

# Community shares

## Practitioner's guide to governance and offer documents





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## WARNING

While every effort has been made to ensure the accuracy of the information in this Guide, it is not intended for use as a source of legal advice in individual cases. When in any doubt about the content of a document, the way to proceed with an offer, or any legal or regulatory requirements or potential liability, it is important to seek professional advice on a case by case basis. No liability is accepted by the authors or publishers of the Guide for any loss or damage whatsoever resulting from reliance on this document.



# 1 Introduction

## 1.1 Background

Community investment is rapidly becoming an accepted way of financing enterprises that serve a community purpose. Unlike the way the term is used by banks and big business when they refer to their philanthropic and charitable grant programmes, in this case, community investment means just that: individuals in a community investing their own money with the expectation that they will receive a return on their investment, and stand a reasonable chance of getting their money back at some point in the future. Community investment is not a grant or a donation. But neither is it purely a financial investment; investors are more motivated by the community benefits and the social return on investment, than they are by the prospect of financial gain.

Community investment brings with it new responsibilities to meet the rights and expectations of investors. This guide focuses on governance documents which set out the legal rights of investors, and offer documents that invite investors to buy shares and create expectations about the investment, for which the promoters are potentially liable. Section 1 sets the context, by describing what is involved in planning a community share offer, the starting points for community investment and the reason why most organisations use either the co-operative society or the community benefit society format for community share offers. Section 2 examines these formats in detail, focusing on the model governing documents produced by three sponsoring bodies that have been pre-approved by the Financial Services Authority, the body responsible for registering co-operative and community benefit societies. Section 3 provides guidance on how community share offers can be structured and

presented to the public, focusing on the contents of four different types of share offer documents. Appendix 1 contains a table making a detailed comparison between the four main sets of model rules that are suitable for community share offers. The guide focuses on withdrawable share capital; co-operative and community benefit societies can issue transferable share capital, but this type of share is treated differently in legislation, and is not addressed here.

This guide is aimed at business advisers and other professionals who provide support to community groups and organisations that are exploring the option of community investment. A companion publication, *Investing in Community Shares*, aims to help the public understand what they should look for in any community investment proposal. Both guides are the product of the Community Shares Programme, a two year action-research project, funded by the Office of the Third Sector and the Department for Communities and Local Government, working in partnership with the Development Trusts Association and Co-operatives UK. The programme is due to be completed by the end of March 2011. Before then, this publication will be consolidated into a more comprehensive document called the *Practitioner's Guide to Community Shares*, which will include case studies and practical examples drawn from the programme's research. It will also include new versions of some of the governance documents presented here, which are currently under review, along with updated advice on offer documents, and new sections on the business case for community investment, community building and engagement.

Investment using community shares is still a relatively new practice, and the know-how underpinning this practice is still growing, evolving and improving. It is too early to describe what is presented here as best practice, but there is a strong commitment to raise standards and ensure that the public who invest in community shares are given the best possible levels of information about the co-operative and community enterprises they invest in.

## 1.2 Planning a community share offer

**There are four key elements to all successful community investment propositions: the business case for investment, the community, the governing document, and the offer document. Each of these elements is indivisible from the other, and weaknesses in any single element will undermine the overall strength of the proposition.**

**The business case:** Community investment is only viable if the venture can work to a business model. It is not suitable for charitable organisations that are reliant on grants, gifts and donations as their main source of income. Some community organisations are engaged in activities which fundamentally must be met through charity, whether from the public purse or private sources. However, there is a growing range of community services where the business model is fully or largely accepted. Shops, housing, energy supplies, transport, leisure, sports, entertainment, food, childcare, adult education, even telecommunications and media services, all affect the quality of community life, and are predominately delivered through a business model. The Plunkett Foundation has demonstrated through its work with over 200 rural community shops how community-ownership can transform failing private businesses into vibrant community enterprises. Ownership and investment go together to form a strong bond, engaging communities in enterprises that serve their interests. Community investment can strengthen the business model, but it also carries the risk that people's money will be lost, or their expectations will not be met. So developing a strong business case is crucial, and one of the best ways of doing that is to engage the community in the ownership and control of the enterprise.

**The community:** In the context of community investment, community needs to be more than a label for people living in the same place. Community also needs to be about shared interests, shared values and shared identity. Indeed, in the globalised world of electronic communications, there are a growing number of virtual communities built on identity rather than place. Community investment relies on identifying and engaging a target community in an enterprise that affects the quality of life for that community.

**The governing document:** Community investment works by selling a share in the enterprise to people in the community. These people, as shareholders, control the enterprise. Their rights as shareholders are embodied in the constitution of the enterprise: what is more generally known as the governing document. A governing document generally does two things: it expresses the purpose of the organisation, its aims and objectives; and it describes how the organisation will operate. If the organisation plans to sell shares to members it must adopt an appropriate legal format for its governing document, either as a company or as a co-operative society or community benefit society.

**The offer document:** Inviting people to invest in an enterprise and risk losing their money must be carried out in a responsible manner. The offer document is the term used in this guide to refer to this invitation to invest, whether it is in the form of a printed document, website, video, or even a presentation at a public meeting. In most, but not all, circumstances, inviting members of the public to invest is a regulated activity, covered by the Financial Services and Markets Act 2000. Statutory regulation provides some protection for investors; they have the right to complain to the Financial Ombudsman, and they may be eligible for compensation from the Financial Services Compensation Scheme. But some types of financial promotion, including many of those described in this guide, are exempt from regulation, or fall outside the scope of the Act. However, even in the absence of statutory regulation, there can still be legal liability to investors. Those communicating information about an investment opportunity or advising people about an offer, will have to pay damages, and may have the investment contract set aside, if the torts of deceit or negligent misrepresentation have been committed, if a contract term is broken, or if the

Misrepresentation Act 1967 applies.

This may well be the case if losses were incurred by an investor who relied on the document, information, or advice in deciding to enter the investment contract and if the loss was due to a false or misleading statement of fact or any negligent statement. 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. The lack of statutory regulation, and consequent more limited protection for investors, underlines the importance of developing robust standards of voluntary self-regulation and good practice.

One of the main reasons for producing the guide is to put forward a set of standards for offer documents that could become the basis for a voluntary code of self-regulation. The content of the offer document is also dependent on the legal form and governing document of the organisation, which is why the guide also examines these issues. The other two essentials of a community share offer – the business case and the community – will be dealt with in the *Practitioner's Guide to Community Shares*, due to be published in 2011. Meanwhile, further information about the business case and community-building techniques can be found on the Community Shares website ([www.communityshares.org.uk](http://www.communityshares.org.uk)).

## What about bonds?

*Bonds or loan stock are generic terms for a debt agreement. These agreements usually state the repayment date and interest rate. The debt is usually unsecured. In commercial markets, bonds are normally tradable.*

*When the Community Shares programme was first conceived, equal weight was given to the idea of shares and bonds. But as the programme has progressed, less and less emphasis has been placed on community bonds. This is because bonds, unlike shares, do not confer membership, and therefore do not contribute to the same community-building processes as community shares. Also, because bonds are a form of debt, they do not improve the 'gearing' of the organisation: its ability to raise commercial debt. Another problem is the need to periodically refinance the organisation when the bonds mature.*

*But bonds do have their uses. Registered charities that are companies limited by guarantee (or charity incorporated organisations, when they become available) cannot issue share capital, so bonds may be an attractive alternative for raising investment capital from their supporters. And bonds might be more attractive to some investors, who like fixed interest rates and repayment dates.*

*Some societies use bonds, in addition to share capital, as a way of enabling wealthier members to invest more than the current £20,000 limit of share capital.*

*Bonds are subject to the same regulations that apply to other forms of financial promotions. Community benefit societies and registered charities are exempt from some of these regulations when issuing bonds to raise capital for their own purposes, in line with their stated objectives.*

## 1.3 Starting points

It is a common misconception that community investment is all about financing new community ventures, where significant amounts of capital are needed to meet the start-up costs involved in launching the new venture. But community investment can be appropriate at any phase of development, ranging from pre-start propositions, through to mature community enterprises that need new capital to consolidate their trading position. Table One identifies five development phases, three of which involve established enterprises with a trading history.

Community investment in the form of shares is particularly appropriate at the start-up and early-stage growth phases because the financial return paid on shares can be changed to reflect the actual performance of the enterprise, which can be hard to predict at these phases.

In the private sector investing at the pre-start and start-up phases is generally considered to be highly risky, and is shunned by most investors, unless there is an opportunity to make large amounts of money. The risks in these early phases are extremely hard to identify, quantify and manage. Yet, without taking these risks it would be impossible for any new venture to get established, so it is usually left to highly-motivated entrepreneurs to take these risks and reap the financial rewards.

The problem for ventures serving a social purpose is that financial risks still have to be taken at these early phases, but without the motivation of personal financial gain. Instead community ventures tend to raise the finance they need in the form of grants, gifts and donations from their keenest supporters. But there is an upper limit to how much anyone can afford to donate. More finance may be available if there is a possibility of getting the money back. Appealing for community investment, rather than donations, may be a more

**Table 1: Development phases in community enterprises**

Development phase	Key Characteristics
<b>Pre-start</b>	New groups or projects that need resources and support to get investment-ready
<b>Start-up</b>	Investment-ready ventures, developed by the community, with or without the support of external agencies
<b>Acquisition and transfers</b>	Community buy-out or rescue of established enterprises facing closure or ownership-succession problems, as well as the acquisition and transfer of community assets, such as land and buildings
<b>Early-stage growth</b>	Established ventures trading for less than three years, seeking investment capital to finance growth
<b>Later-stage growth and consolidation</b>	Established ventures trading for more than three years, seeking investment capital to finance growth, replace capital outflows, or consolidate their trading position

successful way of financing pre-start and start-up community ventures.

Acquisitions and transfers are an important way of establishing new community enterprises. There are two main types of opportunity: the acquisition of private enterprises that serve the community, and the transfer of community assets from public ownership to community ownership. The first of these opportunities represents what might be the main growth area for future community investment. Succession failure, where a business is wound up because the owner is unable to find a buyer or successor, is a significant cause of business closure among small firms in the UK. Local retailing and smallholder farming are both good examples of this problem, where a community buy-out could provide a solution. Asset transfer from public ownership to community ownership can be consolidated by additional community investment to develop these assets.

From an investor's point of view, investing in an established enterprise with a proven track record and trading history, can be far less risky than investing in a new enterprise. Early-stage growth in recently established

enterprises is most often hampered by a lack of finance to fund the cash flow requirements of growth. Engaging the community, as members and investors, can be a powerful way of strengthening the business model, increasing customer loyalty, and making the community enterprise more financially secure.

Later-stage growth and consolidation can be an attractive investment proposition because older, established community enterprises are more likely to have built up financial reserves, which provide greater security for community investors, or, at the very least, they can provide evidence of their actual performance in recent years. Because there is greater security on offer, investors may be prepared to accept lower financial returns, reducing the cost of capital to the enterprise. Investors may also be motivated by the social returns on their investment.

