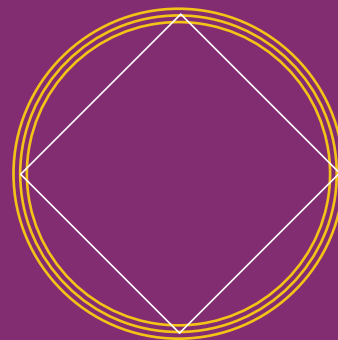
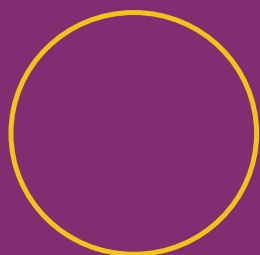


Members' Money



A Legal Guide to Withdrawable Share Capital



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CO-OPERATIVES UK



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This report was written by Anthony Collins and commissioned by Co-operatives UK.

The report comprises legal advice to Co-operatives UK Limited and the participating member societies in this project, namely: Central England Co-operative Limited, Channel Islands Co-operative Society Limited, Chelmsford Star Co-operative Society Limited, Co-operative Group Limited, East of England Co-operative Society Limited, Heart of England Co-operative Society Limited, Lincolnshire Co-operative Limited, Scottish Midland Co-operative Society Limited, and The Midcounties Cooperative Limited.

This report sets out the law applicable in Great Britain as at the date of this report, principally based on the Co-operative and Community Benefit Societies Act 2014 and the Financial Services and Markets Act 2000 and related secondary legislation. In the case of the Co-operative and Community Benefit Societies Act 2014, provisions may be extended to the Channel Islands by Order in Council: however, no such order has been made to date and the Industrial and Provident Societies Act 1965 to 1978 remains the applicable legislation in these jurisdictions. Both Jersey and Guernsey respectively has enacted legislation in respect of financial services and each jurisdiction has its own Financial Services Commission. Co-operatives operating in these jurisdictions are advised to take legal advice locally on applicable financial services laws and regulations.

Introduction: Co-operative capital and why we need a toolkit

The nine societies which have facilitated this project wish to establish a set of model documents, or toolkit, to enable societies to follow a consistent approach in relation to withdrawable share capital (WSC).

There are various reasons behind wanting to do this:

- To review the legislative background, which has been subject to considerable modernisation over recent years, and to have an up to date summary of the law.
- To take account of FCA Guidance on its registration function issued in November 2015.
- Generally to minimise regulatory and other risks.

This report is part of Phase 1 of the Members' Money project, which has also included holding interviews with the nine societies, and working through a questionnaire with them. As is clear from the separate summary of these interviews, amongst those societies there is a wide range both in the extent to which they actively encourage WSC, and of their interest in exploring greater use of it in the future.

By way of broader historical background, WSC played a crucial part in the rapid expansion of retail co-operative societies from 1852 onwards and well into the 20th century, and for many years provided basic financial services to individuals who did not have access to banking services. Both the availability of modern financial services and their regulatory framework mean that WSC no longer fulfils this function for members. Most societies have also now scaled back considerably on the facilities for members to effect WSC transactions.

But as explained in this report, the basic legal facility for WSC remains in place, and continues to be actively used and encouraged by some societies. This project reflects a desire amongst retail societies to explore the opportunities for WSC to continue to attract members' funds today, both as a way of providing societies with access to such capital, and as a way of facilitating increased members' participation, broadening and strengthening the relationship between members and their society.

For present purposes, there are two main areas of law which need to be considered: first the legislation under which co-operative societies are registered (now the Co-operative and Community Benefit Societies Act 2014 (CCBSA 14), which needs to be considered alongside the recently published guidance by the Financial Conduct Authority on their registration function under that legislation (FCA Guidance)¹; and second the law relating to the regulation of financial services contained in the Financial Services and Markets Act 2000 (FSMA 2000) and related secondary legislation.

¹ Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014, Finalised Guidance 15/12 <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>

This report proceeds as follows. We set out next an explanation of co-operative capital and explain its fundamental difference from capital in a company. In section 1 we look at the main legal context in relation to the registration of societies. In section 2 we look at the relevant legal provisions from the regulation of financial services. In section 3, we highlight some risks, flag up an opportunity, and make a recommendation.

Co-operative capital

Shares in a co-operative are fundamentally different from shares in a company, and it is important that these differences are understood. The following are the key differences:

- Co-operative capital is variable, not fixed

- Co-operative shares do not form the basis for the distribution of surplus

- Co-operative shares do not normally give the holder a share in the underlying value of the business

- Co-operative shares remain at par value (unless written down)

- Co-operative shares do not carry votes in proportion to the shares held because a co-operative is democratically controlled

Variable not fixed

Co-operative capital, unlike the capital in companies, is variable not fixed. This means that unlike companies, which can only reduce their capital through complying with certain statutory procedures, there are no legal restrictions on a society increasing or reducing the amount of shares.

