

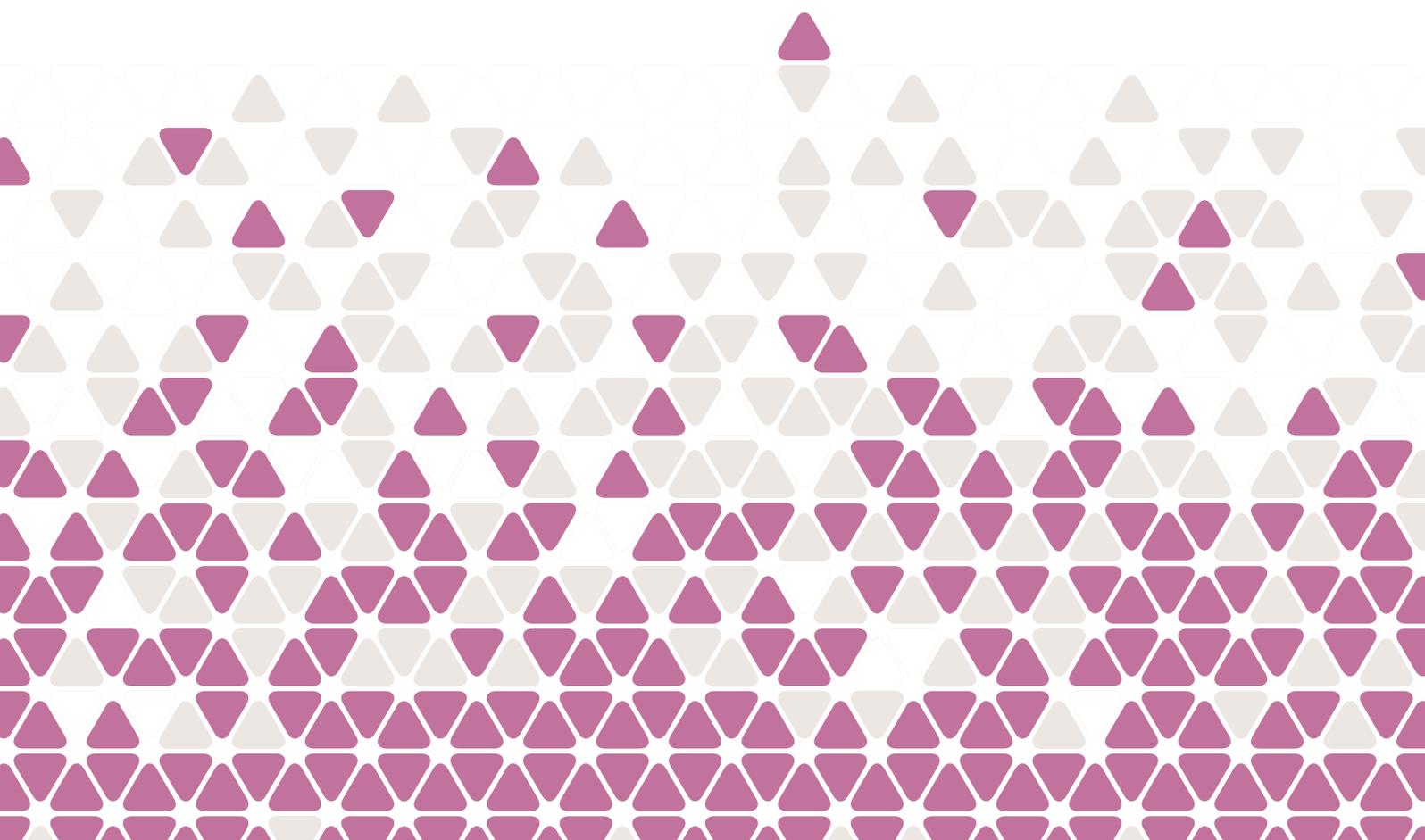
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# The Social Business Frontier

A report that investigates how to recognise and protect  
the social impact that business delivers in the UK

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Prepared by Big Society Capital, with Bridges IMPACT+





# TABLE OF CONTENTS

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Foreword	2
Introduction	3
The UK Social Business Frontier	5
A framework for protecting impact of social business	7
The framework in practice	11
Recommendations	17
Appendices	
i. Using impact locks in practice	20
ii. Acknowledgements	22



## FOREWORD

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What is the purpose of business? What is it there to do? Who is it for?

Business lies at the heart of society – as an employer, a provider of goods & services, a wealth creator and an innovator. In return, society gives business a licence to operate, offers its labour and consumes its goods and services. A healthy society relies on a healthy relationship with business, and vice versa. This interdependence creates a covenant between business and society.

Business has historically been the greatest driver of economic prosperity and social progress. However, recent history indicates that if business does not honour the covenant between business and society, it risks destroying value for both parties. Defining success in business in exclusively financial terms has introduced exactly this risk. It has made the question of how to better align the interests of business and society a pressing issue of our time.

It is therefore timely and welcome that the Social Impact Investment Taskforce has been established under the UK presidency of the G8 to examine this, alongside other related issues. This paper outlines thinking and practice at the frontier of this field. It is relevant to everyone who invests in, is employed by or operates a business. It is tactically relevant because any loss of licence-to-operate is an important risk for businesses to understand. It is strategically relevant because successfully addressing this question has the potential to create substantial value for both shareholders and society as a whole.

**James Perry**

**Chair, Social Business Frontier Working Group**

This report has been prepared by Simon Rowell of Big Society Capital, with Clara Baby and Caroline Tulloch of Bridges Ventures



# INTRODUCTION

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## The social business frontier in the UK

Our society is increasingly moving towards a genuine mixed economy. There is a greater social consciousness in business and a greater range of business models that are able to deliver societal benefit. In the UK, a ‘social business frontier’ between pure social and pure business is emerging in containing organisations that combine and align both financial and social goals.



There is also some evidence that this frontier could be of a significant size. There is at least 1.5 times the number of private companies currently identifying as social enterprises than as registered charities. Society (and Government in particular) should be supporting the development of this frontier, as it provides a real route to help drive social impact at scale.

## Challenges

However, when operating outside the traditional private and social sector distinctions, two challenges emerge. First, it is difficult for an outsider to **recognise** social businesses<sup>1</sup> accurately and the current process largely of ‘self-identification’ does not effectively reveal which organisations genuinely have both financial and social goals. This presents a real risk of “social washing” by companies wanting to appear more socially-conscious than they really are.

Second, it is difficult to evaluate properly how **well protected** the alignment between financial and social goals really is. Preventing the distribution of financial value outside the business (a ‘asset lock’) by a specific empowered regulator (such as the Charity Commission) is a clear way of aligning social impact for registered charities. However, there are many other ways to align financial and social goals with different levels of effectiveness that need not involve a regulator or an asset lock. Without understanding the broader array of mechanisms available, there is a real chance of failing to appreciate the true nature of many good social businesses or to spread awareness of the diversity of ways of protecting social impact.

## Purpose of this report

These are challenges that this report seeks to start to address. Its purpose is to provide new ways to understand which organisations are protecting their social impact and how well that impact is protected. The report does this by looking past the strict legal form of organisations, to focus on the variety of discrete approaches to protecting social impact used by both internal and external means. It investigates the UK landscape specifically to inform stakeholders about possible approaches available and also to encourage tailored reform to strengthen the environment for social business.

