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SAID BUSINESS SCHOOL

CREATING AN ETHICAL STOCK EXCHANGE

JAMIE HARTZELL | AUGUST 2007

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Creating An Ethical Stock Exchange

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EXECUTIVE SUMMARY

CREATING A MARKET FOR ETHICAL CAPITAL

The history of the Stock Exchange dates back to 1694, when William III first made government borrowing transferable from one person to another. This gave rise to a number of 'stock-jobbers' who made money trading in these debts. For many years these traders operated from a courtyard in Sweetings Alley and a nearby café called Jonathan's. But over the next three hundred years they helped to mobilise and pool the nation's savings by investing them in the capital developments and new companies that are so familiar to us today, creating the London Stock Exchange which in 2005 turned over £420 million.

The practice of stock trading has never been popular. Robert Louis Stevenson referred to it as 'knavish in its private practice and treason in its public'. Today the world's stock exchanges are some of the main drivers of the global economy. Government's can thrive or fall according to changes in the fortunes of these markets. Yet as the volumes of shares traded increases, the workings of these markets are becoming more speculative, and less transparent. Vast fortunes are won or lost in a matter of minutes with just a few clicks of a mouse. And the trades that do take place have less to do with the activities of the company itself and more to do with the system that allows the trading.

In 1984, Traidcraft launched the first public share issue ever undertaken by an ethical business. Over the last 20 years, the public appetite for this form of investment has steadily grown. Yet the process of putting together a share issue and of setting up the subsequent trading mechanisms remains haphazard and uncoordinated. Despite this, ethical businesses raising share capital have chosen to make their own arrangements rather than list on the existing markets, which are too focused on financial and not enough on environmental and social returns.

There is then a need for a genuinely ethical exchange which is as supportive of the activities of an enterprise as it is of its profitability. With an increasing number of social enterprises now raising capital through share and bond issues, this market would channel the nation's appetite for direct ethical investment. The market would also open new horizons in ethical investment, presenting a direct challenge to the existing system and a benchmark for other markets to live up to. Section 1 therefore outlines the need for an ethical exchange, the wider context in which it would operate, and the evolution of ethical trading mechanisms to date.

The reason for such a market is so not only to provide a mechanism by which equity investors in social enterprises can disinvest when they need to. Properly constructed, such a market could achieve much more, eventually becoming a vital support service for all public share and bond issues of an ethical nature. For not only could it generate liquidity in shares listed on the market, it could also undertake new issues thereby providing a focal point for the marketing of new and existing ethical investment products, look to raise financial standards within the companies listed on the market, thereby increasing transparency and investor confidence, and help to bring smaller, start-ups to market through Ethical Public Offerings (EPOs), thereby providing an exit route for ethical venture capital investors. Section 2 outlines the activities an ethical exchange would undertake.

In the minds of many of the members of the public who make up the ethical investment community, the trading of shares is an unethical practice, leading to profit through speculation with little benefit to society.An ethical exchange would need to be carefully crafted so that it is protected against exploitation for private benefit, but still remains flexible enough to be treated as a genuine exchange by both individual and institutional investors. This is achieved through the way the exchange functions, trading regulations and crucially the way prices of investment products are set and declared. Section 3 explores how the ethics of the exchange are reflected in its operations and takes a closer look at what we mean by the terms liquidity and speculation.

Such a market could not operate unless managed and regulated by a financial institution with the authority to run a market in bonds and shares and recognised and respected by both the Financial Services Authority and the general public. This institution should already have an ethical outlook before being asked to take on the running of an ethical exchange. However, a key question at the outset is the extent to which this organisation should itself own the exchange, or whether it should be owned by its members, with the activities limited to ensuring that the needs of members are met whilst remaining within the law and rules and guidance set by the Financial Services Authority. This issue is explored in Section 4.

Section 5 is dedicated to the complex issue of pricing. It examines the full range of pricing mechanisms currently in use and which would prove most appropriate for an ethical exchange.

Ultimately, an ethical exchange would need to be self-financing. The exchange has the capacity to generate income, from membership fees as well as services provided. Whether this is likely to be enough to ever make it self-financing is explored in Section 6.

Setting up a working ethical exchange does not necessarily mean that it will prove attractive to the enterprises who might list on it. Some enterprises, for example, may not wish to encourage greater liquidity for their investors. Providing clear and transparent financial information of adequate quality to meet the demands of a increasingly sophisticated investor and of the increasingly strict Financial Services Authority is also a serious challenge to many social enterprises. Whether the level of advice and support needed to meet these standards can be provided at an achievable cost remains to be seen. The limitations of an ethical exchange and the hurdles it will need to overcome are explored in Section 7.

Finally, Section 8 tries to outline a process for bringing an ethical exchange to fruition. The first step should be to bring together the larger enterprises likely to list, to discuss the models outlined in this paper. Also, a market operator would need to be appointed in the early stages.

In summary, the establishment of an ethical exchange is an idea whose time has come. Although complex to develop, the increasing number of social enterprises now raising patient capital through equity and bond issues will inevitably drive the formation of the exchange forward. And just as the development of the London Stock Exchange back in the early 1700s was crucial to the financing of sea-borne trade with the East, so an ethical exchange can play a crucial role in the financing of social enterprise.

SECTION 1

WHY IS AN ETHICAL EXCHANGE NECESSARY?

THE EXISTING MARKETS

There are currently three main trading markets in the UK – The London Stock Exchange, the Alternative Investment Market (AIM) and OFEX. Historically, there was also a stock exchange in each region. These regional exchanges were amalgamated into the main London Exchange, although consideration is now being give to reviving a West Midlands exchange with trading taking place online. In recent years the LSE has also introduced some specialist indices such as FTSE for Good and trading markets such as Nasdaq.

A company not listed on these markets can usually only trade its shares through a matched bargain market. This is usually run by a broker or a recognised financial institution, and involves holding a list of buyers and sellers of the shares and matching them at the price they both wish to pay. However unless both buyers and sellers are available a trade cannot take place. Matched bargain markets usually operate for one company in isolation rather than for a group of companies. Moreover, the Financial Services and Markets Act (FSMA) limits the extent to which the investment can be marketed.

The three mainstream markets can be considered as a hierarchical tree, in which companies graduate from one to the next as they grow in size. Indeed, AIM was established by the LSE for companies at an earlier stage of development. The markets higher up the tree offer greater liquidity, but are more expensive to list on and the listing requirements more stringent. Mostly, these listing requirements relate to procedures to ensure an orderly market and timely disclosure of price sensitive information, although socially responsible governance and probity issues are covered to some extent.

Thus a company might first choose to list on OFEX in order to achieve some liquidity. OFEX was at first a matched bargain market. It is currently the market of choice for co-operatives and social enterprises. The cost of listing is only around £10,000 a year or less and most companies who have undertaken full public share issues will already meet the requirements for a listing.

The OFEX market serves to give the company a publicly quoted share price as well as generating some liquidity in the shares. However this can be deceptive, as some OFEX shares are not traded at all for long periods. The share price then remains static and may not reflect the value that a share might achieve in a more liquid market.

At the point of listing on OFEX, a company may experience a fall in its share price. This is because the directors of the company may up to this point have had near full control over the price of its shares. The temptation then is to keep the price up. But once open market trading is introduced, the share may well drop as a lower share price relative to the company's overall value gives more confidence to the investor and to the exchange.

On the OFEX market, new share issues are undertaken for companies for sums between half a million and one and a half million pounds. However the costs are high (£100,000 to £150,000 in fees alone) and the money can be hard to raise as OFEX is generally shunned by institutional investors.

Although many companies go straight to AIM, a listing on OFEX is often a first step towards an AIM listing. At this point, it becomes possible to attract major institutional and other investors. However, fees for listing on AIM are likely to be between £300,000 and £500,000 even before marketing costs. It is essential then that the company is extremely profitable, or else that the amount to be raised is sufficiently large to make this level of fees relatively insignificant. For a social enterprise, where a high profit level is not to be expected, share issues therefore need to be in the £10 to £20 million range to stand a chance of covering the costs of fees. Raising this level of investment is often unrealistic.

