

**CONSULTATION ON “THE SOCIAL BUSINESS INITIATIVE: PROMOTING SOCIAL INVESTMENT FUNDS”
SUBMISSION OF THE UK SOCIAL BUSINESS INITIATIVE WORKING GROUP**

Members

Stephen Lloyd, Senior Partner, Bates Wells & Braithwaite London LLP (“BWB”) (Chair)
Alastair Ballantyne, Head of Communications, Big Society Capital
Neena Bhati, European and International Campaigns Team, National Council of Voluntary Organisations (“NCVO”)
Mark Campanale, Co-founder and Director, Social Stock Exchange
Paul Cheng, Head of Social Investment, CAF-Venturesome
Luke Fletcher, Associate, BWB
Oliver Henman, European and International Campaigns Manager, NCVO
Robert Hodgkinson, Senior Investment Manager, CAF-Venturesome
Ceri Jones, Head of Policy and Research, Social Enterprise UK
Martin Rich, Director, Social Finance
Karl H. Richter, Coordinator of Euclid Task Force for a European Social Investment Facility and co-author of Making Good in Social Impact Investment

www.bigsocietycapital.com

www.bwbllp.com

www.cafonline.org/Venturesome

www.euclidnetwork.eu

www.ncvo-vol.org.uk

www.socialenterprise.org.uk

www.socialfinance.org.uk

Introduction

The UK Social Business Initiative working group (the “Working Group”), has been formed to provide an opportunity for members of the UK social investment community to formulate and agree a co-ordinated response to the consultation entitled “*The Social Business Initiative: Promoting Social Investment Funds*”, issued by D.G Internal Market and Services on 13 July 2011 (the “Consultation”).

The Working Group warmly welcomes the Consultation and the interest shown by D.G. Internal Market and Services and the European Commission in social investment and its development. More broadly, the Working Group welcomes the Social Business Initiative and the attention which is being given by the European Commission to the particular circumstances and needs of social businesses.

The Working Group met twice to discuss the Consultation on 15 August and 5 September and to agree the final text of this submission. This response proceeds by summarising the views and positions articulated by the members of the Working Group in relation to each of the questions posed by the Consultation.

Box 1 – Defining Social Business

Do you agree that the main features of social businesses are as outlined above? To what extent do you think this initiative should focus solely on those social businesses that do not distribute profits to their investors? Or shall it also focus on those which distribute profits to their investors (e.g. at least to a limited extent)? If so, how might social businesses be distinguished from other businesses?

There is currently no one single widely accepted definition of “social business” in use in the UK.

The term “social enterprise” has greater currency in the UK than social business. In 2002, the UK Department of Trade and Industry defined social enterprise as “a social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners”. The shorthand description used by Social Enterprise UK is of a “business driven by a social or environmental purpose”. In both cases, a social enterprise is understood as being an enterprise in which the social imperative is greater than the profit imperative in the organisation of the business.

In a UK context, the terms “social business” or “social venture” often describe a wider category of enterprise which have a socially positive impact but which are nevertheless primarily driven by a need to maximise profit for shareholders and are not primarily driven by social purpose.

We expect that the definitional challenge will be even more acute when considering the range of legal forms social businesses may take across the European Union. If the European Commission plans to design a separate investment regime as part of its Social Business Initiative, the Working Group believes this is likely to meet with greater success if the regime does not turn sharply on definitional questions of what is or what is not a social business.

An alternative approach might be to have a regime which is defined by the nature or purpose of the social investment fund, which might expressly be to generate positive social impact as well as positive financial returns. A social investment fund of this nature would attract socially motivated investors and might justify different treatment to a general UCITS fund.

Box 2 – The funding challenge

What are the main difficulties social businesses face, in your experience, in getting access to finance?

A large number of studies have been conducted in the UK which evidence the difficulties faced by social businesses in raising finance. Copies of a number of relevant studies are appended to this submission. There is a more comprehensive literature available.

Social businesses are generally unlisted and do not have access to mainstream capital markets. This means that investments in social businesses are generally illiquid, as there is not yet an established secondary market in social investments. There are currently no social investment funds which are open to retail investors. The only social investment funds which exist are closed ended funds which are available only to appropriately qualified investors.

Supply and demand is therefore often mismatched. Investors complain of not enough good product and organisations of not enough capital. The social business marketplace requires engaged investors

who are prepared and able to build the capacity of social businesses and tailor capital to suit the need of social businesses. It requires intermediaries who understand the social business sector and who can manage the expectations of investors, as well as manage investment in social businesses.

