Eurosif Response to the European Commission Consultation on The Social Business Initiative: Promoting Social Investment Funds

September 14, 2011

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Eurosif strongly supports access to social investment opportunities for all investors, including retail investors, as social investments can be one important means of advancing sustainable development through financial markets.

We believe that the UCITS framework represents a robust benchmark for social investments funds but that a specific EU framework is needed for social investment funds.

We believe that long term retail investment vehicles (life insurance, retail and occupational pension products, equity wrappers, etc.) could, especially if coupled with incentives such as tax breaks, be attractive to retail investors in such investments.

While we support funds with a distinct social or environmental motivation, in order to maintain the link to sustainable and responsible investment (SRI), the funds must in addition to their main non-financial objective incorporate other social, environmental and governance considerations into their investment management.

Finally, social investment funds comprise a relatively small subset of institutional and retail markets, whose demand is primarily institutional. Therefore, the Commission should also strive to mainstream SRI in the institutional and retail markets.

Box 1

Do you agree that the main features of social businesses are as outlined above?
Please consider this from the perspective of ensuring effective private investment flows to these businesses, and include any further detail on how to determine the features. If you disagree, please outline the features that you think are important.

To what extent do you think this initiative should focus solely on those social businesses that do not distribute profits to their investors? (Note that, in contrast with pure philanthropic investments, investors would still be able to redeem their investment, or might be offered small returns through portfolio diversification).

Or shall it also focus on those which distribute profits to their investors (e.g. at least to a limited extent)? If so, how might social businesses be distinguished from other businesses?

Please consider the impact this may have in respect of attracting investors to such businesses.

Eurosif agrees that the primary corporate objective of a social business is maximise social returns. Any financial profits or income in excess of costs should be reinvested in the business, or provide moderate return of capital to investors (dividends).

However, we would like to draw your attention to the following: the quest for profits or the maximization of profits by a social business is not antinomic with the very nature of a social business, as long as the profits or a large portion of the profits are reinvested in the business itself and help them to reach their social aims.

The words "social" and "business" are equally important in the definition. Social business is aiming at maximizing both its "social dimension" and its profits, while noting that profit maximization still primarily serves the social dimension.

We believe that there is room to include both social business not redistributing any profits and those redistributing some level of profits to their shareholders. Those social businesses offering some ancillary level of financial returns to their shareholders in addition to redeeming their capital should be included in the definition provided that they meet the other characteristics of a social business as described in the consultation paper.

Cooperatives in France are a good example of how to reconcile an alternate approach to profit and return on investment with redistribution of "profit" sometimes referred to as "surpluses": legislation sets a maximum rate of dividend for the "shareholders" of cooperatives (more or less a bond rate).

While meeting the very philosophical stance of a social business, this broader definition would have the advantage of:

- Encouraging investors to invest in such ventures thus growing the sector further;
- Creating more opportunities for social entrepreneurs to launch businesses and secure financing;

- Helping the sector to create employment opportunities and increase its impact on the community.[1]

The Commission should, however, also consider that a definition incorporating financial return (or lack thereof) may distract from the aim of social businesses. Social entrepreneurs and investors alike typically support a social business to further a social goal, as evidenced in your examples in the consultation document. The financial concern is secondary, and success (return) is typically not measured in financial terms. Further, due to the expectations of entrepreneurs and investors, any excess profits are typically reinvested in the business anyway, as this best supports the goal of the business. Therefore, it is more appropriate for social businesses to be defined in terms of their social impact, not in terms of their incorporation or distribution of profits.

Box 2

What are the main difficulties social businesses face, in your experience, in getting access to finance? (Please provide any data or evidence you have to show the scale and relative importance of the difficulties you identify).

Do different kinds of social businesses face different barriers? (Please include details about how these differences might impact on the access of these social businesses to finance, including over their lifecycle where appropriate.)

To what extent do you think barriers to access to finance are limiting the growth of social businesses across the EU? (Please provide any data or evidence you have to illustrate the scale and nature of these limitations).

Do you agree that there is a need to tackle any such barriers at the EU level?

Eurosif sees two main barriers for access to finance from investment funds. One, mainly on the institutional side, is a lack of broad interest in social businesses, limiting options for investors that seek such assets. This may be driven by a lack of understanding of the benefits of social businesses to fund beneficiaries, and that success (return) for asset managers is generally measured in financial terms only. It is not unreasonable to argue that many investors may prefer to hold their financial and philanthropic portfolios separate, for a variety of reasons, including tax. As the market for social investment funds matures, this may improve. On the retail side, private investors (apart maybe from high net-worth individuals (HNWI)) who want to invest in social businesses have fewer options compared to mainstream funds, as most retail funds are focused on financial returns. Providing better access to finance for social businesses through investment funds could therefore contribute to correcting the retail market failure.