The larger of the AIM companies move to the Stock Exchange. Some have a balance sheet value as small as £10 million, but most are much larger.

Even on the existing markets then there is a gap for those looking to raise sums from £2 to £10 million. Many companies look to raise these sorts of sums from a few institutional investors or VCTs rather than from a wider investment base. However, this type of investment is likely to result in a significant loss of control of the company.

PRICE SETTING ON THE EXISTING MARKETS

In order to list on any of the main trading exchanges, the enterprise must appoint a broker to make a market in the shares of the enterprise. This then enables the shares to be traded even when both buyers and sellers are not available. A market is maintained in a share by the market-maker buying the shares with a view to selling them on at a profit.

The difference in price between buying and selling is called the 'bid-offer spread' and is the market-maker's profit. If the market-maker cannot sell the shares, he or she drops the price until the shares sell. It is in this way, through the demand for and supply of the shares of a company, that the price is set.

Price is not therefore based on an objective measure of the intrinsic worth of a share at the current moment in time, but rather a reflection of the perception of buyers and sellers as to whether the current price reflects the future price that the share is likely to achieve. If an investor considers a share to be under-valued, they buy and if over-valued, they sell. Thus the old saying that the markets are a voting machine in the short term but a weighing machine in the long term.

Investors make their own assessment of value in a number of different ways. Like the market itself, none of these are perfect. The commonest and most intuitive method is to try to estimate the true worth of the company. This is usually done by a combination of methods such as looking at the net asset value of the company per share (measured as shareholders funds divided by the number of shares in issue), the return the company achieves on capital and the dividend flow to shareholders. This form of analysis also assesses the likely performance of the company in the context of the economy as a whole and the business sector in which the company operates.

However, this model for assessing value requires at least two conditions to be met to work effectively. The first is that the market is sufficiently liquid for expectation of value to be quickly reflected in the current price. The second is that investors have all and equal information available to them surrounding the situation of a company. When either of these conditions are not met, anomalies occur and some individuals can benefit over others.

Price-setting on a matched bargain market is usually a much more haphazard affair. Quite often it is left to buyer and seller to agree, but if any price at all is recommended, it is usually the broker running the market who would recommend a price, based on information provided by the company. Thus in a matched bargain market, the company itself has much more control over the share price. This is usually regarded as an unsatisfactory situation open to abuse, as both of the assumptions listed above are not met. However, I present a refinement of this model in Section 5.

Historically, a market-maker used to operate on the floor of the exchange and was referred to as a jobber, whilst the broker merely liased between the investor and the jobber. This separation of roles was intended to stop a conflict of interest arising for the broker between his/her own interests and that of the client.

The need for faster and larger trades led to the distinction between jobbing and broking firms being abandoned with the 'Big Bang' of 1986. Instead 'Chinese Walls' were erected between departments of the same firm, to prevent sensitive information passing between them. Today, two computerised systems of trading are used.

SEAQ is a quote driven system. Users can call up a screen for each security on the system. This shows the bid and offer prices from the market-maker dealing in the stock. All market-makers are obliged to quote prices for their stocks, ensuring there is always a market.The broker can identify the best price on screen and place an order.

The SETS system is an order-driven system that removes the need for a market-maker. It is now the main system used for trading the larger and more liquid FTSE 100 stocks. Under this system, buyers and sellers enter their desired purchases and sales, usually through a broker, and the order book automatically matches them up. Trades can be done either at the best price available at the time, or at a set price, with a set time frame before the bid expires.

UNSUITABILITY OF THE EXISTING MARKETS FOR ETHICAL BUSINESSES

Although the mainstream markets offer a recognised route for companies wishing to attract outside capital, they are not suitable markets for social enterprises for two main reasons.

First, the culture of these markets is very different from the culture of social enterprises. There are few or no companies with a primarily ethical remit, and indeed corporate social responsibility issues are afforded a lower priority on OFEX and AIM than on the main Exchange. The investors in these markets are primarily profit driven, and have little interest in ethical concerns. Indeed the kinds of individuals who invest in social enterprises are unlikely to be at all familiar with, if they have even heard of, OFEX or AIM. Thus a listing on these markets will give existing ethical investors little comfort and may even undermine their confidence in the ethical nature of the company.

Second, in many cases the purpose of listing is for an entrepreneur or venture capital investor in a start up company to be able to realise the gains they have built up through their early stage investment by undertaking an Initial Public Offering. They would hope to achieve a significant profit on their initial investment through this offering, and this will be of far greater concern than the future shape and direction of the company. A listing then tends to signal a major change in the management of a company as the founding members move on. This tends to generate something of a financial 'slash and burn' culture that is presently particularly inappropriate for social enterprises, although there may in the future be cases where a social enterprise wishes to sell on through an ethical exchange.

Social enterprises are much more likely to undertake an EPO because they are looking for early stage investment. They will have members or directors who are less likely to have significant sums to invest, but who are likely to remain loyal to the company they started and not look to make a quick profit through an IPO. They will also wish to ensure that the new investment does not jeopardise their control or the future shape of the company. Listing on mainstream markets is therefore completely inappropriate for social enterprises.

THE EXTENT OF ETHICAL PUBLIC OFFERINGS (EPOS)

Table 1 offers a complete list of public share issues undertaken by ethical businesses off-market since Traidcraft's first issue in 1984. The largest amount raised by any one share issue has increased from £1 million in 1986 to £5 million in 2004. This is significantly more than might normally be raised on OFEX and is comparable with AIM.

In recent years, there has also been an increase both in the number of ethical share issues taking place in the UK and the amount of money raised, as shown in Table 2. This rate of growth looks set to continue, with at least two further issues planned for 2006.

TABLE 1: PUBLIC SHARE ISSUES BY ETHICAL BUSINESSES

COMPANY	DATE	LEGAL FORM	TYPE OF INVESTMENT	AMOUNT RAISED (£M)
Traidcraft	1984	PLC	Share	0.3
Mercury Provident	1985	PLC	Share	0.5
Traidcraft	1986	PLC	Share	1
Paperback	1987	IPS	Loan stock	0.05
ICOFund	1987	IPS	Loan stock	0.5
Centre for Alternative Technology	1990	PLC	Share	1
Mercury Provident	1991	PLC	Share	0.4
Traidcraft	1991	PLC	Share	0.4
Ecological Trading Company	1993	PLC	Share	0.2
ICOF Community Capital	1994	IPS	Withdrawable share capital	0.45
Paperback	1994	IPS	Loan stock	0.07
Out of This World	1995	IPS	Loan stock	1
Shared Interest	1995	IPS	5 year Loan stock	0.65
Wind Fund PLC	1995	PLC	Share	1
Bay Wind	1996	IPS	Withdrawable share capital	1.2
Out of This World	1996	IPS	Loan Stock	0.2
Shared Interest	1996	IPS	5 year Loan stock	0.85
Aston Reinvestment Trust	1997	IPS	Withdrawable share capital	0.41
Out of This World	1997	IPS	Loan Stock	0.2
Shared Interest	1997	IPS	5 year Loan stock	1.2
ICOFund	1997	IPS	10 year Loan stock	1
Wind Fund PLC	1998	PLC	Share	1.3
The Phone Co-Op	1999	IPS	Withdrawable share capital	0.4
Bay Wind	1999	IPS	Withdrawable share capital	0.67
Ethical Property Company	1999	PLC	Share	1.32
Shared Interest	1999	IPS	5 year Loan stock	1
Citylife (Sheffield)	1999	IPS	5 year Bond	0.8
Monkton Group (Good Energy)	2001	PLC	Share	0.66
Shared Interest	2001	IPS	5 year Loan stock	1
Citylife (Newcastle)	2001	IPS	5 year Bond	2
Traidcraft	2002	PLC	Share	3.25
Ethical Property Company	2002	PLC	Share	4.2
Shared Interest	2002	IPS	5 year Loan stock	1
London Rebuilding Society	2002	IPS	Withdrawable share capital	0.06
Citylife (East London)	2002	IPS	5 year Bond	1.9
Unicorn Wholefoods	2003	IPS	Loan stock	0.3
Shared Interest	2003	IPS	5 year Loan stock	1
Golden Lane Housing	2003	Charity	10 year bond	1.5
Café Direct	2004	PLC	Share	5
Monkton Group (Good Energy)	2004	PLC		0.66
Shared Interest	2005	IPS		1
Triodos Renewable Energy Fund (formerly Wind Fund PLC)	2005	PLC	Share	4.75
Westmill Wind Farm	2005	IPS	Shares	3.75
TOTAL				**50.1**

