Comments and Suggestions on Working Group Report on Social Stock Exchange

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We would like to congratulate the working group on the hard work done to put together a report, which significantly moves the conversation on Social Entrepreneurship forward. There is no debate on the need to raise capital to tackle social problems and the enormity of the challenge. The reality is that social return seeking capital will always be scarce, hence how this capital is distributed, matters significantly. Given the sensitive domains and vulnerable populations that social organisations work in, there is an additional need to consider the risks and distributional consequences of significant interventions like the creation of a Social Stock Exchange in the sector.

As academicians engaged in teaching and working in this area, we do not have any competing financial interests and would want any initiative to strengthen the social sector to succeed. We engage with the report from this objective.

Unfortunately, the report lacks several details that would allow for more constructive engagement and seems distracted by many issues that seem out of place, like CSR and tax law. Nevertheless, we offer our views from what is provided and point to areas that need greater clarity. In doing so, we also highlight places for caution and offer our suggestions.

Comments in brief:

- Imagination overly influenced by the for-profit world
- Need for greater clarity on suggested instruments and their tradability
- Need for greater clarity on regulatory authority of various bodies
- Bar on FPEs too low and mixing them with NPOs seems inappropriate
- Problematic assumption that only the “right” organisations will want to report as per reporting standards
- Silence on scrutiny of “investors” in SSE

Suggestions in brief:

- Need for greater engagement with ideas of Social Business (Prof Yunus); B-Labs and B-Corps; Cooperative and Farmer Producer Organisations; Community Interest Corporations (CICs in the UK)

- Keep distinction between NPOs and FPEs sharper, including reporting standards etc. , creating potentially two separate exchanges
- Need to hard code and demand legally binding commitments from FPEs prior to receiving benefits from SSE listing (eg. cap on share of profits that can be distributed to shareholders and an asset lock)
- Reduce the burden of reporting by emphasizing measures aligned with the organisation's operations, internal processes, practices and governance structures based on “data” collected as part of regular functioning (further suggestion in enclosed presentation)
- Define normative yardsticks: i.e. what the regulator considers to be good/satisfactory performance on the reporting metrics
- Limit task of auditing and other intermediary processes to non-profit organisations, or at the minimum those that would qualify to be listed on the SSE
- Develop filters to attract socially committed investors and keep out those that would increase the threat of mission drift among FPEs

Overt reliance on for-profit world

A bulk of the recommendations of the working group speak less to the functioning of the SSE, and more to creating an ecosystem for flow of funds from the for-profit investment world to what they have defined as the social enterprise world.

The language, idiom, instruments and instrumentalities that are used are coming from the for-profit world. We do not deny that there is a lot to be learned from the for-profit world and world of markets, but we also need to recognize *a number of social problems emerge from market failures.* These market failures cannot be addressed by merely changing objectives or priorities (from the pursuit of profit to pursuit of social impact) but also from questioning the processes, tools and culture that governs the mainstream for-profit work.

Unfortunately the report lacks substantive engagement with the ideas that have emerged outside of the for-profit world. These include:

the idea of “social business” provided by Professor Muhammad Yunus;

the world of co-operatives and farmer producer organisations;

the efforts of B-Labs (apart from a mention in an appendix) in trying to incorporate impact generating enterprises as Benefit Corporations and also listing them

the UK experience of Mutual and Community Interest Corporations

If we do not learn from live examples, we will only reinvent the wheel.[1]

Related, the objectives and instruments available to NPOs and FPEs are very different and so are current governing standards. It would serve the interests of both forms of organisations to keep them in two separate exchanges, with different reporting standards, rather than put them in one, with the threat of implicit (and unfair) comparisons.

Lack of Clarity on scope of SSE (particularly with regard to FPEs)

Promoting Exchange?

The working group report engages much more with the possible instruments that can be listed and the tax (exemption) ecosystem that could be created. Also, the report divides up the world into the for-profit and the not-for-profit world and prescribes different instruments and instrumentalities for funding these initiatives. We however, do not get a sense of how the listing would effectively help exchange.

