Financial Conduct Authority

Feedback Statement FS16/11

Call for Input: Regulatory Barriers to Social Investments

October 2016

Contents

In this Feedback Statement we report on the main issues arising from Call for Input: Regulatory Barriers to Social Investments.

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We have carried out this work in the context of the existing UK and EU regulatory framework. We will keep it under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

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Abbreviations used in this paper

FCA	The Financial Conduct Authority
FSCS	The Financial Services Compensation Scheme
MiFID	Markets in Financial Instruments Directive
SITR	Social Investment Tax Relief

1. Overview

Introduction

1.1 This feedback statement sets out the responses we received to our Call for Input on regulatory barriers to social investments[1], published in December 2015. It covers both written responses and the feedback we received from a series of workshop events. The Call for Input asked whether there are any barriers in our rules which are holding back the development of the social investment market.

Who does this affect?

1.2 This Feedback Statement will be of interest to:

- individuals who wish to set up a social enterprise
- existing social enterprises wanting to raise capital
- social enterprises subject to investment by investment funds
- financial advisers interested in offering social investments to their clients, and
- retail and consumer organisations with an interest in investments that have an underlying social purpose

Is this of interest to consumers?

1.3 This Feedback Statement will be of interest to any consumers interested in making investments which have the potential for a social as well as a financial return.

Context

1.4 Social investing is a broad concept which at its heart combines the idea that an investment can have a social 'impact' or 'return' as well as some form of financial return. This social impact or return is usually focused on a specific issue, geographic area or part of the population,

1 *Call for Input: Regulatory Barriers to Social Investments* (December 2015) https://www.fca.org.uk/news/call-for-input-regulatory-barriers-to-social-investments

for example, the rehabilitation of offenders or providing training and then employment opportunities for the long-term unemployed. This is usually done by investing in enterprises which have a specific social objective as their primary goal. While their objectives can overlap, social investment is not the same as green finance which aims to achieve specific environmental aims and may not have any particular social impact in mind.

1.5 Social investing is different to charitable giving or making a donation as there is an expectation that capital may be returned and some financial gain could be made. It is different to corporate social responsibility (CSR). Broadly speaking, CSR is a commitment by companies to behave in a responsible manner in the workplace or wider community. Firms embedding CSR do not, however, necessarily have a specific social impact in mind when they do this.

1.6 Social investments can be made in a range of ways, for example:

- directly in companies that are set up to achieve specific social objectives
- by using collective investment schemes which pool investors' money and then invest in a range of companies aiming to achieve social impact
- via social impact bonds which aim to provide a specific service in return for a financial return if set levels of social impact are met

1.7 All of these routes to social investment involve risk to investors' capital: the expected social impact may not be achieved so there may be no social return on capital and there may be no financial return either. There is also the very real risk that the social enterprises invested in may prove to be unviable and fail, particularly as enterprises targeting social outcomes often share a number of characteristics with early stage 'start-up' companies. Consequently some or all of investors' initial capital may not be returned. Taking these factors into account it is helpful to look on social impact investing as a form of venture capital, in that investments are made in often small, unlisted companies which can have a high failure rate. In this sense social investing is a form of 'non-standard' investment in capital-at-risk investments.

1.8 Our role in relation to this sector is the same as for any other area where such investments are offered to consumers. We aim to ensure consumers are protected appropriately, and to maintain the integrity of the market for social investments.

1.9 As explained above, social investments are 'non-standard' and may be higher risk than more standard investments such as direct or collective holdings in shares, for example. It is therefore important that all communications to potential investors are clear, fair and not misleading when it comes to the financial risks they are taking on. As complex, non-standard investments it is important that an appropriate level of advice or disclosure is given on the financial risks inherent in making social investments.

1.10 This is a relatively new investment area and there is as yet no widespread understanding of its risks, rewards and potential vulnerabilities. The development of such a market requires a strong and consistent regulatory structure which can provide asset managers and investors alike with certainty and protect consumers from being sold or marketed inappropriate investments.

