A Simple Guide to Financial Promotions

A legal briefing for charities and social enterprises considering raising funds through investment

August 2016

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Charities and social enterprises can obtain finance in many ways – through donations, grants or contracts from local authorities, trading with businesses or the public, and by raising investment. In many cases, a charity or social enterprise will get the funds it needs without needing to consider raising investment, such as by way of shares or loans.

The choice to raise investment may be more appropriate for some organisations than others, and should be based primarily on the ability to satisfy the financial commitments made in any offer to investors. A regular, reliable income stream from an asset or trading activity will often be a key financial consideration.[1]

This briefing focuses on the legal requirements that apply to charities and social enterprises when raising investment and communicating investment offers, and addresses the key questions that directors, trustees and senior employees should consider.

Part 1 of this note considers those key questions, including the exemptions available from the requirements of the financial promotions regime and when and how to consider using social investment tax relief ("SITR"). Part 2 gives some examples of charities and social enterprises with different legal forms raising investment in different ways.

[1] The trustees or directors of unincorporated legal forms should think very carefully before raising investment, as there may be a risk of personal liability for the trustees or directors involved.

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PART 1

Key questions to consider

KEY QUESTIONS

1. What is the legal form of my organisation?
2. What type of investment am I offering?
3. How much needs to be raised?
4. Who are the potential investors?
5. How will the offer be communicated?
6. What tax reliefs could be available to investors?

1. What is the legal form of my organisation?

In this briefing "charities and social enterprises" means all forms of charity (company, trust, CIO, charitable community benefit societies or otherwise), non-charitable community benefit societies, and community interest companies ("CICs", either limited by shares or guarantee).[2]

Whilst these legal forms share a mission to act for the benefit of society and an asset lock embedded within their form, the legal requirements for investment offers are not the same for each.

A charitable company, trust or CIO, and both forms of CIC, must follow the rules of the financial promotions regime (see box below) in the same way as a commercial company. By contrast, a community benefit society can use an exemption from the financial promotions regime if the investment offer relates only to non-transferable shares.

If an investment offer needs to follow the financial promotions regime, it must be approved by a firm authorised by the FCA. This means the offer will need to be able to bear the professional fees of the authorised firm, and the organisation will have to be very careful about how it communicates information about the offer.[3] Given the time required to complete the approval process, the fees charged by the relevant authorised firm may be difficult for small investment offers to sustain.

Your first step should therefore be to identify the legal form of your charity or social enterprise, as an exemption from the financial promotions regime based on legal form may have a significant effect on the cost of making the offer.

Alternatively, some organisations choose to ask an authorised firm to approve the offer despite the availability of an exemption (based on legal form or via another exemption), as a means of promoting best practice and giving comfort to investors, and you may want to consider whether this option is appropriate.

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[2] There are other legal forms that could come within a definition of "social sector organisation", such as a Royal Charter Body, but these are outside the scope of this briefing.
[3] The Financial Conduct Authority keeps a register of authorised firms, which may include banks, accountancy firms and solicitors' firms: https://register.fca.org.uk/

Key questions to consider

Financial Promotions Regime

A financial promotion is any communication that invites or induces someone to invest in a particular investment. To protect the public, promoting certain investments is regulated by legislation, including the requirement that those promotions are "approved" by an FCA authorised person. In that case, all communications about the investment will need to be reviewed and verified to make sure they are "fair, clear and not misleading", as well as fulfilling certain other specified requirements under the FCA's rules.

As the approval process requires detailed work and takes time, the costs of approving an investment offer can range from the thousands to the tens of thousands of pounds. It is important to have early conversations with authorised persons about your intended approach to the offer so that the approval process is as efficient as possible. In some cases, these conversations might lead to approaching the offer so that it does not have to be approved, for example by using one or more exemptions.

You should have these conversations as early as possible, and not less than three months' in advance of the date you would like to launch the offer. See this DIY Social Investment Guide for an example of how to take the first steps towards an offer.

2. What type of investment am I offering?

Most investments into charities and social enterprises are by way of shares ("equity") or debt ("loans" or "bonds"), and the amounts raised can range significantly in value. The most appropriate type of investment will depend on the organisation's legal form, financial circumstances and the attitude of potential investors.

