CO-OPERATIVES UK

THINK PIECE 11

The Capital Finance of Co-operative and Community Benefit Societies

A discussion paper for Co-operatives UK

Mark Hayes

"The co-operative principle of limited return on capital needs to be asserted clearly but also understood more imaginatively."

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Contents

2 Acknowledgements

4 Executive Summary

7 Summary of Recommendations

9 Introduction

11 Previous reports

15 Defining capital and membership

17 The regulation of offers and registration as a society

22 The capital finance of co-operative and community benefit societies

23 The yield on investment

23 The principle of limited return

29 The compensation for risk

32 The rights of external investors

33 Taxation

36 The realisation of investments

36 Transferable shares and secondary markets

41 Ethical and legal implications of variable share prices

45 References

48 Endnotes

Executive Summary

The ICA *Blueprint for a Co-operative Decade* contains two key sentences which summarise the challenge. Co-operative capital needs to offer 'a financial proposition which provides a return, but without destroying co-operative identity; and which enables people to access their funds when they need them. It also means exploring wider options for access to capital outside traditional membership, but without compromising on member control'.

Capital is neither subordinated debt nor a deposit. Withdrawable share capital, in particular, is best understood as a form of partnership capital with limited liability. Withdrawable capital enables a community to share the risk of their co-operative enterprise. We should defend their freedom to do so. This is especially important for small societies with small offers that cannot justify the costs of regulated offers.

The price of exemption from statutory regulation is strong self-regulation. Both societies and the public need a better understanding of the nature and appropriate use of community shares. The sector should introduce robust measures to help aggrieved investors pursue claims against societies, directors and promoters for misrepresentation in share offers. The regulator must continue to protect the sector from the unscrupulous through the registration conditions.

The co-operative principle of limited return on capital needs to be asserted clearly but also understood more imaginatively than it has been in the past. Profit-sharing is incompatible with democratic governance in the long run, but this does not mean that capital can receive only an uncompetitive annual interest rate. The best solution to the tax bias against investment in societies would be to take share interest out of tax altogether, making it neither deductible nor assessable. The policy case is that this would be revenue neutral for both Treasury and societies, substantially reduce red tape and unleash co-operative enterprise.

Societies, as human communities, cannot offer investments compatible with the methods of venture capitalism, where the gains on selling the winners cover the cost of backing losers. The risks of early stage and start-up business have to be managed, not offset, which requires the development of specialist intermediary institutions in order to reduce the risk premium demanded by external investors to viable levels.

“Profit-sharing is incompatible with democratic governance in the long run but this does not mean that capital can receive only an uncompetitive annual interest rate.”

The need to protect the society from external investors has to be matched by protection for the external investors from abuse by the society, if external investment is to be forthcoming. The holders of more than 75% of the share capital in a society should be allowed the right to petition a court, through the society, for the society to be wound up if the court judges this to be fair. Voting should otherwise be democratic and often will be limited to users.

Permanent transferable shares offer societies the prospects of significant advantages for the finance of their business and of institutional investment on a large scale. External investors need both an exit and liquidity, and in the case of transferable shares, this can only be provided for institutions by a secondary market or stock exchange. This means variable share prices and some degree of speculation, although in this context society shares are no different from bonds.

> "Permanent transferable shares offer societies the prospects of significant advantages for the finance of their business and of institutional investment on a large scale."

If societies are to issue transferable shares, the larger societies will have to engage with institutional investors and the stock exchange. There is a case for establishing a large society as a financial intermediary, to hold permanent shares in other societies pending their listing, and itself funded initially with withdrawable share capital, prior to its own listing.

Summary of Recommendations

- The right of societies to make offers of withdrawable shares as risk capital ('community shares') without a prospectus or authorised approval should be stoutly defended and a limit on an individual's holding of withdrawable shares retained.
- Co-operatives UK and the Financial Conduct Authority (FCA) should continue to work on the education both of societies and of the public on the nature and appropriate use of community shares.
- Co-operatives UK should extend its code of practice on withdrawable share capital to include community shares, including a requirement to file offer documents, the creation of an ombudsman to pursue claims by aggrieved investors, and a legal expenses insurance fund to pursue individual directors and promoters through the courts.
- The FCA should be encouraged to exercise vigilance in its registration of societies, without stifling legitimate innovation, and if necessary to use its powers to de-register societies where the conditions are no longer met.
- The yield on society shares should be fixed in advance by a formula related to nominal value, not profitability, and the society should always retain the right to redeem at nominal value. The yield should not vary during the term of the shares nor during a period of suspension of withdrawals. The entitlement to share interest should be preferential to any patronage dividend and cumulate in the event of non-payment for lack of distributable profit or cash. This should not prevent societies making separate issues of notice, term and permanent shares, nor the indexation of nominal value to a suitable external index, nor the payment of a premium on redemption to compensate for risk.
- Share interest should be taken out of tax, neither deductible for the purposes of corporation tax nor assessable on the recipient. The conditions of the Enterprise Investment Schemes should make society shares eligible for relief provided that they are not preferred to any other class of share capital.

- Rules should permit one vote per share on motions to amend share rights, to appoint not more than two directors, and to resolve by a 75% majority that the society petition the court for a winding up on equitable grounds.
- Co-operatives UK and the larger societies should work with institutional investors towards the listing of transferable shares with the above rights on the main stock exchanges.
- Consideration should be given to the formation of a large society as a financial intermediary (working title: The Co-operative Capital) to hold transferable shares in smaller societies, funded by withdrawable share capital pending the creation of a viable secondary market in the transferable shares of large societies, including itself. While the emphasis should initially be placed on building a portfolio of transferable shares in established societies, with a view to onward sale on their listing, this institution might also develop the capacity to manage the risk of investment in societies with early stage and start-up businesses, building on existing co-operative lending and development institutions.

Introduction

Capital finance has been a problem for several co-operative sub-sectors, notably worker co-operatives, since the 19th century. Even the consumer and banking sectors are now being forced by events, notably the financial crash of 2008, to consider looking beyond their traditional membership and their own corporate saving for forms of capital which do not compromise control by members.

The purpose of this paper is to open a discussion with expert interested parties on the way forward. Given the limited time available, my research has focussed on high level, sometimes rather abstract, issues of principle in the hope that these are of general application across a very diverse sector. Although informed by several valuable discussions with practitioners and my own experience, the paper does not offer a comprehensive survey of practices across the movement and may well have overlooked some important innovations. Nevertheless certain practical recommendations have emerged for consideration and debate.

The paper concentrates exclusively on the capital finance of societies, meaning co-operative and community benefit societies registered under the soon to be renamed Industrial and Provident Societies Act 1965 ('IPSA 1965'). It is worth reflecting that the problem of capital finance is often a major reason for the incorporation of worker and agricultural co-operatives as companies, so that a solution within the society framework might help unify the UK movement around a single corporate form with a firm foundation in co-operative principles.

Similarly, these considerations apply equally to co-operatives and community benefit societies, which share in common their character as democratic associations and an adherence to co-operative principles, despite the loss of autonomy created by state involvement in the housing sector, again partly a consequence of the problem of capital finance. The paper is written mainly from a UK perspective, although the principles enunciated should have wider relevance.

