Factsheet 3: Shares and bonds

3.1 What are shares?

A share is a legal right to membership and part-ownership of an organisation in return for an investment. There are different types of shares with different rights, determined partly by the terms and conditions attached to the shares (the share agreement) and partly by the corporate legal form of the organisation itself.

Some corporate bodies, principally registered charities and other organisations constituted as companies limited by guarantee without share capital, cannot issue shares. For this type of organisation the alternative is to issue bonds.

Ordinary shares in private limited companies convey full legal title over the enterprise and all its assets. Shareholders have rights over the profits, assets and control of the enterprise, based on the proportion of shares they hold. For instance, a person owning 60% of the ordinary shares in a private limited company has 60% of the votes in any decision about the future of the enterprise, and a right to 60% of the profits declared as dividends and 60% of the residual assets in the event of the business being wound up or sold. In return for these rights, shareholders are last in the line of creditors if the enterprise gets into financial difficulties. The money invested by shareholders is fully at risk; they can lose all the money they have invested.

It is possible to restrict the rights of shareholders. For instance, companies can issue preference shares which carry no voting rights or rights over the residual assets of the enterprise, and carry a fixed rate of return. In return, preference shareholders will usually be higher up the line of creditors than ordinary shareholders, and are therefore less at risk.

The private limited company is just one of the corporate formats that can be used to issue shares. Other formats include the public limited company (plc), the Community Interest Company (CIC) and the Industrial and Provident Society (IPS). Each of these bodies of corporate legislation affect the rights and duties of shareholders in different ways, some of which may be better suited to community share issues.

Of the 81 organisations that are known to have issued community shares, 58 are IPSs, 22 are plcs and only one is a CIC. In line with the increasing popularity of community share issues, there has been a steady rise in the proportion of organisations using the IPS format. Since 1990, over 80% of new community share issues have been by IPSs, rising to over 90% since 2000.

3.2 What are bonds?

A bond is a form of loan. It is a legal agreement between the issuer of the bond and the purchaser which usually states the amount of interest to be paid on set dates on the loan and when the loan will be repaid in full. Bonds are widely used by public authorities, credit institutions and companies, but are rarely used in the third sector. There are a handful of large housing associations that have raised sums in excess of £250m from financial institutions. .

There are not many examples of community bond issues. Of the 81 organisations that have raised capital through community shares and bonds, only six have used bonds, and only three of those have relied exclusively on bonds. Organisations usually turn to bonds when they are unable or unwilling to offer shares. Some organisations, including charities and organisations incorporated as companies limited by guarantee without share capital, cannot have shareholders. For instance, Golden Lane Housing, a charity that provides accommodation for people with learning disabilities, raised £1.7m through a bond issue in 2003.

Other organisations, such as workers' co-operatives, might like the idea of raising capital from their supporters but are not willing to compromise their principles of workers' control. Bonds provide a good solution to this problem, because no voting rights are attached to bonds. For instance, Unicorn Grocery, a workers' co-operative in Manchester, raised £350,000 through the sale of bonds to their customers and supporters in order to buy their premises when they were in danger of being sold to developers. Another way of achieving a similar outcome is to issue preference shares, which do not carry any voting rights.

Some organisations may also prefer to issue bonds rather than shares in order to attract investors who do not want to commit their money for indefinite periods, and who prefer to know what interest will be payable during the full term of the loan.

However, there are a number of disadvantages with bonds compared to shares. Bonds must be repaid by a fixed date, which means that profits will have to be made and set aside to fund these repayments. Of course, it is possible to replace one set of bonds with a fresh issue, but this means re-incurring the cost of raising capital, with the attendant risk that investors will not want to renew their bonds. Bonds can also be more expensive than shares, especially if the bonds carry a fixed rate of interest, compared with shares, where the rate of interest is determined by members each year.

Offering bonds to the public is subject to the same sort of regulation as any other form of financial promotion, such as shares, and is also subject to the same exemptions from regulation. (Factsheet 4 provides more information about exempt offers.)

3.3 Shares versus bonds

There are a number of factors to take into account when deciding whether to issue shares or bonds. The following table outlines the relative merits of both types of capital. Much depends on an organisation's priorities and principles. Most organisations prefer shares over bonds, because share capital does not have to be repaid, and is a more flexible form of capital. But some organisations are either unwilling or unable to issue share capital, in which case bonds are their only option. All types of organisation can issue bonds, as long as the regulations governing financial promotions are followed.

Some organisations, such as Shared Interest, have issued both shares and bonds. Bonds offers can be used to encourage existing shareholder members to increase their investment, albeit on a temporary and short-term basis. Bonds can also provide a way for IPS members to invest more than the £20,000 limit on shareholdings in an IPS.