Most businesses face their primary financing challenge at launch, and social businesses are no exception. Social businesses face additional challenges in that the primary sources of start-up financing (banks and private equity) are typically profit driven. Investors may be hesitant due to lower profitability, lack of liquidity, and lack of credit ratings. These concerns are not being

[1] According to Finansol, a French NGO, French savings invested in social businesses (to the extent it meets the definition of "finance solidaire") created 34 000 jobs in 2010.

compensated by any action to encourage investment in the sector (specific tax benefits for investment management or warranty of any kind). Some may find financing from the philanthropic market. Thus, providing incentives to funding at inception could benefit the market. A Eurosif study of Venture Capital (VC) for Sustainability from 2007 showed that the main sources of funding for this segment were family offices, public funding, and HNWI. This suggests that access to commercial institutional or retail funding is a challenge for entrepreneurs, and one can imagine even more so for socially motivated businesses.

According statistics from Finansol[2] a French NGO specialized in "social finance", pure "social investments" represent a minor source of funding compared to "social savings" and social investments connected to employee-savings schemes (eg. providers of the French defined-contribution pension scheme PERCO have an obligation to offer "social investment" funds). However, it is unclear whether the primary reason for this is lack of supply or lack of demand.

Box 3

If you operate a social investment fund, or are aware of the (national) legislative requirements that apply currently in practice, could you please provide broad detail on these requirements.

How do you think funding through investment funds might effectively compliment other sources of funding, e.g. philanthropic funding? Are there any challenges here?

Do you think that the UCITS framework is sufficient for funding social business without change?

Do you think a bespoke fund framework tailored to the needs of social business might be better suited to channel funds toward social businesses?

(If you think the UCITS framework is not suited, please outline the features of the UCITS framework that you think are mostly responsible for this).

Improving access to retail social investment funds represents an important step to improving access to finance for social business. We believe that EU legislation in particular can contribute to setting a level playing field across EU Member States in terms of helping social business to access funding through investment funds.

In particular, we believe that a legislative framework should focus on incentivizing asset owners, asset managers and retail investors to channel investments towards social businesses by:

- Ensuring that products are sufficiently transparent;
- Ensuring that the fees structure is appropriate;
- Providing investors with concrete incentives (beyond purely social goals) to invest in such funds, eg. tax incentives.

[2] See: http://www.finansol.org/UPLOAD/rubrique/pages/94/94_rubrique.php

We believe that the UCITS framework is not adequate as such to address all these changes but represents a base on which a bespoke social investment fund legislative framework can be founded.

The UCITS framework is a trusted label for investors, both retail and institutional, and regulators should strive to achieve the same with any social investment funds regulation. Eurosif notes that one of the keys to success for the UCITS brand is investor protection principles.

Similarly to UCITS products, but in a framework adapted to their specific characteristics, social investment funds should follow strict rules around eligible investments, investment restrictions, risk management, conduct of business, responsibility of management, organizational requirements, internal procedures and transparency of the products.

Box 4

Do you believe that social investment funds should be open to retail investors? Please give reasons for your answer.

What features of a social investment fund do you think are most important for retail/professional investors?

What specific pre-contractual information do you think would need to be provided to retail investors?

Should the framework encompass funds that explicitly forego greater financial returns for the benefit of the social impact of their investment, or that expose investors to greater risks, or both?

Eurosif wholeheartedly believes that social investment funds should be open to retail investors because:

- There is evidence that there is a growing retail demand for such products, even though the current market is small. For concrete evidence see the response provided by our UK member UKSIF to this consultation. See also data provided by Finansol on retail savings directed towards social businesses/funds.
- Such funds, given their illiquid assets, tend to be more suited to long term investors and as such are an interesting complement to second or third pillar pension schemes. See for instance the French PERCO (already mentioned) and the French Employee Savings Schemes (PEE) that have to offer since 2008 (Loi de Mondernisation de l'Economie) at least one social investment fund ("fonds solidaire").
- Retail investors are, on aggregate, invested in products with the low volatility, at least for an important portion of their portfolio, as seen in the bias towards fixed income products today across Europe. Social investment products have the potential to exhibit similarly low volatility of financial returns.

In terms of the features desired by investors, both retail and professional, apart from advancing purely social goals, these products will generally represent a diversification strategy. This motivation alone has the potential to channel significant capital to social businesses.