A society needs to say in its rules whether its shares are transferable or not, and whether they are withdrawable, or not. Unless a society only has nominal £1 shares, some mechanism is needed for members to liquidate their shares ("exit"), and the ability to transfer or withdraw are the normal routes for doing so. Companies (which have fixed capital) generally rely on transfer/sale; co-operatives societies generally rely on withdrawal and therefore have withdrawable share capital (WSC).

Having variable rather than fixed capital therefore has a number of important consequences.

- It is unusual today for a society to be able to rely on WSC alone to provide a secure capital base for the business.

- Whilst a society with WSC can (and should) include in its rules some restrictions on the ability of members to withdraw share capital, those restrictions cannot in practice and from a capital planning point of view turn that capital into non-withdrawable or permanent capital.

- From a members' point of view, the ability to withdraw provides an exit, and where they hold substantial amounts of WSC need to be able to withdraw capital to meet their personal needs. Unless they can do so, WSC ceases to be attractive to members.
-
- From a third-party creditors' point of view, variable co-operative capital in general and WSC in particular do not provide the same comfort or security as fixed capital. Although co-operative capital is risk capital and will ultimately be available to meet the claims of unsecured creditors, creditors are dependent on the vigilance and efficiency of management in their monitoring of the society's affairs and its WSC, and in using any restrictions on withdrawal to prevent a run on shares.
-

Distribution of surplus

As discussed further in section 1 below, the primary mechanism for a co-operative to distribute surplus or profits is via a distribution to members in proportion to their trade in the society. Although a society can pay interest on share capital as compensation to the members for the use of their funds, such interest is not a mechanism to share profits.

Underlying value

As explained further in section 1 below, it is for societies to specify in their rules what happens to a capital surplus on a solvent winding up. The UK retail societies provide that members are entitled to repayment of their WSC, but any remaining surplus after that should be transferred to another co-operative society or Co-operatives UK. Whilst this approach is not required by statute, it is consistent with co-operative values and principles. The result is that such co-operative shares do not give a member the right to a share in the underlying value of the society/business.

Par value

Co-operative shares remain at par value. A member is entitled to their money back, but no more.

Democratic control

Co-operative societies operate on the basis of one member, one vote, not like companies where there is one vote per share. This means that greater power and influence cannot be achieved in a co-operative by owning more shares.

These features of co-operative capital are set out and emphasised at the outset because there can be a tendency to approach co-operative capital as if it is fundamentally similar to capital in a company, when it is not. It is important to maintain a clear distinction. The picture can be further confused by the use

of language familiar in a corporate context, which is not so appropriate in a co-operative one. For example:

- “issue” or “share issue” are inappropriate because a co-operative does not issue shares like a company (there are even incorrect references in secondary legislation)²
- “investor”, “investment”, “return on investment” are all problematic and potentially confusing words or phrases, normally associated with a corporate entity legally designed to generate an economic return for investors. They are potentially misleading if used in relation to co-operative shares which remain at par value, do not entitle the holder to a share of profits or provide a share in the underlying value, and do not bestow additional voting rights
- “offer” and “share offer”. Whilst these terms are commonly used in relation to a traditional investment proposition, they may be less so in seeking to attract individuals to participate in a co-operative by (amongst other things) owning shares, which arguably is more in the nature of an invitation to participate in membership.

Language is particularly important in the context of financial services, where a principle aim of the underlying law is to ensure that people are properly informed before entering into legal arrangements, and seeks to prevent people being misled.

This project provides an opportunity for societies to reflect on how they present financial engagement to their members, and potentially to seek to encourage a distinctively different financial relationship with members from that of a company with its investors. It is not, and cannot/must not be about “maximising a return on investment”. It is about a different financial relationship, supporting a different way of doing business.

1. Legal context: the Co-operative and Community Benefit Societies Act 2014 (CCBSA)

- 1.1** There are limited statutory provisions in CCBSA 14 relating to shares and share capital, namely s. 14 (Content of a society’s rules); s. 24 (Maximum interest in a society’s withdrawable shares); and s. 67 (Registered society with withdrawable share capital not to carry on banking etc.). We will return to the latter two provisions later, but will consider first the impact of section 14, and how that relates to the basic requirements for maintaining registration as a co-operative society under s. 2.

1.2 Societies that may be registered (section 2)

² The Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 regulation 15(a)(1)

At the point of registration and thereafter, a co-operative society needs to satisfy the Registration Authority (namely the Financial Conduct Authority or FCA) that it meets one of the requirements for registration, which for present purposes means that it is a “bona fide co-operative” (s. 2(2)(a)(i)); and, amongst other things, that its rules contain provisions in respect of a number of matters specified in section 14 (s. 2(2)(c)).

“Bona fide co-operative” is not defined in the legislation, and it is therefore a matter of discretion for the FCA, whose approach is now clearly set out in the FCA Guidance which is discussed further below.

