Community Bonds

A Non-Profit Financing Tool

Review of Structure, Requirements and Process
for
Non-Profit Organizations
Issuing
Community Bonds in British Columbia

Vancity Make Good Money™

Vancity Community Foundation

CapacityBuild Consulting

Acknowledgements

Navigating the complexities of the securities industry and piecing together the practical opportunities for non-profit organizations can be a daunting task. It is not without the significant support, information and input provided by a number of individuals and organizations that this Community Bond overview paper could come together. It is with thanks and great appreciation that we recognize the following people for their contributions as indicated.

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Executive Summary

The concept of a non-profit organization issuing a bond as a security to raise money from investors is rooted in the existing Securities Markets. An understanding is developed of the primary channels of public and private securities markets and a clear differentiation between bonds and stocks is provided. A high level explanation of the British Columbia securities regulatory framework and the regulatory agency gives a sense of the constraints and requirements for any issuer of securities. Within this context are a number of exemptions to the costly reporting requirements of public markets and these are explored in more detail with the relevance to non-profit organizations identified.

Following additional detail on bonds as a specific security instrument and how they can be created by non-profits and cooperatives, a specific exemption opportunity is presented in more detail. Within a group of "other exemptions" to full prospectus reporting is one which applies to organizations formed for benevolent purposes, including non-profits and charities. The impact of this allowance means significantly reduced costs for issuing and maintaining a security (bond) in BC and paves the way for a more practical solution for non-profit organizations. RRSP eligibility as a concept and as a possibility is explained together with its relevance to Community Bond issues.

A number of decision criteria are presented to assist organizations to think about a bond in the context of other funding options. Accessing philanthropic or donated funding remains a very viable, if not preferred, option if it is available. Similarly, more conventional bank debt may be a much simpler option to pursue if the stringent criteria are met. If these other options are not available or not appropriate, a bond may well serve the need for capital.

Typically the expertise required to move forward on a bond issue is not resident within the non-profit itself and identifying appropriate accounting, legal, financial and tax expertise is essential. A listing of required documentation to issue a bond identifies such components as investor information, a Bond document, a Trust Agreement, a Subscription Agreement, and Security Agreements as part of the needed document package. Required roles in taking the bond to market include identifying a Trustee, a Transfer Agent and aligned financial institutions to accept the bond into RRSP accounts (if RRSP eligible).

The final segment of the paper is devoted to identifying the steps in the process from idea generation through to closing the bond transaction with investors. It starts with a clear definition of the project or initiative which will be funded by the bond. Assessing the potential for success of a bond as a funding mechanism requires the application of financial analysis and forecasting and testing the waters on the investor market. This work provides insight on whether to proceed and how best to shape the bond offering.

Designing the terms of the bond is an important step and should incorporate feedback from potential investors as well as meeting the repayment capabilities indicated in the financial forecast. Terms and conditions can be developed according to the characteristics of the project being funded but they need to meet investor objectives and risk tolerances as well. Required documentation is outlined with a description of the key pieces.

One of the differences of a bond issue from other forms of raising capital is the marketing or “sales” process to attract and gain commitment from investors. This process is outlined together with a sense of the timelines to move through the whole process. While each segment of the process can vary widely, a rough estimate would indicate somewhere from 10 months to 2 ½ years from conception to closing the transaction. This will depend heavily on the readiness of the organization at the outset.

The bond transaction closing can be defined as a precise point in time (funding a purchase transaction) or take place over an extended period (ongoing funding of programming and/or multiple projects). Finally, the administration requirements relating to the issue and ongoing support of a bond are presented. Summarizing comments conclude the paper with a glossary of some of the key terms included for reference.

Introduction and Scope

Non-profit organizations have always worked hard to find the financial resources needed to complete their work in the community. They have also demonstrated significant innovation and tenacity in pursuit of funding opportunities. As the funding landscape continues to shift organizations are ready and willing to explore new and, as yet, relatively untried channels to raise money, to engage new segments of the financial community in new ways and to create reliable, unencumbered sources of funding.

This paper has been prepared as a "first read" for organizations looking for new funding possibilities or for those who are curious about the concept of a bond as a potential vehicle for their organization to fund a specific project. Plenty of discussion is circulating about this new world of social finance and about new financial instruments, but the investment sector is complex and it is often difficult to understand how it can be navigated. Many of the organizations which would benefit from a Community Bond issue do not have the expertise within their ranks to even start to "crack the nut" on approaching the question of issuing a bond to investors.

Among a number of financial instruments which are being redirected or repurposed for use by mission based organizations, Community Bonds are gaining traction as an innovative investment vehicle for non-profits. They are being used to leverage an emerging interest on the part of investors to be more purposeful in their investing decisions, choosing to find ways to make a mission contribution while at the same time creating a financial return on their assets.

The intent behind this overview of securities markets and mapping of steps towards issuing a Community Bond is to further understanding, catalyze discussions and awaken curiosity within the non-profit sector. It is hoped that through the information contained here there will be additional clarity on the size of the task, some further perspective on when and how a Community Bond might be appropriate and that it will serve to identify resources for moving ahead.

We start with background and information on the securities and bond markets to provide context and to understand what the regulators need. Following this a review is presented of what a non-profit will need to make decisions about and prepare themselves for a Community Bond issue. The final segment walks through a process map from idea generation to closing the transaction so the entire process is clearer. Along with explanations of the structures and legislation comes a new vocabulary of terms and we have provided a glossary at the end to provide added detail on some of the key terms. Where these terms occur within the document they are in bold type for ease of reference.

PART I – Bond Market Defined

Securities Market Overview

Financial markets around the world actively trade daily in billions of dollars worth of financial instruments. This highly fluid mechanism is at the core of free market economies as those that require capital to undertake new initiatives, expand business enterprise and engage in the exchange of goods and services are matched with those that have capital available and are interested in maximizing their financial return. In Canada, there are several public securities exchanges which act as clearing houses for the distribution and trade in securities of all types. There is also a very active market which trades outside of the public stock exchanges.

The term security is a generic term which applies to a vast array of types of financial instruments. **Security** has a broad legal meaning and fundamentally refers to a document evidencing an interest in the capital, assets, property, profits, earnings or royalties of a company. Security is defined to include such instruments as:

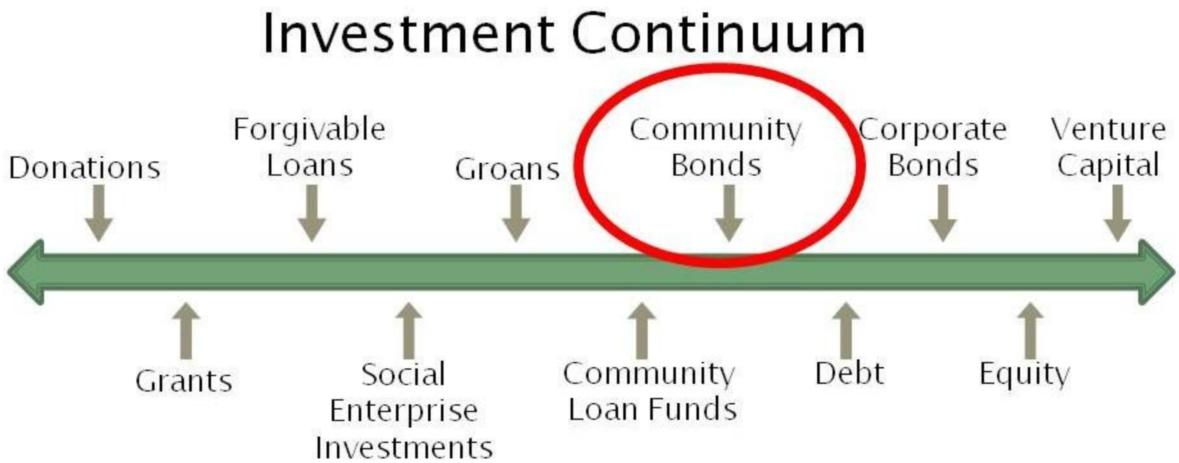
- common and preferred shares
- options, warrants and other convertible instruments
- debt security, meaning any bond, debentures, note or similar instrument representing indebtedness, whether secured or unsecured
- limited partnership units
- memberships in co-operative associations

This list is far from exhaustive and the diversity of types of instruments being developed is only limited by the imagination of those that are seeking to raise capital and issue the securities, within the constraints of the regulatory environment surrounding the trade of securities in Canada.

The securities market includes all of the supporting mechanisms, trading channels and the regulatory environment which sustains this highly active and essential component of a robust economy. To provide context to the nature of financial instruments which securities markets support, Figure 1 below demonstrates the two extremes of an investment continuum which is particularly relevant for non-profit organizations.

While conventional philanthropy and granting mechanisms dominate one end of the continuum, the other end is populated by investment instruments typically used by for-profit corporations in the pursuit of business growth and profitability. Securities markets primarily support the trade of all nature of instruments at the corporate end of the continuum. Capital to support non-profit endeavours has traditionally been sourced at the philanthropic end of the continuum.

Figure 1



As mentioned, there is a strong regulatory environment which surrounds and guides all trading of securities in Canada. Specific legislation is the responsibility of provincial governments however there is a highly consistent approach across Canada with many of the provincial regulations being adopted from national regulation instruments. In British Columbia, the **BC Securities Act** (the Act) is the guiding legislation and the **BC Securities Commission** is responsible for the administration of the Act. The following section on the regulatory environment will provide further detail of the requirements directed by the legislation and the particular relevance to the issuance of a Community Bond.

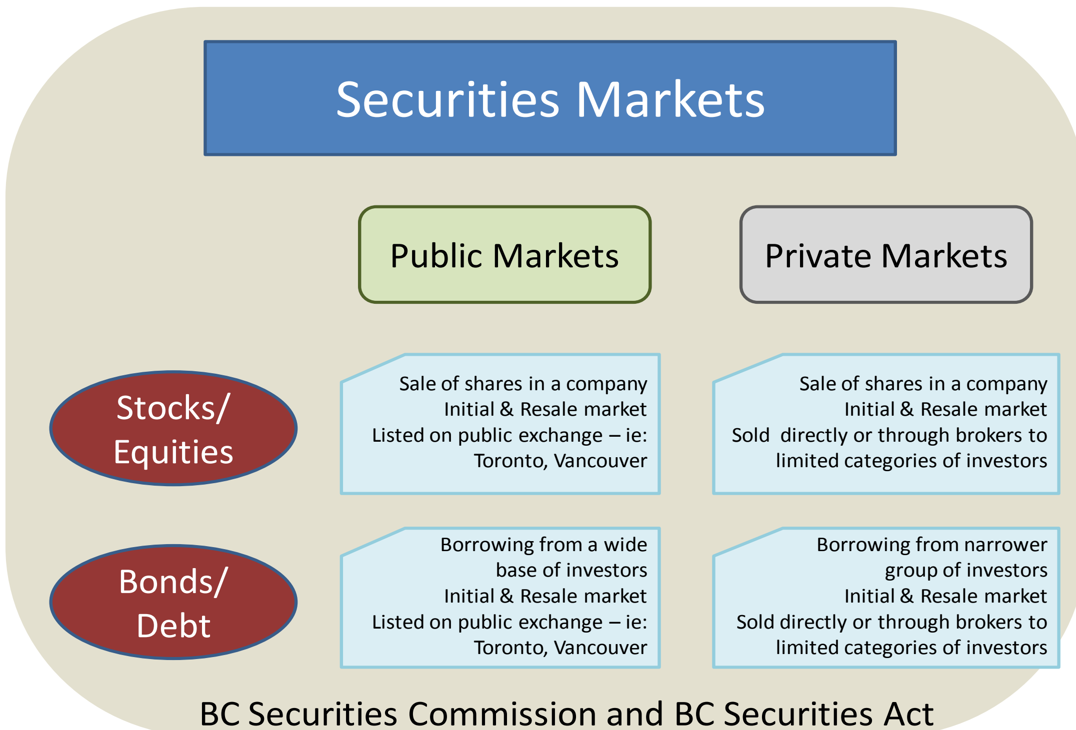
Securities markets are available and open to a wide range of entities to participate. The broad term referred to in the Act is that of a "**person**" which includes an individual, corporation, partnership, party, trust, fund, association and any other organized group of persons. Clearly, a registered non-profit society or a cooperative association is considered a "**Person**" for purposes of the Securities Act and can participate in the issuance and trade of securities, provided the rules are followed.

