a guide to

Community Capital

www.bealocalist.org

Table of Contents

The Need for Community Capital 2
What is Community Capital? 2
Our Definition 2
The Longer Version 2
What's in this Guide? 3
Sources of Capital 4
Individuals 4
Donor-Advised Funds 4
Foundations 5
Banks 5
Credit Unions 6
Community Development Financial Institutions (CDFIs) 6
Angel Investors and Venture Capital 7
Government 7
Community Capital Tools 8
Grants = A gift (usually with some strings) 8
Equity = A stake in the ownership 8
Debt = Borrowing money (often with interest) 9
Secured vs. Unsecured Debt 9
Bonds 9
Hybrid & Non-Traditional Investments 11
Investment Offerings and Community Capital Platforms 13
Direct Public Offerings and Private Placements 13
Direct Public Offerings (DPOs) 13
Private Placements 14
Community Capital Platforms & Mechanisms 14
Investment Clubs 14
Local Investment Opportunities Networks (LIONs) 14
Impact or Targeted Certificates of Deposit (CDs) 15
Local Exchanges 15
Crowdfunding 16
Partnership Lending 17
Lending Circles 17
Peer-to-Peer Lending 17
Individual Retirement Accounts (IRAs) 17
Pooled Investment Notes 18
Ok, so what's next? 18
Glossary of Terms 19

The Need for Community Capital

Business owners and social entrepreneurs in many communities struggle to access the funds they need to launch or expand their businesses and initiatives. At the same time, most of our financial investments go to unfamiliar, opaque investments in far way places and have impacts from which we are disconnected. It doesn't have to be this way. Innovators across North America are creating ways of re-directing financial resources to businesses and organizations that are serving the communities in which they are located by providing needed goods and services, creating high-quality jobs, restoring the environment and enabling prosperity for all through the development of local living economies.

What is Community Capital?

Our Definition

Community capital harnesses the financial wealth that exists within a region to support local, community-serving businesses and organizations, and keeps this wealth re-circulating for the benefit of the whole community.

The Longer Version

BALLE aims to build communities that are healthy, sustainable and equitable – backed by local economies that are strong and resilient. This means using regional resources to meet our needs, and reconnecting eaters with farmers, investors with entrepreneurs, and business owners with the communities and natural places on which they depend.

The dominant financial system is not working. Global capital markets are draining, not building up, the health of our communities. The current system is based on perpetual growth, concentration of power and wealth, and externalized costs; without acknowledging the risks associated with global threats like climate change, natural resource depletion, and inequality.

To restore our communities, we must re-shape the ways in which financial capital flows through our local economies – tapping into the wealth that we have, directing regional resources towards community-serving businesses and organizations that create real, long-term value and re-circulating this wealth for the benefit of the whole community. We focus on financial capital in this guide, but recognize that there are many kinds of wealth in communities, and financial capital is just one of many resources that we must harness to build and support sustainable local and regional economies.[1]

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[1] There are many resources on non-financial capital in our communities. One popular resource is: "The Sharing Solution: How to Save Money, Simplify Your Life & Build Community", by Janelle Orsi and Emily Doskow: www.sharingsolution.com.

Community capital can take many forms. We're interested in the continuum of capital needed for thriving local economies – what we call "integrated capital" which includes gifts, grants, loans, equity, credit enhancement, pre-sales, and other forms of exchanging value to support local businesses and organizations. Examples include:

- A local dairy farmer who receives financing for expansion through the pre-sales of cheese and yogurt
- Lending circles where community members lend each other money to build credit and grow businesses
- A community foundation that supports the ability of a local bank to provide loans to local businesses that wouldn't otherwise qualify by providing a loan loss reserve fund
- Customer purchases of ownership stakes in their favorite local restaurant or farm
- Individual investors or investment funds that re-direct their portfolios to build a regional food distribution system through grants, loans, and equity investments
- A community development financial institution (CDFI) that uses Community Reinvestment Act (CRA) funds to make loans to start-up entrepreneurs in an under-served region
- Member equity shares in a grass-fed cattle producers' cooperative used to fund collective processing and distribution activities

In some cases, community capital initiatives may be designed to complement traditional capital sources by filling in critical financing gaps. In other cases, community capital may be used to reduce or eliminate our reliance on a financial system characterized by opaque and impersonal transactions, by offering tools that enable transparent investments based on long-term relationships and a shared vision of the economic and social transformation we want to see.

We don't have to reinvent the wheel again and again – instead, we can share and evolve ideas together and scale those that are most promising. More information and resources will be added regularly to our website: https://bealocalist.org.

What's in this Guide?

There is a tremendous amount of innovation occurring around community capital right now. This guide is designed to provide an introduction to the ideas and language of community capital, and to pique your interest in learning more by providing descriptions of existing tools with brief examples from communities across North America. This guide provides a high-level primer and a map for readers to connect to a range of resources to learn more. It is divided into four parts:

- Sources of Financial Capital – Overview of capital sources and potential partners that may exist in your community.
- Tools for Deploying Capital –The tools that entrepreneurs and innovators are using to tap into community capital.

- Investment Offerings and Community Capital Platforms – Options for structuring investments, with a review of some of the existing innovative platforms and mechanisms.
- Glossary of Financial Terms – Simple definitions for financial terms.

Sources of Capital

There are many sources of financial capital available within a region, and these will vary significantly by country, state/province and locality. We describe several sources of capital in this section, but local experts and financial organizations can likely direct you to many more.[2]

Individuals

Individuals in your region are an important source of capital and support for local businesses and organizations. Individuals can make donations, provide loans, purchase ownership stakes in businesses become cooperative owner-members, pre-buy goods and services, and contribute in other ways. Right now, most people have their assets in the traditional global financial system, and have very little knowledge about the positive or negative impacts of their investments or the options for re-investing their money locally – these savings and investments are a huge and largely untapped source of capital for re-building our communities.

