

# COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004

---

## EXPLANATORY NOTES

### COMMENTARY ON SECTIONS

#### **Part 2: Community Interest Companies**

##### **Summary and background**

189. *Part 2* of the Act establishes a new type of company, the community interest company, for use by social enterprises wishing to operate as companies. This Part also establishes the Regulator of Community Interest Companies ("the Regulator"), whose role will be to maintain public confidence in the CIC model.
190. The CIC is intended to be used primarily by non-profit-distributing enterprises providing benefit to a community. Such businesses are presently active in areas such as childcare, social housing, leisure and community transport. Many of them already incorporate as companies, either as a company limited by guarantee ("CLG") or a company limited by shares ("CLS"). The special characteristics of the CIC are intended to make it a particularly suitable vehicle for some types of social enterprise – essentially, those that wish to work for community benefit within the relative freedom of the non-charitable company form, but with an assurance of non-profit-distribution status.
191. Companies that are formed as, or become, CICs will continue to be subject to the general framework of company law. In particular, CICs and directors of CICs will have to comply with their obligations and duties under the Companies Acts and the common law, as modified by this Act. The CIC will be a new variant of existing forms of company. It can take the form of a CLG or CLS, and existing companies limited by guarantee with a share capital will also be able to become a CIC. CICs will be registered as companies with the registrar of companies in the usual way, and will be subject to the usual regulatory constraints and powers associated with company status, including the oversight of the Department of Trade and Industry's Companies Investigation Branch.
192. The distinguishing features of the CIC will be:
- in order to become a CIC, a company will have to satisfy a community interest test, confirming that it will pursue purposes beneficial to the community and will not serve an unduly restricted group of beneficiaries. The test is whether a reasonable person might consider the CIC's activities to benefit the community – it is therefore wider and simpler than the charitable test of public benefit;
    - companies of a particular description may be excluded from CIC status by regulations; it is anticipated that political parties, companies controlled by political parties, and political campaigning organisations will be excluded in this way;

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

- CICs will not be able to have charitable status, even if their objects are entirely charitable. However, charities (and all other organisations except political parties) will be able to establish CICs as subsidiaries;
  - each CIC will be required to produce an annual community interest company report containing key information relevant to CIC status. The report will be placed on the public register of companies;
  - CICs will have an asset lock - that is, they will ordinarily be prohibited from distributing any profits they make to their members;
  - however, it is intended that regulations will allow CICs that are limited by shares to issue dividend-paying "investor shares". The dividend payable on such shares will be subject to a cap;
  - when a CIC is wound up, its residual assets will not be distributed to its members. Instead, they will pass to another suitable organisation that has restrictions on the distribution of its profits, for example another CIC or a charity;
  - the Regulator will approve applications for CIC status, receive copies of the community interest company reports and police the requirements of CIC status, including compliance with the asset lock. He will have close links with the registrar of companies. The key role of the Regulator will be to maintain public confidence in the CIC model. He will aim to impose the minimum necessary regulatory burden on CICs, but will have powers to investigate abuses of CIC status and to take action where necessary, for instance to remove directors, freeze assets or apply to the courts for a CIC to be wound up. He will also set the cap on CIC dividends.
193. *Sections 26 to 29* introduce the concept of the CIC and establish the Regulator, Appeal Officer and Official Property Holder. *Sections 30 to 35* set out special requirements which CICs must satisfy. The processes for becoming a CIC are set out in *sections 36 to 40*. *Sections 41 to 51* set out the supervisory powers of the Regulator. The conditions under which it is possible to cease being a CIC are set out in *sections 52 to 56*. Supplementary *sections 57 to 63* provide for various aspects of CIC operation and regulation, including fees and information gateways for the Regulator.
194. A number of sections in *Part 2* provide for certain details of the regulatory regime for CICs to be set out in regulations made by the Secretary of State. A draft of these regulations was published for consultation on 11 October 2004. The regulations will be subject to affirmative resolution.

## Introductory

### ***Section 26 - Community interest companies***

195. This section establishes the concept of the CIC. *Subsection (1)* provides that the CIC is to be a new type of company ('company' here meaning a company registered under the Companies Act 1985 or a former Companies Act). New organisations applying to be incorporated as a CIC will incorporate as a CLS or CLG (*subsection (2)*). Existing registered companies limited by shares or guarantee can also apply to become CICs, and *subsection (2)(b)* additionally allows a company limited by guarantee having a share capital to convert to a CIC. It has not been possible to register as a company limited by guarantee with share capital since 1980, so any new company being formed as a CIC will be either a CLS or a CLG without a share capital.
196. Even if a CIC has charitable purposes, it will be treated as not being established for such purposes, so it will not be a charity (*subsection (3)(a)*) and it will not be able to be recognised as a Scottish charity (*subsection (3)(b)*). Therefore, CICs will not be subject to the benefits or obligations of charitable status, nor will they be subject to regulation

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

by the Charity Commission or the charitable jurisdiction of the High Court. CICs, and outright bequests to them, will not be eligible for any tax reliefs or exemptions which are only available to charities or for charitable giving. So a donation to a CIC for its own purposes will not attract relief, since a CIC is not to be treated as established for charitable purposes. However, a donation to a charitable trust of which a CIC is trustee will be eligible for relief. The charitable status of the trust is unaffected by the status of the trustee.

