

**EXPLANATORY MEMORANDUM TO
THE COMMUNITY BENEFIT SOCIETIES (RESTRICTION ON USE OF ASSETS)
REGULATIONS 2006**

2006 No. 264

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This statutory instrument makes provision to allow community benefit societies to introduce a rule to ensure, that on dissolution or amalgamation, their assets will permanently be used to benefit the community. Often referred to as an "asset lock", this serves to eliminate the possibility that a society's accumulated assets could be distributed to members following conversion to a company incorporated under the Companies Acts.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 Community benefit societies are a form of mutual body which conduct their business for the benefit of the community, rather than for the benefit of members (as with co-operatives) or shareholders (as with companies). Community benefit societies are registered under the Industrial and Provident Societies Act 1965.

4.2 Section 1 of the Co-operatives and Community Benefit Societies Act 2003 gives the Treasury the power to make provisions by secondary legislation to enable community benefit societies to adopt an asset lock. The Government supported the 2003 Act in its passage through Parliament as a Private Member's Bill put forward by Mark Todd MP. This is the first exercise of the power.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Ivan Lewis, has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

In my view the provisions of the Community Benefit Societies (Restriction on Use of Assets) Regulations 2006 are compatible with the Convention rights.

7. Policy background

- 7.1 Allowing community benefit societies to establish an asset lock, if they feel it would be of benefit to their society, allows societies to close off the possibility that assets would be redistributed to members should a society convert to a company incorporated under the Companies Acts. In theory, ‘carpetbaggers’ could seek to become members of a community benefit society with the aim of forcing a vote on conversion of the society to company status and making windfall profits from accumulated investments over the years. The Government recognises that this risk may deter individuals from investing in a society and thus, may serve as a barrier to further growth. Approximately 400 societies will be able to benefit from this provision.
- 7.2 The Community Interest Company (CIC), a new legal form set up by the Companies (Audit, Investigations and Community Enterprise) Act 2004 will also have an asset lock. Like community benefit societies, CICs provide a legal form for bodies wishing to pursue social enterprise goals but will use company law as its basis whereas community benefit societies are regulated by the provisions of the Industrial and Provident Societies Act 1965. Given that CICs and community benefit societies will operate in similar areas of activity, the proposal to give societies the option to adopt an asset lock will therefore ensure a level playing field is in place between these two legal forms.
- 7.3 13 responses were received to the July 2004 consultation document, “Regulatory issues for Industrial and Provident Societies”, which asked for views on the Government’s proposals to set up an asset lock option for community benefit societies. Much of the consultation asked about the procedural and technical aspects of setting up an asset lock. The two key questions – on the scope of the asset lock and the enforcement framework – elicited strong agreement. Consultation respondents strongly supported the Government’s proposals to set up an asset lock option for all community benefit societies except those that are already currently subject to a restriction on the use of their assets (e.g. Registered Social Landlords and charitable community benefit societies which are also subject to separate housing and charities legislation). 8 respondents agreed with the Government’s recommendation. 4 qualified their support by raising concerns about the proposal to exclude Registered Social Landlords and/or charitable societies. The Government remains of the view that extending the asset lock option to bodies already subject to a restriction on the use of their assets would be unnecessary and would lead to legislative and regulatory duplication and confusion.
- 7.4 There was also near-unanimous agreement among consultation respondents (with 12 out of 13 respondents favouring this option) that there should be a light-touch regulatory regime, based on the Financial Services Authority’s current powers as a registrar, recognising that the democratic ethos in community benefit societies places members in a good position to monitor the use of locked assets and that a more interventionist regulatory approach would impose unnecessary regulatory compliance costs.

8. Impact

- 8.1 A Regulatory Impact Assessment is attached to this explanatory memorandum.

8.2 There will be a limited extension of the Financial Services Authority's role as a regulatory body but there will be no other impact on the public sector as the instrument only applies to community benefit societies.