Do different kinds of social businesses face different barriers?

Certain social business take on legal forms which may be described in shorthand as “social first” legal forms and which are almost by definition low profit distributing or non-profit distributing. Examples in a UK context of social first legal forms might include social businesses formed as charitable companies limited by guarantee, community benefit societies and community interest companies.

Social businesses with these legal forms may face particular barriers when accessing finance. Certain social business legal forms, such as the company limited by guarantee, are also unable to receive equity investment and can only issue debt. Some social business legal forms, such as the co-operative, operate on the premise of member participation and are therefore unable to publicly list shares or to permit the free transferability of shares in a secondary market.

The social investment market has therefore seen a broad range of intermediate capital products emerge, such as debt capital with royalty or revenue-linked repayment obligations which behaves more like equity than standard debt, as well as other tiered financing structures, including the use of first-loss philanthropic capital to attract investment seeking commercial risk-adjusted returns.

To what extent do you think barriers to access to finance are limiting the growth of social businesses across the EU? Do you agree that there is a need to tackle any such barriers at the EU level?

It is not clear to the Working Group that there is a need to tackle any barriers to investment in social businesses at the European level. The Working Group is of the view that barriers to investment in social businesses are predominantly at the domestic level.

However, the Working Group welcomes exploration by DG Internal Market of whether exemptions from the Markets in Financial Instruments Directive (“MiFID”) may be needed to enable localised social investment markets to develop across the EU, as the Working Group considered that the compliance burdens on social investment intermediary organisations demanded by MiFID are likely to be disproportionate to the social investment activity involved in the majority of cases, such as the underwriting of community share offers.

Some members of the Working Group believe that an argument can be made for a European social investment funds regime which could sit in parallel to UCITS. It is suggested that this could operate on the basis of individual investment limits into social investment funds, e.g. an investment limit of €10,000 per investor per fund. A requirement of this kind would effectively require individual investors to diversify their investment portfolios, limiting the risk of investor detriment, and permitting less exacting regulation and compliance requirements for passported social investment funds of this kind.

However, some members of the Working Group believe that social investment funds would tend to have a domestic focus and that citizens of EU member states were unlikely to want to invest in social businesses primarily active in other EU member states. In this view, the social investment market in Europe is unlikely to be developed enough to sustain a number of pan-European social investment funds or to justify the expense and complexity involved in the creation of a new or parallel European social investment funds regime. Other members of the Working Group believe that pan-European funds would offer diversification and that this would be a distinct advantage of a new regime.

Box 3 - The role of investment funds

How do you think funding through investment funds might effectively compliment other sources of funding, e.g. philanthropic funding? Are there any challenges here?

Social investment – investment for social as well as financial returns – is an emerging area and the Working Group expects it to develop quickly over coming years in the UK.

A number of factors point to a likely trajectory of growth in social investment in the UK, including:

- the development of “social impact bonds” (see www.socialfinance.org.uk/work/sibs), which are being piloted by the UK Government as a means of privately financing social action;
- the imminent operational launch of Big Society Capital (see www.bigsocietycapital.com), as a social investment wholesaler with a capital base including an estimated £400,000,000 to be received over time from unclaimed assets in dormant bank and building society accounts and £200,000,000 over four years from HSBC, Royal Bank of Scotland, Lloyds TSB and Barclays, and a mission to grow the social investment marketplace in the UK;
- an environment of fiscal austerity with increased need for investment in civil society; and
- the underlying growth of the social enterprise or social business movement in the UK

Some of the major challenges include:

- ensuring that civil society organisations and social businesses are ready to receive investment. Not all organisations are suited or will be able to make a move away from receipt of grant support to receipt of investment;
- increasing social investment is also likely to require developing and promoting new products to investors and intermediaries and encouraging changes in investment behaviours, which will require research and development and time; and
- law and regulation of standard investment products does not generally contemplate the particular characteristics of social investment and so as the social investment marketplace develops, it is likely that changes to existing law and regulation will be needed.

Do you think that the UCITS framework is sufficient for funding social business without change?

The Working Group does not believe that fundamentally changes should be sought to the UCITS framework in an attempt to shoehorn investment into social businesses into the framework.

The UCITS framework has developed a number of elaborate investor protections for good reason and does not discriminate against social investments. The reason social investments are not generally available under the UCITS regime is because the social investment market is not yet sufficiently developed to have a large number of liquid, listed assets.