This is not mainly a legal paper, but it is impossible to treat the financial question in isolation. It is necessary to prepare the ground by making clear what is meant by capital and by membership. Furthermore the ability of (especially smaller) societies to access capital depends on their exemption from certain regulations that apply to companies, so that a discussion of regulation is necessary, which in this context includes registration. Only then can we turn to the main question of capital finance, which in turn divides into the principles governing the yield on, and the realisation of, investments in society shares. These questions cannot be considered in isolation from the taxation regime and the legal rights of external investors. The question of realisation in turn leads inexorably to a consideration of the role of stock markets and whether these are compatible with co-operative principles.

We begin by reviewing briefly the findings of previous work on this topic over the last half century.

Previous reports

The Co-operative Independent Commission (1958) focussed on the consumer movement. Its main conclusions in relation to capital finance were: the need to persuade over 950 independent retail societies to invest their surplus capital in the business of the movement as a whole, rather than in outside securities; to offer competitive interest rates on share capital and borrowings; to move towards a policy of internally financed growth through retained earnings and cash flow supplemented by long-term debt; and to seek loans not only from retail societies but from trade unions and other external investors.

History has seen the consolidation of the movement's funds mainly through consolidation of the movement itself; a move away from traditional withdrawable shares as a source of capital, at least in the case of the Co-operative Group; as well as the suggested move towards internal finance supplemented by long term debt, now standing at £1bn in the form of eurobonds in the case of the Co-operative Group (2012, note 25).

The Financing and Taxation of Co-operatives in the United Kingdom (Plunkett Foundation, 1996) presented a comprehensive review covering the five main co-operative sectors in considerable detail. The report starts from two axioms, that the finance of co-operatives must not prejudice control by user-members and that public policy should not favour incorporation as a company rather than as a co-operative. It was partly coloured by the expectation of an imminent Co-operatives Act, which among other things would divide co-operatives into the categories of individual and common ownership and provide an asset lock for the latter. In the event an asset lock was granted only for community benefit societies.

The report contains much careful analysis and many detailed recommendations. Its key findings on capital finance include the case for transferable shares and corresponding need for a secondary market and specialised financial intermediation; that investors should be paid a competitive return but not in general be allowed to share in profits; that external investors, including retiring members, should have the right to attend meetings and to information but not votes; that reserves should be allocated to members as shares in the case of individual ownership co-operatives; and the need for harmonisation of taxation versus company shares.

The Co-operative Commission (2001) had little to say on capital finance, with the emphasis being placed on internal finance through improved commercial performance together with a restatement of the need to protect unallocated reserves from demutualisation. Its main focus was again on the consumer movement, with other co-operative sectors addressed briefly under the wider heading of the social economy.

Co-operative Capital (Brown, 2004) broke new ground in several areas, including its clear analysis of the issues surrounding capital finance, the connection with initiatives outside the movement in the area of ethical investment, and its proposals for institutional design. The report treats the questions of the profit share and voting rights of external investors as a matter of degree, arguing pragmatically for a 50% maximum share of profits and 25% maximum share of votes, taking into account precedents elsewhere in the EU. This is tempered by the proposal of a multi-stakeholder common wealth council to limit the distribution of profits so as to ensure equity between generations. The report calls for the establishment of a secondary market for ethical and co-operative securities and of a co-operative venture capital fund.

Cook and Taylor (2007) reported on a change in the regulator's attitude towards external capital investment in industrial and provident societies, partly prompted by the risk of regulatory arbitrage (e.g. the proposals in Brown (2004) assumed incorporation as a company). External investment here means capital subscribed by 'non-user investor-members'. The regulator's position was to permit non-user investor-members to hold shares up to the legal individual shareholding limit and was not prescriptive as to their profit sharing or voting rights, save for an exclusion of the right to vote on conversion and a general requirement that user-members should retain control. This policy has not yet been updated since the removal of the individual limit on the holding of transferable shares.

Rodgers (2009) outlines a new approach to the capital finance of housing co-operatives, involving two key elements, the Community Land Trust (CLT) and the Mutual Home Ownership Society (MHOS). While the CLT by definition is restricted to land and related assets, the MHOS introduces an innovation of wider application in the form of the indexation of the nominal value of shares to the replacement cost of the buildings.

As part of a wide-ranging review of the state and prospects of co-operation in Britain, Murray (2010) calls for a new model for financing the growth and integration of the movement, along the lines of the Mondragon bank during its formative era. It does not directly address capital finance but recognises the potentially powerful role of financial intermediaries in institutional development. It also highlights the role of the Mondragon bank in managing the risk of early stage financing of new co-operative enterprises.

Deloitte (2012) reports on a global survey of the practices of 36 very large co-operatives. They record pressure to raise capital, specifically from regulators in the case of financial services but also in general, to increase capacity to withstand another credit crunch. There is an increase in the proportion expecting to raise capital from both user and non-user members, beyond the compulsory user-member shares issued in some jurisdictions. The proportion of non-financial services co-operatives raising voluntary capital from user members is expected to show a marked increase from 19% to 48%. Among financial services co-operatives, 70% of which had already issued voluntary capital to user-members, an increasing proportion expect to have recourse to non-user investors (p. 17). Three examples are given of co-operatives issuing non-voting preferred shares to non-users (p. 18).

The ICA *Blueprint for a Co-operative Decade* (Mills and Davies, 2012) contains two key sentences which summarise the challenge. Co-operative capital needs to offer 'a financial proposition which provides a return, but without destroying co-operative identity; and which enables people to access their funds when they need them. It also means exploring wider options for access to capital outside traditional membership, but without compromising on member control' (p. 29). This statement has informed the structure of this paper.

Defining capital and membership

There is a certain amount of confusion over the distinction between capital and debt, particularly subordinated debt where the creditor's claim is postponed behind those of other creditors. This confusion tends to be linked to a restricted understanding of membership as applicable only to the users of a co-operative's services.

Membership arises from association and capital represents the amount for which the members of an association are liable for loss, which may be unlimited. Incorporation, the creation of a legal person separate from the members, permits the liability of the members to be limited to the amount of the subscribed capital. All forms of incorporation are based on a contract of association between members, whether the rules of a society, the memorandum and articles of a company or the agreement between limited partners. Therefore any holder of a share in capital, which in the first instance is a share in losses rather than profits, is necessarily a member of the association, with rights governed by the contract of association.

By contrast a creditor is a third party who contracts with the corporate body. The practical distinction is that a creditor has the individual right to petition the court under the Insolvency Act 1986 to wind up the corporation if it defaults in payment, in addition to the power of creditors as a group to agree to a winding up at the request of the directors. An individual member has only the weaker right to petition for winding up on the grounds that it is 'just and equitable'. The corporation can otherwise be wound up or dissolved by members only by resolution as a group, whether in general meeting or otherwise.

Thus a failure to make a payment due on subordinated debt represents insolvency, while a failure to pay a company dividend or society share interest or redeem shares does not. All shareholders are members, although in many corporations members are required to subscribe for (or guarantee) only £1 in capital.

In the co-operative movement there has been a similar but opposite confusion in the treatment of the holders of withdrawable share capital as depositors (i.e. creditors). This has been compounded by the regulation of building societies, and later of credit unions, in such a way as to treat their withdrawable shares in precisely this manner. The political consensus of the time led to an exemption for 'the acceptance by an industrial and provident society of a deposit in the form of withdrawable share capital' when banking regulation was introduced in 1979, conditional upon the introduction of the Co-operative Deposit Protection Scheme.