The type of investment will affect how an invitation to invest can be communicated to potential investors - a community interest company offering ordinary shares will face different requirements to a community benefit society offering withdrawable, non-transferable shares (often known as "community shares"). The former is subject to the financial promotions regime, whilst the latter is exempt.

Charities and social enterprises may also wish to make separate offers for different types of investment, depending on the financial needs of the organisation.

If the investment is to be made as a simple loan between the charity/social enterprise and a small number of people, it is likely that it will fall outside the financial promotions regime. Many smaller charities and social enterprises have structured investment offers in this way, including those that are eligible for SITR. It is important that the loan could not be classified as a "debt security" (in which case it is likely to fall within the regulatory regime), and you should seek advice on this point if you are unsure. However, this may be a simple and cost effective route to consider.

3. How much needs to be raised?

The amount being raised can affect both the type of investment offered and the way it is communicated. For example, a community benefit society cannot allow an individual or institution[4] to own more than £100,000 worth of its withdrawable shares. Or, for example in a SITR investment, there are limits to the amount a single investor can hold.

This briefing focuses on investment offers which are beneath €5m. This threshold means that the organisation raising the investment does not need to issue an approved "prospectus" and therefore follow a separate regime to the financial promotions rules.

Alongside the regulatory considerations, you should carefully consider the amount you intend to raise alongside the type of investment offered, to ensure it is financially suitable for your organisation.

What is Social Investment Tax Relief?

Social Investment Tax Relief (SITR) is a tax relief designed to encourage individuals to invest in charities and social enterprises and help these organisations access new sources of finance. Individuals making an eligible investment can deduct 30% of the cost of their investment from their income tax liability.

The maximum investment into an individual organisation is approximately £270,000 over three years. Individual investors can invest up to £1million and can invest in multiple social enterprises per year.

In the 2014 Autumn Statement, the Government announced its intention for this limit to increase to £5million per year and £15million in total per organisation, subject to EU state aid clearance, which is expected in 2016-17 barring any unforeseen delays.

For more information on Social Investment Tax Relief, please click here.

4. Who are the potential investors?

The legal requirements apply differently to different categories of investor, with some classes requiring more protection than others and some categories benefitting from exemptions.

The most common categories of investor are:

- **"High Net Worth Individuals"** - those who, during the previous financial year had an annual income of £100,000 or more or who held, throughout the same year, net

[4] However, if the shareholding institution is another community benefit society, or one of certain other legal forms, this restriction does not apply.

assets of £250,000 or more. “High Net Worth Institutions” are, broadly, those with at least £5m of share capital or net assets.

- **“Sophisticated” investors** - those who can meet a number of different criteria, based on experience of investments, and who have signed a certificate to that effect. You might find sophisticated investors and high net worth individuals/institutions through independent financial advisors, angel networks and social investment intermediaries.
- **Investors who share a “common interest”** - where a pre-identified group of people share a common interest in the organisation and how it will use the investment.
- **“Restricted investors”** - ordinary members of the public who declare that they will not invest more than 10% of their net assets (excluding their primary residence, pensions and life cover) in unlisted shares or debt products.
- **Ordinary members of the public** who do not fit into any of the above categories.

Broadly, investment offers made to High Net Worth Individuals and Institutions, Sophisticated investors and those within the “common interest” category can be made exempt from the financial promotions regime, and so may be good categories of investor to approach to avoid the costs of complying with the financial promotion regime.

However, you must ensure that a communication not complying with the financial promotions regime is only made to those who you already know fall within these exempt categories, so specific steps need to be taken to establish which category an investor falls into **before** a communication promoting the offer can be made to them.

The “common interest” exemption also requires that a sufficiently close connection to the organisation can be established before the offer can be promoted. How “close” this connection must be is not currently clearly defined and consequently this route is not often used by charities and social enterprises. It is commonly accepted that existing company law members or shareholders are sufficiently close, but it is likely that those who have simply signed up to a mailing list, or donated to the organisation, will not satisfy the “close connection” test and advice may be needed in individual cases. Using this route requires that certain steps are taken to make investors aware that the offer is using the exemption.