1.11 On this basis, many social investments take the form of investments subject to the Markets in Financial Instruments Directive (MiFID). MiFID allows for the sale and promotion of investments to retail investors, including social investments, subject to certain requirements. For example, all MiFID investments must be promoted in a way that is fair, clear and not misleading, and with all relevant risks disclosed. And, as with all MiFID investments, advisers may recommend social investments where they are suitable for the investor. We have some additional rules that are relevant for some types of MiFID investment, including social investments:

- Where the investment is a non-mainstream pooled investment, for example, a unit in an unregulated collective investment scheme, these can only be promoted to retail investors who have been assessed as meeting certain criteria in our rules.

- There are also restrictions on the promotion to retail investors of non-readily realisable securities, for example, unlisted shares sold on crowdfunding platforms. Firms are asked to assess investors before making a sale and retail investors who do not take advice and are neither high net worth nor sophisticated are asked to commit to not invest more than 10% of their net investable assets.

1.12 MiFID is currently being revised. A new version of the directive (MiFID II) will come into force on 3 January 2018. MiFID II will introduce new 'product governance' requirements for firms manufacturing and distributing MiFID investments. These will require regulated firms to have a framework for robust and responsible product design and distribution to avoid future cases of consumer harm. Under this framework, for example, we would expect firms to consider the target market for social investments and consider appropriate distribution strategies. We have carried out this work in the context of the existing UK and EU regulatory framework. We will keep it under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

2.
Summary of feedback and our response

2.1 In this chapter we summarise the feedback we received to our Call for Input and set out our responses.

2.2 Many of the responses received relate to issues beyond our remit. This summary confines itself to addressing issues that are within our scope. Links to other issues beyond our remit are set out in Annex 2 for readers' convenience.

2.3 We aimed particular questions at the following groups: social enterprises, financial advisers and other intermediaries (including crowdfunding platforms), and consumers and consumer groups. The questions we asked, respondents' views and our responses are set our below.

Questions for social enterprises

Q1: Have you experienced any problems trying to establish a social enterprise or raise capital for a social enterprise? If yes, please provide details of the problems, identifying in particular those caused or exacerbated by regulation. Where a problem is caused by FCA rules or policies, please identify the rule and explain why.

Q2: How are you interested in raising capital? Who is your target client base for the products you will sell to raise capital?

2.4 Some respondents described the difficulty they experienced when looking for advice and guidance on establishing and funding a social enterprise. These respondents found that many advisers did not understand the differences between social enterprises and other forms of business and the importance of promoting an enterprise's social impact.

2.5 One respondent said that there was a low level of awareness of 'impact investing' in the adviser community. They felt that the abundance of more mainstream investment opportunities meant that advisers did not present the full range of investments to clients, which led to missed opportunities for both social enterprises and investors.

2.6 An authorised intermediary told us that 60% of the capital it had raised for clients was invested directly by individuals. This intermediary usually set the minimum investment per individual at £1,000 and tried to balance opportunities for small investors with its corporate clients' views on the optimum number of investors in the business. In the case of offers which are restricted to high net worth individuals, the minimum investment typically ranged from £10,000 to £25,000. Most investments, we were told, were in the form of debt.

2.7 Views on the impact of our regulation were divided. Some respondents argued that the requirement for financial promotions to be signed off by an authorised person was an effective safeguard for prospective investors. The threshold of 'clear, fair and not misleading', it was argued, is appropriate for any communication that promotes an investment, whether there is a social element or not. Respondents supporting this line considered it important that the same safeguards which exist to protect mainstream investors should be in place for social investors as well, particularly if social investment is to become a credible investment choice on an equal footing with investments in other businesses.

2.8 However a few respondents, while supporting our general approach, told us that the costs of compliance were disproportionate where enterprises wished to raise only small amounts of capital. They suggested that we should create a threshold below which social enterprises could raise capital without the requirement for promotions to be approved by an authorised person. Suggestions for the ceiling for this exception varied from £70,000 to £500,000.

