Social Stock Exchange- A Good Initiative

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The Hon'ble Finance Minister, in her July 2019 Budget speech, announced that India would soon have a social stock exchange (SSE). The proposed exchange would follow SEBI regulation and allow listing of social enterprises and voluntary organisations. In September 2019 SEBI, the capital market regulator, has constituted a working group to study and recommend a framework for the launch of an SSE in India. The concept of a social stock exchange is innovative, but not new. SSEs operate in some form in countries like Canada, UK, Singapore, and Kenya. The formats may vary. For example, the Social Stock Exchange in the UK, which was set up in 2013, functions as a platform connecting social enterprises and potential investors. On the other hand, the SVX, an online impact investing platform, set up by the Ontario government in Canada about ten years ago is aimed for ventures, funds and investors seeking social and/or environmental impact alongside the potential for financial return.

Social enterprise is not defined in the Indian Companies Act, 2013. Section 8 of the Companies Act defines a non-profit company as one established for promoting commerce, art, science, religion, charity or any other useful object, provided the profits, if any, or other income is applied for promoting only the objects of the Company and no dividend is paid to its members. Social enterprises are defined by the UK government as "a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners."[1] Nobel Laureate Yunus has preferred to use the expression social business[2] and defined it as a business to address one or more social problems and is run as a non-loss and non-dividend company. The majority of social enterprises in India are incorporated either as a section 8 (earlier section 25) company or a charitable trust. However, law does not preclude formation of for-profit entities with social purpose. In that sense, a social enterprise should be distinguished from non-profit organisations (NPO). All NPOs are social enterprises, but the reverse is not necessarily true.

It seems that the Hon'ble Finance Minister had in her mind NPO form of social enterprises (the non-dividend type) while announcing the need of a SSE. It sounds quite logical as dividend paying companies can always tap the main stock exchange for fund raising. Since the NPOs do not follow any profitability matrix, it is difficult for the promoters to raise finances through traditional channels (e.g., bank finance). Therefore, the main hurdles that such enterprises faces are (a) lack of funding; (b) inability to sustain focus on performance; and (c) a reluctance to take on the risk of failure.[3] Global markets have already backed issuance of bonds for social purposes. For example, the green bonds are debt instruments designed to raise funds for projects and businesses that have a positive environmental or social impact. A report[4] shows that globally green bond issuance reached about US$48 billion in the first quarter of 2019. It shows

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[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31677/11-1400-guide-legal-forms-for-social-enterprise.pdf

[2] *Yunus, Muhammad (2011). Building Social Business: The New Kind of Capitalism that Serves Humanity's Most Pressing Needs. PublicAffairs. p. 256.*

[3] Ravi, Shamika; Gustafsson-Wright, Emily; Sharma, Prerna; Boggild-Jones, Izzy (2009). The Promise of Impact Investing in India. Brookings India Research Paper No. 072019.

[4] https://www.climatebonds.net/files/reports/global_q1_2019_highlights_0.pdf

that investors have supported bonds that were issued for a social cause, particularly environment-related. Therefore, it is believed that NPOs would get similar response from the investors in the SSE.

Nearly 75% of impact investments in India in 2018 were equity investments in portfolio companies (early stage, series A, and series B) and about two-thirds of the impact investors have earned a return of above 15% in 2018.[5] Thus, impact investments do generate handsome returns in the private market and hence an exchange dedicated for the impact investors should be able to encourage greater participation of impact investors.

Structure of the SSE

The proposed social stock exchange should be able to address the challenges presently faced by NPOs and the impact investors. NPOs face the challenge of access to capital; the investors face the challenge of suitable exit; and the regulator or policy makers lack a credible impact assessment tool. While the SSE would definitely address the first two challenges, the exchange may create a framework for impact assessment.

The social stock exchange could be structured as an online exchange which will connect NPOs with the impact and other investors. In order to discourage retail investors to invest in the instruments issued by the NPOs in the initial stage, the minimum investment size could be set at a higher level (e.g., Rs. 1 million). The exchange could offer three types of services- *level 1, level 2, and level 3*. The compliance norms would vary with the levels. Level 1 allows an NPO to privately place financial instruments (e.g., equity, bonds) with one or more institutional investors (including impact investors). Level 2 allows an NPO to list the fixed-income instruments issued in Level 1 for trading purposes. It may be noted that there will be no fresh issuance of bonds in level 2. This level allows better liquidity for the instruments and also exit options to the level 1 investors. Level 3 allows an NPO to issue fresh instruments (public issue) to investors- both institutional and high net worth individuals (HNIs). Level 1 offerings would have minimum disclosure requirements and may include quarterly reporting of social impact following a standard reporting matrix. Level 2 requires more disclosure in addition to the ones prescribed in level 1. For example, the rating of the issuer, annual financial statements, audit report once a year on impact assessment. Issuers in level 3 can raise fresh capital from the market at a better price from a large number of investors. Therefore, the compliance norms would be more stringent at this level. In addition to the requirements for level 2, a level 3 issuer has to submit quarterly (unaudited) financial results along with a report on social impact.

