

# Entrepreneurs or Banks?

*Why are Cooperatives in the UK regulated by the Financial Services Authority whose main function is to regulate the banking, insurance and investment industry?*

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In this short article *Malcolm Lynch, Head of the Charity and Social Economy team at Wrigleys solicitors* examines how over the last 150-years the cooperative legal form - **Industrial and Provident Societies (IPS) Law** - has failed to keep pace with its more recent sister legal form Companies Law. The article reviews the various failures to modernise and update the IPS law and the registry. It identifies 3 significant areas where government legislative action is required: *the need for regular legal updating of the IPS Law so as to keep it abreast with contemporary business best practise; overhauling the bureaucratic, expensive and outdated registration process; and making the Registry transparent and compliant with European Human Rights Law.*

## **Belated reform is not a satisfactory state of affairs**

The *Industrial and Provident Society (IPS) Law* of the 1850/1860s was designed to enable people to engage in any trade or labour with the exception of banking. Members should receive a limited rate of interest on their withdrawable shares. In 1876, societies without withdrawable share capital could undertake the business of banking.

In 1939, the *Prevention of Fraud (Investments) Act* created a distinction between bona fide cooperative societies and societies for the benefit of the community. The distinction sought to ease concern that withdrawable share capital was being used for banking-type activities by societies. For the most part, however, many changes which were introduced into *Company Law* have passed by *Industrial and Provident Society Law* or have been introduced belatedly. This has not been a satisfactory state of affairs.

## **Lack of a cheap, accessible and fit-for-purpose Cooperative legal model and user-friendly Registry has hindered the development of Cooperatives**

During the last 30-years, the development of the *cooperative and community benefit sector* (CCBS) has been hindered because of failure to modernise both the law and the registry. Many organisations established during this period, that could have been part of the sector, have instead become companies limited by guarantee in absence of a

cheap, accessible and fit-for-purpose cooperative and community enterprise structure under *Industrial Provident Society Law*. Some of the most entrepreneurial of these new wave enterprises, which used the capital limited by guarantee form, have succumbed in no small part due to their legal structure.

The current legislation to introduce a *community interest company* (CIC) has been something of a wake-up call for the CCBS sector. The CIC will either be a company limited by guarantee or a company limited by shares, established with community benefit objects with an asset lock and restrictions, like industrial and provident societies, on the distribution (dividends) paid to its investors. There isn't a great deal to distinguish the CIC from an industrial and provident society except that democracy isn't a compulsory feature of the CIC.

The two principal differences from the CIC are the unique feature of withdrawable share capital of the CCBS and, for now, some of the exemptions which societies have from the law relating to financial promotions by companies on the issue of shares. It is these unique features for societies which provide valuable tools for the conduct of community and cooperative enterprise.

The Prime Minister's Strategy Unit in its 2002 report [Private Action, Public Benefit](#) not only recommended changes to create the CIC but also suggested that there should be modest changes to *Industrial and Provident Society Law*. Modesty is not enough and the fundamentals need to be reconsidered.

Transparency should be the starting point for much change. The CCBS hasn't been immune from the Enron-style corruption by senior executives. It is only in recent weeks that the [Financial Services Authority](#) (FSA) has managed to place guidance on its website regarding the CCBS, and it could still be greatly improved. Unlike the Registrar of Companies, it's not possible to do online searches of the latest accounts of societies to find out who are the directors and secretary and whether any legal mortgages have been taken out against the societies by banks, etc. This inevitably creates risks when lending to societies.

Transparency is also important in ensuring the cooperatives and community benefit enterprises are engaged in legitimate activities and not being established to take advantage of withdrawable share capital. There are two ways of approaching this problem.

Currently there's a bureaucratic system that aims to ensure that applying societies fulfil the requirements of the legislation. Whilst this process discourages those unsuitable, it also delays registration and in reality once societies are registered, few checks are actually made. Access to the CCBS legal form is the very opposite of entrepreneurial.

[Companies House](#) operating from three UK locations – Cardiff, London and Edinburgh – has a system that enables same-day registration by requesting statutory declaration by directors who must state they have done everything necessary to form the company. It seems likely that the CIC will go for the company model but it will require CICs to give details in their annual reports of how they fulfil the requirements of a company established for the community benefit.

## **Cooperatives need to set better voluntary standards of reporting on their principles and values**

Some cooperatives have been criticised for not observing all cooperative principles so it would be very positive if cooperatives produced detailed reports on how they fulfil the principles or why they delegate from them. Similar information of this nature would permit proper judgement to be made of whether a society was acting in accordance with legislation.

There should also be some transparency in how the Registry itself operates. One former Treasury lawyer who used to advise the Registry sought very hard to prevent new registrations on the basis that industrial and provident society legislation was not designed for large organisations! The absence of an appeal mechanism for a registration refusal by the Registry is clearly in breach of the European Human Rights Act. The absence of a formally constituted Practitioner Panel and consultation on policy decisions, both of which are features of the banking and investment parts of the FSA and other regulators, makes for poor decision making by the FSA on cooperative and community benefit societies.

### **For further information:**

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