TABLE 2: NUMBER OF ISSUES AND TOTAL RAISED

PERIOD	NUMBER OF ISSUES	TOTAL RAISED (£ MILLION)
1984-1990	6	3.35
1991-1995	8	4.17
1996-2000	13	10.55
2001-2005	16	32.03
TOTAL	**43**	**50.1**

DEMAND FOR AN ETHICAL EXCHANGE FROM SOCIAL ENTERPRISES

The enterprises who would be interested in listing on an ethical exchange can be categorised under three headings:

- PLCs issuing shares
- PLCs, charities and IPSs issuing bonds and loan stock
- IPSs issuing withdrawable share capital (WSC)

An exchange tailored to the needs of social enterprises is of most interest for those issuing shares in a PLC. As it is difficult to redeem shares, and as it is both legally complex and a great strain on cash flow for a company to buy back its own shares, a market is generally the only way to allow investors to disinvest. This also serves to attract investment in the first place in the knowledge that it will be possible to disinvest.

The seven PLCs who have already undertaken issues and that are still actively trading are Traidcraft, The Triodos Renewable Energy Fund, The Ethical Property Company, Good Energy, Café Direct, Triodos Bank NV and the Centre for Alternative Technology. All of these have limited trading arrangements in place, except for the Centre for Alternative Technology, who has instead looked to buy back share capital from those wishing to disinvest when sufficient profit is available, or to encourage investors to donate their shares to the CAT charity.

Bond issues have been undertaken by Shared Interest, City Life, Golden Lane Housing, ICOF and Out of This World. These are all IPSs, except for Golden Lane, which is a charity. A market would be of some but less interest to these enterprises, as those issuing bonds often have a very loyal following, with investors reinvesting in new issues once the bonds are repaid. A five year period before redemption also means that, although the bond can in principle be traded, the need for investors to do so is more limited as the redemption date is not too far away. For these reasons, only a limited market is required.

However, for these organisations, a market would enable the redemption period to be set over, say, a 10 year period rather than 5 years. This would be possible because the investor would know that they could probably still get their money back through the market at any time, so a 10 year redemption period would not discourage investment. This would then give the social enterprises issuing the bonds greater security and enable them to raise more funds.

The principal co-operatives to raise funds from the public are Bay Wind, Westmill Wind Farm, Paperback, The Phone Co-Op, ICOFund, Aston Reinvestment Trust, London Rebuilding Society and Unicorn Wholefoods.

For co-operatives issuing withdrawable share capital (WSC), historically a market is of limited interest, as the product could not be traded. However, Westmill Wind Farm is an IPS that undertook a share issue in 2005 on the basis of issuing a tradeable share rather than witndrawable share capital and so needs to offer a market in its shares. Even for those issuing withdrawable share capital, there is still a need to attract new investment should existing investors withdraw their funds, though consumer co-ops can often attract investment from their own customer base. And a listing on an ethical exchange may enable these co-operatives to issue bonds or even shares, thereby giving them longer term security of investment.

There are then some 20 organisations in the UK who have already undertaken share or bond issues or issued withdrawable share capital and so are under varying degrees of pressure from their investors to put in place effective trading arrangements. In addition the New Economics Foundation is currently researching ethical businesses already listed on OFEX, AIM and the FTSE who may be interested in an ethical marketplace. And this is in the UK only - there are of course a wide range of ethical businesses in Europe, especially in the Netherlands and Belgium, who might also be interested to list on a European ethical exchange.

However, an ethical exchange has the potential to offer more than the secondary trading of shares. An ethical exchange could enable more companies to raise capital through share or bond issues by supporting them in coming to market in the first place, and also by allowing them to take on new investment on an ongoing basis. For private companies backed by ethical venture capital, becoming a PLC and undertaking an EPO is a logical next step in a company's development. For social enterprises issuing withdrawable share capital or other non-transferable investments, this would be a very useful function.

Overall, an ethical exchange is of great importance as it will change thinking by encouraging both social enterprises and ethical investors to take seriously this means of raising finance. How this would work is explained in Section 2.

THE BENEFITS OF A WIDE PUBLIC SHAREHOLDER BASE

As mentioned above, small investor amounts are difficult for any company to raise, and usually come from VCTs or other large private investors. However, social enterprises that have undertaken EPOs are unusual in that they have a wide public investor base. For example, Traidcraft has over 2,400 shareholders and The Ethical Property Company over 1,200. This is more than most AIM companies, where the average is around 800 investors.

Where a commercial company would see having a large number of shareholders as a burden, as each one needs to be serviced however small their investment, ethically directed companies tend to see it as a strength. This is primarily because of a general commitment to inclusivity on the part of the companies. However it also helps to prevent a handful of shareholders controlling the company, thereby helping to protect its ethicality.

A wide shareholder base also helps with liquidity, in that small holdings are easier to trade than large ones, and more investors means that the demand to sell shares is likely to be more evenly spread over time.

DEMAND FOR AN ETHICAL EXCHANGE FROM INVESTORS

The last twenty years have seen significant growth in ethical investment on the main markets, usually through ethical unit trusts buying shares in a portfolio of listed companies considered to be more ethical than others.

Screened ethical investment reached over £5 billion in 2005, and yet for the larger ethical investment companies such as Henderson Global Investors, the amount of money in mainstream ethical investment is no more than 1% of their total funds. The potential for further growth in this sector is therefore very large.

Although this investment is handled by the larger investment institutions, the money originally comes from over half a million individuals who have chosen to invest in ethical unit trusts. This compares to some 20,000 individual share investments in ethical businesses.

The £50 million invested in ethical social businesses is around 0.1% of total ethical investment. To what extent then can ethical businesses access further funds? This can be done either by individual investors investing directly in ethical investments or by the ethical funds investing on behalf of their investors.

Ethical unit trusts have tended to offer solid financial investments where the ethical nature of the investment is less clear cut. For example, the most popular ethical stock by far is Vodafone, a company with no particular ethical inclination. Although investors with ethical concerns see this kind of investment as a significant improvement on their existing portfolio, as undesirable stocks such as arms and tobacco companies are excluded, many of these investors would still welcome the opportunity to invest in more distinctly ethical products, so long as financial criteria are met. This desire is also recognised by the main ethical funds.

In general, investors have four expectations of an ethical investment:

1. That it delivers a strong social or environmental benefit
2. That it produces or stands to produce an annual return through either capital growth or a dividend
3. That they can cash in their investment within a reasonable time frame when they need to
4. That it is possible to make a fair and reasonable assessment of the value of their investment

Most would expect their money to at least be safe and many would like it to produce a return and/or for their capital investment to appreciate. As a rough guide, one might consider that an ethical investment should present minimal perceived risk to the capital invested, and should offer a rate of return in line with or above current building society account interest rates.

A key indicator for an investor is whether a company has a track record of dividend payments. Table 3 shows the dividends and yields currently offered by ethical businesses. This does not include any return offered to an investor through any increase in share price.

