

An Introduction to Financing

for Cooperatives, Social Enterprises, and Small Businesses

June 2015



Community Wealth Building
Metro Denver's Economic Prosperity Network



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The Community Wealth Building Network of Metro Denver is a partnership of individuals, groups, and organizations from public, private, and non-profit sectors dedicated to elevating awareness and capacity for community wealth building efforts in the Denver Metro region.

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Contents

Introduction	4
Executive Summary	5
Section 1. Debt Finance	8
CDFIs	8
Credit Unions	8
Small Business Administration	9
Public Banks	10
CDFIs in Colorado:	11
Section 2. Crowdfunding	12
Donations (Cause-Based) Crowdfunding	12
Rewards-Based Crowdfunding	12
Debt-Based Crowdfunding	13
Equity-Based Crowdfunding	13
Regulation A+ of the JOBS Act	14
Colorado Crowdfunding Act	16
Crowdfunding Decision Tree	17
Section 3. Equity Financing Mechanisms for Cooperatives	18
Cooperative Exempt Securities Offerings	20
Private Placement Exemptions for Securities Issued by Any For-Profit Business Entity	21
Section 4. Opportunities for Charitable Foundations	23
Program Related Investments	23
Mission Related Investments	24
Grants or Program Related Investments to For-Profit Entities	25
Convertible Grants	25
Section 5: Additional Resources	27
Section 6: Glossary of Terms	30
About the Authors	34
Endnotes	37



Introduction

The pathway out of the “Great Recession” requires new business models, modified investment return expectations, and strong governmental policies to create and enhance a business friendly environment. There is, however, a growing recognition that the U.S. economy, while very effective at serving the economic interests of large corporations and businesses, is failing to alleviate poverty or enable wealth creation for the typical worker. Since business ownership is an effective means to generate wealth and create opportunity, elected officials, economic developers, foundations, social entrepreneurs, impact investors, and nonprofit organizations are focusing increasing attention on spreading this opportunity into low-income communities. Individual entrepreneurial talent and ambition are giving life to new business models and new mechanisms for financing start-up ventures. Also, we are seeing creative collaborations and partnerships that build bridges across groups of experts and segments of the population that were accustomed to separation. These new energies can facilitate wealth generation at the grassroots level to a degree not experienced in more than a generation. Now is the time for new experiments that bring together the best strategies in innovation, community commitment, and sustainability.

One such business model with growing momentum in the U.S., worker cooperatives can provide quality and enduring jobs that benefit their worker-owners and the local community. The model works for most types of businesses and has a successful history in providing better quality jobs and wealth-building opportunities in traditionally low-wage service industries, such as childcare, cleaning services, and home health care. Such businesses if organized as worker cooperatives tend to provide higher wage jobs with benefits, profit-sharing, retirement plans, and worker-owner control over company policies and practices. Worker cooperatives and related business forms are also gaining traction in industries such as marketing, high tech, and all aspects of food production and distribution.

Other business models are also emerging that provide promising strategies for addressing poverty. Individual entrepreneurs and nonprofit organizations are starting for-profit businesses that adopt multiple “bottom lines” (e.g. the Triple Bottom Line of people, planet, and profit). Broadly speaking, such businesses are referred to as social enterprises. These businesses have multiple purposes of making a profit and addressing a social issue, such as employing homeless youth or ex-offenders or increasing a community’s access to healthy food. Furthermore, with the creation of the Benefit Corporation (B Corps) legal entity type, millennials are seeking to combine their social values with their economic goals. These varied business models are turning the private sector into a powerful ally for government and nonprofits. The sectors are coming together in new ways to create an ecosystem conducive to generating wealth in communities that have long been relegated to the economic margins.



Executive Summary

While there is a growing interest and excitement in creating wealth-generating opportunities in low-income communities, there are still many issues to address. This paper was written to address one of the key challenges: how social enterprises and cooperative businesses can access the capital required to launch or grow their business. When discussing this challenge as part of a working group for the Community Wealth Building Network in Metro Denver, the idea arose for a paper that outlines existing finance options. Along with being a resource for a number of audiences involved in starting or financing social enterprises and cooperative businesses, the goal of this paper is to help identify where potential gaps may exist so that funders, socially-minded investors, and communities can work together to address those gaps. The authors hope that this paper can help accomplish both of those functions and encourage readers to use this paper as a tool and a conversation starter in their communities.

The paper was written with the following audiences in mind:

- Individuals in low-income communities who are creating and building businesses either as sole-entrepreneurs or in concert with others in a cooperative format;
- Cooperative developers and community organizers;
- Individual and institutional investors (e.g. socially responsible individual investors; private equity and venture capital funds; community and private foundations);
- City, county, and municipal governments and government agencies focused on economic development and workforce development; and
- The Community Wealth Building Network in Metro Denver, which is the convener of the working group that drafted this paper.

The authors recognize that this is a broad audience and that not every section in this paper will be applicable to every reader. When utilizing this paper as a resource, the reader is advised to refer to the sections that are most relevant to their work. The reader should also consult this paper as a general guide and seek out professional expertise when pursuing specific financing or investment opportunities.

Finance is a very specialized and highly regulated arena, which can be a barrier to business ownership. The authors hope that this paper will provide enough basic information to demystify the topic for people with no prior exposure, as well as provide a level of detail that will be useful for the more well-versed reader.



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In general, there are two types of capital used to finance a business: debt and equity.

- Debt financing provides capital in the form of a loan, which the business then repays, along with an extra amount of interest, over a set period of time. For example, a business might borrow \$1,000 of capital from a community loan fund and then repay that money, plus a 3% interest rate, over a two year period.
- The other type of financing, equity financing, provides capital in the form of stock ownership in the company, which often translates into a share of the profits of the company. For example, a business receives \$1,000 in capital from an investor in exchange for the investor having a 3% ownership stake in the business. If the business makes profits, the investor receives an annual payout of 3% of those profits.

In both cases, the business got upfront capital of \$1,000, but has different obligations to its debt financier (repaying the amount borrowed plus interest) than to its equity financier (sharing some of the profits of the company with the investor because the investor owns part of the company).

This paper deals with both types of financing through a number of different mechanisms. While the paper tries to make each mechanism as clear as possible, there is some overlap and there will be discussion of hybrid financing vehicles, which blend elements of both. The reader should be aware that the finance world is rarely clear-cut. It is governed by complex federal and state-level securities laws and regulations and may require the assistance of an attorney to successfully navigate the terrain. Fortunately, there are individuals and organizations whose focus is to help navigate this complex subject.

When describing the various financing options in this paper, the authors assumed the following to be true about the businesses utilizing this paper:

- They are owner-operated revenue-generating businesses with profits that are primarily financed and driven by operating income;
- They are designed to benefit member-owners or underrepresented and disadvantaged entrepreneurs and communities;
- They to some degree have an objective to address a social or environmental ill, particularly to provide quality, secure employment and ownership opportunities for disenfranchised populations.

This paper is divided into six sections:

Section 1 provides an overview of institutional lenders that provide **debt financing**, i.e. provide loans to small businesses, social enterprises, and cooperatives.



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Section 2 provides a comprehensive overview of **crowdfunding** covering the platforms geared to grassroots investors as well as platforms for the “accredited” investor and explains the different types of financing mechanisms - equity, debt, royalty, and revenue share securities that are available through crowdfunding.

Section 3 focuses on **financing specific to cooperatives**, providing an overview that encompasses raising capital from cooperative members, as well as from outside investors. This section also covers the relevant regulatory mechanisms that govern these financing options - specifically cooperative exempt security offerings and private placement exemptions for securities.

Section 4 covers opportunities for investment that are specific to **charitable foundations**, covering Program Related Investments, Mission Related Investments, grants or investments in for-profit businesses, and some new hybrid models of giving that are in the experimental phase.

Section 5 provides a generalized survey of the literature and highlights **additional resources**.

Section 6 is a **Glossary of Terms**. If the reader is new to finance concepts, we recommended reading this section first.

The authors of this paper worked on a volunteer basis. If you have found this white paper informative and valuable, you may make a donation at www.communitywealthbuilding.org. All donations will go to support the Community Wealth Building Network of Metro Denver. If you have any questions, feel free to reach out to the authors directly. Our contact information is provided in the “About the Authors” section at the end. We, the authors, sincerely hope you find this white paper insightful and engaging.

