CO-OPERATIVES UK

Consultation: Legislative proposals for co-operative capital raising

March 2024

1 Background

1.1 Unlocking new options for co-operatives to raise capital is a top policy priority for Co-operatives UK.

1.2 At Co-op Congress in June 2023 we hosted a roundtable with sector leaders and HM Treasury on capital raising. It concluded that while crowdfunding small amounts of equity from a large number of members and community investors (e.g. Community Shares) meets the needs of many societies, <u>many capital-hungry and/or larger co-operatives would benefit from raising equity in larger amounts from a small number of external investors</u>.[1] The roundtable also concluded that some <u>debilitating ambiguities in society law</u> prevent investment deals of this nature that would otherwise go ahead. This risks the stagnation and eventual decline of the UK co-operative economy.[2]

1.3 Also at Co-op Congress 2023, HM Treasury Minister Andrew Griffith announced a Law Commission review of society law. Capital raising is in the scope of this review. The next government will receive recommendations from the Law Commission that could, if acted upon, help to unlock co-operative investment and growth.

1.4 Co-operatives UK has convened a working group comprising members and experts to agree clear asks and positions on amending capital legislation and the policy of the FCA Mutuals Team. [3] The capital working group is now seeking views from the wider sector on its draft proposals.

2 Wider context

2.1 While it might be necessary, reform of the legal framework would not in itself be sufficient to unlock new capital raising options. Removing legal barriers must be part of a wider strategy, with actions for the sector as well as government. This includes:

- Building institutions in and around the co-operative sector for investment, to enable the pooling and recycling of co-operative capital, as well as the raising of capital from the right kind of private investors, [4] including communities
- Co-operation between co-operatives to pool and raise the capital they need for investment

- Creating opportunities and incentives for private wealth to be invested for social and environmental good, and bending more of the ‘impact investment’ and ‘ESG’[5] ecosystem to our values and approach
- Ensuring government’s enterprise finance interventions, such as those via the British Business Bank and social investment intermediaries, include schemes that cater to co-operatives

2.2 The capital working group believes that the society legal framework currently contains technical obstacles to achieving the above. Even if all the above were somehow in place, these technical obstacle would remain and would create problems in practice.

3 Summary of proposals

3.1 Many capital-hungry and/or larger co-operative societies would benefit from raising equity in larger amounts from a small number of external investors, such as impact angel investors and institutions with ESG portfolios. Withdrawable share capital has significant limitations as a tool for doing so.[6]

3.2 At the same time debilitating ambiguities and anachronisms in society legislation relating to non-withdrawable shares, tradability, and permitted relationships with external investors, prevent investment deals that would otherwise go ahead.[7] In response, the capital working group is proposing the following changes to the Co-operative and Community Benefit Societies Act (CCBSA):

- A provision confirming and clarifying how co-operative societies can issue equity (and equity like) share instruments to external investors (see **part 4**)
- A provision confirming and clarifying how transferable shares can be traded in some circumstances (see **part 5**)
- A provision confirming and clarifying how societies can issue shares that are repayable at their option (see **part 6**)
- A provision confirming and clarifying the fundamental principles of withdrawable shares (see **part 7**)

3.3 These proposals draw wholly on existing practice and legal arrangements in the worldwide co-operative and mutual economy. Issuing equity and equity-like instruments to external investors is an established component of financing in many of the largest and most dynamic co-operative sectors around the world. This tends to involve institutional investors, from within co-operative ecosystems and in private capital markets.[8]