A stock exchange is expected to create an ecosystem, based on the market principle to clear the objectives of trading investments – clearly the buyers and sellers of these instruments are also making profits (or losses) by putting a bet on a particular investment which in turn would provide a better residual claim. It is an important institution to have in the for-profit world because it gives feedback on how the efficiency of the firm is being perceived and thus its capacity to generate returns for the investments made at a certain value at a certain point in time. The beauty of the stock exchange, the rating agency, the analysts and the entire ecosystem around the markets for investments is that they are all trying to measure and interpret only one thing – the residual claims that are being generated on a certain amount of investment. The interpretation may differ and therefore how valuable the firm is, is also subjective, but the underlying attempt to measure is purely the return one provides for risk capital.

We need to be clear that there is a distinct difference between a registry, where one could list or register and having an active exchange. This clarity is lacking in the details that have been shared so far.

In an active exchange, one would expect a large number of buyers and sellers of the instrument actively trading in the instrument. Among the silences in the report, we do not know or there is

[1] The example of Etsy which was a certified B-Corp decided to give up its certification after it was listed and was subjected to the world of commerce on the stock market would have informed the committee of the pressures that enterprises face when they come face to face with the for-profit world. For example, see Gelles, David. "Inside the Revolution at Etsy." *The New York Times*, November 25, 2017, sec. Business. https://www.nytimes.com/2017/11/25/business/etsy-josh-silverman.html.

no indication that there would be an active market for an instrument like a zero coupon zero principal bond. For instance, the report mentions that the zero coupon zero principal bond would be written off in the investee's books. Does that mean that till the end of the project period, this would be shown as a liability, and in case some of the outcomes are not achieved, would the principal have to be returned? Who bears the risk in case it has to be returned? What is the accounting entry of a debit and a credit that would be passed in the write off and how does the balance sheet look after the write off? These are important details to know before we can evaluate the potential of the instrument.

Regulatory Authority?

The report lacks clarity on the regulatory environment it wishes to create for regulating SEs, the role of SEBI and other IRs.

The report's recommendations are around an entity labelled as a "social enterprise", which is proposed to receive fiscal benefits and access to other financial instruments, but the authors then argue that there is no need for a regulator to regulate this entity.

In particular the report mentions that:

> "Given that the social sector is still early in its development, we do not recommend the immediate creation of a regulator for social enterprises, for social reporting or for social auditors..The SSE and the instruments listed directly on the SSE will fall under SEBI's purview but the NPOs and wider ecosystem are outside SEBI's remit and therefore in the immediate term as well as the future, other regulatory bodies will need to pitch in." (p.24)

This is a puzzling recommendation and has different implications for NPOs and FPEs. Given that they operate in the sensitive domains and also often receive tax benefits, NPOs are already strictly regulated with oversight by a clear regulatory body (depending on the specific legal form). In contrast, FPEs which would like to call themselves as "Social Enterprises" and avail themselves of additional benefits that might come with the label, will be governed by nothing more than complying with the reporting requirements and no regulatory oversight than what they would typically need to adhere to as FPEs.

Relatedly, the role of IRs vis a vis that of SEBI in regulation also remains unclear. On the one hand they are envisioned as mere information repositories, on the other they are also encouraged to come together to form a Self-Regulatory Organization.

The report states:

> "The IRs would perform the functions of enumeration (listing of active NPOs and their activities), standardization (articulating a standard reporting format for NPOs and helping them to do information reporting), and verification (due diligence)....We recommend that in the immediate term, the SSE encourage the setting up of a Self-Regulatory Organization (SRO) that will bring together existing IRs such as GuideStar, DARPAN, and Credibility Alliance, for meeting the above ends."(p. 24)

Presumably this refers only to NPOs and the FPEs again escape scrutiny.

The implication of this suggested restriction on the role of SEBI and reputational risk for it also needs greater examination.

If as the report mentions, "Listing, compliance and penalty provisions must be aptly stringent to prevent any misuse of SSE platform by FPEs"(p.31), then there needs to be clarity on the regulatory authority overseeing the listing as well as compliance provisions.

Absence of Definitions

Defining social enterprises, as the report mentions, is tricky. However, regulations rest on definitions and measurements, compliance and verification of compliance. The unwillingness of the working group to define a social enterprise and leave it to them to "demonstrate that they are in the business of *"creating positive social impac*t" while good in theory leaves the definition very open to misuse in practice.