Warm Regards,

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This paper is intended to provide a general overview and guide to the subject matter and is not intended to be comprehensive or exhaustive on any one topic. As with any writing on these subjects, readers are encouraged to consult with an attorney, or other professional, before making decisions informed by or based upon the information in this paper. Referrals to subject matter professionals and experts can be made upon request. The information contained in this white paper is not legal advice and should not be relied upon as such. While every effort has been made to ensure the accuracy of all information, errors or omissions may exist and any liability arising hereunder is therefore disclaimed.



Section 1. Debt Finance

This section outlines some of the most common institutional sources of debt financing available to small businesses, social enterprises, and cooperative enterprises. Traditional banks are not included because their loan products are often not accessible for businesses in low to moderate income communities or cooperatives.

CDFIs

Community Development Financial Institutions (CDFIs) are financial institutions certified by the U.S. Department of the Treasury that have a community development mission and provide financial services in low and moderate income communities. CDFIs are non-government, often non-profit, entities and come in a variety of forms - loan funds; venture capital funds; community development banks; and credit unions. CDFIs make loans to a variety of projects: some CDFIs fund only micro-enterprises or small businesses, some fund real estate and affordable housing and some only fund co-ops. When considering debt financing from a CDFI, it is important to research the CDFIs that exist in the area to make sure their mission, funding requirements, and geographic coverage match the needs of the business/co-op. (See table at the end of this section for a description of CDFIs in Colorado). Important factors to consider: the interest rate on the loan, how much financing is needed, how much collateral the CDFI requires for a loan, and how quickly the loan is needed. CDFIs will often have higher interest rates on their loans than traditional banks, but they will also provide financing for many projects that traditional banks will not. (For instance most banks will not provide loans for less than \$50,000.) For more information on CDFIs in general, visit the CDFI Fund's website (www.cdfifund.gov).

Credit Unions

Credit Unions (CU) are banks that are also cooperatives. This means they are owned by their members, i.e. depositors. The members vote for the CU's board of directors and sometimes on the CU's policies. Unlike traditional banks, a CU's mission is to serve their members, not investors/shareholders, so they often have more community-focused programs and loans, such as financial education classes and small business loans for their members. CUs are accredited and regulated by the National Credit Union Administration (NCUA), similar to how the FDIC regulates banks. There are about 100 CUs in Colorado, each with an individual charter and eligibility for membership, as well as types of loans offered. To find a list of CUs in Colorado, visit the National Credit Union Administration's website (www.ncua.gov).



Small Business Administration

The Small Business Administration (SBA) is a federal government agency whose goal is to support and strengthen small businesses in the U.S. The SBA does not lend money directly to businesses. Instead, it guarantees loans made by, or provides capital to, other lending institutions (community organizations, CDFIs, credit unions, etc.). The SBA also sets criteria for the loans that are made under its programs that are administered by these other institutions. There are multiple SBA loan programs, outlined below in order from most useful to least useful for the purposes of this analysis.

SBA Finance Programs:

7(a) Program – This is the most commonly used SBA loan type. It provides basic loans to small businesses that are starting up, growing, or acquiring. Most for-profit businesses operating in the US on a non-national basis and fitting certain size criteria created by the SBA are eligible. Businesses with a variety of ownership structures – sole proprietor, LLC, etc. – are eligible for 7(a) loans. Worker co-ops were recently added to the types of businesses eligible under the 7(a) program. Consumer and producer co-ops, however, are not eligible. Eligibility varies by industry sector and takes into account average annual revenue and/or number of employees. For program specifics, visit SBA's website (www.sba.gov/size).

Microloan Program (www.sba.gov/content/microloan-program) – The SBA provides microloans up to \$50,000 to qualifying small businesses to start up or expand. The average loan size is \$13,000. Similar to the 7(a) program, the SBA does not lend money directly, but rather through non-profit lenders. A small business seeking an SBA microloan would have to qualify based on the criteria and loan policies of the non-profit lender. In general, most of these lenders would require a personal guarantee from the business owner and some type of collateral (something from the business that the lender could use to repay the loan if the business defaults on its payments – the business's building or equipment are a common source of collateral for a loan). There are more guidelines on the SBA's website, as well as a directory of SBA microloan lenders.

Certified Development Company (CDC)/504 Loan Program (www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/real-estate-and-eq) The 504 loan program provides loans to small businesses to buy land or buildings, improve existing buildings, or construct new facilities. The loans come through non-profit CDCs certified by the SBA in a specific geographic area. To learn more about the qualifications for a 504 loan or to find a CDC in your area, visit the SBA's website.



Community Wealth Building

Metro Denver's Economic Prosperity Network

Small Business Investment Company (SBIC) Program (<https://www.sba.gov/category/lender-navigation/sba-loan-programs/sbic-program/small-business-owners-entrepreneurs>) In addition to small business loans, the SBA also works with investment funds to provide debt or equity to small businesses in need of growth capital. The private investment firms are certified by the SBA as Small Business Investment Companies (SBICs) and the SBA sets parameters for what businesses qualify for SBICs' investments. This program is designed for existing businesses that are growing and can offer a market rate of return on the investment. There are no SBICs currently licensed in Colorado.

Public Banks

A public bank is a bank owned and operated by the government. Public Banks can exist at any level – local, state, federal, or international. In the U.S., there is currently only one public bank, the Bank of North Dakota (BND <http://banknd.nd.gov>). The BND is owned and operated by the state of North Dakota to serve the public interest of the state. All of the state government's money is deposited in the bank and all BND profits are returned to the general fund of the state. This is in contrast to private banks, which distribute profits to private shareholders. The BND partners with credit unions and local banks to offer low-interest loans to small businesses and individuals in North Dakota and zero percent interest loans to government projects like highway construction. The public banking model is gaining traction as other states and municipalities see the community benefits that the BND is helping to create in North Dakota. More information on Public Banks and efforts to create a public bank in Colorado is available at this website: <http://bankingoncolorado.org>.



CDFIs in Colorado:

Name	Type of CDFI	City	Types of Loans
Colorado Enterprise Fund	Loan Fund	Denver	Micro and small business
Colorado Housing Assistance Corporation	Loan Fund	Denver	Housing
Colorado Housing Enterprises, LLC	Loan Fund	Westminster	Housing
Community Enterprise Development Services	Loan Fund	Aurora	Microloans
First Nations Oweesta Corporation	Loan Fund	Longmont	Loans to Native communities
First Southwest Bank	Bank	Alamosa	Business and personal
Funding Partners for Housing Solutions	Loan Fund	Fort Collins	Housing
La Plata Homes Fund, Inc.	Loan Fund	Durango	Housing
Mercy Loan Fund	Loan Fund	Denver	Housing
Mile High Community Loan Fund	Loan Fund	Denver	Housing and commercial real estate
Native American Bank, N.A.	Bank	Denver	Business and personal to Native communities
Rocky Mountain MicroFinance Institute	Loan Fund	Denver	Microloans
Accion NM - AZ - CO - NV	Loan Fund	Office in Denver, HQ in NM	Microloans
Enterprise Community Loan Fund	Loan Fund, runs the Denver TOD Fund	Office in Denver, HQ in MD	TOD Fund
CDFIs that lend specifically to Co-ops			
Northcountry Cooperative Development Fund	Loan Fund - also a co-op	HQ in MN but lends nationally	Cooperatives
Local Enterprise Assistance Fund	Loan Fund	HQ in MA but lends nationally	Cooperatives
Cooperative Fund of New England	Loan Fund	HQ in MA, lends in New England and parts of NY	Cooperatives



Section 2. Crowdfunding

This section outlines the many forms of Crowdfunding, a relatively new and popular avenue for start-up businesses, campaigns, and other organizations looking to promote a business, investment, cause, or other pursuit. All crowdfunding efforts revolve around the same basic premise – to harness the power of the “crowd” for a common pursuit. The unprecedented connectivity that the internet and mobile computing has created now allows businesses and organizations to reach audiences of potential supporters in new ways and with new offerings. Crowdfunding, done right, can be a promising avenue for raising capital for non-traditional business forms, like cooperatives, social enterprises, and start-ups. Additionally, crowdfunding can provide an avenue for individuals to support the businesses in their community.