The FCA Guidance states:³

We generally consider something to be a bona fide co-operative society where it is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

The FCA goes on to say that they generally expect to be able to verify or validate principles 1 to 4 (voluntary and open membership, democratic member control, member economic participation, and autonomy and independence).⁴

However section 2(3) sets out what is not a co-operative society:

“co-operative society” does not include a society that carries on ... business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested ...

In its guidance, the FCA sets out its approach very clearly in relation to s. 2(3) which is worth quoting in full.

- 4.5 Section 2(3) does not stop co-operative societies from paying interest or dividends on money invested, deposited with, or lent to the society or any other person. However, if these activities are the main purpose or ‘object’ of the society’s actual or intended business, then it does not meet the definition of a co-operative society and we cannot register it.
- 4.6 Compliance with the conditions for registration is an ongoing requirement for registered societies and we are under a duty to maintain arrangements designed to enable us to determine whether a society is complying with the Act. The submission of an application for the registration of a society is the first point at which we must be satisfied that the society falls within the definition of a co-operative society, taking into account section 2(3). Our assessment is based on reading

3 Paragraph 4.10

4 Paragraph 4.13

the proposed rules and the information provided in the application form.

- 4.7 There may also be other times where we need to assess if the co-operative society meets the definition, taking into account section 2(3). These include, for example, when a co-operative society applies to register a change to its rules, or publishes information suggesting its main object is to make profits to pay interest on shares. In these cases, we will assess all the information available to us in determining whether a co-operative society is capable of registration (or whether its registration should be suspended or cancelled) by virtue of section 2(3).
- 4.8 If a co-operative society is already trading, then we may analyse the society's accounts to help us decide if the co-operative society exists mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to the society. This analysis could involve looking at:
- The amounts of surplus distributed to members in proportion to their participation in the co-operative
 - The level of interest or bonuses paid on money invested, or deposited with, or lent to the society, against
 - amounts distributed to members as dividends in proportion to their participation in the co-operative
 - the levels of interest, dividends or bonuses paid by comparable, investor-owned businesses
 - The nature of the relationship between members and the society, including:
 - whether it is an association of persons united mainly for the purpose of meeting their common economic, social and cultural needs and aspirations by, for instance, accessing goods, services or employment, or if it is actually an association of capital with the main purpose of generating financial returns
- 4.9 We decide if a co-operative society falls within section 2(3) on a case by case basis, and would usually have discussion with the society to decide this.

Comment

A society's rules and any documentation seeking to attract members' capital need to ensure that they observe these basic registration requirements, which set the parameters within which the FCA can accept registration as a co-operative society.

It needs to be borne in mind that the FCA is the registration authority for societies, and our main concern with the FCA in this report is in relation to that registration function. However, the FCA is better known for its regulatory role in relation to financial services. By and large (see further below) this regulatory role does not apply to WSC as used by retail societies, and the FCA does not have a prudential role in relation to

registered societies⁵ and their use of WSC. That said however, we need to be alert to the following:

- (a) Because of the FCA's role and reputation as a financial regulator, in carrying out its registration role it is likely to be sensitive to matters of financial stability and prudence*
- (b) The relative freedoms from regulation around the use of WSC (as discussed further below) are based on statutory exemptions*
- (c) Individual members may not appreciate the distinction between "registered with the FCA" and "regulated by the FCA". It is important to be very careful with the language used in dealing with individual members to prevent or avoid any misunderstanding*

1.3 Content of a society's rules (section 14)

The specified matters on which s.14 requires rules to contain provisions include the following:

9. Shares

Determination whether any or all shares are transferable, and provision for the form of transfer and registration of shares, and for the consent of the committee to transfer or registration.

Determination whether any or all shares are withdrawable, and provision for the method of withdrawal and the payment of the balance due on them on withdrawing from the society.

There are two potential ways for a share in a society to be liquidated by a member – withdrawal or transfer – and this provision makes it clear that both options are available. However it should be noted that “transferable” and “withdrawable” are not alternative options: so shares can also be both transferable and withdrawable, and neither.

1.4 FCA guidance on withdrawable shares

Since it has to be shown to the satisfaction of the FCA that a society is a bona fide co-operative society, it is important to ensure that all relevant provisions in a society's rules relating to share capital fall within the FCA's published approach. These are set out in section 6 of their Guidance. The key points are as follows.

The FCA sets out its view about some unique features of society (both co-operative and community benefit) shares as follows:

- Their number can fluctuate significantly⁶

5 The term “registered societies” is the term used in CCBSA 14 to describe societies registered on or after 1st August 2014 and societies previously registered under the Industrial and Provident Societies Act 1965

6 See introduction and note on Co-operative Capital

- They remain at par value (unless written down)
- They do not automatically give the shareholder a share in the underlying value of the society⁷
- They cannot be held by the issuing society itself
- They do not carry votes in proportion to the amount of shares held

The FCA notes that the legislation does not define withdrawable shares; that the process of withdrawal should be laid down in the society's rules; that most society rules give the board power to suspend all share withdrawals; others impose long notice periods for withdrawing shares; and that some societies only allow shares to be withdrawn at fixed times or after a certain period of holding the shares.⁸

The FCA Guidance then expresses views about withdrawable shares as follows.