Types of Securities

There are many, many individual types of securities which are distributed and traded in the securities markets. However, taking a very broad view there are two primary categories of securities of which others tend to be a form of, a subset of, or a combination of one or the other.

You will see in Figure 2 which follows the two security types being **Stock**s (or equity securities) and **bonds** (or debt securities). Stocks are issued as shares in a company and represent a proportion of ownership or equity in the company's net assets. They are represented by a share certificate with the number of shares purchased giving the shareholder a proportionate ownership stake and often the right to vote on company decisions with the number of votes equal to the number of shares held. Shareholders rank behind other creditors to the company and only have a claim to the value of the company after all other debts have been paid. The benefit to share ownership is that if the company is highly profitable, the increasing net value belongs to the shareholders and the value of each share increases proportionately.

Figure 2



Bonds represent debt of the **Issuer** to the bond holder. There is no ownership component or voting/decision making rights attached to a bond. The bond issuer owes the bond holders a debt and is obligated to pay them interest and/or to repay the principal amount at a later date. The interest rate on a bond is established when the bond is created and is set for the term of the bond. In this way, the financial return to the bond holder is known in advance and the bond holder must be paid the interest before any of the shareholders can make a claim on the company assets. Because a bond is a **Security** which evidences debt of the issuer, it is not necessary to have a particular organizational structure (such as shares in a company). Any "**Person**" as defined in the Securities Act can issue a bond.

Two Primary Streams for Securities Issues

Within the broad context of securities markets, there are two primary streams or arenas within which the distribution and trading of securities occurs. These streams are often referred to as *Public Markets* and *Private Markets* for securities trading and in the preceding figure we can see that either stocks or bonds can trade in either of these two markets.

Public Markets

A Public Offering of securities refers to the issuance of a security of any type which is intended for sale to the general public using intermediaries and public stock exchanges for the sale and resale of the security. By definition, virtually all organizations which are trading a security through a public offering need to follow a rigorous process of information filing which makes them a **Reporting Issuer** as defined by the Securities Act. This reporting includes the need to file a preliminary prospectus (detailed information document) and a **Prospectus**, as defined in the **BC Securities Act**, which is a more detailed document providing financial, background and risk assessment information for potential investors. There is significant rigour and cost around preparation of a prospectus and specific requirements for its distribution during the promotion and sale of the security.

The contents of the Prospectus are well defined and require such elements as audited financial statements and true and plain disclosure of all material facts relating to the securities to be issued. The Executive Director of the Securities Commission has the power to impose additional filing requirements and conditions if deemed in the public interest to do so. Once you have become a **Reporting Issuer** there are annual requirements of information filing as well.

The costs of preparing and maintaining the sophisticated levels of financial and operational reporting required as a Reporting Issuer, including such elements as errors and omissions insurance to support opinions and statements in the prospectus, puts this means of raising capital out of reach for most non-profit organizations.

Private Markets

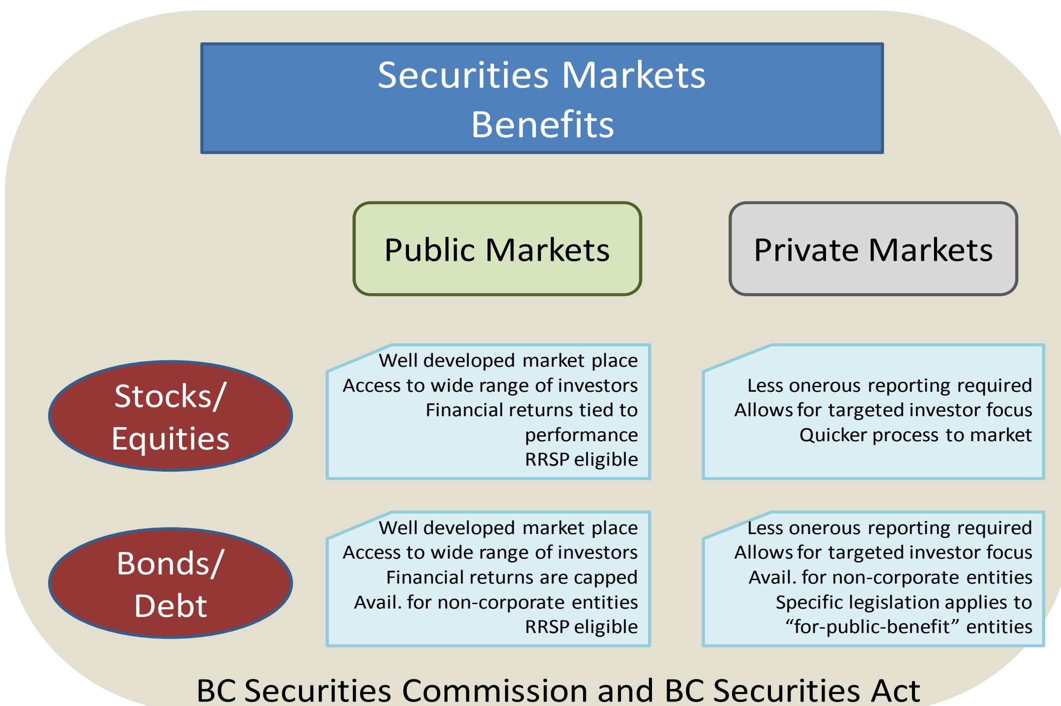
A Private Placement issue of a security refers to the process of issuing and selling a security outside of the public markets. This process will typically involve a more limited group of investors and can be used by either a **Reporting Issuer** or a **Non-reporting Issuer**. The nature of the specific security and the group of investors to which it will be sold will influence which status the issuer is required to maintain.

While there are also many reporting, registration and filing requirements for trading securities in the private market, they are not as onerous or typically as costly as preparing for a public issue of a security. There are also a number of exemptions to prospectus and annual reporting which can apply and serve to reduce the cost and resources required for trading securities in the public markets.

Benefits to the Issuer of Each Market Segment

Each type of security and each of the primary trading channels has certain benefits which make it attractive or appropriate for the issue of a specific security. A brief overview of some of the benefits of each segment is presented in the following Figure 3.

Figure 3



Essentially, for those entities which can issue equity shares, it provides a means to raise capital without a specific annual or long term obligation to provide a return of capital or a specified return on capital. Shareholders receive financial benefits from the fortunes of the issuer only if business success is achieved. Bonds, on the other hand, do have a regular commitment to provide a return to investors and require repayment, however the return is capped and the issuer is not obligated to include bondholders in the success of the business beyond the defined interest payment. Bonds also have the benefit of being available for issue by entities which do not have a share structure.

Public markets provide exposure to a very broad market of investors (essentially global access to investors) and market mechanisms are well developed. Expertise and support agencies are highly functioning and the processes are well defined. Given that the markets are global in nature, the requirements for reporting need to meet international standards for accounting and legal disclosures and this means that the securities are most often available as Registered Retirement Savings Plan (RRSP) investments.

Private markets have the benefits of less onerous reporting requirements which means that securities can be issued more quickly and with less cost. They are typically an advantage when a more narrowly defined set of investors is being targeted. A number of well defined exemptions to full reporting are available and these are described in further detail later in this paper.

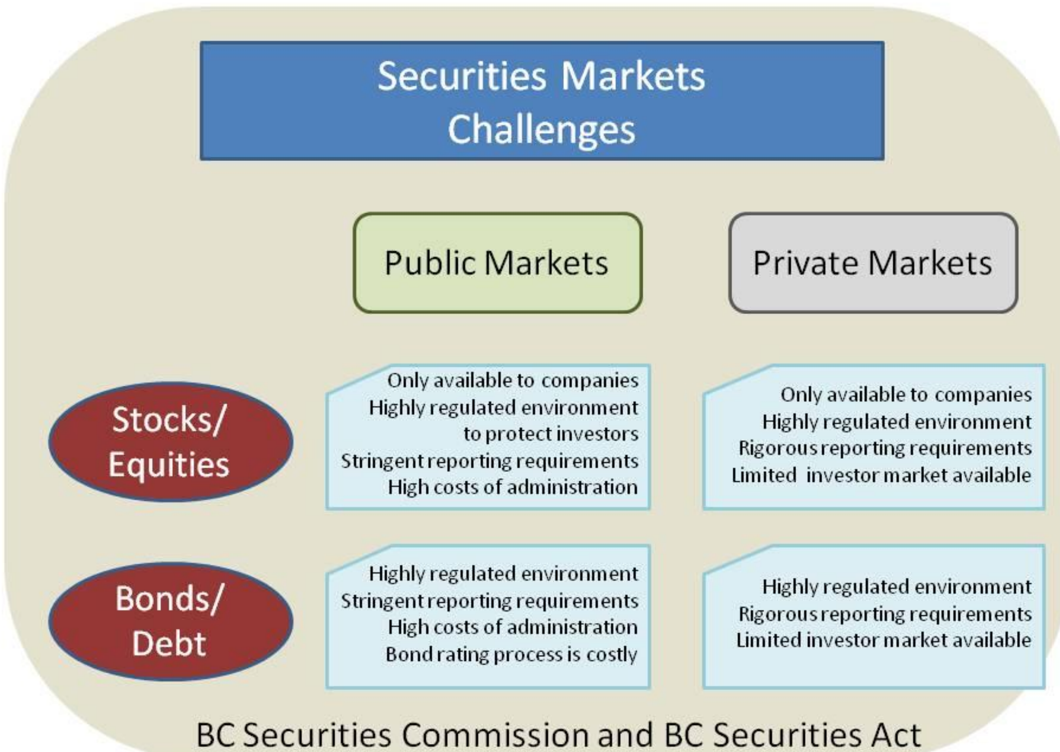
Challenges to the Issuer of Each Market Segment

Challenges associated with each of these identified market segments are presented in Figure 4 which follows. The primary limitation to stocks is that they are limited to entities which have a share ownership structure. This restricts the use of this channel to companies and other entities which convey ownership by way of shares in the equity. Since the Society Act of BC requires that a society must not have "capital divided into shares", non-profit societies do not have the option to issue this type of security.

Bonds have a different investor focus and perspective from the issuer, but, like **stocks**, are complex and have rigorous regulatory and reporting requirements. A primary challenge is overcoming the cost of accounting and legal work necessary to meet regulatory requirements. However, bonds can be issued by many different types of organizations including non-profit societies and cooperative associations.