Donations (Cause-Based) Crowdfunding

Donation crowdfunding is exactly what it sounds like - the campaigns amass donations without being required to provide anything of value in return. This type of campaign serves social causes and charities best. If a person makes a donation to a registered non-profit (usually a 501(c)3) it is considered a charitable gift and is tax deductible. Donation campaigns are often 1-3 months in length and work well for amounts under \$10,000. Examples of crowdfunding portals dedicated to this type of crowdfunding are [GoFundMe](#), [StartSomeGood](#) and [CauseVox](#).

Rewards-Based Crowdfunding

Rewards-based crowdfunding is the most common type of crowdfunding option available. This type of crowdfunding involves setting varying levels of rewards that correspond to pledge amounts. A standard rewards campaign offers at least three levels of pledges/rewards and typically lasts for 30 to 45 days. An example of a crowdfunding portal dedicated to this type of crowdfunding is [Kickstarter](#).

Rewards campaigns tend to fall into one of two categories:

- **Rewards-Based Crowdfunding for Creative Projects:** These are crowdfunding campaigns focused on “creative” as opposed to “hardware” projects. These work well for projects that require between \$1,000 and \$10,000 to complete (in this segment, the average success rate is 64%).
- **Product Pre-Sales Crowdfunding:** These are campaigns designed to help create a market for new “hardware” products and may also be used to secure funding upfront to help with production costs. Works well for client-facing technology / tangible products that require less than \$100,000 in funding.



Debt-Based Crowdfunding

Debt-based crowdfunding allows entrepreneurs to raise funds in the form of loans that they will pay back to the lenders over a pre-determined timeline with or without a set interest rate.

Lending campaigns tend to take place over a time span of four to five weeks and work well for entrepreneurs who don't want to give up equity (i.e. an ownership stake) in their business. There are basically three types of debt-based crowdfunding:

- **Microfinance Crowdfunding:** The most notable example of microfinance crowdfunding is Kiva. Kiva is a non-profit organization with a mission to connect people through lending to alleviate poverty. Leveraging the internet and a worldwide network of microfinance institutions, Kiva lets individuals lend as little as \$25 to help create opportunities around the world. Kiva has recently initiated a new program aimed at entrepreneurs in the U.S. known as [Kiva Zip](#).
- **Person-to-Person ("P2P") Crowdfunding:** In this version of debt-based crowdfunding, the crowd, through online portals, lends money on an unsecured basis to individuals for a variety of needs. Examples of such crowdfunding portals are [LendingClub](#) and [Prosper](#).
- **P2B Crowdfunding:** This is debt-based crowdfunding where the crowd, again through an online crowdfunding portal, lends money to businesses directly. Examples of these types of funding sources are [Funding Circle, U.S.A.](#) and [P2BInvestors](#).

Equity-Based Crowdfunding

There are three types of equity-based crowdfunding: equity, convertible debt, and revenue sharing, and it comes in two different forms, accredited and non-accredited (see definition of "Accredited Investor" in the Glossary in Section 6 below). Equity crowdfunding is on the rise after the signing of the federal Jumpstart Our Business Startups (JOBS) Act in April of 2012.

The three types of equity-based crowdfunding:

- Straight **equity** crowdfunding consists of an exchange of actual shares in a private business for a capital investment.
- **Convertible debt** is when a business issues a promissory note to an investor in exchange for capital and the promissory note can be converted into shares in the business (either common or preferred shares) upon the occurrence of a future specified event. The investor receives a set return/interest rate on their investment until they exchange the promissory note for shares in the company.
- **Revenue sharing** involves a certificate being given to the investor in exchange for their capital that permits them to share in the gross or net revenues of the business, either indefinitely or for a limited number of years, or until a certain return on investment (ROI) is attained.



The two forms of equity-based crowdfunding:

- **Accredited Investor Crowdfunding:** Title II of the JOBS Act provides for what is commonly referred to as “accredited investor crowdfunding”. Under Title II, Congress amended the federal securities laws to permit “general solicitation” and “advertising” by entrepreneurs (known as issuers) to complete strangers (for the first time in 80 years) provided that (i) in every case the entrepreneur has a “process” for verifying the “accredited” investor status of any individual or organization that proposes to become an investor in the offering and, (ii) further, that each individual that does become an investor is, in fact, an accredited investor. Examples of funding portals dedicated to this type of crowdfunding are [AngelList](#), [FundersClub](#) and [CircleUp](#).
- **Non-Accredited (or Unaccredited) Investor Crowdfunding:** This type of crowdfunding, which was at the heart of the JOBS Act and which was the section of the JOBS Act that created most of the excitement when the JOBS Act was initially passed, is still not legal under federal law in the United States due to the fact that the Securities and Exchange Commission (SEC) has not yet written the regulations to implement this part of the JOBS Act. As of April 2015, however, there are 13 states (including Colorado through a bill signed into law by Governor Hickenlooper, known as the “Colorado Crowdfunding Act”) that allow non-accredited crowdfunding, provided offerings are under a certain aggregate dollar amount, and are only made to residents of the state in which the company that’s making the offering is located. The amount that can be obtained from any individual investor in a crowdfunding offering varies from state-to-state and from class-to-class (i.e., different limitations for accredited investors versus non-accredited investors). These offerings generally require limited or full registration of the offering and approval by the state securities regulators. Many of the platforms currently engaged exclusively in accredited investor crowdfunding stand poised to expand into non-accredited investor crowdfunding as soon as it becomes generally available throughout the United States. Currently, however, there are very few platforms dedicated to this type of crowdfunding, one notable exception being [Cutting Edge Capital](#).

Regulation A+ of the JOBS Act

The new regulations address new financing options created under the JOBS Act and were released in March, 2015 and take effect June 19, 2015. In addition to opening private investment opportunities to people at all income levels, Regulation A+ provides small businesses with greater access to capital. This is especially relevant for businesses that also have a social mission, as they can now solicit investments from non-accredited investors who may be more interested in helping a local business be successful, than in maximizing their return on investment.



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This regulation will permit any private business located in the United States or Canada to raise up to \$20 million of capital under a Tier 1 offering, or up to \$50 million under a Tier 2 offering, in a 12 month period. Like any Federal regulation, there are rules, limitations, and stipulations that businesses and investors will need to comply with. Below are a few of the highlights of what Regulation A+ will and will not allow (this is not an exhaustive list):

- **It's no longer a "rich man's sport;" anyone can invest:** Reg. A+ doesn't limit its benefits to just "accredited investors" – anyone, even friends and family, can invest. Non-accredited investors will, however, be subject to investment limits under certain circumstances.
- **Income / net worth does not need to be certified by a third party:** Unlike "accredited investor crowdfunding" (the new Rule 506(c) of Title II of the JOBS Act), investors can self-certify income or net worth. There is no requirement for a separate, third-party verification process.
- **Businesses can now widely advertise that they are looking for money:** There is no prohibition against "general solicitation" or "advertising". Businesses can freely advertise and talk about their offering. Previously, SEC requirements did not allow companies to publicly advertise that they were looking for money.
- **The SEC still has to approve an offering before a business can get investments:** Any company using Reg. A+ will have to file a disclosure document with the SEC and include financial statements (audited if raising money under Tier 2 – which permits raising up to \$50 million - or just reviewed if raising money under Tier 1 – up to \$20 million).
- **When raising a lot of money (up to \$50 million under Tier 2), additional approval from state regulators is not needed:** If raising money under Tier 1 (limited to \$20 million or less), a solicitation for investment approval is needed from state regulators as well as the SEC. However, approval of state regulators is not needed when raising money under Tier 2 (up to \$50 million). When state approval is required, there is a new system available that helps coordinate the review/approval process among the states, called the North American Securities Administrators Association's (NASAA's) Coordinated Review.
- **Exemption from existing shareholder limits:** Under the new Reg. A+, the normal shareholder limits (2,000 people and 500 non-accredited investors) will not apply under certain circumstances. Thus, subject to certain additional requirements, a company will be able to take investments from many more people, including those willing to invest as little as, say, \$100.
- **Freely tradable, unrestricted securities:** The securities issued under Reg. A+ will have the status of "unrestricted" securities and can be freely traded to a third party. Some believe this may create the precondition necessary to give rise to "Venture Exchanges" where secondary, i.e., "aftermarket", trading can occur.



