Can Our Own Communities Serve as a Financial Safe Havens in Troubled Times?

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The fall in global stock market prices over the last year has had a significant impact on most Americans' retirement savings. When monthly 401(k) and IRA statements arrived last week, many small investors saw their investments drop in value by significant amounts. On Friday, October 10, a *Wall Street Journal* headline reported: *"*After Year of Declines, Investors Lose $8.4 Trillion of Wealth.*"*

The response of the federal government and the Federal Reserve to this situation is further eroding small investor confidence: while small investors and their pension funds suffer significant losses, Wall Street firms are receiving multi-billion-dollar loans, investments and bailouts and the executives responsible for creating a mortgage securities and derivatives scandal escape with rich golden parachutes.

A byproduct of reduced confidence in the public stock market is an increased interest in local investment. People concerned about their retirement savings express growing interest in investing locally for the following reasons:

- **Tangibles:** As the air goes out of the debt bubble, capital has been shifting out of complex financial products and back into essential services and tangibles, including commodities, natural resources and precious metals. Thus, many of the basic goods and services created and managed locally should be rising in value now and in the future.

- **Credit Crunch:** As financial centers hoard capital to address their own losses, many small investors see that if they send their savings to Wall Street, Wall Street is not likely to circulate it back to their community. The way to ensure that your cash accounts are circulating locally is to deposit in local banks or similar local or regional financial institutions.

- **Community:** We Americans are committed to our communities. The prospect of helping local small businesses create the jobs and income flows that will help our friends and family members in hard times makes local equity an attractive investment alternative. For the same reasons, those responsible for philanthropic and social venture capital investment decisions are interested in community investment opportunities.

- **Green:** If we are going to reduce waste in our society, we must do it one place at a time. For those of us interested in "going green," there is a lot of opportunity in our own backyard.

- **Risk:** Centralized government and banking policies are resulting in rapid inflation of our money supply. This causes our currency to drop in value, inflating prices. As a result, the cost of food, energy and other essential items in our household budgets rises. In the face of inflation and potential disruptions in quality and availability, the economics of investing in food and energy self-sufficiency at the household and community level become more attractive. An investment in becoming energy self-sufficient takes the sting out of falling levels of dividend and interest income. A lower overhead is the dividend that cannot be cut.

- **Financial Intimacy:** Given current significant levels of financial system fraud, sticking with the people and things that we know, understand and trust is a good way to make sure we are financing legitimate enterprises and are not paying a "corruption tax."

- **Equity in Purchases:** Investing in the businesses and farms that we patronize creates an opportunity to build equity from our own purchases.

Traditionally, local banks have done a good job of circulating customer deposits by making loans to small business, farms and other enterprises in their areas. As the credit crunch deepens, however, it is critical for us to do our homework and support depository institutions that our research indicates are financially sound and circulating their customer deposits in the form of responsible local loans.

Since equity investment is the foundation of financially healthy, sustainable companies, both start-ups and existing businesses are well advised to seek equity capital as well as debt financing. While small investors can pool their capital by investing in mutual funds that hold stock in large corporations, few liquid opportunities exist for small investors to make community-based investments.

So the question is, how do we build the the financial bridges between capital leaving the global stock markets and local entrepreneurs and businesses and farms who can effectively deploy such capital in a way that contributes to a more robust economy in our community? In developing investment vehicles for small investors to invest locally, we will want to address system-wide issues:

Regulatory Issues: Right now, it is easier for most Americans to "invest" money in the lottery than in equity in local community businesses. Traditionally, many regulatory and legal impediments have created significant obstacles to investing locally. For example:

(1) Under federal securities laws, stock must be registered with the Securities and Exchange Commission unless an exemption from registration is available. Registration is prohibitively expensive except for offerings in the millions of dollars. If a community-based offering is made only to investors within a single state and certain other federal contacts can be avoided, the offering may be conducted under the securities laws of the state in which the business is located and the investors reside. In most states, however, an "intrastate" offering still entails significant costs for an attorney to provide investors with the required disclosure and make the required regulatory filings and an accountant to provide financial statements and tax advice.

(2) Generally, small issuers claim a private offering exemption that is available for sales directly by an issuer not involving a public offering, but the offering cannot be advertised publicly and significant financial and other disclosure is required. This exemption is available for sales to an unlimited number of "accredited" investors but only to 35 or fewer investors who are not accredited. This means that the size of the offering may be quite limited unless the issuer is able to sell most of the shares to accredited investors, The definition of "accredited investor" includes institutional investors and major corporations, but an individual qualifies only if he or she has annual income of at least $200,000 ($300,000 together with a spouse) or net worth of at least $1 million. Thus, many small investors do not qualify as accredited investors.