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<sup>1</sup> Also known as “impact-driven businesses” in the report of the Social Impact Investment Taskforce established under the UK’s presidency of the G8.



It aims to be useful to:

- **Social business:** By helping find suitable ways to ensure that their social goals continue in perpetuity;
- **Impact investors:** By helping ensure that their capital supports the impact that they seek (including after their exit);
- **Key stakeholders:** By helping identify the real social businesses to give support to or to buy from; and
- **Government:** By helping provide a means of tailoring regulation and policy to support and promote genuine social businesses.

### Scope of report

This report sets out:

- A review of the UK social business frontier;
- A new framework to identify what social businesses are trying to protect<sup>2</sup> and how this can be protected;
- A review of current experience of social businesses and impact investors; and
- Recommendations for strengthening the 'social business frontier' and expanding the role of social businesses in delivering impact-led solutions to societal problems.

This report finishes by providing preliminary guides on how the impact locks may be used in practice.

This report aims to foster a discussion on this subject, and lead to further exploration of the material by others. It should be read in conjunction with the Report of the Mission Alignment Group of the Social Impact Investment Taskforce, which provides a review of the broader policies that should be enacted in different countries to promote a productive social business environment. It aims to also contribute to the rich collection of research and thought leadership within the broader international taskforce process.

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<sup>2</sup> Note this report does not provide a view on what is 'social' or 'how social' an organisation or investment needs to be. This framework can be used by any organisation aiming to deliver impact, in accordance with its own definitions and objectives.

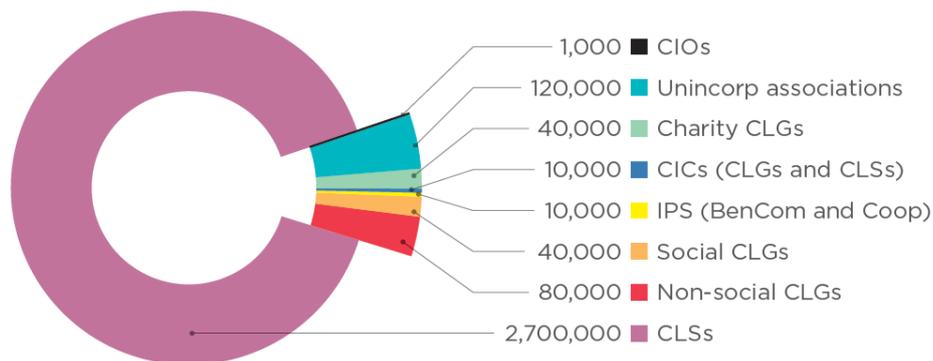
## THE UK SOCIAL BUSINESS FRONTIER

This UK social business frontier is hard to define clearly. It exists between the traditional private and social sectors, but there are no easy ways to recognise those organisations that are members of it. Existing law was not developed with these organisations and their unique approaches to protecting impact in mind, and information is not currently collected in way that enables identification of this group in a reliable manner.

### The current UK landscape of organisations

Private companies heavily dominate the UK landscape. Using legal form as a proxy, of the almost 3 million incorporated organisations in the UK, approx. 2.7 million take the form of (non-charitable) private companies with only around 180,000 within taking regulated social legal forms (including unincorporated associations). The company limited by shares structure is by far the preferred option for organisations by number and likely by size as well.<sup>3</sup>

UK corporate forms



### The “regulated social sector”

The UK has a number of specific legal forms that have been established specifically to serve the needs of social organisations. These include registered charities, industrial & provident societies (including community benefit societies and cooperatives) and community interest companies (CICs). Together, this ‘regulated social sector’ makes a substantial contribution to the economy and society - registered charities alone employ around 800,000 people, representing 2.7% of total workforce.<sup>4</sup>

Charities, as the largest regulated social sector organisation (RSSO), remain one of the most trusted groups in society, with only doctors and police seen as more trusted<sup>5</sup> dwarfing trust in banks, politicians and even courts. This trust has been built over time but may rely on two key pillars of the charity model: (1) a specific regulator responsible for monitoring the charitable mission and (2) the legal requirement that no private gain can be made from any surplus (or profit), as well as any residual assets from the charity (often termed an ‘asset lock’). The regulator (and related registration) makes it easy to identify this organisation and the full asset lock means that it is easy to understand how well the impact is protected.

<sup>3</sup> This data is only approximate and has been compiled from publicly available sources, including NCVO Almanac, Companies House website, Charity Commission website, BIS Small Business Survey and additional NCVO research. The lack of comprehensive data is another finding of this report. Interesting, there is no one location that comprehensively collects, discloses and analyses information by the different company forms as yet, although recent public release by Companies House data of statutory accounts is welcome.

<sup>4</sup> NCVO Almanac 2012.

<sup>5</sup> Charity Commission, Ipsos Mori survey 2012/



Whilst charities have a clear regulator with authority to monitor and enforce charities within its remit, regulation of other social forms is more fragmented. CICs are regulated by the CIC regulator, which is seeing a dramatic increase in applications recently, IPS are regulated by the Financial Conduct Authority (FCA) due to historical factors, whilst the new social investment tax relief (SITR) also gives Cabinet Office a role in regulating social impact bond structures, as a possible new form (or structure) for social organisation. As many of these forms are registered companies too, Companies House plays an underlying role in administration relating to the companies. This set of regulation is not only complex, but it does not address many potential social businesses.

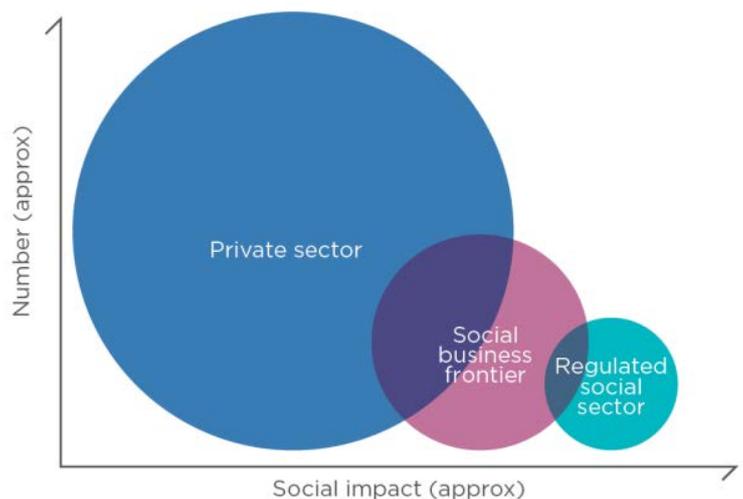
### Social impact delivered by business outside of the regulated social sector

Making a social impact however is not limited only to organisations within the regulated social sector. Many other businesses may want to deliver social impact but for one reason or another, do not take regulated social sector forms. Asset locks and their potential negative effect on capital raising may be a factor<sup>6</sup> but so could the desire to maintain flexibility at an early stage of the business.<sup>7</sup> Under English company law, the ‘company limited by shares’ legal form is already highly flexible, in that it permits a company to add a social purpose and impose bespoke social duties on directors’ decision-making. Therefore, this may be a particularly appealing form to many entrepreneurs.<sup>8</sup>

The potential could be significant. Whilst it’s hard to tell precise numbers, according to the BIS Small Business Survey, there could be up to 250,000 social businesses deliberately delivering social impact that remain outside the regulated social sector (according to those that are a ‘very good fit’ or ‘good fit’ as “social enterprises”) and these organisations employ 2.136 million people and £163bn in turnover. There could be many more social businesses if you include those that self-identify as such. Furthermore, if these organisations can demonstrate impact that can be identified and protected, they may be able to access capital from impact investors with aligned social objectives.