- **Businesses can “Test the Waters” to see if investors are interested before going through the longer process of a formal Initial Public Offering (IPO):** Privately held companies (any company not publicly traded on the stock exchange) can use Reg. A+ to see if investors are interested in supporting the company. By utilizing this provision, companies don't have to guess whether their public offering is likely to be successful. They can see if there is sufficient interest in the offering prior to spending the time and money to prepare an IPO.
- **There will be some ongoing disclosure requirements:** If a company is raising more than \$20 million, it will be required to make annual disclosure filings (but they are greatly scaled-back from what they've been in traditional IPO's). There are no ongoing disclosure requirements for investments under \$20 million if relying upon Tier 1 to issue those investments.
- **Venture capital funds, hedge funds, and private equity funds may not use Reg. A+:** Investment companies (i.e. private equity funds, venture funds, hedge funds) may not use Reg. A+ to raise capital.

Colorado Crowdfunding Act

Governor Hickenlooper signed House Bill 1246, known as the “Colorado Crowdfunding Act” into law on April 13, 2015. Colorado now joins the growing list of states that allow non-accredited investors to invest in privately held companies. There are a few details of the new law to be aware of:

- Any crowdfunding offering must be properly registered with the Colorado Securities Division, which is a division of the Colorado Department of Regulator Agencies (“DORA”).
- Online intermediaries (also known as portals) where private companies advertise their investment opportunities must also be registered with the Colorado Securities Division.
- There are limits on how much capital can be raised by a company and how much an individual can invest. Up to \$1 million can be raised without audited financials and up to \$2 million if the business submits audited financial statements to the state regulators.
- Individual non-accredited investors cannot invest more than \$5,000 in a single business during each round of investing.
- If the individual is accredited, that cap is removed.
- All aspects of the investment transaction must take place between Colorado residents. Transactions that reach outside of Colorado will run the risk of violating federal securities laws. Readers are reminded that non-accredited investor crowdfunding is not yet legal nationally under the JOBS Act.



Crowdfunding Decision Tree





Section 3. Equity Financing Mechanisms for Cooperatives

A cooperative (also referred to as a co-op) is a for-profit business enterprise that is owned by and democratically controlled by the people who either work or shop there (e.g. a taxi-driver co-op or a food co-op), use its services (e.g. a credit union or health insurance co-op), or produce goods/items for it (e.g. a food producers co-op). While cooperatives are business enterprises, their structure differs significantly from the more familiar corporate structure that predominates in the United States and as such co-ops have greater difficulty in obtaining debt financing from traditional sources of capital. This section provides an overview of the main avenues for co-ops to obtain equity financing.

Cooperative equity is generally more layered and diversified (i.e. via many relatively small member-equity holders) than traditional corporate equity structures and tends to come from a variety of places and often from a relatively large number of distinct individuals. Due to certain unique features inherent to the cooperative form, regulatory compliance and registration requirements for cooperative financing vehicles are quite lax relative to traditional corporate security offerings.

As the equity structures of cooperatives evolve, develop, and innovate, more and more non-accredited and accredited investors alike are looking to invest in cooperatives. The community of start-up cooperatives is robust and growing. Likewise, there are estimated to be 2-4 million businesses that would be good candidates to convert to worker-owned cooperatives in the next fifteen years.¹ The capital needs of these start-up cooperatives and converting businesses will be immense in the aggregate. Thus, new options to attract and focus outside investment in cooperatives are beginning to take shape. Since millions of Americans are members of one form of cooperative or another (including members of a credit union), it stands to reason that many would be interested in investing in and somewhat familiar with cooperatives as ethical, sustainable, and impactful business models that provide meaningful alternatives to the traditional investments available through mutual funds and pension funds.²

Below is a brief description of the three main sources of equity financing for cooperatives (patron-member equity, outside non-member investment, and outside investor-member equity) as well as a description of the Securities and Exchange Commission's (SEC) treatment of these different equity categories.

- **Patron-member equity.** Patron-members³ are the individuals who use the services of a cooperative and they typically provide the primary source of equity capital for the cooperative. Generally, a condition of membership is the payment of a membership fee or the purchase of one share of voting common stock, which supports the one-member, one-vote egalitarian nature of cooperatives. These types of payments usually become part of the member equity capital in the co-op. Some cooperatives



Community Wealth Building

Metro Denver's Economic Prosperity Network

require capital to be invested in addition to the membership fee, while others make that opportunity available to its patron-members. This can be in the form of non-voting preferred stock, or non-voting common stock. In offering patron-members the opportunity to purchase both voting common stock and non-voting stock, cooperatives are able to keep the investment level for membership relatively low, while allowing additional capital investment from members.

Once a member joins a cooperative, the total value of that member's contributions of service or labor, (if a worker cooperative), or the value of the member's consumption, (if a purchasing/consumer cooperative), is deemed that member's "patronage." Return on equity comes in the form of a "patronage dividend," which is based upon a formula of the total patronage of the cooperative, divided by each member's individual patronage. The amount of "patronage dividend" or "patronage refund" distributed to members and the amount retained by the cooperative to support continued operations and growth is determined by each individual cooperative based on the needs of the members and the business.

- **Outside non-member investment.** Most cooperatives limit voting rights to patron-members. Cooperatives may choose to issue non-voting preferred stock to outside investors. This has become a standard tool to raise additional capital from mission aligned investors, such as impact investors, and charitable foundations (see Mission Related Investments in Section 4), who invest with a relatively long-term perspective and who support the mission and values of the cooperative. While there is still a financial return component to non-voting outside stockholders in the form of periodic dividends, a primary motivation for investors often includes support of the cooperative business model and the mission to which the cooperative is committed. In general, the capital invested through such non-voting preferred stock is sometimes thought of as "rented" capital, and subordinate to the patronage capital of member-owners.

- **Outside investor-member equity.** Limited Cooperative Associations are a hybrid cooperative model that permits the issuance of voting stock to investor-members. This new multi-stakeholder cooperative model allows cooperatives to maintain the key governance elements of one-member-one-vote, while accessing larger pools of capital. Attracting voting investor-member equity capital can offer a key opportunity for cooperatives to achieve scale.

At present six states, including Colorado, have adopted the Uniform Limited Cooperative Association Act, which provides further flexibility to cooperatives beyond that contained in most states' general cooperative statutes. In addition, by permitting the issuance of voting stock to investor-members, limited cooperative associations can access substantially larger pools of capital from more traditional investors, who may require or have come to expect some degree of voting rights. Investor-member voting rights are statutorily limited, and the ordinary patron-members in a limited cooperative association always have the majority voting control over the affairs of the



cooperative. This new form of limited cooperative association has spawned innovation and the potential for the cooperative model to scale more quickly and globally than traditional pure patron-member cooperatives.

Cooperative Exempt Securities Offerings⁴

Due to certain unique features inherent to the cooperative form (see below), regulatory compliance and registration requirements for cooperative financing vehicles are quite lax relative to traditional corporate securities offerings. The general rule of thumb is that any offering of securities (defined broadly) must either be registered with federal and/or state securities regulators, identify and comply with an exemption, or risk being deemed an illegal offering. Securities regulators at both the federal and state level (at least in Colorado), however, generally will not require that a cooperative issuer register an offering of its securities and will generally not even consider the patron-member equity interests issued by a cooperative to fit the definition of a “security.” Underlying this approach is the general notion that cooperatives are through-and-through self-governing and self-regulating entities and that the inherent checks and balances built into cooperative governance will prevent many of the ills that give rise to the general registration requirement. Furthermore, due to the informed, engaged, and collaborative nature of a cooperative member’s relationship with a cooperative, members are deemed not to need the protection of regulatory oversight, legally required disclosure, or pro forma risk analysis. In other words, cooperative members are believed to be sophisticated investors, capable of judging the risk and nature of an investment in a cooperative. Further, regulators take the view that member investment in a cooperative involves a high degree of direct engagement and the exercise of control, since members are at least theoretically capable of protecting their financial interests through the exercise of voting rights. Lastly, regulators tend to view securities offered by cooperatives to its members as acquisitions of an interest in the cooperative that is primarily for personal consumption or benefit and not for financial gain or upside, although financial gain may be ancillary to the primary purpose of a member’s investment in the securities of a cooperative.

