

## CRITICAL ANALYSIS OF SOCIAL STOCK EXCHANGES AND NON-PROFIT SOCIAL ENTERPRISES

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### KEYWORDS

social stock exchange (SSE), social impact, non-profit social enterprises (NPSEs), Securities and Exchange Board of India (SEBI).

### ABSTRACT

This paper discusses the relevance and significance of social stock exchanges and non-profit social enterprises in the Indian context, particularly regarding Indian laws. Social enterprises are required as an additional factor to improve the social conditions of the underprivileged over and above the government initiatives in that direction. Social enterprises may be for-profit organisations or non-profit organisations. Social enterprises face challenges in raising capital as there will be no returns or muted returns on the contributions made by the investors. The government of India and the Securities and Exchange Board of India took the initiative for the establishment of social stock exchanges to act as a platform for social enterprises to raise capital. The paper examines the evolution of social stock exchanges and the relevant provisions under the securities laws concerning non-profit social enterprises and their listing on SSEs. This paper argues that in the context of securities laws and tax laws, it may be relevant to have a separate mechanism for the dissemination of information to the contributors of such non-profit social enterprises instead of making the social stock exchange as a platform to achieve that objective in the absence of a secondary market for the instruments issued by them.

## 1. INTRODUCTION

### 1. Background

Socialism plays a role in managing the economic resources for the benefit of society. The concept of socialism has undergone a vast change. Still, the underlying principle of having an inclusive society continues to be a part of the concept of socialism as relevant in the present society. In India, these socialist principles were dealt with under directive principles in the Indian Constitution. Article 39 of the Indian Constitution guides the state to ensure the provision of adequate sources for the sustenance of all people regardless of sex. Further, it guides the state to take measures for the equitable distribution of resources to all sections of people. In line with this, the parliament has amended the preamble to add the words socialism in it. Recently, the Supreme Court dismissed the petitions seeking to delete the word 'socialism' from the preamble of the Indian Constitution, considering changed circumstances. In the matter of "Dr Balram Singh and Others vs Union of India and another" the Supreme Court observed that:

*"'socialist' denotes the State's commitment to be a welfare State and its commitment to ensuring equality of opportunity. India has consistently embraced a mixed economy model, where the private sector has flourished, expanded, and grown over the years, contributing significantly to the upliftment of marginalized and underprivileged sections in different ways. In the Indian*

*framework, socialism embodies the principle of economic and social justice, wherein the State ensures that no citizen is disadvantaged due to economic or social circumstances. The word 'socialism' reflects the goal of economic and social upliftment"*

The role of social enterprises is essential in improving the financial and social conditions of the underprivileged and providing welfare measures to them. The government's initiatives, supported by social enterprise activities, will create an inclusive society. Further, similar initiatives by social enterprises are required to improve the environmental conditions for healthy living.

Social enterprises are usually organized as trusts, societies, or companies. If social enterprises are companies, they may be for-profit or non-profit. If they are trusts, they may be private trusts or public charitable trusts, depending on the jurisdiction.

Social enterprises find it challenging to raise capital since they operate based on no returns or lesser returns to the contributors. Contributing capital to such social enterprises is out of their interest in participating in welfare activities to improve the financial and social conditions of the underprivileged and further the interests of society at large by improving environmental conditions.

Alternative investment funds are set up with the twin objective of serving social causes by contributing capital to social ventures and giving muted returns to investors. Thus, they intend to achieve social goals and moderate business returns. However, the same alone is insufficient to address the problem of shortage of capital formation, particularly for the non-profit organisation, which would not be able to meet the expectation of such alternative investment funds about lesser returns which they promise to their contributors.

Social stock exchanges (SSEs) exist in the United Kingdom, Canada, Singapore, and Kenya to enable social ventures to raise capital. Their workings and successes or failures in achieving the objectives are available.

The Securities and Exchange Board of India (SEBI) drove the government initiative to establish and regulate SSEs. By bringing the equity market closer, SEBI facilitates the fund flow for social welfare causes such as health, education, and the environment, which are part of the Sustainable Development Goals to provide inclusive growth.

SEBI has developed a framework for registering social enterprises (SSEs) and listing their securities. Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) were granted registration as SSEs.

However, as the progress of the said SSEs demonstrates, the government and SEBI's initiative to establish SSEs has yet to yield the desired results for several reasons, including legal and tax considerations.

