THE EUROPEAN UNION REGULATORY FRAMEWORK FOR SOCIAL ENTERPRISE

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Abstract:

The paper analyzes the European Union's regulatory and investment initiatives in support of social enterprise. Based on supply and demand side analyses, the research evaluates EU policy intended to create an enabling environment for social enterprise formation, sustainability and scale. These policies are integrated within the EU regulatory framework for "inclusive" growth, as articulated in Strategy "Europe 2020", as well as within the small and medium enterprise investment funds of the Multiannual Programming Period 2014-2020. The research evaluates these regulatory and investment initiatives within the broader context of the EU's evolving strategy for economic revitalization and resiliency, which espouses both traditional and innovative forms of SME finance and regulatory support.

Key words: social entrepreneurship, EU social enterprises

JEL classification codes: E69, F21, G15

Introduction

In response to limited public funding and rising demand for social services, organizations have increasingly leveraged revenue-generating business ventures as a way to meet their social objectives. This trend has led to the emergence of "social enterprise" -- organizations that utilize "earned" income to generate sustainable operating models and deliver improved social outcomes to the communities they serve. These types of organizations navigate many of the challenges faced by both nonprofit and private sector businesses. As revenue-generating businesses with a primary social mission, they rest at the nexus of traditional and social business.

The development and scale of social enterprises (SE) is prerequisite to the materialization of the EU's vision of Smart, Sustainable and Inclusive growth as codified in EU 2020 Strategy. These hybrid organizations are a key component of addressing the recessionary aftereffects of the financial crisis while also supplementing social services in the absence of government intervention. In accordance with this new growth model, the European Union (EU) has implemented an array of financial and regulatory activities to accelerate the positive effects of SE throughout Europe.

Description of the problem

Following the financial crisis, millions across Europe were jobless, while stagnating recovery continued to destabilize the macroeconomic environment. In Central and Eastern Europe, for example, exports had fallen by 23%, while the region's imports contracted by as much as 28%; in Bulgaria, a country which had only recently joined the EU, growing risk aversion among foreign investors continued to decelerate capital inflows.

Just as these problems were becoming more acute, the capacity of government, civil society and philanthropy – the traditional stewards of the public welfare— was attenuating; greater demand for social services came at a time during which governments, bridled with crisis, saw expenditures and revenues continue to diverge. The notion that business would drive economic growth while the government and civil society would address social problems -- tenuous to begin with -- was proving even less tenable. **If the EU was to recover, and if it was to recover in a way that embodied the ideals of socioeconomic equity and environmental sustainability, it would have to find a way for the private, civil and public sectors to collaborate.**

This notion has been a driving force that has blurred the traditional boundaries between industries, sectors and market actors. For-profit business and investors have increasingly embraced the

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notion that they can generate both a financial profit and social and environmental value; non-profit organizations increasingly pioneer revenue-generating ventures to increase the scale and scope of their impact; and the public sector continues to work to accelerate this hybridization rather than to affix traditional boundaries.

Social enterprise rests at the confluence of these trends. They combine philanthropic values with market-based principles, leveraging consumer purchasing power or market gaps to advance pre-defined social and environment goals. They navigate between the public, private and civil sectors. And they advance the precepts of smart, sustainable and inclusive growth through both the products they create and the people they employ.

The Social Enterprises and Social Entrepreneurship Funds Market in EU

Social enterprises (SE) act as drivers for social change by providing innovative solutions and making a significant contribution to meet the objectives of Europe 2020 Strategy. The social economy in Europe is estimated to engage over 15 million employees, equivalent to about 7 % of the working population in the EU (European Commission, 2013). In Europe, over 92 % of SE are organized as associations, foundations or other similar forms, 7 % as cooperatives and 1 % as mutual companies. The greatest number of SEs are found in UK, followed by Germany, Spain, France and Finland (CIRIEC International, 2012).

The social mission of these entities is interrelated with sustainable and inclusive development and intended to address social challenges across Europe. Social enterprises operate in areas such as the the environment, education, healthcare, bio-products, fair trade, and provision of goods and services to socially excluded sectors of the population. These entities are extremely versatile and constantly innovate their products and services, undertaking alternative ways of generating income, thus bringing entrepreneurial and commercial dimension to the provision of general interest services. SEs foster entrepreneurship along several lines: 1) they bring about economic activity to areas neglected due to their low profitability potential; 2) they offer an alternative model of economic growth based on social inclusion, 3) they produce social innovations by identifying and addressing social needs.