Equally, there are as yet no specialist fund managers or collective investment schemes in place to invest in those social businesses which are already exchange listed.

Do you think a bespoke fund framework tailored to the needs of social business might be better suited to channel funds toward social businesses? (If you think the UCITS framework is not suited, please outline the features of the UCITS framework that you think are mostly responsible for this).

Opinion amongst the Working Group members on the merits of a bespoke social investment fund framework at the European level is divided. Some members of the Working Group consider it unlikely that social investment funds will have a pan-European or significant cross-border appeal. The majority of the members of the Working Group think it is unlikely that the expense or bureaucracy which is likely to be involved in the establishment of a parallel framework can be justified, given the emerging nature of the social investment marketplace.

Some members of the Working Group believe that social investment funds might have a thematic appeal across member states and the example was given of social investment funds specialising in generating positive benefits for the environment or international development. The suggestion was made that a framework for social investment funds could be established in parallel to UCITS by operating on the basis of investment caps which would only permit a certain level of retail investment into each fund, such as by only permitting retail investments of up to €10,000, to limit the risks to retail investors. A regime of this kind could conceivably allow some limited retail exposure to unlisted and illiquid social investments, to assist in the development of the market.

Box 4 – The role of investors

What features of a social investment fund do you think are most important for retail/professional investors?

The following features were considered most important for investors:

- the projected returns of the fund
- the size of permitted investments into the fund
- the diversification of assets in the fund
- the track record of the manager of the fund
- the liquidity of the investment

What specific pre-contractual information do you think would need to be provided to retail investors?

The Working Group believes that the pre-contractual information requirements should be the same as for any other retail investment and that the starting point should be that disclosure should not be

any different for social investments except that social investments funds ought to be required to disclose the nature and scale of expected social impact.

Should the framework encompass funds that explicitly forego greater financial returns for the benefit of the social impact of their investment, or that expose investors to greater risks, or both?

Any bespoke social investment framework would need to consider both funds which forego greater financial returns for the benefit of social impact and those that expose investors to greater risks.

The Working Group takes the view that it should be up to investors to decide what level of risk, return and impact an investment is intended to achieve and that what is important is that funds make adequate disclosure to investors in relation to risk, return and impact.

Box 5 - Liquidity

What do you think would be the appropriate time frame for redemption of units in a social investment fund, e.g. monthly? Please give reasons for your answer.

There is no established secondary market for social investments and so it is not currently possible to require periodic redemptions. Investors making social investments at this stage of market development will need to accept that social investments are long-term investments.

As the market develops and more underlying social investments become exchange listed, particularly if a social stock exchange is established, it may become possible in time to require periodic redemptions in social investment funds.

Do you think there are other options for balancing the liquidity that small retail clients might be seeking with a focus on a long-term time horizon? (For instance, requirements on holding certain levels of liquid assets, lock in periods, etc.)

Given the early state of development of the social investment market, investors should be encouraged to see social investments within their portfolio as illiquid and long-term and therefore to be positioned alongside other parts of their portfolio which are more liquid. A regime allowing retail investment up to a defined limit could potentially encourage this kind of portfolio approach.

A fund regime, such as UCITS, requiring certain levels of liquid assets would require diversification in other asset classes and, at this stage of development of the social investment market, would not allow a fund to be wholly dedicated to investment into social businesses. However, it might be possible to establish a social investment fund under UCITS which is diversified across a range of social investments in different asset classes, such as debt, property, equities, cash and real assets.

Box 6 – Risk diversification

Do you think that social investment funds should be subject to diversification rules?

To the extent that the social investment market possesses a diversity of underlying social investment assets, diversification may be desirable. However, the Working Group took the view that diversification should primarily be driven by the judgement of fund managers and by the asset classification which is set out in the relevant offer document at fund launch and should ideally not be driven by external regulation. On this analysis, provided the risks of investment into a particular fund are adequately disclosed to investors, investors should be free to make their own decisions.

Some members of the Working Group believe that a retail investment regime involving investment limits for individual retail investors could in effect require retail investors to diversify their own portfolios and could achieve a similar protective effect to requirements for social investment funds to diversify underlying fund assets.

To what extent do you think investors might expect a fund focused on social businesses to only invest in social businesses?