This paper aims to study the evolution of establishing SSEs in India and the legal framework, focusing more on permitting non-profit social enterprises (NPSEs) to raise capital through SSEs. The paper also briefly discusses the impediments to developing the market for NPSE securities.

## 2. Literature Review

Sanjana S (2019) interpreted the data collected in an online survey and observed that 10% of the social enterprises in the study were aware of SSEs, and 86% were unaware of them. She felt that in India, several social enterprises operate as non-profit organisations to avail themselves of tax exemptions and subsidies to carry out their activities. She argued that listing under SSE should not result in a loss of tax-exempt status, and the Government must lay down guidelines, rules, and regulations to enable the same.

Modiyani Richa and Kazi Faroz (2022) in their paper titled "Role of The Social Stock Exchange In Indian Context," they observed that though the steps taken to create SSEs were promising, the requirement for SSEs to reach the goal is to have minimum regulatory

requirements for taking on board social enterprises and also for reporting and functioning of such social enterprises. They suggest providing benefits to the investors through tax incentives to facilitate fund infusion into social enterprises, as it would ultimately benefit the people who deserve such welfare measures.

Dr. Rajesh Sadwani et al. (2023) observed that the SSEs in India allow both non-profit organisations and for-profit organisations to list on the exchanges. They further observed that the SSEs face challenges in becoming successful platforms as major SSEs globally failed to achieve the objective of investor participation. They further felt that it would be a challenge to identify the set parameters for classifying social enterprise and assessing social impact. They also pointed out some other challenges that, inter-alia, include increased surveillance and financial scrutiny, transaction cost, providing for various financial instruments, tax benefits, etc.

Dr. Pragathi Mehra and Dr. Madhu Vij (2023), studied and analysed the situation of SSEs in many countries. Their study revealed that most SSEs were active for a few years and could not continue beyond that. They observed that though the public information providing the reasons for the failure of such SSEs is not available, it only indicates that the SSEs are in an early stage and need to evolve. They suggest that tax benefits should be extended to the non-profit organisations registered with SSE, regardless of their listing.

### 3. Research Methodology

This Research is descriptive and brief about the social stock exchange based on secondary data. The relevant data is collected from published research articles, journals, websites, and reports. The reports of SEBI's working and technical groups are also used to point out the limitations of non-profit organisations, particularly trusts, which do not fall within the definition of alternative investment funds required to be registered with SEBI.

## 2. EVOLUTION OF SSE IN INDIA

### 1. Background of Evolution of SSEs in India

In India, the government proposed establishing SSEs in 2019 to enable social ventures to raise capital to improve social and climate conditions.

Securities and Exchange Board of India (SEBI), a statutory body under the Securities and Exchange Board of India Act, 1992 (SEBI Act), was the securities market regulator and regulated the stock exchanges under the powers vested under the Securities Contracts (Regulation) Act of 1956. (SCRA)

SEBI constituted a working group on 'Social Stock Exchanges' (SSE) under the Chairmanship of Shri Ishaat Hussain on September 19, 2019 (Working Committee). The Working Committee studied various existing models of SSEs. It made several observations on the requirements for SSEs and social enterprises proposed to be registered or listed on the SSEs and submitted its report, which was released on June 01, 2020. The Working Committee identified the legal issues and tax-related issues that are required to be addressed by the government and SEBI for the effective achievement of the objectives in setting up the SSEs and facilitating the social enterprises to raise capital using the SSEs as a platform. It also suggested measures required for timely disclosures of performance and other disclosures transparently to build investor confidence.

The Working Committee recommendations were intended to support the flow of funds, facilitate fundraising structures, expand the range of available instruments, and provide robust social impact standards and financial reporting.

The Working Committee suggested zero coupon zero principal bonds (ZCZP Bonds) for NPSEs as the donors, philanthropic foundations, and CSR spenders, desirous of making a social impact without any interest in financial returns, as they would prefer that structure. To

increase the credibility of social enterprises in the eyes of such investors, disclosures about the impact of spending by social enterprises whose instruments are listed on the SSE have been recommended so that investors will be aware of the outcome.

However, this paper deals with only the relevant observations and recommendations relating to the legal and tax aspects of the ZCZP Bonds issued by NPSEs.

While recommending ZCZP Bonds as instruments for NPSEs established as trusts and societies, the Working Committee felt that since such entities are not body corporates under the Companies Act, 2013, in the present legal framework, bonds issued by them cannot qualify as securities under the Securities Contracts (Regulation) Act 1956 (SCRA). Therefore, the Working Committee recommended notifying the ZCZP Bonds issued by NPSEs as security under SCRA.