- 6.11 Our view is that it is an indicator that a society is meeting its condition for registration if it only allows the withdrawal of shares if:
- It has trading surpluses that match or exceed the value of shares involved; and
 - the directors believe the society can afford to pay its debts, taking into account:
 - all of its liabilities (including whether it will be able to pay its debts at the date of withdrawal and, for a year after that, any contingent or prospective liabilities) and
 - the society's situation at the date of the transaction
- 6.12 In our view it is an indicator that a society is complying with its condition for registration if:
- the society's board has power to suspend withdrawals of share capital
 - the society's directors monitor withdrawals and, if the society's financial position becomes uncertain, can suspend members' ability to withdraw shares and
 - the directors have agreed whether there should be an annual limit on how many shares can be withdrawn, or a limit to the amount of profits which can be distributed.

Comment

The main risk for a society in relation to withdrawable share capital, particularly when viewed through a contemporary company law lens, is that the ability of members to withdraw their capital leaves the society itself at risk in terms of managing its ability to meet its financial obligations; and it leaves creditors at greater risk in dealing with the society than with a company with fixed capital. The society needs to manage this risk through careful management of WSC, including

7 See note in Introduction

8 Paragraph 6.10

maintaining appropriate liquidity, and monitoring withdrawals.

The FCA's approach and its views set out above do not (and cannot) introduce maintenance of capital requirements; but they certainly reflect a prudent approach to risk where the company law restrictions on the power to distribute surplus do not apply. They effectively encourage societies to ensure that withdrawals are carefully monitored and controlled to ensure that they do not adversely impact the society's solvency; and that a power to suspend withdrawals is part of this mechanism.⁹

1.5 FCA Guidance on Transferable shares

In its Guidance, on the subject of transferable shares the FCA states as follows:

- 6.14 In our view, a market in society shares allowing capital gains for members is normally inconsistent with registration as a society. This is because it may encourage the society's members and officials to operate the business to achieve capital gains rather than to serve either the members or the community through operating its business. Society rules are required by the Act to make every share transfer, other than on the death or bankruptcy of a member, subject to board consent as well as registration.

Comment

It is for a society to decide whether or not its shares are to be transferable, and whether or not they are to be withdrawable. It has been normal for retail societies to provide that shares are not transferable except in specific circumstances such as on death, via the nominations process; and since they remain at par value, and the nature of membership is intended to be a relationship between the member and their society, there is no real basis for a market in shares.

1.6 FCA Guidance on share interest

The Guidance deals expressly with the subject of Share Interest and Co-operative Societies, and the paragraphs are worth quoting in full:

- 6.22 Societies can pay interest on shares.
- 6.23 Generally speaking, interest on shares should only be paid where the society can afford to do so, having taken into account other liabilities and any contribution to the society's reserves. Share interest should not be used as a means of profit or surplus distribution or as a substitute for dividends.
- 6.24 The way a society uses interest on shares can be an indicator

⁹ It is also an essential feature in terms of accounting treatment if shares are to qualify as equity. See further below

of whether it is complying with its condition for registration because:

- in the case of a bona fide co-operative society:
 - the society cannot exist mainly to pay interest on money invested and
 - in accordance with Principle 3 (see page 28), it would be an indicator that a society is a bona-fide co-operative where the distribution of surplus to members is in the form of a dividend based on a member's participation in the co-operative, rather than through payment of interest on shares
- in the case of a society conducting its business for the benefit of the community the society's funds must be used to further the community benefit

6.25 The factors below are indicators of where a society is likely to be complying with the conditions for registration:

- societies are primarily inviting people to become members of the society, along with any accompanying request for capital (additional to the minimum required for membership) from the prospective member
- the maximum rate of interest paid on shares is declared in advance of the period for which it is intended to be paid, whether in its rules or elsewhere
- the declared maximum rate of interest is the lowest rate sufficient to obtain the necessary funds from members who are committed to furthering the society's objects
- in the event the society cannot afford to pay the declared maximum rate of interest, interest payments are reduced, or no interest is paid at all, without compensation in subsequent years
- societies can justify a decision to pay interest at a particular rate, and be able to demonstrate the basis for that decision

6.26 The factors below are indicators of where a society is likely to be failing to comply with the conditions for registration:

- the society seeks to attract capital mainly by focusing on potential return on investment
- the declared maximum rate of interest is in excess of the lowest rate sufficient to obtain the necessary funds from members who are committing to further the society's objects
- a rate of interest greater than the declared maximum rate is paid to members where a society is more profitable than expected
- greater profits in one year are used to compensate members for reduced or no interest payments in previous less profitable years

6.27 We will consider these factors on a case by case basis. What is appropriate for one society may not be appropriate for another.