In most countries there are laws that restrict individuals from making some types of investments (created in response to scandals where people of modest means lost much of their wealth in bad investments). For some types of investments only accredited investors can participate. Accredited investors include individuals with a certain level of financial wealth; e.g. over $1 million in assets or significant annual income.[3] Individuals below this threshold are called unaccredited investors. Just one percent of Americans are accredited investors, and many local investment opportunities are limited to these few individuals.

Donor-Advised Funds

Donor-advised funds allow donors (usually wealthy individuals or businesses) to establish an account with a "charitable sponsor" (often a community foundation or other philanthropic entity) by making irrevocable, tax-deductible contributions to the charitable sponsor. Donors then recommend grants from those funds to give to charitable activities (although the charitable sponsor has ultimate decision-making authority).

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[2] For an example of an excellent statewide resource that outlines sources of capital, financing tools and potential partners, see the Access to Capital guide of the California Financial Opportunities Roundtable: http://www.rurdev.usda.gov/Reports/CA-CalFOR.pdf
[3] For the U.S. definition of accredited investor see: http://www.sec.gov/answers/accred.htm

More information on donor-advised funds:

- National Philanthropic Fund's Annual Donor-Advised Fund Report: http://www.nptrust.org/
- Tides Canada's overview on creating a donor-advised fund: http://tidescanada.org/create-a-donor-advised-fund/

Foundations

Philanthropic organizations are a common source of grant funding. Community foundations are philanthropic institutions that serve a geographically defined region. Other foundations may also have a regional focus for part of their portfolios. In additional to offering grants, which do not require repayment, many foundations are exploring ways to invest their capital in other ways, including as loans or equity in mission-aligned businesses and organizations. These investments are called program-related investments (PRIs) when they primarily serve a charitable purpose and are treated similar to grants for tax purposes, and mission-related investments (MRIs) when they are expected to have a return and must meet investment standards that apply to the foundation's other income-generating investments.

More information on PRIs and MRIs:

- Mission Investors Exchange PRI Report, "Strategies to Maximize Your Philanthropic Capital: A Guide to Program Related Investments": http://is.gd/yybSqJ
- Philanthropy Journal article, "Unscrambling MRIs and PRIs: http://is.gd/hirH28

Banks

Banks take in capital from investors and account holders (depositors) and loan funds out to businesses, organizations and individuals. Banks are subject to federal and state lending guidelines that have become more restrictive in the U.S. since the 2008 recession. Banks are more likely to lend to businesses and organizations with long track records of success and/or valuable assets (these assets are often referred to as "collateral", which the bank could take if the borrower is unable to repay the loan). Many small businesses have a difficult time securing traditional bank financing, particularly those businesses without collateral. There are global, national, and regional/local banks – and while all are potential sources of capital, we've found that small and mid-sized banks, which typically have a local or regional lending focus, tend to be more interested in taking the time to understand and lend to local businesses and organizations. While these small and mid-sized banks hold just 22 percent of U.S. bank assets, they make 54 percent of small business loans.

More information local and mission-driven banks:

- The Institute for Self-Reliance's article, "Why Small Banks Make More Small Business Loans": http://www.ilsr.org/banks-and-small-business-lending/
- One Pacific Coast Bank: http://www.onepacificcoastbank.com/
- Triodos Bank: http://www.triodos.com/en/about-triodos-bank/

In the U.S. the **Community Reinvestment Act** (CRA) requires banks and other financial institutions to direct capital towards activities they might not otherwise prioritize in low- and moderate-income communities, including: housing and revitalization and economic development by providing financing to low-to-moderate income households, small businesses or farms.[4] Monies to satisfy banks' CRA requirements may be available in the form of tax credit investments in economic development projects, grant capital and/or loans at lower than market-rate through the banks themselves or through intermediaries that they designate (these designees are typically Community Development Financial Institutions, described below).

More information on loan, grant and equity capital that may be available from banks to satisfy their Community Reinvestment Act requirements:

- Federal Reserve Bank of San Francisco's "CRA Investment Handbook": http://www.frbsf.org/community-development/files/CRAHandbook.pdf

Credit Unions

Credit unions are member-owned cooperative financial institutions. They have many of the same offerings as banks, such as checking accounts and loans. However, credit unions are owned and controlled by their members (who are also their depositors and borrowers). They often offer lower rates and fees, more broadly accessible products and tend to be more responsive to local community needs. Many are not-for-profit and, in addition to their primary mission of serving their members, pursue broader goals such as community development and environmental sustainability.

There are a range of innovative credit unions across North America. A couple examples:

- Vancity (Vancouver City Savings Credit Union) in Vancouver, BC: https://www.vancity.com/
- Alternatives Federal Credit Union in Ithaca, NY: www.alternatives.org/

Community Development Financial Institutions (CDFIs)

Community development financial institutions (CDFIs) are financial institutions in the U.S. that fill in gaps left by traditional lenders, offering services and products in neighborhoods or to customers that other financial institutions have typically been unable or unwilling to serve. Some of what CDFIs offer can include: lending to non-profit housing developers, mortgage financing for low-income and first-time homebuyers, flexible loan underwriting for small businesses and community facilities, and investments in start-up or expanding businesses (often coupled with technical assistance). The CDFI designation can be given to a range of for-profit and not-for-profit financial institutions such as regulated community development banks and credit unions, and non-regulated entities such as non-profit loan funds or community development corporations.

[4] CRA requires financial institutions to lend to low- and moderate-income households and small businesses & communities ("the lending test") and to make community development investments—typically equity or grants—in these communities ("the investment test"), among other requirements.