For this purpose, regulators need to have measures that are not only aligned with objectives of regulation, but also can be measured consistently across entities and independently verified. While paying attention to the reporting burden, attention also needs to be paid to costs of verification. Among NPOs, this is done to some extent, by the legally binding commitment to not distribute any "residual earnings" to contributors of capital; the report fails to specify any such legally binding commitment for FPEs wishing to be SEs.

To reduce ambiguity and for the regulator to build credibility for the institution, at least some aspects of the definition need to be hard coded. The only hard coding that the report suggests is organisations "committing to minimum reporting standards".

Quoting the report:

> "We believe that a self-declaration approach, whereby enterprises choose whether they want to be categorised as a social enterprise, and consequently commit to additional reporting on social impact, is the best one, because the enterprises themselves are best

> placed to take a call based on the costs or benefits to them of being classified as a social enterprise." (p.8)

The implicit assumption is that if the private benefits exceed the private costs for an organisation, it must create a social benefit and hence be allowed to list on the SSE. There are several examples, including the Andhra Pradesh microfinance crisis of 2010, which point to the social harm that can result from mixing private profits with the stated goals of creating social impact.

Further, this assumption ignores the social costs attached to the listing that the report also suggests for the purposes of incentivizing capital. The social costs include not only the direct fiscal benefits that the organisations might get but also the opportunity cost of philanthropic capital that is diverted its way.

Questions on measurement framework

An abundance of documented experience points to the fact that even though very desirable, the measurement of social impact on the basis of outcomes is notoriously difficult. The report appears to hope that this can be resolved by developing the social ecosystem in India. However, if this were true, then one would expect countries with more advanced ecosystems to have resolved this problem, and they clearly have not. Besides issues of measurement, there are issues of values that need to be resolved in assessing social impact. The example of Ducks Unlimited which claims to "($235+ million in total revenues) and throughout North America conserved more than 14.5 million acres since its inception in 1937" should make this clear when one realizes that the organization's primary supporters are duck hunters.

Do measures "signal" the right attributes?

A critical paragraph describing the philosophy underpinning the approach that the working group has laid out is the following:

> "It is to be noted that the reporting standard ensures a prioritization of social returns. It requires a level of descriptive detail that only bona fide FPEs will be able to provide, and that will be too costly for impostors to mimic. Therefore, only the true FPEs that are creating positive social impact will be able to precisely signal their "social return" credentials to potential investors. In other words, the reporting standard empowers the investor with a very high degree of discrimination so that he/she is able to single out an FPE that is genuinely creating positive social impact." (p.31)

This is a significant but problematic assumption in the report and there is no supporting evidence provided to defend it. In fact, other than stating what needs to be reported, there don't seem to be any "standards" that are specified to evaluate what is being reported.

In the absence of strict, measurable and verifiable standards, the assumption stated above is akin to believing that products and services that are advertised most heavily are necessarily of better quality.

Especially, but not only for, for-profit SE's, it becomes important to understand the "costs" and "benefits" of claiming to be a social enterprise and listed on the exchange.

As the report correctly points out, every enterprise, and every activity has an impact and several would have a positive social impact. The challenge is to look at organisations that create an impact beyond their normal course of business, consciously and in their operating details.
Organisations that are creating a positive social impact and also delivering great profits (as suggested in the report – impact enterprises providing a value proposition better than the hurdle market rates of return) do not need any special listing or dispensation. They are quite capable of being in the mainstream arena with adequate regulations governing their social and environmental impact.

The organisations that merit special dispensation for targeted investments are the enterprises that work for a cause and are unable to provide returns that clear the market rates. Once we say that these are the ones that merit special dispensation, it seems contradictory to adding more costs to them to make them even more unviable in order to merit soft funding.

What are the extra costs? The compliance requirements on impact reporting are over and above regular housekeeping and accounting function. If in order to receive patient funding for an unviable business, we need to make it even more unviable by adding costs. While the report mentions provision of funds to assist in capacity building, it is unclear how organisations will be selected for capacity building even before they have been able to fulfill the reporting requirements.

This issue is better dealt with by having measures that are aligned with the organisation's operations, internal processes, practices and governance structures so that the organisation is primarily reporting what it would be collecting data on as a regular part of its operations.