9. Contact

9.1 Nigel Fawcett at HM Treasury (Tel: 020 7270 4314 or email: Nigel.Fawcett@hm-treasury.x.gsi.gov.uk) can answer any queries regarding the instrument.

FINAL REGULATORY IMPACT ASSESSMENT ON PROPOSALS TO ALLOW COMMUNITY BENEFIT SOCIETIES TO ESTABLISH AN 'ASSET LOCK'

1. PROPOSAL

1.1 The Community Benefit Societies (Restriction on Use of Assets) Regulations 2006.

2. PURPOSES AND INTENDED EFFECT OF MEASURE

Objective 1.2 The objective of the proposal is to provide community benefit societies (incorporated as a type of Industrial and Provident Society) with the option to protect their assets for community benefit purposes for perpetuity.

Devolution 1.3 Responsibility for Industrial and Provident Society law rests with the Chancellor of the Exchequer. It is an area that is reserved to Westminster under the Scottish and Welsh devolution legislation and therefore these changes will apply to Industrial and Provident Societies in Great Britain.

Background 1.4 The community benefit society is one of a number of legal forms available to social enterprises. It is a body run and managed by its members that conducts its business for the benefit of the community rather than for the benefit of members (as with co-operatives) or external shareholders (as with companies). Community benefit societies operate in a wide range of sectors such as childcare, leisure and football supporters' trusts. Community benefit societies are incorporated under the Industrial and Provident Societies Act 1965.

1.5 The Co-operatives and Community Benefit Societies Act 2003 gives the Treasury the power, by secondary legislation, to bring forward provisions allowing Industrial and Provident Societies incorporated as community benefit societies to prohibit distribution of their assets, other than in specified circumstances (such as to another society with a similar rule on use of assets, or a charity). This is known as an 'asset lock'. The Government supported the 2003 Act in its passage through Parliament as a Private Member's Bill (put forward by Mark Todd MP).

1.6 The proposal to allow community benefit societies to adopt an asset lock was one of the recommendations of the September 2002 Strategy Unit Report, "Private Action, Public Benefit". The Government endorsed this recommendation.

1.7 The Strategy Unit Report also recommended the creation of the Community Interest Company (CIC) as a new legal form for social enterprise based on company law. Proposals to establish a CIC legal form were implemented in the 2003-2004 parliamentary session as part of the Companies (Audit, Investigations and Community Enterprise) Act 2004. The CIC form will offer a complementary alternative to the existing forms of incorporation available to social entrepreneurs (including the community benefit society) and will have a built-in asset lock.

1.8 In July 2004, HM Treasury published a document, "Regulatory Issues for Industrial and Provident Societies", consulting on a range of proposals including those to establish an asset lock for community benefit societies. Consultees were asked to provide views on, for example, whether the asset lock option should be available to all community benefit societies and what type of enforcement framework would be most appropriate. The document also included a partial Regulatory Impact Assessment on which consultees were asked to provide views.

Rationale for Government intervention **1.9** Industrial and Provident Society legislation and regulatory practice already place a number of restrictions on the way community benefit societies deal with their assets. However, where a society converts into a company incorporated under the Companies Acts there is currently nothing in law to stop the members then voting to change the company's objects to allow distributions to members – in effect, to demutualise. By adopting the asset lock, and thus eliminating the possibility of private individual gain, societies will be better able to attract members seeking certainty that their investments will be used as intended. In being better able to attract investment, the cost of capital may be reduced for community benefit societies, as the need to borrow to finance activities will be less. The asset lock therefore removes a potential barrier to further community benefit society growth.

3. CONSULTATION

Within Government **1.10** HM Treasury has consulted with the Department for Trade and Industry, the FSA, the Home Office, the Office of the Deputy Prime Minister, the Department for Constitutional Affairs, the Housing Corporation, the Scottish Office, the Welsh Office and the Department for Enterprise, Trade and Investment in Northern Ireland. We have also consulted the Small Business Service and the Office of Fair Trading.