### **Section 27 - Regulator; and Schedule 3 - Regulator of Community Interest Companies**

197. This section creates the office of the Regulator and makes some general provisions about the Regulator's functions and the way in which they are to be carried out.
198. The Regulator must be appointed by the Secretary of State (*subsection (2)*). *Subsection (3)* identifies the functions of the Regulator. One such function is the provision of guidance and assistance. *Subsection (5)* allows the Regulator to issue guidance or to provide assistance about any matter relating to CICs that he wishes. The Secretary of State can also compel the Regulator to provide such guidance or assistance (*subsection (6)*). Other functions are conferred or imposed on the Regulator in the Act, or provision is made for further functions to be imposed by regulations, in *sections 28(6), 29(2), 30(4) to (8), 36(4) and (6), 38(3) and (5), 41 to 51, 55(3) and (5), 59(5), 61(3) and (5), and 62(3)*.
199. *Subsection (4)* imposes a duty on the Regulator to carry out all his statutory functions with regard to three specific factors, or 'statutory objectives', relating to good regulatory practice. This provision complements the common law requirements that apply to all those exercising administrative and regulatory functions, such as the requirement to act reasonably. It is intended to guide the Regulator towards a particular style of regulation which takes into account the nature of those affected by his actions. This intention is reflected in *subsection (7)*, which sets out the approach that the Regulator is to take when carrying out his guidance and assistance function.
200. *Subsection (8)* gives effect to *Schedule 3* which contains detailed provisions concerning the Regulator. *Schedule 3* sets out the Regulator's terms of appointment (*paragraph 1*), and makes provisions about the Regulator's remuneration, staffing, and financial and reporting framework (*paragraphs 2 to 7*). The Regulator's staff will be civil servants. *Paragraphs 8 and 9* make the Regulator subject to investigation by the Parliamentary Commissioner, and disqualify the Regulator from membership of the House of Commons.

### **Section 28 - Appeal Officer; and Schedule 4 - Appeal Officer for Community Interest Companies**

201. This section creates the office of Appeal Officer and sets out his functions. The Appeal Officer is to be appointed by the Secretary of State (*subsection (2)*), and the terms of appointment are set out in *Schedule 4*. These provisions are intended to ensure that the Appeal Officer remains independent of the Regulator.
202. The Appeal Officer's role is to hear appeals against decisions of the Regulator (*subsection (3)*). Only those decisions against which a right of appeal is provided in the Act, including regulations made under the Act or in other legislation, may be the subject of an appeal to the Appeal Officer. Such a right of appeal is provided for in *sections 36(10), 38(10), 45(13), 47(14), 48(13) and (14), 49(5) and (6) and 55(8)*. It is intended that additional rights of appeal to the Appeal Officer will be included in regulations relating to the distribution of assets on winding-up (*section 31*) and approvals of changes of objects (*section 32(6)*).
203. The Appeal Officer will be able to consider appeals on matters of law and of fact (*subsection (4)*). The Appeal Officer will be able to dismiss or allow an appeal, or to

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

report his findings on the facts and his rulings on the law to the Regulator, who will then be obliged to review the decision in the light of those findings and rulings (*subsections (5) and (6)*). The decisions of the Regulator will, of course, also be subject to judicial review.

204. *Subsection (7)* gives effect to *Schedule 4*. *Schedule 4* sets out the Appeal Officer's terms of appointment, remuneration and financing (*paragraphs 1 to 3*), and provides for the Secretary of State to make regulations about the procedures to be followed by the Appeal Officer. *Paragraphs 5 and 6* make the Appeal Officer subject to investigation by the Parliamentary Commissioner, and disqualify the Appeal Officer from membership of the House of Commons.

### ***Section 29 - Official Property Holder; and Schedule 5 - Official Property Holder for Community Interest Companies***

205. This section creates the office of Official Property Holder, which is to be filled by one of the Regulator's staff. Provisions relating to this office are set out in *Schedule 5*. The Official Property Holder's functions are as set out in the Act or any other legislation (*subsection (3)*). The Official Property Holder's role is to hold property where the Regulator has made an order under *section 48(1)* vesting that property in the Official Property Holder, so as to safeguard it for the community interest.
206. *Subsection (4)* gives effect to *Schedule 5*. *Schedule 5* sets out the Official Property Holder's status, his relationship with the Regulator, his financing arrangements and his reporting requirements (*paragraphs 1 to 3 and 5 to 6*). *Paragraph 4* provides that the Official Property Holder shall hold property as a trustee. The Official Property Holder will hold the property vested in him on trust for its rightful owner. The Official Property Holder may release or deal with property that he holds so as to give effect to the rights of third parties in that property, or to comply with the request of various office-holders appointed under insolvency legislation in respect of the community interest company. Otherwise the Official Property Holder may only release or deal with the property in accordance with the directions of the Regulator. The general duties and requirements of trust law will apply to the Official Property Holder in his capacity as a trustee of the property vested in him, subject to the provisions of the Act.

#### **Requirements**

### ***Section 30 - Cap on distributions and interest***

207. This section provides for limits to be placed on the ability of CICs to make distributions to members and interest payments on debentures and debts. It also provides for the role of the Regulator in setting these limits. It therefore forms an important part of the 'asset lock', which is one of the distinguishing features of the CIC (see 'Summary and Background' to *Part 2*, above).
208. *Subsection (1)* prohibits CICs from distributing assets to their members, unless regulations allow such a distribution. The prohibition covers every description of distribution of the company's assets to its members, made in their capacity as members, such as dividends, issues of bonus shares, and payments on the purchase or redemption of shares or on the reduction of share capital. *Subsection (2)* allows such regulations to place limits on any distributions that regulations do permit. *Subsection (4)* allows the regulations to provide for the limits to be set by the Regulator.
209. It is intended that regulations will allow a CIC limited by shares that issues dividend-bearing shares to make limited distributions by way of dividends to the members of the company holding those shares. It is also intended that regulations will allow unlimited distributions to be made to members which are themselves CICs or charities, since such members will themselves be subject to an asset lock.
210. *Subsection (3)* provides for limits on the payment of interest on debts or debentures. It is not intended that regulations under this subsection will be used to set limits on

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

conventional interest payments – that is, payments at a level fixed for the term of the debt. Regulations will be targeted at payments that are related in some way to the performance of the CIC – for instance, payments that rise or fall according to the turnover or profit of the CIC. The intention of this provision is to prevent such instruments – sometimes known as ‘debt with equity characteristics’ – being used to avoid the restrictions that are to be imposed on dividend-bearing shares under *subsection (2)*.