The pre-contractual information to be provided to (in particular retail) investors could be inspired by the Key Investor Information Document (UCITS IV). The information requirements are similar to that of venture capital funds. Particular attention should be given to:

- Transparency of eligible investments (which businesses is the portfolio invested in);
- Transparency of fees;
- Transparency of financial risks.

In designing such a framework, the Eurosif Transparency Guidelines can provide inspiration (see below).

Box 5
What do you think would be the appropriate time frame for redemption of units in a social investment fund, e.g. monthly? Please give reasons for your answer.

Do you think there are other options for balancing the liquidity that small retail clients might be seeking with a focus on a long-term time horizon? (For instance, requirements on holding certain levels of liquid assets, lock in periods, etc.)

Eurosif believes that all funds must be transparent about the risks involved in investing in them, including liquidity constraints. However, the market, not the regulator, should determine the need for liquidity. The framework should therefore allow for investments in illiquid assets, and treated as such by investors.

Box 6
Do you think that social investment funds should be subject to diversification rules?
To what extent do you think investors might expect a fund focused on social businesses to only invest in social businesses?

Should social investment funds be required to invest into different types or numbers of social business? (How many separate businesses might be required?).

Should there also be diversification across asset classes different from social business? (What limits might be appropriate? For instance, 40% social businesses, 60% highly liquid transferable securities).

Funds should be subject to diversification requirements, especially in terms of limits on concentration of fund assets in specific companies or groups.

A fund labelled social investment fund should only (or largely) invest in social business. There might however be a role to play for traditional UCITS funds in integrating a small portion of investments into social businesses provided that (a) this meets the investment restriction rules imposed on these funds and (b) exhibit satisfactory transparency in terms of holdings and risk profile to investors. Such funds are sometimes referred to a 90/10 funds (90% of the fund is invested in traditional, listed holdings and 10% in a social portfolio). In counterparty for this, the investor should be ready to accept a lower rate of return than with a fund fully invested in traditional asset classes.

In the case of a hybrid fund (mix of transferable securities and social business "shares"), it is important to:
- Ensure sufficient look-through into the portfolio holdings;
- Ensure adequate diversification / risk-spreading rules between social investments and traditional investments;
- Ensure adequate diversification within each portfolio bucket (e.g. within the transferable securities bucket).

This framework would work similarly to the UCITS risk-spreading framework.

Box 7
What types of assets should a social investment fund be able to invest in? Please give examples.

Should the funds be limited to certain kinds of strategies (for instance, aimed at maximising their attractiveness for retail investors)? If so, which?

What rules or limits might be necessary to prevent firms using a new framework to circumvent restrictions in other frameworks (e.g. UCITS)?

The funds should not be limited to certain kinds of strategies, and certainly not aimed at maximising their attractiveness for retail investors. The market forces will naturally orientate the investments in social business segments that represent the most attractive opportunities. However, fund providers may choose to launch funds targeting specific social business segments, in a fashion that is similar to, for instance, sector or theme funds.

Box 8
Do you agree that it would be impractical for social investment funds to have frequent valuations of assets? Please give reasons for your answer.

If so, for the purposes of investor protection what frequency might be appropriate?
Please give examples.

Do you think that any non-social business assets that might be permitted should be subject to different valuation requirements? Might different kinds of assets require different approaches?

It may be impractical to expect frequent valuation of social businesses, as with most illiquid assets. However, the need for continuous or even frequent valuation should be tempered by the idea that these types of investments would be most appropriate for investors with long time horizons. As such, quarterly valuations could be sufficient.

Box 9
How do you think 'social returns' might be best addressed and measured?

How might this build on other existing work, for instance on non-financial company reporting, social accounting, socially responsible investing, etc.?

What information do you think needs to be disclosed to investors, and how might this best be presented?

If you have experience in this area please provide examples, data, and as much detail as possible. Please consider that prospective investors might need different information compared with already existing investors.

The social return to the investment portfolio of social investment funds is critical, as this is the primary motivation for investing. Measuring this is a challenge as, unlike for financial value, this is not consistently defined and is specific to the project. Social profitability could be measured using sustainability indicators or specific methodologies such as Social Return On Investment (SROI).

One may consider that the social return is initially expressed in qualitative terms, with quantitative terms included where appropriate. Efforts to develop measures for social benefits in a comparable and consistent manner are being undertaken, and may be integrated into the reporting framework when sufficiently advanced. It may also be appropriate for the Commission to encourage the continued development of such initiatives.

Box 10
Do you agree that investor participation will contribute to the success of these funds? Please give reasons for your answer.

If so, please outline how this might work in practice, and whether this can or should be required as part of the social investment fund framework itself.