For established community organisations, developing a community share offer may involve major changes in the ownership, control, membership and governance of the organisation. Raising additional capital is not, in its own right, a sufficient reason



for making such big changes. However, community investment is not just about raising finance, it is also an excellent vehicle for community engagement and empowerment, giving real meaning to the concept of membership, where members have legal title to the organisation. Developed correctly, community investment can also strengthen the underlying business model of the organisation, making it more competitive, robust and resilient.

## Community shares checklist

Use this checklist to monitor progress towards completing the key tasks involved in planning and launching a community share offer.

### The business case

- Product or service has been identified that will appeal to the target audience
- Product or service is capable of generating social return on investment
- The social return has strong appeal to the target audience
- Product or service can be delivered as a profitable business activity
- Capital requirements of new activity is affordable to the target audience
- Business plan provides evidence of the long term sustainability of the new activity
- Evidence that any financial returns offered to investors are achievable and affordable
- Evidence that the enterprise will be able to honour requests for the withdrawal of share capital within stated terms

### Community building

- The target audience is of sufficient scale to sustain the proposed business activity
- Target audience is capable of developing a community identity
- Plan in place for communicating with the target audience and identifying supporters
- Known supporters can engage with the enterprise in multiple ways as investors, customers, volunteers, providers, activists, experts and/or suppliers
- Supporter base is large enough to meet community investment targets
- Marketing plan for converting supporters into investing members
- Plan to involve members in governance of the enterprise

### The governing document

- Need to establish new legal entity agreed
- Objectives of new entity, and need for community investment, established
- Agreement reached on whether to register as a co-operative society or community benefit society
- Range of model rules suitable for purpose reviewed, and most appropriate selected
- Checked for consistency between capital requirements in business plan and model rules on shareholdings, loans, deposits, and terms and conditions for share capital
- Revisions to selected model rules identified and developed with sponsoring body
- Name for new society agreed and checked for validity
- Registered office, initial subscribers, secretary and first board of directors identified
- Plan in place to meet all obligations of registration

### The offer document

- The development phase of the enterprise has been identified
- The type of offer document planned is appropriate for the development phase of the enterprise
- Draft offer document written and tested with target audience
- Targets, timescales and contingencies for community share offer established
- Plan in place for administering community share offer

## 1.4 Co-operative and community benefit society legislation

The governing documents reviewed in this guide are all based on the Co-operative and Community Benefit Societies and Credit Unions Acts (1965 - 2010). Co-operative societies and community benefit societies are incorporated bodies with limited liability status, the same as companies registered under the Companies Acts. Limited liability status is a major concession for enterprises, which bestows both privileges and responsibilities upon the owner-members of such enterprises.

All societies have share capital, provided by members, and paid-up share capital is fully at risk; if the society gets into financial difficulties, members are last in the line and only get paid after creditors. Like all other types of incorporated body, societies can act, sue and be sued, and own property, land and other assets in their own names.

Most community share offers in the last five years have been made by organisations registered as co-operatives or community benefit societies. This is because the legislation has a number of special attributes that make it particularly suitable for community investment. These attributes include:

**Withdrawable share capital:** This type of share capital, unique to co-operative and community benefit societies, can be withdrawn by investors from the society, subject to its terms and conditions of withdrawal. This means that investors can get their money back, and do not have to find a buyer to 'transfer' their shares to, thus addressing the problem of liquidity that investors would otherwise face. (See: *Liquidity of share capital* p.7)

**Shareholder democracy:** Individual members of a society have only one vote regardless how much money they have invested. This democratic principle of

### Co-operative and Community Benefit Societies and Credit Unions Act 2010

*This new Act received Royal Assent on 18 March 2010. One of the main changes it introduced was to rename the 'Industrial and Provident Societies Acts' as the 'Co-operative and Community Benefit Societies and Credit Union Acts', thus consigning the term 'industrial and provident society' to history. The Act also, for the first time, requires new societies to be registered either as co-operatives or community benefit societies, and applies the Company Directors Disqualification Act 1986 to the directors of societies.*

*Other changes to the governance of societies are being introduced through legislative reform orders, which are likely to result in the upper limit on withdrawable shareholding being raised above the current maximum of £20,000, and the scrapping of any limitations on non-withdrawable (ie. transferable) shareholdings.*

one-member-one-vote contrasts with the one-share-one-vote practice of most companies that allow majority shareholders to dictate terms.

**Upper limit on shareholdings:** Individuals are currently not allowed to have more than £20,000 of withdrawable share capital in a society, although this upper limit is set to increase in the near future. This helps to reduce dependency on individual shareholders, and reinforces the need to build community membership.

**Flexible upper limit on financial returns:** All societies can pay interest on share capital up to a level sufficient to attract and retain the investment. This flexible cap respects the not-for-profit motives of members, at the same time as recognising that they should be compensated for investing and risking their money.

**Optional statutory asset lock:** Community benefit societies can opt to introduce a statutory asset lock, preventing any residual assets being distributed to shareholders if the enterprise is sold or dissolved. This statutory asset lock is the same quality as the one that exists for registered charities and community interest

companies. An asset lock is often important for ventures also seeking to attract public investment or grants. (See: *Asset locks and the use of profits* p.9)

**Optional dividend to reward member loyalty:** Co-operative societies can pay members a dividend based on the level of their transactions with the enterprise. Dividends can be highly effective at encouraging and rewarding member loyalty, while at the same time allowing the venture to adopt a financially prudent approach to its transactions with members. (See: *Co-operative dividends* p.8)

These attributes underline the social and community nature of societies, and help to explain why a society issuing withdrawable or other types of non-transferable shares is not considered to be a 'controlled investment' subject to the financial promotion rules in the Financial Services and Markets Act 2000, and is exempt from the prospectus requirements.

Under the financial promotion rules, controlled investments, such as shares or bonds in companies, including community interest companies, can only be marketed

by an FSA authorised person, or through communications approved by an authorised person. Above a certain size of offer, other regulations come into effect, requiring the enterprise to publish a fully approved prospectus. This can be very expensive, usually prohibitively so, for organisations seeking to raise less than £5m.

Societies do not have blanket exemption from the Financial Services and Markets Act. Societies can issue transferable shares, and this type of share can, under certain circumstances, fall within the scope of the Act. The purposes for which the share capital is to be used can also affect whether it is within the scope of the Act; this could be the case for a society intending to use its share capital not for its own business purposes, but to invest in other organisations.

The sale of a society's withdrawable share capital is an unregulated activity. This means that they can promote their share offers in whatever manner they choose. It also means that, apart from their right, after the event, to sue for damages, or to set aside the investment contract under the law of tort or the Misrepresentation Act 1967 (see Section 1.2), investors in co-operative and community benefit societies are unprotected. There is no scrutiny of the offer documentation in advance of it being issued. Investors have no right to complain to the Financial Ombudsman, and they are not eligible for compensation from the Financial Services Compensation Scheme. This places a legal and ethical duty on all societies to ensure that they promote community investment in a responsible manner.

## Liquidity of share capital

*Liquidity is the term used to describe the ability to convert shares (and other financial instruments) into cash.*

*Companies normally issue 'transferable' share capital, which means that shares can be bought and sold between third parties. Most private companies are owned by a handful of shareholders, often with a majority shareholder who will dictate how shares in the company are transferred. When shareholders want to cash in their investment they will usually find someone willing to buy the whole business, a process often referred to as a 'trade sale'. Liquidity can also be a major problem for smaller companies with more than a handful of shareholders, especially if there is not a majority shareholder. A handful in this context may mean somewhere between six and sixteen.*

*Larger companies may consider listing on a stock market, where shareholders can easily buy and sell shares in the company. Stock market listings are only feasible for large companies – there are fewer than 3,000 British and overseas companies listed on the London Stock Exchange, one of the largest stock exchanges in the world. Even junior stock markets usually only cater for enterprises with capitalisation in excess of £5m to £10m, and some junior markets are criticised for being too illiquid. Transferable shares may also be subject to speculation and rapid changes of ownership, which can have negative effects.*

*Withdrawable shares provide a potential 'exit route' for the investor: the ability to sell shares back to the society. But this exit route depends on the performance of the society, and the provisions it makes for withdrawals of capital. Many societies limit the total value of shares that may be withdrawn in any one year to a fixed percentage, typically 10%. Some new societies suspend the right of withdrawal in the first few years of operation. So while investors have the comfort of an agreed exit mechanism, they need to take a medium-term view of their investments in societies.*

*The withdrawable share mechanism also effectively protects societies from speculators, because shares cannot be traded, and cannot increase in value.*

# 2 The governing document

## 2.1 Introduction

'Governing document' is the generic term for the legal constitution of an organisation. In co-operative and community benefit societies legislation governing documents are known as 'rules'. Any organisation seeking to become a co-operative or a community benefit society must register its rules with the Financial Services Authority (FSA). This registration function of the FSA is distinct from its role as regulator of the financial services industry in the UK. There are two types of society, bona fide co-operative societies and community benefit societies. Both types of society can issue withdrawable share capital, and pay interest on that share capital subject to the limitation placed on it by the FSA that interest rates should be no more than what is sufficient to attract and retain the investment. Although the FSA application form says that it is "unusual" for community benefit societies to issue more than nominal share capital (typically one £1 share per member), this does not mean that it is not allowed. Community benefit societies can issue shares up to the legal maximum permissible to each individual member, currently £20,000.

**Co-operatives** are run for the mutual benefit of members who use the services of their society. This is based upon common economic, social and cultural needs or interests among the members. Typically, this common need or interest will define their relationship with the co-operative as a service user, customer, employee or supplier. Co-operatives have open membership – there should be no artificial restrictions on membership, and membership should be open to anyone who meets the criteria. Recent guidance<sup>1</sup> from the FSA says that co-operatives can have investor-members who are not otherwise users of the society's services. Co-operatives can pay interest on member share capital and a share of the surplus, or dividend, based on the level of transactions (customer-purchases, supplier-sales or employee-wages) with the society.

**Community benefit societies** are run primarily for the benefit of the community at large, rather than just for members of the society. This means they must have an overarching community purpose reaching beyond their membership. Applicant enterprises must also have a special reason for being a community benefit society rather than a company, such as wanting to have democratic decision-making built into their structure. Although community benefit societies have the power to pay interest on members' share capital, they cannot distribute surpluses to members in the form of a dividend. Community benefit societies can opt to have a 'statutory asset lock' which has the same strength as the asset lock for charities and community interest companies. This type of asset lock is not currently available for co-operatives.

### Co-operative dividends

*Companies and co-operative societies use the term 'dividend' in different ways. In a company a dividend is a discretionary allocation of profits to shareholders, paid as an amount of money per share. This is a post-tax expense for the business. Company dividends are subject to income tax for individual shareholders, and are a post-corporation-tax expense for companies.*

*In a co-operative society a dividend is a discretionary allocation of profits paid to members, based on the value of the members' transactions with the co-operative, and not on the amount of capital invested. Dividend rates are determined after the year end, when the society's annual accounts have been prepared, enabling the co-operative to decide how much it can afford to distribute as dividends. Dividends are a pre-corporation-tax expense for co-operative societies.*

*Co-operative dividends are a financially prudent mechanism that also encourages member loyalty. For instance, it means that a co-operative selling goods to its members can set the price of those goods marginally higher, to ensure it makes a profit, which can then be distributed back to members as a dividend. This is more prudent than charging less for goods and dealing with the consequences.*

<sup>1</sup> Investor membership of co-operatives registered under the Industrial and Provident Societies Act, 1965. Policy note by Michael Cook and Ramona Taylor. 2007

There are pros and cons associated with both types of society. Co-operatives have the scope to pay members a dividend (See: *Co-operative dividends* p.8), which can stimulate member loyalty and strengthen the business model. Community benefit societies, with a statutory asset lock, may provide greater reassurance to public funders and grant-giving bodies that none of their money can end up in private hands (See: *Asset locks and the use of profits* opposite). 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 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.