In support of the general principles above, the Securities and Exchange Commission (SEC) has, in several recent cases, declined to enforce the general registration requirement against numerous cooperatives that desire to offer, sell, and issue securities to cooperative members. The SEC has taken the general position that a cooperative’s membership common stock equity is not a “security” as defined under federal law. Without providing a rationale and although limited to the particular facts of each request, these “no action letters” support the general approach that a cooperative may offer, sell, and issue equity stock in the cooperative to its members without registering it with the SEC. Although the determination by the SEC is instructive, it is not binding upon state securities regulators. As such, before a cooperative seeks to offer, sell, or issue securities, a state-level securities registration exemption must be identified and strictly complied with.



Each of Colorado's three cooperative statutes contains a general exemption for the securities issued by cooperatives to its patrons. Cooperative legal practitioners view Colorado's cooperative securities exemption as one of the broadest state-level exemptions available. Thus, Colorado is viewed as a favorable state in which to organize and form a cooperative and to raise capital through securities offerings. In all cases when a cooperative seeks to offer, sell, and issue securities, a federal exemption should be researched as well as a state securities exemption in each state in which the offering is available. Lastly, any attorney familiar with securities law should be consulted anytime one seeks to issue securities. The current state of the law and regulatory opinions leaves open the possibility for cooperatives to creatively and broadly define patron-membership so as to capture this important and valuable securities exemption.

Private Placement Exemptions for Securities Issued by Any For-Profit Business Entity

In spite of the general requirement under federal securities law that the offer, sale, and issuance of securities must be registered with the SEC, certain limited exemptions are available. The so-called private placement exemptions provide narrow means by which to conduct a securities offering without registering it with the SEC. This particular exemption is described here because it is the primary mechanism by which cooperatives are able to offer equity investment opportunities to outside investors (see outside non-member investment and outside investor-member equity described above). Although it is advisable and may be necessary to retain an attorney to ensure proper compliance with securities regulations, the private placement exemption is simpler and less expensive to implement than going the route of a registered public offering via crowdfunding or the additional possibilities for investors created by the JOBS Act.

The private placement exemptions prohibit general advertising and solicitation of the offering, hence the private nature of the offering. There is lengthy case law on the subject as to what constitutes "general advertising and solicitation." A general rule of thumb is that the offering can be discussed one-on-one through "substantial and pre-existing relationships." One of the values of the diverse engagement of individuals and entities in the Community Wealth Building Network in the Denver Metro Area is it provides an opportunity to build relationships between people engaged in grassroots entrepreneurial efforts and potential investors.

The three primary private placement exemptions relate to:

- offerings of up to \$1 million (in a twelve month period) under Rule 504;
- offerings up to \$5 million (in a twelve month period) under Rule 505; and
- offerings of an unlimited amount under Rule 506.

Each of these three private placement exemptions has its own unique requirements and interaction with state-level securities regulations.



Community Wealth Building

Metro Denver's Economic Prosperity Network

One of the more popular private placement exemptions is contained in Regulation D, Section 506, which permits an issuer to raise an unlimited amount of money, subject to certain restrictions and requirements. First, the offering is limited to up to 35 non-accredited investors. The issuer (business) may rely upon the self-certification of an investor's status as an accredited investor. The issuer must perform its own due diligence to ascertain that non-accredited investors are "sophisticated" and thus capable of evaluating the risk and upside of an investment and of protecting her own financial interests. The issuer is required to make adequate disclosures to non-accredited investors prior to the sale of securities. Lastly, general advertising and solicitation are strictly prohibited. Many businesses considering soliciting investment through a private placement prefer Section 506 exempt offerings because federal law preempts the state securities law and so, in addition to complying with Section 506, the issuer just has to send a notice statement and pay a modest fee to state securities regulators.

In limited circumstances, general advertising and solicitation is permitted under private placement exemption, Regulation D, Section 504, but the investment offering is limited to \$1 million in a twelve month period. Under this section, there is no limit on the number of investors, including the number of non-accredited investors. Although this section of the federal law permits general advertising and solicitation, the state-level regulations may differ and a state-level exemption that permits such advertising and solicitation should be identified and complied with. This Section 504 exemption is not viewed as a viable pathway through which to generally advertise a securities offering or sell securities to non-accredited investors. If an issuer desires to generally advertise and sell securities to non-accredited investors, it would be advisable to review the requirements of conducting an intra-state offering under a direct public offering or limited registration regime.

It is advisable and just a good idea to retain the services of an attorney familiar with securities law when going this route. Despite the complicated nature of securities law, this exemption has been used effectively by well-established cooperatives for raising capital to grow their business. See <http://www.bostonglobe.com/business/2015/04/30/fair-trade-coffee-roaster-equal-exchange-wraps-stock-sale/AEN8mTeOR6xImxEXsmT1PM/story.html>



Section 4. Opportunities for Charitable Foundations

To maintain their tax exempt status, private charitable foundations are required by the Internal Revenue Code to dispose of at least 5% of their assets each fiscal year for purposes that further their philanthropic mission. This is usually accomplished by making grants to nonprofit organizations. In most cases, foundations will invest the remaining 95% of their assets with the goal of maximizing financial return. Socially responsible and impact investor commentators have remarked that the two sides of a foundation's financial house are thus often at odds, with the grant-making side looking to maximize impact in connection with the foundation's charitable purpose, and the investment-making side looking to maximize financial return, with little or no regard for the social impact of those investments.

Some foundations, eager to use more of their resources to further their philanthropic objectives, are looking beyond the 5% of assets they are required to allocate as grants and choosing to deploy all or some of their remaining capital to further their philanthropic missions. For example, the F.B. Heron Foundation in New York City has made the decision to use all of its assets in furtherance of "helping people and communities help themselves prosper, especially those that are economically disadvantaged." Gary Community Investments in Denver is also taking this route and making grants and financial investments to improve the lives of Colorado's low-income children and their families.

Knowing that capital leads to more capital, there is a growing interest in investing foundation capital in entrepreneurial endeavors in low-income communities, as a strategy for alleviating poverty. This is new and uncharted waters for most foundations. Below is a brief explanation of options currently available to foundations.

Program Related Investments

A tax-exempt charitable foundation can make a debt, equity, or other investment in a non-profit or for-profit entity that qualifies as part of their annual asset distribution requirement through a mechanism known as a "program related investment⁵" (PRI). Through a PRI, a foundation can count the principal amount of the investment toward satisfying a portion (or all if the investment is large enough) of its annual 5% asset distribution requirement. Generally, any return or interest derived from a PRI becomes part of the foundation's general assets, just like a return on a stock investment. This vehicle blends some of the most important and impact-friendly elements of both the grant-making and investment functions - it furthers a foundation's charitable purposes, like a grant, but is regenerative in that the investment has potential for limited return to the foundation's assets.



Community Wealth Building

Metro Denver's Economic Prosperity Network

PRIs are quite flexible and can take the form of equity, debt, forgivable loans, convertible loans, and other types of investments. PRI's can help social enterprises, community-focused businesses, worker cooperatives, and nonprofit organizations access working or growth capital, establish or provide a backstop for credit, provide seed capital, provide a source of bridge financing in anticipation of subsequent investor financing, and often serve to attract other investors to a project. Foundations may seek and obtain from the Internal Revenue Service a "private letter ruling," to determine whether a particular investment would qualify as a PRI.

To qualify as a program related investment, an investment must satisfy each element of a three-part test, which is contained in the Internal Revenue Code.

- The primary purpose of the investment is to accomplish one or more of the charitable, religious, scientific, literary, educational, and other exempt purposes described in Section 170(c)(2)(B) of the Internal Revenue Code;
- No significant purpose of the investment is the production of income or the appreciation of property; and
- No purpose of the investment is to lobby, support, or oppose candidates for public office or to accomplish any of the other political purposes forbidden to private foundations by section 170(c)(2)(D) of the Internal Revenue Code.