As yet then there are a limited number of companies offering a financial return, although in the last two years the numbers have increased as both Café Direct and Traidcraft have paid a dividend.

Strengthening the financial aspects of ethical investments made through EPOs is one of the main routes to attracting significant further investment. A well-functioning ethical marketplace would be an essential part of strengthening these financial aspects and so attracting this investment.

A second issue central to attracting investors, particularly the institutions, is to be able to attach a clear and fair value to the shares of an ethical business. This issue is discussed further in Chapter 5.

TABLE 3: DIVIDENDS AND YIELDS OFFERED BY ETHICAL BUSINESSES

PLCS	SHARES IN ISSUE	NET DIVIDEND PAYABLE	FOR HOW MANY YEARS PAID
Ethical Property Company PLC	6,282,000	3% approx	6
Triodos Renewable energy Fund	7,250,000	3% approx	6
Traidcraft PLC	4,200,000	2.5% approx	2
Café Direct PLC	5,000,000	Expected	1
Good Energy	1,333,000	Expected	N/A
Centre for Alternative Technology	1,000,000	Not expected	N/A
Westmill Wind Farm	4,750,000	12% average total return predicted	0

BOND ISSUES	TOTAL £	YIELD	
Paperback	£90,000	Approximately 5%	??
ICOF	£1,000,000	2% approx (paid in WSC)	??
Shared Interest	£18,000,000 (including WSC)	None (0.5% on WSC)	??
Golden Lane	£1,000,000 (estimate)	None as yet, expected	
City Life	£4,700,000	None intended	
Out of This World	£1,000,000	None expected	

WITHDRAWABLE SHARE CAPITAL		DIVIDEND	
Bay Wind	£1,900.000	6% approx	??
Phone Co-Op	£371,565	3.5%	5
London Rebuilding Society	£60,000	None, but CITR available @ 5%	
Aston Reinvestment Trust	£410,000	None but CITR available @ 5%	

SECTION 2

THE EVOLUTION OF AN ETHICAL EXCHANGE

HISTORY OF ETHICAL SHARE TRADING TO DATE

At the time of the first share issues by Traidcraft in 1984 and the Centre for Alternative Technology in 1990, no thought was given to the subsequent trading of shares post-issue. It was not until 2000 (?), leading up to their third share issue, that Traidcraft chose to appoint brokers Brewin Dolphin to provide a matched bargain market in their shares.

Triodos Bank offered a matched bargain market in shares in the Wind Fund after their first issue in 1995. However trading was minimal. In 1999, The Ethical Property Company also traded their shares post-issue through Triodos, increasing the level of trading significantly. When in 2004 Café Direct undertook a share issue through Triodos and Good Energy considered doing so, Triodos gave consideration to the notion of starting a single market for all ethical shares, to also include Golden Lane Housing, and provisionally called Ethex. However, the bank was unable to commit the resources required to get the project underway and it floundered. Good Energy chose to list on OFEX instead.

Triodos traded all shares at a fixed price, with the price as far as possible based on NAV but in practice set by the directors of the company traded. Matching of trades took place on set trading days, from two weeks to two months apart. A reasonable level of trading took place, but sellers always slightly outnumbered buyers.

With the arrival of Café Direct into the market for an ethical exchange, The Ethical Property Company saw fit to call a meeting of the main ethical PLCs being Café Direct, The Ethical Property Company, Traidcraft, Good Energy and the Triodos Renewable Energy Fund. Four potential providers of a single ethical share market were asked to present to the group, namely Triodos, Brewin Dolphin, Share Mark and OFEX.

The group agreed that Brewin Dolphin was the provider of choice. This was because OFEX and Share Mark's trading mechanisms were considered inappropriate. Triodos did not have the economies of scale to run a market, whereas Brewins also acted for a number of off-market companies, such as small breweries and football clubs. Brewins also offered to provide valuations of the companies' shares, creating greater transparency in pricing and relieving the directors of each company of this responsibility.

Brewins now handle trading for The Ethical Property Company, Café Direct and Traidcraft, with the Triodos Renewable Energy Fund planning to switch to Brewins soon. To date, Good Energy has remained with OFEX. Capita provide registrar services through Brewins. In the case of The Ethical Property Company, the switch to Brewins has resulted in a higher level of trading on a more frequent basis. For the first time in some time, the company has an excess of buyers over sellers and has been able to take on new investment.

More recently, there has been a flurry of interest in an ethical exchange, with The New Economics Foundation undertaking further research, both Investing for Good and Share Mark interested in developing and running a market, and the topic being a strong theme at the 2006 Skol Forum. There have also been discussions on setting up a single website highlighting to the general public investment in all the companies mentioned above.

WHAT WOULD AN ETHICAL EXCHANGE DO?

An ethical exchange should offer a genuine complement to the mainstream markets as well as being able to play a comprehensive role in supporting EPOs. A full list of the possible functions is described here.

GENERATE LIQUIDITY IN INVESTMENTS IN SOCIAL ENTERPRISES

The primary role of an ethical exchange would be to generate liquidity in ethical shares and bonds once an issue has been undertaken. This would not only help investors to disinvest when they need to, but is also likely to attract more investors in the first place, as they will be more confident that they will eventually be able to disinvest.

However at the end of the day liquidity can only be created by there being a steady stream of new investors wishing to buy shares. To be successful, then, an ethical exchange will need to market to new investors.

BRING NEW ISSUES TO MARKET

The institution that runs an ethical exchange will need to be authorised by the FSA, as well as having substantial knowledge of the share and bond markets. Many of the enterprises who are members of the exchange will also all have undertaken share and bond issues, and so will have substantial experience to offer companies looking to undertake EPOs.

An ethical exchange will therefore be in a strong position to assist enterprises in coming to market, and should be able to put their knowledge to maximum effect through an exchange and so ensure costs of undertaking an issue are minimised. In addition, the fact that these social enterprises have gone through a due diligence procedure will give investors greater confidence in the investments presented. This stands to encourage them to invest larger sums.

Having a market where EPOs can be undertaken will also give greater confidence to ethical venture capital trusts, knowing that there is a tidy exit route for their funding that will not jeopardise the ethics of the company.

Although an ethical exchange need not require social enterprises to undertake an issue through the exchange, doing so would ensure that companies coming to the exchange already meet its ethical and financial criteria and that the necessary due diligence work has already been undertaken. However, social enterprises that do not run their share issues through the ethical exchange should still be able to list, even though extra expense is likely to be involved.

ATTRACT NEW INVESTORS

An ethical exchange will increase the pool of ethical investors available to social enterprises, as there will be one well-known port of call for those looking to invest ethically. It is also likely to create greater interest amongst institutional investors than the current smattering of matched bargain markets.

An ethical exchange would also give investors greater confidence that the investment they are making is at a fair price, will be settled efficiently and that a level of due diligence has been undertaken.

The collective marketing of investments could also serve to reduce the cost of marketing, the high cost of which is the main barrier to raising share and bond investment for small companies. This collective marketing could take place through a number of vehicles such as a website, a newsletter, regular open days for investors and investees and through general publicity for the exchange. Investors in one company would be entitled to receive information on all the others. It might eventually even prove possible to achieve permanent listings in newspapers and other areas as for the main exchanges.

The establishment of an ethical exchange is likely to generate substantial media coverage, which will in turn attract new investors.

SUPPORT SMALLER ENTERPRISES WITH START-UP FINANCE

The bringing together of so much knowledge in raising finance creates an opportunity for smaller enterprises to be supported. This then means that the ethical exchange can support the start-ups. Although public share and bond issues may not be appropriate for all social enterprises, it would be possible to produce guidelines on the advisability of undertaking an issue and the minimum level of investment that the exchange might undertake to raise.

CREATE NEW FINANCIAL OPPORTUNITIES

The pooling of knowledge of financial issues and of investments should also lead to new financial opportunities for social enterprises.