3.4 The capital working group is particularly inspired by the following examples:

- Core Capital Deferred Shares (CCDS) are a class of equity share issued to external investors (mainly institutions) by UK building societies. Holders of CCDS have just one vote regardless of the size of their holding and to all intents and purposes have no right to vote in general meetings. CCDS holders receive a distribution out of surpluses in proportion to their holding. Distributions are at building societies' discretion subject to a cap set out in their rules. Nationwide's CCDS are traded on the London Stock Exchange.[9]
- Mutual Capital Instruments (MCI) are equity shares issued by Australian co-operatives and mutuals that can be held by and traded between external investors. A key feature of MCIs is how mutual governance and purpose are safeguarded. Legal reforms in Australia in 2019 enabled the creation of MCIs and since then $340 million (AUD) in equity has been raised from investors.[10]
- Provisions in legal codes in countries with significant co-operative economies, including those for external investors, tradable securities and protection of co-operative purpose and control in Span,[11] provisions for external investors and co-operative protections in France,[12] the separate treatment of voting rights for external investors in The Netherlands,[13] provisions for issuing transferable shares to external investors in New Zealand [14] and provisions for external investors to hold special classes of share in financial and agricultural co-operatives in Japan.[15]
- The role of specialist institutional investors in the Italian co-operative system that recycle co-operative capital, while also brining in private capital and public money.[16]
- The use of external investment ('non-user member investors') in new and early-stage co-operative societies in the UK that, although running up against the limits of crowdfunding with withdrawable shares, charts a course for capitalising ambitious, growth-oriented new co-operatives

4 External investors in co-operatives

4.1 The capital working group proposes that a provision be added to the Co-operative and Community Benefit Societies Act (CCBSA) confirming that co-operative societies can issue equity to external investors. In practice, such investors would likely include institutions in and around the co-operative sector, impact investors and institutional investors with ESG portfolios.

4.2 The group also proposes that the CCBSA requires co-operative societies to safeguard co-operative purpose, ownership and control when issuing shares to external investors. This would put the interpretation the FCA already includes in its guidance on a firmer statutory footing.[17]

4.3 These safeguards could include:

- Limiting each external investor to no more than one vote, no matter the size of their investment, if they are given votes at all
- Restricting matters that external investors can vote on at a general meeting, including preventing them from voting on matters relating to changes to purpose, governance and registration as a co-operative society, if they are given votes at all
- Restricting the representation of external investors on the board so that they are always in a minority, if they are given representation at all

Question 1: Would these measures strike the right balance between safeguarding co-operative values and principles and enabling external investment?

4.4 ICA Principle 3 and current FCA guidance rightly stipulate that returns to members must be limited.[18] But this does not apply to external investors, who will sometimes require more market-level terms and returns, even when they have a social and solidarity motivation. And while CCBSA 2.3 prohibits co-operative societies from existing mainly to generate profits for investors, this does not preclude making distributions to external investors on market-level terms, so long as steps are taken to ensure doing so does not become the main purpose of the business.[19]

4.5 The capital working group proposes that the CCBSA includes a provision confirming that external investors can be offered market-level terms and returns, such as:

- a distribution of surplus, at the discretion of the co-operative, when performance allows it
- the possibility of higher returns for investors who take more risk (e.g. early stage investors)
- the possibility of profiting through the sale of shares to other investors
- the possibility of being repaid capital at a premium above par value, at the discretion of the co-operative, when performance allows

Question 2: What should our 'red lines' be for allowing co-operative societies to offer external investors 'market-level' terms and returns?

5 Transferable shares

5.1 The CCBSA infers that societies can issue ‘transferable’ shares and requires that rules provide *“for the form of transfer and registration of shares, and for the consent of the committee to transfer or registration”.*[20] At present the FCA interprets this as requiring each individual share transfer to the be approved by the board,[21] which effectively rules out frequent transfers between members and the trading of shares among external investors.

5.2 The capital working group proposes that the CCBSA contains provisions confirming:

- that shares can be transferred between members and non-members without each transfer requiring Board approval
- that investor shares in co-operative societies can be traded among external investors

5.3 Transferable securities are already automatically regulated under the UK’s new Prospectus Regime,[22] which exists to protect the investing public.

Question 3: How can co-operatives ensure that allowing some of their shares to be traded among external investors aligns with their values and principles?

6 Repayable shares

6.1 The CCBSA provides that societies can issue shares that are transferable and/or withdrawable or non-withdrawable. But the law is silent on whether they can repay shares at their option, in a way similar to how companies redeem or buy back shares at their option. Some legal experts warn that this means any repayment (or ‘redemption’) by societies could be challenged under 19th century case law, which established that in the interests of creditor protection, redemption and buybacks were illegal.[23] Company law has since been changed to provide procedures for lawful redemptions and buybacks.[24]

6.2 The capital working group proposes the CCBSA includes a provision that confirms that societies can repay non-withdrawable shares at their option. This would establish a new exit route for investors, including members who invest, while increasing the ability of societies to control their capital position.