Regarding the tax aspect, the Working Committee report observed that tax policy is critical for the success of SSE. It has recommended that the following tax incentives be considered to foster the NPSEs to raise capital:

- (i) exemption of 100% tax on donations to all NPSEs that benefit from the SSE;
- (ii) allow all investments in securities/ instruments of NPSEs listed on SSE to be tax deductible;
- (iii) allow CSR expenditure of corporates that goes to the SSE tax deductible from their taxable income;
- (iv) remove the 10% cap on income under section 80G of the IT Act for claiming deduction under 80G;
- (v) allow 100% tax exemption for first-time retail investors on their investments in the SSE MF structure, subject to an overall limit of INR 1 lakh.

The technical committee appointed by SEBI also recommended that the necessary amendments be made to include ZCZP Bonds in the definition of Securities under SCRA.

The technical committee also recommended amending the regulations governing social venture AIFs to prohibit them from accepting and working on 100% grants with only social returns, as contributors expect no return of capital but only intend the social return. It has also suggested changing the name of social venture funds to “social impact funds” to explicitly cover the intent of such funds.

The technical committee endorsed the views on the proposals of the Working Committee and recommended extending such incentives.

Basis the recommendations of the Working Committee and technical committee, SEBI has made appropriate amendments to the relevant regulations to facilitate the establishment of SSEs.

### **3. ANALYSIS OF RELEVANT PROVISIONS UNDER SECURITIES LAWS**

Examining the provisions of the SCRA is relevant in understanding the reasons for the Working Committee and technical committee recommendations to amend the definition of securities under the SCRA to include the ZCZP Bonds issued by NPSEs.

The objective of SCRA is to restrict undesirable transactions in securities in the securities market. SCRA envisaged the concept of recognition and the regulation of stock exchanges with the intent that they act as the first-level regulator of the securities market. As a statutory body under the SEBI Act, SEBI became the securities market's regulator and was also entrusted with regulating the stock exchanges.

The definition of securities under SCRA is inclusive. It includes marketable securities issued by a body corporate, among other things. The courts interpreted the word ‘marketable’ as capable of being sold in the stock market.

ZCZP Bonds issued by the NPSEs will not fall under the above definition of securities. The units of pooled investment vehicles as securities were included in the definition of securities in SCRA in 2021. However, there is an ambiguity there as the pooled investment vehicle definition appears to cover only such investment vehicles that pool the investors' funds for

making investments under the regulations made by SEBI. The ejusdem generis rule may imply that such funds shall be like collective investment schemes, mutual funds, or AIFs. This view is further fortified by the specific provision under SCRA, which, while permitting the pooled investment vehicles to borrow or issue debt securities, states that the trust assets shall be distributed to the investors after paying debts. This condition cannot be complied with by NPSEs as no distribution to investors is contemplated to the investors on ZCZP issued by NPSEs at any stage.

To provide clarity, the ZCZP Bonds issued by NPSEs ought to have been explicitly defined as securities instead of leaving the arena to the judiciary to make some purposive interpretation in the context of the social objective intended to achieve, as such bonds cannot be strictly construed as debt securities in the absence of return of at least the principal amount.

SEBI amended the Securities and Exchange Board of India (Investor Capital and Disclosure) Regulations, 2018 (ICDR Regulations), in 2022, introducing chapter X-A, which dealt with registering and listing social enterprises on SSEs.

ICDR Regulations apply to NPSEs that are only registered with SSEs or that are registered with SSEs and raise funds on their platforms. They also apply to for-profit social enterprises.

The ICDR Regulations confine the definition of for-profit social enterprises to a company or a body corporate but do not include a section 8 company incorporated under the Companies Act, 2013. In contrast, the definition of NPSE is broad enough to include charitable trusts registered as public trusts under any statute or registered under the Indian Trust, 1882, a charitable society registered under the Society Registration Act, 1860, a section 8 company incorporated under the Companies Act, 2013.

The ICDR Regulations provided eligibility conditions for identification as social enterprises, which include a broad spectrum of activities that have a social impact. They also provided for other conditions, such as spending 67% of the three-year average revenue on social activities to benefit the target population.

The ICDR Regulations initially permitted only institutional and non-institutional investors to access the SSE. However, in 2023, they were amended to allow retail investors to access the SSEs.

The ICDR Regulations allowed the NPSEs to issue ZCZP Bonds for a specific tenure and to list them on SSEs.