More information on CDFIs:

- Opportunity Finance Network, a national network of CDFIs: http://opportunityfinance.net
- The CDFI Coalition's website: www.cdfi.org
- The Reinvestment Fund, an innovative Philadelphia, PA-based CDFI[5]: www.trfund.com

Angel Investors and Venture Capital

Angel Investors and Venture Capital firms invest in early stage companies that they typically anticipate will grow quickly and have the potential to yield a large financial return through the sale of the company. These early stage companies often involve significant risk of failure, but those that are successful return large financial profits to these early investors.

Venture capitalists are professional investors who invest others' money, often funds from wealthy individuals or institutional investors (investors that pool money from multiple investors such as pension funds), and usually are actively involved in driving business decisions in these ventures by helping to build the management team, sitting on the board, etc. Many venture capital models align poorly with our vision for community capital because investors may look only at the financial bottom-line and expect fast rates of growth, often forcing business owners to take a myopic and short-term approach to rapidly scale and increase profits, sacrificing other core elements of their missions like community benefit, living wages for their employees, and environmental stewardship. In addition, these investors typically look for "rapid exits" from their investments, often by forcing the sale of a successful business after just a few years, which threatens local ownership.

Angel investors are wealthy individuals investing their own money in start-up companies. Some operate solo while others organize themselves to find deals together, such as through Investors Circle, which coordinates mission-driven angel investors.

There are a range of mission-driven VCs and angel investors. A few examples:

- Investors Circle, a non-profit network of angel investors.
- CalCEF, a family of California non-profits that includes a venture fund targeting the acceleration of clean energy technology development and deployment.

Government

Federal, state/provincial, and local governments often provide support to local businesses and organizations through grants, loans, loan guarantees and by other means. Governments are also able to issue tax-exempt bonds (discussed below) for a range of activities. The options vary by location, and many funds are made available as competitive grants with defined criteria.

[5] A BALLE "Accelerating Community Capital" Webinar on The Reinvestment Fund is available here: https://bealocalist.org/july-2011-community-capital-webinar-recording

In the U.S., some federal agencies that offer funding include the U.S. Department of Agriculture (USDA) and the Small Business Administration (SBA).

You can learn more about the options available in your community by starting conversations with local financial institutions, economic development organizations, and staff at state and local government agencies.

Community Capital Tools

Enabling regional capital sources to meet local needs and opportunities often necessitates a creative spin on traditional capital-raising strategies. This creativity is required to both meet the unique needs of local investors and entrepreneurs, and to comply with government financial regulations. Before we explore the range of community capital tools, we review the investment tools that are deployed in the “traditional” financial system.

There are three primary types of traditional capital investment tools: 1) grants, 2) equity, and 3) debt. Each of these tools comes in a variety of forms, has different financial risks and returns, and may be appropriate for different investors, innovators, and entrepreneurs – and at different stages of a company or project’s life. In many cases, a blend of all three of these investment classes can be harnessed to fund a project in a way that meets the unique needs of investors, businesses, and the community. We also describe several adaptations of these tools as hybrid investments, which share characteristics of grants, equity and/or debt.

Grants = A gift (usually with some strings)

Grants (aka gifts or donations) are sources of capital that usually fund a defined set of work or activities and do not have to be repaid. Grants fund important community initiatives and can help lower the cost of starting and running a project. Grant monies come from a range of entities including individuals, governments, and philanthropic organizations such as community foundations. The volume of grant monies available is limited and grants are often highly competitive. More information on grants is available from the Foundation Center: http://foundationcenter.org/

Equity = A stake in the ownership

Equity investments are purchases of an ownership share in a project or business. Unlike debt, which must be paid back (often with interest), equity investments have no repayment timeline. Instead, they entitle investors to partial (or full) ownership of a venture. In some cases, equity investments are set up to pay all or a portion of profits to investors in the form of dividends (usually cash payments). In other cases, equity investors simply benefit over time from the increase in a company’s financial value (realized when the company is sold or the investor sells her shares), or from the business’s delivery of a range of non-financial benefits.

The most common form of equity investment is common stock. Each “share” of common stock entitles its holder to a portion of the ownership of a company, and a dividend payment (if applicable), and typically includes a vote in decision making at “shareholder meetings”. For many entrepreneurs and innovators, seeking equity investments from values-aligned stakeholders in their local community is preferable to the impersonal world of venture capital.

Another form of equity is member equity in certain types of cooperatives. Cooperatives are organizations through which members are also the owners and organizational decision makers. For more information on cooperatives, visit: http://www.ncba.coop/

Debt = Borrowing money (often with interest)

Debt investments entail the lending of money to a project or business. Unlike equity, debt must be paid back (often with interest) and typically has a pre-specified payment schedule and interest rate. A debt investor is not given any ownership in the business or project, has no voting rights, and is not entitled to dividends. Debt is “more secure” than equity – in the event that a company or project fails, the remaining funds or assets (if any) go to debt investors before equity investors / owners get a penny.

Secured vs. Unsecured Debt

The underlying “security” of debt (i.e. a lender’s ability to recover their capital from a borrower in the event the borrower is unwilling or unable to pay) can be set up in many ways to meet the needs of lenders and borrowers, but loans are broadly characterized as “secured” or “unsecured”. Secured debt is a loan for which a borrower pledges a specific asset or assets as collateral (often specific property) against the loan. To the extent the borrower is unable or unwilling to repay the loan the lender can take possession of those assets. An unsecured loan, on the other hand, has no assets pledged against it. Because unsecured loans are considered riskier than secured loans, they often have higher interest rates and shorter repayment lengths, or are available only to borrowers with good credit (i.e. a history of reliable debt repayment).

