

**Response to Industry Canada's Consultation on the
Canada Business Corporations Act (CBCA):
Incorporation Structure for Socially Responsible Enterprises (SREs)**

Prepared by the MaRS Centre for Impact Investing
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Response to Industry Canada’s Consultation on the Canada Business Corporations Act (CBCA): Incorporation Structure for Socially Responsible Enterprises (SREs)

Issue: the utility of SREs in the Canadian context and the extent to which current CBCA incorporation provisions and structures facilitate the creation of SREs.

Recommendations:

- The MaRS Centre for Impact Investing (MCII) **supports the exploration of legislative amendments to the CBCA that would introduce a purpose-built hybrid corporate form for SREs** (or social enterprises), combining social purpose requirements with the ability to attract equity and debt investments.¹
 - A hybrid corporate form could **respond to the needs of a sub-set of social enterprises** that are seeking to raise share capital, while locking in a social purpose to ensure its longevity, and providing assurances to customers and investors who are driven by social impact considerations. This could have significant impact on the growth of social enterprise activity in Canada.
 - The introduction of a hybrid model could potentially be accompanied by **tax incentives**, for the enterprise itself or for investors.
- However, to facilitate the creation of social enterprises, **MCII would prioritize actions to:**
 - **Address constraints on social enterprise activity in the non-profit and charitable sector;** and
 - **Catalyze impact investment** into social enterprises through matched capital investments in existing or new impact investment funds, credit enhancements, tax incentives, outcomes payment funds, or other measures.²

These recommendations are generally outside the remit of Industry Canada, and are the subject of two forthcoming papers, which are being developed by Canada’s National Advisory Board to the Social Impact

¹ MCII is assuming that Industry Canada is interested in amendments to the CBCA that would

² The Canadian Taskforce on Social Finance defined impact investing as: “Actively placing capital in businesses and funds that generate social and/or environmental good and (at least) a nominal principal to the investor. Impact investors seek to harness market mechanisms to create social or environmental impact.”

Canadian Task Force on Social Finance, *Mobilizing Private Capital for Public Good*, <<http://www.marsdd.com/mars-library/mobilizing-private-capital-for-public-good-canadian-task-force-on-social-finance/>> (Social Innovation Generation, December 2010).

Investment Taskforce, launched by the G8. These papers will be finalized in Summer 2014.

- Additional, complementary actions could also be considered, including:
 - To improve access to small and medium-sized enterprise (SME) **business development and capacity building supports** for social enterprises (for-profit, non-profit, charitable and co-operative); and
 - To adopt **social procurement policies** that would increase government demand for goods and services supplied by social enterprises (e.g., a catering company or print shop run by at-risk youth).
- These recommendations draw from the 2010 report of the Canadian Task Force on Social Finance.³
- **Should Industry Canada choose to pursue CBCA amendments related to social enterprises, MCII would be happy to provide support as needed.**

Context:

- **Definition:** The Canadian Task Force on Social Finance has broadly defined a social enterprise as an organization or business that uses the market-oriented production and sale of goods or services to pursue a public benefit mission. Social enterprises can serve many functions – they may, for example, employ or serve marginalized people, provide education and training opportunities to youth, engage in environmental conservation or develop and sell clean energy solutions, to name a few.
- **Organizational structures for social enterprises:** Social enterprises in Canada can adopt a range of forms, from enterprising non-profits and charities, to co-operatives and social-purpose for-profit businesses – including over 100 registered B Corporations.⁴
- There is also a new hybrid corporate form for social enterprises in British Columbia – the Community Contribution Company (C3). We understand that there are currently 14 C3s registered in British Columbia. Nova Scotia has similarly passed Community Interest Company (CIC) legislation; however, the regulations are still in development. Ontario has launched a consultation process on a potential hybrid corporate form.
- Annex A describes the structural options currently available to social enterprises in Canada.

³ Ibid.

