensure that it has taken the marketing cost of such incentives fully into account in its business plan.

Payment of interest or dividends in kind is subject to income tax (see Section 9.1). The recipients of such payments should be given information on how to declare this income to HMRC.

6.12 Nomination of beneficiaries

Some societies choose to include a section in their share application form that encourages the applicant to nominate one or more beneficiaries of their shares in the event of the nominator's death. This may be seen as a promotional tactic to encourage applicants to think of share capital as a long-term investment for the benefit of future generations.

The Industrial and Provident Societies Act 1965 Sections 23-25 makes provisions for members to nominate who will inherit their shares in the society. These nomination rights extend to all forms of property in the society, including loans, deposits and shares. The legislation says that the maximum amount of share capital that can be transferred to a beneficiary is either £1,500 (Section 23) or £5,000 (Section 25) although it is unclear whether this only applies to nomination rights or is a maximum limit on transfers to one person. If the beneficiary is already a member of the society, the maximum individual shareholding rule still applies and if it is exceeded any excess should either be paid in cash or converted into a loan.

7 The use and distribution of profit

7.1 Guiding principles

Profitability is central to the long-term financial sustainability of all enterprises. It enables enterprises to build free reserves, finance the cost of capital, provide returns to shareholders, and support beneficiaries. Sustained losses will erode shareholder capital and eventually threaten the survival of the enterprise.

The purpose and use of profit in a co-operative or community benefit society is different from that of a private or public limited company. The purpose of private enterprise is to maximise the wealth of shareholders by generating profits and capital gains in the perceived value of the enterprise. This is not the case for societies. Section 1(3) of the Industrial and Provident Societies Act 1965 states that "*a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person*". Section 1(2) defines the purpose of a community benefit society as *"being, or is intended to be, conducted for the benefit of the community".*

Schedule 1 of the Industrial and Provident Societies Act 1965 requires all societies to have rules stating "*the mode of application of profit of the society (Schedule 1 (12))"* (See Section 4.2.12). Most model rules interpret this as meaning that there should be a maximum rate of interest payable on share capital. It is usually accompanied by a commitment to reinvest some of the profit in the development of the society, and to use some for the benefit of the broader community.

This interpretation of Schedule 1 profit treats the interest paid on share capital as a form of profit distribution. However, 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 deductable expense before any liability to corporation tax.

A society can pay interest on share capital without reference to its financial performance. But, as a matter of good practice, it is strongly advised that societies treat interest on share capital as a discretionary expense, which is only paid if the society can afford it.

Societies should only pay interest on share capital if they can do so out of profits generated in the previous financial year or half year. Even then, interest on share capital should be subordinate to reinvestment in the society and, depending on what type of society it is, other applications of profit.

The following sub-sections provide guidance on how each of the three main types of society should use and distribute profits, preceded by a sub-section on the general principles applying to interest paid on share capital.

7.2 Interest on share capital

All three types of society are allowed to pay interest on members' share capital, subject to Financial Conduct Authority's general guidance on interest rates, and specific guidance produced by the Charity Commission for charitable community benefit societies (see Section 7.5).

Most societies adopt rules that set a maximum rate of interest. Interest on share capital should be treated as a discretionary expense. It should only be paid if the society can do so out of current trading surpluses. The actual interest rate payable should only be determined after the financial year end, when the profit for the period is known and the board of directors is in a position to make recommendations to the annual general meeting of members about the application of profits (see Section 4.2.3). These recommendations should include other uses of profit, such as reinvesting in the society, supporting other initiatives of benefit to the community, or in the case of co-operative societies, paying a dividend to members (See Section 7.3).

Establishing a maximum interest rate, along with a policy statement on the use and distribution of profit, is a matter of good practice. It provides members with a clear statement about the financial return they can expect, and how this ranks against other possible uses of profit.

The FCA says that interest rates "*should be no more than is necessary to obtain and retain enough capital to run the business*". There are four different ways of interpreting this guidance:

- Interest rates should be no higher than those charged by alternative sources of capital such as commercial debt. This is usually expressed as a maximum percentage interest rate, typically 2% or 3% above the Bank of England Bank Rate (or equivalent). This interpretation does not take into account the fact that a society may struggle to attract commercial debt on anything like the same terms as share capital. Member share capital is unsecured and fully exposed to the risks faced by the society. Members may reasonably expect to be paid a premium for their investment, over and above that received by a secured lender.
- The interest rate should be comparable with the financial returns a member might expect from other forms of investment. This could include interest rates offered on savings and deposit accounts, or the historic returns on investment in listed securities. However, it is difficult to make fair comparisons because of the differences in the risk associated with these investments, and because the returns on listed securities will usually include capital gains as well as dividend income.
- Interest rates should be no higher than the rates offered by other societies. The Community Shares Unit can provide current data on the interest rates offered by societies. This interpretation does not take into account significant differences between societies, such as their profitability, risk profile, and the attitudes to risk of their members.
- Interest rates should be determined empirically, based on the inflow and withdrawal of member share capital. This is a more practical option for an established society, which can adjust its interest rates from one year to the next, than it is for a new society that is attempting to raise share capital for the first time.

The interest rate offered by a society may not be the most important factor in determining whether a person decides to invest in the society. Other important factors include the liquidity of share capital, the risk of insolvency, and the strength of commitment of members to the purpose of the society. A society should carefully consider all these factors when determining how it will attract and retain the capital it requires.

Apart from interest rates, there are a number of other matters to consider when determining a society's policies on interest payments.

It is normal practice for societies to credit interest payments to members' share accounts rather than sending out interest payment cheques. This increases the amount of share capital in the society, and improves capital liquidity if the money is not tied up in fixed assets.