Bonds

All debt is a form of loan. Bonds are popular loan structures that enable lenders/investors to take a fractional share in a loan, which can help small investors to participate in larger financings and large investors to diversify their risk across many loans. Bonds can usually be sold to other investors with relatively low transaction costs (i.e. they are liquid = easy to buy and sell). These characteristics typically result in more attractive (to the borrower) rates and terms, but must be balanced against the higher costs of issuing bonds relative to standard loans.

Debt Credit Enhancement

Credit enhancements reduce investor risk and can allow borrowers to get better loan terms or qualify for a loan when they wouldn't otherwise. Philanthropic or government capital is often deployed as "credit enhancement" to improve the terms of or expand access to debt. Common credit enhancements include:

- **Loan Loss Reserves (LLRs)**. LLRs are a pool of monies that, in the event of loan nonpayment (default), lenders may use to recover all or a portion of that loss. LLRs typically sit in a bank account until they are needed. They are commonly used to support pools of small loans and the "protection" offered to investors is usually capped at a percentage of an overall loan pool, i.e. for 10% LLR, lenders can collect up to 10% of the amount they invested should they experience substantial losses.[6] Slow Money Northwest raised grant monies from local stakeholders for a 20% LLR to support the Farmer Reserve Fund, a microloan program offered through North Coast Credit Union for beginning farmers and food businesses.[7]

- **Loan Guarantees.** Loan guarantees are similar to LLRs – a third party "guarantees" loan repayment to the lender in the case that the borrower fails to make payment. They typically cover 100% of a loan or loan pool and are not typically "capped" at a maximum payout amount (though they can be).

- **Subordinated Debt.** Rather than sit in a bank account like an LLR, subordinated debt is actually used to fund a portion of loans or loan pools with "senior" debt investors. In the event that there are loan defaults, senior debt investors recover 100% of their investment before the subordinated debt investors recover any of their investment. One benefit of subordinated capital is that because it funds part of a loan or loan pool, it typically earns interest. This interest rate can be set such that it partially or fully offsets anticipated customer default rates and makes the credit enhancement "evergreen," i.e. customer principal and interest payments fully offset losses expected due to customer defaults. This is fundamentally different from LLRs, where monies sit in an escrow account earning de minimus interest and are typically depleted as loan defaults occur.

- **Debt Service Reserves (DSRs)**. Debt service reserves provide credit enhancement by protecting lenders from short-term fluctuations in a borrower's ability to make debt repayments. Short-term cash flow constraints are common among small businesses, particularly in industries like agriculture, where most revenues come in a single season but loan payments are due year-round. DSRs can allow farmers to make seasonal debt repayments that align with their revenue streams.

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[6] For example, a 10% LLR of $100,000 could support a $1,000,000 loan pool. Lenders could use the LLR to cover losses and if the loan pool lost more than $100,000, the additional losses would be borne by the lender.
[7] A BALLE "Accelerating Community Capital" Webinar on the Farmer Reserve Fund is available here: https://bealocalist.org/february-2013-community-capital-webinar-recording

Hybrid & Non-Traditional Investments

There are also several hybrid and non-traditional investment vehicles that share characteristics of both traditional debt and equity:

- **Convertible Debt.** With traditional debt, a lender receives its loan principal back by the end of a loan period. With convertible debt, a lender typically has the option of receiving either its loan principal or a pre-negotiated number of ownership shares in a company. If the company's value has increased substantially since the loan was made, the lender will typically opt for equity. There is room for flexibility around what an investor might opt to receive in lieu of cash at the end of a loan's term.

- **Preferred Stock.** With traditional stock, a shareholder receives an ownership stake in a company that entitles them both to vote on company matters and to receive financial benefits in the form of stock value increases and/or dividend payments. Preferred stock, on the other hand, more closely resembles debt – holders are typically not entitled to vote on company matters and are often entitled to a fixed dividend, not a share of company profits.[8] Preferred stock is typically "senior" to common stock (i.e. it collects before common stock in the event of the company going out of business), but is "subordinated" to debt

- **Pre-Sales.** Pre-sales involve the "forward sale" of goods or services and are neither debt nor equity. By pre-selling products, a business can raise up-front capital without giving up ownership rights or owing money to lenders (they just "owe" products or services). For example, Credibles enables local food businesses to raise money through customer pre-payments that entitle the buyers to purchase products from the business.[9] Whether a pre-sale is treated as a "security", which can trigger financial regulatory compliance, depends on a state's securities laws and whether pre-sales are used to fund an existing or new business.[10] Claire's Restaurant and Bar, in Hardwick, VT, used "community-supported restaurant subscriptions" to raise $50,000 that helped launch the restaurant.[11]

- **Royalty Financing.**[12] Equity financing requires businesses to give up a portion of company ownership, and some companies lack sufficient assets or credit history to gain access to attractive debt or don't want to be saddled with an obligation to repay debt. Royalty financing is a hybrid through which investors earn a pre-arranged percentage of a business's revenues

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[8] Preferred stock is a very flexible instrument – its terms (e.g. dividend rate, redemption policies) and the rights of preferred shareholders (e.g. voting rights), can be defined by businesses to meet their goals and needs.

[9] A BALLE "Accelerating Community Capital" Webinar on Credibles is available here: http://bealocalist.org/march-2013-community-capital-webinar-recording

[10] Broadly construed, a security is a financial instrument that represents some type of financial value and implies some type of risk or opportunity for financial gain to the holder of the financial instrument. Because new businesses are generally considered riskier than existing businesses, using pre-sales to fund an existing business poses less risk that a pre-sale would be treated as a security.