The Working Group is not aware of any market research on investor expectations for social investment funds and is unable to comment with authority on this question. It was considered important that any social investment fund should engage in full and accurate disclosure to investors with respect to its percentage levels of investment into social businesses. Ideally, a social investment fund would be completely committed to social investments, although it was acknowledged that a time window may be needed to allow for investments into illiquid assets to be made.

Should social investment funds be required to invest into different types or numbers of social business? (How many separate businesses might be required?)

The Working Group is of the view that mandatory requirements for investment into different types or numbers of social businesses would be extremely unhelpful. The Working Group believes that the choice of investments should be in the hands of fund managers and that provided adequate disclosure is made to investors of the overarching fund investment policies, investors should be able to determine whether or not investment into a social investment fund is an attractive option.

Should there also be diversification across asset classes different from social business? (What limits might be appropriate? For instance, 40% social businesses, 60% highly liquid transferable securities).

The Working Group does not consider mandatory diversification across asset classes to be necessary. Again, provided adequate disclosure is made to investors of fund investment policies, investors should be free to decide whether or not to invest into a social investment fund.

Box 7 – Types of assets and strategies

What types of assets should a social investment fund be able to invest in? Please give examples.

It is not considered necessary to limit social investment funds to any particular asset classes or to any particular legal form of underlying investee social business.

Should the funds be limited to certain kinds of strategies (for instance, aimed at maximising their attractiveness for retail investors)? If so, which?

It is the firm view of the Working Group that investment strategy should be a matter for management discretion.

What rules or limits might be necessary to prevent firms using a new framework to circumvent restrictions in other frameworks (e.g. UCITS)?

The use of investment limits for individual retail investors could be used to create a regime with a very different scope to UCITS or other investment frameworks.

There might also be scope for requiring social investment funds to obtain the approval of national social regulators, such as the Community Interest Company regulator in the UK. A national approval requirement of this kind, potentially in addition to a standard national financial services authority approval in respect of the fund and/or fund manager, could limit the potential for abuse.

Box 8 – Asset valuation

Do you agree that it would be impractical for social investment funds to have frequent valuations of assets? Please give reasons for your answer.

At the current stage of development of the social investment market, it is not clear to the Working Group how a frequent valuation of assets requirement would work.

One suggestion was that social investment funds could operate a ‘mark to model’ method of asset valuation, similar to the method sometimes used in private equity contexts, with periodical updates on the discount rates used in the models to reflect what is actually happening with the investee social businesses. A new regime could permit a regulated version of mark to model, with an annual audit completed by external auditors to ensure that valuation methodology is objective and robust.

At a more mature stage of development, when there are more listed social investments and established secondary markets, frequent valuations requirements will be more manageable.

If so, for the purposes of investor protection what frequency might be appropriate? Please give examples.

The Working Group takes the position that if frequent valuations are determined to be necessary, annual valuations would be likely to be most appropriate given the stage of market development.

Do you think that any non-social business assets that might be permitted should be subject to different valuation requirements? Might different kinds of assets require different approaches?

The Working Group cannot see how different valuation requirements for different assets could overcome the underlying issue of the illiquidity of the majority of existing social investments.

Box 9 – Social assessment and reporting

Social investments do not necessarily need to prioritise social returns over financial returns and the Working Group believes that this view should be challenged.

A social investment may or may not prioritise social returns over financial return. What distinguishes a social investment is that it is made with the expectation of both financial and social returns. This means that social investments can occur along a spectrum, ranging from those which prioritise financial return to those which prioritise social returns.

How do you think 'social returns' might be best addressed and measured?

The Working Group is of the view that social investment funds should be required to report on social returns but that different impact metrics and reporting mechanisms may be appropriate to different forms of social investments and that any social investment regime would need to be open and flexible enough to permit different approaches to measuring and reporting on social returns.

It was noted, for example, that large NGO's might be able to engage in detailed analysis of social impact, whereas this might be beyond the capacity and skills of small social businesses. It was also felt that a social investment fund would be likely to have difficulty in aggregating the different social impacts of its underlying portfolio of social business investees.

Ideally, measurement systems should be flexible and capable of being scaled both up and down. When specific metrics are used, the metrics should be used consistently and it should be possible to track developments in outcomes over time on a like-for-like basis.

How might this build on other existing work, for instance on non-financial company reporting, social accounting, socially responsible investing, etc?

A number of different approaches to social impact measurement have been and are being developed, including Social Return on Investment, Global Impact Investment Ratings System, Outcomes Star, Social Auditing and others. The social impact measurement field is developing and established standards have yet to find universal or near universal acceptance.