211. The provisions in *subsections (4) to (8)* set out the role that the Regulator will have in setting the limits to be imposed under *subsections (2) and (3)*. *Subsection (5)* sets out various ways in which the Regulator may set those limits. *Subsection (5)(a)*, in providing for a limit to be set by reference to a rate determined by someone else, will allow the Regulator to set a limit which is linked to, and may rise and fall with, an index such as the Bank of England base lending rate. *Subsection (5)(b)* gives the Regulator scope to set a number of different limits applying to different categories of CICs. For instance, it may be considered desirable to set a less restrictive limit on dividends payable to shareholders investing in CICs carrying on certain types of activity, or those operating in certain geographical areas so as to encourage investment in such activities or such areas.
212. In considering how to set the limits, the Regulator is bound by *subsection (6)*, which refers back to the statutory objectives set out in *section 27*, and requires the Regulator to apply these in a particular way when exercising this function. The requirement in *subsection (6)(b)* to “have regard to [a limit’s] likely impact on community interest companies” is intended to point the Regulator toward considering both the beneficial effect which a less restrictive limit may have on the availability of investment in CICs, and the need to maintain public confidence in CICs as primarily non-profit-distributing organisations.
213. There is provision in *subsection (7)* for regulations to give a power to the Secretary of State to require the Regulator to review limits. It is intended that the Secretary of State might use this power to ask the Regulator to consider using the flexibility in setting limits provided by *subsection (5)* in particular ways. The power is limited to the ability to request a review, so as not to prejudice the independence of the Regulator.

### ***Section 31 - Distribution of assets on winding up***

214. This section provides for regulations to impose restrictions on the distribution of a CIC’s assets on winding up, so that the Regulator can ensure that such assets are preserved for the community benefit. The restrictions will only apply to any assets which remain after the company’s liabilities to creditors have been satisfied. It is intended that regulations will provide that any such assets may only be transferred to other CICs or charities, as these organisations have an asset lock. Regulations may in due course allow the transfer of such assets to an industrial and provident society (“IPS”) with an asset lock, once regulations establishing such an asset lock for IPSs have been made under the Co-operatives and Community Benefit Societies Act 2003.

### ***Section 32 - Memorandum and articles***

215. Like other companies, CICs will have a “constitution” set out in a memorandum and articles of association. *Section 32* sets out requirements relating to the memorandum and articles of CICs.
216. *Subsection (3)* provides for regulations to set out provisions which must be included in the constitution of each CIC, and provisions which cannot be included in the constitution. Subject to such regulations and the requirements of company law, a CIC is free to include any other provisions it wishes in its memorandum and articles. However, if a CIC’s constitution contains any provision which is inconsistent with regulations made under this clause, that provision will have no effect (*subsection (5)*). *Subsection*

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

(4) expands on this by indicating particular provisions which regulations may require CICs to include in their constitution:

- provisions about the transfer and distribution of assets (*subsection (4)(a) and (b)*). These will establish the 'asset lock' on distributions to members in each CIC's constitution (see also the note on *section 30*), and will also set out the terms on which CICs may transfer assets to third parties. CICs will not be allowed to transfer assets to other bodies or individuals for less than the value of the asset, except in pursuit of their community interest aims. However, where a CIC wishes to transfer assets to another organisation with community interest aims and an asset lock (i.e. a CIC or charity), regulations will allow it to do so, subject to certain safeguards; and
- provisions intended to limit the ability of investors to control a CIC with a view to maximising the return on their investment, at the expense of the CIC's community interest purposes (*subsection (4)(c) to (f)*).

217. Regulations may also restrict a CIC's ability to amend its objects as stated in its memorandum (*subsection (6)*). It is intended that a CIC will need to seek the Regulator's approval if it wishes to change its objects. This is so that the Regulator can ensure that:

- the altered objects are consistent with the requirement that CICs carry on activities in the community interest, and
- the CIC has made reasonable efforts to notify those affected by its activities (its "stakeholders") of the proposed change.

### ***Section 33 - Names; and Schedule 6 - Community interest companies: names***

218. This section imposes requirements and restrictions on the names CICs are permitted to use. It also gives effect to *Schedule 6*. *Schedule 6* amends the *Companies Act 1985 (c.6)* so as to apply that Act's restrictions on the use of company names and trading names to the use of the name "community interest company" and specified variants. It:

- amends section 26 of the Companies Act 1985 so that:
  - companies may not be registered with names that include, otherwise than at the end of the name, the expressions "community interest company" or "community interest public limited company", or their abbreviations or Welsh equivalents (*paragraph 2(2)*);
  - in determining whether one name is the same as another (in which case it cannot be registered), the terms "community interest company", "community interest public limited company" and their abbreviations and Welsh equivalents are to be disregarded when they appear at the end of a name (*paragraph 2(3)*);
- amends section 27 of the Companies Act 1985 so as to add alternative statutory designations for CICs (*paragraph 3*);
- amends section 30 of the Companies Act 1985 to ensure that CICs cannot benefit from the exemptions available under this section (*paragraph 4*);
- amends section 33 of the Companies Act 1985 so that a private limited CIC must not trade under a name that indicates in English or Welsh that it is a public limited company (*paragraph 5*);
- inserts into the Companies Act 1985 a new section 34A which
  - makes it an offence for companies to trade under a name which includes at the end of the name, or anywhere else in the name, the expressions "community interest company" or "community interest public limited company" or their abbreviations or their Welsh equivalents, unless they are a CIC; and

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

- makes it an offence for anyone other than a company to trade under a name which includes at the end of the name the expressions "community interest company" or "community interest public limited company", or their abbreviations or their Welsh equivalents (*paragraph 6*).

*New section 34A(5)* introduces penalties for the improper use in a trading name of the words "community interest company" or "community interest public limited company" or their abbreviations or Welsh equivalents. These restrictions on trading names do not apply to anyone who was trading with such a name at any time during the period from 1 September 2003 up to and including 4 December 2003, the date of publication of the Companies (Audit, Investigations and Community Enterprise) Bill. Nor do they apply to trade marks which are registered as at 4 December 2003, regardless of whether they have ever been used.