To register a community benefit society, the FSA requires the applicant to give 'special reasons' for not registering as another form of company. Generally speaking, the FSA will accept any reason associated with the unique attributes of a community benefit society, ranging from member democracy to the statutory asset lock. The FSA wants to know what groups or categories of people will benefit from the creation of a community benefit society, and whether any limits have been placed on the amount of withdrawable share capital held by members. It also wants to know whether the society has charitable objects, and although it does not require societies to register as charities, societies that do have charitable objects may be required to register as charities by the Charity Commission.

## Asset locks and the use of profits

*All co-operative and community benefit societies are required to have rules stating how profits can be used. These rules will usually allow societies to re-invest profits, or use profits for social, community and charitable purposes, and limit the distribution of profits to members. The rules will also usually explain what happens to any residual assets in the event of the society being wound-up and dissolved. Residual assets are what is left when all creditors have been paid, and the shareholders have been repaid the capital they invested. Residual assets usually arise when an enterprise re-invests its profits, and builds up reserves of capital on its balance sheet.*

*Most co-operatives adopt rules which reflect the International Co-operative Alliance's (ICA) Statement on Co-operative Identity. This statement lists seven co-operative principles, one of which addresses member economic participation, and says, "members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership." This principle can be interpreted as requiring co-operatives to be at least partially asset-locked.*

*The FSA requires that all community benefit societies have rules which prevent the distribution of residual assets to members on dissolution. Instead, any residual assets should be transferred to another body with similar objects, or, if no such body exists, used for similar charitable or philanthropic purposes. While this requirement has the hallmarks of an asset lock, it does not prevent a community benefit society from voting to change its rules or convert into a company.*

*The Community Benefit Societies (Restriction on Use of Assets) Regulations 2006 addressed this weakness by allowing community benefit societies to adopt rules that impose a statutory asset lock, equivalent to the asset lock in charities and CICs. Societies that want to have a statutory asset lock must change their rules, adopting the precise wording found in Schedule 1 of the 2006 Regulations. These regulations only extend to community benefit societies and do not cover co-operatives.*

## Community benefit societies and charitable status

*Community benefit societies were, in the past, able to apply to HM Revenue and Customs for exempt charity status. This gave them the same tax treatment as charities without actually having to be a registered charity. However, the Charities Act 2006 included provisions to require community benefit societies with exempt charity status, and an annual turnover in excess of £100,000, to register as charities with the Charity Commission. This provision has not yet come into effect, but could do so any time from late 2010.*

*It is not clear how the Charity Commission will treat applications from community benefit societies that pay interest on withdrawable share capital. Representations have been made to the Charity Commission, arguing the case in favour of allowing community benefit societies with charitable objects and community investment to be registered as charities.*

## 2.2 FSA registration requirements

The FSA website has a section devoted to the registration of new co-operative and community benefit societies, which provides all the necessary forms ([www.fsa.gov.uk/pages/doing/small\\_firms/msr/societies/index.shtml](http://www.fsa.gov.uk/pages/doing/small_firms/msr/societies/index.shtml)). The application form states that it takes 15 working days to examine each application. The cost of registration ranges from £40 if the applicant is using model rules (although the sponsoring body may charge an additional fee) up to £950 if the applicant is not using model rules.

Applicants are required to submit a set of rules that must cover 14 matters required by the FSA (See: *FSA Co-operative and community benefit societies rules requirements* opposite) Rules can cover additional matters, as long as these matters do not conflict with legislation and are acceptable to the FSA. 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 the FSA. Rules can be added, amended or rescinded, but only with the support of a general meeting of members and the permission of the FSA. The application form also requires applicants to state whether they are registering a bona fide co-operative or a community benefit society, and to provide additional details if they are registering the latter. The difference between these two types of societies is explained later in this section.

Applications can be made to register new societies, or to convert an existing company, including community interest companies (CIC) into a society, subject to certain conditions. Organisations that are registered charities can only become one type of society – a community benefit society – as long as this is approved by the Charity Commission. Similarly, CICs can only convert into community benefit societies, and they must have a statutory asset lock (See: *Asset locks and the use of profits* p.9).

### FSA co-operative and community benefit societies rules requirements

The FSA requires all applicants to submit a set of rules for the proposed society, together with information covering a range of other matters, including:

- Proposed date for the financial year end
- Type of society (co-operative or community benefit)
- Close links with other societies or companies (e.g. subsidiaries, groups, and/or holding companies)
- Use of model rules issued by a sponsoring body.

The rules must cover the following 14 matters:

Statutory matters	Details
<b>A. Name</b>	The name of the society.
<b>B. Objects</b>	The objects of the society.
<b>C. Address</b>	The registered office of the society to which all and notices to the society may be addressed.
<b>D. Admission of members</b>	The terms of admission of the members, including any society or company investing funds in the society under the provision of the 1965 Act.
<b>E. Conduct of meetings</b>	The mode of holding meetings, the scale and right of voting, and the mode of making, altering or rescinding rules.
<b>F. Board members</b>	The appointment and removal of a Committee of Management, and of managers or other officers, and their respective powers and remuneration.
<b>G. Shareholdings</b>	The maximum amount of interest in the shares of the society which may be held by any member otherwise than by virtue of the relevant legislation.
<b>H. Loans and deposits</b>	Whether the society may contract loans or receive money on deposit subject to the provisions of the said Act from members or others; and, if so, under what conditions, under what security, and to what limits of amount.
<b>I. Terms and conditions for share capital</b>	Whether the shares or any of them shall be transferable, the form of transfer and registration of the shares, and the consent of the committee thereto; whether the shares or any of them shall be withdrawable, and the mode of withdrawal, and the payment of the balance due thereon on withdrawing from the society.
<b>J. Audits and auditors</b>	The audit of accounts by one or more auditors appointed by the society in accordance with the requirements of the Co-operative and Community Benefit Societies and Credit Unions Act 1968. (Also covers audit exemption provisions.)
<b>K. Terminating membership</b>	Whether and, if so, how members may withdraw from the society, and provision for the claims of the representatives of deceased members or the trustees of the property of bankrupt members, or, in Scotland, members whose estate has been sequestrated, and for the payment of nominees.
<b>L. Use of profits</b>	The mode of application of profits.
<b>M. Official documents</b>	If the society is to have a common seal, provision for its custody and use.
<b>N. Investments</b>	Whether and, if so, by what authority, and in what manner, any part of the society's funds may be invested.

## 2.3 Sponsoring bodies and model rules

Sponsoring bodies publish model rules that have been pre-approved by the FSA. The FSA publishes a list of sponsors on its website. Currently, it lists 22 sponsoring bodies, although there are only three sponsors that produce rules that are suitable for community investment and are marketed as such by the sponsoring body. These bodies are:

- Co-operatives UK
- Somerset Co-operative Services
- 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 FSA on behalf of their clients. 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 societies rules, or even to write your own rules. The FSA 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.

Most organisations choose to use model rules offered by sponsoring bodies, amended to suit their own particular circumstances. Co-operatives UK offers two sets of model rules, one called the Community Co-operative Rules, and one for community benefit societies, called the Community Finance Rules. Wessex Community Assets (WCA) has developed model rules for community benefit societies called the Community Assets Rules. It also offers an amended version of these rules, called the Enterprise Investment Rules, which have been approved by HM Revenue and Customs as satisfying the requirements for Enterprise Investment Scheme (EIS) tax relief. Finally, Somerset Co-operative

Services (SCS) has designed model rules for a multi-stakeholder co-operative, the Somerset Rules. It describes these rules as a template for the design of different types of multi-stakeholder co-operative ranging from a community land trust to a workers' co-operative.

What follows is an analysis of how these model rules deal with each of the 14 matters (A-N) the FSA requires all co-operative and community benefit societies rules to address. Appendix 1 contains a summary table identifying how and which of the rules in each of the

four models relate to the FSA requirements, as well as providing a summary of all the additional rules to be found in these models.

### A. Name

Choosing a name for a society is usually a straightforward task. The box below outlines the main requirements of the FSA when naming a society. Getting the name right is very important when it comes to promoting a community share offer – it is the opportunity to encapsulate the whole project in a few memorable words.

### Naming a co-operative or a community benefit society

*The process of naming a society is fairly similar to naming any other corporate body. There are some obvious matters to think about. The name must be original, and not the same as, or very similar to, the name of an existing organisation. There are 'sensitive' words that imply pre-eminence in a geographic area, or some other authoritative status, which may only be used if they can be justified. There are other sensitive words which imply specific objectives, or trading activities which may require a special licence, approval or permission. There are words that are protected by appointed bodies, and restricted words protected by legislation. The FSA website contains a guide to naming a co-operative or community benefit society, which goes into more details about all these matters. It also provides the following summary of the reasons why it may refuse to register a proposed name:*

- "Where it is the same, or too similar to another society's, existing company's or charity's name.
- Where it is the same as, or very similar to a name held previously – within the last ten years – by a society, charity or company that is now defunct. But in certain circumstances, we may make an exception. For example, where the business or the locations, or both, are different, or the former organisation never traded. We may need more information.
- Where regional, national or international (including Europe wide) pre-eminence is implied or stated in the intended name, but no supporting evidence of the scale of the society's activities is given. You will need to show the society's business is substantial in relation to its activities or products and that it is eminent in its own field.
- Where royal, public authority or government patronage is implied but none exists. You will need to show us evidence – such as a letter of support or formal consent from the body or person concerned – of a genuine connection and permission to use the word or words.
- Where a name will be offensive.
- Where a name would constitute a criminal offence.
- Where a name is in another language and you have not given an explanation or meaning of the name."

## B. Objects

Objects describe the purpose of an enterprise and the scope of its operations. The general advice when writing the objects clauses of any organisation's governing document is to ensure that they are broad and flexible enough to enable the enterprise to fully engage in trade. The sponsoring bodies all adopt a broad brush approach to the rules on objects, although, in addition, the Somerset Rules invite applicants to state the mission of the society and commits the organisation to the ICA Statement on Co-operative Identity.

It should be noted that to register as a co-operative society, it is an FSA requirement that the society should be carrying on "an industry, business or trade, whether retail or wholesale". This would seem to exclude co-operatives which 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".

All the models, with the exception of the Somerset Rules, contain additional rules setting out the powers of the society.

## C. Address

This is the registered address of the named society. All the model rules make provision for this to be included.