Eurosif agrees that investor participation can be valuable, for example through volunteer work in the companies or participation in advisory committees. However, the degree of investor participation should be defined in the governance structure of the fund, and not be governed by legislation. While direct participation may be appropriate for some investors, others may be content to limit their involvement to the receipt of regular reports.

Box 11
Which particular features of social investments might require specific risk management requirements?

When considering this question, please also consider issues of non-financial outcomes and risks.

Social investments require a specific set of risk management procedures in order to protect the investor and ensure that the goals of the fund are being pursued in an appropriate fashion. This is especially the case for retail funds, where the investor may be less sophisticated.

Risk management procedures that go beyond that expected of a mainstream fund includes enhanced management oversight over portfolio companies. This is needed because many social entrepreneurs may not be skilled in managing the requirements of running a company with outside investors, such as accounting, reporting and dialogue. Further, the fund manager must ensure that procedures are in place to consider not only the social impact of the business, but incorporate other non-financial elements including environmental and governance elements. Additionally, there must be appropriate risk management and reporting structures that ensure that the stated social goal of the business is pursued and not deviated from.

Box 12
What should be the duties of a depositary (e.g. tracking the funds' assets, reconciling units or shares issued with subscription proceeds received)? Please give reasons for your answer.

Please take into account the specific kinds of assets that might be held by a social investment fund.

Box 13
How might the sustainability and profitability of a social investment fund regime be ensured?

Are there any particular factors in your experience that might determine the commercial success of the fund?

In your view, what kinds of incentive structures might be appropriate or inappropriate for the managers of the funds (e.g. performance fees versus flat management fees)?

Social investment funds will require either incentives for existing distribution channels, or new distribution channels to be successful and sustainable.

In the current common fund distribution channels there are a lack of incentives for distributors to distribute such products. Today, European funds distribution is largely channelled through banks (except in the UK where Independent Financial Advisors are the dominant channel) and fund « supermarkets ». The current distribution system requires the fund manager to pay significant trailer fees to the distributor to have access to their distribution platform. This results in « guided open architecture » for third party funds and a dominance of in-house products. This situation could result in a challenge for fund manager to sell funds that cannot be charged too highly because of their financial return promise, and cannot therefore offer attractive enough trailer fees to distributors.

Advice at the point of sale could also be a challenge in that products may require specific training/expertise for financial advisors / bank advisors.

The level of fees may also be a challenge given the financial return perspectives of the products.

Given this, there may be a need for either incentives to encourage supply for or demand of funds. Alternatively, one may need a new distribution channel, for example in the non-profit space in order to ensure the successful promotion of funds.

Box 14
What steps do you think should be taken to improve transparency for investors in relation to funds targeting social businesses?

What steps do you think should be taken to improve transparency for fund managers about the social businesses which they target?

Please consider how to balance burdens on social businesses against effectiveness in ensuring their 'investment readiness'.

Transparency for investors is critical for investment funds, and especially so for social investment funds given that it is an asset class that is relatively unfamiliar to investors. Transparency requirements should therefore be part of the fund disclosure requirements, for example in the form of a Transparency Code (see below).

Box 15
How do you think common criteria for defining, labelling and rating social funds and social businesses might be most effectively established?

Who should establish them and develop them over time?

How might they be verified, to ensure they are appropriately used in practice?
Please set out views on the pros and cons of different approaches.

Based on our experience in the Socially Responsible Investment field, and given the very fluid nature of social business, we would advise you to form a multi-stakeholder advisory committee whose role would be to provide input into the definitions of social business funds first.

A second step to establish a labelling / rating system for funds would be to establish, together with the same group maybe, a rigorous process for "certification" or labelling. The process should be robust enough to be based on a set of objective, undisputed criteria and potentially subject to third party assurance.

We would be happy to introduce to you the work we have recently been doing on strengthening Eurosif's Transparency Guidelines, in order to turn these into a Transparency Code, similar to what you refer to in your question. See answer to box 16.

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Box 16
Do you think a strong new EU label (e.g. supported by a common logo) would help social investment funds succeed? Please give reasons for your answer.

How might the appropriate use of such a brand be ensured in practice, and potential for confusion with other brands or labels diminished?

Yes, a European label would certainly contribute to the success of such funds. If designed properly and owned by an independent body, it would build investor's confidence in the products.

In order to explore how a European labelling model could be developed, Eurosif recommends that the Commission assess current European/national initiatives. An illustration of such a pan-European label, was given by Eurosif in its response to the PRIP Consultation earlier in 2011- the European SRI Transparency Code.