219. The Schedule also:

- amends section 43(2)(b) of the Companies Act 1985. A private limited CIC may re-register as a public limited company and vice versa. In each case its name must still comply with *section 33 (paragraph 7)*;
- amends section 351(1)(d) of the Companies Act 1985. The name of a private limited CIC will not contain the word "limited" in its name. The effect of this amendment is that such a CIC should mention in legible characters in all its business letters and order forms the fact that it is a limited company (*paragraph 8*); and
- amends paragraph 8(2) of the Schedule to the Limited Liability Partnerships Act 2000. A limited liability partnership may not be registered with the same name as a registered company. For the purposes of determining whether one name is the same as another, there is to be disregarded "community interest company" or "community interest public limited company" or their Welsh equivalents or abbreviations at the end of the name (*paragraph 10*).

### ***Section 34 - Community interest company reports***

220. This section introduces a requirement for the directors of CICs to provide an annual community interest company report to the registrar of companies, who will forward a copy of it to the Regulator (*subsections (1) and (4)*). A copy of the report will be placed on the companies register. The time limits for compliance with the requirement, and the penalties for non-compliance, will be the same as those applying to the filing of annual accounts under section 242(1) of the Companies Act 1985 (*subsection (2)*). The relevant time limits and penalties are set out in sections 244 and 242A of that Act.

221. *Subsection (3)* provides for regulations to set out what information is to be included in the report. *Subsection (3)(a)* requires the regulations to provide that the report must include information about the remuneration of directors of the CIC. *Subsection (3)(b)* allows regulations to provide for the inclusion of other information. It is intended that the content of the report will include statements of:

- what the CIC has done during the year to benefit the community;
- the steps, if any, that the company has taken to involve in its activities those affected by the activities (its "stakeholders"); and
- the dividends paid on any dividend-bearing shares issued by the CIC, and equivalent information in respect of other financial instruments the return on which is capped under the provisions of *section 30*.

222. Regulations may apply to the report the same procedural requirements as apply to directors' reports (*subsection (3)(c)*). These requirements are set out in Part 7 of the Companies Act 1985, and include provisions as to the approval of the report, the laying

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

of the report before any general meeting of the company, the revision of the report and the distribution of the report to members.

### **Section 35 - Community interest test and excluded companies**

223. This section makes provisions about the community interest test, which is used in determining the eligibility of a company to be formed as a CIC (*section 36(5)(b)*) or to become a CIC if already incorporated (*section 38(4)(b)*). The Regulator can also exercise certain supervisory powers if a CIC ceases to satisfy the community interest test (*section 41(3)(c)*). All CICs will be expected to carry on their activities for the benefit of the community for as long as they remain CICs.
224. The section describes the community interest test (*subsection (2)*), and clarifies the meaning of the term “community” for the purposes of this test (*subsection (5)*), so that a community can be a section of a larger community (either geographic or a community of interest) and can be overseas. The test is that a reasonable person might consider that the activities being carried on by the CIC are being carried on for the benefit of the community. Therefore, if a reasonable person can conclude that the activities of the company are being done for the benefit of the community, those activities will pass the test, unless those activities are prescribed by regulations under *subsection (4)* as not satisfying the test.
225. *Subsection (3)* sets out the circumstances in which an object in the memorandum of a company is to be treated as a community interest object. The question of whether a given object is a community interest object is relevant for the purpose of *section 41(3)(d)* (conditions for exercise of supervisory powers), and is discussed in the note on that section below.
226. The section also provides for regulations to:
- establish that certain activities are, or are not, to be considered as satisfying the community interest test (*subsection (4)*), and
  - specify what constitutes a section of the community (*subsection (5)*).
227. For instance, it is intended that regulations will identify a group consisting of employees of a single employer (e.g. in a company sports association) as capable of comprising a sufficient section of the community for the purpose of the community interest test. These powers to make regulations are intended to make it possible to clarify the breadth of the community interest test over time.
228. Regulations may also provide that certain descriptions of company are excluded companies (*subsection (6)*). Excluded companies are not eligible to be formed as a CIC or to become a CIC (*sections 36 (5)(b)* and *38 (4)(b)*). It is intended that initially political parties and companies owned by them, and political campaigning organisations, will be classed as excluded companies. If a CIC becomes an excluded company, the Regulator may order the transfer of shares or membership in that CIC under *section 49*. It is intended that the Regulator would use this power to remove a CIC that became owned by a political party from the control of that party.

Becoming a community interest company

### **Section 36 - New companies**

229. This section sets out the process for an organisation not already incorporated as a company to incorporate as a CIC. Since CICs are companies under the Companies Act 1985, the standard company registration provisions apply along with the additional provisions set out in this section. Applicants will be required to deliver to the registrar of companies both the normal documents required for formation as a company, and some additional documents called the ‘prescribed formation documents’ (*subsection (1)*). Regulations will set out what these additional documents should be (*subsection (2)*). It is intended that the documents will consist of:

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

- a ‘community interest statement’ confirming the applicant’s intention to serve the community rather than private benefit, and to pursue activities in the community interest; and
  - a declaration that the applicant, when formed, will not be a political party or controlled by a political party (it is intended that regulations under [section 35\(6\)](#) will prescribe political parties and companies owned by them as excluded companies).
230. The registrar will pass a copy of all the documents to the Regulator without registering them ([subsection \(3\)](#)). If the Regulator is satisfied that the company is eligible to be formed as a CIC under the terms of [subsections \(4\)](#) and [\(5\)](#), he notifies the registrar who completes the company registration process.