Mission Related Investments

Mission Related Investments (MRIs), sometimes known as impact investments, describe investments made by a foundation that are more in-line with the foundation's mission, as opposed to the status quo investment pattern for many foundations where the sole purpose is maximizing return on investment. As a trustee of the F.B. Heron Foundation in New York City asked when that organization was discussing shifting their investment strategy to one where all investments were in-line with the foundation's mission, "Are we a mission-based organization or an investment organization that donates some of its profits to charity?"

Unlike PRI's, MRI's do not have a legal definition and do not qualify towards the 5% asset distribution requirement. An MRI must meet the Prudent Investor standards defined by the IRS and relevant case law and other requirements that apply to a foundation's investment activities, but otherwise, MRI's are flexible and can take a variety of investment forms, such as debt, equity, convertible loans, and other types of investments. In addition to not counting towards a foundation's required annual 5% asset distribution, MRIs have an expectation of a market rate financial return. With PRIs, the financial return is a secondary consideration, with the furtherance of mission being the primary purpose of the investment.



Grants or Program Related Investments to For-Profit Entities

While most foundations are not accustomed to making grants or PRI's to for-profit entities, the good news is that it is possible. This activity requires that the foundation and the business receiving the grant or PRI assume what the Internal Revenue Service (IRS) refers to as "expenditure responsibility." This requirement involves a higher level of ongoing reporting and oversight on the part of the for-profit entity and the foundation.

To comply with the IRS requirements for expenditure responsibility, foundations require for-profit grantees to assume responsibility for:

- Ensuring that the grant is spent only for the purpose(s) for which it was made;
- Submitting full and complete reports to the foundation on how the funds are spent; and
- Contributing to the full and detailed reports the Foundation must submit on its expenditures to the IRS.

As more foundations begin to focus on addressing economic opportunity, it is anticipated that this mechanism will become more common.

If a foundation does not want to take on the expenditure responsibility requirements of investing directly in for-profits, it could make a Program Related Investment to a 501(c)(3) registered Community Development Financial Institution (CDFI), who will then lend the money to small businesses or community enterprises. This will achieve a similar result in terms of making foundation capital available to for-profit entrepreneurs in low-income communities. However, a direct investment or grant by a foundation may be considered preferable in that the foundation may offer its capital at lower rates than a CDFI. As foundations consider making investments to for-profits, new advisers and entities with this specific expertise are emerging in order to help guide them through the process.

Convertible Grants

One of the funding methods currently being explored by the Beanstalk Foundation in Denver and by the U.S. Federation of Worker Cooperatives is a form of hybrid grant/loan.

For Beanstalk Foundation, a grant will be made to a charitable organization with a social enterprise to support a designated charitable program or activity, under terms that encourage restoration of the grant dollars to Beanstalk Foundation upon the occurrence of certain circumstances (generally when the underlying charitable program or activity achieves a certain level of success, as determined by specific operational metrics or other factors defined by Beanstalk Foundation). Beanstalk Foundation does not view such grants as loans, and will not report the grants as "loans" on



Community Wealth Building

Metro Denver's Economic Prosperity Network

its IRS Form 990-PF, due to the fact that there is never any legal obligation for the grant recipient to repay the grant dollars to Beanstalk Foundation. Rather, there is an understanding that if and when the recipient organization achieves the specific degree of success with its charitable program, the recipient organization is encouraged to restore the dollars to Beanstalk so that the dollars may be “re-granted” to other non-profit organizations with a social enterprise, to support additional charitable activities.

In the event that the recipient charitable organization does not achieve the defined level of success for its charitable program, or simply does not wish to restore the grant dollars to Beanstalk Foundation after achieving the defined level of success, Beanstalk will not undertake any action to recover the grant dollars – it will simply view the transaction as a grant without any potential return of funds.

As for the U.S. Federation of Worker Cooperatives, it is creating a revolving grant fund to help existing co-ops grow their business. The fund will initially provide a grant to a co-op to help them with the planning and technical assistance phases necessary to expand their business. When the co-op reaches the level of growth that allows it to attract other sources of financing, the co-op will include the original grant amount in the loan or equity they acquire and then be in a position to pay the grant back to the Federation.



Section 5: Additional Resources

BALLE (Business Alliance for Local Living Economies) - <https://bealocalist.org>

Has a 21 page extensive and detailed PDF download titled "A Guide to Community Capital."

Colorado Microfinance Alliance - www.coloradomicrofinance.org

Provides a list of organizations in Colorado offering microfinance loans in amounts varying from \$200 to \$300,000.

Community Development Financial Institutions (CDFIs) - www.cdfifund.gov

Provides a description of CDFIs and a list of CDFIs around the country. For a list of Colorado CDFIs, see Section 1.

Community-Wealth.org - <http://community-wealth.org>

A project of the Democracy Collaborative, CommunityWealth.org offers a list of "Strategies and Models" at <http://community-wealth.org/strategies/> which includes descriptions of a variety of community wealth building programs and initiatives, as well as some funding mechanisms.

Cooperative Development Foundation - www.cdf.coop

The CDF was created in 1944 after WWII to facilitate reconstruction in Europe by providing funding for co-ops. Their website lists several funds focused primarily on assisting development of co-ops to address housing and the elderly. The CDF also offers scholarships and grants for education and training of co-op staff and boards.

Co-opLaw - <http://www.co-oplaw.org>

A collaborative legal resource library created by the [Sustainable Economies Law Center \(SELC\)](#) Co-op Law offers a detailed tutorial on "Financing A Cooperative" at <http://www.co-oplaw.org/financing/>.

CuttingEdge - www.cuttingedgex.com

Provides an excellent and accessible explanation of Direct Public Offerings (DPOs) on both the FAQs and "Resources" page. The site also provides links to the Cutting Edge Capital website for more in-depth discussion of each topic.



Community Wealth Building

Metro Denver's Economic Prosperity Network

Cutting Edge Capital - www.cuttingedgecapital.com

Provides an informative blog and offers a free download of materials (www.cuttingedgecapital.com/freedownload) including:

- a PDF guide to securities;
- a video guide on what types of investment vehicles to use; and
- a decision tool on different types of investments.

Cutting Edge Capital also offers a DPO bootcamp (www.cuttingedgecapital.com/dpobootcamp) for a fee to guide organizations through their own DPO process.

Democracy At Work Institute - <http://institute.usworker.coop>

Has a plethora of white papers on worker cooperatives, including a catalog of efforts by local government institutions to support cooperative development in their regions.

Grassroots Economic Organizing - www.geo.coop

Has a page entitled "Raising Capital for Worker Cooperatives" (www.geo.coop/node/60), which lists unique out-of-the-box examples of funding used by various worker-owned cooperatives.

ICA Group - www.ica-group.org

Supports democratic employee ownership and social enterprises including worker co-ops and Employee Stock Ownership Plans (ESOPs). ICA provides business development and strategic planning and evaluation for social enterprises and co-ops. ICA's website also offers resources about co-ops and business conversions to employee ownership.

Impact Finance Center - <http://www.impactfinancecenter.org>

The University of Denver's Impact Finance Center is focused on increasing investment in entities having a positive social impact.

National Cooperative Bank - www.ncb.coop

Provides comprehensive banking services to cooperatives and member-owned organizations. The NCB was chartered by Congress with an appropriation of \$184 million to support and be an advocate for America's cooperatives. NCB's loan programs focus on housing cooperatives, community associations, business cooperatives, and socially responsible enterprises. Based in DC they have offices in NYC & CA and a large presence in Ohio.



Community Wealth Building

Metro Denver's Economic Prosperity Network

Northeast Investment Cooperative - www.neic.coop

Northeast Investment Cooperative is the first investment cooperative of its kind in the United States. It allows the people of Northeast Minneapolis to pool their resources and collectively buy, rehab, and manage commercial residential property in their neighborhood.

Rocky Mountain Employee Ownership Center - <http://rmeoc.org>

Has resources for companies considering converting to employee ownership.

Rocky Mountain Farmers Union - www.rmfu.org

Has a Co-op Development Center that offers technical assistance and training to startup and existing cooperatives in Colorado.

Slow Money - <http://slowmoney.org>

Seeks to catalyze the flow of capital to local food enterprises and organic farms.