## D. Admission of members

These rules determine who can (and cannot) be a member. Traditionally, co-operative societies and community benefit societies had different approaches to membership. Co-operatives tended to restrict membership to a single user group such as customers, suppliers or workers, but also practiced open membership

within that group, encouraging people who qualified for membership to join. Until recently, membership was not offered to people whose only relationship with the co-operative was that of investor. In 2006 the FSA published a policy note which supported the introduction of 'non-user' investor-members to co-operatives. It considered practices elsewhere in Europe which restricted the voting powers of non-user members, but made no specific recommendations in this area.

In contrast, community benefit societies rules tend not to qualify the basis of membership. No distinction is made between users and non-users, instead membership is aimed at people who support the objects of the society. Traditionally, community benefit societies did not practice open membership, but this is now changing with the growth in community investment, which relies on open membership.

This is reflected in both the Community Finance Rules and the Wessex Rules. The former offer membership to anyone who supports the objects of the society, and the latter state no qualifying criteria for membership other than the purchase of a share. The Community Co-operative Rules restrict membership to people "living, working or active within the community", but as the rules do not define community it is open to interpretation as to whether the community is geographic, or a community of interest. It should be noted that the Community Co-operative Rules currently make no provision for paying members a dividend based on transactions, although this rule is likely to be amended in the near future.

The Somerset Rules propose a multi-stakeholder approach to membership, providing applicants with the scope to define multiple categories of membership, distinguishing between stakeholder roles,

especially the difference between 'user' and 'non-user' roles. Users are beneficiaries and include customers, workers, suppliers and producers: essentially anyone who has a transactional relationship with the enterprise. Non-users are those whose role is primarily that of investor. This categorisation of membership enables two things to happen: it provides a basis for restricting the voting powers of non-user investor members (See: *E. Conduct of meetings* below), and it permits different dividend rates to be paid to user members.

One interesting feature unique to the Community Finance Rules is the provision to introduce 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, if members are required to pay the annual fee.

The Wessex Rules contain additional rules that allow for nominee shareholdings. They allow the board to approve up to five nominees, who can hold shares on behalf of their clients, and exercise 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 more investment from wider sources, they could weaken the community-building aspects of community shares. An amendment enabling nominee shareholdings is available for the Somerset Rules.

## E. Conduct of meetings

All four sets of model rules include rules that provide for annual general meetings, 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.



## Annual subscriptions

*Maintaining a large membership can be expensive. Regularly updating members' contact details, notifying members of general meetings, making arrangements for members to participate in elections, and sending members copies of the annual report, can all mount up. If most members are also regular customers of the enterprise then these membership costs can be offset against marketing, but if most members are only investors then the cost of servicing them has to be considered against the benefits of having a large membership.*

*One way of recouping the cost of membership is to charge an annual subscription. Members could be asked to pay an annual subscription by direct debit, or they could have the annual subscription debited from their share account. This charge could be offset by the interest paid to members on their share capital. For instance, if a society charges an annual subscription of £10, and pays 2.5% interest on share capital, members with £250 in share capital will have their annual subscription offset by the interest paid to their account.*

All four models also set a quorum for general meetings, in most cases 10% of the membership. This could be high for some organisations with memberships running into the thousands. Consideration should be given to ensuring that the quorum is realistic and achievable. Both the Wessex Rules and the Somerset Rules allow members to nominate a proxy, which in the case of the Wessex Rules can count towards the quorum. The Wessex Rules also contain provisions for postal ballots, at the discretion of the board of directors.

All four sets of model rules describe how votes must be conducted at meetings, and the arrangements for a simple show of hands, compared with a secret ballot. These rules also set the majority required to amend, rescind or add new rules, ranging from a two-thirds majority in the Community Finance Rules to a three-quarters majority in the Community Co-operative Rules and the Wessex Rules. The Wessex Rules contain an additional rule that allows 10% of the members present to block a resolution to wind-up the society.

The Somerset Rules have far more complex arrangements for the conduct of meetings to accommodate this model's multi-stakeholder

philosophy. These arrangements are designed to prevent non-user investor members ever having more than 25% of the total vote on any matter. Furthermore, non-user members are prevented from voting on resolutions to wind-up the society, or to convert it into a company. Voting is weighted in favour of user-members, who have 75% of the voting power, spread proportionately between the different categories of user-members. The different categories of members can either cast their vote as a block vote (decided at a separate meeting before the general meeting) or as individual votes at general meetings, appropriately weighted according to their category. The Somerset Rules also contain provisions to allow a minority one-third vote to pass resolutions calling on the board to draw up and publish policies in specified areas.

In addition to all this, the Somerset Rules include further rules designed to protect the interests of a broader range of stakeholder than just members. Provision is made for the convening of a Commonwealth Council, to provide "oversight" on "key decisions" made by general meetings. The Commonwealth Council is composed of a wide range of people, including non-members, with the aim of encompassing all possible stakeholder

interests. The rules specify a list of key decisions, and if a Commonwealth Council has been convened, it has the powers to veto these decisions until agreement can be reached with the board.

## F. Board members

The FSA requires all co-operative and community benefit societies rules to state how members of the "committee of management" will be appointed and removed, and similarly for the officers of this committee, and the arrangements, if any, for remuneration.

The four sets of model rules vary in their approach to these requirements. The Community Co-operative Rules require a minimum of three, and maximum of 15, board members, with powers to co-opt up to a third of the board. The Community Finance Rules have the same minimum, but a lower maximum of 12 board members; they also provide for co-option and for the appointment of two professional external directors. The Wessex Rules require at least two directors, but do not specify a maximum number, nor do they require directors to be members. The Somerset Rules specify the same minimum and maximum number of directors as the Community Finance Rules.

All four models require the board to be elected by members, with three of them specifying that at least a third of directors must stand down each year; the Community Co-operative Rules require all directors to stand down each year, although as with the other model rules, they may seek re-election. All four models allow board members to be paid for their services to the society.

All the models make provision for removing directors from office, although there are some differences in provision. All except the Wessex Rules, allow directors to be removed by a majority vote at a general meeting of members; the Wessex Rules

give this power to the board itself. All four models enable directors to be removed if they miss three consecutive board meetings, are declared bankrupt, or are deemed medically incapable of carrying out their duties as directors.

The model rules also vary slightly on the appointment of officers. All co-operative and community benefit societies are obliged by law to appoint a secretary. This is the only officer post specified in the Wessex Rules. All the others specify a secretary and treasurer, and both sets of model rules produced by Co-operatives UK also specify the appointment of a chairperson.

Even though it is not required by the FSA, all four models provide rules about proceedings at board meetings, focusing mainly on quora and the role of the chair. The Community Finance Rules make specific provision for meetings to be held by phone or by means of other forms of electronic communication. These Rules and the Wessex Rules also allow for board resolutions to be passed by signed consent, rather than at meetings.

The Wessex Rules contain two additional rules that are not required by the FSA. The first is a rule requiring directors to obtain legal advice when issuing any form of financial promotion. The second places a requirement on the society to indemnify its directors, officers and auditors against any liability they may incur in the performance of their duties. The Somerset Rules also require the board to obtain “expert, independent advice before making any issue of shares”.

### G. Shareholdings

All co-operative and community benefit societies must have rules that stipulate the maximum shareholding a member may have. Normally this is the maximum permitted by law, 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. All four sets of model rules refer to an upper limit based on the maximum permitted by law, although the Somerset Rules specify a maximum of £50,000, which limits shareholding by other co-operative and community benefit societies in the new organisation, and another part of the same rule prevents any member from owning more than 25% of the total share capital. The Community Co-operative Rules contain a similar rule, preventing any one member from owning more than 20% of the total share capital, if the society has more than ten members.

All the models also include rules on the minimum shareholdings of members. The Community Co-operative Rules state a minimum of £1, whereas the Community Finance Rules and the Wessex Rules allow the boards to determine a minimum shareholding. Both these models also make provision for members to purchase shares in instalments. The Somerset Rules also allow the board to determine the minimum shareholding, although the rules specify that this minimum must not exceed £50 for user-members.

Unless a society is only concerned with building its membership rather than raising share capital, a minimum investment significantly more than £1 is advisable. In practice, societies have set minimum shareholdings ranging from £50 to £1,000. Given that the annual cost of servicing a member can range from £10 to £30, this can add significantly to the cost of share capital. Members may be persuaded to pay an annual subscription to cover the costs of membership, in which case a lower minimum investment may be practical, but otherwise societies should be mindful of the costs of servicing and maintaining a large membership.

### H. Loans and deposits

Co-operative societies and community benefit societies rules must say whether they will allow members or others to hold deposits or make loans to the society and, if so, under what terms and conditions. All the models have rules which expressly forbid deposit taking, but allow the society to borrow up to £10m, including from members as well as other sources such as banks or commercial lenders. Three of the models specify an upper limit to the interest paid on loans of base rate plus 3%, the exception being the Wessex Rules, which refer to a rate not higher than that needed to attract the loan. These provisions mean that societies adopting any of these models can issue bonds as well as withdrawable share capital. This may be an important way of attracting additional capital, especially from members who already have the maximum permitted shareholdings.

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 on that basis. 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.

### I. Terms and conditions for share capital

Co-operative and community benefit societies can issue share capital that is transferable and/or withdrawable, or neither, and 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 issue transferable shares. Transferable share capital may be

less attractive to investors because they have to find a buyer when they want to sell their shares. There are no established secondary markets for co-operative societies or community benefit societies transferable share capital, nor any stockbrokers with experience of operating matched bargain services in such share capital. Societies can operate their own matched bargain service, by maintaining lists of people who want to buy and sell their shares, but this can be a very slow way of providing liquidity. Also, transferable share capital can, under some circumstances, be subject to regulation: any society intending to issue or trade in transferable share capital is advised to obtain legal advice on how it can be promoted. However, Energy4All has successfully helped a number of co-operatives make regulated offers of community shares which are transferable and withdrawable. In certain circumstances transferable shares may be more appropriate, especially if the society wants to raise larger amounts of capital (above £1m) or where an extended period of non-withdrawal of capital would improve cashflow.

Only the Somerset Rules make any provision for transferable share capital. These rules allow transferable share capital to be issued to non-user members, and, as is common for societies, for the board to have the right to refuse the transfer of shares to a person of whom they do not approve. The Somerset Rules also provide for withdrawable share capital, which can be issued to any category of member.

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

## Enterprise Investment Scheme

*The Enterprise Investment Scheme (EIS) offers 20% tax relief to new equity investors in small firms. This means that 20% of the amount invested can be offset against income tax liabilities in the year the investment is made.*

*The scheme is operated by HM Revenue and Customs (HMRC), and is only open to qualifying investments: excluded activities which do not benefit from this tax relief include property development; farming or market gardening; holding, managing or occupying woodlands, and any other forestry activities or timber production. Under the scheme all shares must be paid up in full, and the minimum investment is £500. Shares must be 'full-risk', with no preferential rights to dividends, or to the enterprise's assets in the event of a winding up. There must also be no arrangements to protect the investor from the normal risks associated with investing in shares, and no arrangements for the shares to be purchased by anyone else after the end of the relevant period (a minimum of three years).*

*Discussions have been held with HMRC about the circumstances under which co-operative and community benefit societies issuing withdrawable share capital can qualify for EIS. The main concern of HMRC is that the rules of a society issuing withdrawable share capital should not offer a guaranteed or pre-arranged exit for the investor. HMRC operates an advance assurance scheme whereby they will advise on whether an investment will qualify under the EIS.*

share capital is treated in the accounts of the society.