It is observed from the final fundraising documents of 'SGBS UNNATI FOUNDATION' and 'SWAMI VIVEKANANDA YOUTH MOVEMENT' available on the websites of SSEs that it was made clear in the said documents, as a risk factor, that ZCZP Bonds issued by NPSEs and listed on the SSEs are not available for trading in the secondary market and that an investor will not be able to trade such ZCZP Bonds or redeem their investments in such ZCZP Bonds.

It is evident that the SSE platform provided to NPSEs that issue ZCZP Bonds to raise funds only facilitates disseminating information about such entities' activities to investors about how the funds are used and the social impact they create. The object appears to build credibility for the NPSEs in the investors' minds, contributing to the social cause.

Securities Contracts (Regulation) Rules 1957 (SCRR) prescribed certain minimum requirements for the public offer of securities, such as a minimum public shareholding. The ICDR Regulations provide that NPSEs issuing ZCZP Bonds are deemed to have complied with the provisions of rule 19 of the SCRR. However, a reading of rule 19 of SCRR indicates that the rule applies to public issues of equity or securities convertible into public companies, providing minimum public shareholding to facilitate liquidity for public shareholders on the secondary market on the stock exchange platform.

In terms of the recommendations of the Working Committee in its report, SEBI amended the Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012 (AIF Regulations) and incorporated the concept of social enterprise, social stock exchange, social



units, social venture, and social impact fund and deleted the definition of social venture funds. They also provide that 75% of the investible funds of social impact funds should be invested in the unlisted securities or partnership interests of a social venture, units of social ventures, or securities of social enterprises. The AIF Regulations also provide that such funds can accept grants subject to a minimum contribution of INR 10,00,000/- (Rupees Ten lakhs only) and that no profit should be given to such grantor.

In the case of social impact funds, if there is a change in the manager or sponsor or change in control of such manager or sponsor, there is a requirement for obtaining the consent of the investors and to provide an exit to the dissenting investor under the SEBI AF Regulations and the guidelines issued thereunder. However, there is no such requirement applicable to the NPSEs, which are established as charitable trusts or societies, though the ZCZP Bonds issued by NPSEs are listed on the SSE since such entities do not fall under the definition of target company under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011 (Takeover Regulations).

#### 4. CONCLUSIONS AND SUGGESTIONS

The objective of SCRA is to prevent undesirable transactions in securities. The Working Committee and the technical committee reports show that tax incentives for investments in NPSEs listed in the SSEs are needed. In such cases, a listing mechanism on the stock exchanges, which are securities market regulators, is also required.

Secondary market acquisition of the ZCZP Bonds may not be attractive to investors without any tax benefits, and the returns are only the social impact their contribution has made. It is observed from the data available on the National Stock Exchange (NSE) website that as of August 20, 2024, 10 social enterprises have raised public issues. At least two NPSEs have mentioned in the fundraising documents that there is secondary market trading in the ZCZP Bonds proposed to be issued by them. Any philanthropic investors would prefer to give a grant to such entities directly to avail the tax benefits and, at the same time, contribute to social causes.

It is not clear as to whether, if the ZCZP Bonds acquired in the secondary market are treated as capital assets in the books of the investor and at the time of redemption since no return will be provided, whether the same can be claimed as capital loss offset against any capital gain earned by such investor from sale of some other assets. If it is made as a primary investment in ZCZBs, since the tax exemption is being provided, the benefit of the capital loss is not provided. However, in the absence of such tax exemption for investors in the secondary market, there is an ambiguity as to the treatment of the same at the time of redemption, and social impact is the return. The government may not consider extending tax benefits for investors acquiring in the secondary market as it would result in leakage. Further, if such tax benefits are provided, there would be an artificial market in the secondary market. The investors may avail of the tax benefits and resort to trading in the said ZCZBs. It results in undesirable speculative transactions in ZCZBs, resulting in tax evasion contrary to the objective of SCRA.

The structure envisaged in the Working Committee may work for social enterprises, providing muted returns. Still, it may not work in India, as their muted response to listing on the social stock exchange indicates.

Instead of an attempt to create a market for the units of the NPSEs, which further involves the issue expenses, including the merchant banker fees, legal advisors, and other advisor costs at the time of the initial public offer of ZCZB Bonds and subsequent transaction costs, the government ought to have provided a separate mechanism for such NPSEs by way of transparent disclosures to the contributors as contemplated in the existing structure.

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