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INSIGHT: India Proposes Social Stock Exchange

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Rahul Rishi and Meyyappan Nagappan, of Nishith Desai Associates, discuss the recently announced Social Stock Exchange in India, and the tax challenges involved.

The announcement by the Indian government to set up a Social Stock Exchange (SSE) in the Union Budget speech is a welcome step indeed.

This should be of interest to both international funds and philanthropic foundations that are looking to make socially or environmentally responsible investments either as part of their requirements being an Environmental, Social, Governance (ESG) oriented fund or under the Project Related Investment (PRI) scheme under which U.S. foundations may invest a portion of their corpus into investible instruments.

Support for Social Enterprises and Voluntary Organizations Through an Electronic Trading Platform

The Hon'ble Finance Minister, Ms Nirmala Sitharaman, has proposed to create an SSE for listing social enterprises (SEs) and voluntary organizations. The proposed exchange is expected to fall under the regulatory ambit of the Securities Exchange Bureau of India (SEBI). This should allow listing of SEs and voluntary organizations to raise capital by way of debt, equity or as units like mutual funds through an electronic fund-raising platform.

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The budget announcement is indicative of government's intention of being supportive of the activities of SE,s and there is a real need for the government to play the market maker in this space as currently the lack of a market making platform is resulting in inefficient and insufficient allocation of funds to SEs.

There is increasingly more international capital looking for investments that are driven by more than just pure profit and Indian entrepreneurs are setting up SEs to tackle complex problems that have the potential to have large scale impact in India. However, both for investors and SEs finding the right investment and instrument becomes a complex task, with even information gathering from both perspectives becoming a significant hurdle. With an increasing demand for capital by SEs and voluntary organizations in India, setting up a SSE can potentially usher direct ethical investment environment in India and boost the availability of funding to SEs.

Such an exchange can potentially provide a mechanism by which investors in SEs can make need-based investments based on disclosures and other transparency standards set by the exchange for listing instruments. Further, it would allow liquidity in instruments of social enterprises listed on the market, build investor confidence through the transparency requirements and provide an easy exit route for investors.

Unclear Laws and Need for a New Framework

Having said that, there are multiple issues that need to be carefully examined to manage and regulate such SEs. For example, it is currently unclear what would constitute a "social enterprise" or "voluntary organization."

Globally, social enterprises have a social or environmental mission at the core of their work and operate in a financially sustainable manner, and they are typically registered as non-profit organizations, co-operative or small non-profit entities.

While the SEBI has defined ''social enterprise'' for the purpose of social venture funds, it is not clear if the same definitions would be adopted for the purpose of an SSE. Further, the budget speech also mentioned that voluntary organizations would be able to list as well. It is imperative to clarify what would be covered within its ambit.

Moreover, setting up an SSE does not necessarily mean that SEs will find listing on it a practical or viable option.

Several SEs operate by way of non-profit structures such as charitable trusts or societies or a Limited Liability Partnership (LLP). In fact, many SEs may not at present be institutionally capable of complying with sophisticated disclosure and listing standards.

Further, many social enterprises or voluntary organizations may not be able to issue any instrument capable of being listed on the SSE due to restrictions in the regulatory or tax laws that are applicable to them, for instance public charities or limited liability partnerships may not be able to issue any freely transferable debt or equity instruments. Enabling such issuances or listing would require changes to other laws to enable such voluntary organizations or LLPs to issue new instruments such as a ''social success note'' that is freely transferable and is allowed to be listed on the SSE.

Tax Challenges

While an ''electronic funding platform'' presumably allows for equity investments into SEs, Section 8 companies may still face issues as increased liquidity would also bring its own set of tax challenges.

It is important to understand that a large chunk of SEs in India operate through a non-profit model by way of tax incentives and subsidies. And in order to enable such non-profit SEs to be governed under the SEBI for the purposes of listing, considerable changes need to be made in respect of allowability of non-profit SEs on dividend payouts, return on investments, bond issuance, use of funding mechanisms used by the mainstream markets without running the risk of losing their tax-exempt status.

While SSEs exist in many countries, such as the Impact Investors Exchange in Singapore, it remains to be seen what form of platform takes shape under the SEBI's guidance. It also remains to be seen whether the SEBI would advocate a full-fledged stock exchange or would limit its access only to institutional or sophisticated investors.

The measurement criteria that would qualify SEs to receive investments, accreditation among investors and social businesses, the intermediaries and valuation metric will require extensive deliberations and public consultations.

There is great potential and opportunity in creating social financing markets through the SSE. However, the corresponding legal and regulatory tools needs considerable tweaking as they otherwise discourage stakeholders from engaging in social financing.

As listing of social enterprises will essentially operate at the intersection of finance and philanthropy, the hybridity does present a regulatory challenge and policy makers will have to design a platform that bridges this regulatory gap.

The proposed SSE should enable tools for distinguishing conventional businesses from social and impact businesses, establish procedures for standardizing social business transactions, prioritizing beneficiaries' interests and investment-affected communities.

Further, strong investor and beneficiary-protection norms, listing and corporate governance requirements, reporting requirements and enforcement mechanisms are critical in making a robust regulatory framework around SSE. Additionally, in our experience, since close to 90% of the funding comes from abroad in this sector, the regulations should be framed keeping that in mind.

Planning Points

Building up to this promising future, stakeholders should consider the following steps in the run up to the drafting of the rules regarding the SSE:

- policy papers, either individually or through industry bodies or organizations, addressing obstacles faced by stakeholders for the government to consider while drafting the regulations;
- building consensus within the industry and engaging with government officials to ensure that the new framework meets the requirements of the stakeholders;
- closely tracking any developments regarding an SSE, in terms of draft rules or public consultations, and consider innovative financing arrangements for proposed projects in the current year.

In effect, while an SSE is a great move in the right direction, we need a whole new ecosystem that enables this space to truly tap its potential and remove hurdles for existing stakeholders who are encumbered by several legal restrictions. The current developments show tremendous potential since Ms Nirmala Sitharaman is both the Finance Minister and the Minister of Corporate Affairs. This means that it is quite possible for the right framework to be put in place through industry collaboration and demonstration of political will in the Union Budget speech.

We have already seen in practice how the social venture funds, which were meant to enable investments into social enterprises, have not been the resounding success they could have been. This can be attributed to lack of regulatory clarity and the difficulty with several social enterprises or voluntary organizations being able to receive such investments due to restrictions under other regulatory and tax laws. It is hoped that the same mistakes are not repeated.

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