This report therefore focuses its attention on understanding the variety of approaches to protecting impact taken by these unidentified social businesses in order to better recognise who is on the social business frontier and how well they are protecting their impact. However, in the long-term, this report can also benefit existing regulated social organisations, to help inform existing RSSOs about how to understand and enhance their own impact protection, but also the remaining approx. 2.5 million companies about what approaches they can take to start protecting their impact.

Scale of social business opportunity



<sup>6</sup> James Perry, Asset locks: A Berlin Wall between social enterprise and the real economy? Pioneer’s Post, 2013.

<sup>7</sup> UnLtd, Pushing Boundaries, 2014.

<sup>8</sup> For example, many of the changes to state company laws that Benefit Corporations are seeking to implement are already possible in England.



# A FRAMEWORK FOR PROTECTING IMPACT OF SOCIAL BUSINESS

This report was prepared through discussions of the Social Business Frontier Working Group and the collection of around 20 case studies of social businesses. It was found that there are currently no prevailing and easily identifiable forms of social business, but instead a variety of approaches that social businesses are applying to protect their social impact. In order to understand the ‘social business frontier’ – and to start building a framework for interpreting it – we have therefore unpicked exactly what elements of impact different social businesses are protecting and how they are protecting it.

## What are impact locks trying to protect?

There are three distinct “**elements of Impact**” which an organisation may choose to protect and each is protected by a different “**lock**”:

Element of Impact	Meaning	Protected by
Impact performance	Does the social business deliver the quality, depth and scale of outcomes that was intended?	Performance lock <sup>9</sup>
Commitment to outcome and beneficiary type	Does the social business act in accordance with its original commitment to a defined outcome for a defined beneficiary?	Mission lock
Distribution of financial value	Does the social business deliver the financial value of the business to the intended beneficiaries?	Asset lock (full or partial)

Each type of lock is relevant for organisations in different circumstances:

- **Performance lock:** All social businesses should be interested in actively seeking to deliver social impact and finding ways to lock in this impact performance that are suitable to their business;
- **Mission lock:** Social businesses that have clear trade-offs between achieving their social mission and making a financial return, or are at risk of migrating to achieving an ‘easier’ outcome or ‘easier to reach’ beneficiary, should protect against such ‘mission drift’ through a mission lock; and
- **Asset lock:** Social businesses that have beneficiaries who will be impacted significantly more through distribution of financial value should use an asset lock.<sup>10</sup>

<sup>9</sup> Note that performance lock describes a mechanism by which there is some effective sanction on under-performance, such as failure to make payment back to investors if a social impact bond’s targets are not met. Many locks targeting impact performance at present do not necessarily require specific impact targets to be met but simply that impact is appropriately validated, with the assumption that the market will penalize the organisation’s financial performance if an appropriate level of impact is not delivered.

<sup>10</sup> Which organisations should use which locks in which locks is a rich topic to investigate further and likely to be very helpful to social businesses and investors to understand. Further research on this area forms one of this report’s recommendations.



## How are impact locks protected?

In order to protect these elements, an organisation requires an “**enforcer**”, or series of enforcers. These are parties that protect the element (/s) of impact by monitoring the organisation and creating a consequence of breaching of the lock. In practice, this could be a regulator, such as the Charity Commission, that has certain legal powers to admit organisations to charity status if they have a certain community purpose (mission lock) and don’t distribute assets (asset lock). In fact, there are a number of possible enforcers and they have been grouped into 8 broad types below:

Enforcer	Description
<b>Social regulator</b>	Regulator empowered by law and able to exert control through awarding or removing legal status.
<b>Influencing social owner</b>	Any owner (in a CLS) or member (in a CLG) able to exert control through majority voting rights and targeting social objectives. May be charity, beneficiary or social investor.
<b>Golden shareholder</b>	A charity or beneficiary able to exercise a negative right (a veto) over key social objectives.
<b>Social certifier</b>	Independent entity providing a certification to organisation meeting certain social criteria.
<b>Social customer</b>	Purchaser of products from the general public that is driven by considerations of social impact.
<b>Impact investor</b>	Investor in an organisation that targets social and financial returns (this could apply to investors not calling themselves impact investors as well).
<b>Social commissioner</b>	Public sector commissioner that incorporates social impact into contracting and tendering process.
<b>Social board of directors</b>	Board of directors of a company that has embodies social impact into its governance, through articles of association or otherwise.

Each enforcer protects each element in a specific way, resulting in a matrix of practical tools that can be used. Taken together, it is possible to analyse which elements of impact an organisation has chosen to protect, and which combination of enforcers and tools it has chosen to protect them.



What we're trying to protect... How we are protecting it...

	Enforcer:	Social Board of Directors	Social Commissioner	Impact Investor (contractual enforcement)	Social Customer	Social Certifier	Social Golden Shareholder (charity or beneficiary)	Influencing Social Owner (charity, beneficiary or social investor)	Social Regulator (CIC or CC)
<b>Performance lock (impact performance)</b>		<ul style="list-style-type: none"> <li>Impact performance as standing item on Board agenda</li> <li>Social impact sub-committee</li> </ul>	<ul style="list-style-type: none"> <li>Contractual payments linked to social outcomes</li> </ul>	<ul style="list-style-type: none"> <li>Social covenants related to impact performance targets</li> </ul>	<ul style="list-style-type: none"> <li>Purchase from companies demonstrating strong impact performance</li> </ul>	<ul style="list-style-type: none"> <li>Impact audit to validate performance</li> <li>Annual disclosure against pre-agreed targets</li> </ul>		<ul style="list-style-type: none"> <li>Can vote to remove Board members if impact performance below expectations</li> </ul>	
<b>Mission lock (commitment to outcome &amp; beneficiary)</b>		<ul style="list-style-type: none"> <li>Vote on amendments to mission in Articles</li> <li>Nominate social impact director</li> </ul>		<ul style="list-style-type: none"> <li>Social covenants related to Articles</li> <li>Use of funds clause linked to social purpose</li> <li>Approval for funds used for other purposes</li> </ul>	<ul style="list-style-type: none"> <li>Purchase from companies with strong mission-led brand</li> </ul>	<ul style="list-style-type: none"> <li>Social mission test on joining</li> <li>Approve any change of mission</li> <li>Validate operations remain on mission</li> </ul>	<ul style="list-style-type: none"> <li>Can exercise controlling vote, if organisation is deemed to go off-mission</li> </ul>	<ul style="list-style-type: none"> <li>Can vote to remove Board members if company diverges from mission</li> </ul>	<ul style="list-style-type: none"> <li>"Community Interest Test" (CIC) and "public benefit test" (CC)</li> <li>Charitable purpose/social objects</li> </ul>
<b>Asset lock (distribution of financial value)</b>		<ul style="list-style-type: none"> <li>Vote on dividend payment</li> <li>Vote on management pay</li> <li>Vote on sale of assets</li> </ul>		<ul style="list-style-type: none"> <li>Dividend restrictions during investment period</li> <li>Rights to exploit IP assets if developed not for social purposes</li> </ul>			<ul style="list-style-type: none"> <li>- Any distributions via dividends benefit the social owner</li> <li>- value remains in social sector but not necessarily on-mission</li> </ul>	<ul style="list-style-type: none"> <li>Residual asset restrictions</li> <li>Profit distribution restrictions</li> </ul>	
<b>Definition:</b>		Board of directors of a company that embodies social impact into its governance, through articles of association or otherwise.	Public sector commissioner that incorporates social impact into contracting and tendering process.	Investor explicitly targeting social objectives as well as financial returns.	The beneficiary as customer; or a purchaser of products from the general public that is driven by considerations of social impact.	Independent entity providing a certification to organisation meeting certain social criteria.	A charity or beneficiary able to exercise a negative right (a veto) over changes to key social objectives.	Any owner (in a CLS) or member (in a CLG) able to exert control through majority voting rights and targeting social objectives. May be charity, beneficiary or social investor.	Regulator empowered by law and able to exert control through awarding or removing legal status
<b>Tool used:</b>		Board voting rights	Social contract terms	Social covenants	Purchase behaviour (direct or indirect)	Access to hallmark	Shareholder voting rights	Shareholder voting rights	Licence to operate
<b>Duration:</b>		Indefinite - until change by shareholders	Finite - contract life	Finite - contract life	Indefinite	Indefinite - until certification ends	Indefinite - until change in rights agreed by golden shareholder	Indefinite - until/unless amended under Special Resolution	Indefinite - until consent to change by regulator