Question 4: What rules should be put in place to protect creditors and other investors when societies are using repayable shares?

7 Withdrawable shares

7.1 The CCBSA infers that societies can issue shares that are withdrawable but is silent on the fundamental principles of this capital. The capital working group proposes the CCBSA includes a clearer provision on withdrawable shares. This should clarify the following points that are largely established practice:

- that withdrawal is an option exercised by the shareholder
- that societies can retain full discretion to limit or suspend withdrawals
- that societies can set long notice periods for withdrawal
- that societies can stipulate that withdrawal can only be an option after a certain period of time
- that societies can set fixed times at which withdrawals are allowed
- that withdrawable shares can be transferable or non-transferable

Question 5: Do you agree with our proposals for withdrawable share capital?

Question 6: Do you have any other points you would like the capital working group to consider?

8 Next steps

8.1 This consultation will run until 5 April. The capital working group will then agree and publish finalised proposals to feed into the Law Commission review.

9 How to respond

9.1 Please **email your response to** policy@uk.coop **by the end of Friday 5 April 2024**.

Notes and references

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[1] By 'external investors' we mean people and organisations that are not the members that the co-operative exists to benefit, that have more of an investment relationship with the co-operative. This includes institutions, angel investors, high net worth individuals and impact investors, including those with partial social and solidarity motivations. It would include investment institutions in and around the co-operative sector, social investors, public bodies and community investors.

[2] Evidenced by slow growth in the UK and under-representation in sectors and markets where co-operatives offer solutions and where co-ops in other countries play a significant role, such as finance, housing, agriculture, care and manufacture. An inability to invest in decarbonisation and in technology to remain effective and relevant would also be a serious risk for the future of the model.

[3] The capital working group currently consists of: Ben Reid, Chair (Co-op Exchange, ICA), Emma Back (Equal Care Co-op), Doug Field (East of England Co-operative), Paul Gerrard (The Co-op), Peter Kelly (Midcounties Co-operative), Isla McCulloch (Co-operatives UK), Peter Hunt (Mutuo), Stephen Gill (Co-op Exchange, Co-operatives UK), Edward Parker (Midcounties Co-operative), Dave Alcock (Anthony Collions Solicitors), John Dawson (Co-operatives UK), James Wright (Co-operatives UK). Membership was self-selecting from a group that has remained actively involved in conversations since Co-op Congress 2023.

[4] We recognise that many private investors could be inappropriate and even dangerous for co-operatives. Most co-operatives raising 'external investment' will most likely need to work with institutional investors with social and co-operative purpose, institutions and individuals specifically seeking to have a positive social or environmental impact through investment, and 'ESG' investors. For a great analysis of the options, the risks, and the mitigations, see this report for the International Co-operative Alliance.

[5] ESG investment is a service wherein asset managers invest people's money with consideration of environmental, social and governance impacts

[6] *Limitations of withdrawable shares*

While withdrawable share capital (WSC) is ideal in many circumstances, is has significant limitations when co-operatives need to raise large amounts from a smaller number of external investors, because:

- The £100k holding limit for WSC in the CCBSA, while important, severely limits its utility for raising large amounts from a smaller number of external investors
- The medium/long term uncertainty in capital planning created by withdrawability limits the extent that WSC could be relied on
- The lack of liquidity in early years of WSC investment, and the need to rely on a certain level of business profitability to enable withdrawal in later years,

is a turn-off for many external investors, who require more, and more flexible, ways to realise value from their investment

- The convention that WSC can only ever be withdrawn at par value or less, means that repayment is not considered as a way to offer a ‘risk premium’ for investors who took a risk in tying their capital up in an unproven start-up or early growth business

In addition to this, ambiguity in the CCBSA as to what ‘withdrawable’ means, can be problematic for some societies and investors.

While the CCBSA infers that WSC can be transferable, it is very ambiguous as to what transferability could mean in practice, which has severely limited practical use of this option by societies.