[11] A BALLE "Accelerating Community Capital" Webinar on Claire's Restaurant and Bar is available here: https://bealocalist.org/March-2012-Community-Capital-Webinar-Recording

[12] For more details on royalty financing, visit "Comparing Royalty Financing to Debt and Equity Financing" by Marco Vangelisti from Slow Money Northern California, http://slowmoneynocal.org/comparing-royalty-financing-to-debt-and-equity-financing.

until their initial investment and a pre-negotiated premium is earned, or for a specified period of time (often 3-5 years). By necessity, this financing tool is most appropriate for businesses that are approaching profitability or are already profitable. Royalty financing relieves entrepreneurs of the implicit pressure to grow rapidly towards an "exit" that early equity investors often create, avoids diluting the ownership of a company and, compared to debt, may work well for businesses with highly seasonal revenue streams.

5 Tools for Local Investing

By Michael H. Shuman

If you've been told that it's impossible to invest your life savings in anything but Wall Street, here's some practical advice to prove the financial "experts" wrong:

1. **Move Your Money –** Move all your day-to-day financial activities, including your checking, loans, credit cards, and mortgage, to a local bank or credit union. These are the institutions that recycle their capital locally.
2. **Stretch Your Co-op –** Because memberships in a cooperative are not deemed "securities," they can be more easily used as vehicles for local investments. Other coop investment tools, such as borrowing from members, are securities, but the costs of compliance are modest. Some coops, like Weaver Street Market in North Carolina, pay their members handsomely to borrow money for capital projects. The La Montanita Grocery Coop in New Mexico has created a revolving loan fund so that members' capital can support local farmers and food processors.
3. **Sponsor Local Businesses –** Last year, web sites like Kickstarter and IndieGogo raised more than $100 million for small businesses and projects. Even though all you get for your money is a t-shirt or token of appreciation, you know that thousands of small contributors like yourself are helping to get a big idea off the ground. It's important to scan these sites for businesses in your own community. A new generation of web sites, like Lucky Ant and Community Funded, specifically facilitate local sponsorships.
4. **Create a Local Investment Fund –** Pools of capital are preferable to one-off investments because they diversify risk. There are thousands of local-investment pools around the country, most of them linked with local economic-development programs, but nearly all of them are only open to accredited investors. Important exceptions that allow unaccredited investor participation include MountainBizWorks in North Carolina, the New Hampshire Community Loan Fund, and ECDI in Columbus, Ohio. These funds demonstrate that it's possible to create non-profits that can take money from all kinds of local investors and then use the funds to grow local businesses.
5. **Promote Program Related Investments –** By law, foundations must give away at least 5% of their assets each year. The other 95% is typically invested in distant stocks and bonds. Work with your local foundations to help them move that 95% (or even just 1%) into local business. If these businesses are "program related" and the investment does not succeed, the foundation can apply losses to fulfill its annual grant obligation.

More on these tools below, and elaborated in Local Dollars, Local Sense: How to Shift Your Money from Wall Street to Main Street and Achieve Real Prosperity (White River Junction, VT: Chelsea Green, 2012). The author may be reached by phone (202-669-1220), email (shuman@igc.org).

Investment Offerings and Community Capital Platforms

Now that we've covered the types of capital tools that are on the table, this section highlights some of the ways in which these offerings can be structured and then describes existing innovative platforms for investing locally or accessing debt and equity capital.

Direct Public Offerings and Private Placements

While certain financial tools described in this guide are not considered "securities" some debt and all equity investments are defined as securities[13]. The offer and sale of securities in the U.S. is regulated by both Federal and State governments and typically requires formal securities registration. Small businesses often qualify for exemptions to Federal securities registrations, and the way in which – and to whom – debt and equity investment opportunities are advertised and sold impacts whether businesses are eligible for exemptions.

Direct Public Offerings (DPOs).[14] A DPO is a tool used by businesses to sell debt or equity directly to the public. With a DPO, a company is free to advertise and offer securities directly to the public rather than using an investment bank or intermediary (whereas an initial public offering or IPO typically involves an investment bank or intermediary). By permitting public advertising, DPOs enable entrepreneurs to seek funding from a broad range of investors. But, there is a trade-off. DPOs generally necessitate Federal and State securities registrations that can be expensive and time-consuming. To reduce these costs, small businesses often use exemptions to Federal securities registration requirements – these exemptions restrict the amount of money businesses can raise through DPOs and the number, type, and location of investors from whom they can raise funds.[15]

In California, People's Community Market (PCM), is in the process of raising up to $2 million of preferred stock through a DPO to fund a full-service grocery store, health resource center and community hub to help families attain healthier and more socially connected lives in the underserved community of West Oakland. Accredited and unaccredited California residents may invest in the preferred stock, which will pay 3% annual interest and a 1% annual store credit, and is redeemable after 7 years (or may be left outstanding). By raising money only from California residents, PCM avoided federal securities filings through a Federal securities law exemption and was only required to register its offering with the State of California.

Cutting Edge Capital provides more information on DPOs: (http://www.cuttingedgecapital.com/what-is-a-direct-public-offering) and provides a listing of recent DPOs on their Cutting Edge X (https://www.cuttingedgex.com).

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[13] A discussion of securities and why they matter is available from Cutting Edge Capital: http://www.cuttingedgecapital.com/what-is-a-security-and-why-does-it-matter/

[14] A BALLE "Accelerating Community Capital Webinar" on Direct Public offerings is available here: http://bealocalist.org/august-2012-community-capital-webinar-recording

[15] While exemptions to Federal securities registration requirements can reduce offering costs, businesses often must pay tens of thousands of dollars to meet the requirements of the Federal exemptions and comply with relevant State securities laws and exemptions.