As mentioned previously, the public markets channel for distribution of securities has the primary drawback of regulatory and reporting burden. The high costs associated with the initial distribution and ongoing annual reporting requirements means that the amount of capital raised must be sufficient to warrant (and cover) these costs. There are costs associated with providing information about business and financial affairs on a regular basis to the Commission, the security holders and the investing public. Private markets also have a number of complex requirements, but the level of due diligence and reporting requirements are significantly less than with public market security trading.

Figure 4



For a non-profit organization to issue a Community Bond, it would typically only make sense to be done within the private market with sale of the security made directly to a group of investors identified by the organization and its networks. The smaller size of a Community Bond (relative to larger public bond offerings) means that transaction fees and costs must be maintained at a low level. This can only be achieved if the organization can remain a **Non-Reporting Issuer** and be exempt of the need for onerous public reporting requirements.

Regulatory Environment

Background

An understanding of the regulatory environment surrounding the issue of securities is helpful when considering whether the costs and effort to meet the requirements are going to be worthwhile to raise needed capital. The regulatory regime has developed and evolved over time, but the primary reasoning behind it is to provide protection to investors. Through rigorous due diligence and meeting established reporting standards, it is believed that investors will be better prepared to make suitable investment decisions based on third-party established fact and a clear understanding of the financial risks.

Often the lure of high financial returns will be sufficient to cause investors to purchase securities of a high risk nature. When the underlying business venture is new or unproven, the potential to earn high returns is speculative in nature and the initial investment could be lost entirely. For these reasons, regulators require the use of established high standards of accounting and financial reporting and enforce very clear statements of associated risks for investors. Whether the securities are stocks or bonds, failure of the underlying business venture will reduce or eliminate financial returns and can mean that some or all of the initial investment will also be lost.

BC Securities Act

The **BC Securities Act** is the primary legislation governing the initial issuance, purchase and ongoing trading of securities in BC. The Act distinguishes between the initial sale of a security and resale of that security and we note that the resale is generally subject to the same restrictions which were placed on the original sale. Mechanisms are in place to regulate the ongoing trading of all securities and penalties are well defined which would be incurred by the security issuer if not adhering to the letter of the regulations. The Securities Act also defines several categories of investors depending on the nature of sophistication and personal financial worth.

Our review of the relevant securities legislation has focused on potential exemptions to the costly and onerous prospectus and reporting requirements which generally accompany the issuance of any type of security instrument. A comparison across provincial jurisdictions reveals that most elements of the BC Securities Act appear to be very consistent with other jurisdictions. It is important to note, however, that the issuer of a security must meet the regulations in the province of issue and in all jurisdictions where the security is sold and traded. The adoption of certain National Instrument documents by many, if not all, provincial regulators creates a high degree of consistency across provincial jurisdictions. Some variation occurs in certain definitions and with respect to some of the reporting requirements and eligible exemptions amongst provincial Securities Acts.

The **BC Securities Act** provides the context for a non-profit organization to issue a Community Bond in BC which is the same regulatory framework that applies to all types of investment securities which are issued and traded through both public and private markets.

BC Securities Commission

In British Columbia it is the **BC Securities Commission** which is responsible for administration of the **BC Securities Act**. As such, the Commission regulates all aspects of security issuance, resale, ongoing trading, reporting and maintenance of the public record of information relating to securities trading. The Commission defines its mission as:

> *Our mission to ensure a fair and efficient securities market that warrants public confidence while fostering a dynamic and competitive securities industry in British Columbia. We do this by regulating the trading of all securities in BC through the Securities Act, rules, regulations, policies and instruments.*

The **BC Securities Commission** is responsible to ensure provisions of the **BC Securities Act** are followed including the information which needs to be prepared for background and description of the project being funded, financial forecasting and identification of risks and mitigating circumstances. The Commission regulates the nature of information prepared and sets out the requirements around its distribution – to whom and what timing. It sets out ongoing disclosure requirements of securities issuers and has power to ask for additional information at any time and to generally control the issuance of securities in British Columbia.

Securities distributions and trades are controlled by the Commission by requiring submission, acknowledgement of receipt and approval of proscribed documentation prior to the security issue. Securities issuers must adhere to the specific requirements of the Securities Act and heavy fines and penalties are available to be imposed by the Commission for breach of the regulations. This includes halting trading of the related securities until such time as regulations have been met.

Many legal and accounting firms have a specialty practice which supports companies wishing to issue securities and have a deep understanding of the regulatory rules and practical application of those rules. With suitable expertise, it is quite feasible to successfully navigate the requirements. While the Securities Act has clear requirements for issuing securities, there is a mechanism of exemptions for many, many different situations which provides for a much more practical approach on specific types of security issues or for securities sales to knowledgeable investors.

Trading in Securities

In addition to the rules around issuing a **Security**, there are regulatory requirements for selling or trading in securities. Primarily a "**Person**" who trades in a security or acts as an advisor, fund manager or underwriter must be registered with the Securities Commission. The purpose is to ensure that only persons who meet a certain level of knowledge and who are bound by certain standards and rules can trade securities.

This applies to all public market issues and many private market issues. An issuer of securities however is not required to register with the Commission if they have issued a security under one of the acceptable exemption scenarios. It would appear then, that a non-profit organization using an acceptable exemption for issuing a security (a Community Bond) would not be required to be registered with the Commission in order to sell the bond to investors.

Reporting Requirements

The rigour of meeting reporting and information requirements and hiring the necessary expertise to ensure all requirements are met initially and on an ongoing basis make the prospect of issuing a Bond or other security a costly endeavour. A close review of the **BC Securities Act** and related legislation identifies areas where non-profit organizations can reduce the burden of cost, time and resources which would normally be required in the preparation and sale of a Community Bond.

Far from being an exhaustive list and in an effort to provide some sense of the reporting framework, an overview of key documentation requirements is listed below with a brief description of each.

Prospectus

Prior to issuing a security in the public market, the first step is to develop a preliminary prospectus document which must be filed with the Securities Commission. If receipted and approved further work is done on the transaction and a **Prospectus** document is produced and filed with the Commission.

A Prospectus is a disclosure document that contains a full description of the business, affairs, securities and management of an issuer. The Securities Act requires that a prospectus must contain full, true and plain disclosure of all material facts relating to the securities offered which includes:

- a description of the company's business
- information on the issuer's business, history, products, competitors and markets
- financial condition including audited financial statements (complying with International Financial Reporting Standards (IFRS))
- biographies of officers and directors and information about their compensation
- any litigation that is taking place
- a list of material assets
- other significant and pertinent information

Notably, a prospectus must not contain any "misrepresentations" which is defined as "an untrue statement of a material fact or an omission to state a material fact that is required to be stated or necessary to prevent a statement from being false or misleading in the circumstances in which it was made". If there are any misrepresentations included in a prospectus, the recourse of the investors who may incur a loss is significant and extends to the directors and agents involved in the security transaction.

Offering Memorandum

In some circumstances a document can be used in place of a prospectus called an **Offering Memorandum** (OM). This document contains similar information to a prospectus but does not need to meet the same level of reporting standards or detail and is less costly to produce. The format and contents for an Offering Memorandum are very clearly specified by the Securities Commission. It includes financial statements audited to international reporting standards and a specific required statement about the risks associated with the investment.

A primary difference of the Offering Memorandum from a Prospectus is that the Directors represent the completeness and accuracy of the facts in the OM document, and therefore carry additional liability should there be any misstatement. The investor under an OM issue is also required to sign a risk statement form which tends to be an abrasive statement of the risks he is assuming when purchasing the security.

Other types of Documentation

There are many additional forms and types of documentation which relate to securities issues, each with its own format and required information contents. Depending on the circumstances one or more of the following documents may be required for full disclosure and completeness of information reporting:

- statement of material facts
- business acquisition report
- information circulars
- copies of constating documents, by-laws, trust agreements
- annual information form
- filing of material contracts
- material change reports
- management discussion and analysis of financial statements

It is clear then, that the requirements, particularly for Reporting Issuers can be time consuming, costly and onerous. The amount of capital raised would need to be sufficiently large to warrant the resources needed for this level of due diligence and ongoing reporting.

Continuous Disclosure

Once an issuer becomes a **Reporting Issuer**, it is subject to continuous disclosure requirements. Included in these requirements is annual and regular filing of reporting information about the company and any changes from previously filed documentation. Once established as a Reporting Issuer, then, the costs to maintain this status continue on an annual basis.

Exemptions from Reporting Requirements

The **BC Securities Commission** recognizes that the Prospectus and registration requirements, which serve to protect the investing public, do not always need to be as rigorous as described above. For example, people who are related to the principals of an issuer (family, close friends and associates) may not need the information provided in a prospectus before they buy securities. They are considered to have knowledge about the issuer and the transaction given their relationship. Also, investors which can demonstrate a certain level of financial net worth are considered to be sufficiently astute (or at least need less protection from potential losses) and do not need to have the same rigorous reporting as a prospectus offers.

For these reasons, the Securities Commission provides exemptions - exceptions by which individuals and companies are freed from registration and prospectus obligations. Issues of securities under any one of the exemptions take place in the private market. A key guiding document entitled National Instrument 45-106 refers to a wide series of conditions under which the prospectus requirements do not apply. The BC Securities Commission supports exemptions from the registration and prospectus requirements for private placements of securities including:

- **a private issue** – a limit of 50 security holders and restriction of sales of the security to directors, officers, employees, family members, close personal friends and business associates

- **family, friends and business associates** – an issue which is limited in its distribution to investors which are members of the immediate families, close friends and close associates – the number of investors is only limited by a test of reasonableness on the number of close friends

- **accredited investors** – investors who personally meet specific minimum annual income and net worth levels fall outside of regulated information delivery requirements

- **minimum investment of $150,000** – an organization can sell securities to anyone without providing any disclosure to the purchaser, provided the purchaser buys at least $150,000 worth of securities

- **offering memorandum** – allows an issuer to sell its securities to anyone, regardless of their relationship, wealth or the amount of securities purchased if a signed risk acknowledgement form is obtained from the purchaser and a copy of the Offering Memorandum document is delivered to the purchaser.

Only one of the exemption categories can be used for any one security issue. It is not necessary to apply to the Commission to use many of these exemptions, only to ensure that all of the conditions of the exemption are met. There are also other types of exemptions which exist for specific situations. In most cases, if an exemption is being relied upon, a report of exempt distribution must be filed with the Commission within 10 days of selling the securities.

It is possible for a non-profit organization to utilize any of the exemptions listed above in order to reduce the cost and time of putting together a bond issue as long as the intended investor group meets the criteria for the exemption. The complexity of circumstances and qualifying conditions remains substantial, however, and reinforces the need for appropriate expertise to provide clarity and assessment of a specific security issue.

Selling securities

There are some specific restrictions related to selling securities which are issued under an exemption to the prospectus and registration rules. No commission or finder's fees may be paid in connection with a trade under the private issuer exemption, (except a trade to an **Accredited Investor**) or under the family, friends, and business associates exemption.

Other than this, there are no other restrictions on advertising or soliciting for purchasers under the other exemptions mentioned earlier. For other exemptions you can retain someone to find purchasers for you and pay them a commission or finder's fee. However, you must ensure that the purchaser meets the requirements of the exemption that you are relying on to sell the securities. Further, BC securities laws prohibit making a misrepresentation or conducting unfair practices when trading in securities.

Bonds as a Security Instrument

It is relevant at this stage to provide additional detail on **Bonds** as a security instrument as we can see from the overview in the previous sections that the opportunity for a non-profit organization is limited to a bond issue. In its simplest form a bond is a type of debt where money is borrowed from another party on defined terms of repayment with a set return on the investment usually in the form of regular interest payments. A bond does not confer any type of ownership or decision making rights to the investor.