### ***Section 37 - Existing companies: requirements***

231. This section sets out the steps that an organisation already incorporated as a company must take if it wishes to become a CIC. [Subsection \(1\)](#) requires the company to pass special resolutions to make the company’s memorandum and articles consistent with the requirements laid down under [section 32](#), and to make the company’s name consistent with [section 33](#). Where changes are made to the company’s memorandum under section 4 (alteration of objects) or section 17 (changes to provisions in memorandum that could be included in articles) of the Companies Act 1985, section 5 of that Act gives members of the company a right to apply to court. Therefore, [subsections \(3\)](#) and [\(4\)](#) provide that where such changes to the memorandum have been made, the company must not submit its application to become a CIC until either the changes to its memorandum have been confirmed by the court, or the deadline for objecting has passed.
232. Under [subsections \(2\)](#) and [\(6\)](#), the special resolutions are to be forwarded to the registrar of companies, along with the memorandum and articles in the form that they would take once altered by those special resolutions. The company must also submit some additional documents, called the prescribed conversion documents. Regulations will set out what these additional documents should be. It is intended that the documents will consist of:
- a ‘community interest statement’ confirming the company’s intention to serve the community rather than private benefit, and to pursue activities in the community interest;
  - a declaration that the company is not a political party or controlled by a political party (it is intended that regulations under [section 35\(6\)](#) will prescribe political parties and companies owned by them as excluded companies); and
  - either a declaration that the company is not a charity or a Scottish charity, or in the case of a company that is a charity, the written consent of the Charity Commissioners as required under the terms of [section 39](#).
233. All these documents and special resolutions must be submitted to the registrar of companies at the same time.

### ***Section 38 - Existing companies: decisions etc***

234. This section sets out the process through which the Regulator will determine whether an existing company seeking to become a CIC is eligible to do so. Once the Regulator has made his decision, he must give notice to the registrar of companies. Any alterations to the company’s memorandum and articles, as made by the special resolutions submitted with the application to become a CIC, will only be recorded and take effect once the Regulator has decided that the company is eligible to become a CIC and the registrar of companies has recorded its new name.

### **Section 39 - Existing companies: charities**

235. This section contains additional provisions applying to an existing company that wishes to become a CIC and that has charitable status. These provisions do not apply to companies that are "Scottish charitable companies" as defined in [section 40\(8\)](#), to which [section 40](#) will apply instead (*subsection (4)*). The key procedural provision is that the Charity Commissioners must consent to the change of name required under [section 37\(1\)\(c\)](#), and thus to conversion to CIC status (*subsection (1)*). The Charity Commissioners have a right to apply to the High Court for an order quashing the conversion of any charity that was made without their consent (*subsection (2)*). The Charity Commissioners' right to apply for such an order is, of course, without prejudice to the power of the Attorney General to apply to court to quash a registration which has been improperly or erroneously allowed. The section also provides that the assets held by the charitable company at the moment of its conversion to a CIC must remain applicable to the company's original charitable purposes (*subsection (3)*).

### **Section 40 - Existing companies: Scottish charities**

236. *Subsection (1)* prevents a Scottish charity, or a company which is not a Scottish charity as defined in [section 63](#) but that is registered in Scotland and established for wholly charitable purposes, from becoming a community interest company. If, despite this prohibition, such a company attempts to become a CIC and changes its name to comply with [section 33](#), the altered certificate of incorporation issued on the change of name may be quashed by order of the Court of Session (*subsection (2)*). The right of the Commissioners of Inland Revenue to apply for such an order is, of course, without prejudice to the power of the Attorney General to apply to court to quash a registration (by a company registered in England and Wales, or in Wales) which has been improperly or erroneously allowed.
237. Charity law is a devolved matter in Scotland. Scottish charities are prohibited from altering their purposes, as set out in their constitution, in any way which would result in the loss of their charitable status. Since CICs are excluded from charitable status ([section 26\(3\)](#)), Scottish charities should not be able to lose their charitable status by converting to a CIC. A consultation draft of a Charities and Trustee Investment (Scotland) Bill was published on 2 June 2004. Clause 15 of that draft Bill contains provisions making it possible for Scottish charities to lose their Scottish charitable status. Those provisions, if enacted, will make it appropriate to use the mechanism in *subsection (3)* whereby the prohibition on Scottish charities converting to CICs may be lifted, via regulations. The conversion process that would then apply contains similar safeguards to the conversion mechanism in [section 39](#).

### **Supervision by Regulator**

### **Section 41 - Conditions for exercise of supervisory powers**

238. This section restricts the circumstances in which the Regulator is able to exercise the supervisory powers conferred by [sections 42 to 51](#). It constrains the Regulator in three respects. First, *subsection (1)* imposes a general requirement on the Regulator to make use of these powers in such a way that his supervisory activity is not greater than is needed to maintain confidence in CICs.
239. Second, *subsection (2)* prevents the Regulator from exercising the powers listed in that subsection unless the "company default condition" is satisfied. The purpose of this provision is to ensure that the Regulator can only use these relatively intrusive powers where it is necessary to do so and there are particular grounds for doing so. The grounds are set out in *subsection (3)*.
240. One of the four triggers of the company default condition [section 41](#) relates to community interest objects (*subsection (3)(d)*). These are defined in [section 35\(3\)](#). If they wish, CICs will be able to state wide objects in their memorandum, such as commercial trading objects. Alternatively, they may choose to limit themselves to 'community interest

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

objects' that only include specific activities for the benefit of the community. A CIC may wish to do this, for instance, to demonstrate to potential investors, grant-givers or other stakeholders that it is restricted to particular activities. If a CIC chooses to limit its objects in this way, then a failure to carry on activities in pursuit of those objects will be sufficient grounds to trigger the company default condition.

241. The third constraint is applied by *subsection (4)*. This prevents the Regulator from exercising the power to order a transfer of shares or other membership interests in a CIC under *section 49* unless the CIC in question is an excluded company within the meaning of *section 35(6)*. It is intended that regulations will provide that companies subject to the control of a political party will be excluded companies (see also the note on *section 35(6)* above).