SmallBizLending.org - www.smallbizlending.org

Provides resources and advice for small businesses seeking financing. The website includes an extensive list of lenders in Colorado, including CDFIs, community development companies, municipal programs, and governmental bank lending partner organizations (smallbizlending.org/colorado-lenders-grid).

Small Business Administration - www.sba.gov

Provides descriptions of and resources for how to obtain loans along with investment options for small businesses from the SBA, including SBICs and similar programs (see Section 1 for more information on SBA loans).

US Federation of Worker Cooperatives - www.usworker.coop/financing-resources

Provides a finance resources page that offers links to:

- lending institutions whose focus is co-ops and employee-owned enterprises,
- the KivaZip microloan program,
- crowdfunding through Indigogo & Kickstarter, and
- a direct public offering platform: CuttingEdge.



Section 6: Glossary of Terms

Accredited Investor: Under U.S. securities law, strict rules limit the opportunity to invest directly in businesses to only certain wealthy individuals. It is believed that only 2% of the population fits within the legal definition of an accredited investor, thereby leaving 98% of the population to invest through relatively limited channels. Under the U.S. federal securities laws, an “accredited investor” is an individual who (i) has earned more than \$200,000 in each of the past two years with a reasonable expectation of earning the same or more in the current year (however, where the investor is a couple, more than \$300,000 a year in each of the past two years with a reasonable expectation of earning the same or more in the current year), or (ii) has a net worth of \$1 million or more, excluding their principal residence. Under this same rule, certain organizations under certain conditions (e.g., high net assets) can also be ascribed the status of accredited investor. If you are not an Accredited Investor, you are referred to as an Unaccredited or Non-accredited Investor. The JOBS Act and certain Crowdfunding platforms have created opportunities for Unaccredited/Non-accredited Investors to make direct investments in businesses.

Cash Flow: Simply put, cash flow is the total amount of money being transferred into and out of a business, especially as it affects the liquidity (see definition below) of the business.

Common and Preferred Stocks/Shares: See Equity

Cooperative: A for-profit business enterprise that is owned by and democratically controlled by the people who either work or shop there (e.g. a taxi-driver co-op or a food co-op), use its services (e.g. a credit union or health insurance co-op), or produce goods/items for it (e.g. a food producers co-op). Co-ops usually abide by a set of universally recognized Cooperative Principles and Values (see <https://www.ncba.coop/7-cooperative-principles>) A cooperative is an autonomous and independent organization owned, financed, and controlled by its members that provides and distributes benefits to those persons based on the amount of their use while also seeking to provide education, training and information with a concern for community responsibility.

Convertible Debt: Convertible debt is a debt (see definition below) that upon the occurrence of one or more previously stipulated events will, either automatically or upon a voluntary declaration made by the holder of that debt or by the person or organization that created the debt, convert into another form of property interest. In the context of a business, convertible debt is a monetary obligation of the creator of the debt which has, in the hands of the holder of the debt, the ability to be converted, upon the occurrence of one or more contractually-stated events, into a partial or full ownership interest in the business.



Debt or Debt Financing: Business capital derives from two primary sources, equity and debt. A debt is a monetary obligation owed by a business or its owner to a third party in exchange for receiving something of value. The creation of the debt puts the holder of that debt in the position of being a creditor of the business or the owner who created the debt. An example of debt is taking out a mortgage loan from a bank.

Equity: Any property interest that constitutes a claim to the full or partial ownership of a business or asset. In the case of a corporation, for example, such an interest would be represented by shares of stock, denominated as either **common** (has voting rights as a shareholder of the company) or **preferred** (does not have voting rights but receives dividends/pay-out before common stockholders) in nature. In this paper, stock is referring to stock in a private company, as opposed to a public company whose stock can be purchased through a stock exchange, such as the New York Stock Exchange. In the case of a Limited Liability Company (LLC) such an interest would take the form of membership “units.” In the case of a cooperative, members of the co-op business invest money in the form of equity into the business and often can take that equity with them if they leave the co-op. In some circles, the term is also loosely used to describe such things as royalties or revenue sharing payments (both of which are defined below), but technically-speaking, such interests do not constitute a claim on the ownership of the business. Rather, such interests are more properly categorized as a lien in favor of, or a debt owed by the business to, the holder of the right to receive the royalty or revenue sharing payments.

Exit Strategy: The strategy or objective whereby the business interest or ownership interests are liquidated. This is ordinarily achieved through a merger, acquisition, sale of all or substantially all of the business' assets, or an initial public offering on a public stock exchange. While generally not the goal, dissolution or winding down of the business can also technically be considered an exit. (The businesses and entrepreneurs that this paper addresses are typically not focused on an exit strategy - i.e. their goal is to provide on-going quality jobs in specific geographic regions, rather than sell the business to another entity or take the company public. The goal here is to keep the wealth in the local community.)

Liquidity: In the context of running a business, liquidity means the extent to which a business can pay its debts as they come due. When a business cannot pay its debts in the ordinary course of its affairs, and such a condition continues unabated, the business will fail. A slightly different situation occurs when the liabilities of a business exceed its assets. In such a situation, the business is said to be “insolvent”. A business suffering cash flow (and thus liquidity problems) may not necessarily be insolvent. For example, a company could have more than ample assets to cover liabilities, but nevertheless still be experiencing severe cash flow or liquidity issues. In the context of investments, liquidity refers to the relative ease with which the current owner of the investment can dispose of its property interest in the investment and trade it to a third party. Where transfer of the ownership of the investment to another party is extremely difficult, for whatever reason (e.g., lack of marketability, contractual restrictions, etc.) that investment is deemed to be “illiquid”.



Patient Capital: An investment of capital where the investor recognizes that the entity they are investing in may take longer than a traditional business to become profitable, due to the nature of the business and this is acceptable to the investor because they are also interested in the particular mission of this business. The investor is willing to have their capital tied up in the business for longer than the typical investor.

Promissory Note: A legal document that obligates the recipient of a loan to repay the lender. This document is essentially a contract, and sets forth the terms and conditions applicable to the loan. Terms can include some or all of the following: maturity or repayment date, interest rate, prepayment, collateral, affirmative (musts) and negative (must nots) covenants of the borrower, reporting requirements, default, remedies, dispute resolution and other legal terms.

Royalty/Revenue Sharing: Royalty or revenue sharing interests are property interests in which the holder of the interest has a legally-enforceable right to receive from the individual or business which created the right, a certain portion of the revenues of such individual or business, as stipulated in a previously-executed, binding agreement between the parties. Such an interest places the holder of the interest in the position of being a creditor of the individual or business in question.

Security: Generally and in non-legal terms, a security is an interest in the profits or underlying value of a for-profit business. Federal law defines a security as “any note, stock ... bond, debenture, evidence of indebtedness [or] certificate of interest or participation in any profit-sharing agreement ...”⁶ A **security offering** describes an event during which a business allows others (usually accredited investors) a chance to purchase a security or interest/equity in the business. A security offering is regulated by the federal government (Securities and Exchange Commission) and also by state laws. In Colorado, securities are regulated through the Division of Regulatory Agencies (DORA) Division of Securities.

Securities and Exchange Commission (SEC): “The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” The SEC was established by Congress in 1934 to enforce newly-passed securities laws after the stock exchange crash in 1929, to promote stability in the markets, and to protect investors. Today, the SEC helps to regulate the securities markets in the US and to enforce rules and regulations to help protect investors.

Social Enterprise: A social enterprise can be a for-profit or non-profit entity whose primary purpose is the common good. Definition from the Social Enterprise Alliance: “They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas.”



Community Wealth Building

Metro Denver's Economic Prosperity Network

Start-up: A start-up is a business that is in the very beginning phases of becoming a business. This often means the business is not generating revenue yet or is only making a small amount of revenue and instead is developing a business model and testing its product/concept. The single most important issue faced by most start-ups is demonstrating a viable business model to meet market demand. In addition, many start-ups struggle with successfully managing cash flow, which can doom a business to failure. In attempting to successfully manage cash flow, many start-up businesses (and, indeed, businesses in general) seek to secure working capital from outside sources, thereby ensuring that the business will have adequate funds and will not run out of the money necessary to conduct its operations on a day-to-day basis.