Bonds are attractive to investors who are seeking greater certainty of pre-determined financial returns and wish to avoid the up-and-down cycles of share values in their investment portfolio. To be successful, a bond issued by a non-profit organization needs to be perceived to have a reasonable chance of being repaid according to the terms and that the interest rate reflects the level of risk associated with potential default on either interest or principal repayment.

A bond can be secured (as when a mortgage over real property is connected to the bond) or unsecured (where the obligations under the bond are simply to come from operating cash flow of the issuer). This will impact investors' assessment of risk of the investment and will therefore impact the interest rate which investors will require.

One mechanism that is used to validate the level of financial risk associated with a bond issue is a third party **bond rating**. There are several bond credit rating agencies such as Standard & Poor's, Moody's or Dominion Bond Rating Service (DBRS) which can provide a credit risk rating for the entity issuing a bond. The rating is selected from a scale of ratings anywhere from "extremely strong" to "highly vulnerable to non-payment". The process of obtaining the rating, however, is very costly to achieve and to maintain annually. These external ratings are generally used for public market issues where the investor markets are far removed from the issuer. A rating is not required but can be useful when appealing to broad investor audiences.

A component of community bonds is the non-financial return which comes from social or environmental benefits (referred to as community returns) delivered by the issuing organization. As the non-profit conducts its work in the community, these outcomes form part of the return to the bond holder in the way of additional return on their investment. This is similar to the way that donors are seeking community returns on their financial contribution. For a donor 100% of their return is in the way of community returns.

This type of community bond will appeal to a smaller circle of potential investors; those for whom the community returns are important. It is because of this more limited appeal to investors that the cost and resources of issuing in the public markets is not typically warranted for non-profit organizations. Indeed there are very few, if any, examples of non-profit organizations issuing securities in the public market. Typically a Community Bond is not as competitive an investment offering based purely on financial return. Investors for community bonds are best identified through mission related networks as these are the investors most likely to value the community returns associated with the bond investment.

Non-profits and Charities

It is permitted, therefore, within the existing legislation for non-profit societies and charitable organizations to issue a bond for sale to the investor public. The society's charitable status is not impacted and a bond can be considered third party debt in the same light as a loan from a bank would be. The money raised through the sale of a bond is not eligible for a charitable tax receipt, however, as the purchase of a bond is considered speculative and does not qualify as a charitable donation for income tax purposes in case of default. By the same token, the use of funds by the issuer is not constrained by charitable mandate, but only by the defined "use of funds" as described by the issuing organization in the bond offering information.

For non-profits and charities a Community Bond issue provides aligned donors and supporters an additional vehicle to provide financial support to the work of the organization. Funds invested will be paid back to the investor in the future and a modest financial return can be provided while making the capital available to the non-profit to expand their work in the community in the meantime. A Community Bond also has the draw of being very connected to a defined community project – the ultimate "buy-local" investment strategy.

As an example of effective use of the Community Bond model in Canada, the Centre for Social Innovation in Toronto www.socialinnovation.ca was able to raise $2 million of investment funds to assist in purchasing a new building site. By offering a Bond with terms and conditions which were sufficiently attractive to investors, the funds were raised in a compressed time frame to meet the purchase deadlines. See www.communitybonds.ca for information, the background story and materials to explore the process of launching a Community Bond.

Co-operatives

Cooperative Associations are governed by provincial legislation which is separate from the Business Corporations Act and the Society Act. Under the Cooperative Association Act there are two relevant categories of Cooperatives; for-profit Coops which can issue investment shares and bond securities, and non-profit **"Community Service" Coops** which are prohibited from issuing investment shares but have the right to issue a bond.

With respect to issuing securities, for-profit Coops operate in a similar manner to any for-profit companies in BC. There are some specific rules around how investment shares in the Coop are issued, but this is similar in substance to a company issuing shares. It would be possible for a Coop to become a Reporting Issuer and access public markets for sale of its investment shares. However, due to the typically closer network of interested investors for a Coop, an issue in the private market is more practical and the exemption categories discussed above are available. The restrictions on distribution and required reporting information as described under the exemption being used would apply.

Non-profit "Community Service" Cooperatives are restricted from issuing investment shares in the Coop but can issue a bond in a manner similar to other non-profit entities. In issuing a bond they are eligible to use any of the exemptions which are available to corporations and to non-profit organizations.

Benefits of Bonds

Community Bonds offer a number of benefits for non-profit organizations to raise capital as compared with other options such as capital campaigns and traditional bank debt. By seeking an investment rather than a "donation" of capital, the pool of available capital suddenly becomes much larger. The principle of investing money for "good" will appeal to existing donors as a further option to support the non-profit organization, as well as appealing to people who do not currently donate money but for whom the concept of investing their capital resonates.

A bond is a more flexible way of borrowing money as compared to the rigid and highly structured approach of conventional banks. During the bond design phase, specific terms and conditions can be created which align with the amount and timing of available cash flow from the project which is being funded. Interest payments can be accrued for a period and principal payments can be deferred or planned as a lump sum payment later in the amortization period.

A Community Bond provides an innovative and additional mechanism for donors and investors to financially support a non-profit organization without giving up their investment capital permanently. It places the value of the community asset in the hands of the community members and integrates community and financial returns in the same investment vehicle. A Community Bond is also able to leverage the already present network of members and supporters of the non-profit organization.

Barriers to Bond Issuance

One might reasonably ask, if bonds have been an available capital raising mechanism for non-profit organizations for many years, why there is not more awareness and volume of bonds issued? One sector which has effectively raised capital through the bond mechanism for decades is private education institutions. Private schools and universities have leveraged the pool of investors represented by parents and alumni to purchase land and buildings for school premises development.

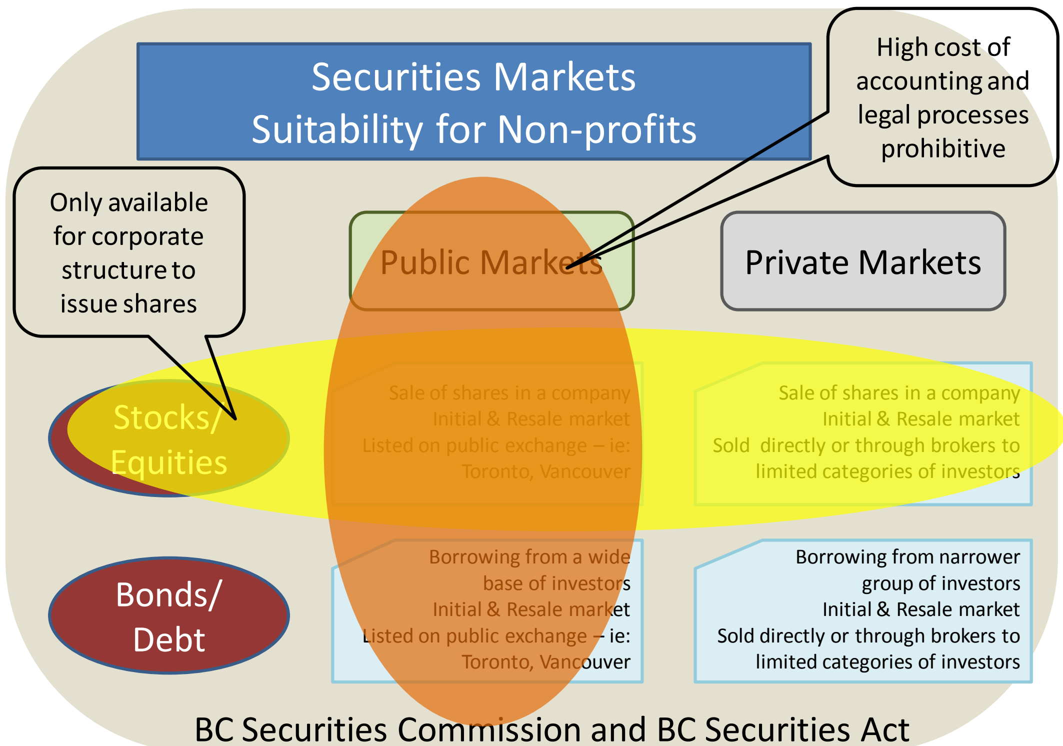
Beyond a lack of basic awareness and understanding of bonds as a feasible way to raise capital, there are a number of practical barriers which must be overcome. As discussed previously, the cost of time and financial resources is a significant hurdle to overcome. Finding ways to reduce and avoid some of the usual costs of issuing a bond is essential. The significant complexity to public and private market regulations also stands as a barrier. Generally, non-profit organizations do not have the needed expertise about capital markets and securities available to them and are often challenged to know where to turn to ask questions.

A further barrier is general lack of market awareness of how community benefits can be woven into financial instruments. It is a very early stage market for mission related investment vehicles and they are not well understood by investors. As a departure from the traditional philanthropic model of grant and donor based activity, investor financial instruments which integrate social, environmental and financial returns are just now emerging in the market. There is considerable interest however, as investors seek more than simply to "pad their wallets" as part of a more comprehensive investment strategy and is it an exciting time to consider providing an investment opportunity into this marketplace.

Opportunity for "Benevolent" Organizations

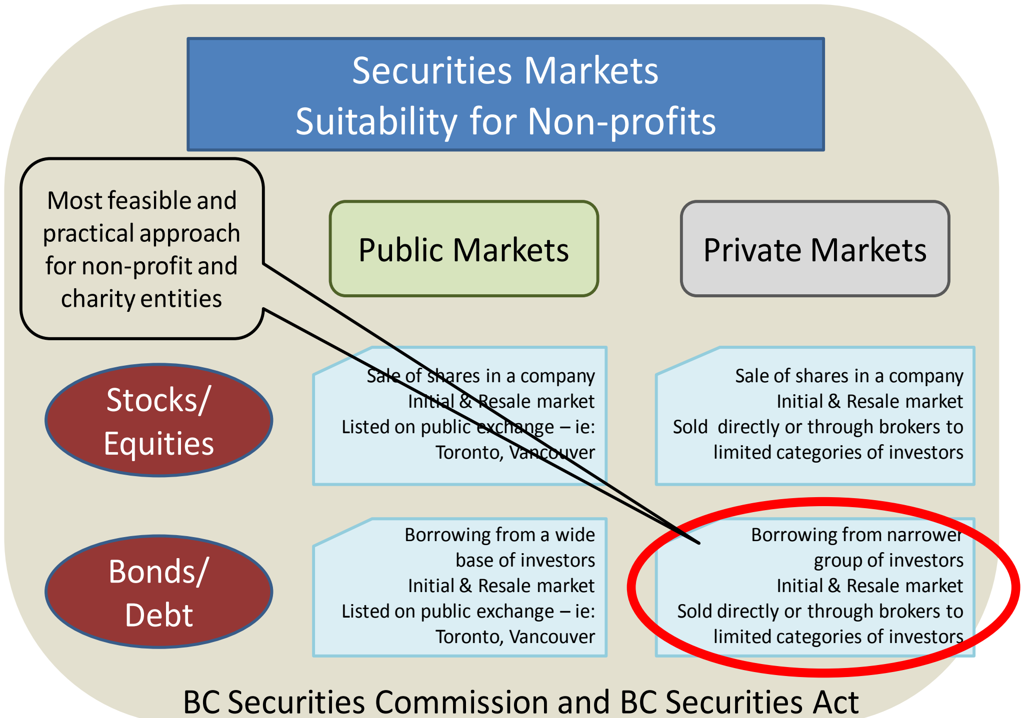
To narrow down to the most relevant opportunity for non-profit and charitable organizations amongst the plethora of options available, we present the following Figure 5 to capture the overall securities market, the area eliminated by definition in yellow (non-profits are unable to issue shares) and the area eliminated by practicality of cost and resources in orange (public markets have costly and onerous reporting and documentation requirements).