## Evaluating impact locks

Not all impact locks are created equal and no impact lock is perfect. Therefore, in practice, evaluating the effectiveness of the impact lock may be useful to understand how locks compare. There is no exact science to comparing the strength of locks, however three factors should be considered:

- The *appropriateness* of the locks: Does the lock target the right element of impact that this social business needs to protect (e.g. between performance, mission, assets)?
- The *robustness* of the enforcer: How substantial is the enforcer as an entity (size, funding)? What tools can it use to enforce breach of any locks (e.g. impose criminal sanctions, stop payments)?
- The *standard set* by the lock: Does the lock set a standard of performance high enough for the social business make reasonable efforts to achieve this or can it naturally pass this easily? (e.g. a full asset lock on all profits would be a higher standard than a lock on 5% of profits)

## Impact locks in use in the UK

This report did not conduct a wide-ranging survey into what locks are being used in the UK. However, through its review, it is possible to conclude that there are many different locks in use by social businesses in the UK. There are also many different enforcers in use to enforce these locks. Some basic insights about the UK can also be made.

### Enforcers

The roles of regulator and social owners appear to be the most recognised enforcers that currently exist, as well as the role of the social board of directors in enforcing social impact within a business' governance. There appears to be less recognition so far that other existing key stakeholders to a social business (such as impact investor and social commissioner) can play the role of enforcers.

### Locks

Asset locks appear to be the easiest to recognise and understand and discretely impose within regulation and documentation. Mission locks appear more difficult to recognise beyond applying a social mission into a company's articles of association. There are many different types of impact validation techniques that exist to act as performance locks, however pure performance locks remain limited and difficult for an external body to recognise.

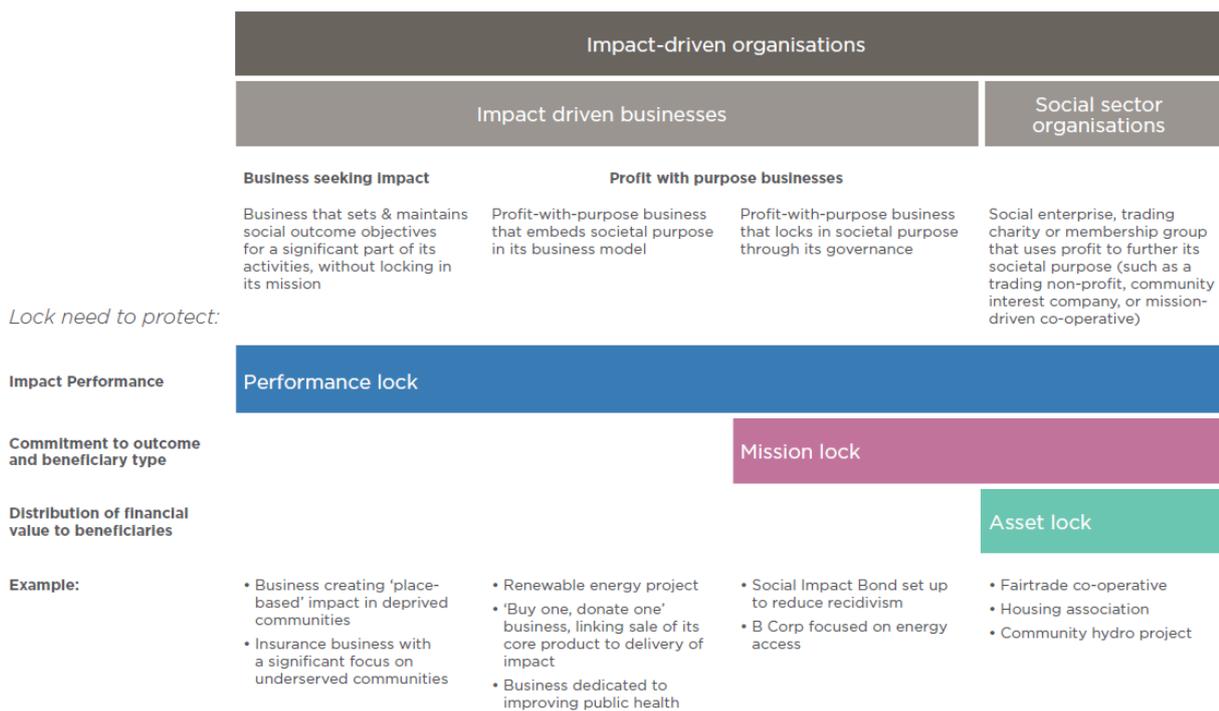
# THE FRAMEWORK IN PRACTICE – THE UK SOCIAL BUSINESS FRONTIER

While the previous section investigated the different individual locks that exist, this section describes how locks may be bundled together to work in a social business as a whole. This can help understand how to recognise different approaches of social business.

## Social business approaches

Generally, different organisations may seek to protect different elements of impact, prioritising those areas they feel may be at particular risk due to their market environment, stakeholders or business model. Organisations also rely on a combination of stakeholders to protect impact, rather than wholly relying on one enforcer. The combined effect of the locks and stakeholders should be evaluated when understanding approaches to social business.

This results in a range of bespoke packages of impact protection. However, broadly these can be grouped into a series of approaches<sup>11</sup>:



“**Social Sector Organisations**” will typically seek the greatest level of impact protection, with an asset lock preventing excessive private gain where there is an explicit trade-off between social and financial returns, alongside a protection of the social mission and of impact performance.