SE operations align to entrepreneurial, social and governance dimensions. Typical SE elements include a) a primary social mission advanced through reinvestment of their surplus for the promotion of social aims and b) an inclusive and participative manner of governance involving employees, consumers and stakeholders. SEs adopt a coordination mechanism based on cooperation, reciprocity and democratic governance that ensures the active participation of all interested stakeholders in their operations. These organizations cultivate “social capital” as their activities require active collaboration and civic engagement. SEs work to achieve systemic change by introducing new business models, improving value chains and exploring unused resources in the provision of public and general interest goods.

SEs produce both economic and social outcomes -- contributing to improving market competitiveness, increasing consumer choice and broadening opportunities for skill development and innovation. With respect to impact measurement, a lack of standardized metrics persists, with the majority of SEs relying on their own measurement practices or not measuring social outcomes through a formal evaluation process. These inconsistent practices lead to difficulty in comparability and standardization at both the enterprise and investment level. Moreover, due to their low visibility, SEs find it difficult to obtain financing from socially-driven entrepreneurship funds (SEFs), which reduces the opportunities for sustainable and inclusive growth across Europe. On the demand side, the lack of diverse sources of financing increases the cost of capital and limits resources for generating social change.

According to the European Commission (2015), SEs adopt a “hybrid” business model through which revenue generation materializes through both market and non-market sources, including government subsidies, grants, donations and membership fees. The mapping exercise undertaken by the European Commission indicates that the public sector funding dominates the revenue streams of SEs, which reflects the extent of overlap with public sector priorities, such as work integration and welfare services. The welfare effects of deeper economic integration in the EU is not only limited to production and consumption, but includes positive influences on employment, production, income levels, specialization etc. (Marinov, E., 2015).

A key operational challenge for SEs relates to a lack of sufficient visibility, which leads to low awareness and limited recognition of their socioeconomic value. A dearth of recognition depresses growth and financing prospects. SEs also face difficulties in attracting staff and managers with the requisite necessary skills and experiences. In addition to deficiencies in human capital, the SEs lack networks and infrastructure for business development services (such as strategic planning, consulting services and specialized training). For a majority SEs, growth prospects extend beyond their access to appropriately structured capital. However, new public sector funds, such as the European social entrepreneurship funds (EuSEFs) created under the EU-wide new regulatory regime (see below), have helped to address this finance gap. Despite the increasing availability of public sector capital, issues such as the absence of common mechanisms for measuring social impact has continued to impose limitations on private investment. And finally, SEs must navigate an array of regulatory issues across EU member states, which additionally serves to inhibit development and scale.

According to estimates of the European Investment Fund, there are approximately fifty social entrepreneurship funds (SEF) in Europe with a focus on SEs. The average size of these funds ranges from EUR 10 to 20 million. The venture philanthropy market in Europe is approximately EUR 1 billion, which represents less than 10 % of the EU venture capital market and less than 1 % of the private equity market. The largest SEFs are located in UK, where the social investment market is considered to have reached maturity, and France, followed by the Netherlands and Germany. Despite the new regulatory framework for European social entrepreneurship funds, the cross-border activities of these funds have only reached 4 % compared to 12 % for the venture capital market and over 20 % for the private equity industry. The limited supply side opportunities reduce competition among SEFs, which contributes to increasing inefficiency within the EU capital markets.

According to estimates from EVPA (2014), support for SEs through venture philanthropy and social investing has continued to rise -- reaching EUR 8 million in 2012/2013. The economic and social development sectors attracted the highest amount of social investments (22% of funding), followed by education (14%), research (13%), health (13%), culture & recreation (9%). Non-profit organizations, those without trading revenues, and SEs are the key targets of venture philanthropy. Grants (57%) represent the primary financing instrument for social enterprises, followed by debt instruments (20%) and equity (quasi-equity), reaching 15 % of total investments. More than 57% of venture philanthropy organizations in Europe invest domestically, while only about 9 % invest internationally. The majority of venture philanthropy organizations prefer to exit the investment through sale to management team (28%), followed by sale to other social investors (25%) and sale to corporate or commercial investor (14%). Only 4 % of investments were exited through the public shareholder base.

The Social Business Initiative

The Single Market Act of 2012 included the Social Business Initiative (SBI) -- created under the EU Programme on Social Change and Innovation (2007-2013) -- as an instrument to bolster the social economy and create an enabling environment for SE. The initiative established a financial instrument of EUR 90 million to improve access of social enterprises to EU funding. The initiative also introduced the investment priorities for the period 2014 – 2020 via Regulations of the European Regional Development Fund and the European Social Fund.