⁴ For more information, see: <http://impactinvesting.marsdd.com/strategic-initiatives/benefit-corporation-b-corp-hub/>

The challenge:

- The traditional binary division between the non-profit and for-profit sectors can inhibit social enterprise development, and limit the application of innovative approaches that blend the skills and strategies of both sectors to address social policy challenges.
- While there are a number of structures that social enterprises can currently adopt in Canada, these structures entail certain restrictions and challenges, and may not fit the needs of all social entrepreneurs.
 - Non-profits and charities have clear public benefit missions, but face limitations on allowable business activities. This can challenge their ability to ensure financial sustainability, attract investment, and scale up effective services. Generally, they cannot raise share capital.
 - Co-operatives are an important part of the social enterprise ecosystem; however, they use a specific, membership-based structure, which is not suitable for all social enterprises.
 - For-profit enterprises have flexibility to attract debt and equity investments, but may be unable to provide adequate assurances – for investors, clients, founders and employees – that a social purpose will be prioritized, or maintained over time.
 - In Canada, a social purpose can be included in a company's articles of incorporation, and directors are allowed to consider stakeholder interests beyond shareholder profit; however, this falls short of a clear mandate requiring directors to consider a social purpose, giving shareholders the right to hold directors accountable to this purpose, and providing official standards and recognition.
 - While independent impact measurement and certification standards, such as the B Corporation certification, have developed to fill this gap, they lack the legitimacy of an official designation and may be insufficient to protect a social mission in the context of a sale, predatory takeover or change in shareholder goals.
 - The lack of an official designation or due diligence process for identifying for-profit social enterprises can add to transaction costs for individual investors, impact investment funds, and socially minded consumers.

The opportunity:

- It is becoming axiomatic that innovation is needed to improve outcomes in the social sector. Addressing social challenges – from youth unemployment, to homelessness, to chronic disease – will require the resources, ideas, and local-level insights of a wide range of actors, from the public, private and non-profit sectors.
 - Just as support for SMEs is critical to fostering business innovation, a supportive ecosystem for social enterprises is critical for fostering social innovation.
 - Social enterprises combine public benefit objectives with the business acumen, revenue generation, and use of investment capital that is typical to the private sector, to develop sustainable business models, innovate, and scale their operations for greater impact.
- There is increasing interest in social enterprise among young entrepreneurs. This is evident, for example, among MaRS clients, and in the growing number of social entrepreneurship programs at business schools in Canada and abroad.
- A purpose-built hybrid corporate form would reflect the combination of profit and social purpose that characterizes social enterprises. This could help to legitimize and accelerate the growth of social enterprise activity, expand the options available to social enterprises, and improve market efficiency and investor/consumer confidence through clear, legislated social purpose requirements.

Considerations:

- Hybrid corporate forms seek to strike a balance between encouraging investment into these organizations and ensuring that profits are used for public benefit. Based on lessons learned from international models (outlined in Annex B), **four key success factors** should be considered:
 - Rigorous **social purpose** requirements;
 - Presence of a **regulator** to oversee compliance;
 - An appropriate combination of **flexibility to attract investment capital** and **tax or other incentives** to make the model a viable choice and ensure take-up; and
 - **Clear criteria and metrics**.
- Broadly speaking, international models follow two approaches:
 - The United Kingdom (UK) CIC involves an asset lock and dividend cap. This model maintains strong social purpose requirements, with limitations on profit. British Columbia's C3 and Nova Scotia's CIC

have adopted elements of this model. Take-up could potentially be incentivized through a tax credit and/or targeted social procurement policy, recognizing the limitations on access to capital associated with the above restrictions.