2.9 One respondent proposed a special financial promotions regime for all 'community organisations' which were not authorised persons. The proposal would remove the need for offers below £500,000 communicated by community organisations to be approved by an authorised person. Instead minimum standards would be set out and such communications would be restricted to persons certified as high net worth investors, sophisticated or restricted investors (or those who have received advice from a regulated person), but formal sign off by an authorised firm would not be required. It was argued that overall this would protect investors while lowering the cost of compliance.

Our response

2.10 The feedback from social enterprises suggests that there is no single obstacle to the growth of social investment. While some respondents commented on the burden of regulation, many thought regulation brought positive benefits and pointed to other difficulties.

2.11 Having considered the responses, we are not persuaded that our current regulatory approach disproportionately impacts social enterprises in comparison with other small to medium sized businesses. Nor are we persuaded that the risk presented to consumers, and so to our objectives, is less for this type of business than it is for others.

2.12 Social investments carry risks, just like any other investment. These risks include the risk that the investor may not be able to sell their investment quickly at fair value, the risk of only limited return and the possible loss of their capital. Additionally, unlike more familiar investments, it can be difficult to value the investments in a social enterprise as the market in them is still developing. In these circumstances we do not believe that a relaxation of our financial promotion and suitability rules for social investment would be consistent with our consumer protection objectives.

2.13 We are also concerned that less experienced investors may be encouraged to invest by the social outcome, but be unable to weigh that benefit against the likelihood of losing their money. The suitability test is therefore important, as it protects individuals who are risking their money, but may not have an understanding of the market in which the business will operate and the chances of its success. The test ensures that firms providing investment advice take reasonable steps to satisfy themselves that the personal recommendations they make are suitable for their clients, and take into account the client's personal circumstances, knowledge of the market and risk appetite.

2.14 Regulation carries with it a cost and some respondents told us that the cost could make it uneconomic for small social enterprises to raise capital from the public. We have considered whether there are grounds for setting a minimum threshold below which some or all of our financial promotions' rules should not apply. However, the size of a particular capital raise may bear no relationship to the risk participating investors could be taking with their savings. In addition, the social objective could in itself encourage the investment of more money than some investors can afford to lose. We are not persuaded that increasing the risk to retail investors in order to reduce the costs to social enterprises is consistent with our consumer protection objective. As a point of principle we do not believe that social investors should receive less protection than other types of investor.

2.15 We recognise that retail investors are able to donate money to community and other schemes with a social purpose but they may not be able to invest in the same schemes. However, with donations individuals have no expectation of any return on their money. Social investments involve the prospect of some form of financial return, and this clearly has the potential to influence individuals' decision making. We do not therefore accept that social investments are sufficiently similar to donations as to merit lighter treatment under regulation.

2.16 We do not regulate the promotion of all types of social investment. The promotion of withdrawable shares issued by societies registered by us under the Co-operative or Community Benefit Societies Act is not subject to the financial promotion regulations. However, we have other powers in relation to these societies and we have published guidance on these societies.

2.17 We expect an invitation to join a co-operative or community benefit society to emphasise the benefits of membership and not a return which may be paid on invested money.

2.18 In the case of a community benefit society, we expect the benefit to the community to be the primary reason for joining the society and this should be clear from any promotional material. Signposting this clearly is an indication of compliance with our guidance.

2.19 Finally, it is important to understand what makes a financial communication 'a promotion' and so subject to our rules. For example, there must be an 'invitation' or 'inducement' to invest, and communications which seek to inform or educate about the mechanics or risks of investment are not considered to meet these criteria. Further information on this can be found in the Perimeter Guidance Manual.

Question for financial advisers and other intermediaries, including crowdfunding platforms

Q3: Have you experienced problems in advising investors who wish to invest in social enterprises, or for whom investment in a social enterprise may be suitable? If so, please provide details of these problems.

2.20 One respondent told us that it had proven uneconomic for them to participate in this market because of the small numbers of potential investors and investments, and the additional Professional Indemnity insurance (PI insurance) cost.

2.21 Some respondents commented on the unregulated nature of certain investments and raised issues relating to the availability of information in order to carry out due diligence on which to base recommendations. Concerns were also raised around the time necessary to carry out due diligence on social investments, and the cost of doing so. In addition, respondents shared concerns about a perceived lack of clarity over regulatory treatment of social investments, including the evaluation of the risk by both the regulator and PI insurers.