The Social Business Initiative contained three main directions in support of social innovation and the social economy in Europe:

- Capital Access
    - The European regulatory framework for social investment is intended to facilitate access to the financial markets for social enterprises. Moreover, social stock exchanges are designed to enable the trading of SE shares while the establishment of EU passport for European social entrepreneurship funds (see below) seeks to incentivize private investment in SE. In addition, structural funds have been reformed to enable member states to direct structural fund financing to SEs. The European Commission developed a comprehensive strategy for support and promotion of these entities via the structural funds through providing guarantees, quasi-equity and loans.

- Visibility
    - The SBI increases the visibility of SEs by developing approaches to evaluate their impact and performance. These activities include the creation of frameworks for the segmentation and development of SE business models. Public and private insertions and conducted landscape analyses of the SE sector to enhance visibility. For example, the European Commission mapped European SE market to identify best practices in public sector intervention in support of SE growth.
- Legal and Regulatory Environment
    - The SBI improves the legal environment for social enterprises, particularly during enterprise formation by conferring SE's legal and fiscal definition through standardized processes. Supportive regulatory frameworks enable and promote hybrid nature of SEs. The initiative creates an enabling fiscal framework for SE to deliver goods and services. National rules on public procurement in particular differ greatly among EU member states. Moreover, state aid rules concerning provision of services of general economic interest should be simplified by applying the minims regulation for social enterprises providing such type of services.

As part of the initiative, the European Commission proposed the establishment of a) the Programme for Employment and Social Innovation (see below) for the programming period 2014-2020 and b) the EuSEF (see below) to develop the EU market for SE financing through the provision of equity, debt and risk-sharing instruments for SEs. In 2013, the European Commission adopted the Social Investment Package which articulated the vision for modernization of welfare states in the context of the economic crisis and longer-term structural challenges. The package emphasized public investment in the development of human and social capital and the role of the private and third sectors in improving the process of socio-economic inclusion.

Main Aspects of the Programme for Employment and Social Innovation 2014 – 2020

Social innovations (SI) encompasses the development of new products, services, models, markets and processes. SI satisfy a social demand and lead to a more efficient use of assets and resources, while also catalyzing the production of social outcomes across economic sectors (non-profit, public and private). SI is included in the Europe 2020 Flagship Initiative, "Innovation Union" and Horizon 2020. In terms of EU intervention, SE is regarded as a source of growth and job creation. The Horizon 2020 SME financial instruments are open to socially innovative enterprises in addition to the existing EU structural and investment Funds.

The **European Programme for Employment and Social Innovation 2014-2020** is a continuation of the EU Programme on Social Change and Innovation for the new programming period. The program identifies SI as a means for solving social challenges and supporting SEs with long term impact. According to the program, the social economy and social entrepreneurship constitute an integral part of the EU social market and play a significant role in achieving greater social convergence across Europe.

The Programme is expected to improve SE access to different types of finance through its EUR 919 million Microfinance and Social Entrepreneurship Axis. The support will encompass development of the social investment market by providing equity, quasi-equity, loan instruments and grants of up to EUR 500,000 available to SEs which meet the following criteria: annual turnover not exceeding EUR 30 million; an annual balance sheet total not exceeding EUR 30 million; the SE must not be part of a collective investment undertaking. The Programme has been established to contribute to the implementation of Europe 2020 targets and is one of the four financial instruments targeting employment and social affairs in the 2014-2020 period.

Main Elements of the European Social Entrepreneurship Funds Regulatory Framework

The new regulatory regime, which established the European Social Entrepreneurship Funds (EuSEF) brand and marketing passport, is expected to contribute to increased investment activity. The heightened market transparency may serve to encourage investors to identify investments and thus allocate greater amounts of capital in SEs. In addition, heightened transparency can help to boost cross-border activity of social investment funds, leading to a more vibrant and competitive social entrepreneurship fund market.

The Regulation on European Social Entrepreneurship Funds (EuSEF) introduces a harmonized set of rules for qualifying social entrepreneurship funds. The regulation permits certain alternative investment fund managers to market their EuSEF throughout EU pursuant to a single passport without opting for full compliance with the Alternative Investment Fund Managers Directive (AIFMD). In case the assets under management of the AIFM of EuSEF exceed the EUR 500 million threshold, they become liable to AIFMD authorization and must comply with AIFMD together with the specific requirements contained in the EuSEFs Regulation.