Investors who fall into the “Restricted Investor” category may receive communications about investment offers, but those communications must comply with the financial promotions regime. Ordinary members of the public who do not fit into any exempt category above may not be able to invest at all (unless another exemption applies to the offer).

The Appropriateness Test

This test applies where an offer must follow the financial promotions regime. Unless an individual investor (either High Net Worth, Sophisticated or Restricted) has received advice from an authorised person, he or she must pass an appropriateness test. The test is usually a set of questions which have been designed to show that the investor understands the nature of the investment which is being offered and the nature of the risks attaching to the investment. It is relatively straight forward process to complete.

In many cases, organisations can work with crowdfunding platforms to identify "Restricted Investors" before they are given the chance to invest, and so the identification process can be streamlined and coordinated with the application to invest.[5]

Communications which are only "signposts" to the existence of an investment offer, or which ask a potential investor which category they might fall into, are not considered financial promotions, and can be made without restriction.

5. How will the offer be communicated?

Where the financial promotion regime applies, the method of communication can be very important in making sure the legal requirements are met. This is because the financial promotions regime requires that "direct offers" can only be taken up by High Net Worth, Sophisticated or Restricted Investors who have passed an appropriateness test (see box). Where an approved offer is to be distributed widely, an online process through a crowdfunding platform may be the most efficient way to ensure that the offer is only received by suitable recipients and that ordinary members of the public take the correct tests before an investment can be made.

It is important to understand that preliminary communications, such as adverts, fliers and website pages may also need to be approved and not only the investment offer itself, which can add complexity and approval costs.

Where a charitable company limited by guarantee or CIC decides to offer an investment to ordinary members of the public without using a crowdfunding platform, it should take advice on the prohibition on private companies making offers to the public and what this means in practice with respect to how any investment offer should be structured.[6]

Where an exemption from the financial promotion regime applies, the "Restricted Investor" and appropriateness test requirements do not apply, but the offer must still be made in accordance with the particular exemption.

[5] The UK Crowdfunding Association represents many of the crowdfunding platforms in the UK engaged in investment-based crowdfunding. A list of the Association's members can be found here.
[6] Section 755 Companies Act 2006 provides that private companies (including community interest companies) cannot make public investment offers except on certain conditions. This restriction is separate to the financial promotions regime.

6. What tax reliefs could be available to investors?

Certain investment offers can allow individual investors to benefit from tax relief. Structuring the investment so that the target investors are more likely to receive tax benefits from their investment is likely to increase the success of the offer.

Social Investment Tax Relief ("SITR") (see box) is designed to encourage investment in charities and social enterprises, and Big Society Capital's "Get IT" program provides further help in using SITR. Charities and social enterprises might also consider using the Enterprise Investment Scheme, ("EIS") or Seed Enterprise Investment Scheme ("SEIS").

These three reliefs share in common the effect of reducing an investor's taxable income by a proportion of the amount they invest – SITR and EIS apply 30% relief, and SEIS 50% relief. However, only SITR applies to both equity and debt investments, and is likely to be more useful to charities or CICs limited by guarantee, which cannot offer equity.

The new "Innovative Finance ISA" (an ISA that applies to investments made through crowdfunding platforms[7]) is also due to extend to debt-based and equity investments, which might provide an additional source of investment for charities and social enterprises.

[7] At the date of this note, the Innovative Finance ISA only applies to "peer-to-peer" investments. The extension dates for debt-based and equity investments have not yet been confirmed, but it is likely debt-based investments will be eligible by the end of 2016.

PART 2

Examples of investment offers by charities and social enterprises

Community Benefit Society[8]

Village Pub Ltd is a community benefit society founded to buy and run a local pub. Because of its legal form as a community benefit society, Village Pub can issue non-transferable shares or debt without needing to follow the financial promotions regime. This means that communications promoting an offer do not have to be approved by an FCA authorised person, regardless of the investor category being targeted, which should make the offer cheaper to issue. Village Pub can use a paper or online application process, and send information about the offer to both locally and non-locally based members of the public. Whilst the communications do not have to follow the financial promotions regime, they should still be made responsibly and comply with the general law (for example, they should be accurate and should not contain any potential misrepresentations).[9] The Community Shares Unit provides guidance for community benefit societies on making investment offers.