Nevertheless, the appropriate analogy is not with a deposit but with the capital introduced by business partners, which they are entitled to withdraw, in particular upon resignation or retirement, on terms normally set by agreement so that the remaining partners can continue in business (otherwise the partnership must be dissolved). When the Banking Act exemption came up for review in the process of introducing the Financial Services and Markets Act 2000, it was successfully argued that the issue of withdrawable share capital may, but does not necessarily, involve the acceptance of a deposit. The exemption was changed to read 'in so far as [a society] accepts deposits in the form of withdrawable share capital'. The distinction hinges on whether there is an additional contract beyond the society's rules, express or implied, creating an obligation to repay, with or without interest. Provided that no such obligation is created, societies are free to issue withdrawable shares as capital (i.e. true, risk-bearing, capital) and they have increasingly done so since then.

The regulation of offers and registration as a society

Even though the relationship between a corporation and its members is primarily governed by its contract of association, the invitation to become a member and subscribe for capital has complex legal ramifications. The potential for misrepresentation and fraud has led during the last century to the requirement for companies to file a prospectus and for offers of transferable securities to be made or approved by authorised persons. These measures are intended to ensure that the statements upon which subscribers are entitled to rely are recorded and well-founded, as a basis for holding to account those responsible for making them.

Since 1988, statutory compensation has been available where an authorised person is in default and since 2001 an ombudsman can pursue claims on behalf of personal investors. Societies alone remain entitled to make offers of withdrawable[1] share capital without a prospectus or authorised approval. This privilege does not relieve the society and related parties from their responsibilities but significantly increases the burden of proof on the investor.

The 1930s saw a spate of investment scams involving the use of societies to avoid the restrictions introduced by the Companies Act 1928[2]. The result was the introduction in 1939 of the present definitions of co-operative and community benefit societies and the prohibition of the use of societies as investment vehicles (Snaith, 2001). These registration conditions are an effective form of structural regulation which avoids the disempowerment and alienation of membership created by prudential regulation, as in the case of building societies (Hayes, 2010) and arguably, housing associations. Nevertheless the application of the conditions involves the exercise of discretion by the regulator, which requires both sufficient resources and a good knowledge and understanding of the co-operative sector and its principles among the staff responsible for registration.

The urge to 'cut red tape' in registration may have the unintended consequence of a backlash requiring the extension of FSMA regulation to all offers by societies. The case of Presbyterian Mutual, a Northern Ireland IPS which failed in the aftermath of the financial crash in 2008, is a stark warning. The society had raised some £310m in capital and loans (£100m in shares) and has been under investigation by the FSA (Boyd, 2009), presumably for conducting an unauthorised banking business by accepting deposits in the form of loans or for breaching the investment vehicle prohibition. Advances to congregations and mortgages on owner-occupied property totalled £27m, with the balance in commercial lending and investments, while capital and loans had increased by 60% in 2 years. The Northern Ireland government was forced to introduce legislation to permit an administration (rather than liquidation) and to provide a £225m bailout fund. The parallels with the US savings and loan debacle are clear, as is the risk to Great Britain's co-operative sector of any similar event.

The UK co-operative sector should encourage the FCA to exercise vigilance in its registration of societies and if necessary to use its powers to de-register societies where the conditions are no longer met. This requires clarity not only over the application of co-operative principles to particular cases but over the nature of community benefit societies and the meaning of section 1 (2) IPSA 1965 (as amended – the investment vehicle prohibition). Vigilance does not mean restriction of legitimate innovation and it is in the public interest that it remains possible, if more expensive, to register societies that do not follow existing model rules or precedents.

In relation to capital finance, the investment vehicle prohibition should not be interpreted as preventing the payment of the market price for capital. The question is unlikely to arise where a society is a community benefit society or pays patronage dividends but a high rate of share interest in the case of a society that makes no other distribution of profit might suggest otherwise.

Tests of the principle of paying 'the minimum rate necessary to attract and retain the capital required for the society's object' might include verifying whether membership was being restricted so as to prevent the raising of cheaper replacement capital, and conversely, whether directors were actively seeking cheaper capital; or the observation of substantial net growth of share capital in the context of a low proportion of share capital and reserves represented by gross trading assets (including loans to and shares in other societies). The inclusion here of shares in other societies as trading assets reflects the fact that the prohibition relates to the use of societies as an investment vehicle, not to the conduct of a finance business. This means that societies like Radical Routes and Rootstock, which use their capital exclusively to finance other societies, are quite legitimate.

The question then arises whether the above conditions of registration are sufficient protection for investors. The objective here should be to protect investors from the unscrupulous, not from themselves. There should be no question of prudential regulation of the conduct of a society's business, although much more support could be given to the education of society members to enable them to hold directors and management to account. Nevertheless invitations to subscribe for new shares should undoubtedly meet certain standards; the question reduces to whether the state should police this, directly or indirectly.

The case for the status quo is:

- Societies should be democratic associations of people who either already know each other directly or have a genuine opportunity to meet and exercise governance together;
- Withdrawable share capital is withdrawable at nominal value so that an assessment of the share price is unnecessary. The rate of return should be specified in advance. Subscribers need to be able to assess risk, but the co-operative nature of the enterprise may permit this to be done without formal documents beyond the audited accounts;
- The individual shareholding limit helps to prevent people from misguidedly sinking their life savings in a single risky enterprise. The price of a higher limit may be statutory regulation and in practice the average shareholder's (i.e. median) investment is almost certainly substantially lower than £20,000. Where capital needs are greater, the possibility of regulated offers of transferable shares is now available, at least in principle;
- A requirement either to register a formal prospectus or obtain approval for an offer would involve professional fees which are disproportionate or prohibitive for smaller enterprises of precisely the type for which societies are best suited.

There may be a case for the sector to adopt a degree of self-regulation, building on the experience of Co-operatives UK as a promoting body and its various voluntary codes, including the code on withdrawable share capital. Specifically it would help aggrieved investors pursue claims against societies, directors and promoters for damages arising from misrepresentation in offers of withdrawable share capital. This might be done through the creation of an office of ombudsman or arbitrator within a voluntary code that could be embedded in society rules. The elements of this would include:

- an acceptance by societies of obligations as part of their membership of Co-operatives UK, which would allow them to place a label on share offers referring to a 'Community Shares Ombudsman' or similar; the obligations would include:
- the acceptance of a Co-operatives UK code of practice on offers of withdrawable share capital, suitably modified to take into account the issue of community shares by new societies;
- the filing of all offer documents and audited accounts with Co-operatives UK – this would not mean approval by Co-operatives UK , the point is to record the representations made by analogy with the registration of prospectuses;
- the acceptance by a society of a Co-operatives UK ombudsman's decision as binding, if accepted by the investor.

Such a system would not directly prevent or compensate for egregious behaviour. In the event of a society's complete failure, it would provide evidence as a basis for action against individual directors and promoters through the courts. Consideration might be given to a legal expenses insurance fund for such cases. Nevertheless it would set a standard for good practice and provide a process through which redress might be achieved by informal or formal mediation, short of an arbitration decision. It would contribute to the creation of a culture in which co-operative capital was understood neither as a deposit nor as a way around the Companies and Financial Services and Markets Acts. Last but not least, Co-operatives UK and the FCA should continue to work on the education both of societies and of the public on the nature and appropriate use of withdrawable share capital.