### ***Section 42 - Investigation; and Schedule 7 - Community interest companies: investigations***

242. This section gives the Regulator powers to investigate the affairs of CICs, and to appoint people other than members of the Regulator's staff to carry out such investigations. This means that where necessary the Regulator can use third parties with appropriate expertise in particular areas, such as accountancy. The Regulator may also authorise members of his own staff to carry out investigations (*paragraph 5 of Schedule 3*). *Subsection (3)* gives effect to *Schedule 7*, which details the investigation powers conferred on the Regulator by *clause 40*. These are powers to require a CIC or any other person to provide documents and information (*paragraph 1*). The powers, and the further provisions contained in the Schedule (*paragraphs 2 - 5*), are based on the powers conferred on the Secretary of State under new *section 447* of the Companies Act 1985. It is intended that if, after using these powers, the Regulator concludes that a full investigation of a CIC may be required, he will refer the matter to the Companies Investigation Branch of the DTI, which will consider whether to carry out an investigation under Part 14 of the Companies Act 1985.

### ***Section 43 - Audit***

243. This section gives the Regulator a power to require an audit of a CIC's annual accounts. Any auditor appointed under this clause will have all the rights of an auditor as set out in section 389A of the Companies Act 1985 (as amended by *section 8* of the Act) (*subsection (3)*). The offences for non-compliance with that section of the Companies Act 1985 will also apply.

### ***Section 44 - Civil proceedings***

244. This section gives the Regulator the right to bring a derivative action on behalf of a CIC. It is intended that the Regulator would use this power to bring court proceedings in the name of a CIC where the directors of a CIC fail to bring such proceedings, in a situation where it would be in the interests of the CIC or the community to bring those proceedings. For instance, the power will allow the Regulator to bring a claim in respect of a breach of duty by the directors themselves. The Regulator will have to reimburse the CIC for any costs it suffers as a result of the action (*subsection (6)*) and in return any costs awarded must be paid to the Regulator (*subsection (7)*).

### ***Section 45 - Appointment of director***

245. This section gives the Regulator a power to appoint a person to be a director of a CIC. This power may only be used if the company default condition is satisfied (*section 41(2)*). It enables the Regulator to take action to remedy the circumstances that have caused the company default to arise, such as mismanagement or failure to satisfy the community interest test. For instance, the Regulator may wish to appoint a director with financial expertise to remedy mismanagement of a CIC's assets.

246. The section contains provisions to ensure that a director appointed under this power will be capable of influencing the direction of the CIC. For instance, the appointment cannot be blocked by the constitution of the CIC (*subsection (3)(b)*), and the director is to have all those powers available to other directors of the company (*subsection (6)*). The other directors of the company will retain their existing powers. However, the section also prevents a CIC from removing a director appointed under this power (*subsection (7)*). A director appointed under this power will have to comply with the common law and statutory obligations and duties applicable to directors generally.
247. Where a change of directors arises from the use of this power, the Regulator, rather than the company, is required to notify the change to the registrar of companies (*subsection (8)*). Where the Regulator has appointed a director under this power, and that person subsequently ceases to be a director, the CIC is required to notify the Regulator, rather than the registrar of companies, of this change in its directors (*subsection (10)*). The requirement is on the company to notify the Regulator of this change because it is the company that will ordinarily first become aware of such an event. Failure to comply with this requirement is an offence (*subsection (11)*) punishable on summary conviction by a fine not exceeding level 5 on the standard scale (currently £5,000) (*subsection (12)*).

### **Section 46 - Removal of director**

248. This section gives the Regulator power to remove a director from a CIC (*subsection (1)*) or suspend a director for up to one year (*subsections (3) and (4)*), and prevents a CIC from reinstating a director removed by the Regulator (*subsection (2)*). The exercise of these powers is subject to the company default condition being satisfied (*section 41(2)*).
249. The section sets out procedures which the Regulator must follow when exercising these powers (*subsections (8), (9) and (11)*). Where the Regulator makes an order to remove a director and then discharges the order, the discharge does not in itself reinstate the person concerned as a director (*subsection (7)*). Any director suspended or removed by the Regulator will have a right of appeal to the courts in respect of the use of this power (*subsection (10)*). The Civil Procedure Rules (Part 52) or, in Scotland, the Rules of the Court of Session (Part III of Chapter 41) set out the procedural rules applying to such an appeal.

### **Section 47 - Appointment of manager**

250. This section gives the Regulator a power to appoint a manager to carry out functions in relation to a CIC. This power is subject to the company default condition being satisfied (*section 41(2)*). The Regulator may wish to appoint a manager to take control and run the day to day operations of a CIC for a certain period of time, rather than to influence the general direction of the CIC through the appointment of a director. Therefore the Regulator is able to specify the manager's functions and powers (*subsection (3)*), and to prevent the directors of a CIC from carrying out such functions (*subsection (4)(b)*).
- In order to ensure that this power does not affect the rights of third parties or the insolvency process, *subsection (6)* provides that the appointment of a manager under this clause does not affect the rights of any third party to appoint a receiver or manager, or the rights of any receiver or manager appointed by a third party. For similar reasons, *subsection (8)* provides that if certain office holders under insolvency legislation are appointed in respect of the CIC, the Regulator must discharge any order appointing a manager to that CIC. The clause allows the Regulator to seek directions from a court in connection with the manager's functions (*subsections (9) – (10)*). This might be done in order to counter obstruction of the manager by a CIC or its officers, since disobeying the court's directions would amount to contempt.

### **Section 48 - Property**

251. This section gives the Regulator various powers to protect the assets of a CIC. The Regulator can vest the CIC's property in or transfer it to the Official Property Holder (*subsection (1)*), or freeze or otherwise restrict the assets of a CIC and the commitments it may make (*subsections (2) and (3)*). The exercise of these powers is subject to the company default condition being satisfied (*section 41(2)*). The section contains provisions to ensure that the use of these powers will not trigger any rights against a CIC's property which would result in the loss of that property, or in a breach of a restriction on the transfer of the property (*subsections (4) and (5)*). The discharge of an order under this clause may not necessarily automatically result in the return of the property to the CIC, so *subsection (7)* enables the Regulator to make the necessary vesting orders. *Subsection (10)* creates an offence where a person contravenes an order of the Regulator in respect of the property of the CIC or the transactions that may be entered into by the CIC, and *subsection (11)* fixes the penalty for contravention as a fine not exceeding level 5 on the standard scale (currently £5,000). *Subsection (12)* ensures that the creation of a criminal offence by *subsection (10)* does not prevent civil proceedings. This means that a CIC will be able to seek damages if property is lost or reduced in value because it was not transferred to the Official Property Holder in breach of an order.