- The United States Benefit Corporation legislation, on the other hand, clarifies the social purpose and accountability requirements of a social enterprise while maintaining the flexibility afforded to conventional corporations. This model may suit the needs of social enterprises that are looking to attract mainstream capital. This model would build on the B Corporation certification initiative. Tax incentives for investors, although less important than for the CIC, could also assist in opening the finance pipeline to these enterprises.
- These approaches are not mutually exclusive; rather, they reflect the needs of social enterprises across a spectrum.
- The Benefit Corporation model is a low cost option that allows entrepreneurs to choose a social or environmental third party standard that is suited to their objectives; however, these benefits should be weighed against the limited oversight that the lack of a regulator would entail.
- For social enterprises on the impact-first end of the spectrum, preferential tax treatment may be important to offset the costs of running a social enterprise (e.g., the cost of running a program focused on providing job training and other supports to at-risk youth, while also running a printing business). Other social enterprises may be more competitive in traditional markets, with limited needs beyond those of traditional businesses (e.g., access to capital and business development support).
- A hybrid corporate form would not replace existing social enterprise structures. Social entrepreneurs should have the flexibility to choose the model that best suits their needs. Importantly, introduction of a hybrid corporate form should not undermine attention to the challenges faced by enterprising non-profits and charities.
- The risk of low take-up could be mitigated by designing a model based on stakeholder input, allowing flexibility for adjustments based on ongoing monitoring (as has been done in the UK), and engaging in education and promotion activities.
- Consultations with provinces would also be warranted, to find alignment where possible, and avoid a confusing array of hybrid structures.
- In considering legislative amendments to facilitate social enterprise development, Industry Canada may wish to take into account the results of Ontario's consultation process on hybrid legislation (forthcoming), as well as the recommendations of the Social Impact Investment Taskforce,

launched by the G8, and of its Mission Alignment Working Group, which are expected in September 2014.

- The Ontario Government created a social enterprise stakeholder panel, to provide advice on potential legislation to establish a hybrid corporate structure for social enterprises in Ontario. This process is ongoing; it is not yet known if the results will be made public.
- The Mission Alignment Working Group of the Social Impact Investment Taskforce is developing minimum standards for enabling for-profit social enterprises to define a social mission, and provide assurances to impact investors that it will be maintained over time.

Annex A: Organizational structures for social enterprises in Canada⁵

Organization type	Description
For-Profit Corporate Structure	<ul style="list-style-type: none"> • Not specifically designed for social purpose • Can receive certification as a B Corporation • Incorporated under the <i>Canada Business Corporations Act</i> or provincial equivalent; can also be structured as a sole proprietorship, a partnership, or a business trust • Flexibility in activities, capital raising, managing assets and revenue • No preferential tax treatment; cannot receive funds from charities, except through market-rate investments • Responsibility to shareholders, where shares have been issued to raise capital
Registered Charity	<ul style="list-style-type: none"> • Non-share capital corporations with legally enforced social purpose (within the definition of charitable purpose) • Restrictions on business activities; can operate a related business (substantially run by volunteers or linked and subordinate to the charity's purpose); assets are locked • Generally derive their revenue from a combination of earned income, government grants and donations; as qualified donees, can receive grants from other charities; can be eligible for debt financing; generally cannot issue shares • Favourable tax treatment; can issue donation receipts for donor tax benefits
Non-Profit Organization	<ul style="list-style-type: none"> • Non-share capital corporations with legally enforced non-profit purpose (broader range of allowable activities/purposes than for charities) • Generally derive their revenue from a combination of earned income and government grants; not eligible for charitable grants; can be eligible for debt financing; generally cannot issue shares • Subject to increasing scrutiny regarding earned income activity; not allowed to have the intention of generating a profit • Favourable tax treatment; cannot issue donation receipts

⁵ Based in part on: Susan M. Manwaring and Andrew Valentine, Miller Thomson, "Social enterprise in Canada: Structural options," SiG@MaRS: 2011

<p>Cooperative</p>	<ul style="list-style-type: none"> • Owned and democratically controlled by its members; generally designed to benefit members • One member one vote • Must reinvest surplus to benefit members or broader community • Ability to raise outside capital through shares and loans • Limits on interest and dividends; may pay patronage dividends • No preferential tax treatment
<p>Community Contribution Company (C3)</p>	<ul style="list-style-type: none"> • Introduced in British Columbia (BC); option became available in July 2013 • Modeled on the UK CIC; informed by the BC Social Innovation Council • Established through amendments to the <i>Business Corporations Act</i> and C3 regulations • Legally enforced social purpose; majority of profits must be used for community purposes or transferred to a qualified entity • Cap on dividends payable to investors of 40% of annual profits; asset lock upon dissolution (at least 60% of assets must be directed to qualified entities); bar on paying an interest rate related to the company's profits • Requirement for annual reporting on community contributions; no official verification of reports; no regulator • A taxable corporation • We understand that there are currently 14 C3s registered in BC.
<p>Community Interest Company (CIC)</p>	<ul style="list-style-type: none"> • Introduced in Nova Scotia; modeled on the UK CIC; similar to the above • <i>Community Interest Companies Act</i> passed in December 2012; regulations are still in development (option not yet available) • Registrar of Community Interest Companies to oversee formation and conduct of CICs