Public consultation **1.11** On 30 July 2004, HM Treasury published a consultation document on the option for community benefit societies to apply an asset lock. A wide range of Industrial and Provident Societies, professional bodies, representative organisations and individuals were notified of the consultation. The consultation document was available on HM Treasury's website and printed copies were available on request. The deadline for comments was 29 October 2004.

1.12 A total of 13 organisations and individuals responded to the consultation. A number of respondents provided general comments on the costs and benefits of the asset lock proposals but were unable to further quantify those costs or benefits. A summary of responses to this consultation is available on HM Treasury's website or by contacting Aleem Wallani (Aleem.Wallani@hm-treasury.x.gsi.gov.uk or 020 7270 4957)

3. OPTIONS

1.13 In addition to the option of doing nothing, two sets of options are discussed below. The first set discusses whether the option to apply an asset lock should be available to all community benefit societies. The second set discusses what type of regulatory framework is needed to monitor the use of locked assets during the 'lifetime' of a society. These two sets of options are **not mutually exclusive** (i.e. options 2a or 2b can be taken up with options 3a or 3b).

Option 1: No action

1.14 There is currently nothing in law to stop the members voting to change the company's objects to allow distributions to members – in effect, to demutualise. No action may lead to the possibility of private individual gain and societies being less able to attract members seeking certainty that their investments will be used as intended. This may raise the cost of capital, as the need to borrow to finance activities will be higher.

Option 2a: Allowing all community benefit societies to establish an asset lock

1.15 This would give all community benefit societies the option to apply a lock on their assets if they believed that it would add value to their society. However, as community benefit societies with charitable status and those registered as Registered Social Landlords are already subject to restrictions on the use of their assets, allowing these bodies to adopt an asset lock could, in the view of HM Treasury, the Office of the Deputy Prime Minister and the Home Office, lead to unnecessary confusion and duplication.

Option 2b: Allowing all community benefit societies to establish an asset lock except for societies incorporated as Registered Social Landlords and those with charitable status

1.16 This avoids the problem of duplication and confusion mentioned above.

Option 3a: Asset lock with a light-touch regulatory framework

1.17 The democratic ethos common to many community benefit societies means that in many cases the members of a society are well-equipped to call its Board to account for their actions. So one option for enforcement of the lock during the lifetime of the society would be to leave it to members to monitor the use of locked assets and take action where appropriate, through the usual democratic channels. The unalterable rule in a society's constitution would commit societies to transferring locked assets to a body with a similar asset lock on dissolution. The consultation document referred to this option as the Option A regulatory approach

1.18 Under this approach, the Financial Services Authority (FSA) would have powers to cancel the registration of a society in breach of the asset lock. Where a society dissolves as a result of a breach of the asset lock, the draft Regulations would require a society to transfer its remaining locked assets to a body with a restriction on the use of its assets (i.e. another asset-locked community benefit society, a charity, a CIC, or a Registered Social Landlord). The FSA would also have powers to enforce the asset lock namely, (a) issue an enforcement notification, which would require society to take all steps necessary for securing that the contravention was brought to an end and was not repeated; (b) require officers of the society (or members of the committee of management) to repay to the society the amount of its loss, if the FSA considered that the officer or member in question had been knowingly concerned in the breach of the asset lock; (c) remove officers and all, or any, of the committee of management where it considered that they had been knowingly concerned in a breach of the asset lock. Finally, (d), particularly where a speedy resolution is required, the Regulations give the courts the power to grant an injunction to prevent a contravention, its continuance or repetition or require an officer or member of the committee of management to prevent the contravention of bring it to an end.

Option 3b: Asset lock with a formal regulatory framework

1.19 An alternative option would be to create a more substantial interventionist framework for regulating the use of assets during the lifetime of the society, in addition to the opportunities for monitoring and redress provided by societies' own democratic governance structure. This would serve as an alternative option to resolving concerns about the asset lock through the internal processes of the society.