In order to ensure that the market players do not abuse the market quality, it is important that only reliable and accredited institutions are allowed to participate in the market. The SSE would formulate an easy-to-implement accreditation process for both the issuer and institutional investors.

Level 1 issuers would be able to meet their financing requirements from select set of impact investors whose objects are aligned with those of the issuers. At level 1, the SSE would disseminate information on NPOs and impact investors and create a mechanism for the interested parties (issuer and investors) to clinch a deal in a transparent manner. Once a deal is consummated, the exchange will widely disseminate the details of the deal in a prescribed format. Registered members should be allowed to view the post-issuance quarterly reports submitted by the issuers.

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[5] Ravi, Shamika ibid

It may be noted that trades in level 2 are to facilitate exit for level 1 investors and not to allow NPOs to raise funds. Impact investors include endowments funds, insurance companies and domestic financial institutions. Endowment funds may not face near or medium-term liquidity demand; however the other types of investors may need to churn their portfolio in medium term. Level 2 is designed to cater primarily to those investors. Retail investors can be allowed to trade in bonds in level 2 and the institutional investors (including fund of funds) in both types of instruments. The minimum trading size in level 2 should be Rs. 25 lakhs so that small investors do not participate in this level. The SSE would disseminate market activity in level 2 every day after market hours.

Level 3 activities would be very similar to any other market platform. Since the NPOs are allowed to raise money from a large pool of investors at this level, market regulations and risk management should be of highest order. In order to encourage high net worth individuals who would like to contribute to social cause, the minimum lot size could be fixed at Rs. 1 million. Once the market matures and investors' interest ascertained, the lot size can be lowered. The SSE would disseminate market activity in level 3 every day after market hours.

Types of Instruments

Apart from equity, the SSE may allow issuance of impact bonds – social impact bond (SIB) and development impact bond (DIB). Impact bonds are specific type of outcome based bonds with financial returns. The promise of financial returns is important to make such bonds attractive to impact investors. In case of impact bonds, the financial risk is borne by the investors who provide the upfront capital and hence these investors would look for appropriate return. Social Impact Bonds (SIBs)—also known as "social innovation financing" or "pay for success"—offer governments a risk-free way of pursuing creative social programs that may take years to yield results. Usually, governments decide what problems they want to address and then enter into a contractual agreement with an intermediary (or bond-issuing organization) that is responsible for raising capital from independent investors including banks, foundations, and individuals, and for hiring and managing nonprofit service providers. If the project achieves its stated objectives, the government repays the investors with returns based on the savings the government achieves as a result of the program's success. In case of Development Impact Bonds (DIBs), the payment is made to the investors by a third party (e.g., a corporate entity). Payment is based on what the project or service has achieved and not on the processes or work that has been done. If any project fails to deliver desirable outcome, the government or the third party would not compensate the investors and hence the investors in that case stand to lose their entire capital. Generally, for both SIB and DIB, a service provider is involved. The service provider is obliged to deliver service to the target population (called beneficiaries) and would thus be compensated once the desirable outcome is achieved. The service provider can be structured as an NPO and can approach SSE for raising upfront capital to fund their need.

In a private market, a fund manager (social impact bond issuer) has a critical role to pay. She has to identify and approach high net worth individuals, foundations and even some corporate to subscribe to the SIBs. Next, she needs to know the service providers (NGOs and/or social enterprises) who have access to the beneficiaries and have organizational set up and programmes to deliver results. The fund manager also has to liaise with the government and finalise terms of repayment. The structure of SIBs is such that investors do not consider their investments as charity and assurance from government on repayment of the bonds actually enhance the creditworthiness of issuers. While the SIB at the outset specifies that its goal is to bring about change in society, yet it would need to be competitive with other instruments in the market for people other than philanthropists to be interested.

In a public market (the SSE), much of the information on the service provider and investors would be available on the platform and hence it would become easier for the NPOs to find out appropriate investors. Similarly, investors would also have access to a variety of social enterprises to choose from.

Companies in India, who are required to spend 2% of their three-year average after-tax profits on CSR (Corporate Social Responsibility) can avail this route to ensure that they pay for results. This way impact assessment of social investments can be ensured. The CSR mandates that the funds collected would not be used for infrastructural developments under any category. This implies that for education outcomes, construction of school buildings, purchase of school equipment like chairs, tables cannot be accounted as CSR spends. Similarly, for environment sustainability, setting up of solar panels is not a CSR activity. Therefore, CSR expenditure should create impact and the corporates spending the hard earned money should be happy doing so if the investment creates impact in the society. SIB may help achieve the impact. The corporate sector can play the government's role in a SIB structure or 'buy out' the contribution of initial donors in DIBs.

In order to ensure that a SSE functions as an efficient platform, the role of the regulator, and the impact assessors cannot be undermined. It is very important that the SEBI, while launching the SSE, also comes out with the guidelines of enlisting competent impact assessors. Assessment of impact is crucial for the success of any impact funds. The financial returns attached to impact bonds directly depend on the impact created by the fund and hence a reliable measurement of the impact would be necessary to make the SSE dependable and sustainable.