About the Authors

R.P. Burrasca: rpburrasca@coloradocrowdfunding.org. R.P. Burrasca is both the founder and primary organizer of Colorado Crowdfunding www.coloradocrowdfunding.org, the state of Colorado's first, oldest, and largest community organization dedicated exclusively to the subject of crowdfunding, in all of its iterations, with its principal mission being to educate the general public about the power of crowdfunding and to advocate for its widespread adoption as an alternative financing tool, both at the state and federal level. In addition, Mr. Burrasca has been a practicing attorney for more than 34 years, specializing in all aspects of finance and corporate law, particularly as it pertains to venture capital and other types of private equity, and has led or been deeply involved in numerous mergers and acquisitions, complex commercial transactions, joint ventures and complex securities and finance transactions. He has personally handled billions of dollars in corporate transactions and has served as the CFO of both large and small businesses and has been the Managing Director of several dozen more. Besides his duties at Colorado Crowdfunding, Mr. Burrasca is the managing director of Windom Peaks Capital, LLC, a small investment banking boutique located in Denver, Colorado.

Susan Grossberg: sg@grossberglawoffices.com. Susan recently relocated to Denver, Colorado from Boston, Massachusetts where she was a consumer bankruptcy practitioner in solo practice as Grossberg Law Offices. Susan also taught consumer bankruptcy law as an adjunct professor at Northeastern University School of Law. She is the 2004 recipient of the Denis Maguire Pro Bono Award, a 2013 Massachusetts Lawyers Weekly "Top Women Of The Law" honoree, and received the 2014 Eastern Division Pro Bono Publico Award from the Massachusetts Bankruptcy Court. Susan received her bachelor's degree in economics from the University of Michigan and her law degree from Northeastern University School of Law, and served a one-year term as a judicial clerk to Justice Kenneth Laurence of the Massachusetts Appeals Court. Susan is using the move to Colorado to pivot her career to working with and for purpose-driven social enterprises and cooperatives.



Community Wealth Building

Metro Denver's Economic Prosperity Network

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Prior to moving to Colorado in 2014, Anne was a consultant for Opportunity Finance Network, a national network of CDFIs that invest in opportunities that benefit low-income, low-wealth, and other disadvantaged communities across America. She also worked on a number of consulting projects related to healthy food access in Philadelphia and has experience as a community organizer and environmental policy advocate. Anne was a founding Steering Committee member of the Philadelphia Area Cooperative Alliance (PACA), a cross-sector co-op development organization. Anne was also a member of the Steering Committee and Personnel Committee of Mariposa Food Co-op. Anne holds a Master of City Planning from the University of Pennsylvania in Philadelphia, PA and a Bachelor of Arts from Oberlin College in Oberlin, OH.

Michelle Sturm: meshe11@mac.com is a freelance consultant working with nonprofits and foundations, drawing on a twenty-five year background in the nonprofit sector. Michelle has an extensive network across Colorado from her tenures at the Anschutz Family Foundation, the Colorado Healthy Community Initiative, and Volunteers for Outdoor Colorado. In 2014, Michelle worked with the Rocky Mountain Farmers Union, Rocky Mountain Employee Ownership Center, The Denver Foundation, and Co-operate Colorado to plan the second Community Wealth Building conference in the Denver Metro Area. She continues to work with these entities to bring about a robust community wealth building ecosystem in the region and serves as a consultant to The Denver Foundation's Economic Opportunity Department to further the community wealth building agenda. Her freelance practice is best characterized as partnering with people intent on coming together in new ways to address persistent challenges. Michelle, along with Anne and Jason, is a founding member of the Community Wealth Building Network of Metro Denver. www.communitywealthbuilding.org.



Community Wealth Building

Metro Denver's Economic Prosperity Network

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Jason holds a B.S. from Cornell University's School of Industrial and Labor Relations and a J.D. cum laude from Suffolk University Law School, where he received honors with a concentration in international law. Jason has published more than 6 scholarly law review articles on international, human rights and renewable energy topics and speaks regularly about socially responsible alternative financing and capitalization strategies, cooperatives and social enterprise business models. Jason is an adjunct professor in CSU's Global Sustainability and Social Enterprise program, where he teaches an MBA course on business law and ethics. He is also a guest lecturer at C.U. Law's Entrepreneurial Law Clinic.



Endnotes

1 See <http://institute.usworker.coop/projects/conversions>.

2 In full disclosure, one of this paper's authors, Jason Wiener, is co-developing a cooperative investment club as part of an endeavor named the "Cooperatize Challenge™". The goal is to replicate the well understood and respected robustness of a professionally managed investment fund, while directing equity and debt investments to worthy, well-managed, and sustainable start-up and converting cooperatives. This type of fund would be governed on a one-person-one-vote basis, to align itself with the broader cooperative movement and its trusted governance model.

3 Patrons are those individuals, associations, or entities that qualify as members in a cooperative and utilize or contribute value or services from or to the cooperative. The concept of patronage is rooted in the utilization and/or contribution of value to the cooperative. Patronage derives from the contribution of labor and is generally distinguished from membership that derives purely from the contribution of capital.

4 Federal law defines a "security" broadly. The definition is created both by statute as well as through case law and the issuance of SEC "no action letters." See definitions section and related footnotes above, in Section 3.

Colorado Exemption: Article 56 - 7-56-509. "**Any security**, patronage refund, per unit retain certificate, capital credit, evidence of membership, **preferred equity** certificate, or other equity instrument issued, sold, or reported by a cooperative **as an investment in its stock or capital to the patrons of a cooperative** formed under or subject to this article or a similar law of any other jurisdiction and authorized to transact business or conduct activities in this state **is exempt from the securities laws contained in the "Colorado Securities Act"**, article 51 of title 11, C.R.S. Such securities, patronage refunds, per unit retain certificates, capital credits, or evidences of membership, preferred equity certificates or other equity instruments may be issued, sold, or reported lawfully by the issuer or its directors, officers, members, or salaried employees **without the necessity of the issuer or its directors, officers, members, or employees being registered as brokers or dealers under the "Colorado Securities Act"**, article 51 of title 11, C.R.S."

Colorado Exemption: Article 58 - 7-58-1009. "**Any security**, patronage refund, per unit retain certificate, capital credit, evidence of membership, **preferred equity** certificate, or other equity instrument issued, sold, or reported by a limited cooperative association **as an investment in its stock or capital to the patron members of the association** or by an entity subject to this article or a similar law of any other jurisdiction and authorized to transact business or conduct activities in this state **is exempt from the securities laws contained in the "Colorado Securities Act"**, article 51 of title 11, C.R.S. Such securities, patronage refunds, per unit retain certificates, capital credits, or evidences of membership, preferred equity certificates, or other equity instruments may be issued, sold, or reported to patron members of the association or entity lawfully by the issuer or its directors, officers, members, or salaried employees **without the necessity of the issue or its directors, officers, members, or employees being registered as brokers or dealers under the "Colorado Securities Act"**, article 51 of title 11, C.R.S."

5 See: <http://community-wealth.org/strategies/panel/pris/index.html>
<http://www.grantcraft.org/guides/program-related-investing>
<http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Program-Related-Investments>
<https://www.missioninvestors.org/mission-investing>

6 This definition has been interpreted and applied in more than a half-century of case law. Three important tests expand upon this definition. (1) The "Howey" test defines a security as: (i) an investment of money; (ii) due to an expectation of profits; (iii) arising from a common enterprise; and (iv) which depends solely upon the efforts of a promoter or third party. The "Forman" test looks at whether an investment is made principally for personal consumption and the degree to which an expectation of profits is merely incidental to ownership. If the answer to the first part is "yes" and the answer to the second part is "no", then a court would likely deem the investment not to be a "security". A discussion of securities law would be incomplete without reference to a third test. Although a minority of courts apply the "risk capital" test, one should be aware of its existence. The "risk capital" test generally applies to debt instruments and it more or less builds upon the "Howey" test. It adds an element that looks to the degree to which the investment is adequately secured by collateral. Additionally, subsequent lower court and Supreme Court decisions have widened the "Howey" test by eliminating the "solely" condition from the fourth branch of the test, i.e., the dependency referred to in the fourth branch no longer needs to be predicated "solely" on the efforts of a promoter or third party. Some minor or incidental involvement by the purchaser of the investment in the running of the business would not prevent the interest purchased from falling within the definition of a "security".