Both the Triodos Renewable Energy Fund and the Ethical Property Company have been able to attract new investment beyond the close of their share issues using an options mechanism. The Ethical Property Company has also established a small liquidity fund that can buy shares from those wishing to sell when no buyer is available. These two mechanisms together mean that an investor is close to being able to buy and sell shares in the Ethical Property Company at any time on a continuous basis.

On the longer term, an ethical exchange might find that it can employ a number of the financial mechanisms used by the mainstream markets. Perhaps the most useful of these would be funds established to hold several or all of the ethical investments on the exchange. These would be similar to mainstream ethical unit trusts and would most likely be particularly attractive to institutional investors who are looking for ways to invest large amounts of funding in small companies.

A market would also be able to identify and promote the tax opportunities available through the companies listed. These include EIS and Inheritance tax relief.

OFFER TRAINING IN FINANCIAL AND COMPLIANCE ISSUES

Given that most ethical investments have tended to be stronger on ethical performance than financial, an ethical exchange could play a strong role in helping to develop the financial and compliance capacity of the social enterprises listed on the exchange. This will also help to raise financial standards in the market, thereby improving investor confidence.

Training in compliance issues will also help to ensure that companies meet the stringent requirements of the Financial Services and Markets Act and understand how to factor them into their business planning

Examples of the kinds of training an ethical exchange might offer include:

• Understanding balance sheet, cash flow and profitability
• Valuing a social enterprise
• Understanding financial promotions
• Social Auditing and business transparency

A certain level of financial compliance will anyway be necessary for an organisation to be able to list on an ethical exchange, both in terms of Companies Act requirements and rules imposed by the exchange.

SECTION 3

HOW THE EXCHANGE WOULD WORK

The principal attraction of an ethical exchange is that it offers a positive alternative to the mainstream markets. As well as playing a key role in developing investment in the social enterprise sector, the exchange would challenge the mainstream markets by setting an ethical standard for them to meet.

• Thus an ethical exchange needs to be structured to avoid the perceived social and environmental inadequacies of the existing markets. These are the views that the majority of companies listed have no or limited social and environmental priorities; that there is a lack of accountability amongst those who operate the exchanges for the social consequences of their actions; and that traders on the existing markets are engaged in excessive speculation and profiteering.

By clearly seeking to avoid these limitations, an ethical exchange should be able to attract significant new investment as well as raising standard in ethical investment generally.

AVOIDING SPECULATION

An ethical exchange would look to create liquidity, whilst aiming to avoid and discourage speculation. However the two are very closely related.

Liquidity is the speed with which a buyer or seller can be found for a share once a potential trade has been brought to the market. Within the principal financial markets, the liquidity rate is now very high, particularly with computerised trading and a global market, though of course technically a 100% liquidity rate can never be achieved.

Stock market speculation can be defined in three different ways:

• Borrowing to invest in the market, then repaying the loan from any gain.
• Buying and selling shares to make profit, particularly taking large risks for large profits.
• Buying and selling stocks and shares to make money off a short-term rise or fall in the stock price, even over just a few hours.

The first practice was prevalent at the time of the stock market crash of 1929, and indeed helped to bring the crash about, as when stocks began to fall, panic set in and loans were recalled. The second is the simplest definition of speculation, but this is not the kind of speculation that an ethical exchange would look to avoid. Indeed it is essential that investors are prepared to take this kind of risk if they are to invest in social enterprises.

It is the third definition of speculation that we are concerned with here, as this practice can lead to rapid changes in share prices, meaning that the 'professional' investor profits at the expense of those less actively engaged, and also increases the extent to which the market becomes the driver of a business rather than the underlying business fundamentals. This kind of speculative investor has no interest in the business of the company in which he or she invests, only in the opportunity to make a quick profit.

Ironically, the rapid buying and selling of shares that gives rise to speculation is only possible through a high level of liquidity. But it is increased liquidity that we are trying to create through the establishment of an ethical exchange. This then raises the question, what level of liquidity, and possibly even what level of speculation, is desirable and ethical? A simple answer would be that a market need not aim for 100% liquidity, but need only provide a level of liquidity that investors expect in order to meet their need to buy and sell.

One key difference then between the existing markets and an ethical exchange is that on the existing markets liquidity is the mechanism used to determine price. But on an ethical exchange price would be in part a function of liquidity and in part a question of intrinsic value. This issue is discussed further in Chapter 5.

NON PROFIT NATURE

Like the social enterprises that list on it, the ethical exchange's primary focus would be as much to support the social enterprises that list on it as to make a profit. It might even be a non-profit entity such as a Community Interest Company, particularly if it is run as a trade body.

The exchange would function as a sophisticated matched bargain market. This would mean that at least initially there would be no market-makers or brokers profiting from the purchase and sale of shares at differing prices (known as the bid-offer spread). At a later stage, if the volume of trading increases, it may prove beneficial to introduce market-makers. However at all times, transactions taking place on the exchange would be transparent, with no hidden charges.

Annual accounts would be produced and made publicly available, showing how funds earned by the exchange had been used. Ideally, a social audit of the ethical exchange according to agreed performance criteria should be carried out each year.

MEMBERSHIP

Enterprises joining the exchange will need to meet the criteria outlined above. In addition, the market operator is likely to need to go through a due diligence procedure prior to listing an enterprise to ensure that the requirements of the Financial Services and Markets Act and the Companies Act are met. This procedure would also determine the price at which an investment is to list. The procedure is likely to be less complex for an enterprise that has already undertaken a public share or bond issue recently, particularly one in which the market operator has played a key role.

In addition to the enterprises listed becoming members of the exchange, potential investors should be asked to join before receiving information on the investments, making the ethical exchange closer to being an ethical investment club. This may help with compliance issues. In addition, these members might be charged an annual fee to help pay the costs of marketing. A higher fee could be charged to institutional members.

Enterprises listed on the exchange would be expected to encourage their existing investors to join the exchange. In addition the exchange could be marketed to the customers of ethical financial institutions such as Triodos and the Co-Operative Bank. Ideally, all ethical investors and depositors should become members of the exchange.

THE 'RULE BOOK'

The market operator will need to devise a rule book – akin to the Stock Exchange's Purple Book and AIM Rules – which set out the listing requirements for companies in order for them both to comply with statutory regulations and to ensure that the quality of enterprises listed on the market is maintained.

COMMUNICATIONS WITH INVESTORS

Investors would be kept informed of the performance and developments of the companies listed on the exchange through:

- A dedicated website which would include a mechanism for dissemination of price sensitive information
- A bi-annual newsletter with news of the enterprises and details of trades and prices
- Copies of annual reports of the companies listed
- Circulars providing information on events that are required to be reported to shareholders (e.g. significant acquisitions etc)

In addition the market operator could provide a dedicated enquiry line for servicing investor enquiries and investment requests. This would be able to provide factual information only and not advice on investments.

CHARGES

Investors would be charged an annual membership fee, paid in order to give them access to information about the companies listed, as well as transaction charges on purchases and sales. Enterprises listed would be charged an annual membership fee together with further charges for transactions, advice services and share issues. Brokers dealing in the shares of companies listed might also be charged a fee. Charging and likely income is dealt with in more detail in Section 6.

THE SHAPE OF AN ETHICAL EXCHANGE IN THE FUTURE

Should it succeed and grow, one can imagine a market listing social enterprises in which the traditional market sectors, such as 'Oil Gas and Utilities', are replaced by more desirable headings, such as 'Renewables'.