Interest on share capital is paid gross of personal income tax. It is the responsibility of members to inform HMRC of any interest on share capital paid to them or credited to their share account. This should be borne in mind by societies when devising schemes to allow members the option of waiving interest on share capital or donating it to a good cause. Even though the member does not receive the interest they may still be liable for income tax on that payment.

A society with more than one class of share may pay different rates of interest, if doing so serves the aims of the society. For example, a society may issue a new class of share capital to finance a wholly-owned subsidiary, with all the risk borne by this new capital. In order to attract this capital it may be necessary to offer a different interest rate from that applicable to other shares in the society.

Some societies may be financed by members' loans in addition to members' share capital. In such cases it is usual for a society to reflect the differences in exposure to risk by setting a lower rate of interest on the loan capital than the share capital. Even if the loans are unsecured and exposed to the same risks as share capital, a society should not pay a higher rate of interest on loans than shares. The only exception would be if the society had grounds for believing that it would be unable to attract and retain sufficient capital unless it offered a higher rate of interest on loan capital.

7.3 Profit and dividends in co-operative societies

The term profit is rarely used by co-operatives because it does not sit easily with co-operative values and principles. Instead, the term surplus is used by the International Co-operative Alliance's (ICA) Statement on the Co-operative Identity, which states how surpluses should be used:

"Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."

The second of these purposes, to benefit members in proportion to their transactions with the co-operative, is usually referred to as a rebate or dividend. A co-operative society, but not a community benefit society, can distribute profits in the form of a dividend on member transactions.

The rules of a society describe who can be a member, and the basis of the member's transactional relationship with the society, for instance, purchases by customer members, sales by supplier members and wages of employee members. The amount of share capital held by a member of a co-operative society has no bearing on the dividend they might receive. Instead, dividends are normally proportionate to a member's

level of transactions with the society.

This principle enables co-operative societies to exercise financial prudence in their transactions with members. It can also be an important source of competitive advantage, encouraging member loyalty and rewarding member participation. Members transact at price levels which improve the likelihood that their co-operative will make a surplus. If and when this surplus is achieved, some of it can be returned to members in proportion to their transactions. Thus, the surplus paid by members is rebated to them in the form of a dividend. Members of a consumer co-operative may accept paying higher prices in the knowledge that some of the surplus generated is returned to them in the form of a dividend.

A co-operative society is free to set dividends at whatever rate it deems reasonable. The FCA offers no guidance on this matter, and society legislation imposes no limits. The directors of a co-operative society have a duty to determine a rate that will further the objects of the society. In most cases, the directors will recommend a dividend rate for approval at an annual general meeting of members.

Dividends can be paid into the member's share account, which will bolster the share capital held by the society. Dividends are treated as a pre-profit expense and are paid gross of income tax. Dividends paid by co-operative societies are treated as ordinary taxable income and are not subject to UK dividend tax rates.

In contrast to dividends, interest on share capital has a lesser role in co-operative societies. The ICA Statement on the Co-operative Identity says *"members usually receive limited compensation, if any, on capital subscribed as a condition of membership."* This could be taken to mean that it only applies to the minimum investment requirement, not the actual amount of share capital held by a member.

A co-operative society that trades exclusively with its members, and distributes the entire surplus to members in the form of dividends, may qualify for mutual trading status and be exempt from paying Corporation Tax on its profit (See Section 9.4).

7.4 Use of profit in community benefit societies

The profit of a community benefit society must primarily be used to benefit the community. This may best be achieved by reinvesting profit in the society, given that the objects of the society, and its trading activities, should be of benefit to the community. Alternatively, profit can be donated to other organisations with the same or similar objects. Paying interest on share capital should be subordinate to these uses of profit.

As a matter of good practice a community benefit society should make recommendations regarding the use of profits to members at an annual general meeting, following the presentation of the annual report and accounts. These accounts should state the operating surplus of the society, and propose what proportion of this operating surplus should be reinvested in the society, donated to other organisations, and used to pay interest on share capital.

As part of its annual report the society should explain how the proposed reinvestment of profit will enable

the society to achieve its objects and be of benefit to the community. The same applies to any proposed donations to other organisations. The annual report might use social accounting techniques, or other methods that help members understand how the society benefits the community.

7.5 Interest and profit in charitable community benefit societies

In common with all charities, a charitable community benefit society should devote its resources to the pursuit of its charitable objects. Profit should either be re-invested in the society or used to support its charitable objects. In this context, the payment of interest on share capital is seen as an operating cost, and not a distribution of profits.

The Charity Commission has published the following statement on the payment of interest on share capital by societies which are treated as exempt charities by HMRC.

"The Commission's position is that a power of a community benefit society to pay interest on shares is not incompatible with charitable status, provided that the following features are required by the society's rules:

> *1. The interest rate is set at a level which is not in itself a motivation to buy shares and which the charity trustees can justify as being in the interests of the charity by reference to available commercial rates for borrowing.*
>
> *2. The cost is part of the society's revenue expenses and met before the surplus is determined.*
>
> *3. The rates are declared in advance of the period for which they will become payable, just as for a bank or building society account, and never retrospectively.*
>
> *4. There is a power to suspend interest payments in the interests of the society.*
>
> *5. There is a power of the society to withhold repayment of the shares, either temporarily or indefinitely and to write the value down below the nominal £1.*
>
> *6. The shareholding does not confer any rights to the underlying assets of the society.*
>
> *7. In the event of a solvent dissolution, shareholders cannot be paid more than the nominal value of their shares."*

This statement relates to the rules of the society, and determines the maximum rate of interest payable on share capital. The directors have the discretionary powers to pay less than this maximum amount.