Figure 5



From this, one quadrant is clearly evident as a possible channel for non-profit organizations to issue securities. By issuing a bond instrument in the private markets, it is possible to raise capital, access investor's portfolio wealth and manage the costs of issuing a security to a more reasonable level. Figure 6 highlights the quadrant of focus for Community Bonds.

Figure 6



A number of standard exemption options were presented earlier in this paper which allow organizations to avoid the cost of preparing full prospectus documentation and providing ongoing regular reporting for the issuance of a security. Each of these exemptions is regularly used by companies issuing securities today. One or more of these exemptions may be useful and applicable for a non-profit organization to consider depending on the specific nature of the bond and to which investors it is intended to be sold.

In addition to these standard exemptions, however, there is a long list of very specific circumstances where the issuer is exempt from prospectus and annual reporting requirements. Amongst these exemptions is a particular exemption which applies to organizations which are not for profit in nature. Details of this exemption and associated requirements are outlined below.

Specific Exemption for Non-profit Organizations

One of the key national legislation documents which speaks to rules regarding exemption from prospectus requirements called National Instrument 45-106 has in its section 2.38 under Part 4 - Other Exemptions a specific reference to non-profit organizations. This document has been adopted by BC and the rules as stated apply for securities issues in BC. In this section, entitled Not for Profit Issuer, it states:

> *2.38 The prospectus requirement does not apply to a distribution by an issuer that is organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes and not for profit in a security of its own issue if*
>
> *a) no part of the net earnings benefit any security holder of the issuer, and*
> *b) no commission or other remuneration is paid in connection with the sale of the security.*

To use these exemptions, an issuer must be organized exclusively for one or more of the listed purposes and use the funds raised for those purposes. The conclusion which follows is that an organization which can be evidenced to be organized for benevolent purposes and not for profit (ie: most non-profit and charity organizations registered in BC) which is issuing its own security, is not bound by the prospectus and public reporting requirements of a Reporting Issuer as long as the benefit to bond holders is limited to any interest paid on the Bond and there is no sales commission paid when the Bonds are sold to investors.

Further clarity is provided in the Companion Policy to NI 45-106 and states "if the securities are debt securities and the issuer agrees to repay the principal amount with or without interest, the security holders are not considered to be receiving part of the net earnings of the issuer. The debt securities may be secured or unsecured."

Using this exemption there would be nowhere near the same level of rigour and external review which is imposed for Reporting Issuers. This exemption would likely include all registered charitable organizations as the process of obtaining charitable registration should provide sufficient evidence of acceptable charitable purpose for organization under the exemption. Faith-based organizations and charities are named specifically within this exemption. For other non-profits, it would be important to obtain reasonable assurance that the society is considered to be organized for benevolent purposes.

Selling Securities under this exemption

The sale of a Community Bond under the exemption rule above means that traditional channels of broker/dealers would generally not be available. Since the intended investor market is narrower than the general public and the non-profit organization already has a network of members, donors and supporters, the primary channel for selling the bond would be directly to this group and by word of mouth. Conventional channels are possible as long as no payment such as commission is made to the seller in connection with the sale. Additionally, the issuer is required to provide a copy of an information statement which gives details of the organization and the bond transaction to each of the bondholders as part of the bond sale transaction.

RRSP Eligibility

Of great interest to many Bond issuers, particularly if the target investment size is smaller and the investors are of limited means, is the ability for the investor to use funds in their Registered Retirement Savings Plan (RRSP) account to make the Bond purchase. This is a sound strategy as typically RRSP accounts are invested for a longer time horizon and this is where many people carry the bulk of their investment assets. For qualifying investments (those that are deemed eligible by the Canada Revenue Agency (CRA) to be purchased within an RRSP account), the investor can either take funds already held within an RRSP account, or, if they have additional RRSP investment room, they can make a new contribution, benefit from the tax deductibility, and direct those funds to the Community Bond purchase.

The regulatory body which determines which investments qualify for an RRSP account is the Canada Revenue Agency (CRA). Within the Income Tax Act, one type of eligible investment is a Mortgage Secured Bond. Other types of bonds are eligible if they are issued by governments, crown corporations, Canadian trust companies, foreign banks, mutual fund trusts or public companies and those listed on the stock exchange.

This means that the primary type of Bond which can be issued by a non-profit or charity and held within an RRSP account, outside of limited exceptions, is to have a property that is either owned or being acquired and can be pledged through a mortgage to secure the Community Bond. If RRSP eligibility is an important component of a bond, appropriate expertise must be engaged when designing the bond terms and conditions to ensure its eligibility for RRSP accounts. A restriction on RRSP eligibility is that the investor cannot own more than 10% of the total bond issue. This ensures the principle of "arm's length investment" necessary for RRSP eligibility.

RRSP eligible securities must be held by the investor in a Self Directed RRSP (SDRRSP) account. If the investor does not initially have a SDRRSP, he can open a SDRRSP account and purchase the Community Bond investment through it. The investor also has the choice of transferring in other RRSP investments already held in another RRSP account. It is up to the investor to determine how the Community Bond fits within their overall investment strategy and what changes they need to make to rebalance the blend of equity, income generating and cash holdings across their whole RRSP portfolio.

Why Consider RRSP Eligibility

Many community-based investors have a strong desire to support an investment such as a Community Bond, but may not have the investment resources at hand to make a substantial investment of choice at the time the bond becomes available. At the same time, these investors may have more substantial holdings already existing in their RRSP portfolio. These RRSP assets are generally invested in mutual funds or traditional corporate and government securities deemed to be providing the best financial return, however the investor may wish to align his investment philosophy more closely with his values and community intentions.

By ensuring the Community Bond qualifies as an eligible RRSP security, the issuing organization can tap into these substantial investment resources and create a strong base of aligned investors, keenly interested in the long term success of the organization and willing to hold the bond investment for many years.

PART II – Bond Requirements

Decision Criteria for Issuing a Bond

It is important to consider the issuance of a Community Bond within the context of all options available to raise capital for the organization. As a non-profit or a charity there are a range of options available in the form of donations and grants. This option has the lowest requirement for repayment, but does come with specific expectations as to how the funds are spent and reporting on related outcomes. This could include publicly funded capital grants, mounting a capital campaign, a rigorous annual giving campaign or contributions from private or public foundations.

Another option is bank debt in the form of a capital loan or mortgage. This generally requires far less time, energy and money to raise, however has very strict criteria, rigid repayment requirements and most often requires tangible security such as a mortgage over real estate. In all cases, bank debt or Community Bond, the borrowed money must fund a project which will have a positive revenue stream in order to pay back the bond.

If other sources of capital are not available or not feasible and the project meets the need for sufficient revenue to pay back the debt, then a Community Bond may be a viable alternative. A bond can be issued in tandem with other sources of capital (ie: donations for 40% of the amount required with a bond for the remaining 60%; or grants for 10%, bank debt for 25% and a community bond for 65% of the total capital required).

Expertise

Securities market transactions and issuing a bond require unique skill sets in financial and legal planning, documentation and process. These skill sets are not part of a typical non-profit management or Board of Directors and will therefore need to be sourced outside the organization.

Primary skills include accounting to ensure the organization financial reporting is at a reasonable standard for external reporting purposes. Further financial planning and forecasting expertise will build on historical financial records to develop a comprehensive go-forward picture of the project for which the bond money will be used.

Legal advice is important all along the way to ensure the organization fits within the reporting exemption category selected, that bond design is geared towards an RRSP eligible investment if so desired and to create the various documents needed for bond, security and investor application to purchase.

To raise awareness and interest about the bond and to support the bond sales process, effective communications skills and clearly articulating the project, purpose and repayment is critical. This will ensure that investor questions are answered effectively and create the greatest chance for full subscription of the bond offering. Securities administration skills are needed, either in-house or contracted out, to manage subscription intake, funds transfers and ongoing interest payments and investor relations.

It is noted that sufficient seed funding is required to engage various external experts and support early stage consulting and advisory fees.

Financial Partners

In order to issue a Community Bond and make it widely available to investors, it is necessary to have a **Trustee** to represent the interests of the individual bond holders. There will be a Trust Agreement made which defines the role of the Trustee who, in turn, signs each of the Bonds which get purchased and represents the individual Bond holders and their rights and interest in the Bond and related security. The trustee will also collect investment monies and hold them in trust until the bond issue is fully subscribed and the closing of the transaction is achieved. The Trustee role can be fulfilled by a reputable law firm or by a larger financial securities or trust company.

To assist with handling the documentation, interest payments, tracking of investors and issuing of statements and reports on the status of the Bond over time, it is possible to engage a Security or **Transfer Agent**. This is an agency which administers documents and interest payments on behalf of the organization and bondholders. Similarly, RRSP account administration and management is required for bond holders investing via their RRSP portfolio. Identifying willing financial partners to accept a little-known Community Bond into their clients' RRSP accounts is an essential part of successfully leveraging the RRSP channel of investment.

A final financial partner related to the transaction is the current banker to the organization. If there is any existing borrowing in place, or there is uncertainty over rights on collateral assets pledged to support the borrowing, the existing bank may require an agreement called an **Inter-lender Agreement** to agree to the bond issuance and to provide clarity on rights to organizational assets.

Documentation

The complexities of a securities transaction are reflected in the documentation required to bring it to market. The primary Bond document will be drawn up by a competent lawyer familiar with securities law and how it pertains to non-profit organizations. It will contain a number of standard elements which provide the Bond holder with all of the critical details of the Bond. These details should include:

- the name of the bond holder
- principal sum
- key dates
- bond maturity date
- description of all series of the bond (if there is more than one)
- interest calculations and payments
- repayment of bond principal (timing, amounts, frequency)
- security details
- standard legal clauses
  - default conditions
  - early redemption conditions
  - notice requirements
  - jurisdiction of issuance and legal application
- signature of issuing organization
- a Trustee Certificate

In addition to the Bond document above, there is an additional set of documents which are typically part of the transaction and are needed to complete the issuance of the Community Bond:

- Investor Information
  - provides the organization background, rationale and financial analysis to support the purpose and use of Bond funds
- Term Sheet
  - a brief synopsis of pertinent terms and conditions of the Bond
- Trust Agreement (or Bondholder Agreement)
  - sets up the relationship between the Bond issuer and the **Trustee** including all of the obligations and requirements of each party
  - Bond holder rights will be explicitly stated
- Security Agreement
  - a pledge of assets of the issuing organization in support of bond payments which reduces the level of financial risk for a bond
- Inter-lender Agreement
  - provides approval of the bond by all lenders to the issuing organization and provides clarity on the security rights of each lender

- Registered Mortgage Charge
    - the document which gets registered against the real property (if pledged as security for the bond) and links the rights of the Bond holders to an interest in the property
- Subscription Agreement
    - the official request by the investor to purchase units of the Bond (similar to an order form)

The most important factor in all of this documentation, aside from legal correctness, is that investors understand what the steps are, have access to the documents and know where to go for additional information. Being available (or creating a contact point for information) to answer questions as they come up to support those investment conversations will facilitate the process and help to shepherd potential investors along. It would be disappointing to lose a committed investor along the way simply because the process became too arduous or complex.