The following table sets out the main FTSE companies categorisations listed in the Financial Times and suggest alternative ethical headings as well as some of the companies that might fit them:

TABLE 4: MAIN FTSE COMPANIES CATEGORISATIONS LISTED IN THE FINANCIAL TIMES

FTSE SECTOR	ETHICAL EXCHANGE SECTOR	COMPANIES THAT MIGHT LIST ON AN ETHICAL EXCHANGE
Aerospace and Defence	None	None
Communications and IT	Ethical providers	The Phone co-op, rural broadband co-ops
Finance and Insurance	Community and Ethical Finance, micro-credit	City Life, ICOF, Triodos Bank, London Rebuilding Society, Aston Reinvestment Trust
Food and Drink	Organic Food and Farming, whole Foods	Unicorn Wholefoods
Health and Pharmaceuticals	Natural Health, care co-ops	Neal's Yard
Industrial Manufacture	Environmental technologies	Resource Revolution, Centre for Alternative Technology
Leisure and Media	Community radio and TV , eco-tourism	
Oil Gas and Utilities	Renewables	Bay Wind, Good Energy, Triodos Renewable Energy Fund
Property and Construction	Ethical Property, eco-housing, social housing	Ethical Property Company, Golden Lane Housing
Forestry and Mining	Sustainable timber, recycling companies	
Retail Distribution and Packaging	Fair trade, local shops, recycled goods, eco-produce	Traidcraft, Shared Interest, Out of this World, Cafédirect, Paperback
Transportation and Automobiles	Low energy transport, sustainable transport, sustainable fuels, bicycle shops, car club operators	Smart Moves, Parry's People Movers

SECTION 4

THE STRUCTURE OF AN ETHICAL EXCHANGE

THE STAKEHOLDERS

The three main stakeholder groups within the exchange would be the social enterprises who would wish to list on it, those who would wish to invest in the enterprises listed and those responsible for the execution, regulation and legal compliance of the market. A fourth stakeholder who would be a valuable addition to the market would be one or more brokers who would be able to offer a professional opinion on the value of, and a suitable price for shares.

Enterprises would need to meet ethical and financial criteria in order to win membership. Investors would also become members of the exchange, receiving regular information in exchange for a membership fee.

THE FUNCTIONS OF THE ETHICAL EXCHANGE

The functions of the exchange fall into three headings:

TRADE AND NEW INVESTMENT EXECUTION

This is the business of maintaining lists of buyers, sellers and enquirers, providing them with the necessary information on how the market works and carrying out the trading and issuing of shares, collection of stamp duty and transaction fees, and the execution of the paperwork necessary to support it.

This role could be extended beyond a passive matching service to include an active opinion from a broker on the value of shares, as well as an active match-making service designed to improve liquidity. This would take place through buyers being encouraged to buy at a higher price if no shares are available, thereby encouraging sellers; and on the other hand sellers being encouraged to take a lower price if it will enable the sale to take place.

COMPLIANCE WITH THE FINANCIAL SERVICES AND MARKETS ACT AND THE COMPANIES ACT

This is the business of ensuring that the practice of the social enterprises listed on the exchange and of the exchange itself meet the requirements of the Financial Services Act and the Companies Act. While the responsibility for compliance remains with the directors of the company, the exchange would seek to maintain certain standards through its rule book. Companies may be required to provide information at certain times and be subjected to sanctions if they fail to comply with laws.

MARKETING

This is the business of attracting new enquirers to the exchange through publicity and marketing.

The first two functions would need to be conducted by an FSA registered body with the appropriate approvals to manage an exchange. It therefore seems sensible that the market operator should perform both of these functions. It is probably most appropriate for this operator to also be the company's registrars, and indeed some operators may insist on this.

Marketing could be carried out by the enterprises themselves, the market operator, the broker or all three operating together. Investor members could also support marketing initiatives. Careful attention would need to be paid to possible conflicts of interest for the market operator and the broker in this area.

OWNERSHIP AND CONTROL OF THE EXCHANGE

There are three alternative ways to structure the ownership of an ethical exchange.

First, the exchange could be a project of the market operator. Under this model, the market operator has the freedom to set the terms on which a social enterprise joins the exchange and a social enterprise chooses to join if it considers those terms attractive. The market operator would execute the trades and would also hold the list of investors and social enterprises that are members, dealing with each directly. Marketing would be undertaken collectively by the market operator and by the individual companies for their own investments.

Second, the exchange could be a trade body, either a co-operative or a company limited by guarantee, controlled by its members. The market operator would deal with compliance and market execution and the trade body would deal with the market operator on behalf of members and would negotiate the fees collectively. The trade body would hold the list of investors and enterprises that are members and would provide them with marketing information. The market operator would ensure that the trade body complies with the FSMA and the Companies Act. Members would pay fees to the trade body, and the trade body would appoint the market operator in much the same way as a company appoints an auditor.

Third, the exchange could be a project of the market operator, but a trade body would also be formed, albeit with fewer powers than outlined above. In this case the market operator would hold the list of members, collect fees and deal directly with the social enterprises, however all parties would be required to join the trade body which would be assigned certain powers and activities, such as co-ordinating members meetings, inputting into strategic development and undertaking some publicity and marketing. Under this model the trade body would be able to influence the market operator but would not be able to transfer the exchange from one market operator to another.

Of these options, the first would be preferable from the point of view of the market operator as it allows them the greatest freedom of operation, and indeed some social enterprises might prefer this model as it is the simplest model requiring the least commitment on their part.

The second option conveys advantages however, as it allows for limiting the market operator's potentially monopolistic position. But it will require substantial commitment from the enterprises listing as well as these enterprises undertaking more of the financial risk of running the market.

The third option is a compromise position that may offer the best starting point, as it is a pragmatic option that allows for the formation of a trade body without that body taking on significant responsibilities. Alternatively, a more powerful trade body may be a safer long -term option, with initially many of the responsibilities of that body delegated to the market operator. This leaves open the possibility of moving towards either of the first or second options as things progress.

ELIGIBLE INVESTMENTS

In order to be listed on an ethical exchange, an investment product must be transferable. This means that it can legally be sold on to another investor without having to be redeemed.

Shares are usually fully transferable, although some companies have articles of association that restrict the transfer of shares. Any such restriction would need to be reviewed and most likely removed.

Bonds are sometimes transferable, sometimes not. However, research would indicate that most if not all of the enterprises discussed here have issued their bonds on a transferable basis, and so could be listed on an ethical exchange. Depending on the repayment terms specified in the original investment, even those bond investments that are not transferable could be repaid and new bonds issued to a new investor, meaning that the social enterprises could not list on the market but could still attract new investment through it.

Withdrawable share capital is transferable only in certain cases. But given that an investor can withdraw their funds at any time, there will be a need for the co-operative issuing the withdrawable share capital to replace it. So although withdrawable share capital could not be traded on an ethical exchange, it may be possible for new withdrawable share capital to be attracted through the marketing undertaken by the exchange.

PRICING SOCIAL AND ENVIRONMENTAL RETURNS

Another key role then that an ethical exchange would play is to assess a company's social and environmental performance, and report on this to investors.

An ethical investor will assess the risk of an investment before making it. This assessment is likely to be based not only on the risk of the enterprise under-performing financially, but also failing to deliver the promised social returns.

It is arguable that the social return that an enterprise offers should be factored into the share price. However, to allow that a company should be able to translate social returns into financial and reflect these in its share price is likely to remove the incentive for social enterprises to try to match the returns on offer in the commercial sector, and so on the long term to discourage them from becoming competitive commercial concerns.

On the other hand, a measure of social performance cannot be avoided, as the investor faces a risk that the social return promised through investment in a social enterprise may not materialise, in which case they might have chosen not to invest in the first place.

The ethical exchange would then need to offer a simple method of evaluating the social and environmental performance of the companies listed. This could be done by extracting the non-financial objectives described in the company's share issue prospectus, and translating these into a set of targets and indicators that can be assessed annually through a social audit. This audit would both give an element of comfort to investors and assist the company with its business planning.

Over time, these audits would fall into a pattern on a sector by sector basis. Social enterprises could then be compared to PLCs listed on the main markets and operating in the same sector.

The assessment of social worth of an enterprise would then be a parallel process to the assessment of financial worth and would provide further information that could be offered to an investor to help them in their decision making process.