Private Placements.[15] Like DPOs, private placements can be completed for both debt and equity. However, private placements are non-public offerings – meaning that they may not be advertised by the business seeking to raise money. They also are largely offered to accredited investors. The same Federal and State securities registration requirements apply to private placements, but they often qualify for Federal exemptions that eliminate caps on the amount of capital raised before securities registrations are required, an exemption not available to DPOs. Sales of debt or equity to "friends and family" with whom one has a pre-existing relationship are typically exempted from most securities laws as well. Co-op Power used a private placement to raise over $800,000 of equity capital to finance its Northeast Biodiesel plant. The private placement afforded them the flexibility to work with investors to structure an innovative agreement focused on long-term employee ownership and community benefit.

Community Capital Platforms & Mechanisms

Entities that pursue DPOs are free to advertise their stock or bond offerings widely. For others – those that complete private placements, or investors and borrowers seeking loans that don't have to be registered as securities – finding investors that share the same goals can be more challenging. This section describes a number of platforms and mechanisms that can be harnessed to bridge the gap between investors and opportunities for investment.

Investment Clubs. Investment club members pool their money to make debt, equity or other types of investments. This allows members to collectively make larger investments and/or to diversify their risk by investing in more businesses together with other members. Investment club members meet regularly to evaluate investment options and the group requires a majority vote of members before any investment decisions are approved. Generally, every member of an investment club must actively participate in these investment decisions in order for the club to avoid membership interests being treated as securities. The No Small Potatoes Investment Club in Maine makes micro-loans to local food businesses, offering 3 percent interest unsecured loans up to $5,000 with terms up to 3 years.

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[16] For more information on Private Placements, visit Slow Money's Private Placement Primer, Financing The New or Growing Enterprise by John Friedman, available here: http://www.slowmoney.org/uploads/1/3/6/7/1367341/slow_money_private_placement_primer.pdf

[17] Like direct public offerings, businesses taking advantage of Federal securities registration exemptions for private placements often must pay tens of thousands of dollars to meet the requirements of the Federal exemptions and comply with relevant State securities laws and exemptions.

[18] A BALLE "Accelerating Community Capital" Webinar on Co-op Power is available here: http://bealocalist.org/january-2012-community-capital-webinar-recording

[19] Investment clubs with even a single unaccredited investor member can only invest in securities in which unaccredited investors are eligible to invest.

[20] A BALLE "Accelerating Community Capital" Webinar on the No Small Potatoes Investment Club is available here: https://bealocalist.org/september-2011-community-capital-webinar-recording

Local Investment Opportunities Networks (LIONs). Local Investment Opportunities Networks (LIONs). LIONs help members that want to invest money locally to become aware of investment opportunities. LIONs are not investment vehicles – instead, they are mechanisms for potential investors to get alerted to potential investment options. Once LION members have become aware of an opportunity, they make their own decisions about whether to invest in a business or initiative and take individual risk in making that investment. Entrepreneurs and business owners typically submit business plans to the LION, and LION members that have pre-existing relationships with the applicants[21] receive these business plans. These members then contact the applicant directly if they are interested in making an investment. LIONs are effectively "match-making" organizations, and they can be used to facilitate both equity and debt investments.[22] In Port Townsend, Washington, LION members have invested almost $3 million since 2006 in 43 deals, of which about 80% were structured as loans.[23] More information about LIONs and other local investment options is available at the Local Investing Resource Center: http://www.local-investing.com/

Impact or Targeted Certificates of Deposit (CDs). A CD is similar to a savings account, but has a fixed term during which a customer may not withdraw deposited funds (or must pay a penalty). Financial institutions are then free to use these deposits, typically lending or otherwise investing these monies at higher rates of interest. Several financial institutions and their non-profit or business partners have developed "impact" or "targeted" CDs – in which CD investments are targeted to specific areas of customer interest (e.g. clean energy) or to specific businesses. These products allow customers to save, rather than spend, to support a business or cause that they believe in. In Massachusetts, Equal Exchange, a fair-trade worker-owned coffee cooperative, partnered with a local bank to create the "Equal Exchange CD". The CD is open to both accredited and unaccredited individuals. Equal Exchange can use up to 90% of the pooled monies invested in the CD (currently over $1 million) as a line of credit (a line of credit is effectively a pre-authorized loan used as needed). While the CD is Federally-insured from theft, if Equal Exchange defaults on its loans, the bank is not obligated to repay investors.[24]

Local Exchanges. Local exchanges enable the trading of private securities in a region. While there are still legal challenges to operating a local stock exchange, Mission Markets has just begun offering communities the opportunity to run their own portals to sell initial and secondary offerings of local business to local investors. They provide communities with most of the back-office, legal, and administrative services, so that one staff person can focus on recruiting companies and investors, and get paid through fees imposed on listed businesses. Unlike a typical Wall Street exchange, a community portal looks more like E-bay, where shares are listed for days or weeks at a set price until a buyer makes a purchase.

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[21] Having a pre-existing relationship between the potential investor and the applicant is critical to qualifying for exemptions to Federal securities registration. Some LIONs host social events so that investors and entrepreneurs can develop relationships.
[22] Unaccredited LION members may only invest in securities in which unaccredited investors are eligible to invest.
[23] A BALLE "Accelerating Community Capital" Webinar on the Port Townsend LION is available here: https://bealocalist.org/may-2013-community-capital-webinar-recording
[24] A BALLE "Accelerating Community Capital" Webinar on the Equal Exchange CD is available here: http://bealocalist.org/november-2011-community-capital-webinar-recording

Crowdfunding. Crowdfunding typically involves raising many very small investments from a large group of investors/donors (often through an online platform help to reduce the transaction costs of raising these monies). The Jumpstart Our Business Startups (JOBS) Act, signed in 2012, may make it easier to raise non-grant capital from both accredited and non-accredited investors, but that law is currently undergoing what is expected to be a fairly long Federal rule making process. A few crowdfunding platforms do permit "at risk" equity or debt investments. For example, Mosaic, an Oakland, CA-based crowdfunding platform connecting investors to solar power projects has gone through full securities registration processes in CA and NY and offers "Solar Power Notes" to accredited and unaccredited investors with a minimum investment of $25. The notes pay interest of 4-6% over 5 year terms. Kiva also offers debt investments to both accredited and unaccredited investors, but because lenders do not earn interest, loans on the platform are exempted from securities laws. More on crowdfunding below.