Cost of Bond Issuance

The question of the cost of issuing a bond is similar to the question: "How much does it cost to build a house?" It depends completely on the situation and the readiness of the issuing non-profit organization. If significant ground work needs to be done before the bond design work can be done in earnest, the costs will be higher. It will also depend on the availability of expertise at low or no-cost to the organization.

For conventional bond transactions in public markets it can cost hundreds of thousands of dollars to put together all of the reporting information and prospectus preparation work. In a private market Community Bond issue it may be possible to complete basic consultant and legal support work for costs in the range of $50,000. When raising $1MM plus it can be worthwhile to invest this amount of money into the preparation and documentation work. It is important to identify some upfront money to fund initial preparations and bond development consultation work.

Once the bond has been issued and bondholders secured, ongoing costs will include:

- Trustee fees
- Security Agency fees for ongoing transfers
- Transaction charges (for payments, interest payments, ownership transfer, etc.)

In a simple Bond issue, it may not be necessary to outsource all of this administration work and much of the documentation may be handled directly by the issuer of the bond. This would minimize funds and documents passing through the Trustee and minimize associated fees. In the case where the administration of information and payments to Bond holders is conducted by the issuing organization, this work becomes part of organizational administration costs.

RRSP Requirements

While the benefits of RRSP eligibility and accessing a potentially significant investor category are clear, the process has some additional complexity to it. There are restrictions, reporting requirements and documentation needs which are specific to establishing and maintaining RRSP eligibility and access.

Further, there needs to be one or more financial institutions which agree to process their client's request to purchase the Community Bond and hold it in the RRSP account at their institution. There is limited appeal from the financial institution's perspective as the investment amounts are relatively small and they will want to ensure the investment meets RRSP eligibility requirements. This is often met by a lawyer letter of opinion to the financial institution but, naturally, there is a further cost to have the letter of opinion prepared.

RRSP Supplemental Documentation

There are a number of additional documents which will be required in order to make the investment flow through an RRSP account. These documents will be stipulated by the RRSP Trustee and may include such documents as:

- Self Directed RRSP account application
- Deposit form
- Designation of Beneficiary
- Direct Transfer-in form
- Authorization for Group Plan holders
- Letter of Direction
- Deposit Disclosure

Demystifying and simplifying the Self Directed RRSP process for Community Bond purchase are two important goals to enable full subscription of the Bond offering.

Security Agent

The role of the Registered Security Agent for an RRSP investment is to monitor the movement of funds into or within RRSP accounts. The Security Agent must have CRA authority and the systems in place to effectively monitor, track and provide appropriate statements and tax forms in alignment with CRA rules around RRSP accounts. In Canada, the Banks and large investment companies are all equipped to handle this, however their willingness may be low and the costs associated with processing what might be considered small investment amounts may be prohibitively high.

One way to combat resistance from individual investment managers is to establish a relationship with one financial institution who will act as the "preferred supplier". In this way, the documents and process can be ironed out and will be the same for each investor. The drawback here is that the investor is required to open an additional SDRRSP account to facilitate the Community Bond purchase – not insurmountable, but a further hurdle in the process.

PART III–Process of Issuing a Community Bond

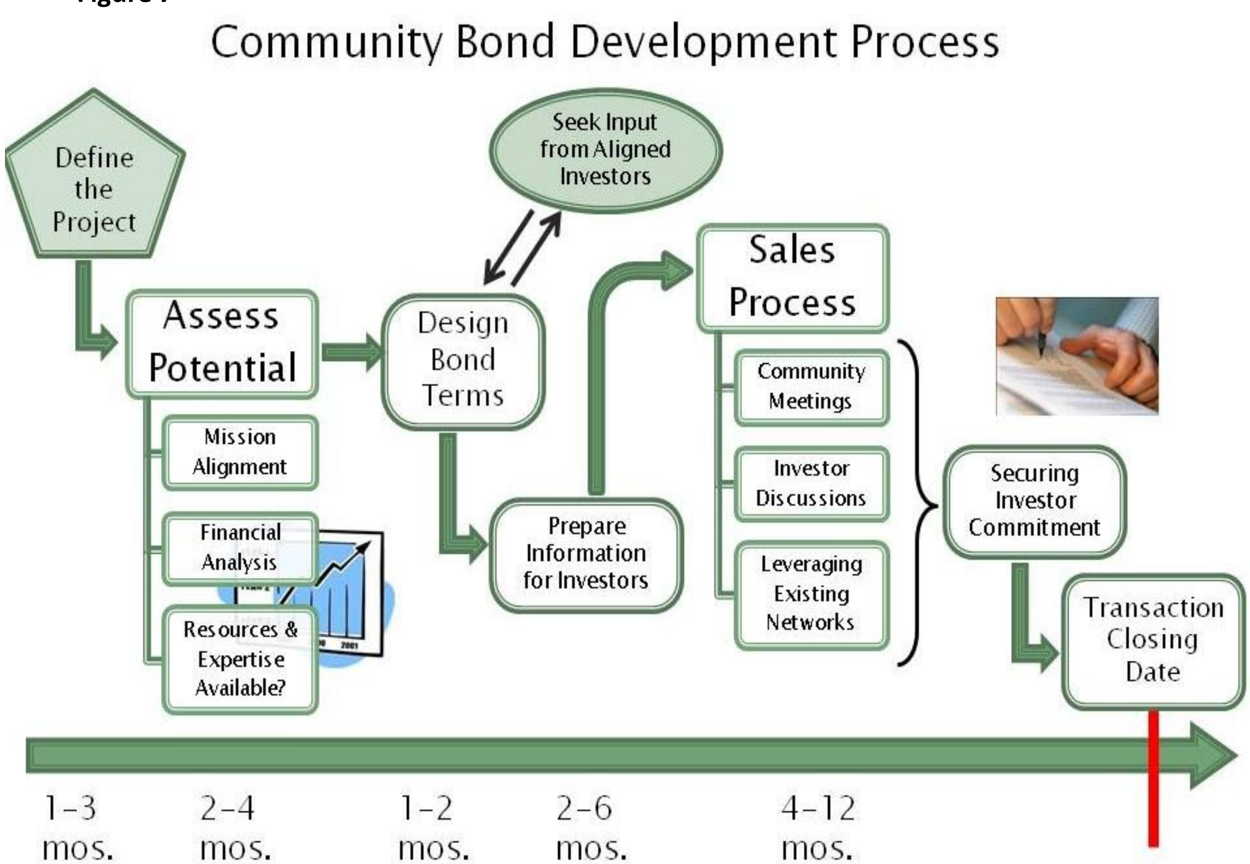
Basic Process Steps

Once a decision is made to issue a Community Bond as the best way to raise capital for an initiative, the work begins to prepare financial forecasting, think about terms and conditions, amount required and how the funds will be repaid. There is a significant complexity to putting the pieces together in a way that meets the needs of your organization and will appeal to potential investors. The "secret sauce" is in finding the right balance between those two objectives.

Getting a feel for the right balance between financial and social returns is really more of a dialogue between your organization and potential investors. The market for Community Bonds is not as well established as for conventional corporate bonds, and therefore the task of determining what potential investors are seeking is more difficult. Layer over that the combination of financial *and* social returns and the task becomes even more challenging.

A process map for Community Bond development is provided in Figure 7 below.

Figure 7



Project Definition

The process of creating an investment instrument in which people are confident to place their financial resources, and successfully taking it to market is a worthy challenge. It starts with a clear articulation of the specific details of the project or initiative being undertaken. The more carefully the project is defined in the early stages, the easier it will be to design an appropriate bond instrument, communicate the value to potential investors and successfully sell sufficient bonds to raise the required amount of capital.

A solid underlying opportunity, strong financial projections for the project, the opportunity for a return **OF** capital at some point in the project, the opportunity for a financial return **ON** capital during the project and a social or environmental return linked to the investment are all important parts to a successful Community Bond issue. These must be coupled with sufficient effort on a marketing campaign to inform investors, get them excited about the opportunity, answer their questions and let them know exactly how they can participate.

Assessment of Potential

Once the nature of the project is clear, assessing the strength of the project and the organization against some basic elements will help to better understand whether there is sufficient potential to take a Community Bond issue forward.

Building on Organizational Mission

Firstly, ensure that the project is closely aligned with the organization's strategic plan and that it effectively advances the stated Mission of the organization. It would be useful to compare several options for financing against mission objectives and rank according to the perceived impact each will accomplish. This step will assist with galvanizing the organization around a Community Bond issue and confirm commitment to the initiative. It will also inform future discussions and communication materials about the Bond as the link to organization strategy and intended community outcomes will be clear.

Financial Forecasting

Likely the most critical step in preparing to move forward on a Community Bond offering is a solid financial analysis. Gathering all the costs into one place and planning out how the project will unfold and how revenues will be created provides the core evidence to support the request for financing thorough the Bond issue. The forecast is a forward looking plan and needs to span several years – likely through to the end of the amortization period of the Bond. As with all financial forecasts there is a high degree of estimation as to future expenses, however, it remains extremely worthwhile to identify known costs and to support the accuracy of estimates wherever possible. By mapping out the timing and magnitude of both expenses and revenues it is possible to have a very clear picture of likely success of Bond repayment.

Ideally the model will be constructed from an already strong organizational financial system and a clear understanding of what currently drives revenues. The financial model will serve as an effective decision tool for moving ahead with a Community Bond offering, as well as an informational support to investors and a benchmark to manage the project once underway. While projects rarely turn out exactly as forecast, the closer the project ends up to the cash flow model created at the outset, the greater will be investor confidence regarding financial management capacity.

Overall Project Feasibility

Project feasibility is a function of an initiative which is well aligned with organization values, energy to carry the initiative forward and sufficient availability of expertise to develop and launch a Community Bond issue. One aspect is to prove out financial feasibility of the initiative through detailed financial analysis and forecasting, but another important aspect is to demonstrate sufficient interest amongst investors for the project itself and for making sufficient investment of capital to reach the goal. Similar to running an effective Capital Campaign in fundraising (which many of you will be familiar with), testing the market of potential investors, raising awareness and testing the chances of success are important building blocks.

Discussions with potential investors need to start early in the project and follow an iterative process as the Community Bond is being developed. Start with a few potential investors who have the financial capacity to make an investment and have demonstrated both support for your mission and have made prior investments which have a social or environmental return. Float the idea of the Community Bond and back-test their reaction to it. Seasoned investors will quickly be able to size up what they see as the strengths in an opportunity and are ready to challenge where they see gaps.

Another element of these early discussions is to get the “buy-in” of influential investors. The more they are exposed to the idea and have an opportunity to shape the final Bond offering, the higher the likelihood is of them making a significant investment in the Bond. A degree of contingency planning also needs to be incorporated into the financial analysis to allow for unforeseen events, delays in revenue generation or unanticipated expense increases.

Gauging your eventual success can be a challenge. Gaining feedback from investors and informing them about the current stage in the process will assist in understanding the likelihood of future success. A back up plan which contemplates a lower total amount of investment raised will ease the stress if there is reluctance on the part of investors to commit.

Bond Design

The early stage dialogue with potential investors is crucial to informing the combination of characteristics that will eventually make up a successful Community Bond offering. These investors will also have lots of innovative ideas – some which can be incorporated nicely and others which are more radical. Gather all of these suggestions and bring them back to your investment team for consideration. Incorporating organizational values and objectives together with financial mechanics and legal limitations will tell you which of these suggestions are going to work best.