CRITERIA FOR MARKET LISTING

Social enterprises looking to become members of the exchange will need to meet certain criteria. These would be designed to offer comfort to all stakeholders - To the investor that the investment was of a suitable financial and ethical quality, to the market operator that the enterprise could meet the demands of the FSMA and Companies Act and to the other member enterprises that the new enterprise listed will uphold the aims and standards of the exchange.

These criteria fall under three broad headings.

FINANCIAL CRITERIA

In order to be able to list, the enterprise would need to meet two financial requirements.

The first is that the enterprise should either have paid a reasonable amount of dividend or interest in the past or should intend to pay them in the future or, if there is never any intention of offering a return, this should be very clearly stated. This is to avoid investment products coming onto the market that are for the investor to all intents and purposes a gift rather than an investment.

The second is to have a mechanism in place for calculating an appropriate share price for the investment. This last issue is dealt with more thoroughly in Section 5.

SOCIAL AND ENVIRONMENTAL CRITERIA

Any organisation seeking a listing should be a dynamic social enterprise making a positive contribution to society and the environment and with a strong and sustainable future. It should also meet ethical and corporate governance standards.

Although it is very difficult to specify criteria of this nature, it is important for an ethical exchange to have a written policy for the sake of transparency and of offering a standard of ethical performance to share or bond holders. However these criteria need to allow for a degree of flexibility in their application. This is not a difficult balance to achieve (the legal system manages to do it by striking a balance between the setting of the law and its later interpretation) but it does require considerable thought and development, as well as a responsible body to apply the rules.

TRANSPARENCY AND THE PROVISION OF INFORMATION

It would be necessary for each enterprise to make available information about its ongoing business to the ethical exchange, particularly should this information be price sensitive. The provision of this information and the due diligence required to confirm it will be essential to avoid both mistakes being made and the market being exploited by scams.

Any enterprise should be also able to prove its ongoing practical commitment to social aims. This is best done through a social audit, and an enterprise should in due course develop one once listed. But in general, a commitment to a high standard of transparency will be essential.

Table 5 below sets out a summary of a possible full set of criteria for listing. These will need to be applied judiciously by the body responsible for admission.

For the purpose of the table, an unethical business can be described as one causing damage to the environment through its activities, engaged in arms sales, pornography, tobacco or animal testing or with a poor human rights or employment rights record. Certain other activities, such as petroleum or car sales, may also be judged unethical in certain cases.

Social enterprises that lack essential criteria or who possess preventative criteria would not be eligible for listing. Desirable characteristics would weigh in favour of a listing, whilst undesirable characteristics would weigh against, but would only in a very few cases effect the choice of whether an organisation is granted admission. Rather the exchange would wish to engage with the enterprise to develop the desirable criteria and to lose the undesirable criteria once the enterprise is listed as part of a training and development programme.

The ethical criteria would be applied by the body responsible for running the exchange. This would either be the enterprises that are already members, the market operator or both working together. This body could also adjust and improve on the criteria as it sees fit.

If the exchange was to grow significantly and to have sufficient companies listed to be divided into sectors as described in the next section, it might then be desirable to introduce additional criteria for each sector.

TABLE 5: SUGGESTED CRITERIA FOR A COMPANY LISTING ON AN ETHICAL EXCHANGE

ESSENTIAL CRITERIA (MUST HAVE/BE)	PREVENTATIVE CRITERIA (CANNOT HAVE/BE)
• A tradeable investment • A financially sustainable business with a realistic dividend policy and a means of valuing the business • A defined social purpose that accords with the exchange's overall objective of building a sustainable society and a sustainable environment • Committed to transparency in its business dealings	• An unethical business
DESIRABLE	**UNDESIRABLE**
• An annual social audit • A business with long-term prospects and opportunities • A commitment to honesty and transparency. • An innovative social enterprise	• An enterprise paid by unethical businesses for its services or knowingly receiving grant funding from an unethical business • An enterprise that is in any way undemocratic or discriminatory towards its employees, volunteers or clients • An enterprise that lacks the support of the community it serves

SECTION 5

PRICING SHARES AND BONDS

Although bonds can vary in price on the mainstream markets, their price may not need to change significantly on an ethical exchange if at all, although they may change marginally in price in relation to the interest rate they offer in relation to current savings rates. However the pricing of shares is highly complex. Given the very different nature of an ethical exchange to the mainstream markets, a whole new pricing mechanism will be necessary.

THE FIVE MODELS

Five options on how the price of a share on an ethical exchange could be determined are set out below. These can be thought of as a progression away from the fixed pricing that ethical businesses have historically initially adopted, and towards open market pricing. Each option has its strengths and weaknesses, but in summary fixed pricing is more open to criticisms of unfair price determination and poor liquidity, whereas open market pricing is more prone to profiteering through speculation.

OPTION 1 – FIXED PRICE TRADING.

Trades take place on the exchange only at a fixed price, being the price at which the shares were first issued. Buyers and sellers can trade at other prices, but these trades would need to take place off market. This is the model used by the Centre for Alternative Technology.

OPTION 2 – SET PRICE TRADING.

Prices on the market can vary. An independent broker makes an assessment of the value of the shares, and this is adapted by the market operator depending on the demand for shares. The company itself has the right to accept or reject the share price.

This method implies greater scrutiny which gives more confidence to the investor. This is the model used by Traidcraft and by the Triodos Renewable Energy Fund. Traidcraft uses a broker, whereas Triodos makes its own assessment of price.

OPTION 3 – SET PRICE TRADING, BUT WITH THE ADDITION OF A LIQUIDITY FUND.

This is the model currently used by the Ethical Property Company. The Company has formed an employee benefit trust into which a number of individuals have loaned money at a favourable interest rate. The trust then becomes a player on the market, buying the shares of those wishing to sell quickly and selling them on to new investors in order to release cash back into the fund.

While other investors trade at a fixed price, the trust's purchases and sales are made at a price slightly below or above the set price, realising a small profit to the trust. These funds are used to support an employee share purchase scheme. The trust then acts as a market maker, but one where any profits made are retained by the company for the benefit of its employees.

A further twist to this model is the issuing of options to the employee benefit trust to purchase shares. If there is a surplus of buyers over sellers, the trust then exercises some of its options, selling the shares to the buyer. This brings new share capital into the company even if no share issue is open.

OPTION 4 – VARIABLE PRICE, ORDER DRIVEN.

This is a variation of the model used by SETS and does not require a market maker, although brokers may well assist with the process. A guide price is put forward by a broker, the company or the market operator. Buyers and sellers then place orders, according to the price they would like to achieve which might be at, above or below the guide price. They can either place a 'best price' order, asking for the best price available at that time, or they can place a 'target price' order, asking that the trade can only be executed at a target price. If the target price is not available by a certain date, the order either expires or becomes a 'best price' bid.

This model extends option three, in that the offer to purchase at a price different to the set price is open to all investors rather than only the employee benefit trust. It introduces a bid-offer spread, set by the investors, but still leaves them the option of buying and selling only at the guide price. It also leaves scope for the liquidity fund outlined in option 3 to be introduced into the market, and indeed improves on it as it forces the trust to be more price competitive.

OPTION 5 — VARIABLE PRICE, QUOTE DRIVEN.

This is a variation of the SEAQ model, which is still used on the main exchanges for shares with limited liquidity. There is no guide price, but instead there is a market-maker in the shares of the social enterprise. The market-maker must always offer both a sale and a purchase price, at a bid-offer spread. The market maker pays for his work through the profit made on purchases and sales as a result of this price difference.

WHICH MODEL?

Of these, the best model would be Option 4, with the liquidity fund outlined in Option 3 available where possible. Option 4 is the most flexible model, as it allows room for options 1, 2 and 3 still to operate within it. And indeed, options 1 and 2 may be the best models for some companies when they first list on the ethical exchange, and it is only once their trading has matured that they should open up to the possibility of a variable price.