Which of the three types of crowdfunding are we talking about?

By Elizabeth Ü

People use the term "crowdfunding" to refer to any of several techniques to raise funds from supporters or future customers, so it can get a bit confusing. One of the most common forms of crowdfunding is the practice of using online crowdfunding platforms (such as Kickstarter, IndieGoGo, and StartSomeGood) to raise **gift** money from donors in exchange for small tokens of appreciation. A second form of crowdfunding involves a business collecting payments in advance (aka **presales**, see page 11 above) for products they intend to deliver later. In addition to raising gift money and preselling products, businesses can offer people in their communities financial returns to reward them for **investing** – provided that everyone abides by the appropriate laws. This is the third type of crowdfunding, and the most legally challenging.

What these models all have in common is that they are methods where an entrepreneur can solicit small investments from a large number of (usually non-wealthy) investors. The first example is not subject to securities laws, but there are some relevant laws related to "gifts/donations" to be aware of. For entrepreneurs who plan to pursue the latter two forms of crowdfunding investment, there are several basic securities laws that you'll need to understand.

In the next couple years there will likely be new online platforms that will make it easier for entrepreneurs to offer debt and/or equity investment opportunities to non-accredited investors. Businesses will likely take the new crowdfunding laws resulting from the JOBS Act of 2012 and turn them into legal, user-friendly, web-based fundraising tools. As of this writing, there are already several websites that help streamline the process of raising money from accredited investors; successful companies are usually tech-related, though some food manufacturers have raised funds on these platforms as well.

*Adapted from **Raising Dough: the Complete Guide to Financing a Socially Responsible Food Business** (Chelsea Green Publishing 2013), which covers the three forms of crowdfunding, securities laws, and exemptions, plus many other methods for raising small business capital from individuals, foundations, financial institutions, and government agencies.* *© Elizabeth Ü*

Partnership Lending. Partnership lending involves a partnership between a financial institution and a community organization (or other sponsor) in which the community organization provides loan capital, defines loan eligibility, terms, and requirements, and the financial institution manages loan origination and servicing. Partnership lending solves a challenge for each partner – community organizations often have clients and capacity to raise money but lack the ability to manage a loan fund while financial institutions have expertise at managing loans but little risk tolerance. In Ithaca, NY, Alternatives Credit Union (ACU) has pioneered partnership lending, working with local community organization partners to deliver capital to low-income individuals and businesses.[26]

Lending Circles. Lending circles involve a "circle" of friends, family and/or colleagues that collectively act as microfinance lenders to one another. Financial institutions or other organizations often provide support such as closing and servicing loans, and reporting payments to credit bureaus to help participants build their credit history. For example, Mission Asset Fund (MAF), a non-profit in San Francisco, CA, sponsors lending circles in which it partners with community organizations that have strong relationships and standing within a community to help build credit for low-income individuals.[27]

Peer-to-Peer Lending. There are several online platforms that allow individuals to make direct loans to each other. Examples are Lending Club and Prosper. Prosper has well over a million members, and has facilitated $500 million in loans.

Individual Retirement Accounts (IRAs). IRAs are (often) tax-deferred investment accounts that individuals setup to save for retirement. In most cases, pre-tax income is put into these accounts, and this income can be withdrawn after retirement (and taxed then – often at a lower tax rate than one pays during working years). Many IRAs are employer-sponsored and have a limited number of investment funds into which an employee may allocate their contributions. These limited options prevent individuals from investing their retirement savings in their local community. However, two approaches have targeted tapping into this >$1 trillion of wealth for local investment.

- **Including regional investment options among standard IRA offerings.** The Reinvestment Fund (TRF), a CDFI based in Philadelphia, PA has successfully gotten IRA custodians to include its promissory notes (i.e. debt) in employee IRA investment options. TRF files securities registrations for these notes, and they are available to accredited and unaccredited individuals with IRAs through participating institutions. TRF lends monies raised through the notes to help fund projects that meet regional development needs. Rather than exposing unaccredited investors to the risk that projects default, TRF structures the notes as "general

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[25] A BALLE "Accelerating Community Capital" Webinar on Community Partnership Lending with Alternatives Federal Credit Union is available here: https://bealocalist.org/september-2012-community-capital-webinar-recording

[26] A BALLE "Accelerating Community Capital" Webinar on Mission Asset Fund is available here: https://bealocalist.org/February-2012-Community-Capital-Webinar-Recording

obligations" (TRF pledges all of their assets to repaying the debt). In exchange for this low investment risk, TRF offers investors a low fixed return on the notes and marks up the interest when it re-lends to make up for potential loan defaults.

- **Self-directed IRAS (SD IRAS).** SD IRAS enable individuals to invest their savings in virtually all of the investments described above. Individuals place their IRA with a custodian, such as The Entrust Group, that allows the account holder to direct their investments.