Shares versus bonds (from an issuer's point of view)

The issue	In favour of shares	In favour of bonds
Attracting community investors	Shares offer ownership and membership as well as an investment opportunity	Investors know when they will get their money back and are higher up the list of creditors
Attracting other forms of capital investment	Lenders will usually treat share capital as security	Demonstrates community support for project to grant providers and charitable funders
Community engagement	Shareholders have legal title to the organisation	Bond holders can be invited to become members using mechanisms other than shares
Cost of attracting investment	Depends on whether it is considered an exempt offer	Depends on whether it is considered an exempt offer
Governance	Shareholders are members and can have voting rights over the organisation	Bondholders do not have an automatic right to membership or any voting rights over the organisation
Amount individual investors can invest	Limit of £20,000 in IPS shareholding reduces dependency on small number of investors	No limit on individual bond holdings, allowing wealthier community members to invest more
Cost of capital	Interest or dividend paid to shareholders is variable and linked to performance	Fixed interest rates means that cost of capital is known and can be planned for in advance
Redemption of capital	No requirement to redeem share capital, except for some types of withdrawable share capital in Industrial and Provident Societies	Community investors know when the bonds will be redeemed and their capital returned to them
Tax treatment	Community investors may qualify for Enterprise Investment Scheme (EIS) tax relief	Interest paid to bondholders is an allowable pre-tax expense from profits

3.4 Buying and selling shares and bonds

Most investors will only buy shares or bonds if they know how they can eventually get their money back by selling their investment. One of the main attractions of bonds is that investors know exactly when the organisation will redeem the bond. Shares are not redeemable. Instead, ordinary shares in most companies, including CICs, are transferable between one person and another. So, if an investor wants to get their money back they must find someone who is willing to buy the shares from them. To make this process easier, larger companies, especially plcs, can apply to be listed on a stock exchange. There are several different stock exchanges in the UK, in addition to the largest of them all, the London Stock Exchange.

Shares that are traded on a stock exchange are subject to market forces. The value of shares can go up or down, based on what potential purchasers are prepared to pay. This in turn is subject to much analysis and some speculation.

None of the 84 organisations we have identified have share capital listed on a stock exchange. There are practical problems associated with the cost and requirements for listing, and the compatibility of these requirements with the terms and conditions attached to community shares and bonds. Research is currently being conducted into the feasibility of establishing a social stock exchange which may address some of these barriers.

As an alternative, some organisations have turned to stock brokers or other financial intermediaries, who are prepared to operate what is known as a "matched bargain service" where the brokers keep details of people who want to buy shares and match them with people who want to sell shares in the same organisation. There is usually a formula or mechanism in place to fix the value of the shares, and the brokers might charge a commission for their services. Organisations can operate a matched bargain service in their own shares, although there are restrictions on how such a service is promoted, and FSA authorisation may be necessary.

The main problem with matched bargain services, and with most other mechanisms for trading company shares, is the difficulty of establishing a secondary market for shares. It is much easier to attract community investors to invest in a new project rather than an existing project. Existing investors might be persuaded to increase their investment; finding new investors for existing projects is much harder because all the new investors are doing is releasing existing investors from their commitment.

These problems tend not to arise with unlisted companies in the private sector because there are usually only a handful of shareholders who tend to act in unison. Most small unlisted private companies are subject to "trade sales" where the buyer, often another business in the same trade sector, purchases all or most of the shares in the company in order to grow their own business.

Based on the evidence so far, it might seem that buying and selling community shares is likely to be problematic. However, there is another option, only available to IPSs, which overcomes many of these difficulties. Shares in IPSs can be transferable and/or withdrawable, in contrast to ordinary shares in companies, including CICs, which can only be transferable.

Withdrawable share capital is unique to IPSs. Most IPSs have rules about how much notice must be given by members wanting to withdraw some or all of their capital, and may also have rules preventing members from withdrawing any capital for the first few years after the IPS is first established. Additionally, most IPSs issuing withdrawable share capital have rules that give their directors the discretionary power to refuse members' requests to withdraw capital. These exceptional powers are used to prevent an IPS getting into financial difficulties if it cannot meet requests for share withdrawal. Directors tend not to use such powers lightly; members have the power to appoint and remove directors at general meetings.

Like shares, bonds can be traded on the bond market if the issuer is a listed company, or through brokers operating a matched bargain service. The value of bonds on these markets can vary, depending upon prevailing perception of credit risk , interest rates and how close to the redemption date the bonds are. However, most community investors are prepared to wait until the redemption date of bonds is reached, so the development of trading mechanisms for bonds is rarely necessary.