Officially launched in November 2004 with support from the European Commission, the European SRI Transparency Code aims to create more clarity on the principles and processes of retail funds with regards to ESG issues. From a national perspective, this European Code has been embedded into the AFG (Association Française de Gestion Financière) in France so that all members of the AFG with retail SRI funds must be signatories of the Code.

Commitments from signatory funds (350 as of January 2011) are submitted to Eurosif in the form of a response document that follows several guiding principles:

- Responses should be informative and clear. Generally speaking, required information (on tools and methodologies) should be as detailed as possible;
- Funds should report data in the currency that they use for other reporting purposes;
- Reasons preventing the fund from providing the required information should be clearly stated;
- Signatories should systematically state if and when they hope to comply with the questions they cannot answer at this time;
- Responses will have to be updated at least on an annual basis and should have a precise publication date;
- Responses to the Code should be easily accessible from the fund's and/or fund managers' website. In any case, signatories should make it clear where to find the information required by the Code;
- Order and exact wording of the questions should be respected;
- Signatories are responsible for their answers to the questionnaire.

Eurosif is responsible for maintaining and publicising the Transparency Code, with the collaboration of National Sustainable Investment Forums (SIFs) in EU Member States. The signatories to the Code are highlighted on Eurosif's website, national SIFs' websites and SRI related publications. Eurosif has created a logo that is awarded to those institutions using the

Code. This award is updated by Eurosif and renewed by the financial institution on an annual basis.

Eurosif is currently developing a compliance manual for the Code, to be finalised by the end of 2011. A selected third party auditor will use this manual to audit funds' responses to the Transparency Code. Eurosif will update the Commission on further developments.

All information pertaining to the European SRI Transparency Code can be found at: http://www.eurosif.org/sri-resources/sri-transparency-code

Box 17
What steps do you think might be taken at the European level to facilitate better intermediation between funds and social businesses? Are there particular responsibilities that you think fund managers should take on?

Do you think there are any possible actions at the European level that might ensure effective distribution of social investment funds?

Box 18
How might tax incentives be made useful? Please provide data on any existing such incentives you are aware of.

Are there any other measures you think might be possible to maximise investor's access to social investment funds, or the attractiveness of these for investors?

Tax incentives could play a key role in channelling in particular retail monies to such social investment funds. These tax incentives can be built on a bespoke basis or build upon tax incentives for existing financial wrappers such as life insurance products, retail or occupational pension products, etc. (see comments on French PERCO, PEE, and also the Plan Epargne Action).

Facilitating the inclusion of social investment funds, again, largely long-term oriented, in such wrappers, would be key to their success.

APPENDIX

About Eurosif

EUROSIF, the European Sustainable Investment Forum, is the pan-European network whose mission is to develop sustainability through European financial markets. Eurosif works as a partnership of the national Sustainable Investment Forums (SIFs) within the EU and with the support and involvement of Member Affiliates. Recognised as the premier European forum for sustainable investment, Eurosif's Member Affiliates are drawn from leading institutional investors, asset managers, NGO's, trade unions, academic institutes and research providers, together representing assets totalling over €1 trillion. Eurosif's work includes a focus across asset classes - equity and fixed income markets, microfinance, renewable energy, property, private equity and hedge funds - all centred on the industry trends and future legislation affecting this space. The key benefits that Eurosif Affiliate Members receive include EU interfacing, SRI information and European wide initiatives that integrate Environmental, Social and Governance (ESG) issues into the financial services sector.

For the full list of Eurosif Member Affiliates, please see www.eurosif.org

Eurosif has two main roles: (1) to provide an international forum that allows members and member affiliates to work together on issues pertaining to Sustainable & Responsible Investment (SRI, see below for definition of SRI and its market size in Europe) and Corporate Governance in the EU financial services sector, and (2) to collect input from members and member affiliates and then communicate their ideas and initiatives to European policy makers, including the European Commission as well as the European Parliament. Therefore, this note is mainly driven from and by the interest and expertise of our membership.

Sustainable and Responsible Investment Definition

Eurosif continues to use the term "SRI" as the most readily acknowledged expression for this field and defines SRI as follows:

> *Sustainable and Responsible Investing (SRI) is a generic term covering any type of investment process that combines investors' financial objectives with their concerns about Environmental, Social and Governance (ESG) issues.*

Market Size

Eurosif recently published the latest Sustainable and Responsible Investment (SRI) figures and trends in its "European SRI Study 2010". This unique study highlights the scale of European SRI as well as European and National trends across nineteen countries. Based on a survey of asset managers and self-managed asset owners, we found that total SRI assets under management (AuMs) have reached €5 trillion as of December 31, 2009, corresponding to a remarkable growth given the financial crisis over the past two years since the study was last published.