1.20 This option would require a regulatory body to bring it into effect. The Government considered the options for this carefully. Since the Regulator for Community

Interest Companies will be responsible for regulating the asset lock for CICs, there may be some high-level synergies in bringing together the regulatory roles for the two asset locks at some stage in the future. One option is for the **CIC Regulator** to take on this role. The enforcement powers available in respect of breaches of the asset lock will be different for each form; and the underlying legal environment will be that of company law in the case of CICs and Industrial and Provident Society law in the case of societies. The consultation document referred to this option as Option B regulatory approach.

4. BENEFITS

Option 1:

1.21 There are no benefits to not giving community benefit societies the option to lock in the value of their assets, as they will have to meet the same registration requirements whether they adopt the asset lock or not.

Option 2a:

1.22 All community benefit societies would be able to make use of the option to lock in the value of their assets and thereby provide certainty to members. But there would be no real benefit to extending this option to charitable community benefit societies and those registered as Registered Social Landlords, since these bodies are already subject to a restriction on the use of their assets.

Option 2b:

1.23 All community benefit societies, except Registered Social Landlords and charitable community benefit societies, would be able to make use of the option to lock in the value of their assets. As set out above, this option would have the benefit of preventing unnecessary duplication and confusion in the regulation of asset locks for Registered Social Landlords and charitable societies.

Option 3a:

1.24 The main benefit of this light-touch regulatory option is that it would give greater flexibility to community benefit societies and would likely result in lower costs than a more interventionist approach. Societies may judge a more formal enforcement framework to be inflexible and an unnecessary burden, especially in light of the capacity of societies for democratic self-monitoring. A further benefit of the light touch approach is that it is more likely Regulations could come into effect sooner (as a formal interventionist framework would likely take time to establish – see also paragraph 1.39), thus ensuring that societies can realise the benefits of the asset lock in general at an earlier point.

Option 3b:

1.25 This option would deliver a more interventionist regulatory framework for the asset lock. It would give members an additional option for investigation and recourse where societies appear to be in breach of the lock during their lifetime, and may offer greater certainty for potential members that their investment will be used as intended.

Business sectors affected **1.26** These proposals will potentially benefit all community benefit societies. As of 2004, there were around 1,700 Industrial and Provident Societies registered as community benefit societies. Around 1,300 of these are charitable community benefit societies (of which around 700 are Registered Social Landlords); therefore option 2b will apply to approximately 400 community benefit societies.

1.27 It is not possible to predict how many community benefit societies will seek to take up the option to apply the asset lock. However, consultation respondents indicated that many would consider applying it or would advise other societies to apply it.

Issues of equality and fairness **1.28** We do not consider that the proposal will bring any disproportionate benefits or have disproportionate effects on particular groups. Indeed, as CICs will have an in-built asset lock, a failure to give community benefit societies the option to apply an asset lock if they wish to do would risk creating an uneven playing field.

5. COSTS

Option 1:

1.29 There will be no direct financial costs if the position remains as it currently stands. However, there may be indirect costs in the long run if community benefit societies are not able to assure members that investments will be used as intended. Without the option of an asset lock, societies may also be disadvantaged in comparison with CICs, in terms of attracting investment.

Option 2a:

1.30 The following costs are associated with the option to adopt an asset lock for societies:

Registering the asset lock **1.31** The ‘restriction on use’ rule setting up the asset lock would need to be registered with the FSA either as an amendment to existing rules, or as part of a new constitution (for new societies). The costs associated with drawing up this rule should be minimised through the proposal to require community benefit societies to use a proforma ‘restriction on use’ rule to set up the asset lock. In addition, an existing community benefit society seeking to apply the asset lock as an amendment to its rules would be required to hold a vote at a general meeting, for which notice has been given according to the rules of the society. The main costs to societies here are likely to be administrative costs associated with the need to call a general meeting, and hold a vote of members.