The capital finance of co-operative and community benefit societies

Having prepared the ground, it is possible to address the main concern of this paper, the challenge set out by the ICA Blueprint to identify 'a financial proposition which provides a return, but without destroying co-operative identity; and which enables people to access their funds when they need them. It also means exploring wider options for access to capital outside traditional membership, but without compromising on member control'.

This paper has already argued that withdrawable share capital should remain very much a live option, provided that it is understood as a legitimate form of partnership capital rather than a deposit. However the removal of the individual limit on holdings of transferable shares creates a new opportunity and raises new questions.

These are taken under two headings, relating respectively to the yield, or financial return, on investment and to the realisation of investments, the manner in which investors can recover their outlay together with any undistributed yield.

It is necessary to decide clearly whether co-operative principles allow non-user investors to share in profits as a reward for risk-taking and how much control over a society investors should exercise. Not much progress will be made without a modest degree of tax reform. A decision also needs to be made as to whether secondary markets, complete with variable share prices and some degree of speculative trading, are compatible with co-operative principles, while recognising that without secondary markets, there is little prospect of issuing genuinely transferable shares or of large-scale institutional investment into the sector.

The yield on investment

The principle of limited return

> *Capitalists hired wage labourers, paid the market price for labour and appropriated all the gain. Co-operative labour proposes to hire capital, pay the market price for it, and appropriate all the gains.* (attributed to Holyoake, 1893, by Murray, 2010)

> *For, if capital has to be ventured at a hazard, the people who venture it will expect to exercise control, and to harvest the profits, more or less in proportion to their venture. Associations that raise capital at fixed interest and distribute surplus in accordance, not with investment, but with purchases, do not enable them to do this. The graded machinery of debentures, preference shares and ordinary shares furnished by joint stock companies is much more satisfactory. In risky undertakings, therefore, Purchasers' Associations will not work.* (Pigou, 1920, p. 327)

There are a number of divergent views about the appropriate reward for investment in societies. These can be summarised as:

- Societies should pay a simple interest rate below the market rate. The primary motive for investment should be the benefit to the member as user, including patronage dividend, or to the community.

- Societies should pay the minimum rate required to attract and retain the capital necessary for their business. This means a competitive rate for the type of capital offered, in line with the above quotation from Holyoake (1893).
- Investors should be allowed to share profits but not be able to force a conversion. This is the position adopted in Cook and Taylor (2007).
- Without conversion and control rights, equity shares are of no value to outside investors. This would be the standard City view, in line with the above quotation from Pigou (1920).

The Co-operative Independent Commission (1958) noted that prior to 1939 consumer societies had a surfeit of capital from their members (although the report is silent on the position of agricultural and worker co-operatives). It is a matter of history that share accounts came to be treated as savings deposits with corresponding low interest rates, with the primary return to members arising through the dividend on purchase. By contrast, IPSA 1852 specified a maximum rate of 5% at a time when inflation was zero, which represents a return acceptable to many modern institutional investors.

The question of the appropriate rate of return becomes pertinent when capital is sought from external investors, i.e. non-user investor-members. The compensation for risk cannot then be subsumed into the patronage dividend nor can it be expected to be waived for the benefit of the community. If Holyoake's dictum is accepted, the question remains how to 'determine the minimum rate required to attract and retain the capital' and whether this minimum rate should include a share in profits (i.e. a payment related to the profitability of the society and not simply to the amount of capital invested).

Cook and Taylor (2007) record that the FSA (now FCA) is willing to be guided by the movement on the appropriateness of profit sharing and, as noted earlier, Brown (2004) advocated a profit-sharing multi-stakeholder model. Both are influenced by precedents elsewhere in the EU, notably the possibility of a European Co-operative Society operating within the UK. Nevertheless Cook and Taylor (2007) note that the European statute requires 'disinterested distribution', i.e. an asset lock. Provisions for profit sharing by non-user investor-members in other states, such as Italy, need to be understood in that context. It might well be in the interests of societies, particularly those running early stage businesses, to have a variable cost of capital in line with performance rather than a fixed rate. However an asset lock removes the investor's claim on the undistributed profits so that the investor's return is limited to the proportion of profits (and therefore cash flow) that the society is prepared to distribute in each year, given competing claims from user-members and for retention to finance growth.

The multi-stakeholder model in Brown (2004) provides for a common wealth council to control the level of distribution to investors and protect the unallocated reserves. The principal objection to this approach is the potential for internal dispute and it seems unlikely that external investors will find such a structure attractive, where they are not motivated by charitable or philanthropic concerns. There is an extensive academic literature (Heath, 2011; Heath and Norman, 2004; Hansmann, 1996) on the problems of multi-stakeholder governance. The UK movement's own history contains examples of the difficulty of sharing profits between consumers and workers with conflicting interests.

Accordingly the rest of this paper assumes that capital is paid a limited return in line with traditional co-operative principles. This means that capital is paid a rental by a formula fixed in relation to the amount subscribed and that the society retains the right to redeem capital at nominal value. It is from this perspective that we return to the question of how to 'determine the minimum rate required to attract and retain capital'. To this phrase might be added the words 'from institutional investors' if the movement is to mobilise external capital on a large scale.

Traditionally the rate of interest on withdrawable share capital is determined within the context of withdrawal on demand. The rate is set as the market-clearing price which balances inflows and outflows of capital in the same manner as a deposit with a bank, or more precisely, a building society. A society with a surplus of capital can lower its share interest rate and allow the outflow of capital to exceed the inflow, and vice versa. The tacit assumptions are that there is a large membership with a relatively high turnover in shares and that sufficient liquidity is maintained so that withdrawals do not have to be suspended from time to time in order to match outflow to inflow.

The introduction of notice and term shares introduces no questions of principle that have not already been solved by building societies. Notice shares reduce the need to maintain liquidity and may carry a higher rate of interest accordingly. Term shares have a rate of interest fixed until maturity, which requires separate issues of shares each with their own interest rate, with each offer limited to the period for which the interest rate remains competitive. In principle, a term share can have a variable interest rate fixed by a formula rather than as a single number, e.g. in relation to LIBOR or a relevant government bond. Variable rates on term shares are unusual but in any case the formula, if not the actual rate, remains fixed for the term, unless the society redeems early. This reflects the fact that the subscriber needs to know in advance the return for the full period for which the capital is committed. A corollary is that the rate of interest on shares normally withdrawable on demand should not be varied while withdrawals are suspended.

There is no reason of principle why societies should not follow building society practice in issuing notice and term shares in multiple issues of share capital, although non-financial businesses have less use for notice shares. Mills (2009) argues for the use of 10–15 year term shares to fund renewable energy projects and indeed there has been a surge of such offers, many promoted by energy4all. Gen-Community (2012) offers the prospect of a 7% yield. However, several of these offers (e.g. Westmill 2012, Drumlin 2012, Brixton 2012) do not fix the rate of return but simply present projections in the style of a company offer. Part of the reason for this may be the conditions of tax relief under the Enterprise Investment Scheme, designed with companies in mind, which do not allow cumulative preferred dividends (see below for a further discussion of taxation). Nevertheless the co-operative principle appears to require that the rental price of capital be fixed in advance and cumulation seems appropriate. This does not affect the fact that share interest cannot be distributed from capital but only from cumulative profits or other gains.

