

# Submission to the Social Impact Investing Discussion Paper

## Introduction

In considering the two questions raised in Section 5.4 “Legal Structures for Social Enterprises” in the Social Impact Investing Discussion Paper - and the interest expressed in that Paper for increased diversity in operating social enterprise legal models – the consultation might find useful the work that the Social Enterprise Legal Models Working Group (LMWG) has been undertaking in this field in Australia.

You can see information on the history and background of this working group at:

<http://www.employeeownership.com.au/social-enterprise-legal-models/> .

The LMWG was originally convened by Centre for Social Impact as part of the “Social Innovation, Entrepreneurship and Enterprise Alliance” (SIEE – now defunct). Originally, the LMWG operated under a charter to investigate ‘catch up’ with the range of social enterprise business models/legal structures developing elsewhere. Over a couple of years (2013 to 2015), the LMWG completed its work in terms of the charter, and since that time, it has been operating as an expanded ‘knowledge sharing network’ only. The coordinator of the group/network is Alan Greig a Board member of Employee Ownership Australia Ltd (EOA), and the author of this submission. EOA also hosts the LMWG’s web-page (at the link above). The working group’s Chair was Malcolm Rodgers, PSM, a former Director of Market Regulation in ASIC and an expert on corporations law.

The LMWG produced a “Final Report” with a number of recommendations regarding the need to approach legal structures for social enterprise as a strategic business issue, particularly with regard to accessing adequate capital. This report can be seen on the LMWG’s web-page linked above. The report considered – and extensively reported on – the range of social enterprise structures being legislated for in other countries, including the “community interest company” (CIC) in the UK and the “for social benefit corporation” in the US, amongst others. For example, there are nearly 13,000 CICs in the UK following the introduction of this legislation in the UK in 2005. For more information on the LMWG’s work on CIC style legislation in Australia, see the section on this topic below.

Needless to say, Australia is way behind other jurisdictions in the development of legal models/structures specifically for social enterprise. On these developments overseas, the LMWG has produced a “**Summary of legal models in other jurisdictions**” which can be accessed on the LMWG web-page (see link above).

Within the terms of its charter to undertake educational work on choice of legal structure for social enterprise, the LMWG developed a “**Legal Models Comparison Matrix**” (see link above) as a tool to assist with the identification of suitable legal forms for any social enterprise in Australia, highlighting the choices involved in - and the minimum requirements for - incorporating under any of the six forms of incorporation available in Australia.

As a key part of this educational program, the LMWG produced a well- attended webinar on the topic in March, 2015, the recording for which can be accessed - see the link above (with thanks to University of NSW Business School) – and which has been viewed over 350 times.

The LMWG is also actively promoting research on the development of more diverse and social enterprise specific legal models, and in this regard it has recently held discussions with a Law Centre at the University of NSW to establish a “**Legal Models Beyond the Corporation**” research program. More information on this will be available shortly.

## A “Community Interest Company” (CIC) Structure for Australia.

The LMWG continues to work on a specialist legal model for social enterprise in Australia, in conjunction with the Prime Minister’s “Community Business Partnership” (CBP) group, lead by Angela Perry, Chair of EOA and a member of the Partnership. You can see the CBP’s separate submission to the Impact Investing Discussion Paper on the progress made in the area of legal models so far.

For more information on its work on CIC, you can see the separate web-page on this topic at: <http://www.employeeownership.com.au/a-community-interest-company-structure-in-australia/> .

You can also see my article in Pro Bono News “**Community Interest Companies’ Could Change the Face of Social Enterprise in Australia**” which quotes a range of comments from social enterprise sector sources for consideration on the topic. You can access this article at: <http://probonoaustralia.com.au/news/2015/10/community-interest-companies-could-change-the-face-of-social-enterprise/> .

To understand the CIC question more fully – especially from within a relatively well accepted, long standing and jurisdiction wide definition of social enterprise - the best briefing paper on this is “**What makes a social enterprise a social enterprise**” from Social Enterprise UK, which can be accessed under “Resources” at the LMWG web-link above.

For the excellent UK policy document on legal models for social enterprises – one that was used as background by the UK Cabinet Office for the development of the community interest companies legislation in the UK in 2005 – you can access the report “**Private Action, Public Benefit: Organisational forms for social enterprise (2002)**” at the LMWG web-page linked above.