- 6.28 There are some instances where these factors are not appropriate, specifically in the case of non-user investor shares in co-operative societies, and shares in agricultural co-operatives. In these instances other indicators will suggest whether societies comply with the bona fide co-operative society condition for registration. Non-user investor shares are dealt with from paragraph 6.31 below. For agricultural co-operatives, requirements in the rules around the use of share capital linked to members' participation in the business suggest compliance with the legislation.

Co-operative societies

- 6.29 The indicators outlined above on share interest are relevant for co-operative societies in relation to the capital subscribed by members over and above that subscribed as a condition for membership.
- 6.30 The amount of interest paid on capital subscribed as a condition for membership should be limited, if any at all.

Comment

These provisions are essentially aimed at ensuring that the payment of interest is at a level consistent with registration as a co-operative society. They provide important guidance against the background of societies in the past which had sought to attract capital effectively as an "investment proposition". This was contrary to section 2(3), and it required a clear statement of general principles regarding interest on co-operative capital, which the Guidance now provides.¹⁰

The Guidance continues:

- 6.31 Generally co-operative societies offer membership to people who can use their services (whether as workers, producers or consumers). However, a co-operative society may sometimes need to raise capital from people who cannot or do not use the society's services. We describe these members as 'non-user investor members' – people who have only an investment relationship with the society.
- 6.32 While offering membership to non-user investor members gives a co-operative society access to capital, it also brings risks to its ability to comply with its condition for registration. The way capital is accessed must not compromise the society's compliance with the condition for registration. The following factors are indicators that the society is complying with its condition for registration as a bona fide co-operative society:
- The rules of a society which wants to raise capital from non-user investor members expressly provide for non-user investor shares,

¹⁰ This is very similar to the problems which had arisen in the 1920s and 30s following the introduction of prospectus requirements for companies – see further in section 2 below

and the terms attached to these shares are clearly stated

- The voting rights of non-user investor shareholders are restricted by the rules of the society. The society's rules prevent this category of shareholders voting on a motion to convert the co-operative to a company. Societies can, however, include a power to elect one or more non-user investor share representatives to the board
- Ultimate control of the society remains with members other than non-user investor members at all times. Non-user investor members do not together have voting rights that when combined would result in user-members losing control of the society.

Comment

It is helpful to understand the background to these paragraphs covering "non-user investor members".

They were introduced in 2006 because of European legislation which permitted the registration of a European co-operative society (ECS) in EU member states. (As far as we are aware, no such ECS has been registered in the UK.) This legislation permitted "non-user investor members" in an ECS reflecting what legislation in other European jurisdictions (not the UK) already permitted. It was felt by the Financial Services Authority (the predecessor to the FCA in its registration role) that unless they accommodated a similar approach in the UK, the registration of new UK co-operative societies might be adversely affected.

The concept of members who do not participate in the business of a co-operative does not sit comfortably with the ICA Principles, and therefore with the basis of registration of a co-operative society in the UK. The FCA's cautious approach reflects this, whilst seeking to be pragmatic.

1.7. Maximum interest in a society's withdrawable shares: s.24 CCBSA 14

The legislation has always specified a maximum limit on the interest any individual may have in a society's withdrawable shares. For a long time this was £20,000, but the figure is now £100,000. Individual societies may include a lower maximum limit in their rules.

It is important to recognise that where societies permit joint share accounts, the whole of the amount in such accounts needs to be taken into account and added to any amount held in an individual share account. The same applies if any shares are held on trust.

The maximum limit does not apply where the member concerned is a registered society; or to certain other rather narrow and specific instances.

1.8. Restrictions on banking: deposit-taking: s.67 CCBSA 14

Section 67 CCBSA provides that a registered society which has any withdrawable share capital must not carry on the business of banking. Subsection (2) grants an exemption from this prohibition for small savings schemes (the taking of deposits of not than £400 etc.), but none of this has relevance to the activities of societies operating withdrawable share capital.

However, accepting capital on a withdrawable basis is nevertheless deposit-taking, and the Financial Services and Markets Act 2000 (FSMA 2000) regulates banking, deposit-taking and other financial services activities which are discussed further below. In other words, accepting withdrawable share capital would fall to be classified as a regulated activity, but for a specific exemption. The Financial Services and Markets Act 2000 (Exemption) Order 2001 provides that an “industrial and provident society, in so far as it accepts deposits in the form of withdrawable share capital” is exempt from the general prohibition on deposit-taking.¹¹

Comment

It is important to understand that the acceptance of withdrawable share capital would be a regulated activity, but for this specific exemption afforded to co-operative and community benefit societies. In other words, the starting point from a regulatory point of view is that a concession has been granted to allow societies to continue to do what they had been doing for many years.¹²

It is important to bear this in mind, for two reasons. First, it means that viewed from the outside, co-operative and community benefit societies are being allowed to do something without regulation (by virtue of a concession) which others are only permitted to do within a regulated environment. Second, it needs to be recognised that from a regulatory or governmental point of view, withdrawing a concession does not look as harsh as introducing restrictions.