### **Section 49 - Transfer of shares etc**

252. This section gives the Regulator a power to order the transfer of shares (*subsection (1)*) or, in the case of a CIC limited by guarantee, to extinguish the membership interests of specified members of the CIC (*subsection (2)*). The only interests that may be extinguished by an order under *subsection (2)* are the interests that a person has by virtue of being a guarantor of the CIC. If the CIC is a company limited by guarantee with share capital, the interests that any member has by virtue of being a shareholder in that CIC are unaffected by an order under *subsection (2)*, but may be the subject of a separate order under *subsection (1)*.
253. The power can only be exercised if it appears to the Regulator that the CIC in question is an excluded company (*section 41(4)*). It allows the Regulator to arrange for the control of a CIC to change hands, with a view to the CIC ceasing to be an excluded company. Without such a power the Regulator would only be able to stop the CIC being an excluded company by using the power under *section 50* to seek the winding-up of the CIC.
254. The power does not apply to any share which may pay a dividend or entitle its holder to a distribution of the assets of a CIC in the event of a winding-up (*subsection (3)*). It is intended that under regulations made under the power conferred by *section 32(3) and (4)*, such shares will not enable their holder(s) to control the CIC in question.

### **Section 50 - Petition for winding up**

255. This section gives the Regulator the right to petition the courts for a CIC to be wound up. This will be without prejudice to the power of the Secretary of State to wind up CICs and other companies on public interest grounds (*section 124A of the Insolvency Act 1986*).

### **Section 51 - Dissolution and striking off**

256. If a CIC is dissolved or struck off the register of companies, any assets remaining in the company pass to the Crown, the Duchy of Lancaster or the Duchy of Cornwall as bona vacantia (the legal name for ownerless property which by law passes to the Crown). This section allows the Regulator to go to court for an order to make void the dissolution of the CIC (*subsection (1)*) or to get the CIC's name put back on the register of companies (*subsection (2)*). These powers will enable the Regulator to safeguard the

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

assets of a CIC for the community interest where the CIC has been struck off the register without having been wound up, or where an asset has been overlooked in a winding up.

257. Section 652A of the Companies Act 1985 allows the directors of a private company to make an application to the registrar of companies for the company to be struck off the register of companies. If any such application is made by the directors of a CIC, *subsection (3)* requires the directors to send a copy of the application to the Regulator. If no such copy of the application is sent to the Regulator and the CIC is subsequently struck off the register of companies, the Regulator may apply to the court under section 653(2B) of the Companies Act 1985 for the company to be restored to the register.

Change of status

### ***Section 52 - Re-registration***

258. This section brings together provisions on the re-registration of CICs. *Subsection (1)* provides that once a company is registered as a CIC, it will not be able to re-register as an unlimited company. Such companies are able to take advantage of reduced regulatory and reporting requirements under the Companies Act 1985, and this would be inconsistent with the reporting requirements placed on CICs by *section 34*, which are intended to complement the requirements on ordinary limited companies. *Subsection (2)* ensures that any certificate of incorporation issued in respect of a private limited CIC upon re-registration as a public limited CIC or vice versa will contain a statement that the company is a CIC.

### ***Section 53 - Ceasing to be a community interest company***

259. This section provides that a CIC cannot lose its status as a CIC except by the methods described in the following sections. This provision is effectively part of the 'asset lock', since it ensures that the members of a CIC cannot get round the restrictions to which CICs are subject, by ceasing to be a CIC and then distributing the company's assets. If a CIC is dissolved, it is intended that the residual assets will be preserved for the community benefit, under regulations to be made under *section 31*. Conversion to a charitable company under *sections 54* and *55*, or to an industrial and provident society *section 56*, would impose other restrictions on the distribution of assets.

### ***Section 54 - Becoming a charity or a Scottish charity: requirements***

260. This section sets out the steps that a CIC must take if it wishes to give up CIC status and become a charitable company. *Subsection (1)* requires the CIC to change its name and make any other appropriate changes to its constitution by special resolution, and *subsection (2)* requires such changes to be notified to the registrar. Where changes are made to the company's memorandum under section 4 (alteration of objects) or section 17 (changes to provisions in memorandum that could be included in articles) of the Companies Act 1985, section 5 of that Act gives members of the company a right to apply to court. Therefore, *subsections (3)* and *(4)* provide that where such changes to the memorandum are made, the company must not submit its application to give up CIC status until either the changes have been confirmed by the court, or the deadline for objections has passed.
261. For CICs with their registered offices in England and Wales, or in Wales, conversion to a charitable company will not be permitted without a written statement from the Charity Commissioners that in their opinion, the CIC will have charitable status (and will not be an exempt charity) once the special resolutions have taken effect (*subsection (7)*). For CICs with their registered offices in Scotland that wish to become a Scottish charity, a written statement from the Inland Revenue will be required, confirming that the CIC has applied for recognition as a Scottish charity, and would be granted such recognition if it ceases to be a CIC (*subsection (8)*). The relevant written statement must also be sent to the registrar (*subsection (6)(b)*).

**Section 55 - Becoming a charity or a Scottish charity: decisions etc.**

262. This section sets out the process through which the Regulator will decide whether a CIC seeking to become a charity or Scottish charity is eligible to cease to be a CIC. The company will not be eligible if the Regulator has exercised certain supervisory powers in respect of that CIC, and the exercise of those supervisory powers is still ongoing (*subsection (4)*).