There is no reason of principle why the rental price of capital has to be expressed as an annual interest rate. Industrial and agricultural investments may generate their returns over a long period of time after, perhaps, an initial period of losses. Even if the internal rate of return[3] on the investment can be expressed as an interest rate, this does not mean the profits will arise at a uniform steady rate. There is no reason why the yield to investors should not begin only after a certain period and then increase as the investment comes on stream. Thus the projections in the renewable energy offers do not conflict with co-operative principle provided that they represent the maximum amounts that will be paid as share interest in the relevant year, and not simply an indication of the likely return from a distribution of profits as a dividend on capital.

Nevertheless the use of such projections, even as a maximum, rather than a formula provides fertile ground for dispute, especially without cumulation, as events will almost certainly not develop exactly according to plan. Furthermore, investors may well be aggrieved if shares, offered on the basis of long-term projections of a certain yield, are redeemed as soon as it becomes possible to raise replacement capital at a lower cost (although this can be covered by paying the risk premium on redemption). Arguably it is the duty of the directors to accept, and indeed actively seek out, cheaper replacement capital if the society is not to be treated as an investment vehicle. On these grounds it seems better practice to specify both the coupon, year by year if necessary, and the expected redemption date in the original offer.

Similarly there is no reason why the nominal value of shares should be fixed at £1. Reference has already been made to Mutual Home Ownership Societies, in which the nominal value is indexed to the depreciated replacement cost of the buildings occupied by the housing co-operative. Alternatively, the indexation of nominal value to consumer prices would create an investment similar to government index-linked bonds, which would be intelligible and potentially attractive to institutional investors. A coupon in real terms of 5% which kept pace with inflation would be fully in line with the original intentions of IPSA 1852. The time pattern of returns, rising over time in terms of money, would be a better fit for industrial investment in physical assets than a conventional interest rate. This again raises questions of taxation that are considered below.

To summarise the argument so far, co-operative principle requires that the prospective yield on capital be fixed in advance, at the time of the offer, for the term of the investment. This does not rule out the tailoring of the time pattern of the return to capital in line with the expected pattern of returns on investment in the society's business, nor the linking of nominal value to a suitable index that is independent of the profitability of the society.

The compensation for risk

The next question that needs to be considered is that of risk, including the critique made by Pigou in the quotation at the head of this section, and whether risk capital will be forthcoming from external investors on terms acceptable to societies.

Pigou refers to the ability of companies to raise debentures and preference shares, which had not been issued by consumer societies in 1920, partly because they had no shortage of capital from user-members. Behind his critique lies a recognition that the use of user-members' capital as a form of savings deposit is incompatible with investment in long-term industrial projects, although this had not prevented the wholesale societies financing production across the globe from internal cash flow. A century on, it is clear that very large societies can issue debentures and preference shares to institutional investors, although these investments do not carry the level of risk associated with smaller enterprises. Furthermore the proportion of preference shares in these societies' capital is small, e.g.7% in the case of the American agricultural co-operative CHS, 15% in the case of Rabobank (CHS, 2012; Rabobank, 2012).

Since 1990, smaller societies have issued shares to user-members as risk capital in withdrawable form and in May 2012 the Co-operative Group amended its rules to permit the issue to its users (i.e. consumers) of transferable shares. In the case of the Group, there may have been a need to change the culture and break with the tradition of treating withdrawable share capital as a deposit; the use of transferable, non-withdrawable, shares creates a new understanding with members. Nevertheless the new Member Investor Shares can be issued only to individual user-members (for good reason, as we shall see) and are not available to institutional investors. The wider question is whether shares bearing a level of risk rather higher than the existing debentures and preference shares can be issued to non-users including institutions.

Pigou recognises that external subscribers of risk capital will expect to have a say, directly or indirectly, in how their money is used. The separation of ownership and control in large enterprises does not alter the normal tendency of management to pursue the interests of investors, particularly in a culture as financialised as the UK's. Furthermore most of the return on investment in a company arises from capital gain, arising partly from the accumulation of undistributed profits but more importantly from the opportunity to capitalise future profits by the sale of the business as a whole, without serious reference to the interests of the human community which it embodies and serves, notwithstanding section 172 of the Companies Act 2006.

The return on ordinary company shares is defended partly on the grounds of risk, that the profits on the winners offset the losses on the failures. By analogy with insurance, a portfolio of shares is expected to produce an average return which covers the losses and yields a net profit as compensation for bearing the risk. However the analogy is misleading, apart from the pooling of risk. The risks of investment in shares are not open to actuarial calculation in the same way as fire or mortality risk. There is no reliable basis for calculating a fixed risk premium (in the sense of an insurance premium) that an enterprise should pay for its capital. The premium that a lender or preference share investor demands is simply a matter of competitive supply and demand. Outright control with unlimited return to capital, not to mention the possibility of speculation, substitutes for calculation and avoids the need to divide the return on capital between compensation for risk and pure rent. The term 'co-operative venture capital fund' (Brown, 2004), if understood literally, is an oxymoron.

Thus societies committed to democratic control face the possibility that there are currently no viable terms on which external risk capital may be available to them in the open market. In the absence of an objective, rational basis for calculating the appropriate risk premium, market investors may demand a higher premium than any business can reasonably expect to generate as a return on physical capital, leading to 'junk bond' syndrome.[4] Societies are rationed in the capital market by the fundamental uncertainty surrounding their future trading performance.

The way forward lies, not in the objective reduction of uncertainty, which is impossible, but in creating a conventional expectation of the risks associated with co-operative enterprise, based on track record and a comparison with a portfolio of similar investments, combined with credible mechanisms for the appropriate protection of investors' interests. Since few risk-bearing fixed-return equity investments currently exist in the UK (and none in the co-operative sector as such), the circle can only be broken by the creation of such securities by the largest societies and by the establishment of specialist intermediaries and markets to enable new and smaller societies to make credible offers and engage with institutional as well as personal investors.

Murray (2010) suggests the creation in the UK of an analogue of the Caja Laboral Popular in Mondragon. This proposal recognises the key role of the contract between the bank and the member co-operatives in managing enterprise risk and ensuring accountability. Until the mid-1980s, the Mondragon bank was able in effect to mobilise external capital from the community in the form of deposits, which was then used and guaranteed by the member co-operatives. Changes in banking legislation at European level have outlawed this model, although there could be no objection to the establishment of a society issuing both withdrawable and transferable shares in order to play a similar role as a financial intermediary. The principle is already established in ICOF Community Capital, Shared Interest and Rootstock. The practical issues surrounding the establishment of such an organisation are beyond the scope of this paper, which concentrates on the fundamental issues about the nature of capital finance for co-operatives that require resolution before such institutional innovations can sensibly be addressed. Nevertheless the key point made here is that intermediary institutions will need to be developed in order to reduce the risk premium demanded by external investors to manageable levels, for all but the larger societies.

The rights of external investors

The primary financial value of control to an external investor is the ability to sell the enterprise for a capital gain, which is obviously incompatible with co-operative principle. There remains the question how much say in governance, short of the right to sell, should be granted to external investors. The need to protect the society from the investors has to be matched by protection for the investors from the society. A first step is to give preference to the payment of share interest and redemptions over patronage dividends, so that incentives are aligned to that extent.