2.22 Our introduction of the restricted investor category in PS13/3[2] was welcomed by one respondent as both helpful and proportionate. The same respondent noted that the new investor category had not had any negative impact on its ability to raise capital for its clients. A 'restricted investor' is a retail investor who wishes to receive promotional communications relating to non-readily realisable securities and who certifies that he/she will limit their investments in accordance with the restrictions set out in COBS 4.7.10.

2.23 The respondent also told us that as part of their research before making their submission, they had sought the views of financial planning firms on potential regulatory barriers. The consensus was that there were no regulatory barriers to advising clients on social investments. However, there were other features of the market which could discourage intermediaries to enter it. Our respondent told us that these included:

- Internal compliance: how can suitability requirements be satisfied? Firms which do advise clients on social investments believe this requires a different conversation exploring clients' motivations as well as their financial needs.
- Due diligence: how do firms evaluate social investments and how can they benchmark them when the market is still developing?
- Risk: how will the firms PI insurer view this activity?
- Choice: there are few social investment opportunities available, particularly investments which attract Social Investment Tax Relief. Those which are available tend to be small in size and scale, leaving clients at risk of feeling over exposed for a comparatively modest investment.

2.24 Some respondents claimed that the absence of a definitive framework for measuring social impact was a negative factor and one respondent commented that if an impact isn't measureable, it can prevent a recommendation being made.

2.25 Another respondent said that clients found it difficult to understand that social investment can occupy a middle ground where both impact and financial return can be achieved with the same capital. Intermediaries also highlighted the challenge of recommending suitable products in absence of robust product development identifying clear target consumer markets and social aims.

2.26 One social enterprise believed there to be a knowledge gap on social investment among the advisor community and felt that solely commercial criteria were being applied to the market. This approach had, in the opinion of the respondent, stalled the growth of the market.

2.27 Concern was expressed by some respondents that there was a tendency to bracket social investments with traditional green/ethical investments. The latter, it was argued, are well established forms of investment at both retail and institutional level with different risk profiles, regulation and guidance. These respondents thought that association with social investments could have a detrimental impact on the market for green and ethical investments. However,

2 PS13/3 *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes* (June 2013)

other respondents considered green and ethical investments had a social impact, so could be regarded as social investments in their own right.

2.28 One adviser told us that clients could be attracted by a particular cause, or rate on a bond, without fully understanding the differences between an unregulated and a regulated investment. This bias led to clients making inappropriate comparisons, for example, between the return on high risk products with retail banking deposit rates. It was said that some clients attached little importance to the presence or otherwise of FSCS and Financial Ombudsman Service protection, ease of exit, the financial strength of the business being invested in or the diversity of its underlying assets.

2.29 A range of respondents, including some who attended our workshops, raised questions about the jurisdiction of the Financial Ombudsman Service to deal with complaints relating to the delivery of a social impact. Their concern was the risk that they might become the subject of a complaint to the Financial Ombudsman Service over social outcomes which could be difficult to predict or measure.

Our response

2.30 Any new development in financial services brings with it uncertainty before it becomes mainstream and is more easily appraised. In this context, regulation plays an important part in satisfying potential investors that they will be treated fairly and can therefore consider new markets as part of their investment portfolio.

2.31 In all cases, we expect firms selling these investments to act honestly, fairly and professionally in accordance with the best interests of the client, whether the sales are made directly or indirectly, using platforms or via financial advisers.

2.32 There is nothing in MiFID, MiFID II or our rules which prevents investment advisers from recommending social investments to their clients. These rules require firms to understand the client's financial situation, investment objectives, and knowledge and experience in the relevant investment field. The financial return might not be a client's only, or primary, objective so investments which fulfil a non-financial objective such as social impact will be suitable for certain clients. Any risks or disadvantages of these investments must also be clearly explained in the same way as for any other recommendation which might be made.

2.33 Where no advice is provided to retail clients the appropriateness test applies, so all firms (both MiFID and non-MiFID) must satisfy themselves that clients have the knowledge and/or experience to understand the risks involved.