It is important that any social investment fund regime is agnostic with respect to different forms of impact measurement. At the same time, there is a need to ensure that certain minimum quality standards are met. Minimum standards could be articulated on a principles basis or there could be a requirement for some form of independent assurance or auditing of social reporting.

What information do you think needs to be disclosed to investors and how might this best be presented?

The Working Group considered that the approach to measurement of social returns should as far as possible be a matter for the discretion of management and should be disclosed to investors.

Box 10 – Investor Participation

Do you agree that investor participation will contribute to the success of these funds?

The Working Group believes that the relationship between investor and fund manager should be the same within the context of a social investment fund as it is within the context of a standard fund.

A typical investor would not expect to be on the Investment Committee or directly involved in the daily running of a standard financially-focused fund and commensurately we do not believe that investor participation is advisable, or indeed practical, for social investment funds. The fund manager should employ a professional team to undertake these activities in both contexts and investor participation is highly unlikely to be beneficial to any party.

Certain knowledgeable investors might be invited to sit on an Advisory Committee for a financially-focused fund and social investment fund managers might wish to mirror this approach. The Working Group acknowledges that the “investor experience” is particularly important in the context of social investment, as investors are typically keen to see the impact that investments are making and often want to feel engaged with the underlying projects.

The Working Group does not believe that investor participation is a subject that should be mandated within a social investment fund framework. Instead, it should be left to fund manager discretion.

Box 11 – Risk Management

Which particular features of social investments might require specific risk management requirements? When considering this question, please also consider issues of non-financial outcomes and risks.

The Working Group believes that, if there is to be a bespoke social investment fund regime, there may be a need to protect the social mission of the investment fund. This could be achieved by means of national authority approval and regulation of social investment funds which are required to be constitutionally committed to creating positive social impact in addition to financial returns and which are not required to change the nature of the social focus without regulatory approval.

With respect to general risk management, the Working Group believes that investors and intermediaries should be free to implement their own risk management strategies as they see fit, within the existing framework of financial regulation and best practice.

Box 12 – Depositary

What should be the duties of a depositary (e.g. tracking the funds' assets, reconciling units or shares issued with subscription proceeds received)? Please give reasons for your answer. Please take into account the specific kinds of assets that might be held by a social investment fund.

The Working Group agrees that it is difficult to see how a depositary could be expected to hold social investment fund assets, given that the majority of social investments are currently unlisted. It is possible that a safekeeping function may be possible and appropriate at a later stage of market development when there are more listed social investment assets.

However, the Working Group believes that it is essential for control functions to be exercised in respect of social investment funds, to remove the risk of abuse and fraud. To limit costs, control or audit functions would ideally incorporate both a financial audit and, in effect, a social audit. There may also be a role for depositaries when it comes to winding up a social investment fund, to prevent directors from disposing of assets prior to a statutory liquidation process.

Box 13 – Remuneration and cost structures

How might the sustainability and profitability of a social investment fund regime be ensured? Are there particular factors in your experience that might determine the commercial success of the fund?

The Working Group did not consider it possible to guarantee or ensure the sustainability and profitability of social investment funds generally. In a particular case, sustainability and profitability are likely to be determined primarily by the success of any underlying investee social businesses and the ability of the fund manager, although specific state or other guarantees may also be available.

In your view, what kinds of incentive structures might be appropriate or inappropriate for the managers of the funds (e.g. performance fees versus flat management fees)?

The Working Group believes that if social investment funds are to be promoted to retail investors, there is a need for regulation of management fees and incentive structures, particularly given the long-term and illiquid nature of most existing social investments.

It is possible to imagine a requirement for national authority approval of fees and incentive structures for retail social investment funds. National authorities could be obliged to ensure that fees are reasonable and proportionate given the nature of the fund, such as by ensuring that fees do not exceed certain percentage limits and/or by ensuring that carried interest is only available to managers where investments are realised and returns exceed a reasonable hurdle rate.

Any regulation of management fees would need to be sensitive to the different strategies and approaches used by different investment funds but could potentially be based on the “total expense ratio”, being a measure of the total costs of fund management, of each individual fund.

Box 14 – Improving transparency and clarity

What steps do you think should be taken to improve transparency for investors in relation to funds targeting social businesses?

The Working Group considered that the Prospectus Directive disclosure requirements would be likely to provide an adequate basis for initial disclosure to investors.