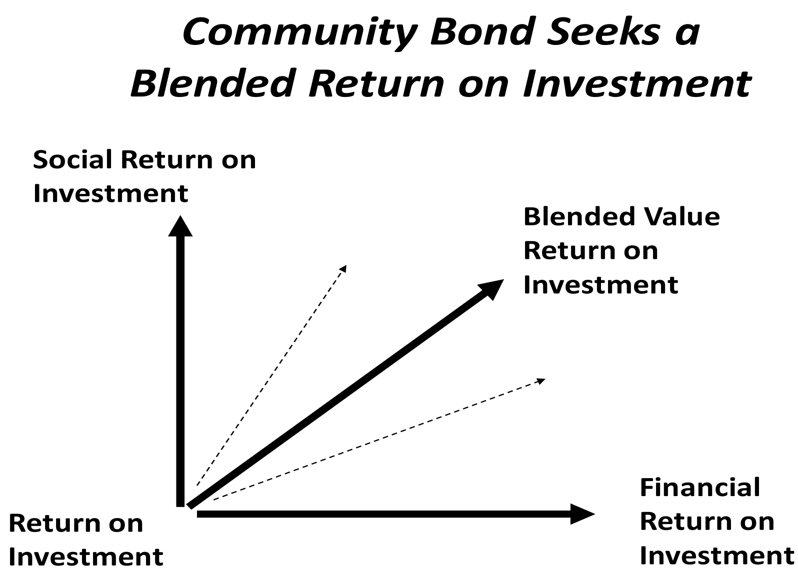
The Bond design exercise will set out the specific characteristics of the Bond itself. Some will be driven by alignment with organizational strategy while others will be dictated by financial constraints identified through the financial analysis. Still others are a function of legal requirements in setting up the Community Bond. The following items are typically included in designing Bond characteristics:

- total amount of funding required
- purpose of the funds
    - a clear and succinct statement of the purpose of what the funds will be used for
- speed and frequency of principal repayment
    - regular repayment, or
    - deferred start to principal repayment, or
    - lump sum repayment down the road
- frequency and payment of interest
    - can be paid monthly, quarterly, annually
    - can be accrued or paid out regularly
- description of any collateral security offered
    - the chances of success in a Bond offering are considerably higher if the Bond has tangible security supporting it
- size of bond investment (minimum or maximum)
- reasonable financial return
    - can be as low as 0% (if community outcomes are significant)
    - higher rates of return will attract a wider scope of investors

- when designing a community bond, it is the combination of financial and community returns which will attract investors who have an interest in furthering those community returns
- other information
  - there may be other specific details or unique features in addition to the items above which form a key part of describing the type or characteristics of the Bond

The following Figure 8 demonstrates the dynamic between social and financial returns on financial investments.

Figure 8



Keep in mind that non-profit organizations are typically regarded as high risk to conventional investors. The dependence on donated and philanthropic funding and the lack of predictability of revenues makes investors uneasy. If the revenue model indicates control over generating sales some of this risk is mitigated. The opportunity for Community Bonds lies in two areas:

a) investors who understand and are aligned with your mission will perceive less risk with the investment due to their higher level of knowledge

b) mission based investors may be willing to take a lower (or no) return on their investment capital than would normally be associated with the level of financial risk in order to achieve the social or environmental outcomes of the project

Financial modelling that is done to establish the viability of the project will demonstrate the rate of interest which the project can afford to pay on the Bond. Having a financial model which show what happens if the interest rate is changed is an excellent tool to test the sensitivity of the project to rate changes and indicates how much leeway there may be in setting the interest rate. Balancing the financial return (interest rate) on the Bond with community outcomes (social and environmental values) is the "fine line" you will walk and will depend on how close the target investors are to your mission and how deeply they value the community outcomes.

Other Characteristics

The core facts about the Community Bond can be condensed into a succinct document (as little as one page) called a "**Term Sheet**". The Term Sheet may appear to be very cold and "corporate" without the opportunity to put forth all the excellent reasons why an investment in the Community Bond is such a worthwhile endeavour, but from the investor perspective, they need to know with precision exactly what they are getting. There are other documents which support the Term Sheet and provide the rationale and key motivating factors for making an investment in the particular Community Bond.

It is possible to structure a Community Bond with more than one "series" within the Bond issue. This may include a Series A Bond, a Series B Bond, etc. There are many reasons to have more than one series however the primary purpose is to design different features between the various series. One may have a higher interest rate or a longer repayment period than the other. One may not receive principal repayment for a longer period at the beginning of the Bond period (or may wait until maturity to receive a lump sum payment). The term or amortization could be different for differing series or the Bond holder's interest in the security (such as a mortgage) may have a different ranking (which creates different risk levels for the investor). The flexibility to create more than one set of Bond characteristics allows the Bond issuer to appeal to more than one category of investor, thereby increasing the chances of having the Bond fully subscribed.

Development of Documentation

The primary tool of communication with potential Community Bond investors is a well written and thorough package of information. This collection of documents will contain everything the investor needs to know including full disclosure of organizational background, mission and values, financial information, organizational structure and management, opportunity description, Bond terms and conditions and an assessment of the likelihood and magnitude of associated risks.

Each investor will have a slightly different perspective and will focus on different aspects of the organization and opportunity. For this reason, the information intended for investors needs to be exceedingly thorough, well written, be concise and tell a compelling story. The investor should come away with a strong sense of how this investment opportunity fits with his/her own financial and mission objectives and understand how his funding will be leveraged.

Initially, investors will need to review an executive summary type document where they can gain an overview of what is proposed. The complete collection of information will be used as a follow-up and to provide the investor with a tool to better assess the appropriateness of the investment. More time spent up front creating complete information will mean less time following up to answer questions, particularly as it gets close to the wire on gaining investor commitments for Bond purchase.

In addition to the investor information documents, legal documents for the Bond, the **Subscription Agreement** and the Trust Agreement will need to be prepared by a suitable lawyer for the transaction. These tend to follow fairly standard structures but will require tailoring to the organization and the particulars of the transaction.

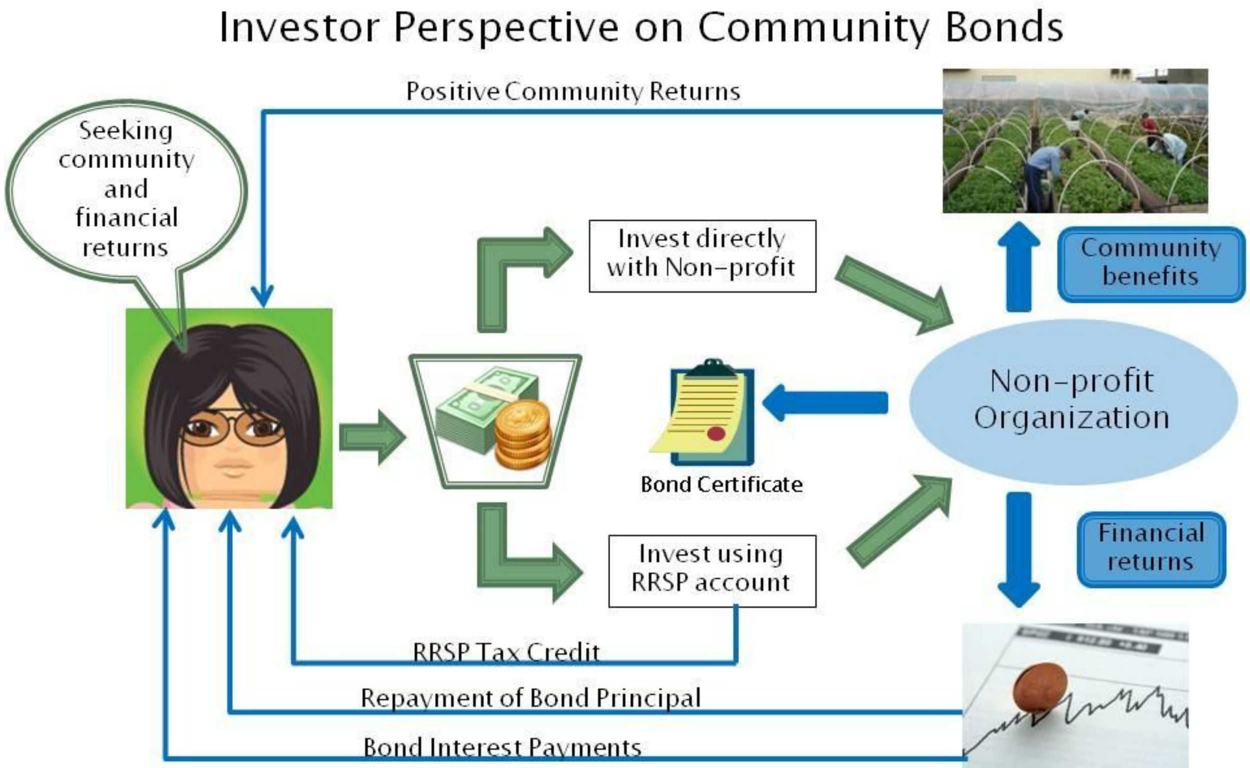
The Bond "Sales Process"

A very important stage in launching a successful Community Bond issue is to attract sufficient investor interest to fully subscribe or "sell out" the Bond and raise the full amount of capital required. This component is as important, if not more important than all the work of analysis and design which has been done to get to launch. Identifying the "market" of investors who will be most attracted to the investment opportunity is the starting place. This comes from knowledge of the non-profit sector, discussions with key potential investors and a basic understanding of what motivates investing behaviour.

You must know why the Community Bond is appealing to investors and build excitement around the opportunity. Leverage existing networks of the organization and the Board of Directors using word of mouth as a powerful communication tool. Effective communication materials and development of key messages will serve to convey a consistent message to investors and provide answers to the questions they will undoubtedly have. Investor risk is mitigated if the investor knows and believes in the non-profit organization issuing the bond and believes that it has the resources to continue to be sustained over the time horizon of the bond.

Often in marketing an opportunity such as a Community Bond, it's not the people <u>you</u> know – it's the people your network knows. The best approach is to take the perspective of the investor and "get in their shoes" as to what motivates their investing behaviour. Figure 9 which follows maps out the investor perspective and shows how money invested is translated into various benefits to the investor. We see returns to the investor in the form of tax benefits (RRSP channel), return of initial capital, a financial return on capital invested and the benefits of community outcomes as well.

Figure 9



Contacts created during the design phase of Bond development represent the first group of potential investors who also have significant networks of their own, more likely tied to the investment world than your own circle of contacts. Your goal should be to gather from them a lengthy list of additional potential investors to whom you can market the Bond Offering once the structure is established and your information package completed.

Overcoming the fear of objection is one of the basic skills in effective selling. What if the investors you talk to don't like what you have to offer? Bear in mind that you don't have to create a Bond that everybody loves. All you need is sufficient interest to raise the amount of capital you have targeted. Emphasizing positive outcomes and the benefits to the investor is the strongest marketing approach.

Timelines

The total time frame from initial idea of a Community Bond to completing the transaction with investment money collected will vary tremendously depending on a wide range of factors. For many organizations there can be a period of years of incubating the concept and toying with the idea prior to moving ahead in earnest. For others, the circumstances and available opportunity which is presented demands rapid action and all stages of the process are accelerated, many of which are completed concurrently.