Ongoing management **1.32** It is possible that community benefit societies may have to change their systems in terms of IT, training and accounting, to take account of the asset lock. For example, community benefit societies may wish to issue guidance or train members and staff on use of locked assets and to raise awareness of the new rules. It is unclear whether such changes would be necessary to the same extent for all societies. In addition, it is hard to divorce such potential costs from general compliance by community benefit societies with the Industrial and Provident Societies Act 1965.

1.33 Many of these costs are difficult to quantify. Consultation respondents were unable to identify or quantify these costs but no concerns were expressed that these costs would be high.

Option 2b:

1.34 This option would restrict the costs mentioned above to all community benefit societies except those that already have an asset lock through being a Registered Social Landlord or a charitable community benefit society.

Option 3a:

1.35 In addition to costs involved in taking up the asset lock mentioned in option 2a, there may be separate costs associated with the enforcement framework for the asset lock.

1.36 Option 3a would give the FSA powers of enforcement, namely (a) to cancel the registration of the society; (b) to issue an enforcement notification which would require a society to take all steps necessary for securing that the contravention was brought to an end and was not repeated; (c) to require officers of the society (or members of the management committee) to repay to the society the amount of its loss, if the FSA considered that the officer or member had been knowingly concerned in the breach of the asset lock; (d) to remove officers or one or all of the members of the committee of management, where it considered that they had been knowingly concerned in a breach of the asset lock..

1.37 Under option 3a the FSA can only act if it considers that a society is or is likely to be in breach of the lock. It is expected that some kind of investigation would be required to provide the necessary evidence. It is extremely difficult to predict how much such investigations would cost, since much would hang on the complexity of the issues involved, and whether the investigation might result in FSA intervention and/or publicity. The cost of an investigation into a relatively complex issue, such as insider trading in a company, can run to tens of thousands of pounds. If the issues to be investigated in a case of concern that a society had breached the asset lock were simpler, the costs of investigation could of course be significantly lower.

1.38 The FSA has the power under section 48 of the Industrial and Provident Societies Act 1965 to directly recoup the costs associated with the production to it of books, accounts and other documents from the societies being investigated themselves. The total costs are likely to depend on the procedure whereby the FSA satisfies itself that a society is in breach of the lock but it is likely that investigative costs under this option would be lower than that for option 3b. Costs arising from an application to the Court for an injunction under Regulation 16 will fall to the parties, subject to any award by the Court.

1.39 Option 3a assumes an important role for members of asset-locked societies (through their democratic governance structure) in monitoring the use to which the assets are put. In view of this, it could be argued that this option places a heavier responsibility on members of a society to ensure that the community benefit society is acting as intended. For example, there could be costs to individuals in greater scrutiny of the activities of the organisation. It is not possible to quantify what costs these additional member responsibilities and staff resources would involve.

Option 3b

1.40 This option would involve set-up and ongoing costs. The ongoing cost of this option would depend heavily on the regulatory body chosen, on the number of societies registering an asset lock, and on the procedures adopted for handling investigations, but is likely to be higher than that for the enforcement framework outlined in Option 3a. As with Option 3a, the principle of full cost recovery would mean that the ongoing costs of this option would be met by those societies using the lock. This cost would be in addition to the registration and periodic fees already charged by the FSA.

1.41 As set out above, one option is for the **CIC Regulator** to take on the role of regulatory body under Option 3b. Some preliminary assumptions for the costs of regulation via the CIC Regulator are set out below. The lower take-up option below is based on an assumption of 50 societies using the lock, whereas the higher take-up option assumes ongoing responsibilities for around 400 societies. The figures for legal support and investigation costs are a very provisional range, reflecting uncertainty as to the level of investigative activity that will be needed and the complexity of investigations. If few investigations are required and they are relatively simple, we would expect the cost to be at the low end of these ranges.