If Village Pub wishes to issue transferable shares, the offer will fall within the financial promotions regime.

Charitable Company

Fitness for Life is a charitable company limited by guarantee that promotes healthy exercise. It wants to raise funds to build new fitness centres which offer subsidised exercise classes. Because it is limited by guarantee and cannot offer equity, Fitness for Life has chosen to raise funds by offering bonds to individual investors, and would like the investors to benefit from SITR. As a charitable company, it does not have an exemption from the financial promotions regime based on its legal form, so any investment offers will have to comply with the financial promotions regime, or rely on another exemption(s).

Fitness for Life could choose to only offer the investment to exempt categories of investor (such as high net worth individuals) and therefore avoid the expense of asking an FCA authorised person to approve communications promoting the offer. If so, it should identify investors as being in this category before inviting any investment.

If Fitness for Life chooses to offer the investment to ordinary members of the public, communications promoting the offer would have to be approved by an FCA authorised person, and investors would have to satisfy the “Restricted Investor” and appropriateness tests before they could apply. Fitness for Life may therefore choose to only allow investments through a crowdfunding platform, which can manage this process and ensure that investments can only be made by an appropriate applicant.

In order to make sure the loans are eligible for SITR, Fitness for Life should ensure that the loans meet all the eligibility criteria for SITR, and may choose to apply for advance assurance from HMRC to be certain of eligibility. See the DIY Social Investment guide for more details on applying for advance assurance.

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8 Please note these examples are fictional and provided for illustration only.

9 For further information on the general law applying to investment offers, please see the publication “Marketing Social Investments: Supporting Technical Manual”, written by Bates Wells Braithwaite in partnership with the Social Investment Research Council, 2014.

Examples of investment offers by charities and social enterprises

Community Interest Company

Community Care CIC is a community interest company limited by shares which provides community care services. Community Care wants to raise working capital so that it can expand its workforce and move into new communities, and has chosen to offer shares in the community interest company to individual investors. Like a charitable company, a community interest company does not have an exemption from the financial promotions regime based on its legal form, so any investment offers by Community Care will have to comply with the financial promotions regime, or rely on another exemption(s).

Community Care could use the "common interest" exemption, in which case it will have to ensure that the people offered the investment have a sufficiently close connection to Community Care, and that the steps required by the exemption are followed.

If Community Care chose instead to appeal to a broader range of potential investors, they could use a crowdfunding approach instead. If so, the offer would most likely fall within the financial promotions regime, and all communications promoting the offer would have to be approved by an FCA authorised person. Any investor would also have to pass the Restricted Investor and appropriateness tests, or benefit from another exemption.

SUMMARY TABLES

Legal forms and financial promotions

	Community Benefit Society	**Charitable company limited by guarantee**	**Community Interest Company**[1]
Transferable Shares	X	X	X
Non-Transferable Shares[3]	√	X	X
Debt[2]	√	X	X

√ = Exempt from financial promotions regime
X = Not exempt

1. A CIC may be limited by shares or by guarantee.
2. For the purposes of this table, 'debt' is shorthand for any instrument creating or acknowledging indebtedness. It does not include a 'mere loan' agreed between the organisation and an individual, which are outside the scope of the financial promotions regime.
3. A non-transferable share is not the same as a withdrawable share, although very often withdrawable shares are also non-transferable shares. A society is able to issue non-transferable, non-withdrawable shares, although this is commonly not for capital raising purposes.

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Types of investor

Exempt types of investor – financial promotions rules may not apply	Protected type of investor – financial promotions rules apply
High Net Worth Individual	Ordinary member of the public passing the "Restricted Investor" test
High Net Worth Institution	Ordinary member of the public (who does not pass the Restricted Investor" test
Sophisticated investor	

Types of investor and applicable regulatory regime

	Potential exemption from financial promotion rules?	Applies within financial promotions regime?
High Net Worth Individual	Y	Y
High Net Worth Institution	Y	Y
Sophisticated Investor	Y	Y
Common Interest Group	Y	N
Restricted Investor	N	Y

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