The requirement that FPE reports are scrutinized by an external auditor is commendable, what is of concern is that it seems to be the only additional requirement for a FPE to be listed on the SSE. Having a common minimum reporting standard across NPOs and FPEs also implies that while NPOs continue to be governed by other stringent operating and reporting standards (for example, those specified by the Charity Commissioner, IT Authorities, Ministry of Home Affairs etc.) to be allowed to function in this space in addition to those that might be specified by the SSE, FPEs face no additional requirements.

There is also no mention of how these reports will be used and what are the requirements that organisations need to fulfill. What would be considered essential? What would be desirable? Other than collecting them, how is the regulator supposed to use these numbers?

For instance, organisations are expected to report on : "Remuneration of key managerial personnel and remuneration and reimbursements of members of the highest governing body - Compensation Ratio of highest-paid and lowest-paid employee". Are there any specific standards that organisations need to comply with? We believe that the regulator should specify those standards, even if they evolve over time.

Guarding against conflict of interest

Who will the auditors be?

From a regulatory standpoint, it is important to think ahead and define these to be conscious of the different interests that prevail. While intermediaries will be needed to create an ecosystem, who these intermediaries will be and what their interests are likely to be needs careful thought. There is no doubt that potential beneficiaries from the creation of a SSE include intermediaries that will get into the business of verification and certification. What organisations save by way of efficiency, should not be spent on certifying that we were efficient.

Should for-profit organisations be allowed in this space as auditors? Should they at least fulfil standards required of organizations they audit in terms of prioritizing social value over financial? These questions should not be postponed as the information generated by these auditors will be critical to the functioning of the SSE.

Given that the domain is in its nascent stage, with multiple information asymmetries, ***we strongly suggest that till the sector matures and the regulators themselves have greater clarity on what data needs to be collected and how it should be interpreted, the task of auditing should be limited only to non-profit organisations***. Leaving it open to opportunistic profiteering might have a debilitating impact on the sector as a whole.

Regulatory role to private actors ?

We are concerned about some references which assign the responsibility for some quasi-regulatory functions to private bodies. For example, as part of the immediate minimum reporting standards the report suggests that "if the SE is an FPE, it must have received funding from any one or more of the impact investors who are members of the Impact Investors

Council" (p.49). While not entirely clear, the suggestion seems to be that only FPEs that have received funding from specific organisations would be eligible to be listed on the SSE. Without devaluing it, we have to recognize that the IIC is a private body, with a particular view and financial interests. It is worrying that decisions of a private body are sought to influence the shape of a public regulatory institution.

More generally, going forward, we hope there will be adequate representation of different stakeholders, even with competing interests to participate in critical decision making around the design and functioning of the SSE.

"Qualified" Investors?

An important dimension that has not received any attention in the report is whether the SSE will be open to any investor that wishes to invest or transact in it. The experience of most FPE that have tried to work with a social purpose is that the investor priorities play a critical role as social enterprises strive to pursue a balance between "purpose" and "profit" while trying to grow. Given the SSE might offer investors incentives for investment, it would be appropriate to have filters for investors as well to reduce the threat of mission drift, especially among FPEs.

Way Forward

In addition to the suggestions made earlier, we would like to specifically suggest the following:

To reduce ambiguity and for the regulator to build credibility for the institution, at least some aspects of the definition need to be hard coded. The only hard coding that the report suggests is organisations "committing to minimum reporting standards". This is too porus a standard. If FPE are to be brought into the ambit and the risk of misappropriation reduced, more standards need to be hard coded.

Two immediate ones are on the basis of ownership and restrictions on share of residual earnings that can be distributed. The example of Community Interest Company (CIC) which by some accounts is the fastest growing legal form for social enterprises in the UK is noteworthy on this account. Besides others, one of the defining elements of a CIC is that a maximum of 35% of a CIC's distributable profits can be paid out in dividends to the company's shareholders annually. We urge a deeper study of this model and its appropriateness in the Indian context.

In addition, we would like to draw your attention to a set of indicators that we had developed to help evaluate the inclusiveness of organisations (enclosed presentation). We would be happy to discuss these further with you if they are of interest.