All four model rules 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. It also has major implications for investors, who must be informed of this fact when they are invited to invest in the society.

Another reason for having rules that allow for the suspension of withdrawals is the length of time it may take for a new investment to generate sufficient profits to be able to cope with 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 have rules that make it clear that withdrawals are suspended for at least the first three years of trading. Wessex Community Assets offers a specially adapted set of its model rules that meet the relevant criteria for EIS.

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. Each of the four model rules has a slightly different approach to this. The Community Co-operative Rules set a minimum period of notice of 13 weeks, whereas the Community Finance Rules set it at three months, and the Wessex Rules at 180 days minimum. The Somerset Rules do not state a minimum period of notice, which means that the board can decide how long they take to respond to a request for withdrawal, unless the offer document through which the shares were sold stated a minimum notice period for withdrawals.

Another common condition applied to withdrawable share capital is the right of the board to reduce the value of shares. This right is usually linked to an auditor's assessment that the net asset value of the enterprise can no longer support the full value of the share capital, therefore justifying a temporary or permanent reduction in share value. The Community Co-operative Rules is the only set of model rules not to contain this provision. Instead, these rules have a provision to limit the amount of share capital that can be withdrawn in any one year to 10% of the total.

Uniquely, the Wessex Rules allow a new class of withdrawable share to be issued for a "special purpose". These special-purpose shares can have different risks

and rights attached to them, at the discretion of the board, including a different rate of interest. These special-purpose shares can be reduced in value according to the performance of the special-purpose fund. The Community Finance Rules also contain a unique provision that allows the society to charge administrative costs for the withdrawal of share capital.

The terms and conditions applied to withdrawable share capital will 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 will want to present in its offer document. Enterprises should

carefully consider what amendments to the terms and conditions applicable to share capital would be beneficial before adopting any set of model rules.

#### **J. Audits and auditors**

All co-operative and community benefit societies are required to have a rule specifying 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.

This is covered by all the model rules, which allow societies to apply for the relevant exemptions. Some of the models also have additional rules stating the statutory obligation to make annual returns to the FSA.

#### **K. Terminating membership**

Provision must be made for the different circumstances under which membership of the society may be terminated, and the arrangements for handling terminations. All the model rules allow for members to cancel their membership, or for membership to be terminated if the member no longer satisfies the criteria for admission. All the models, with the exception of the Wessex Rules, also allow the board to expel members under certain conditions. The Community Finance Rules allow membership to be terminated if a member fails to pay the annual subscription fee. The Somerset Rules allow a society to cancel membership of any person failing to respond to communications over a period of two years.

The models differ in the precise arrangements they make for handling the termination of membership. The Community Co-operative Rules enable the society to convert withdrawable share capital into loans repayable within three

## **Planning for liquidity**

*All societies need to plan how they will manage the liquidity of their share capital. There are two basic approaches – 'investor-churn' and 'reserves-replacement'.*

*'Investor-churn' is based on the notion that in any enterprise there will be a regular turnover, or churn, of members, particularly where these members are also customers of the enterprise. A vibrant enterprise would expect to make a net gain in the number of customers and members, with the number of new customers joining exceeding the number of old members withdrawing. In these circumstances withdrawals of capital should be more than replaced by the inflow of share capital from new and existing members. This inflow of share capital can be supplemented by the society crediting members' share accounts with any interest or dividends payable to members. Societies adopting this approach to liquidity need to make an open offer of membership, and may find it better to have shorter periods of notice for withdrawal to encourage member investment.*

*'Reserves-replacement' is based on the society generating and setting aside surpluses to replace member share capital. This could be done through a depreciation fund, if there is no intention to replace the fixed asset, or through general reserves. In either case, the society has to be sufficiently profitable to be able to make these transfers. Societies working to this method of liquidity management should probably make provisions to limit the percentage of share capital that can be withdrawn in any one year.*

*Whichever approach to liquidity is taken, it is necessary for all societies to have contingency arrangements in place, in case the business fails to perform as planned. These include provisions to suspend withdrawals or reduce the value of share capital. It is also worth remembering that, while most members will invest for a social purpose rather than financial gain, societies are allowed to offer a competitive rate of interest on share capital, sufficient to "attract and retain" the investment.*

years, if the right to withdraw share capital has been suspended. The Somerset Rules contain a similar provision, except that the loan is repayable over two years rather than three.

Rules governing the termination of membership have important long-term consequences for societies that promote community investment. They enable a society to manage their membership and make sure members remain in touch with the enterprise, and do not become an unnecessary burden as dormant or untraceable members.

#### L. Use of profits

The rules regarding the use of profits differ for co-operative societies and community benefit societies. Co-operatives are designed for the mutual benefit of members, and may therefore decide to use some of their surpluses to pay a dividend to members, based on their level of transactions with the co-operatives. The Somerset Rules allow up to 20% of profits to be distributed to user-members based on their contribution to the co-operative, and because this model allows for different categories of user-member, there is scope to offer different dividend rates to these categories. The same model rules also allow up to 80% of profits to be used to pay interest on non-user share capital, while limiting the interest paid on user-member share capital to base rate plus 3%. It should be remembered that the FSA say that interest rates on share capital should never be more than is sufficient to attract and retain the investment.

The Community Co-operative Rules do not make any provision for the payment of dividends based on transactions, although they do allow profits to be used for interest on share capital up to a maximum of 10% per annum.

The FSA 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 (See: *Asset locks and the use of profits* p.9), which requires co-operatives to use at least some of their profits to create “indivisible reserves”.

Both sets of model rules for co-operatives embody the principle of indivisible reserves to some extent. The Community Co-operative Rules mention the statutory possibility of dissolution by three-quarters of the members signing an instrument of dissolution and expressly forbid any residual assets being distributed to members, requiring instead that they are transferred to some other non-profit body subject to the same restrictions. Solvent dissolution is also possible by members' voluntary winding up under the Insolvency Act 1986. The Somerset Rules require at least 20% of residual assets to be transferred to a common ownership or asset locked body, but do allow the distribution of the remaining residual assets, reserving up to 20% for user members with the remainder going to non-user members.

The FSA 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”. This is reflected in both sets of model rules for community benefit societies. The Community Finance Rules and the Wessex Rules make it clear that members cannot benefit financially if the society is wound up or converted into a company. However, both stop short of having a statutory asset lock, as determined by the Community Benefit Societies (Restriction on Use of Assets) Regulations 2006. Any organisation requiring this statutory asset lock, and using either set of model rules, would need to have them amended.

While community benefit societies cannot pay dividends to members, they are allowed to use their profits to pay limited interest on share capital. The Community Finance Rules state that interest rates cannot exceed the minimum rate necessary to obtain and retain the capital, but the Wessex Rules do not specify any principles determining interest rates.

#### M. Official documents

The FSA requires the rules to 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. All the model rules except the Somerset Rules 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.

There is a strong case for societies that intend to pay interest and/or dividends, or that plan to charge members an annual subscription fee, to introduce 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 have the added advantage of automatically re-investing all interest and dividend payments, as well as enabling societies 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. All the models, except the Wessex Rules, contain this rule.

## 2.4 Additional rules

### N. Investments

Section 31 of the Co-operative and Community Benefit Societies and Credit Unions Act 1965 allows societies to invest funds in other corporate bodies and local authorities. The model rules produced by Co-operatives UK make specific reference to these powers in their rules, while the Wessex Rules provide these powers in a more general rule about the powers of the society. The Somerset Rules, while allowing the society to invest funds, require individual investments of more than £10,000 to be based on a social investment policy drawn up by the board. This model also classes some investments as 'key decisions' which are subject to special rules (See *E. Conduct of meetings* p.12).

All the models contain additional rules over and above the requirement for registration with the FSA. Below is a summary of these additional rules, together with an explanation of how these rules may assist community investment, where this is the case. Further details of these additional rules are contained in Appendix 1.

**1. Secondary rules:** Both sets of Co-operatives UK model rules contain provisions for societies to develop secondary rules, as long as these rules are consistent with co-operative and community benefit societies legislation. The Somerset Rules make similar provisions, referred to as standing orders. A society does not require the approval of the FSA to amend, rescind or add to its secondary rules. However, it is a matter of good practice to have secondary rule changes approved by general meetings.

**2. Miscellaneous provisions:** These are an assortment of rules which are intended to provide clarification.

**3. Rules to support on-lending activities:** If a society raises capital for the purposes of on-lending, this could be construed as a regulated activity. Societies planning to use this provision should seek legal advice.

**4 – 8. Somerset Rules:** All these additional rules are contained in the Somerset Rules and are intended to assist in the governance of a multi-stakeholder co-operative, and to embed co-operative values and principles. They include provisions for member education, the recognition of key decision areas affecting the mission and purpose of the co-operative, the creation of a Commonwealth Council, relationships with the wider co-operative movement and the adoption of social accounting practices.

## 2.5 Registration costs

Registering a society is generally more expensive than registering other forms of corporate entity, although, arguably, the cost of registration is higher because it also includes the cost of legal advice to develop a governing document that is fit for purpose. For organisations that develop their own rules and apply directly to the FSA, there is a non-refundable fee of £950 charged by the FSA to examine the application and rules, and to register the society if the application is satisfactory.

Co-operatives UK currently provides a free service for organisations registering with their Community Co-operative Rules, although it does pass on the FSA charges for registering with model rules, which are £40 if there are no amendments, £120 for up to six amendments, £350 for between seven and ten amendments, and £950 for more than ten amendments. The fee for registering using the Community Finance Rules are £660+VAT if there are no amendments, £790+VAT for up to six amendments, £1,070+VAT for between seven and ten amendments, and £2,000+VAT for more than ten amendments. These fees include legal advice on amendments and the drafting of amended rules.

Wessex Community Assets charges a basic fee of £500+VAT to register using the Wessex Rules. Amendments cost an additional £100+VAT for up to six rule changes. An extra fee is payable if more than six rule changes are required. These fees cover the cost of all advice and support on amendments and changes to the rules.

Somerset Co-operative Services charges a basic fee of £190 (or £90 plus three instalments of £40 each) to register using the Somerset Rules. This fee includes an hour's free advice; any advice beyond the first hour is charged at an hourly rate of £50. Amendments costs £70 per rule.

## 2.6 Obligations of registration

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

## 2.7 Annual returns

Registered co-operative and community benefit societies are required to make annual returns to the FSA. There is a standard form, which should be completed by the society's secretary, and returned to the FSA 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 which 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 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 accountants 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 less 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 FSA, 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.

# 3 The offer document

## 3.1 Different types of offer

In the introduction to this guide, the point was made that community investment can be appropriate at any phase of development, ranging from pre-start proposals through to mature community enterprises that need new capital to consolidate their trading position. In developing this guidance it was recognised that different types of offer document were needed to address the different development needs of enterprises. Table Two describes four different types of offer document, and shows how they relate to the key development phases experienced by many community enterprises. These phases are described more fully in Section 1.3.