Annex B: International models

UK Community Interest Company (CIC)

- The UK introduced CICs in 2005. They were created under the *Companies (Audit, Investigations and Community Enterprise) Act 2004* and specific rules were set out in the *Community Interest Company Regulations 2005*.
- CICs are intended to:
 - Create a purpose-built structure for social enterprises that wish to devote their profits and assets towards a community benefit objective;
 - Provide assurances to impact investors that investments would be directed to a social purpose, through regulation of asset lock and community purpose requirements;
 - Raise the profile of social enterprises; and
 - Encourage social enterprise activity.
- CICs involve:
 - An asset lock: A statutory clause guarantees that the CIC's assets are used for the benefit of the community. Dividend and performance related interest caps aim to balance the objective of encouraging investment with that of guaranteeing that assets are locked into advancing a social purpose. Different rules on dividends apply depending on the specific structure of the CIC. In the case of dissolution, any remaining assets must be transferred to a CIC or other asset-locked body, such as a charity.
 - A community interest test: a community interest statement is required in order to register as a CIC, and must satisfy the test that a reasonable person would consider the organization's activities to be carried out for the benefit of a community.
 - Oversight: a CIC regulator determines eligibility, provides guidance, monitors CIC activities, and has investigation and enforcement authority. The regulator has a mandate to maintain public confidence in the CIC brand.
 - Transparency: An annual public report is released on CIC activities, including benefit to the community, directors' pay, assets, dividends paid, and interest paid.
 - Limited liability: CICs provide limited liability for members; they can be limited by guarantee or by share, and can use different structures, from co-operatives to single-member companies.

- Access to capital: CICs can access debt markets. CICs limited by shares can raise capital by selling shares. CICs have greater flexibility than is afforded to charities in the UK, but no tax exemption.⁶
- As of November 30, 2013, there were 8666 CICs on the public register. 78 percent had opted for the CIC model limited by guarantee, which does not permit dividend payments, 10 percent were using the model limited by shares, allowing uncapped dividend payments to asset locked bodies, and 12 percent were using the model limited by shares and subject to the dividend cap.⁷
- Many UK social investment funds explicitly target CICs, along with charities and similar social purpose entities. While much of the significant social investment capital in the UK market has not yet made it to the front lines, it may create an incentive for adopting the CIC model. The recently introduced Social Investment Tax Relief will likely have a similar impact.

Challenges

- Access to capital has been a challenge for CICs, with the interest and dividend caps creating disincentives for investors. A number of surveys and reviews have been conducted since CICs were created, resulting in changes to improve access to capital. Finding the right balance between incentivizing impact investments into CICs and ensuring that CIC assets are devoted to the benefit of the community has been a subject of ongoing monitoring and adjustment.⁸
 - Create – an award winning CIC that went bankrupt in 2013 – cited challenges to accessing capital as one of the factors that contributed to its demise.⁹
- Following a review in 2009, which concluded that the dividend and interest caps were overly restrictive and complex, these caps were raised. The CIC Regulator also committed to another review in three years, and in 2010 established the Technical Panel, comprised of finance experts, CICs and academics, which meets on an ad hoc basis to advise on issues pertaining to CICs.

⁶ Office of the Regulator of Community Interest Companies, *The benefits of A Community interest Company (CIC)*, <https://www.gov.uk/government/publications/community-interest-companies-introduction>, (2013).

⁷ Department for Business, Innovation and Skills, *Changes to the Dividend and Interest Caps for Community Interest Companies: Response to the CIC consultation on the dividend and interest caps*, www.bis.gov.uk/cicregulator, (December, 2013).

⁸ Ibid.