“**Profit-with-purpose businesses**” that lock a societal purpose into their governance” may be able to generate a commercial growth opportunity, and may choose not to incorporate an asset lock, but potential tensions involved in serving a broader stakeholder agenda and ‘mission drift’ can be mitigated by a

<sup>11</sup> This framework is not intended to be prescriptive but to act as a summary ‘grouping’ of how different social businesses may choose to protect different elements of impact. This framework is also consistent with the Impact Continuum, as presented in the Report of Social Impact Investment Taskforce, as well as the Report of the Asset Allocation Working Group of the Social Impact Investment Taskforce, where impact *investments* (rather than the underlying social business forms) are characterized according to their impact and financial return characteristics. Taken together, the reports aim to provide a helpful set of coherent frameworks to help both social businesses and investors navigate the market.



mission lock preventing a migration to an 'easier' outcome or beneficiary.

“Profit-with-purpose businesses that embed societal purpose in their business model” have an intrinsic lock on impact performance through the alignment of social objectives and financial performance in the business model. These organisations benefit from a strong, market-led performance lock, and with little risk of mission drift, often do not need an additional explicit mission lock. In addition, without a trade-off between delivering social impact and financial returns, there may not be a need to incorporate an asset lock.<sup>12</sup>

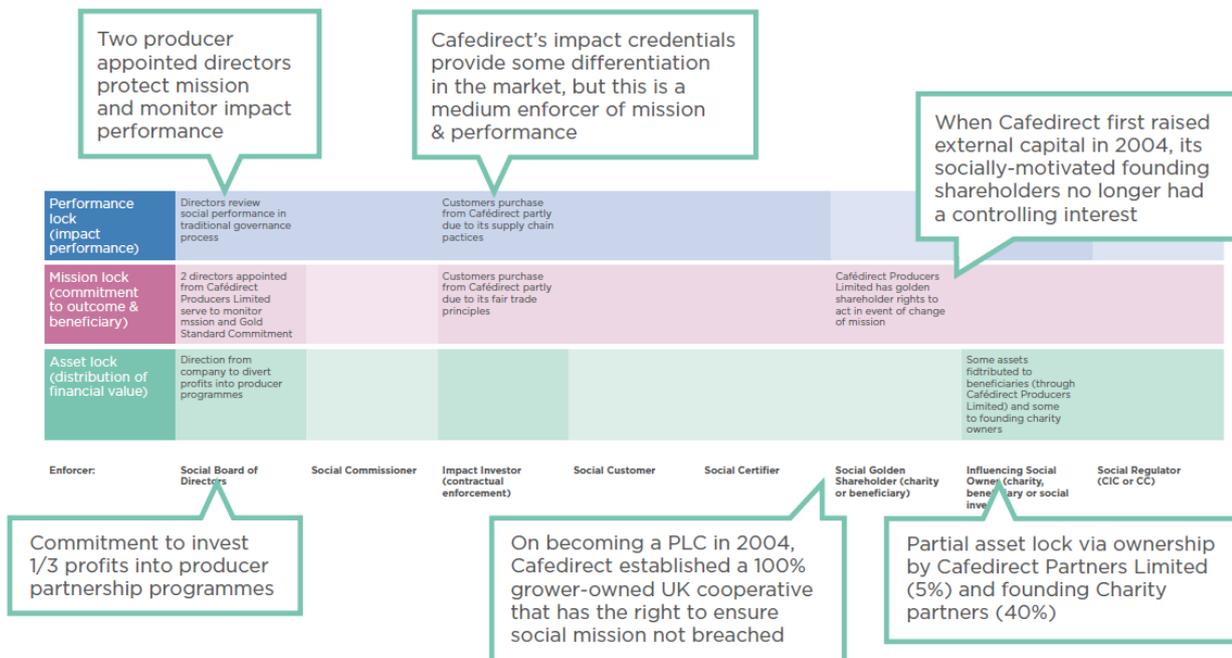
### Examples of the framework in use

#### Case Study: Cafedirect Plc (Social Sector Organisation)

Legal structure: Unlisted PLC

Model: Cafédirect was originally founded in 1991 by Oxfam, Traidcraft, Twin Trading and Equal Exchange to support small-scale growers in developing countries. In 2004, Cafedirect became a PLC by successfully raising £5m from over 4,500 mostly individual shareholders, diluting the original owners to 40%.

Impact locks: Performance Lock – Medium  
*Diverse customer base such that impact performance is not the only purchase driver*  
Mission Lock – Strong  
*Grower-owned cooperative acts as golden shareholder*  
Asset Lock – Medium  
*Social ownership structure remains in part through grower co-operative and founding shareholders though remains a minority*



Rationale: Cafédirect needed to raise capital to grow, and wanted to ensure that changes to the ownership structure did not dilute or distort its impact.

Implications: Cafédirect has remained governed broadly by the same guiding social principles, and raised a further £1.6m from Oikocredit and existing shareholders.

<sup>12</sup> See CAF Venturesome, *Three Models of Social Enterprise: Creating Social Impact Through Trading Activities*, 2008.



### Case Study: Peterborough Social Impact Partnership (organisation embedding a societal purpose into its governance)

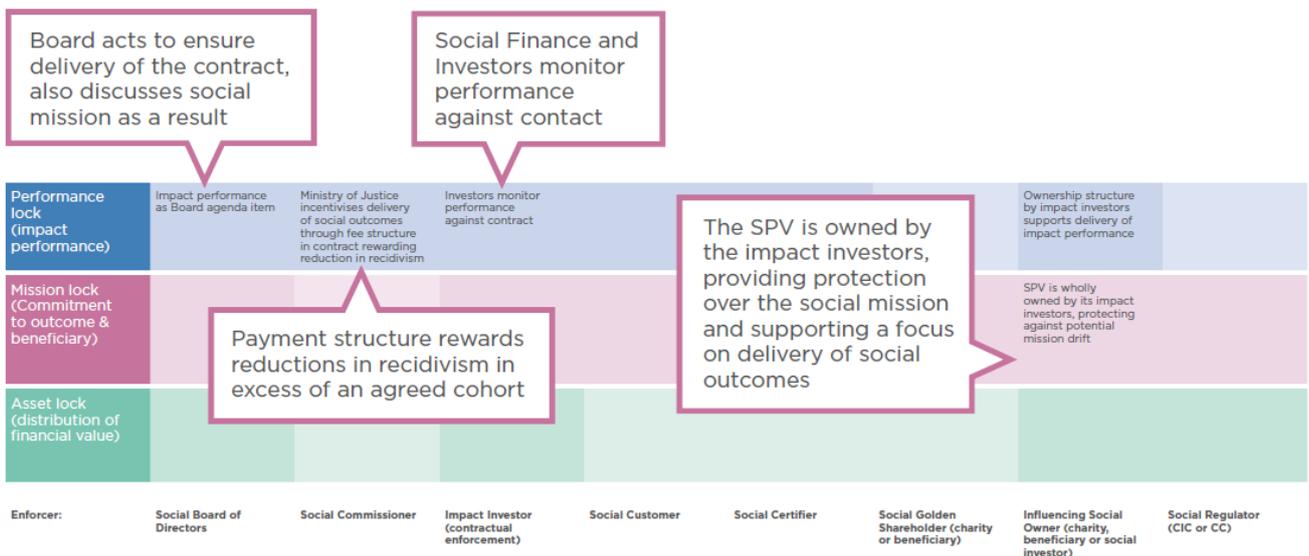
Legal structure: Limited Liability Partnership

Model: Special purpose vehicle (SPV) set up to reduce recidivism by an estimated 3,000 short-sentence male prisoners leaving HMP Peterborough over a 6-year operational period, which currently reoccurs at 60%.