The Working Group also considered that a mandatory annual disclosure regime might be appropriate. A regime of this kind could require an established form of annual report with disclosure of prescribed details, including, as a minimum, an annual valuation, investments held, transactions conducted, returns realised and material developments.

What steps do you think should be taken to improve transparency for fund managers about the social businesses which they target?

The Working Group believe that it should be for fund managers to determine what information they need from social businesses and how that information should be provided.

Box 15 – Improving transparency through common criteria

How do you think common criteria for defining, labelling and rating social funds and social businesses might be most effectively established?

The Working Group does not consider the social investment market to be sufficiently developed to justify common criteria for officially defining, labelling and rating social funds and social businesses. The social investment market is seeking to establish common criteria for defining, labelling and rating social businesses and, in time, will likely do so in relation to social investment funds.

The Working Group believes that appropriate disclosure on the part of funds to investors is of greatest importance and that any claims made by social investment funds must be justifiable.

Who should establish them and develop them over time?

The Working Group believes that common criteria for defining, labelling and rating social funds and social businesses should be led by the market and by civil society.

The Working Group does not consider this to be an area in need of regulation, other than possibly with respect to the general definition of social business or social investment funds for the purpose of demarcating the parameters of a bespoke regime.

How might they be verified, to ensure they are appropriately used in practice?

National authority approval of initial social investment fund prospectuses and the auditing of social investment fund reports, including auditing of social reporting, could potentially provide a sufficient level of independent verification for the purposes of a bespoke regime and investor protection.

Box 16 – A common EU label

Do you think a strong new EU label (e.g. supported by a common logo) would help social investment funds succeed? How might the appropriate use of such a brand be ensured in practice, and potential for confusion with other brands or labels diminished?

The Working Group did not consider there to be grounds for an EU label for social investment funds at this stage unless a labelling system could be made to work in a very simple and straightforward way. The Working Group had concerns about the bureaucracy which might be involved in any new labelling system and queried whether this could be justified at this stage of market development.

The Working Group believed that research should be conducted to explore whether a labelling system would have the effect of improving distribution or levels of investment into social investment funds and acknowledged that a system could potentially be beneficial as the market develops.

Box 17 – Ensuring effective integration with social businesses and distributors

What steps do you think might be taken at the European level to facilitate better intermediation between funds and social businesses?

Most investment funds do not set out to discriminate against social businesses. Instead, most social investments do not match most funds' investment criteria, which is unlikely to change.

At a European level, one source of facilitation would be the provision of capital to assist social businesses to get market-ready, or indeed an early stage investment fund which seeks to get social businesses up and running before refinancing them into more commercial funds in due course.

If at a European level all funds were required to report on social impact, this would also help to break down barriers between social investment funds and standard investment funds.

Are there particular responsibilities that you think fund managers should take on?

The Working Group does not believe that fund managers should be required to take on any additional responsibilities other than responsibilities directly related to fund management.

Do you think there are any possible actions at the European level that might ensure effective distribution of social investment funds?

The Working Group believes that one of the reasons why social investments are not widely distributed to retail investors is because of their current largely illiquid and unlisted nature and the consequent conclusion on the part of the Financial Services Authority that investments, for example, in unregulated collective investment schemes with a social focus are not suitable for retail investors.

If a view could be taken at the European level of the suitability of social investments for retail investments, for example, that it is suitable for retail investors to invest up to a certain defined

investment limit of, for example, €10,000 in unlisted, illiquid social investments, this would be likely to significantly aid the development of a retail market for social investments and would enable the lawful distribution of social investments to retail investors on the part of intermediaries.

Box 18 – Use of other incentives, including tax

How might incentives be made useful?

The Working Group agrees that a case could be made to Her Majesty's Government for tax incentives to encourage investment into social investment funds. The Working Group welcomes any steps the European Commission can take to clarify and confirm the compatibility of tax incentives for UK based social investment funds with European law, including State Aid.

Are there any other measures you think might be possible to maximise investor's access to social investment funds or the attractiveness of these for investors?

The Working Group considers that tailored exemptions from MiFID, which exempt financial services activity in relation to social investments, might aid the development of social investment intermediaries and therefore the growth of the social investment marketplace.

**Note prepared by Luke Fletcher of Bates, Wells & Braithwaite London LLP
on behalf of the UK Social Business Initiative Working Group
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APPENDIX

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