⁹ Matt Black, interview with Norman Pickavance, ex-chair of Create, *The Create story: From social enterprise poster boy to high and dry*, <http://www.pioneerspost.com/pp-tv/20130910/the-create-story-social-enterprise-poster-boy-high-and-dry> (2013).

- A 2012 survey of CICs and the UK Cabinet Office's 2012 Red Tape Challenge on Social Investment continued to point to challenges related to investment in CICs.¹⁰
- According to the Regulator's 2012-13 annual report, there were 766 CICs dissolved that year, which amounted to 10 percent of those registered. Of these, 72 percent had been trading for under three years and of these, 70 percent had been dormant through this time. Under one percent were subject to compulsory liquidation. These CICs cited a few reasons for dissolution, with 25 percent pointing to lack of funding, 20 percent indicating that the company had engaged in no trading activity since incorporation, and 15 percent suggesting that the company was no longer viable.¹¹
- Most recently, a 2013 joint consultation on the design of a new tax relief for investments in social enterprises (introduced in the UK's 2014 Budget) and on the CIC dividend and interest caps was conducted.
- The CIC Regulator's response to this consultation concluded that:
 - "the maximum dividend per share cap should be removed
 - the maximum aggregate dividend cap should be retained at 35%
 - the maximum interest rate for performance related interest should be increased from 10% to 20%".
- The CIC Regulator has committed to another review three years following the introduction of these legislative changes, which will also assess the impact of the recently introduced Social Investment Tax Relief.¹²

UK Social Investment Tax Relief

- In its 2014 Budget, the UK introduced a new social investment tax relief, which came into effect on April 6, 2014.
- This tax relief aims to bring new investors, who are willing to take on more risk, into the social investment market. It also aims to help social enterprises innovate and grow, and to provide them with similar benefits to those afforded to other businesses, which benefit from SME tax relief measures.

¹⁰ Department for Business, Innovation and Skills, *Changes to the Dividend and Interest Caps for Community Interest Companies: Response to the CIC consultation on the dividend and interest caps*, www.bis.gov.uk/cicregulator, (December, 2013).

¹¹ Regulator of Community Interest Companies, *Annual Report 2012/2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/243869/13-p117-community-interest-companies-annual-report-2012-2013.pdf, (2013).

¹² Department for Business, Innovation and Skills, *Changes to the Dividend and Interest Caps for Community Interest Companies: Response to the CIC consultation on the dividend and interest caps*, www.bis.gov.uk/cicregulator, (December, 2013).

- Eligible social enterprises will be able to receive up to about £290,000 in investment over three years. The tax relief will apply to investments in specific organizational forms that exist for a social purpose, including charities, CICs and Community Benefit Societies, as well as investments in SIBs.
- This income tax relief is set at 30 percent, equivalent to existing tax relief schemes for venture capital (Enterprise Investment Scheme, and Venture Capital Trusts).¹³
- It is estimated that this measure could generate about £480M in social investment over five years.¹⁴

US Benefit Corporations

- Benefit Corporations must meet standards related to corporate purpose, accountability and transparency. They do not receive special tax treatment. Benefit Corporation legislation has passed in 23 US states, and is being considered in 15 others. Over 500 Benefit Corporations are registered.
- Requirements vary between states, but in general, Benefit Corporations must:
 - Have a social and environmental benefit purpose;
 - Consider the impact of decisions on employees, the community and the environment, as well as on shareholders; and
 - Provide a public annual benefit report that uses a third party standard to assess social and environmental performance.
- This legislation is enabling – it allows corporations to consider a multiple bottom line and allows consumers and investors to identify these corporations. Specifically, it:
 - Permits directors to consider non-financial interests, even in the case of a sale;
 - Expands shareholder rights to enforce the social purpose; and
 - Provides some protection of the social mission over time, by requiring a two thirds shareholder vote to remove or change social purpose requirements.

¹³ HM Treasury, *Budget 2014*, <https://www.gov.uk/government/publications/budget-2014-documents>, (2014).

¹⁴Worhstone assisted by Wragge & Co LLP, *The Role of tax Incentives in Encouraging social Investment*, <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf>, (City of London and Big Society Capital, 2013).