Not all invitations to join a co-operative or a community benefit society should be treated as invitations to invest. This is why the first type of offer document is called a 'membership offer'. There is a long tradition of societies offering membership based on the purchase of a single share, usually priced at £1. Some of these societies also charge an annual subscription fee, which can be significantly more than £1, depending on the membership services on offer.

It would be wrong to apply the same standards to an offer document where the public is being invited to part with £1, to another type of offer, where they may be invited to invest up to £20,000. This section of the guide defines what constitutes a membership offer, and suggests some standards of practice that should apply to this type of offer.

'Pioneer offers' are appropriate for new ventures, either at the pre-start, start-up, or early-growth phases of development. They may also be appropriate for helping to finance the preparation work for acquisitions and transfers. Developing initiatives at these phases of development can be both expensive and highly risky. While some groups are able to obtain small grants to cover some of their development costs, many other groups end up using their own resources, and often money donated by their keenest supporters, volunteers, activists and champions. Instead of supporters making donations in an ad-hoc fashion, a pioneer offer would allow them to invest in the enterprise and, if the venture is successful, be rewarded by the possibility of one day recouping their investment.

'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. The target audience for time-bound offers can be the community the enterprise will serve, and beyond. This places an even heavier duty on the promoters to ensure that the offer is accurate, transparent and achievable.

'Open offers' are only appropriate for established enterprises that have a track record to support their investment offer. There are a number of situations where open offers are appropriate. For instance, societies that trade with their community will want to invite new customers to become members, and by making an open offer they can attract new investment and provide liquidity for existing members. (See: *Planning for liquidity* p.16) Open offers can also be an appropriate way of building up capital to fund the organic growth of the business, reducing dependency on debt. The financial return offered by the society is likely to have an

**Table 2: Offer documents and development phases**

Development phase				
Pre-start up	Start-up	Acquisition and transfer	Early-stage growth	Later-stage growth and consolidation
<b>Membership offer:</b> where the purpose is to recruit members rather than raise investment capital				
<b>Pioneer offer:</b> a high-risk offer, aimed at known supporters, to raise funds to spend on getting 'investment ready'				
	<b>Time-bound offer:</b> offer to invest in an 'investment ready' project subject to target amount and timescale for completion of offer. Investors refunded if targets are not met			
			<b>Open offer:</b> where the offer is not subject to a target amount or timescale, but share capital is liquid	



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impact on the flow of capital, so, maintaining competitive interest rates, within the limits appropriate to a society, might be an important factor in attracting and retaining sufficient capital.

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 a good idea to prepare a phased campaign 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-up with 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 demonstrate the level of support they have to other funders.

The next step is to plan how the offer will be communicated to the target audience, and prepare a marketing and sales campaign. The best choice of marketing media and the focus of the campaign will be different for each type of offer. Practical administrative arrangements have to be put in place, covering how applications will be made, the processing of payments, and the recording and issuing of membership records.

The final step is to prepare the offer document, drawing on the guidance provided in this publication, and supplemented by expert guidance and support from elsewhere. Both the Wessex Rules and the Somerset Rules have this latter requirement written into the governing document. The Community Shares Programme is actively working towards establishing shared standards of guidance and expertise among all the promotional and professional advice bodies with an interest in this area.

## 3.2 Membership offers

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, even suppliers or paid workers.

All membership offers need to address the following:

- 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. (See: *Members rights in a co-operative or a community benefit society* opposite)
- Some societies charge an annual subscription fee to cover the cost of providing membership services. The society's rules need to allow for annual subscription fees, and should also allow membership to be terminated, and share capital cancelled, if the annual subscription is not renewed.
- The terms and conditions of membership should be clearly stated, as well as the rights of members and the role of members in the life of the society.

A membership offer document need only address the above matters, and can be relatively brief. Societies that intend to charge annual membership subscriptions, may want to consider what impact this will have on future offers where the aim is to attract significant amounts of investment capital, and where investors might be put off investing if they have to pay an annual

subscription just to maintain their investment. This problem could be addressed in the rules by having two classes of share. An alternative would be to deduct the annual subscription fee from a member's share account, although this practice would have to be clearly explained, and provided for in the society's rules.

Membership should be open to anyone who is eligible, based on the society's membership rules (See: *D. Admission of members* p.12). No other restrictions should apply to membership offers.

### Members' rights in a co-operative or community benefit society

*All members of a co-operative or community benefit society have a right to:*

- *A copy of the annual report and accounts*
- *A copy of the rules of the society*
- *An invitation to attend the Annual General Meeting, and any other general meetings called by the society*
- *Vote in elections to appoint board members, and to vote on resolutions presented at general meetings (may include postal ballots)*
- *Access the register of members*
- *Stand for election as a board member*
- *A share certificate, and/or a statement of their share account*
- *Interest payment on their shares, or dividends on their transactions, if part of the society's rules and proposed by the board*
- *Withdraw share capital (if the shares are withdrawable) within the terms and conditions determined by the society.*

*In addition to these rights, many societies encourage members to:*

- *Use the services of the society*
- *Support the society as a volunteer, campaigner or provider of expertise*
- *Express their opinions about the society's policies and future plans*
- *Participate in the affairs of the society and learn how to become more actively involved*
- *Recommend the society to other people in the community.*

*Providing these rights to members can be expensive. Costs can be reduced by ensuring that the society's rules permit electronic communication and asking members to accept such communications, and by maintaining share accounts, rather than issuing share certificates and annual interest and/or interest payments.*

## 3.3 Pioneer offers

The purpose of a pioneer offer is to raise finance to cover the cost of development work to get a new venture investment-ready. Before deciding to make such an offer, serious consideration should be given to the alternative of seeking donations to cover these costs. Donations may be a far better way of paying for development costs because they do not burden the new venture with long-term financial commitments. However, there is an upper limit to what most people can donate, which may be significantly lower than the amount they are prepared to invest. If the development costs are likely to be high, or are only likely to be financed by a relatively small group of supporters, then it may be fairer, and more effective, to raise the capital through a pioneer share offer.

Pioneer offers are different from the other types of investment offer in that they are usually much higher risk propositions. The money raised will be spent on development costs which the society will be unable to recoup if the proposals turn out to be unfeasible, or the society subsequently fails to attract additional capital to finance its planned investment. It is important to note that, like a company, a society cannot enter into any contract until it has been registered. If the pioneer offer is issued before registration, appropriate contractual and trust mechanisms should be in place to deal with the offer and its proceeds. This may involve personal liability for those planning to set up the society.

Before making a pioneer offer, the venture needs to prepare a development plan, identifying all the potential development costs that must be incurred to get investment-ready. The forecast for development costs should be kept in scale with initial estimates of the start-up costs of the venture. Development costs should not normally exceed between 5% to 10% of the full start-up costs. Because pioneer members are being asked to take far

higher risks than subsequent investors, consideration should be given to making pioneer members a separate class of membership, with different terms and conditions attached to the share capital. This could include the prospect of a higher rate of financial return, or preferential rights to withdrawal.

Because of the high level of risk associated with pioneer offers, the following conditions should apply:

- Pioneer offers should only be made to known supporters or members, who fully understand the risks associated with the offer. Pioneer offers should not be promoted to the wider community.
- Pioneer offers must emphasise the high-risk nature of the investment, and should not promise any form of financial return. It should also be made clear that further investment will be needed before the venture can be launched.
- The offer should set a target for the amount to be raised, based on a fully-costed development process. It should explain the contingencies if the target is not met, and also what will be done with excess capital if the offer is over-subscribed.
- The document should set out the terms and conditions applying to share capital, which should include the indefinite suspension of withdrawal rights until after the society is trading and profitable, when the suspension will be reviewed.

By targeting pioneer offers at known supporters only, there is less need to develop an expansive offer document. However, it remains vital that high standards of accuracy, transparency and care are applied in drafting the document because the promoters are still legally liable under contract and civil law. Pioneer offer documents may often only need to address the following matters:

### **Purpose of the investment:**

Focusing on the need to raise money to pay for development costs and get investment-ready.

### **Development costs:**

Outline of development costs, target amount to be raised, contingencies if less than the target amount is raised, what will be done with the surplus if more than the target amount is raised. A proposed timetable for the development process.

### **Terms and conditions of investment:**

The high levels of risk and the possibility of losing all the money invested. Indefinite suspension of withdrawal rights until the society is trading and profitable, when the suspension will be reviewed. Details of plans to call for further capital when the project is investment-ready, and details of any plans to have more than one class of share capital.

Although pioneer offers do not need to impose deadlines for uptake, it is a good idea to set out a proposed timetable for the development process, which would include a target date for completing the pioneer offer.

## 3.4 Time-bound offers

Time-bound offers are used to raise finance for investment-ready projects by either new or established enterprises. Time-bound offers are usually open to anyone who qualifies for membership, and because these documents are promoting an investment opportunity to the general public, it is crucial that they meet high standards of probity. This should include a commitment to proceed only if the fundraising targets are met; if the targets or contingencies are not met then investors should be refunded.

The commitment to refund investors if the targets are not met is a substantial one. It means that the society must make provisions to hold the investors' money in a suspense account until the deadline date, and have contingency plans for making refunds. It is possible to make an administrative charge in the event of having to issue refunds, but this would have to be clearly stated in the offer document.

All time-bound offer documents should be supported by a business plan, which should be made available to potential investors on request, as should the governing document of the enterprise. The business plan should contain the evidence to support key statements made in the offer document, especially any forecasts for financial returns or the future liquidity of share capital.

Producing a high-quality time-bound offer document is a time-consuming and difficult task. It is important to get the balance right between writing a marketing document that clearly communicates the investment proposition, and a technical document providing accurate financial and legal information. Outlined below are the recommended contents of a time-bound offer document:

- **Summary:** Approximately 100 words explaining the purpose, nature and

targets for the offer. It should also state who the offer is aimed at and how much they can invest.

- **Purpose of the investment:**

A description of what the finance is needed for, together with some indication of how much will be spent on fixed assets, and how much will be spent covering early losses.

- **Projected social returns:**

An outline of the social purpose of the proposed investment, and how the social impact will be monitored and reported to members.

- **Targets and contingencies:**

The target amount sought and the deadline for completion. Plans to raise capital from other sources (grants, loans etc). A timetable for implementing the investment, commencing trading, and generating a return on the investment. Contingency plans if these primary targets are not met.

- **Nature of the offer:** The time-bound nature of the offer, and a commitment to refund investors if the targets or contingencies are not met. Any administrative charges that may apply to refunds, and the timescales for making these refunds. What will happen if the offer is over-subscribed.

- **Investment:** Who is eligible to invest and become a member. Different categories of membership (if more than one). Arrangements for joint membership, nominees and investment by instalments (if allowed). Minimum/maximum investment allowed. Annual member subscription charges, if any. Any other restrictions on membership.

- **Cashing-in shares:** How and when members can withdraw share capital. How the society plans to finance withdrawals.

Any initial period when withdrawals will not be allowed. The subsequent withdrawal notice period and conditions. Right of the board to suspend withdrawals and reduce the value of shares. The non-transferable nature of shares.