It therefore follows that caution is needed throughout the consideration of the use of withdrawable share capital; that care should be taken not to (and not to be seen) to abuse the concession; and that care should be taken at all times to consider the interests of those who might be seen as being exposed to risks as a result of the concession (individual members providing withdrawable share capital, third party creditors).

The FCA's approach set out above may reflect these points.

1.9. Debt or equity

Although it is for a corporate entity to make its own decision about appropriate funding and the level of debt and equity, in discussion

¹¹ Article 4, and Part II of the schedule, paragraph 24

¹² Financial services regulation was only introduced in 1986, and then updated in 2000

with the FCA it was flagged up that the level of external borrowing by a society could become an issue in relation to registration as a co-operative.

As mentioned above, the FCA generally expect to be able to verify and validate whether Principles 1 – 4 have been met through a society's rules and governance arrangements. It should be noted that Principle 4 (Autonomy and Independence) could potentially be undermined if a society, as a result of substantial external borrowings, enabled a lender to dictate aspects of the running of the society or gave the lender a high level of control. However it was acknowledged that this was an extreme position, more likely when a society was in financial difficulties.

1.10. Co-operatives UK's Code of Best Practice on Withdrawable Share Capital

The description of the statutory and regulatory background would be incomplete without referring to this Code of Best Practice, first developed by Co-operatives UK in 2000 with the agreement of HM Treasury, reviewed and then amended in 2004/5 in consultation with the Financial Services Authority, and again in 2010/11.

The governing principles of the code are:

- (a) Societies should take their responsibilities seriously to ensure the accurate, appropriate use and management of Withdrawable Share Capital (WSC), and to act fairly and reasonably in all their dealings with their members in relation to WSC;
- (b) Societies will ensure that members are fully informed as to the nature of share capital and the risks attached to it;
- (c) Information will be provided in the most accessible and easily understood form so members can understand how WSC accounts operate. This will include the information being made available in writing at relevant outlets, on the society's website, other electronic forms as appropriate and in material provided when an account is opened or important changes to terms are made;
- (d) Societies will ensure literature is available which can explain clearly the nature of WSC, the risks attached to it and the terms that apply to it, including timely notice of any changes in the terms and conditions applicable in their case and details of the procedure to be followed to deal with a member's complaint.

The Code of Best Practice includes guidance on opening accounts, information wording to provide in writing at the earliest opportunity, operating share accounts, terms and conditions other than interest, advertising of WSC, advertising interest rates, complaints and monitoring and compliance.

It is noted that the Code of Best Practice appears not to have been reviewed since the FCA Guidance was issued in November 2015, and it may be appropriate to consider with the FCA whether such a review might be appropriate.

2. Legal context: Financial Services and Markets Act 2000

FSMA 2000, as already explained, sets a regulatory framework in relation to a range of financial services activities.

Essentially it operates by creating a general prohibition on any person carrying on a regulated activity, unless they have been authorised to do so or exempted by the legislation for the need for authorisation.¹³

As explained above, deposit-taking is one of the areas covered by FSMA 2000, but co-operative and community benefit societies are exempt from the prohibition in so far as they accept deposits in the form of withdrawable share capital.¹⁴

There are three other areas which need to be considered in the context of societies seeking to attract withdrawable share capital: (1) prospectus requirements; (2) financial promotions; and (3) dealing in and arranging investments. It is also necessary to say something about the general law of misrepresentation beyond what is covered by financial services regulation. Lastly it is convenient to deal with money laundering regulations at this point. Before doing so, it is appropriate to say something by way of introduction to this subject.

Company law started introducing requirements for the contents of prospectuses in 1900. This arose because of the need to provide some protection for people who were being invited to subscribe for shares in companies, and who might have no redress if their money was lost due to false statements. That was, and remains today the basic reason for regulation in this area.

As is explained more fully below, co-operative and community benefit societies enjoy significant exemptions both in relation to prospectus requirements and financial promotions, and these concessions or privileges need to be treated with care. There are important historical reasons for this.

The prospectus requirement introduced into company law in the early 20th century imposed significant obligations on those seeking to raise capital for commercial ventures. But those prospectus requirements only applied to companies not “industrial and provident societies” (as they were known at the time), and as a result the unscrupulous got round company law by raising capital through such societies. This became a serious problem in the 1930s, resulting in substantial changes to industrial and provident society law¹⁵ which essentially involved the introduction of the much stricter requirements for the registration of societies which apply today.¹⁶ In other words, these registration

13 s.19 FSMA 2000

14 Financial Services and Markets Act 2000 (Exemption) Order 2001, article 4, and Part II of the schedule, paragraph 24

15 These were introduced by the Prevention of Frauds (Investments) Act 1939

16 Section 2 CCBSA 14, and its predecessor which was s. 1 of the Industrial and Provident Societies Act 1965

requirements were a mechanism to prevent the avoidance of prospectus requirements.