Funds eligible for the EuSEF designation must invest at least 70 % of their aggregate capital contribution and uncalled committed capital in assets that are qualifying investments**:** equity or quasi-equity instruments, secured or unsecured loans granted to qualifying portfolio undertakings, shares of qualifying portfolio undertakings or units or shares in other EuSEF**.** The qualifying portfolio undertakings by EuSEFs are those enterprises which a) do not trade on a regulated market or multi-trading facility and b) generated measurable positive social impact as a primary objective in accordance with its rules of association. Other key criteria for these qualifying undertakings include (The Social Investment Business, 2012):

-the enterprise should provide services or goods to disadvantaged or excluded people in an entrepreneurial and innovative way;

-the method of production of goods or services should contain social objectives;

-the enterprise should use its profits chiefly to attain its social objective and distribute its profits to shareholders in such a way as not to prevent its primary social objective.

-the activities of the enterprise are managed in a responsible and transparent manner by involving all workers, customers and stakeholders affected by its business activity.

The EuSEF designation is a voluntary regulatory regime for fund managers who choose to market their funds using the EuSEF label. The designation requires the fund to be supervised by the member state in which it is located. The members state must inform the European Securities and Markets Authority (ESMA) of all EuSEFs it has registered under the Regulation. ESMA executes oversight over all registered EuSEFs in cooperation with member state authorities in which the funds are marketed. ESMA maintains a publicly accessible central register of all EuSEF managers in the EU in accordance with the Regulation on EuSEFs.

The qualifying manager of the respective EuSEF should establish procedures and practices to measure the degree to which the qualifying portfolio undertakings in the EuSEF realize positive social impact. This objective is supported by wide transparency requirements. The manager of the EuSEF is obliged to present the investment strategy of the EuSEF and its objectives, including the following: a description of the assets other than qualifying portfolio undertakings; an outline of the risk profile of the EuSEF; valuation of the assets in the portfolio; costs and associated charges; remuneration calculation for the fund manager; and submission of annual reports to the competent authorities in the home member state in accordance with the existing reporting standards. EuSEFs can only be marketed to professional investors under Markets in Financial Instruments Directive (MiFID) who invest a minimum of EUR 100,000 and confirm in writing that they are fully cognizant of the risks involved in these investments. This group of investors includes socially driven entrepreneurs, high network individuals, industry sector experts and angel investors.

The Capital Markets Union (CMU) Action Plan Consultation by the European Commission (European Commission, 2015) led to a review of potential amendments to EuSEF regulations. The main issue under the said consultation encompasses clarification of the established threshold of EUR 500 million for Alternative Investment Funds Managers Directive authorization required for EuSEF participation. Currently, when the managers of EuSEF exceed the EUR 500 million threshold, they must obtain authorization under AIFMD. This requirement may discourage managers from growing their funds and is not likely to promote the growth and development of the social investment industry in Europe. According to the EVCA (2011), 98 % of all EuVCFs manage portfolios under the EUR 500 million threshold. Since implementation of the regulation, 34 EuVCFs have been registered aiming to raise approximately EUR 1.3 billion capital.

The review process also includes an assessment of the minimum investment commitment of EUR 100,000 by individual professional investors. Currently, EuSEFs can be marketed to non-professional investors who are able to subscribe a minimum of EUR 100,000. The eventual reduction of the investment threshold would broaden the investor base and reduce the risks for investors, especially for those with limited experience in social impact investing. Based on these features, the Regulation on EuSEFs may be opened to non-EU originated managers with expertise and skills in establishing and operating social investment funds. A key objective of the CMU is to catalyze the inflow of capital in the EU, which will be facilitated by allowing non – EU managers to invest internationally according to their sector specific specialization.

Conclusion

As EU countries develop new legal and fiscal infrastructure for social enterprise development, policymakers and practitioners must balance traditional forms of civil society with innovative and market based development strategies. An array of EU interventions may serve to create such balance and form an enabling environment for SEs, which includes enabling investors and creating a robust process of intermediation. SE is not a panacea. Instead, SE provides a clearly-defined organizational form through which entrepreneurs can pursue both "profit and purpose" and investors can leverage their investable assets to generate both social and financial returns. Because of SE's social potential, the EU and other government entities are highly incentivized to engage in market intervention in support of SE formation and scale. However, these efforts should avoid market distortion or an over-dependence and non-sustainable reliance on government grantmaking. The success of public sector intervention in support of SEs will not be determined by the scale or scope of SEs themselves – but the scale and scope by which SEs increase social cohesion and foster sustainable economic growth.

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