2.34 Despite the application of these rules, the possibility of complaints to the Financial Ombudsman Service relating to social impact concerns some advisers, particularly because early stage uncertainty about the social investment market will likely be reflected in the cost of PI insurance. Providers will initially have little claims experience on which to base their evaluation of risk in what remains a relatively new market.

2.35 However, we feel this may stem from a misunderstanding of how the Financial Ombudsman Service is likely to approach such cases.

2.36 We believe that the presence of the Financial Ombudsman Service to provide independent adjudication over complaints is an important protection for social investors, just as it is for other types of investors. However, clarification of its approach may be helpful to financial advisers. We propose, in conjunction with the Financial Ombudsman Service, to carry out a communication programme targeted at social impact investment stakeholders, explaining how the Financial Ombudsman Service's rules apply in this particular context. We will work together with stakeholders to find the most effective way of delivering this programme which may include round table meetings, road shows or webinars.

2.37 Separately we have considered whether there is any merit in creating a new self-certified class of investor, as suggested by some respondents, which would enable investors to self-certify their social motivations. Self-certification is already available under our rules to 'sophisticated investors,' 'restricted investors' and 'high net worth investors'. As a consequence of self-certification, investors may receive financial promotions that have not been approved by an authorised firm, with content which may not conform to FCA rules. It could also allow 'social investment' Unregulated Collective Investment Schemes (UCIS) to be promoted to these investors, since the promotions would become exempt from the FSMA s.238 promotion restriction.

2.38 We have not seen any evidence which suggests there is a relationship between the wish to make a social investment and the knowledge and skills necessary to distinguish a sound investment from a poor one. Having engaged with the Financial Ombudsman Service, we have also learned of complaints where consumers had been promoted high risk unregulated collective investment schemes after completing 'high net worth' or 'sophisticated investors' declarations without understanding them. We therefore consider that creating a special class of self-certification could expose socially minded investors to additional and unnecessary risk of loss, even if there is a ceiling on such investments and the amount of exposure might seem small.

Questions for consumers and consumer groups

Q4: Have you identified barriers to investment in the social sector for retail investors? If yes, please provide details of these barriers, in particular identifying those that may be caused by regulation.

Q5: What kind of rules do retail investors need to consider when making sound investment? Have you identified any consumer protection concerns in this area? Please explain these concerns and how they might be addressed.

Q6: Do you have any evidence (e.g. figures, case studies or other practical examples) of the appetite retail investors have for social investments and related products, particularly compared to donations?

2.39 One respondent, a social enterprise, commented that it had turned away investment from retail investors who wished to support its purpose, but who did not qualify as certified sophisticated investors or high net worth investors. It contrasted the effect of the restriction on its capital raising with that of a society registered under the Co-operative and Community Benefit Societies Act, which could raise capital from retail investors without regulatory constraints. It believed that the restriction on the retail market resulted in significant sources of capital being untapped.

2.40 Another respondent told us that most of the barriers to the growth of social investment came from the immature and fragmented market place rather than from regulation. A small number of respondents commented upon the absence of an effective secondary market for buying and selling social investments.

2.41 A number of respondents reported what was seen by them as an advice barrier. They argued that financial advisers are reluctant to advise on social investments not only because they are considered too specialised and there is little data to support them, but also because investors in this area may have non-financial objectives that can make suitability difficult to establish. This creates advice liability concerns. The role of the Financial Ombudsman Service is discussed in the response to financial advisers.

2.42 A number of respondents suggested that some investment products should have enhanced risk warnings, and that the marketing and promotion of social investments should reflect their limited suitability to mainstream retail investors, including those qualifying as high net worth or sophisticated. Consumer protection safeguards, we were told, including recourse to the FSCS and, where relevant, the Financial Ombudsman Service should feature prominently.

Our response

2.43 We recognise that social aims can be a powerful driver for many investors. However, as suggested by one respondent, this can lead to bias because, all other things appearing equal, an investment which has a social benefit may look more attractive. It carries with it the satisfaction that a wider social benefit is being achieved by the investor through their investment.