Similar problems have arisen again more recently, where people have registered or (sought to register) co-operative societies to raise capital as an investment proposition. This is obviously an abuse of the registration process, resulting in the need for the clarification of the FCA's registration role as set out in its recent Guidance. It is important to bear this in mind, because if abuse or avoidance became a significant problem again, this could put at risk the exemptions currently enjoyed. For this reason, we recommend a cautious approach, in order to reassure the FCA that the sector itself takes these matters very seriously. The existence of the Code of Best Practice continues to be helpful in this respect.

2.1. Prospectus requirements

The starting point is that if transferable securities are to be offered to the public in the UK for the first time, a prospectus must be submitted for approval to the FCA, in its role as the UK Listing Authority, whether or not such securities are going to be listed on the Stock Exchange.

The basic reason why the withdrawable shares used by UK retail societies would not fall within this requirement is that they **are not transferable**.¹⁷ The limited situations in which transfers might apply (nominations etc.) would not affect this.

There is a further exemption where the securities are not offered to the public. However, securities offered to members of the society would be unlikely to bring it within this exemption because "offer to the public" is so widely drawn (there is such an offer if there is a communication to any person which presents sufficient information on the transferable securities and the offer to enable an investor to decide whether to buy them).¹⁸ But given the fact that prospectus requirements do not apply to shares which are not transferable, there is no need to seek to rely on this exemption.

2.2. Financial promotions

There is a prohibition against anyone, other than an authorised person, communicating in the course of business any invitation or inducement to engage in investment activity unless the content of the communication has been approved by an authorised person.¹⁹

There is no exemption for a society's transferable shares.²⁰ However non-transferable shares fall outside the definition of a "controlled

17 The 2016 Co-operatives UK Consumer Co-operative model rules provide that shares "can be withdrawn, but cannot be transferred except when permitted by these rules"

18 S. 102B Financial Services and Markets Act 2000

19 Financial Services and Markets Act 2000 s. 21 (1) and (2)

20 Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 paragraph 14(2)(b)

investment” for the purposes of these rules.²¹

2.3. Dealing in and arranging investments

FSMA 2000 regulates those who deal in investments as principal or who arrange deals in investments. A society, like any other business which issues its own shares, is excluded from regulation as such a person.²² In addition, non-transferable shares in a society are outside the definition of an “investment” for the purpose of FSMA 2000.²³

2.4. FCA as registration authority for registered societies

The FCA Guidance referred to above relates to the FCA's role as registration authority for co-operative and community benefit societies under the CCBSA. During the consultation leading up to the publication of the Guidance, the FCA stated that it does not intend to ask societies to submit a share offer document to it for scrutiny or approval where shares are not subject to FSMA 2000. The FCA points out that an offer of withdrawable, non-transferable shares to members and prospective members is not a regulated activity under FSMA 2000 and that the Financial Promotions regime does not apply to such offers.

2.5. Misrepresentation

Although WSC is not regulated for the reasons set out above, societies need to be aware that the terms of any document inviting members' funds, together with the rules of the society and any other associated documents create legal responsibilities just like any other transaction. Any misleading statements are capable of amounting to a breach of the Misrepresentation Act 1967. Where any terms are ambiguous or vague resulting in a dispute, there is a risk of a court construing them in favour of shareholding members and against the society. Great care must therefore be taken in preparing documents in connection with share capital.

2.6. Money laundering

The Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 (the 2017 Regulations) impose obligations on those conducting certain business in the UK including financial services.²⁴

Societies are exempt from the 2017 regulations in relation to WSC within the statutory limit set by s. 24 CCBSA 14 (£100,000 per person)

21 Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 paragraph 14(3)(c)

22 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, arts 18, 28 and 34

23 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, arts 73 and 76

24 Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, SI 2017 no.692

referred to above.²⁵ The Channel Islands' jurisdictions have enacted Money Laundering and Terrorist Financing legislation and regulations that do not contain an exemption in respect of WSC, and societies operating in these jurisdictions are obliged to comply with local regulations.

As the 2017 Regulations do not directly relate to co-operative and community benefit societies per se, in order to demonstrate, from a good governance point of view, compliance with the 2017 Regulations the societies should have effective procedures in place to detect and prevent money laundering. The Joint Money Laundering Steering Group has provided guidance as to how societies can put proportionate processes in place to carry out risk assessments which includes standard forms for taking ID as well as guidance for simplified and enhanced due diligence.²⁶ Identity verification of customers who will be depositing money with the society is vital as well as obtaining documents to identify the source of funds.

Comment

As the new 2017 Regulations came into effect on the 26 June 2017, it is important that each society's money laundering policy is updated to refer to the new regulations and an updated risk assessment is conducted for members subscribed to withdrawal share capital. Training of staff may also be necessary to ensure they are aware of the society's procedures in relation to money laundering.

25 Reg. 15(1)(a)(i)

26 The Joint Money Laundering Steering Group, Prevention of Money Laundering/Combating Terrorist Financing, Part 1, Annex 5 (pages 136-156) 23 June 2017 - <http://www.jmlsg.org.uk/>

3. Risks, an opportunity and a recommendation

3.1. Risks

Arising from the interviews carried out (see separate summary), our meeting with the Financial Conduct Authority, and our review of the law for the purposes of this report, we summarise below the main areas of legal risk in relation to WSC.