Impact locks: Performance Lock – Strong  
*Payments based on achievement of social outcomes*

Mission Lock – Medium (exists but not necessarily needed)  
*SPV is wholly owned by founding impact investors and wound-up on completion so technically mission lock but largely driven to perform one contract*

Asset Lock – None  
*SPV does not have an asset lock, but focuses on contract delivery*



Rationale: The Ministry of Justice, acting as social commissioner in this example, sought to incentivise the delivery of strong social outcomes, allowing innovative, impact-led models to flourish.

Implications: The initial results have shown a 23% relative decline in reoffending compared to the national population. Despite delivering strong outcomes, this contract is expected to end earlier than anticipated due to national restructuring of the probation service.

### Case Study: The Gym Group (for-profit business with a significant societal outcome objective embedded into its core product)

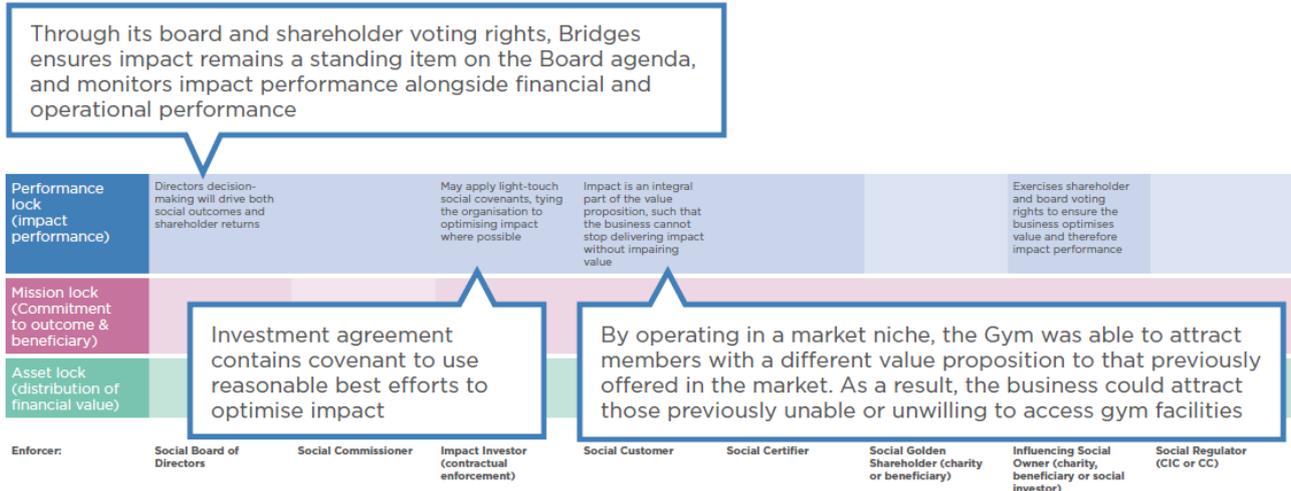
Legal structure: Company limited by shares

Model: The Gym pioneered the concept of low-cost gyms in the UK, providing state-of-the-art fitness facilities in purpose-built gyms which are open 24 hours and located primarily in underserved areas, offering low cost memberships from £10.99 a month, with no sign up fee or fixed-term contract. As a result, the Gym attracts a high proportion of first-time gym users (30%), and has a broad demographic including



students and shift-workers.

- Impact locks:
- Performance Lock – Strong  
*Performance largely based on serving social customer base and impact investor role*
  - Mission Lock – None  
*No mission locks*
  - Distribution Lock – None  
*No distribution locks*



Rationale: The Gym needed capital to expand but had a business model inherently targeted at less wealthy customers. The Gym members became the social customers with power to enforce behaviour even after impact investment period ended.

Implications: The Gym has been a success in growing membership and number of branches to 47 now without increasing its membership price (still listed from £10.99 per month). Whilst Bridges sold its majority equity stake in June 2013, the broader publicity around the business ensures the impact model will remain protected.

### Investors' approach to impact locks

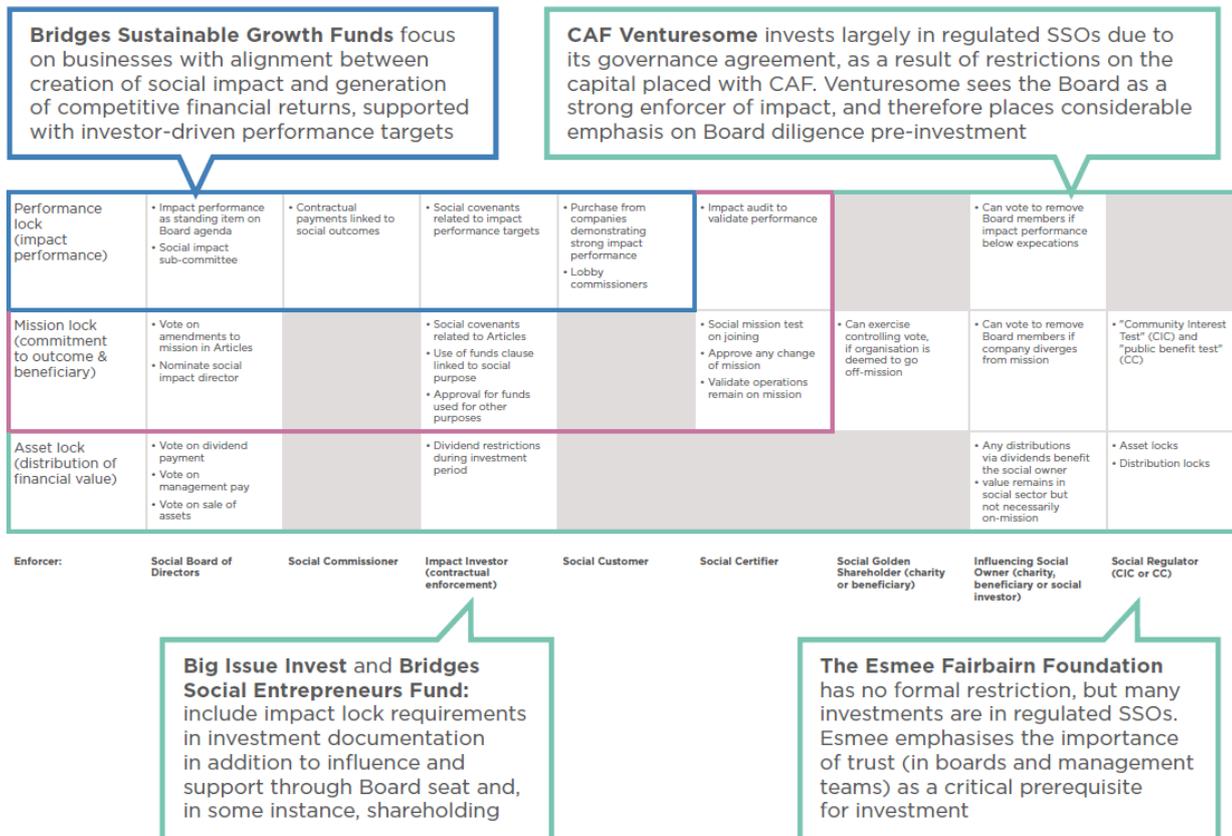
Impact investors are those that “intentionally seek to target both societal and/or environmental objectives along with a financial return and measure the achievement of both”.<sup>13</sup> There are an increasing number of impact investors in the UK and they are playing an increasing role in supporting social businesses in financing their operations and growth.