- **Projected financial returns:**

Summary of financial forecasts. Policies on pricing, profit levels and use of profits. Projected interest rate on share capital invested, if any, with reference to the supporting evidence for such projections. Administrative arrangements for issuing share certificates or managing members' share accounts.

- **Member involvement:** Nature and type of society (including reference to asset lock if any). Members' rights, including voting rights and rights to information. Details of arrangements if there is more than one category of membership.

- **Lack of regulation:** Statement that the offer is unregulated and not covered by any form of compensation scheme. It should be made clear that investors could lose some or all of their investment.

- **Risk factors:** Main risks facing the investment project and the enterprise as a whole, and how these risks might be mitigated.

- **Track record:** Track record of the enterprise to date, brief biographies of directors and their advisers, plus details of their actual or planned personal investments in the enterprise.

- **Supporting documents:** Details of how to obtain a copy of the full business plan and governing document. Other relevant information or sources of information and advice.

The difficulties of providing all this information in an accessible and engaging

## 3.5 Open offers

style are recognised. However, this should not be a reason for demoting some of this information to the 'small print' of the offer document, or to produce marketing materials that allow people to invest without this information being disclosed to them.

It is also 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.

Finally, it is important to remember that the board are legally liable under contract and civil law for the contents of any offer document, and must ensure that it does not mislead the public or misrepresent any facts about the society.

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 most 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, so that membership and investment grows in line with the business. Open offers are not time-bound or linked to a specific investment plan, and because of this are not subject to the same rigorous requirements as time-bound offers. Instead, open offers should be restricted to established societies with at least three years of trading history, and/or that have fully liquid share capital, meaning that members can withdraw their investment subject to reasonable terms and conditions.

Societies planning to make open offers need to consider the terms and conditions of this offer, and 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.

All societies that plan to make open offers should be required to publish their investment policies, explaining the reasons why they are encouraging new investment, and how additional capital will be used. This should focus on the broader principles guiding investment by the society, rather than details of specific investment plans.

In comparison with a time-bound offer document, an open offer document can

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 in drafting the document, as the board remain legally liable under contract and civil law. Open offer documents should contain information about:

- **Purpose of investment:** The reasons for making the open offer of investment. The investment policies of the society.
- **Terms and conditions of investment:** Who is eligible to be a member. Minimum/maximum investment. Period of notice. Other terms and conditions applying to share capital, including the board's right to suspend withdrawals or reduce the value of shares. Members' rights and responsibilities.
- **Returns on investment:** Summary of the financial returns and social impact achieved by the society over the last three to five years.
- **Current member investment:** Brief analysis of current level of membership and investment, and turnover in membership and investment in the last three years.
- **Supporting documents:** Details of how to obtain copies of the annual reports and accounts for the last three years, plus an up-to-date copy of the society's rules.

## 3.6 Administering an offer

Preparing the offer document is only one part of the process of making an offer. Other details that have to be addressed include the application form, restrictions on applications, money laundering and processing applications, as well as issuing share certificates and managing share accounts.

- **Application forms:** Application forms can be kept very simple, requiring no more than the name and address of the applicant, and the amount of share capital they are purchasing. Some societies use the application form as a marketing tool, using a range of tick boxes to encourage applicants to invest more than the minimum amount, or to promote long-term thinking by encouraging applicants to nominate a beneficiary in the event of their death or bankruptcy. The form can also be used to encourage applicants to read the

information provided, by asking for their signature to statements saying they understand the terms and conditions of the offer. Legally, no-one under 16 years of age can become a member (although this may change in the near future), and the application form should make this clear.

- **Restrictions on applications:** In addition to the age restriction, some societies restrict applications to people who belong to the community served by the enterprise, or do not allow applications by people who live outside the UK. Such restrictions should normally be specified in the society's rules.

- **Money laundering:** Societies should be aware of the potential for offers to be used for money laundering purposes. Withdrawable share capital is exempt from money laundering considerations, and

there is no legal obligation on societies to carry out identity checks on applicants. However, societies planning to make on-line offers or to accept applications from people living outside the UK, may want to put into place secondary measures to check the identity of investors. This could include restrictions on the methods of payment that are allowed, and the currency of the transaction, thus restricting investment to applicants holding a traceable UK bank account.

- **On-line applications:** A few societies have developed on-line application and payment methods. Putting aside the set-up costs of establishing these systems, and concerns about the security arrangements of such methods, societies may find this a very efficient way of administering an offer, although it may exclude some potential investors who do not use the internet for these purposes. It might also affect the geographic spread of applications, with a consequent affect on the identity of the community.

- **Investment by instalments:** Some societies have rules that allow members to invest in instalments, usually monthly payments over one or two years. Such arrangements may make it more attractive and more affordable to invest, especially if the society has a high minimum investment of £250 or more. It is fairly simple to enable members to invest by instalments; the application form should include a section to issue a bank mandate to set up a standing order and direct debit payment. As well as ensuring the society's rules allow investment by instalments, a society needs to think about the impact on cashflow, and make arrangements to cover any short-term gap in funding. It also needs to decide what it will do if a member cancels payment before completion; it would normally be considered reasonable to charge an administration and cancellation fee. These terms would need to be clearly set out in the offer document.

### Application forms

All application forms should contain the following details:

- Full name and address of the principal applicant
- Names of joint applicants (if applicable)
- Amount of share capital to be invested
- Confirmation that the principal applicant is aged 16 or over
- Confirmation that the applicant has read the offer document and accepts the terms and conditions it states.

Optional information that may be requested, includes:

- Details of nominee in the event of principal applicant's death or bankruptcy
- Details for paying for shares by instalment (standing order or direct debit)
- Email address of applicant, and permission to use this address instead of post.

● **Processing applications:** Any society making a time-bound offer needs to plan how it will process applications, ensuring that it has the administrative capacity to process all applications quickly during the offer period. This should include the use of some form of suspense account, possibly administered by an independent third party, with arrangements in place to refund investors if the targets are not met and the offer fails. The society also needs to have the administrative capacity to deal with any mechanisms it has put in place to cope with contingencies such as under- or over-subscription.

● **Share certificates and share accounts:** The rules of a society will determine whether it has to issue a share certificate to members, or whether it can instead provide members with a regular statement of their share account. (See: *M. Official documents* p.17) Share accounts are simpler to administer and provide greater flexibility for societies that pay interest and/or dividends or charge an annual subscription fee. Instead of issuing share certificates and interest and/or dividend cheques, societies can send members a statement of their account, showing their investment, withdrawals, payments and charges. If the society's rules provide for a 'lien on shares' and annual subscription fees, then these fees can be deducted from a member's share capital instead of requiring payment.

● **Tax relief:** Some share offers may be eligible for tax relief through the Enterprise Investment Scheme (See p.15). Societies that think their investors may be eligible for this scheme should seek to obtain advance assurance from HMRC that the offer will qualify.

# Appendix 1:

## Co-operative and community benefit societies model rules for community share offers

The following table compares the four main sets of co-operative and community benefit societies model rules that are suitable for societies planning to make community share offers. The models have been developed by the following sponsoring bodies:

- Co-operatives UK: Community Co-operative Rules and Community Finance Rules
- Wessex Community Assets: Wessex Rules (Wessex Community Assets Rules)
- Somerset Co-operative Services: Somerset Rules (Somerset Multi-stakeholder Co-operative Rules).

The numbers in the boxes are the rule numbers used by that particular model. The table is split into two sections: the first section compares rules that are required by the FSA to appear in the governing document; the second section lists additional rules to be found in each of the four models.

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
<b>Type of Society</b>	Bona fide co-operative	Community benefit society	Community benefit society	Bona fide co-operative
<b>Rules required by the FSA</b>				
<b>A. Name</b>	1. ✓	1. ✓	1. ✓	1.1. ✓
<b>B. Objects</b>	2. Fixed broad objects encompassing any trade or activity. No definition of community required. 3. Short section listing powers of the society to make welfare provisions.	2. Invites applicant to state objects of the society, which should be broad but not vague. 3. Long section granting wide-ranging powers to the society to provide welfare, engage in trade, business and partnerships.	2. Requires description of the community to be served and objects to be pursued.	1.3. Invites applicant to state the mission of the society, and make a general commitment to co-operative principles.
<b>C. Address</b>	4. ✓	4. ✓	1 & 34. ✓	1.2. ✓



Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
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**Rules required by the FSA**

<b>D. Admission of members</b>	5-8. Open to any corporation or person "living, working or active within the community".	5-8. Any person who supports the objects of the society, and has paid the annual subscription fee (if any).	6. No qualifying criteria for becoming a member other than the purchase of one share. 11. Allows for joint ownership of shares by groups of up to four people. 12. Specifies that members must be at least 16 years old. 16A. Allows the board to approve up to five nominees at any time. The approved nominees have proxy votes for all members they represent at general meetings. The block votes of a nominee are restricted to 5% of the total votes cast.	1.5. Allows the society to determine more than one category of member, based on a distinction between users and non-users. An individual is only allowed to belong to one class of membership. 1.6. Allows the board to establish an application procedure and probationary period for some membership classes. Allows the board the right to refuse membership where there is a good reason.
<b>E. Conduct of meetings</b>	15-20. Provision for quarterly general meetings, annual general meetings and special general meetings. 21-32. Proceedings at meetings, including voting rights, definition of quorum (10% of members), show of hands and secret ballots. 33. Requires three-quarters majority to amend, rescind or add rules.	12-17 Provision for annual general meetings and special general meetings only. 18-29 Proceedings at meetings, including voting rights, definition of quorum (10% of members), show of hands and secret ballots. 30. Requires two-thirds majority to amend, rescind or add rules.	27-28. Provision for annual general meetings and special general meetings only. 29-30. Proceedings at meetings, including voting rights, definition of quorum (10% of members), show of hands and secret ballots. Also includes provisions for postal ballots. 31. Requires three-quarters majority to amend, rescind or add rules. Certain rule changes can be blocked by 10% of members voting against the change. 36. Assumes that formal notices posted to the registered address of members arrive within two days.	2.2. Provision to create a Commonwealth Council to provide oversight on the affairs of the society. 2.6. Provision for general meetings, including AGMs, to be called by the board, or the Commonwealth Council, or by 20% of all members, or 30% of the members of one class. Allows members to consent to electronic communications. 2.7. Allows resolutions on specified matters to be passed by a one-third in favour vote at general meetings. Also provides formula for weighting the votes of different classes of membership, limiting non-user members to a maximum of 25% of the total vote.