Cook and Taylor (2007), in line with their enabling approach, adopt the principle that the co-operative nature of the society must be preserved and control remain in the hands of the user-members, concluding that non-user investor-members should not be allowed to vote on a resolution to convert the society into a company. Their assumption is that all members (users and non-users) will have one vote. However we are mixing oil and water here and the democratic principle is not necessarily an equitable basis for a group of non-user investors to reach a collective decision. Secondary co-operatives already depart from the strict one member, one vote, principle in the interests of equity, when voting rights are allocated to members in relation to trade or primary membership. One possibility—another is separate meetings of users and non-users— is to allow members one vote per share on motions to amend share rights; to elect not more than two directors (one for moral support, to give non-users a voice in the board room); and to resolve by a 75% majority (in the event that payment of share interest or capital redemption is more than, say, 2 years in arrears) that the society petition the court for a winding up on the grounds that it is just and equitable to do so (Insolvency Act 1986, section 122). This last provision is intended as a last-resort measure to give investors redress against unfair non-payment, without giving them either the positive power to force a conversion or the unconditional rights of a creditor. The court would then decide whether the investors were being treated unfairly or simply had to accept that their risk had crystallised.[5] Essentially the court would decide whether the 'partnership' had broken down and should be dissolved.

Taxation

No discussion of financial return can be complete without reference to taxation. Plunkett Foundation (1996) presented a comprehensive review and argued for a level playing-field between co-operatives and companies. KPMG (2012) records the present position in relation to capital finance. In summary, share interest is treated like gross loan interest, deductible for the purposes of corporation tax and taxable as income of the recipient. The interest is recognised for tax purposes when credited to a share account as well as paid in cash. Since no capital gains can arise on society shares with a fixed nominal value, neither the taxation nor relief of capital gains appear relevant. Offers of shares by some societies have qualified for income tax relief under the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme, although there is no value to them in the exemption from capital gains on disposal.

For individual shareholders there is a significant tax bias against investment in societies relative to investment in companies. Much of the return on investment in companies arises in the form of capital gains, for which there is an annual personal allowance of £10,600 (2011/12) in addition to the allowance against income tax. This means that an individual with a portfolio of a value up to £350,000, generating capital gains of 3% per annum and income of 2%, need not suffer any capital gains tax. The rate of taxation on any capital gains remaining above the annual allowance is lower at 18%/28% compared with 20%/45% on income (2011/12). Furthermore society shares are not eligible for the tax shelter of an Individual Savings Account (ISA).

The Enterprise Investment Schemes offer substantial tax relief to personal investors in the form of a tax credit of 30% in the main scheme and 50% in the Seed version. An unintended consequence of the conditions of the schemes is to undermine the co-operative principle of limited return. Eligible shares cannot carry cumulative dividends nor have a preferential claim on winding up. The intention of the scheme is to reward risk-taking so that these measures are understandable within a company context. However their effect appears to be for the issuers to offer a dividend on capital in breach of co-operative principle.

There are two simple reforms that would redress the tax balance between co-operatives and companies in the area of capital finance. First, share interest should be taken out of tax altogether, like alimony, becoming neither deductible for the purposes of corporation tax nor assessable as income of the recipient. It would become for tax purposes, what in law it is already, a distribution of the net income of the society after taxation. This measure would be broadly revenue-neutral for the Treasury, since the revenue gain would be at least 20% in terms of corporation tax and the loss 20% in terms of basic rate income tax. It would cut red tape and reduce government spending, since at present personal investors are expected to declare their interest and tax codes or assessments have to be processed. For societies it would also be broadly neutral, in that share interest rates could be reduced to offset the increase in corporation tax without imposing an after-tax loss on the investor.

There would be no dividend tax credit but this would be a price worth paying for the simplification of the tax regime and would compensate the Treasury for any loss of higher-rate income tax.

The lack of a dividend tax credit would also reduce the incentive to set up societies to avoid higher rate tax, although any such schemes should be caught by the investment vehicle prohibition. To the extent that higher-rate taxpayers were encouraged to invest in genuine societies, the exemption from higher rate tax would help to compensate for the lack of a capital gains tax exemption.

The benefits for the capital finance of societies would be substantial. Risk premiums and the indexation of nominal value could be paid on redemption without incurring a tax charge and the overall time pattern of the return to capital could be tailored to fit the needs of the business without reference to the timing of tax payments. Profits, including share interest, could be allocated fully to members, after appropriate transfers to specific reserves, in the form of transferable shares, without prejudicing the finance of the business. Given a satisfactory secondary market (see below), societies would be able to finance their growth without the need, in principle, to make any cash distribution.

It is worth noting in passing that this suggestion moves the locus of taxation from the individual to the society, precisely the opposite of the proposals in Plunkett Foundation (1996). Plunkett expected the principle of common ownership to be enshrined in law and argued for transfers to indivisible reserves to be exempt from corporation tax, increasing the resources available for the internal finance of growth. The report also argued for the value of bonus shares to be taxed as a capital gain on realisation (section 3.19) but did not address the overall bias of the tax regime for personal investors.

The second reform would be for the conditions of the Enterprise Investment Schemes to recognise the co-operative nature of societies by making their shares eligible for relief, despite cumulative dividend and preference over patronage dividends, provided that they were not preferred to any other class of share capital (all other conditions being met). In other words, the shares should be recognised as being the principal risk-bearing capital instrument despite their superficial resemblance to the cumulative redeemable preference shares of a company. A society could still have multiple classes of share eligible for relief, provided they all ranked pari-passu. This reform would allow societies to make use of the enterprise incentives, including through intermediary funds, without compromising their character.

The realisation of investments

Transferable shares and secondary markets

Withdrawable share capital is the traditional means by which people can access their funds when they need them. The practical mechanisms have been fully developed by building societies for shares withdrawable, not only on demand, but also at notice or after a fixed term. Provided that it is made clear that withdrawable share capital is like partners' capital rather than a deposit, so that losses may be charged to a member's share account, there are no difficulties of principle in allowing withdrawal only after a certain period rather than upon demand. The problems with withdrawable share capital arise from the perspective of corporate finance, relating to the type of asset financed and the needs of the investor.

There is an important distinction between an 'exit' and 'liquidity'. An exit is any method by which investors can realise their capital, while liquidity means, going beyond this, that capital can be realised at the investor's option at any time at current open market value. Thus an unlisted company can offer the prospect of an exit to an investor in ordinary (non-redeemable) shares through a trade sale, even though its shares remain illiquid in the meantime. Share capital withdrawable on demand provides both an exit and liquidity but this does not apply to term shares or transferable shares. A purely transferable share in a society without a listing on a secondary market offers neither an exit (except on winding up) nor liquidity.