[7] *Non-withdrawable shares*

As non-WSC is not subject to the £100k holding limit, it has the potential to be useful for raising larger amounts from a smaller group of external investors. But the CCBSA contains a number of debilitating ambiguities that, in practice, prevent societies and investors from using this option when they might otherwise do so, including:

- on whether co-operatives can repay non-withdrawable shares at their option, similar to how companies can redeem shares are their option
- on the tradability of co-operative shares, particularly those held by external investors (see **part 4**)
- on permissible relationships and returns for external investors in co-operative societies (see **part 4**)

Relationships with external investors

It is established practice around the world for co-operatives to raise some equity from external investors (i.e. investors solely with a financial, or financial-social, relationship with the co-operative, who are not ‘user-members’). While rare in the UK, this does happen and is becoming more important.

The CCBSA is silent on whether external investors are permitted. The FCA Guidance makes clear that co-operatives can have external equity investors (or ‘non-user investor members’ as it calls them), so long as these investors have very limited voting and representational rights, to protect co-operative purpose and control.

Some stakeholders believe that if external investor equity is to be used on a bigger scale in the UK, then if would be better if the CCBSA provided legal certainty on the following:

- that this permitted
- on the critical protections of co-operative purpose and control

ICA Principle Three is clear that returns on investment made by members should be limited, to ensure they are primarily motivated to support the activities of the co-operative. The FCA Guidance rightly limits share interest paid to members.

But ICA Principle Three **does not apply in the same way to external investors**, who have more financial motivations that need to be served. These investors require slightly higher, and perhaps partially performance-related, returns on their investment. This could come in the form of:

- The ability to sell shares for a profit (if tradability were permitted)
- Higher interest rates for earlier, high-risk investors
- Share interest that partially tracks performance
- Premiums on share repayment (if repayment were legally permitted) or withdrawal (in the rare cases WSC is usable)

The CCBSA rightly prohibits a co-operative society from existing primarily to generate returns for investors. Having external members and rewarding their investment financially is not at odds with this prohibition, so long as protections of co-operative purpose and control are in place. Clarifying this in the CCBSA could be very useful.

The FCA Guidance is detailed on returns for members but very ambiguous where 'non-user investor members' are concerned. Its interpretation of what is permitted here is unpredictable. Potentially, more certainty in the CCBSA would be needed to enable serious investment deals, so long as legislative is permissive and not prescriptive.

[8] For an overview of the role of external equity the financing of co-operatives around the world, see this report for the International Co-operative Alliance

[9] See here: https://www.nationwide.co.uk/investor-relations/ccds-terms-of-access/ccds-market-data-and-investor-information/#overview

[10] https://bccm.coop/help-advice/raise-finance/mutual-capital-instruments/#:~:text=MCIs%20are%20a%20new%20type,protecting%20the%20mutual%20ownership%20structure.

[11] https://coops4dev.coop/sites/default/files/2021-06/Spain%20Legal%20Framework%20Analysis%20Report_0.pdf

[12] https://coops4dev.coop/sites/default/files/2021-09/France%20Legal%20Framework%20Analysis%20National%20Report.pdf

[13] https://coops4dev.coop/sites/default/files/2021-08/Netherlands%20Legal%20Framework%20Analysis%20Report.pdf

[14] https://coops4dev.coop/sites/default/files/2021-06/New%20Zealand%20Legal%20Framework%20Analysis%20National%20Report.pdf

[15] https://coops4dev.coop/sites/default/files/2021-06/Japan%20Legal%20Framework%20Analysis%20National%20Report.pdf

[16] For analysis of the role of this institutions in Italy see here

[17] See FCA guidance 6.1.30 and 6.1.31 here: https://www.handbook.fca.org.uk/handbook/RFCCBS/6/?view=chapter

[18] See FCA guidance here: https://www.handbook.fca.org.uk/handbook/RFCCBS/6/?view=chapter

[19] See FCA guidance 4.2.1 here: https://www.handbook.fca.org.uk/handbook/RFCCBS/4/?view=chapter

[20] https://www.legislation.gov.uk/ukpga/2014/14/section/14

[21] See FCA guidance 6.1.13 here: https://www.handbook.fca.org.uk/handbook/RFCCBS/6/1.html

[22] https://www.handbook.fca.org.uk/handbook/PRR.pdf

[23] https://en.wikipedia.org/wiki/Trevor_v_Whitworth

[24] See Part 18 of the Companies Act here: https://www.legislation.gov.uk/ukpga/2006/46/part/18