**Section 56 - Becoming an industrial and provident society**

263. This section makes provisions about the conversion of a CIC to an IPS. Companies can convert to an IPS under the Industrial and Provident Societies Act 1965, but under *subsection (1)* CICs are to be prohibited from doing this until such time as regulations remove the prohibition. If the prohibition is removed, regulations may also amend section 53 of the Industrial and Provident Societies Act 1965 to ensure that conversion takes place in a particular manner (*subsection (2)*).
264. The section prohibits conversion because IPSs do not currently have an asset lock, so that the ability to convert to an IPS would allow CICs to circumvent the asset lock (see note on *section 53* above). The section makes provision for regulations to remove the prohibition because the Co-operatives and Community Benefit Societies Act 2003 includes a power for the Treasury to introduce an asset lock for community benefit societies, which are a sub-set of the IPS corporate form (see section 1(1) and (2) of the Industrial and Provident Societies Act 1965). It is intended that regulations under *subsection (1)* will only be made in the event that the Treasury enacts secondary legislation to introduce an asset lock for community benefit societies. If such regulations are made, they will only allow CICs to convert to community benefit societies that have such a lock, and not to a community benefit society without an asset lock, or to any other type of IPS. It is anticipated that in this event, regulations would need to be made under *subsection (2)* to enable a seamless transition from CIC to IPS status, ensuring that the organisation's assets remain protected from distribution at all times.

Supplementary

**Section 57 - Fees**

265. This section provides for regulations to set the fees that may be charged by the Regulator (*subsection (1)*). The Regulations may provide for the registrar of companies to collect fees on behalf of the Regulator, so that only a single payment would need to be made in respect of matters that involve both the Regulator and the registrar (*subsection (2)*). An example would be the formation of a company as a CIC, where the Regulator applies the community interest test and the registrar of companies registers the company. In addition, the section enables the Regulator to charge fees (without the need for regulations) for providing services which he is not legally required to provide (*subsection (3)*). However, the Regulator cannot use the power under *subsection (3)* to charge fees for the provision of guidance of general interest.

**Section 58 - Extension of provisions about registrar etc.**

266. This section will enable regulations to apply relevant provisions of Parts 24 and 25 of the Companies Act 1985 to any documents sent to the registrar under this Part of the Act, and allows those provisions to be modified if required. This Part of the Act imposes new functions and obligations on the registrar of companies. In particular, it provides for documents to be delivered to, and recorded by, the registrar. Part 24 of the Companies Act 1985 contains provisions in respect of the powers and functions of the registrar, including provisions relating to the delivery, recording and inspection of documents. Part 25 of the Companies Act 1985 makes provisions for confidentiality orders in respect of documents held by the Registrar.

### **Section 59 - Information**

267. This section sets out the terms on which the Regulator will be able to disclose and receive information in connection with the exercise of his functions or the functions of other bodies.
268. As many of the Regulator's functions will require interaction with the registrar of companies, *subsection (1)* makes provision for regulations to require the registrar to provide information and documents to the Regulator.
269. *Subsection (2)* places a specific duty on the Accountant in Bankruptcy in Scotland to forward copies of notices of the appointment of a liquidator of a CIC to the Regulator, since in Scotland such notices are received by the Accountant in Bankruptcy and not the registrar of companies.
270. *Subsection (3)* amends section 31(2) of the Data Protection Act 1998. It creates exemptions from an individual's entitlement under that Act to obtain a copy of information held on him. The exemptions apply to public bodies acting to protect CICs against misconduct or mismanagement in their administration or acting to protect or recover the property of CICs (*subsection (3)(a)*). The exemptions will apply whether the misconduct or mismanagement is by a director or any other person (*subsection (3)(b)*).
271. The section also enables public authorities to pass information to the Regulator (*subsection (4)*). Similarly, the Regulator can pass information obtained in exercising his functions to other public authorities (*subsection (5)*). These disclosures of information are subject to the constraints set out in *subsections (6) to (8)*. The constraints include, in the case of disclosures to non-UK authorities (*subsection (6)*), the restrictions contained in section 243(6) of the Enterprise Act 2002, so that the Regulator, before disclosing information to an authority outside the United Kingdom, must consider:
- whether the reason for the request is sufficiently serious to justify disclosure;
  - the existence of appropriate protection against self-incrimination in criminal proceedings in the requesting country;
  - the existence of appropriate protection for the storage and disclosure of personal data in the requesting country; and
  - the existence of any mutual assistance agreements covering the information concerned with the requesting country.
272. *Subsection (8)* allows a restriction to be placed on further disclosure and *subsection (9)* makes it an offence to disclose information in contravention of any such restriction, the penalty under *subsection (10)* being a fine up to level 3 on the standard scale (currently £1,000).

### **Section 60 - Offences**

273. This section provides that where a corporate body (e.g. a company) commits an offence, those directors or other officers of the corporate body who are to blame for the offence can be penalised, as well as the corporate body itself.

### **Section 61 - Orders made by Regulator**

274. This section sets out procedural requirements for the making of orders by the Regulator. For instance, it specifies those to whom the various types of order are to be given (*subsection (1)*). *Subsection (3)* allows the Regulator to make savings and transitional provisions when discharging an order, so as to provide a measure of control over the extent of the discharge where necessary. For example, an order under *section 48(1)*, vesting the stock and equipment of a CIC in the Official Property Holder,

*These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004*

might be discharged in part, so that all the stock is vested back in the CIC, but with a proviso that the CIC may not sell the stock for less than 50% of its book value, and with transitional provisions to make arrangements for the physical transfer of the stock. *Subsection (5)* requires the Regulator to give reasons for those of his orders and decisions for which the Act confers a right of appeal to the Appeal Officer or to the courts. The Regulator must give his reasons to those persons who have the right to appeal the order or decision. This is to ensure that they will have the information they need to make a decision about whether they have grounds to appeal.

### ***Section 62 - Regulations***

275. This section contains provisions about the making of regulations under this Part of the Act. *Subsection (5)* specifies which of those regulations are to be made by affirmative procedure. The other regulations made under this Part of the Bill will be subject to negative procedure in both Houses (*subsection (6)*).