2.44 Such biases, while understandable, reinforce the need for basic safeguards that ensure consumers understand the financial risks they take on through social investing.

3. Conclusion

3.1 In considering the evidence we received in response to our Call for Input, we have been guided by our operational objectives. These are to protect consumers, ensure market integrity and promote effective competition. As a point of principle we do not believe that social investors should receive less protection than other types of investor.

3.2 We want to see the market for social investment develop in a way that provides appropriate protection for consumers and is sympathetic to the philanthropic motives shared by people who actively choose to invest in a business because it has a social purpose. We believe robust regulation is an important pre-condition to establishing social investment as a viable, mainstream option alongside more traditional forms of investment.

3.3 We approached our Call for Input keen to understand whether any elements of FCA regulation are acting as inappropriate barriers to the sustainable growth of the market for social investments. Having reviewed the responses received, we have not identified any such barriers.

3.4 The social investment market is still in its early stages and we believe appropriate consumer protections are important if investors are to have the confidence to invest, and if the market is to flourish.

3.5 As the market develops, we see clients' understanding of the nature of social investments as key.

3.6 Understanding the client is critical. Is the client interested in social impact only and can they afford to lose all of their investment? Are they hoping for returns, but is the primary objective social? Or are they looking for returns and is the social impact secondary?

3.7 Financial advisers need time to understand this growing market in order to advise clients appropriately, but there is nothing in the current regulatory framework that prevents them from doing so. Rules around advice and suitability ensure that socially-minded investors benefit from the same protections as other investors.

3.8 However, responses suggest that there may be misunderstanding of the role of the Financial Ombudsman Service among sections of the adviser community. This misunderstanding may be unnecessarily holding back recommendations to invest in social enterprises. We will work with the Financial Ombudsman Service to clarify for advisers, and their PI insurers, the type of complaints they may consider and how they will be approached

3.9 In summary, we do not believe regulation is preventing the social investment market from developing. It can, on the contrary, ensure the development of strong practices which in turn lead to investor confidence and so encourage and support market development.

Annex 1
List of non-confidential respondents

Act on It

Association of Professional Financial Advisers

Barclays Wealth and Investment Management

Bates Wells & Braithwaite

Beacon Centre for the Blind CIC

Big Issue Invest Fund Management Limited

Big Society Capital

Breadshare CIC

British Private Equity and Venture Capital Association

Building Arts CIC

The Cart Shed CIC

Charities Aid Foundation

CIC Association

Clearly So

The Community Shares Company

Community Shares Unit

Co-operatives UK

EQ Investors

Ethex

Ethical Futures

Financial Services Consumer Panel

Firestation Arts & Culture CIC

Games for Life (CIC)

Geof Cox

Iridescent Ideas CIC

Jobs, Friends and Houses

John Copping

JUST

KUH Art Collective

Lincolnshire Co-operative

Manchester Active Lifestyles CIC

Möbius GATH CIC

Mydex Data Services Community Interest Company

National Council for Voluntary Organisations

New Philanthropy Capital

Nottinghamshire Community Energy

Page Russell

Parmenion

People-Centered Economic Development

Peter Munro

Radstock Co-operative Society

Sarratt Village CIC

Scottish Midland Co-operative Society

Shared Interest Society

Social Enterprise Mark Company CIC

Social Enterprise Solutions CIC

Social Enterprise UK

Social Finance

Social Investment Forum

Social Investment Scotland

Southern Co-operative

SRI Services

Stian Holen

Sustainable Hockerton

Trillion Fund

Triodos Bank

UBS Wealth Management

UKSIF

Wrigleys

Your Healthcare CIC

Annex 2
Further information

For further information on the wider context for social investing please see the report of the G8 Social Impact Investment Taskforce and the information set out by the European Commission's expert group on social business, GECES. Readers may also be interested in further information on Social Investment Tax Relief.

www.gov.uk/government/groups/social-impact-investment-taskforce

http://ec.europa.eu/growth/sectors/social-economy/enterprises/

www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief

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PUB REF: 005263

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