Pooled Investment Notes. Several organizations offer pooled investment notes – funds raised from these notes are invested (often as debt) in a range of mission-aligned businesses and organizations. Examples include:

- **RSF Social Finance Social Investment Fund.** RSF Social Finance, a non-profit financial services organization, offers minimum $1,000 investments in their Social Investment Fund to accredited and unaccredited investors currently at 1% interest. These investments support RSF's Social Enterprise Lending Program, which has made over $250 million in mortgage loans, lines of credit, and inventory financing to non-profit and for-profit social and environmental organizations.
- **Calvert Foundation Community Investment Notes.** The Calvert Foundation has offered senior, fixed-interest general obligation bonds to accredited and unaccredited investors for 15 years. These notes are available online (through MicroPlace, a for-profit online brokerage offering retail investors a range of social investment opportunities), with a minimum investment of $20. Over $200 million has been raised to date, and the proceeds are lent to a range of non-profit organizations and for-profit social enterprises in the areas of affordable housing, microfinance, community development, and sustainable business.

OK, so what's next?

Innovators around the globe are changing the way capital flows through our economy –developing the tools, networks and infrastructure to replace a fundamentally broken financial system with a system grounded in meeting community needs using community resources. This guide has offered you the basics – but there are more resources for you within the BALLE network including thought leaders, webinars, and conferences to help you learn more. For those that are ready to take the next step – to get your money out of big banks that don't reflect your values, or to raise capital for your venture from local investors – the right financing tools and investment platforms will be a function of both the existing community capital infrastructure in your community and your goals for your business or investment. Check out the resources on our website: https://bealocalist.org/community-capital-toolkit-resources, listen to the BALLE community capital webinars: https://bealocalist.org/community-capital-webinar-series, or attend an upcoming event: https://bealocalist.org/balle-live-webinar-series. And, most importantly, now that you know what to look for, start reaching out to the financial institutions and networks in your own community, and join an existing effort or start your own initiative!

Glossary of Terms

- **Accredited investors** are individuals with a certain level of financial wealth; e.g. over $1 million in assets or significant annual income. Individuals below this threshold are called unaccredited investors.
- **Angel investors** are wealthy individuals investing their own money in start-up companies.
- **Bonds** are popular loan structures that enable investors to take a fractional share in a loan
- **Community Development Financial Institutions (CDFIs)** are not-for-profit financial institutions in the U.S. that fill in the gaps left by traditional lenders, offering services and products in neighborhoods or to customers that others are unable or unwilling to serve.
- **Community Reinvestment Act (CRA)** a U.S. law requiring banks and other financial institutions to direct capital towards a number of activities they might not otherwise prioritize, including: housing and revitalization in low-moderate income communities, and economic development by providing financing to small businesses or farms.
- **Convertible debt** gives a lender the option of receiving either its loan principal or a pre-negotiated number of ownership shares in a company.
- **Credit enhancements** reduce investor/lender risk by protecting against losses, examples include loan loss reserves, loan guarantees, and subordinated debt.
- **Credit unions** are not-for-profit member-owned financial cooperatives.
- **Debt investments/Loans** entail the lending of money to a project or business, which must be paid back (often with interest).
- **Debt Service Reserve Funds (DSRFs)** protect lenders from short-term fluctuations in a borrower's ability to make debt repayments.
- **Direct Public Offerings (DPOs)** are a tool used by businesses to sell debt or equity directly to the public.
- **Dividends are payments** (usually a portion of profits) to the owners of a company.
- **Donor-advised funds** allow donors (usually wealthy individuals or businesses) to establish an account with a "charitable sponsor" (often a community foundation or other philanthropic entity) by making irrevocable, tax-deductible contributions to the charitable sponsor.
- **Equity investments** are purchases of an ownership share in a project or business.
- **Loan guarantees** enable a third party to cover up to 100% of a loan or loan pool losses to protect lenders from risk.
- **Loan Loss Reserves (LLRs)** are a pool of monies that, in the event of loan nonpayment (default), lenders may use to recover all or a portion of that loss.
- **Mission-Related Investments (MRIs)** are those made by foundations if they are related to the foundation's mission but are also expected to have a return, and must meet applicable prudent investor standards like the foundation's more conventional investments.

- **Preferred stock,** unlike traditional stock, gives stockholders a fixed dividend (not a share of company profits) and does not entitle them to vote on company matters.

- **Pre-sales** involve the advanced sale of goods or services and are neither debt nor equity.

- **Private placements** are a tool used by businesses to sell debt or equity privately to those they already have a relationship with.

- **Program-Related Investments (PRIs)** are those made by foundations if they primarily serve a charitable purpose, and are treated similar to grants for tax purposes.

- **Revolving Loan Funds (RLFs)** are pools of money that, once capitalized (or funded), are self-replenishing. Loans are made to borrowers, and as loan principal and interest is repaid, it can then be re-lent to new businesses and projects.

- **Royalty financing** is a debt-equity hybrid where investors earn a pre-arranged percentage of a business's revenues until their initial investment and a pre-negotiated premium is earned, or for a specified period of time (often 3-5 years).

- **Secured debt** is a loan for which a borrower pledges a specific asset or assets as collateral (often specific property) against the loan. If the borrower is unable or unwilling to repay the loan, the lender can take possession of those assets.

- **Securities** are broadly defined as "investment contracts" - some debt and all equity investments are securities. The offer and sale of securities in the U.S. are regulated by both the Federal and State governments and typically require formal securities registration processes, though there are exemptions possible.

- **Subordinated debt** is used to fund a portion of loans or loan pools along with "senior" debt investors; in the event that there are loan defaults senior debt investors recover 100% of their investment before the subordinated debt investors recover any of their investment.

- **Venture capitalists** invest others' money (often funds from wealthy individuals or institutional investors) in early stage companies, and expect rapid growth and large returns.