Like social businesses, impact investors take a variety of approaches to protect impact in the businesses they invest in, as they seek to ensure their capital is used effectively to maximise social outcomes. All impact investors seek to protect impact performance in their investments, and some will also seek an asset lock to prevent excessive private gain where there is a trade-off between financial returns and social impact, and/or a mission lock to protect against mission drift where this may be a risk.

<sup>13</sup> Report of the Social Impact Investment Taskforce, September 2014.



Examples of some of the different approaches taken are set out below:



For most impact investors, their practical approach to social businesses is manifested in a robust impact diligence process pre-investment, with some also choosing to protect impact through the investment documentation, reinforced through their engagement with social businesses. Some impact investors may choose to invest in for-profit business with a significant societal outcome objective embedded into its core model (Bridges Sustainable Growth Funds) while others may seek mission locks to protect against mission drift and asset locks, usually driven by a requirement in their governance agreement to ensure that private benefit is incidental (Esmee) or is less than public benefit (Big Issue Invest).

As a result, impact investors themselves also play a critical role as enforcers. They are often heavily engaged across multiple elements of impact and deploying multiple locks to monitor and managing their investments in a social business over the investment period. The enforcement role of investors could provide some comfort to other external stakeholders to the social business that certain elements of the impact are protected, at least for the period of the investment, and could be leveraged further to build recognition and confidence in these social businesses.



## Relevance of impact locks over time

In many cases, impact locks should endure through the life of the social business making them easy to recognise and protect impact indefinitely. However, the reality is that many social businesses develop over time and as they change their activities, new risks that affect the social impact may need to be addressed by locks. Key times in a business' life may require evaluation of impact locks:

- **Entering new markets:** When entering new markets, whether public, private, social or consumer, new impact locks may be demanded of social businesses (for example, to serve Government procurement contracts, certain asset locks may be required).
- **Raising capital:** When raising capital from new investors, the risk of mission drift increases because of different investor motivations so an organisation may choose to add in new mission locks. Whilst Cafédirect was able to consolidate its existing mission locks in its golden shares when it opened up to thousands of new shareholders, Coop Bank showed that if such changes have not been appropriately embedded ahead of time, there is less opportunity in a crisis.
- **Acquisitions:** When the social business has been acquired by a non-social organisation (such as Unilever's ownership of Ben & Jerry's), different locks and enforcers (apart from social ownership) can be used help continue to protect social impact. These may include performance lock, such as independently accountable separate social impact boards and certification by a social performance certifier. It is also likely that the reasons for acquisition, such as a strong socially committed customer base, will also continue to act as an enforcer of the social mission.
- **Turning social:** When a mature regular business decides on a strategic review that it wants to start becoming more social, it can also start to use impact locks. First, it can embed social performance into its governance structure (such as through a social impact director), second, it can hold itself accountable to external social performance evaluation (through a social performance certifier) and tightening its social mission in articles (e.g. COOK has just completed this process), and third, it can issue a golden share to a credible third party organisation to keep watch over its social mission.

# RECOMMENDATIONS FOR STRENGTHENING THE SOCIAL BUSINESS FRONTIER

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This report has reviewed the current landscape for social business, developed a framework for understanding how social business can protect their impact and described how it works in the UK. This section describes how the lessons from this report can be used to better strengthen the environment for social business by the actions of business and investors, market builders and Government.

## Recommendations for social businesses and impact investors

### Develop, promote and use the impact lock framework

The social impact lock framework is a universal framework that can be applied to all stakeholders, including social business, investors and commissioners, and across the different elements of impact. The framework has not been tailored for users yet; however early efforts in the next section show how stakeholders could use it.<sup>14</sup> Further, whilst this report has unearthed some locks that are being used in practice, there is no doubt many more locks being used.

*Further study should be conducted on the impact locks being used (including an evaluation of their strength) and guides developed to describe when such locks can and should be applied by both businesses and investors. The result could be a user-friendly tool database with example strength rankings that could be used as examples for others.<sup>15</sup>*

### Develop specific social governance options for businesses wanting to ‘turn social’

Impact locks can also be relevant for regular businesses wanting to ‘turn social’ and this report provides a framework for understanding how this can best be done. The most common (and easiest) first step for a business to begin protecting its social impact is to embed impact locks in the company’s governance structure (‘social board of directors’). This could include developing a social impact sub-committee, appointing a social impact director, embedding impact duties across all directors, and adding social impact reporting requirements; however many more actual and potential locks may exist. English corporate law helpfully also provides that directors’ duties (and company purposes) are flexible and can be easily adapted to social purposes.

*A broad stakeholder review of the social governance structures available to regular businesses should be conducted to devise a standard “social impact entry route”. This review should be conducted in partnership with key business sector actors, such as the Institute of Company Directors and Business in the Community, to develop a template of specific actions that mature businesses can take to begin to protect social impact. Consideration should also be given to what existing governance standards could start to embed these options (such as the UK Corporate Governance Code). It should also build on existing mechanisms that provide governance of sustainability practices within a business.*

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<sup>14</sup> We also understand that Prime Advocates will demonstrate how these principles can be applied to key company and transaction documentation and support this effort.

<sup>15</sup> One area that is in particular need of further research is products that directly link financial and social performance (direct and strong performance locks). There are still limited examples of these from an investment context and further research could yield important developments (including learning from abroad).

## Recommendations for market builders

### Develop a Social Performance Certifier in the UK

To protect impact performance, most impact-driven businesses in the UK currently rely on having social owners and a social board of directors. While these enforcers can be extremely effective, they do not provide an objective assessment of impact performance that can be trusted and benchmarked by customers, procurers, regulators or investors. Social commissioners or impact investors can help here, with their contracts providing external validation of impact performance. However, this enforcement does not endure beyond the end of the contract or investment period.

*A 'social performance certifier' should be established in the UK to offer social businesses a complete and transparent presentation of their impact performance, which is validated by a third party and can be benchmarked. This should building on the work of existing social performance certifiers<sup>16</sup>, but achieve widespread recognition. An effective social performance certifier will:*

- *Assess a range of impact-driven business models, both with and without an asset lock;*
- *Build a hallmark with strong brand recognition among procurers, regulators and investors; and*
- *Foster a UK community that attracts others to join and shares best practice.*

The social performance certifier should clearly target evaluating the business's actual social performance to its intended beneficiaries to drive improvement in social performance over time against set targets. However, broader 'sustainability' practices of the business could also be taken into account in the certification.<sup>17</sup>

### Develop a recognised standard for golden shareholders

The 'golden Shareholder' is a relatively unique UK concept that effectively protects social mission with a robust and identifiable mechanism over an indefinite period of time. They appear to be only lightly used in the UK for social purposes and greater coordination may improve this.

*A consistent standard for golden shareholders should be established to increase consistency between golden shareholder structures and build greater external trust in its power. This minimum standard could cover the following key principles:*

- *A review of the UK social business frontier;*
- *Social mission to be enshrined in an organisation's constitution;*
- *Basic guiding principles for business operations to meet social mission are published;*
- *Veto rights over the change of an organisation's social mission or guiding principles;*
- *Key monitoring rights (e.g. director on board, certain periodic reporting, audit); and*
- *Golden shareholder to be recognised relevant expert (e.g. charity working on social issue).<sup>18</sup>*

This standard could be developed by an independent legal body (e.g. Law Commission or key law firms) alongside experienced golden share businesses. A loose community of golden shareholders could also be coordinated to share best practice and uphold the basic principles.

