Capital: Foundations for New Growth in Co-operatives

Linda Barlow

This short article is a reflection on the lecture given by Ian Snaith during Co-operative Fortnight and outlining the basic rules of capital within co operatives registered as industrial and provident societies (IPSs). It sets out the differences between the share capital available for co-operatives and the share capital of companies limited by shares and examines the value of potential capital injection from what are known as 'non-user investor members' and recent developments. It also looks at how Co-operatives UK in partnership with its members is developing a self-help approach to work with, learn from, and support those that are using share capital to own and run co-operative businesses.

Over the last five years there has been renewed interest in the co-operative model from government seeking to spin out services into 'public service mutuals' and community groups seeking to take over or rescue an asset that, if lost, would have a negative impact on their local community. The truth is that co-operatives have always been able to generate capital by issuing shares to members and in return the member can exercise certain rights in that co-operative, by virtue of some basic co-operative rules. These are:

(a) one member, one vote. A core principle of co-operation, in that in return for the payment of initial shares, a member receives one vote and one vote only at general meetings of the co-operative; and

subject to agreement of the members:

(b) to receive distributions from the co-operative based on the transactions a member has with the co-operative and not on the number of shares the member holds in the co-operative;

(c) to receive a limited return on the capital employed in the co-operative.

Like other businesses, co-operatives enter into financial relationships with their members (more usually referred to as shareholders) and third parties.

However, unlike other businesses, section 1(3) of Industrial and Provident Societies Act 1965 (IPSA1965) states that in a co-operative this must not be the overarching relationship and under no circumstances must the relationship be a purely financial one.

In respect of a co-operative's members, guidance produced by the Financial Conduct Authority (FCA) goes one step further and sets out that in the case of a co-operative's members they:

> should receive only limited compensation (if any) on any share or loan capital which they subscribe. Interest on share and loan capital must not be more than a rate necessary to obtain and retain enough capital to run the business.

So what types of share may a co-operative society issue?

IPSA is very light on the types of share co-operatives may issue and says very little about the terms and conditions attached to these shares. As such, provided that it is clearly set out in the governing document, co-operatives may choose to issue, withdrawable, transferable shares and/or preference shares as well as novel types of share — yet to be invented, provided that they comply with the co operative principles.

Withdrawable share capital, a feature unique to the (IPSA) is the most widely used type of share capital used by co-operatives. Currently, a member which is a natural person may hold up to £20,000 of this type of share capital in a co-operative. However, there is no limit if the member is another industrial and provident society (IPS).

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Unlike conventional company shares, which can be transferred or sold by shareholders to others at a mutually agreed price based on their personal valuations, withdrawable share capital cannot be transferred between people. Instead, the Law allows shareholders to withdraw their share capital, subject to agreed terms and conditions that protect the co-operative's financial security. Withdrawable share capital is not as heavily regulated by the Financial Services and Markets Act 2000 (FSMA 2000) as transferable share capital in conventional companies. This means that co operative societies enjoy some exemptions from FSMA covering the approval of financial promotions. However, this flexibility means that investors in co-operative societies have less protection as there is no scrutiny of share offer documentation in advance of it being issued.

Withdrawable share capital is proving increasingly popular amongst community activists that wish to raise capital and figures from the Community Shares Unit (CSU) taken from research by Ernst and Young show that since 2009, there have been 131 community share offers compared to 108 initial public share offerings.

Room for Manoeuvre – Opening up the Co-operative Capital Base

It makes sense for a co-operative that is owned and controlled by its members on a one member, one vote basis to operate by stringent rules that prevent members and third parties from gaining too much control purely by reason of the amount of capital s/he or it holds in the co-operative but this can limit the a co-operative's access to capital.

In 2006, the Financial Services Authority (now the FCA) opened up the possibility of permitting a 'Non-User Investor Members' class of membership in co-operatives and societies generally. In short, for the first time a co-operative could choose to admit members who may have an interest in the co operative's activities but whose primary function is to inject capital into the co-operative. However, the choice to admit non-user investor members is balanced by a number of conditions, which are:

- The governing document must still adhere to the basic co-operative rules and include a clear provision on the rights of non-user investor members.
- The rights of non-user investor members do not extend to participating in decisions on the conversion of the co-operative to a limited company but may include participating in decisions on the application of co-operative's surplus and/or electing non-user investor members to the co-operative's governing body.

A number of sponsoring bodies have produced model rules that permit a non-user investor class of member and Co-operatives UK membership classification policy recognises co-operatives with a non-user class of membership provided that this is restricted to 25% or less of the whole membership and, where such members are permitted to hold office, that they comprise a minority of the Board. However, is this enough in order to enable co-operatives to generate the capital they need to be real competitors in the UK economy or are there limits to the business sectors co-operatives can infiltrate due to capital restrictions?

One such restriction is the combination of the limit on shareholdings of withdrawable share capital with the inability of co-operative societies, unlike companies, to issue redeemable transferable shares. This results in a disadvantage for co-operative societies in that they cannot take advantage of substantial injections of capital from individual members, unless that member is also an IPS.

In July this year, following a successful campaign from Co-operatives UK, HM Treasury issued a consultation on its plan to increase the current statutory limit on withdrawable shareholding. The intention is that the current limit, which was set in 1994, will be raised initially to £31,000 but with scope to increase this further for co-operatives that require higher capital input. The government is currently consulting the co-operative sector on how IPS legislation can be improved and raising the limit on withdrawable share capital plays a key part in the discussion on how to level the playing field between co-operatives and other corporates.

Towards the Future with an Eye on Best Practice

A number of initiatives are ongoing which seek to grow the co-operative economy through improving the legislation for co-operatives in the UK, supporting co-operatives on the ground and educating the public to make them more aware of the co-operative option.

Broadly these initiatives include:

(a) Improvement of the current FCA guidelines on capital reward and shares with flexibility within the co operative principles.

(b) The development of the Community Shares Unit (CSU). Delivered by Co-operatives UK and Locality and backed by the Department for Communities and Local Government, the CSU is a dedicated support service for those interested in, and involved with, community share offers. The CSU is currently devising a community shares handbook intended to be a guide for practitioners about the legal requirements of IPS legislation as well as good practice recommendations relating to community shares.

(c) Co-operatives UK has recently published a discussion paper by Mark Hayes on capital finance for co-operatives, which makes a series of recommendations to enable co-operatives to unlock access to capital without comprising member control.

The Author

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Notes

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