Preliminary estimate of costs via the CIC Regulator (under Option 3b)

	Low take-up (£000)	High take-up (£000)
Staff costs	100	140
Admin costs	15	15
IT systems	5	5
Legal support	30	50-100
Investigations	Up to 100 if complex	Up to 200 if complex
Total	Up to 250	Up to 500

1.42 If the CIC Regulator were chosen to take on the role of regulatory body, this would also have issues for the timing of introduction of the asset lock. Since the CIC Regulator will be independent of Government, has only recently been appointed, and would need some time to establish the CIC regulatory regime before taking on any additional responsibility, enforcement of the asset lock through the CIC Regulator is unlikely to be possible in the short term.

6. CONSULTATION WITH SMALL BUSINESS

1.43 The Government consulted the Small Business Service and it was agreed that there seems to be no impact on small business. Small business representatives were asked for their views during the consultation but none were put forward.

7. COMPETITION ASSESSMENT

1.44 As the proposal merely introduces an option that community benefit societies can choose to take up if they believe it adds value to their business, this proposal in itself has no competition implications.

1.45 However, depending on the extent to which the option is taken up, this proposal may put community benefit societies with an asset lock at an advantage compared to those that have not taken up the asset lock option. This is because investors may be more inclined to invest where they can be confident that assets will be protected for the community benefit. Nevertheless, the Government believes that the option of applying an asset lock for societies will itself better enable the community benefit society sector as a whole to compete with other social enterprise forms for investment.

8. COMPENSATORY SIMPLIFICATION MEASURES

1.46 In the report of the Better Regulation Taskforce (published 16 May 2005), one of the two principal conclusions was that the Government should apply a “One in One out” approach to new regulation, with Ministers and departments giving a high priority to simplifying or removing over-complex and burdensome regulation as they do to the introduction of new. An order to raise the audit threshold applicable to industrial and provident societies is being laid alongside these regulations. Although the two draft Statutory Instruments pre-date this report, they could be said to comply with the spirit of it. The Asset Lock Regulations impose a regulatory burden, albeit voluntary, and the Audit Threshold Order reduces a burden.

9. ENFORCEMENT AND SANCTIONS

1.47 As discussed in this Regulatory Impact Assessment, the Government considered whether there should be a light-touch regulatory approach (option 3a) or a more substantial regulatory framework involving monitoring of the use to which assets are put during the lifetime of the society (option 3b). Consultation respondents expressed a near-unanimous preference for option 3a, the light-touch regulatory approach. This is also in line with the recommendations of the Hampton review for risk-based regulation, which was accepted in full by the Government at Budget 2005.

10. IMPLEMENTATION AND DELIVERY PLAN

1.48 Those community benefit societies that are permitted and wish to introduce a permanent asset lock will be able to do so by amending their rules and registering the amendment with the FSA. They will be permitted to do this immediately after the regulations come into force. The FSA will be responsible for registering the amendments to societies rules and for taking enforcement action where there is a breach of their rules.

11. POST-IMPLEMENTATION REVIEW

1.49 The effectiveness of the asset lock Regulations and the regulatory approach put forward will be monitored on an ongoing basis by the Treasury, in consultation with the FSA.

12. SUMMARY AND RECOMMENDATION

1.50 The government recommends option 2b and 3a. The benefits of option 2b are that all community benefit societies will be able to apply the asset lock option, except Registered Social Landlords and charitable community benefit societies. These two types of bodies are already subject to restrictions on the use of their assets; this option should therefore ensure there is no unnecessary duplication or confusion. The benefits of option 3a are that it will provide for a light touch regulatory approach and will reduce costs on societies. Members of a society and the FSA will be able to intervene, where necessary, to prevent misuse of locked assets. Both options 2b and 3a had the strong support of consultation respondents.

1.51 The asset lock, although regulatory in nature, is unlikely to create a continuing administrative burden for those societies that adopt it, apart from any initial set-up costs. The FSA will not be actively monitoring compliance with the Regulations, but will rely on complaints to initiate action.

'I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs:

Signed by the responsible Minister

.....

Ivan Lewis, the Economic Secretary to the Treasury.

Date.....

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