Longstanding UK social enterprise exponent, Jonathan Bland who toured Australia in 2015 recommended in his article “**Social Enterprise in Australia: Realising the Potential**” published in Pro Bono News following his visit (see: <https://probonoaustralia.com.au/news/2015/07/social-enterprise-in-australia-realising-the-potential/> ) the following:

“ Getting the legal and regulatory framework right – this could mean creating new legal models for social enterprises like the highly successful Community Interest Company in the UK or introducing tax relief like the new Social Investment Tax relief in the UK which incentivizes private investment into social enterprise.”

From the LMWG’s perspective on this matter, there are two major issues to be addressed if this is to be achieved:

1. The downside of not having a CIC is that assets may be stripped from a successful social enterprise operating as a Pty Ltd company through sale, merger or winding up. There is no legal provision for locking the assets into permanent use for the social objective in such companies operating as a social enterprise.
2. The cost and complexity of achieving “asset lock” at the moment via the setting up of a Trust or similar provision – which most advisors are now advising needs to be done, with costs between \$10,000 and \$20,000, plus ongoing administration costs and governance complexities – are a barrier. These costs and complexities could be avoided if a CIC structure was available offering ease of registration.

In addressing these two issues, the LMWG’s objectives have been:

1. To initiate a legal structure specifically for social enterprise that will provide not only for a social enterprise “identity”, but more importantly, for a level of “comfort” for social investors, philanthropists and other donors/funders who are providing ‘subsidised’ finance or donations towards the setting up of the social business, that the ‘entity’ cannot be sold,

traded or wound up for personal gain, or operated to the sole benefit of providing shareholders with maximum financial gains from their investment.

2. The model would be easy to facilitate in policy terms and through legislative implementation, and would operate within an existing regulatory framework, eg: ASIC. On this, the LMWG is supportive of – and has learnt much from – the Canadian “Community Contributions Company” legislation and its approach to a CIC type structure.
3. That the focus would not solely be on the needs of ‘impact investors’ as the reason for the new legal structure being required, but that all ‘stakeholders’ in a social enterprise who would be looking for assurance that the enterprise will remain committed/legally obligated to achieving its social objectives, are being considered. This means all those dealing with the social enterprise business in some way will have an interest, eg: purchasers committed to social procurement, ordinary customers and suppliers, governments (including local government), the community in which the enterprise operates, beneficiaries, employees and those who act as managers and directors.

On the “need” for CICs, it is interesting to look at the original source document on the topic, specifically **“Box A: Evidence of difficulties encountered in choosing a legal form”** at page 13 (see “Organisational Forms for Social Enterprise”, UK Cabinet Office, 2002 linked above).

It details a range of needs requiring a CIC beyond that of the “asset lock”, with all of them being potentially relevant to the case for a CIC form in Australia. These issues are (pages 13 to 16):

1. Lack of a robust lock on assets against conversion into a for-profit enterprise.
2. Weakness of the brand.
3. Difficulty in choosing an appropriate legal form.
4. Problems in establishing some governance models within existing legal forms.
5. Difficulties in obtaining finance.
6. Limitations on access to equity finance.
7. Obstacles for smaller community organisations.
8. Costs of registration

As for the evidence the LMWG has been considering on the “impact” of the introduction of the CIC legislation in the UK, the best comes from the report **“The RBS SE 100 Index: A Five Year Analysis of the UK’s Social Enterprises, 2010 – 2014”**. From this, there are two important indicators:

1. CICs – though small (given they are primarily useful to, and designed for, social enterprise start-ups) – now make up 80 of the “Top 100 Fastest Growing” social enterprises in the UK.
2. CICs now make up one in every two hundred newly formed companies in the UK.
3. There are now over 13,000 ‘community interest companies’ registered in the UK, and growing steadily at the rate of about 250 new registrations per month, see the January, 2017 registrations at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/588959/companyListMonthly\\_Jan2017.csv/preview](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/588959/companyListMonthly_Jan2017.csv/preview)

The attractiveness and power of the CIC Model has been highlighted as a result of the small survey the LMWG undertook in 2015 (see Attachment 1 below). The following are some of the points which were made in favour of the CIC model in these discussions in Australia.

1. The visibility and ease of the model will attract new people towards establishing social enterprises, so boosting entrepreneurship and economic growth within the social economy.
2. There are clear attractions in having the CIC “asset lock” which are not available in the alternatives such as the company limited by guarantee.