Term shares allow a society to fund long-term assets safely, solving the society's maturity, interest rate and liquidity risks, and providing the investor with a definite exit. Recent renewable energy issues are good examples. However, although this may be sufficient for certain types of investor, notably enthusiasts or a specialist institution, term shares do not provide liquidity. Furthermore it is unusual in general for businesses to issue shares on a project finance basis, where the cash generated by the acquired assets is used to redeem the capital, rather like a terminating building society. Most businesses comprise more than a single project and the returns on individual assets cannot always be identified, so that there is a need for permanent capital, which can be rolled over internally from one project to another and is redeemable only at the society's option. 'Permanent' here means transferable and redeemable at nominal value only at the society's option at an indefinite date.[6]

Without liquidity, the funds available for investment in term shares of a maturity suitable for industrial investment (say 10–20 years) are restricted because the investor is locked in until maturity. The knowledge that the investor's circumstances may change unexpectedly limits the proportion and type of funds the investor will commit to illiquid investments. A secondary market for shares is important, not only as an exit for holders of permanent capital, but also for the liquidity it provides for term shares as well. Liquidity is important for long-term institutional investors mainly because it provides an objective basis for valuation.

In principle, permanent shares offer societies significant advantages. The cost of raising replacement capital continuously, the market risk of changes in interest rates, the cost of maintaining liquidity and the risk that liquidity is insufficient at times of market stress, are all transferred from the society to the investor. In a banking context, the suspension of withdrawals may trigger a loss of confidence, making withdrawable share capital unsatisfactory from a regulator's perspective. Worker and agricultural co-operatives, as well as possible new forms such as public sector community benefit societies, have long expressed an unmet demand for non-user permanent capital, with limited scope for user-member withdrawable share capital in their particular contexts.

The allocation of reserves to members in the form of permanent shares reduces the risk of demutualisation if it allows members to realise the equity in their society individually without conversion. Furthermore the wide gap between the real and perceived value of membership reduces commitment, and provides management with effective control of the unallocated reserves at zero cost of capital. Although some might greet the latter with equanimity, others argue (e.g. Briscoe et al, 2012, in the context of the Irish agricultural co-operative sector) that active, properly motivated, individual ownership is a necessary condition of the preservation of the co-operative model in the absence of an asset lock. In the specific case of the Co-operative Group, the issue of permanent shares from the historical reserves would not only allow a much higher level of dividend on purchase in the form of shares, for the period during which historic reserves were allocated, but also protect the society if it issued shares to non-users. It might thereby remain possible to ensure that 75% of share capital was held by user-members while offering the protection of equitable winding up to institutional investors.

Yet all these advantages cannot be achieved without an active secondary market or at least a market maker. Brown (2004) makes the case for a secondary market as a corollary of the need for permanent capital. The report recommends supporting the establishment of an independent ethical stock exchange, Ethex, which nine years later has recently launched an online marketing platform (although still some distance from becoming a recognised exchange). There is also a plan to establish a Social Stock Exchange with a similar vision of attracting institutional investors interested in social as well as financial return, although it remains to be seen whether anything comes of this. The underlying philosophy of these initiatives (see Jessica Brown, 2006) is somewhat confused and lacks the clarity of co-operative principles. This claim is best illustrated by the perverse consequences of ethical investment for a secondary market.

Ethical investors are motivated by a mixture of motives, including social, environmental and philanthropic as well as financial. They cover a broad spectrum, depending on the mix, ranging from large funds with an ethical screen to individuals who would be happy to write off their investment in a good cause. A number of organisations (see Brown, 2004), both companies and societies, have tapped this market for primary issues. To the extent that non-financial motivations dominate the investment decision, these organisations have been able to raise funds on concessionary terms. The concession comes at a price, that such investors are interested only in primary issues and not secondary purchases, precisely because they want to make a difference. There is little interest among them in second-hand shares, where the proceeds of purchase go to an existing shareholder and not into the enterprise.

The implication is that such investors will get fair treatment only when their shares are redeemable at nominal value, as in the case of societies. Otherwise, as in the case of companies, the price of transferable shares will fall in the secondary market to their objective financial value. In cases where the issuing company is immune from take-over for social reasons, there is no ultimate exit short of winding up, so that the shares can be valued only on the basis of their dividend yield, which is often zero. The consequence is that there is no reliable secondary market in the shares of these companies, which explains in part their support for initiatives such as Ethex. Therefore any transferable shares issued by societies should not offer or expect a concessionary rate of return, it should be the market rate as determined by supply and demand in the secondary market. The legal and ethical implications of a fluctuating market price are considered further below.

A further difficulty is that historically stock markets are the creatures of investors, not issuers. Their murky origins in the speculative deals made in early 18th century coffee houses should not obscure the fact that the primary purpose of a securities market is to permit the transfer of assets. This is a legitimate social function even if the finance of enterprise, which some might see as the primary justification of the stock market, is in fact only a subordinate goal. The members of a stock exchange are not the issuing companies, but the dealers in securities.

The implication is that the creation of a market for transferable shares in societies requires active collaboration with investment institutions, starting with those who have already invested in the Group's eurobonds and other securities issued by the Co-operative Bank. It is conceivable that a group of institutions could create a separate market for society shares, off the main exchange, but it is most likely that in the end the shares would have to be listed in the normal way. From an institutional perspective, society shares would be regarded as a form of corporate bond alongside building society Permanent Interest Bearing Shares (PIBS), for which there are well-established precedents.

As with the management of risk in start-up and early stage businesses, there is a case for the formation of a society as a financial intermediary, along the lines of a large scale Rootstock, to purchase permanent shares in smaller societies funded by the issue of its own listed transferable shares. Indeed such an intermediary (working title: The Co-operative Capital) would be a necessary staging post on the road to listing on a secondary market, given the minimum size of a viable listing. The nominal value of its transferable shares could be related to the nominal value of the society shares in its portfolio, calculated in a similar fashion to a unit trust. However such an intermediary would provide smaller societies merely with indirect access to the market; the emergence of a secondary market in the first place would need to be encouraged by the larger societies, including the Group and The Co-operative Capital itself, through direct issues of transferable shares.

To the extent that the intermediary was funded by withdrawable share capital, it could attract funds only from societies and individuals and would not be able to raise substantial institutional funds. This route could represent either an alternative to engagement with the City or a necessary preliminary stage, during which to build a portfolio of holdings each sufficiently large to warrant a listing. It would require the full and active support of the movement as a whole if it were to reach members and attain sufficient scale cost-effectively. The use of withdrawable share capital would allow the intermediary to mobilise capital on potentially favourable terms from ethical investors beyond the user membership of the movement. The intermediary would face a maturity mismatch between the permanent nature of its shareholdings in other societies, pending their listing, and the withdrawable nature of its own shares, however with sufficient scale this could be managed by the usual methods. It might begin by issuing its own shares in exchange for permanent shares issued by societies, partly through conversion of existing shares, so that the intermediary became the preferred route for non-users to invest in the sector and the principal exit for users needing to realise all or part of the value of their shareholdings. The parallel with the early Mondragon Caja Laboral Popular is clear.

Ethical and legal implications of variable share prices

An important feature of a secondary market in securities is that market prices usually diverge from nominal values and from issue prices (where these differ from nominal value). This is new territory for societies accustomed to withdrawable share capital and raises the question whether variable prices are compatible with co-operative principles. Beyond the question of principle, variable prices require measures to prevent market manipulation and insider trading.