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<sup>16</sup> For example, the work of B Lab, SROI, the CIC Regulator and SEUK.

<sup>17</sup> This is consistent with the Mission Alignment Group that reports that "regular and validated reporting on intended mission" is needed, in addition to "transparency on wider ESG considerations".

<sup>18</sup> Other terms could also be added to these standards, such as economic rights to some dividends or additional rights of veto (such as over capital structure changes), however these should be included at the discretion of the business.

## Recommendations for Government

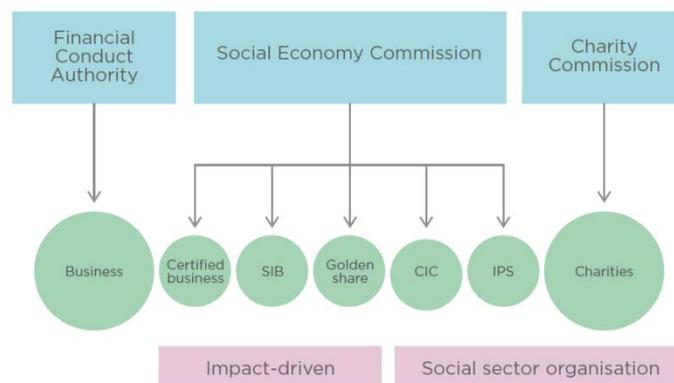
### Establish a Social Economy Commission to champion social business in Government

The current regulatory regime is not set up to effectively deal with social business. The regulated social sector is regulated by the Charity Commission (with IPS and CICs having their own bespoke arrangements) and the private sector is regulated by the Financial Conduct Authority, with no focus on impact-driven businesses. There is a real risk of fragmentation of the regulatory system without empowered regulators to act as effective enforcers of social impact for this unique group.

*A new independent authority, the 'Social Economy Commission' should be established within the Department of Business, Innovation and Skills (BIS) to coordinate, register, monitor and champion the non-charity forms of social business.<sup>19</sup> This could cover the following organisational forms:*

- **Community Interest Companies** – building on the established processes of the CIC regulator;
- **Industrial & Provident Societies** – transferring authority from the FCA;
- **Social Impact Bonds** – transferring accreditation role from Cabinet Office for SITR; and
- **Impact-driven businesses** – including certain profit with purpose businesses.<sup>20</sup>

#### New regulatory landscape



Certain impact-driven businesses, such as those with golden shareholders and submitting to social performance certifiers, could be registered indirectly through their respective community bodies (such as BLab) that could then be accredited with the Social Economy Commission. The Commission could therefore remain inclusive permitting a range of different approaches to social impact protection but also encourage growth of this group. Entry would require a basic commitment to a minimum level of social impact performance locks to help drive value of social impact.

The scope of the Social Economy Commission would be to capture information across all these forms, champion simpler and better use of relevant regulation across Government, such as the *Social Value Act*, and incentivise businesses to consider impact protection and promote excellent impact practice. Building on an accreditation role for Social Investment Tax Relief, the Commission could also be the authority for technical determinations of eligibility for relevant tax and other fiscal incentives. Levels of regulation of enterprises could vary and the Commission should continue to leverage the existing brands of organisations, such as CICs that have seen a significant increase in registrations. Alongside the Charity Commission, the Social Economy Commission could play a key role reshaping of the public, private and social sectors.

<sup>19</sup> This follows the recommendation in BWB, Ten Reforms to Grow the Social Investment Market, 2012

<sup>20</sup> It may also be possible to include Community Development Finance Institutions as accredited for Community Investment Tax Relief within this broader remit, particularly as they also fall under the jurisdiction of BIS



## USING IMPACT LOCKS IN PRACTICE

This note provides a short description of how stakeholders can interpret the impact lock framework to use impact locks and provides some suggestions as to the circumstances when they are appropriate.

### How to decide which locks to use

(1)	Select which elements of impact you are seeking to enforce	✓
(2)	Select the time period for which you are seeking protection (e.g. contract specific, or indefinite)	✓
(3)	Select which enforcer(s) are most appropriate, in light of the elements you wish to protect and the time-period you have chosen	✓
(4)	Select the tools (and strength) that can be used by those enforcers	✓
(5)	Draw up the right information needed to monitor the tools	✓

### When to use impact locks

#### **A performance lock:**

- You care about the positive societal impact the business generates, and you want to ensure it delivers the quality, scale and depth of outcomes you intended or targeted.
- You want to ensure the positive societal outcomes the business generates are taken into account when you bid for contracts
- You want to ensure the business continues to deliver strong impact performance even after you sell the business, or after other investors alter the ownership structure
- You want to be able to use your positive impact performance as a tool to motivate and inspire employees
- Your customers care about the positive societal impact your business generates, and demonstrating strong impact performance will drive growth and/or improve customer loyalty

*Disadvantages of using a performance lock:* there may be a cost (resource cost or otherwise) associated with appropriately monitoring, reporting on impact performance sufficiently for the enforcers to be able to validate and protect it.

#### **A mission lock:**

- You want to ensure the business acts in accordance with its social mission
- You want to ensure the mission is not altered or diluted over time, when you sell the business, or after other investors alter the ownership structure
- You want to be able to use your social mission as a tool to motivate and inspire employees
- Your customers care about the social mission of your business, and maintaining this mission will drive growth and/or improve customer loyalty

*Disadvantages of using a mission lock:* on a sale of the business, it may not be possible to realise maximum financial value if future investors do not see value in the mission lock.



### **An asset lock (full or partial):**

- You want to ensure your direct intended beneficiaries are always the sole / primary recipients of any financial value generated by the organisation
- You want to ensure private or non-community benefits are limited / incidental / outweighed by public benefits

*Disadvantages of using an asset lock:* it may be difficult to attract sufficient capital to scale the business if the asset lock results in too great a distortion of the risk/return profile for investors. Some entrepreneurs may be disincentivised if potential returns are significantly impaired as a result of the asset lock.

**Note:** *These locks are not mutually exclusive, and an organisation can choose to 'layer' different locks, depending on the individual priorities of the business and the risk of diluting each element of impact.*

### **Using the Matrix – Enforcers**

When to use .

**A Social Board of Directors** > You wish to embed impact locks into the governance structure of the organisation, tying decision-making and accountability to impact as well as to financial considerations.

**A Social Commissioner** > You are bidding for a public sector contract.

**An Impact Investor** > You are seeking external capital, and would like an investor with aligned values and objectives.

**A Social Customer** > Your customers care about the societal impact your business generates, and are willing to buy from your business more as a result; OR your customers are the beneficiaries of the organisation, and you are selling them a socially beneficial product or service.

**Social Certifier** > You would like to draw on external validation or your mission and performance in order to gain support from your socially-minded stakeholders (commissioners, customers, investors and employees).

**Social Golden Shareholder** > You want to ensure that your social mission is protected in perpetuity.

**Influencing Social Owner** > You want your ownership structure to reflect the values of the organisation. This may be less important if you can protect your impact in other ways.

**Social Regulator** > You are seeking the maximum protection of your social mission and assets into perpetuity.



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