3. The annual report and social impact statement required by a 'CIC Commissioner' under CIC legislation is more attractive to those wanting to deliver social good than what can be done reporting as a company limited by guarantee.
4. To many, operating as a CIC based 'social enterprise' is in itself an attraction – the 'brand' has separate, positive recognition.
5. The ability to offer equity funding through a CIC is a very attractive proposition for those wanting to generate increasing revenue, or to establish new income streams.
6. It is also more efficient from the 'red tape' perspective – it would be much better to operate under a CIC regulator than the ACNC.
7. For the more entrepreneurial in the NFP/social enterprise sector, it avoids the 'dead-hand' of risk averse Boards and enables much greater freedom of action.

I also covered the work being undertaken in Australia on community interest companies in my Pro Bono News article **"Building the 'New Economy' With Sustainable Social Enterprise"** - which was published in Pro Bono News last month, which you can see it at:

<http://probonoaustralia.com.au/news/2016/07/building-new-economy-sustainable-social-enterprise/> .

Finally, the reference in the Treasury consultation paper about the UK CIC being nothing more than a "branding exercise" comes from a report published in May, 2010 (before equity investment actually started to grow in social enterprise) called **"Investing in Social Enterprise: the role of tax incentives"** by Vince Heaney, which can be seen at:

<https://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55240ffbe4b0983c73de9429/1428426747176/Investing+in+Social+Enterprise.pdf>

The reference is on page 44 of this report.

In regard to this reference in the Treasury consultation paper on CICs, the LMWG has been advised the following by Prof. Bronwen Morgan, University of NSW Law School: "The marketing reference says 'The main advantage this status has provided has been as a branding exercise for non-charitable social enterprises' – in context, it can be read as suggesting that because CICs have not attracted large levels of investment therefore their main advantage comes down to branding. There is no citation in the report for the under-utilisation of CICs limited by shares, or low investment levels in them – **but he is in context actually supportive of CICs being used more** – and the main argument of the paper is to point out that this will not happen unless they get a tax exemption attached to the legal form. In the Australian Federal Government paper, the Heaney reference is used out of context as a wholesale argument against CICS, though."

As stated above, CICs of course are now being formed at the rate of 250 per month in the UK so there is huge demand – and that demand is very much underpinned by commercial need/substance rather than simply "branding".

The Consultation paper also suggests that "Trusts" will cover what new legal models – such as CICs - are being asked to do in terms of protecting assets for social purpose. Again, as stated above, this is something which the LMWG has well considered over time - and consulted upon - but has found that the "cost and complexity" questions leave this option open only to the larger, more well off organisations.

## Crowd Sourced Equity Funding (CSEF)

Largely overlooked in the discussion paper is the contribution which CSEF could make to impact investing. On this topic and its relationship to impact investing, some interest will be found in the my articles on social enterprise being able to access crowd sourced equity and community shares.

1. **“Crowd sourced equity – a new source of funding for social enterprise”** which can be seen at: at: <http://probonoaustralia.com.au/news/2015/08/crowd-sourced-equity-funding-a-new-funding-source-for-social-enterprise/>.
2. **“Community shares funding social enterprise”** which can be seen at: <http://www.probonoaustralia.com.au/news/2015/08/community-shares-funding-social-enterprise>

The data used in these articles was sourced from the Nesta UK report **“Understanding Alternative Finance”** which you can see at: <https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf> and which covers the nine new forms of finance under development, all of which could be used for the purposes of impact investing.

While the Crowd Sourced Equity Funding Bill, 2016, currently before Parliament is yet to get to grips with these developments, which is a pity because more ‘regulation-lite’ CSEF could provide very useful avenues of impact investing for social enterprises. On this topic, see the submissions by both Employee Ownership Australia and the Business Council of Cooperatives and Mutuals to the recent Senate Enquiry into the CSEF Bill at: [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/Crowdsourcedfunding16/Submissions](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Crowdsourcedfunding16/Submissions) .

## Social Investment Made Simple

Given the much wider world that is operating than that seen by ‘impact investors’ - and given the need for increased ‘diversity’ in social enterprise as advocated above - you will find this article of interest towards expanding the breadth and effectiveness of social investment/impact investing - see the guide **“Social Investment Made Simple”** at: <http://knowhownonprofit.org/funding/social-investment-1> and note all the various “instruments” that can be used for social investment/impact investing, as well as the reasons as to why each is “needed”.