A partial solution, which nips the problem in the bud, is for the issuing society to peg the market price of its transferable shares at nominal value, by dealing in the market itself. On this scheme, the society always stands ready to buy shares if supply exceeds demand and to issue new shares if demand exceeds supply. This assumes a satisfactory resolution of the legal aspects of an open offer of transferable shares, namely the FSMA offer and prospectus requirements. It is not difficult to see that this amounts to a variant of a withdrawable share capital regime with the added costs of stamp duty on transfers between shareholders and regulatory compliance. This is particularly so because the share interest rate would need to be variable in line with current market rates, if the market-clearing or equilibrium market price of the shares were to be held at nominal value so as to limit the need for the society's intervention. A failure of the society to buy back shares would have the same impact on the share price and investor confidence as a suspension of withdrawals. It is therefore hard to see why such a scheme would be preferred to the traditional withdrawable share capital model, unless to escape the idea that withdrawable share capital is a deposit or to take advantage of the removal of the individual shareholding limit on transferable shares, neither of which are compelling reasons.

Alternatively, on the normal assumption that the issuer does not deal in its own shares, the price of permanent shares will fluctuate in the secondary market. Variable prices mean the possibility of speculation, something alien and repugnant to a co-operative culture forged in the struggle against speculators and profiteers. The question is whether this is a matter of absolute principle or of degree: if the former, there is no role for genuine transferable shares in the co-operative movement; if the latter, the question becomes one of the acceptable degree of speculation.

A useful precedent has been set by the bonds and preference shares issued by the Co-operative Group and Bank. The prices of these securities can fluctuate in the market because of changes in market interest rates and in perceptions of the risk of default. If interest rates or perceived risk fall, the holders can make a capital gain. If interest rates or perceived risk rise, the holders make a loss unless they are willing to hold the security until maturity. Differences of view between investors can result in one holder making a gain to which there must correspond a loss by others. A speculative investor might take a different view from the market, as to the future course of interest rates or the degree of risk attaching to the shares, and might profit thereby. In particular, market-makers earn their income by mopping up excess supply or demand at any given time precisely by offering a price which turns a profit relative to their expectation of the normal price for the security, and thereby provide the important function of smoothing out intra-day and day-to-day fluctuations and maintaining the liquidity of the market. This is no different in principle from the function of retailers of goods or the Co-operative Bank's dealers in foreign exchange. No market is speculation free, indeed any dealer, including a retailer, must 'speculate' as to the best time to buy or sell.

The fluctuations in the price of the Group's eurobonds and listed securities are not cause for concern, because the return on the securities is fixed and they are redeemable at nominal value. There is an important difference between stabilising and destabilising speculation. If an asset has a firm normal equilibrium price, speculation tends to drive the market price towards equilibrium. If the equilibrium price is uncertain, speculation may drive the market price further away from equilibrium, leading to a bubble. Manufactured goods have firm equilibrium prices governed by the production cost of new goods, even if the prices of goods held in stock can rise or fall if demand fluctuates outside normal limits.

By contrast, the prices of company shares are intrinsically uncertain, deriving their value from an expected stream of earnings extending far into the unknown future. In these circumstances prices become a matter of convention and speculation can become self-fulfilling, as the long history of stock market bubbles and crashes testifies. In the case of a fixed interest security there is no uncertainty about the money value of the future stream of interest and principal payments, so that there exists a fairly firm normal equilibrium price, given market expectations of interest rates and the risk of default. In such a context, speculation offers limited prospects of gain and tends to be stabilising.

The answer to the question of speculation in transferable shares therefore turns out to be a deeper application of the co-operative principle of limited return on capital. Provided that the society's commitment, the rental price of capital, is fixed in advance on a particular issue of shares and the society has the right to redeem the shares at nominal value, there is no difference of principle between transferable shares and bonds. In practice the fluctuations in perceived risk may be greater, producing a wider range of fluctuations in the market price, yet the variation is bounded. This principle is not affected by the time pattern of payments on the shares, e.g. an indexed nominal value or a redemption premium, although fluctuation may be greater the more that payments are loaded towards redemption.

A different consequence of variable prices is the potential created for market manipulation and insider trading. Officers of societies will need to understand the concept of price-sensitive information and their duties and obligations. Societies themselves should not purchase their own shares through individual bargains or provide financial assistance for others to do so, as distinct from making partial redemption at nominal value, pro-rata to all shareholders. There is no obvious case for exempting societies from the regulations and codes that apply to companies in relation to dealings in transferable securities.

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Endnotes

1. The right to offer transferable shares without approval was withdrawn by The Financial Services Act 1986 (Investment Services) (Extension of Scope of Act) Order 1995 in response to EU legislation.
2. Section 33 of the Companies Act 1928 introduced the prohibition of the issue of an application form separately from a prospectus and section 92 required any written promotion to include a signed statement of written particulars, under penalty of substantial fines and in the latter case, up to 6 months' imprisonment (Jordan and Borris, 1928).
3. The internal rate of return is the rate of interest which reduces the net present value of a stream of cash flows over time to zero, where the net present value takes into account outlays as well as receipts.
4. The BofA Merrill Lynch US High Yield Master II Option-Adjusted Spread (BAMLH0A0HYM2) shows the spread over US Treasury bonds ranging from 2.5% in 1998 and 2007 to 10% in 2003 and 22% at the height of the financial crisis in 2009.
5. If legislation were possible, it might be better if the investors were given the right to petition the FCA, which in turn could, if it saw fit based on its understanding of co-operative principles, petition the court. However shareholders already have the right to petition the court directly and the proposal in this paper is simply to make the sanction more effective by enabling them to require the society to make the petition on their behalf.

6. Ian Snaith (2013) has questioned whether societies have the legal right to redeem non-withdrawable shares, short of winding up. He reasons that the common law principle of capital maintenance applies to both companies and societies; the inconsistency of withdrawable capital with case law is trumped by statutory exception. An alternative view is that society legislation protects the interests of creditors differently from company law and has more in common with partnership law modified by limited liability. Under section 57 IPSA 1965, the interests of creditors are protected by the potential liability of members to repay any withdrawals in the event of insolvency within one year.

   If Snaith is right, the removal of the individual shareholding limit on non-withdrawable shares is of little practical benefit in isolation and could even be harmful. If non-withdrawable shares can be redeemed only on winding up (or via conversion into a company), societies cannot replace expensive capital when cheaper capital becomes available, which undermines co-operative principles, as indeed would any pressure to convert into a company. Furthermore, if the society does not have the option to redeem at will, the value of transferable shares in the secondary market will be reduced, since it can reflect only the running yield and the value of any redemption (including any indexation or premium to compensate for inflation or risk) will be heavily discounted. User members are very unlikely to vote for winding up or conversion except in distress, precisely when redemption is of little or no value.

   Snaith considers that further legislation is necessary to clarify the legal position and recommends the extension to societies of the provisions of the Companies Acts that permit the redemption or purchase by the company of non-withdrawable share capital. An alternative, if legislation really is necessary, might be a small revision of section 57 to put beyond doubt that contributory liability extends to all classes of share capital, whether withdrawn or redeemed within one year of insolvency.

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Mark Hayes is an academic economist at the University of Cambridge with research interests in macroeconomic theory, in particular the economics of Keynes, and in the co-operative movement, including Fair Trade.

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Co-operative enterprises have operated from the start with a distinctive approach to finance. This discussion paper, *The Capital Finance of Co-operative and Community Benefit Societies* by Dr. Mark Hayes of the University of Cambridge, goes back to these first principles in order to explore the potential for new models of capital finance that can sustain business success without compromising member control.

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