The starting point, it needs to be said, is that WSC is an established concept, with a longstanding history, and which societies who wish to do so appear to be using without significant problems. No major problems were flagged up by the FCA.²⁷ The latest FCA Guidance provides a clear and easily understood summary of how they approach their registration function in relation to WSC. There is one particular area of opportunity mentioned below in relation to the use of WSC but where through use of the suspension of right of withdrawal, a quasi-fixed term approach could be explored further.

The principal areas of risk are as follows.

Falling foul of section 2 (3)

As explained above, it is important that societies must not carry on business “with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested”, a problem which has occurred in the past (though not with retail societies, as far as we are aware) and which resulted in significant changes to the law.²⁸

This risk is generally avoided by ensuring that the society's primary purpose is some form of trade with its members (e.g. retail). Thereafter, the principal mitigation is through taking account of the guidance above about levels of interest paid, how WSC is presented generally to members, and the language used.

Using language more appropriate to a company share offer

The history of the legislation²⁹ demonstrates that from time to time it is wrongly used to raise funds when company law should be used instead. In the past this has been done deliberately; sometimes it is inadvertent. Whatever the underlying reason, it creates a problem for the FCA; its functions and role are prescribed by the legislation which sets out the eligibility criteria for the registration of societies which need to be enforced.

This risk is also easily avoided by taking account of the guidance above about language, but perhaps more fundamentally by promoting

27 Our discussions with the FCA were with them in their capacity as registering authority under the Co-operative and Community Benefit Societies Act 2014, in relation to matters covered by that Act.

28 See Handbook of Co-operative and Community Benefit Society Law second edition 2014, Co-operatives UK section 2.1.5 in Chapter 2

29 See previous footnote

a greater understanding of the nature of co-operative capital, and emphasising its distinctiveness from shares in a company, and the different underlying relationship which exists between members and their society compared with that between investors and a company. The more the style and language used in relation to WSC appears to describe something similar to shares in a company, (a) the more misleading it is to the reader/recipient of the communication and (b) the greater the need for the FCA to address the situation.

Encouraging the use of standard or model documentation in relation to WSC further helps to mitigate this risk.

Doing anything which might jeopardise current exemptions

As pointed out above under the review of the law relating to financial services, registered societies enjoy a number of exemptions from regulation which enable them to use WSC relatively easily and cheaply.

It is important to recognise that the larger retail societies comprise only one group of registered societies using WSC. By way of example, registered societies and WSC are used for raising funds for a wide range of community projects via processes promoted by the Community Shares Unit, a joint initiative between Locality and Co-operatives UK. Many of the fund-raising initiatives supported by the Community Shares Unit are on a much smaller scale than the use of WSC by larger retail societies, their context is usually very different as new start-ups, and their approach and communications strategies also differ greatly.

In the context of this project, there was discussion with the FCA about whether retail societies might make use of crowd-funding platforms for WSC. Two points were raised about this possibility. First, such platforms tend to list community share “offers” according to the interest rate paid on capital, which does not sit comfortably with Co-operative Principles and the guidance referred to above. Second, such platforms can contain a mixture of regulated and unregulated offers.

It was suggested in one of the interviews that a bespoke crowd-funding platform could be developed for retail societies, owned by Co-operatives UK, and available for use by member societies. It seems unlikely that this would be a viable proposition, given the costs and uncertain demand for such a platform.

Having said that, if there was sufficient interest amongst societies to develop online facilities for attracting WSC and carrying out basic transactions, there is nothing to stop them doing this. It should be borne in mind that “crowd-funding” is not a term of art: it is simply an online mechanism for communicating an opportunity to potentially interested parties.

Avoiding the risk of jeopardising existing exemptions essentially requires societies to be prudent in relation to any innovation. It is also relevant to point out that whilst the FCA is unwilling to “approve”

particular approaches or procedures, it is very happy to engage in dialogue in a developmental phase, and flag up any concerns in advance.

3.2. An opportunity

In discussion with the FCA about the possibility of developing better and more effective use of WSC by retail societies, there was discussion about the potential for societies to have a particular class of withdrawable share on which the power to withdraw was deferred for a period – say up to five years.

The terms for such shares might provide for a higher rate of interest to be paid than that applicable to general WSC. It was noted that such an approach could already be adopted within the general powers in a society's rules. However it might also be appropriate to introduce a specific power by way of rule amendment, both to highlight the approach to the wider membership and to secure members' express support.

Participating societies may wish this to be explored further in Phase 2, including the development of draft rule amendments.

3.3. A recommendation

In the course of undertaking this project, we noted that Co-operatives UK's Code of Best Practice on Withdrawable Share Capital has not been reviewed/revised since the enactment of the Co-operative and Community Benefit Societies Act 2014, and the publication of the FCA Guidance. It seems appropriate that it should be so reviewed, in discussion with the FCA, and we would recommend this.