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
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**Rules required by the FSA**

<p><b>E. Conduct of meetings (cont.)</b></p>				<p>2.9. Quorum for meetings is at least three user-members plus 10% of members of each other class of membership. 4.2. Non-user members may not vote on resolutions to convert the society into a company.</p>
<p><b>F. Board members</b></p>	<p>34-42. Minimum three, maximum 15 board members. Can co-opt up to one third of the board. Board members can be paid. All directors must stand for (re)election at AGMs. 43. Requires the board to appoint a chairperson, secretary and treasurer. 44-47. Short section outlining powers and duties of the board. 48-52. Sets quorum of half elected members. Requires minutes of meetings to be taken. Decisions taken by simple majority. Chairperson does not have a casting vote.</p>	<p>31-40. Minimum three, maximum 12 board members. Can co-opt up to one third of the board, plus two professional external directors. Board members can be paid. At least one-third of board members must stand down at AGMs. Allows for authenticated electronic or postal ballots for the election of directors. 41. Requires the board to appoint a chairperson and treasurer. 42. Requires the board to appoint a secretary. 43-45. Short section outlining powers and duties of the board. 46-51. Sets quorum of half the board membership or three members. Allows meetings to be conducted by phone or other electronic means. Allows resolutions to be passed by the signed consent of all members without meeting. Requires minutes of meetings to be taken. Decisions taken by simple majority. Chair does not have a casting vote.</p>	<p>17-18. Minimum two board members, no stated maximum. Directors do not have to be members. At least one-third of board members must stand down at AGMs. Board members can be paid on a basis approved by an AGM. 19. Requires the board to appoint a secretary. 20. Provision for non-voting co-opted members of the board. 21-23. Sets quorum of two members, unless board set a higher minimum. Chair has casting vote. Board can appoint a director to chair meetings generally, or to chair a particular meeting. Allows resolutions to be passed by the signed consent of all members without meeting. Directors are required to disclose any material interest in a matter being considered by the board, and must not vote on that matter.</p>	<p>2.5 The board will appoint a treasurer and secretary, unless an appointment has been made by a general meeting. 2.8. Minimum three, maximum 12 board members. If the number of user members is less than ten, then all will be directors. All directors must be members. Either all, half or a third of directors must stand down at AGMs. Board members can be paid. 2.9. Sets quorum of three members for board meetings. 4.5. The board can co-opt members, as long as there is always a minimum of 75% of user-members represented on the board. Board members must complete a register of interests which may conflict with those of the society.</p>

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
<b>Rules required by the FSA</b>				
<b>F. Board members (cont.)</b>			24. Requires the society to indemnify its directors, officers and auditors against any liability they may incur in the performance of their duties, and in successfully defending themselves against any proceeding for breach of these duties. Also allows the society to take out insurance for these liabilities.	
<b>G. Shareholdings</b>	9. Provisions for minimum shareholding of £1, payment in instalments with minimum of £1 paid, and maximum shareholding permitted by law. Plus, if more than ten members, then no one member must have more than 20% of share capital.	52. Provisions for the board to determine a minimum shareholding, for payment in instalments over 12 months, and maximum shareholding permitted by law.	4-5. Allows the society to set a minimum shareholding for membership, and the maximum shareholding permitted by law. 6.2 Commits the directors to obtaining legal advice when issuing any form of financial promotion. 6.5. Shares can be purchased in instalments.	1.6. Allows the society to set a minimum shareholding for membership (not exceeding £50 for user-members), and a maximum shareholding of £50,000 or the amount permitted by law, whichever is lower. 4.3 No one member may hold more than 25% of the total withdrawable share capital or loans from members.
<b>H. Loans and deposits</b>	53. Expressly forbids deposit taking. Right to borrow up to £10m at interest rate of no more than 3% above base rates, or 6.5%, whichever is higher. Right to receive donations or interest-free loans from members towards its work.	59. Expressly forbids deposit taking. Right to borrow up to £10m at interest rate of no more than 3% above base rates, or 6.5%, whichever is higher. Right to receive donations or interest-free loans from members towards its work.	33. Expressly forbids deposit taking. Right to borrow up to £10m at interest rate not higher than it needs to fund the activity and bearing in mind its intention to attract members who invest for a social benefit rather than financial reward.	3.2. Expressly forbids deposit taking. Right to borrow up to £10m, including from members and private individuals, at interest rate of no more than 3% above base rates.

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
<b>Rules required by the FSA</b>				
<b>I. Terms and conditions of share capital</b>	10. Minimum 13 weeks notice of withdrawal. No provision for reduction in share value. Board has right to suspend withdrawals. No more than 10% of total paid up capital in any calendar year.	53-57. Minimum three months notice of withdrawal, provision for reduction in share value. Board has right to suspend withdrawals. Right to charge administrative costs of handing withdrawals.	27-9. Minimum 180 days notice of withdrawal. Board has right to suspend or limit withdrawals. 3 & 16. Allows for shares to be reduced in value, and allows for more than one class of share with different risk and return profile, but the same voting rights as ordinary shares. Also prevents shares being re-valued above par.	1.7 Allows for the issue of withdrawable and/or transferable share capital. Only non-user members can hold transferable share capital. No period of notice for withdrawal specified in the rules. Board has right to suspend withdrawals, or reduce the value of withdrawable shares. Requires board to obtain independent expert advice before making any issue of shares.
<b>J. Audits and auditors</b>	54. ✓ 55-57. Annual returns, accounts and balance sheet made to FSA must be available to members, or anyone with an interest in the funds of the society.	60. ✓ 61-63. Annual returns, accounts and balance sheet made to FSA must be available to members, or anyone with an interest in the funds of the society.	25. ✓	5.4. ✓ 5.5. Annual returns will be made to the FSA, as required by law.
<b>K. Terminating membership</b>	11. The society may offset a member's debt against their shareholding (lien on shares). 12-14. Includes provision to convert share capital into three-year loan stock if withdrawals are suspended. Also includes provisions for expelling members. 58. Provision for the transmission of share capital on death or bankruptcy of a member.	9-11. Includes provision for termination if a member fails to pay the membership subscription. Also includes provisions for expelling members. 58. The society may offset a member's debt against their shareholding (lien on shares). 64. Provision for the transmission of share capital on death or bankruptcy of a member.	7. Allows members to withdraw shares and stop being members. 13. Detailed provisions for the handling of share capital on death or bankruptcy of member, dependent on whether the member has more or less than £5,000 share capital and/or has appointed a nominee.	1.8 Provides the board with the discretion to cancel membership of person who for the last year has not met the criteria for their class of membership. The society may offset a member's debt against their shareholding. Can also cancel membership of person who fails to respond to communications over a period of two years. Members can also be expelled. Withdrawable share capital held by cancelled members is converted to two-year loan stock. 1.9. Provision for the transfer of property on death or bankruptcy of a member.

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
<b>Rules required by the FSA</b>				
<b>L. Use of profits</b>	<p>59. Profits can be used for general reserves, interest on share capital up to 10%, or social or charitable objects in the community.</p> <p>63. Requires three-quarters of members to sign order, and any residual assets must not be distributed to members, but transferred to some other non-profit body subject to the same restrictions.</p>	<p>65. Profits can be used for general reserves, interest on share capital should not exceed minimum rate necessary to obtain and retain the capital, or social or charitable objects.</p> <p>69. Requires three-quarters of members to sign order, and any residual assets must not be distributed to members, but transferred to some other non-profit body subject to the same restrictions.</p>	<p>14. Prevents members from benefiting financially if the society converts, transfers its business or is wound up. Allows the society to require members to sign a contract to such an effect.</p> <p>15. Profits can be used in pursuit of the society's objects, for interest on share capital, with interest rates set by directors, or set aside in a reserve fund. Any proposed use of the reserve fund must be approved by a majority of members at a general meeting. It can also use profits for co-operative, charitable or educational purposes with the approval of members at a general meeting.</p> <p>32. Provides for members to be fully refunded all share capital if funds are available, and for any surplus to be given to another similar society or charity.</p>	<p>13.3. No less than 20% of profits to be transferred to general reserves for the development of the society, and for making payments for social and charitable purposes. Up to 20% of profits can be distributed to user members in the form of dividends based on their contribution to the society. Up to 80% of profits can be used to pay interest on the share capital of non-user members. User-members can be paid interest on share capital, limited to 3% above base rate.</p> <p>3.4. Provides for withdrawable share capital to be refunded before other types of share. At least 20% of residual assets must be transferred to common ownership or asset-locked body. Up to 20% of residual assets can be distributed to user-members in proportion to their contribution over the past five years. Any remaining residual assets to be distributed to non-user members on the basis of their shareholding.</p>
<b>M. Official documents (common seal)</b>	60. Common seal optional.	66. Common seal optional	6.3. Commits the society to issuing a share certificate.	(No arrangements for a common seal.)

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
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**Rules required by the FSA**

<b>N. Investments</b>	61. Subject to Section 31 of Co-operative and Community Benefit Societies and Credit Unions Act 1965.	61. Subject to Section 31 of Co-operative and Community Benefit Societies and Credit Unions Act 1965.	33. Covered by the powers of the society.	4.7 Some investments are classed as 'key decisions' and subject to special rules. 6.3 Investments over £10,000 must follow a policy on social investment, including in other co-operatives.
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**Additional rules contained in some models**

<b>1. Secondary rules</b>	62. Right to develop secondary rules consistent with the Act.	68. Right to develop secondary rules consistent with the Act.		2.3 Provision for general meetings to develop standing orders.
<b>2. Miscellaneous provisions</b>	64. Provision to employ an arbiter in the event of a dispute with a member. 65. Clarification of which Acts are referred to in the rules.	70. More detailed provisions to employ an arbiter in the event of a dispute with a member. 71. Clarification of which Acts are referred to in the rules.	35. Provision if the Euro is made the legal currency in England and Wales. 37. Provides definitions of some terms used in the rules.	
<b>3. Rules to support on-going lending activities</b>			38-42. Series of rules covering money laundering, systems and controls, business principles, fidelity insurance and accounts, in the event that the society decides to engage in on-lending activities.	

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
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**Additional rules contained in some models**

4. Key decisions				4.7. Provision to introduce 'key decisions' which must be approved by the Commonwealth Council or a general meeting. The rule identifies ten key decisions concerned with business plans, acquisition or sale of assets, creation of subsidiaries, raising additional capital, employment or membership policies.
5. Education				5. Additional rules concerning the public identity of the society, the provision of information to members, and the presentation of financial and social accounts.
6. The wider co-operative movement				6.1-6.6. Commitment to ensure that other co-operatives have the opportunity to bid for contracts valued over £1,000, and that any investments by the society over £10,000 follow a policy on social investment, including in other co-operatives. Also requires the society to appoint a person responsible for relations with the wider co-operative movement.

Model	Community Co-operative Rules	Community Finance Rules	Wessex Rules	Somerset Rules
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**Additional rules contained in some models**

7. Commonwealth Council

4.7 If convened, the Commonwealth Council must be notified of any "key decisions" two weeks before their implementation, and if the Council requires, the key decision cannot be enacted until a majority of the Council and the board are in favour.

6.7 Provision to convene a Commonwealth Council. The Council to be composed of different stakeholder groups including user and non-user members, employees, volunteers, past members, suppliers, customers, local co-operatives, and communities in which the society is located. The size and procedures of the Council to be determined by the board, amended by general meetings. The Council will be free to consider any matter affecting the society.

8. Social accounts

7.1-7.2 Provision to introduce annual social accounts, providing evidence of achievements against stated aims and objectives. The accounts should be verified at least one month before an AGM by a social accounts panel, chaired by an independent qualified social auditor, a lay social auditor, or member who is not a director.



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