- While sharing some characteristics with the Certified B Corporation, the Benefit Corporation differs in that it is a legal status and does not require a certification process.
- There is no official oversight. Only shareholders and those responsible for the third party standard being applied have a right to monitor the corporation's social benefit activities.

Challenges

- Unlike the UK CIC, this model does not involve asset locks or dividend caps, making it more attractive for mainstream investors, but providing less certainty to potential impact investors about the organization's commitment to and maintenance of a social purpose.¹⁵

Certified B Corporations

- B Corporations are certified by B Lab – a US non-profit – as meeting a high overall social and environmental performance standard.
- There are over 100 certified B Corporations in Canada. MCII is the Canadian hub for B Corporations.
- Compliance with the certification standards is monitored through a random audit process.
- The decision to maintain a B-Corporation designation is voluntary. There are no asset locks or dividend caps.

Challenges

- The B Corporation certification is not a legal status. It does not carry the legitimacy of an official designation, and does not provide assurance that the social or environmental mission of the organization will be maintained over time.¹⁶

Flexible Purpose Corporations (FPC)

- The FPC, introduced in California, Washington and Texas, shares many of the characteristics of the Benefit Corporation. There are about 31 FPCs, all in California.¹⁷

¹⁵ For more information, see: <http://www.benefitcorp.net>

¹⁶ For more information, see: <https://www.bcorporation.net>

¹⁷ Bowen, D, *Supplemental Language Report Budget Letter 12-16; Item 0890-001-0228*. <http://www.sos.ca.gov/admin/reports/flexible-purpose-and-benefit-corps.htm> (Secretary of State's Office Business Programs Division, 2013).

- FPCs must specify a special purpose in their articles of incorporation, in addition to other corporate purposes. Special purposes can be charitable or public purpose activities, or the promotion of positive impacts, or mitigation of negative impacts, on employees, suppliers, customers, creditors, the community or the environment.
- Directors are expected to pursue these special purposes in addition to profit maximization. The pursuit of a special purpose could trump profit maximization, at the directors' discretion.
- There is no official oversight. Only shareholders have a right to monitor the corporation's special purpose activities.¹⁸

Challenges

- Similar to those identified for Benefit Corporations.

US Low-Profit Limited Liability Company (L3C)

- The L3C has been introduced in a number US states. It was first introduced in Vermont in 2008. A recent count estimates that there are 1,051 L3Cs.¹⁹ L3C legislation was recently repealed in North Carolina.
- The L3C shares the structure of a limited liability company but must have a social purpose and include the L3C designation in its articles of organization. It does not require an asset lock or dividend cap.
- The benefit of the L3C is to send a signal to investors – and in particular to foundations and donor directed funds – that the company in question has a charitable or educational purpose, that profit generation is not a significant purpose, and that the intention of the company is to carry out activities that would qualify for Program Related Investments (PRIs).²⁰
 - PRIs focus primarily on advancing a foundation's programmatic goals and may generate below market-rate returns. They can therefore play an important role in early-stage social enterprise development. Foundations are able to count the opportunity cost of a PRI towards their grant disbursement quotas. The rules governing PRIs in the US are more facilitative than in Canada.
- By attracting PRIs, L3Cs could support tranching investing, with foundation PRIs taking the first, high-risk, low-return position and creating a more attractive investment proposition for commercial investors.

¹⁸ Official California Legislative Information, Corporations Code Section 2600-2605, <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=corp&group=02001-03000&file=2600-2605>

¹⁹ InterSector Partners, L3C, http://www.intersectorl3c.com/l3c_tally.html

²⁰ Vermont Secretary of State, <https://www.sec.state.vt.us/corporations/start-or-register-a-business/low-profit-llc.aspx>

- There is no official oversight. Only shareholders have a right to monitor the corporation's social benefit activities.

Challenges

- The lack of official oversight, and lack of asset locks or dividend caps, may result in uncertainty among potential impact investors about the organization's commitment to and maintenance of a social purpose.
- The initial intention of the L3C was to provide a structure that would automatically qualify for PRIs. This aim, however, has not been realized, as the Internal Revenue Service (IRS) has not approved the L3C for this purpose.