In Figure 7 presented earlier, a timeline is provided at the bottom of the figure with broad estimates of a reasonable timeframe for each stage in the process once a non-profit organization has made the decision to proceed. This assumes that the required resources and expertise have been identified. The time estimates by stage are summarized in the chart below:

	Community Bond Development Stage	**Low Time Estimate**	**High Time Estimate**
1.	Define the project	1 mo.	3 mos.
2.	Assess Feasibility	2 mos.	4 mos.
3.	Design Bond terms	1 mo.	2 mos.
4.	Prepare information for investors	2 mos.	6 mos.
5.	Bond sales process	4 mos.	12 mos.
6.	Securing investor commitment	Incl. in sales process timing	
	Total Est. Development Time	**10 mos.**	**2 ½ years**

Closing the Bond Transaction

The nature of how the Community Bond transaction is brought to a close will depend on whether the project has a "hard" date for funding (such as the purchase of a property) or is able to be rolled out over a period of time. If the project is to fund a specific transaction then the lead up will involve gathering investor contributions, usually with a **Trustee**, pending issuance of the bond certificates and release of funds to the Bond issuer at the transaction date.

If further funds are required after the specific purchase date, a continuous closing where new investors come on stream on an ongoing basis is possible. Note that the sales process doesn't have to stop at a defined closing date, but the process requires resources and can get "tired" with investors if it goes on over a long period of time. The nature of the underlying initiative will dictate whether it is appropriate to "leave the door open" to new investors over time.

A potential challenge at the time of closing the Bond issue is only raising a portion of the targeted level of investment funds. Building some flexibility into the project is a useful strategy and allows for last minute adjustments to still proceed with reduced funding. There may be specific requirements (such as a loan which is contingent on raising a specified amount through the Bond issue) which need to be met for the project to go ahead. In this case it is wise to have a few key financial sponsors who have the capability to invest additional amounts if absolutely required for the project to go ahead.

Ongoing Bond Administration

Once the Community Bond has been issued and investors have put money into the project, ongoing administration of the group of investors is required. The administration work can be shared between the Bond issuer and external services, or all of the ongoing administration work can be outsourced. There are well established firms providing a wide range of administrative services to securities issuers which are completely fluent in the regulatory environment and can ensure full adherence to regulatory compliance requirements.

All of this comes at a fee however, and as discussed previously, the amount of funding raised and/or the number of total investors in a Community Bond may be much lower than for a typical public market securities transaction. It is therefore essential to seek ways to minimize the ongoing expenses associated with bond administration. There is a minimum requirement to have a named Trustee (can be a reputable lawyer) for the Bond holders and for RRSP directed investments investor accounts are held at external financial services providers. Other than that it is possible to retain other administrative activities in the non-profit and act as the liaison with the Trustee and the RRSP account providers.

Key administrative duties include establishing and maintaining an accurate record of investors and ensuring timely payment of interest and principal amounts. Accurate calculation of interest payments (whether paid out or accrued) and tracking of repayment dates and lump sum payment amounts is required. Administration and processing of new investor contributions will also be required if the Bond remains open for investors going forward.

There is an ongoing need to sustain a channel of investor communications with periodic progress reporting and a mechanism to receive and respond to specific investor questions. Sustaining investor confidence is the very best way to avoid anxiousness and a desire for investors to “cash in” their bond as soon as possible. Investor communication will also be the marketing channel to bring in further sales of additional bond units if so desired.

Summary and Conclusions

The opportunity for a non-profit organization to issue a Community Bond is an exciting and innovative way to increase access to capital and leverage a non-traditional channel of funding for community and mission based work. While the legislation has not changed recently and this type of bond is not a new instrument in the securities market, awareness of its availability by non-profit organizations is growing and examples of successful Community Bond issues are increasing.

The complexities of securities markets has kept the Community Bond "off the radar screen" for non-profits generally and it deviates significantly from traditional social mission funding models. The opportunity, however, leverages a unique securities reporting exemption only available to non-profit organizations which serves to reduce the costs of issuing a bond and sustaining ongoing reporting.

A Community Bond is only one of many ways that non-profit organizations can access capital and it requires a significant amount of work and energy to bring to fruition. It requires a change in mindset from conventional philanthropic fund raising and applying for grants to a more entrepreneurial approach to independently growing the capital base of the organization.

Clear benefits from a Community Bond emerge through access to a vast supply of capital which is currently under-developed for community organizations. A Bond leverages emerging awareness of social investment by investors (do you care what your money does at night?) and connects financially in a very different way with donors and supporters. Investment in a Bond provides investors with a mechanism to do more "good" with more of their financial resources.

Glossary of Terms

As with any area of complex legislation, there is a unique lexicon of terminology which is used extensively and requires some specialized knowledge. We provide here some explanation of several important terms relating to securities markets and issuing a Community Bond.

Accredited investor	includes: • individuals who have at least $1 million in financial assets (cash and securities) • individuals with net income which exceeds $200,000 (or $300,000 with spouse – most recent 2 years) • individuals who have at least $5 million in net assets • corporations, limited partnerships, trusts or estates having net assets of at least $5 million • financial institutions • registered advisers or dealers • pension funds • certain mutual funds
BC Securities Act	legislation governing all aspects of issuance and trading in securities in BC
BC Securities Commission	is responsible for the administration of the **BC Securities Act**
Bond	is an instrument of indebtedness of the bond issuer to the holders. It is a debt security, under which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay them interest and/or to repay the principal at a later date. Interest is usually payable at fixed intervals
Bond Certificate	a document provided to the investor upon purchase of a bond to evidence the specific security, the amount invested and the official name of the investor
Bond Purchase Agreement	same as a **Subscription Agreement**

Bond Rating	a credit risk rating of the entity issuing a bond provided by one of several bond credit rating agencies such as Standard & Poor's, Moody's or Dominion Bond Rating Service (DBRS). The rating is selected from a scale of ratings anywhere from "extremely strong" to "highly vulnerable to non-payment". The process of obtaining the rating is very costly to achieve and to maintain annually. These external ratings are generally used for public market issues where the investor markets are far removed from the issuer. A rating is not required but can be useful when appealing to broad investor audiences
Community Services Cooperative	a Cooperative Association formed under the Cooperative Association Act (BC) which is non-profit in nature and must identify a charitable purpose within its Memorandum of Association. Community Service Coops are not permitted to issue investment shares
Convertible Bond	a debt instrument which has conditions under which it can (or must) "convert" to an equity instrument (shares) at a future date if the conditions are met
Eligible investor	a definition used in some Canadian provinces (not in BC) which uses similar qualification categories to **Accredited Investors** with lower financial requirements and is applicable to some categories of investment
Inter-lender Agreement	provides acknowledgement and approval of the bond by all lenders to the issuing organization and provides clarity on the relative rank of security rights of each lender
Investor Information	provides the organization background, rationale and financial analysis to support the purpose and use of Bond funds
IPO (Initial Public Offering)	the first offering of securities by a company in the public markets
Issuer	an entity which creates and sells a security to investors as a means of raising capital
Non-reporting Issuer	if the organization is not a **Reporting Issuer**, it does not have to comply with the public disclosure requirements. Both Reporting and Non-reporting Issuers must comply with registration and prospectus requirements or be able to rely on an exemption from those requirements

Offering Memorandum	an information document which contains similar information to a **Prospectus** but does not present the same level of rigour or detail and is less costly to produce. The format and contents for an Offering Memorandum is very clearly specified by the **BC Securities Commission** under its Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers (or Form 45-106 F3 for Qualifying Issuers)*
Person	for purposes of the **BC Securities Act** a "person" includes an individual, corporation, partnership, party, trust, fund, association and any other organized group of persons and the personal or other legal representative of a person to whom the context can apply according to law
Private Issue	one status of exemption from **Prospectus** reporting which allows the **Issuer** to sell a security to a limit of 50 security holders with restriction of sales of the security to directors, officers, employees, family members, close personal friends and business associates
Prospectus	is a document that describes a financial security for potential buyers. A prospectus commonly provides investors with material information about investments such as a description of the company's business, financial statements, biographies of officers and directors, detailed information about their compensation, any litigation that is taking place, a list of material properties and any other material information. In the context of an individual securities offering, such as an **initial public offering**, a prospectus is received and approved by the **BC Securities Commission** and is distributed to potential investors
Registered Mortgage Charge	the document which gets registered against the real property and links the rights of the Bond holders to an interest in the property
Reporting Issuer	is a company or other organization which must provide information about its affairs on a regular basis to the **BC Securities Commission**, its security holders and the investing public by way of a **Prospectus** and has any securities listed on an exchange. If it does not comply with the requirements and is not able to rely on an exemption from them, it is violating BC securities laws. This may result in penalties such as severe fines or the shutdown of operations. An organization would become a Reporting Issuer if it desires to issue and sell securities to the general public and use intermediaries and public markets for the sale and resale of those securities

Registered Seller	a **Person** or entity which has the requisite knowledge and experience to qualify to trade in securities and is registered to do so with the **BC Securities Commission**
Resale of Securities	after an initial distribution of a security to investors, many securities can be sold amongst investors or sold back to the issuer and these transactions constitute a resale of the security. The regulations most often provide similar requirements and restrictions on the resale of a security which applied to its initial distribution
Security	has a broad legal meaning and includes: • a document evidencing title to, or an interest in, the capital, assets, property, profits, earnings or royalties of a person, • common and preferred shares • options, warrants and other convertible instruments • debt security, meaning any bond, debentures, note or similar instrument representing indebtedness, whether secured or unsecured • a contract of insurance issued by an insurer, and • an evidence of deposit issued by a savings institution, • limited partnership units • memberships in co-operative associations
Security Agreement	a pledge of assets of the issuing organization in support of bond payments which reduces the level of financial risk for a bond
Sophisticated Investor	an unofficial term often used to describe investors who meet one or more of the exemption definitions including an **Accredited Investor** or meet the minimum $150,000 hurdle exemption criteria for securities purchase
Stock	constitutes the equity stake of its owners. It represents the residual assets of the company that would be due to stockholders after discharge of all senior claims such as secured and unsecured debt. The stock of a corporation is partitioned into shares
Subscription Agreement	the official request by the investor to purchase units of the **Bond** (similar to an order form)
Term Sheet	a brief synopsis of pertinent terms and conditions of the **Bond**

Transfer Agent	provides administrative services to receive **Subscription Agreements** from investors, issue related documentation, maintain a record of all investors for a security issue, calculate and pay interest and ensure timely payment of principal to investors
Trust Agreement	sets up the relationship between the **Bond** issuer and the **Trustee** including all of the obligations and requirements of each party. Bond holder rights will be explicitly stated
Trustee	acts "in trust" on behalf of bond holders to represent their interests relative to the obligations of the bond issuer. If there is a breach of the terms of the bond by the issuer, the Trustee provides the mechanism for individual bond holders to pursue recourse

About the Author

As principal of Capacity Build Consulting, Scott Hughes is a leading social finance practitioner assisting organizations to overcome the challenges of financial management and scarce capital to increase financial resilience. Scott's experience builds on a 20 year career in commercial finance which included 10 years with a large community based credit union (Vancity Savings CU) where he developed and directed the social lending portfolio.

Through his work, Scott has provided a range of financial services and tools to public and private companies, charities, not-for-profits, social enterprises and cooperatives. Strong financial results have been complimented by successes in designing and implementing innovative strategies such as a tailored lending policy and financial literacy tools to increase financial resilience for not-for-profit organizations.

Research into the concept of Community Bonds issued by mission based organizations builds on his practical experience in non-profit funding models. Scott works directly with organizations to diversify access to capital and to increase financial and business management capacity.