What is needed in Australia of course is all of these, not just some of them.

Different forms of social enterprise will need different forms of social investment at different stages of development – and some in greater variety. There should be no standardised, one size fits all approach to social investment, as there should no standardised approach to social enterprise.

It should be noted that “community investment” is a key part of the broad mix, as pointed out in the discussion on CSEF above – an area of interest to the cooperative sector where some of the most effective social impact is now occurring in Australia.

It is worthwhile detailing the types of useable social investment forms from this document – far more diverse as it is than what is indicated in the impact investing discussion paper :

- Secured loan - Use your tangible assets to raise funds
- Standby/underwriting facility - Secure credit to use if / when income drops
- Overdraft facility - Secure agreed credit when your account reaches zero
- Bridging loan - Finance to cover short-term cashflow shortfalls

- Pre-funding of fundraising - Loans which help meet short-term fundraising targets
- Working capital facility - Finance to support dips in cash flow
- Grant - Finance which expects no financial return
- Philanthropic capital - Used by foundations and philanthropists to create social benefits
- Community investment - Selling shares to people in the community to create a co-operative enterprise
- Venture philanthropy - High-engagement grant-making
- Patient capital - Suitable for big social or environmental impact project
- Growth/development capital - Finance to help an organisation or project grow
- Equity investment - Finance from the sale of your shares
- Quasi-equity/revenue participation - Combining some of the benefits of equity and debt
- Community Development Finance Institutions (CDFIs) - Finance from small social investment providers
- Social impact bonds - Investment from the private sector
- Charitable bonds - Using long-term debt to finance growth

## **Conclusion:**

In relation to the two “Consultation questions” asked in the discussion paper, namely:

28. Have you faced a legal impediment as a director of a social enterprise from making a decision in accordance with the mission of the enterprise, rather than maximising financial returns, that only a change in the legal structure could resolve? If so, what amendment to Commonwealth legislation, regulation or ASIC guidance would you consider is needed to address this problem?

29. Would making a model constitution for a social enterprise assist in reducing the costs for individuals intending to establish a new entity? What other standard products or other industry-led solutions would assist in reducing the costs for individuals intending to establish a social enterprise?

I believe the work of the LMWG on social enterprise legal models over the past few years – as described above - admirably contributes background and substance to the asking of these questions and to their answers. Further material – including quoted replies from the social enterprise sector on similar questions – are more fully detailed in the submission of the PMs Community Business Partnership group, towards which the LMWG has also contributed.

I would like to thank to the Treasury for this opportunity to participate in this discussion.

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## **Attachment 1.**

### **Survey: Background information and questions asked of a small group of social enterprises on social enterprise legal models.**

#### **Background**

Social enterprises are a way of doing good outside of the constraints of charitable status.

Social investors invest in social enterprises for the social purpose that can be achieved through generating revenue from 'market trading'.

To do this, it will be important that a social enterprise can demonstrate that it can "lock in" its social mission through an "asset lock" (the assets that would be derived from finance provided by social investors).

NFP structures such as the company limited by guarantee and the incorporated association are incorporated with an "asset lock", but cannot provide for "patient capital" equity holdings on the part of social investors. Their form is primarily for "charitable purpose".

For-profit structures such as a pty ltd company or public company limited by shares can access equity capital from social investors for social purpose, but find that they cannot install a secure and irreversible "asset lock" under this form of incorporation.

Securing an 'asset lock' in for profit structures requires a "Trust" to be set up to protect the assets. This can involve considerable cost (through the legal advisors required), as well as complex governance, administration and reporting arrangements.

The cost and complexity involved in setting up such trusts can act as a barrier towards setting up and operating as a formal social enterprise.

We would like to document the answers to the following questions therefore into "case studies" for a report being written for the Federal Government on "Legal Models For Social Enterprise" (anonymity can be provided in the report if required).

1. How do you see your social enterprise operating with an "asset lock"?
2. Have you been advised to set up a trust to protect your assets?
3. Has the 'cost and complexity' of doing this been an inhibitor in terms of access to capital and your progress as a social enterprise?
4. If a cheaper and simpler social enterprise legal form similar to the "community interest company" in the UK (with a built-in and regulated 'asset lock') were available, would this have been beneficial to your progress?
5. What other solutions do you think might be available to secure your assets in perpetuity for your social mission.