Option 5 would not be appropriate. This is more of a profit driven model not suited to an ethical exchange, less transparent to investors. It is anyway unlikely that a market-maker would find the prospect sufficiently attractive to be prepared to make a market.

On the long term, Option 1 is an unsatisfactory model as the share price does not reflect the fortunes of the company.

One can see a situation on an ethical exchange, then, where companies first use option 1, move quickly to option 2 and end up at option 4 once mature. However, some ethical investors may be opposed to option 4, as they might regard this as speculation. This model, which is currently not in use by any ethical business, would need to be introduced with care.

RULES FOR SETTING PRICE

On an ethical exchange, the market operator and/or the trade body or broker would work with each enterprise to be listed to determine a mechanism for setting the share price. This would be done on the basis of the methods outlined above and according to a set of rules particular to the enterprise.

The directors and owners of the enterprise would agree the rules, the directors would be trained in applying them and the rules would be published so that they would be available to all potential investors. Confidence in this process could be strengthened by the price also being assessed by an independent broker.

The rules would also set a frequency for the review of the price. On the review date, the enterprise would propose a price to the market operator who would check that it is fair and accords with the rules before listing the new price on the exchange.

In the interest of transparency, the rules should be presented at an AGM and a vote held to win acceptance from shareholders.

COMMUNICATING PRICE TO INVESTORS

In order that any brokers or market makers or even the companies themselves can be confident that they are presenting a fair price to investors, as much information as possible should be made available on the investment to potential investors.

The rules for calculation of price should be published on the website, made available to those registering on the exchange and referred to in other communications with shareholders such as the newsletter and Annual Report.

A report detailing the decision each time the price is reviewed should also be posted to the website within 7 days of the meeting and sent to all those registering on the exchange.

SECTION 6

FINANCING THE EXCHANGE

Although some grants and sponsorship may be available to an ethical exchange, particularly in the early stages, it needs to be able to finance its own running costs. This section then looks at the likely sources of income and expenditure and whether the figures stack up.

The London Stock Exchange, which first sought funding of £20,000 to build the Stock Exchange in 1801, is now itself a listed company turning over some £420 million a year. This income comes predominantly from transaction charges to brokers, charges for the provision of information about prices and trades, and fees charged to issuers.

The finances of an ethical exchange will need to operate slightly differently. These figures are best looked at under the four exchange function headings of trade execution, compliance, information provision and new issues.

TRADE EXECUTION

Firstly, as brokers will not make a bid-offer spread on shares, they stand to profit less from each transaction on the ethical exchange as opposed to the existing markets. Nevertheless, it should be possible to charge brokers a small fee for trades taking place through the exchange.

Brewin Dolphin currently levy a 1% charge on all transactions. This could be increased to 1.25%, generating a small income for the exchange.

COMPLIANCE

Compliance is both expensive and unavoidable. Like insurance, it is very hard to judge when one has sufficient cover. An enterprise is always to some extent at risk from non-compliance, no matter how hard it tries.

Compliance costs would consist of an initial health check, checking of share price declarations, and approval of all investor communications. On-going training in compliance issues might also be offered.

Basic compliance costs should be covered by the annual membership fee from listed enterprises. Further, additional, one-off compliance payments may also be required as the work can vary greatly from company to company. Where a share issue is undertaken, this should be done with future compliance issues in mind. Compliance costs can then be paid from the proceeds of the share issue as a share premium cost.

SUPPORTING ETHICAL INVESTORS

The market is being established for the benefit of ethical investors, and it can be assumed that they would be willing to pay for the service. They could be charged a joining fee, on payment of which they would be sent an initial outline of the market, then more detail on particular companies and opportunities for investment. Much of this could take place on the web. A joining fee might be extended to an annual membership fee.

NEW ISSUES

Share issues are a very costly and complex exercise, usually costing from 5% to 10% of the sum raised. This is then an area in which the ethical exchange shows the greatest potential for both saving enterprises costs and achieving improved results.

An ethical exchange offers the opportunity to pool marketing costs to maximum effect. It also creates one focal point to which investors can come for any ethical investment. If these investors are shared between all social enterprises listed on the exchange, this is a potentially highly significant cost saving.

The exchange could then earn income through charging a company an ongoing listing fee, as well as a charge for professional and marketing services in connection with an issue of up to 10% of sums raised. This could generate significant income for the exchange.

ADDITIONAL INCOME AND COSTS

There would be a range of further potential income sources for an ethical exchange such as grant funding, sponsorship from major investment institutions, training income and even investors in the exchange itself. Each of these would need to be looked at on a case by case basis.

A key issue, though, will be if the ethical exchange will be able to employ any of its own personnel directly, particularly if it chooses to set up a trade body separate to the market operator. Although the employment of staff is likely to greatly strengthen the exchange, it is unlikely to prove viable in the early stages without grant support.

A full cash flow projection would need to be devised in order to ascertain the financial viability of the exchange. This is beyond the scope of this paper.

SECTION 7

NEXT STEPS TO CREATING A MARKET

BARRIERS TO A MARKET

There are still many hurdles to overcome before an effective ethical exchange can be created. The main ones are listed here:

POOR RETURNS FOR INVESTORS

Some of the social enterprises that could list on the ethical exchange are offering no or a poor financial return. This may mean that the ethical exchange is of limited interest to ethical investors.

LIMITED DEMAND FROM ETHICAL BUSINESSES

The idea of the ethical exchange may not appeal to all ethical investment companies, private investors or potential issuers of securities. Those with withdrawable share capital and those with transferable bonds may not find it sufficiently attractive. Even the companies seeking admission might not feel that the benefits of the exchange outweigh the costs.

Some ethical investment companies might feel that listing on the ethical exchange might only serve to encourage their investors to disinvest, where previously there had been no apparent demand for disinvestment. Particularly, those who have already undertaken share or bond issues but do not plan a further issue may not see it worthwhile to encourage liquidity.

Social enterprises may also fear a degree of loss of control over the workings of their social enterprise by listing on the ethical exchange, although appropriate drafting of rules should enable companies to retain their individual character. They may also perceive the exchange as creating a demand for higher profitability and the payment of dividends that some social enterprises do not want to rise to. In these cases, the issue of bonds may prove more appealing.

RELUCTANCE OF COMPANIES TO WORK TOGETHER

A great deal of the long-term strength of the exchange, and in particular its ability to market effectively and to support the smaller social enterprises, depends on the member enterprises working together to advise other members and to share lists of investors. Members may be unwilling to commit to this level of co-operation and support for other groups.

SOME SOCIAL ENTERPRISES MAY FIND IT HARD TO MEET THE LISTING REQUIREMENTS

The ethical exchange demands a high standard of compliance and understanding of financial issues. A lack of knowledge of these issues plus an unwillingness or inability to commit resources to them may impede the operation of the market.

LACK OF OBJECTIVITY MAY LEAD TO CRITICISM

The ethical exchange may be criticised for not being sufficiently professional or objective, particularly in cases where the setting of share prices remains with the directors.

For example, directors and members of the social enterprises listed may be reluctant to drop the share price of their social enterprise when necessary. Also, if rules for price setting by directors are to be used, care will need to be used to ensure that the rules themselves do not create targets for performance that are likely to influence the way a company reports or behaves in a manner that affects its core business.

Another issue is whether pricing can be looked at in isolation of other investment options. For example, could the Ethical Property Company operate at say a 5% discount to NAV when other FTSE property companies operate at a 25% discount? This will effectively offer investors a lower return on investment than a property company with the same level of earnings. This could open the exchange to some criticism. Thus the relationship between pricing on the ethical exchange and on other markets needs to be considered.

It should of course always be open to investors to buy or sell at a price other than that recommended.

A FULL BUSINESS PLAN

Despite these difficulties, the idea of an ethical exchange is clearly a practical and realistic business opportunity. All that is lacking to bring it to fruition is a talented social entrepreneur willing to develop a full business plan, raise the necessary funding and drive the project forward.

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