(3) Investors in private offerings, whether under state or federal law, often must show that they have a level of sophistication that enables them to understand the merits and risks of the investment or have an advisor with such ability. Many small investors would not have that level of sophistication unless they were to take classes or otherwise study investment analysis and/or had experience in the type of business conducted by the issuer.

(4) Many, if not most, small investors hold a significant portion of their investment assets in the form of IRAs or 401Ks, which must satisfy the requirements of the Employee Retirement Income Security Act ("ERISA"). ERISA places strict restrictions on the type of investments that may be held in such accounts by putting the onus on the trustee to show that the investments are "safe." This showing is difficult for securities that are not publicly traded. Finding a trustee willing to put in the time it takes to satisfy the fiduciary duties under ERISA and assume the significant risks of departing from the traditional types of investments presents a challenge.

(5) Pooled investments of any significant size or complexity may entail satisfying technical requirements under the Investment Company Act of 1940 (or similar state laws in the case of intrastate offerings). An exemption from this law is available for non-public offerings to 100 or fewer investors, but this exemption cannot be claimed if the offering is advertised publicly. If no exemption is available, many complex requirements having to do with recordkeeping, registration of the investment company's investment advisor, capital requirements for the investment advisor, financial statement and other disclosure and independence of the governing body will apply. Undertaking this compliance would not be feasible except in the case of a very large offering.

The challenge is to navigate these requirements responsibly without creating unacceptable risks for less experienced investors.

Liquidity and Diversification: Traditional investment vehicles for private venture capital investment have been illiquid and involve large minimum capital requirements. We need to find ways for local investors to pool their capital and achieve diversification and liquidity. Securities law requirements play a role here, too, because generally, securities offered in non-public offerings are restricted and cannot be sold except under an exemption from registration requirements. Some markets for unregistered securities do exist, but the requirements for sales generally preclude participation in this market by investors who do not satisfy standards for income and net worth exceeding even the requirements for accredited investors.

Expertise: Most small investors have grown comfortable with investing in liquid securities and mutual funds through their brokerage accounts. Under existing constraints, local investment opportunities are complex and difficult to understand even for sophisticated investors. We need to attract professionals who can capitalize on what we have learned about investment clubs, venture capital and angel networks to create and manage local investment pathways. In addition to needing to understand and work with the securities law and ERISA constraints described above, professionals charged with the task of carrying out community offerings will need to be able to work with community leaders and state regulatory authorities to assure that safety and accountability to the relatively inexperienced segment of the investing population can be achieved. The costs of employing such professionals at market rates for the necessary services would be significant.

Human Capital: Many of our best and brightest young people are leaving small communities for greater opportunities elsewhere, while retirees with investment capital are closed out of the mainstream. We need to find ways to engage all the generations to work together to ensure that we have the best human capital available to create, finance, govern and manage enterprises locally.

Strategic Control: Many small business owners seek debt financing for permanent working capital needs to avoid sacrificing privacy and decision-making freedom to outside equity investors. Stimulating local equity investment will necessitate the creation of capital structures that ensure business owners retain privacy and strategic control. An example of a capital structure that may satisfy these requirements is the "A/B" share model, whereby shares with limited or no voting rights are issued to passive investors. Such a structure may be suitable for relatively unsophisticated investors only where some intervening third party (such as an investment advisor) is in a position to protect the interests of investors.

An obstacle to achieving an effective network of community based investment vehicles across the country is the knowledge management, legal and other costs required to create the early deals upon which others may be based. For a given community, the costs may be brought down if it joins with other communities to find ways to share these costs, thereby amortizing them across a sufficiently large capital base for the resulting products to compete with existing capital market investment vehicles. Alternatively, this type of effort could be funded by philanthropic dollars or social venture investment looking to kick-start private reinvestment in small and green business and communities. With focused investment, powerful state-of-the-art digital methodologies may be used to create and share deal templates, "how to" manuals, lessons learned, software innovations and databases and similar knowledge management tools so that each community does not have to reinvent the wheel. Given recent downsizing in financial industry employment, community investment is a potential area of opportunity for professionals with financial experience and skills.

While creating a safe haven for our capital in our own communities is a complex undertaking, the opportunities are growing to invest in our neighbors and ourselves. During the period October 24-28, I will be participating in "Financial Permaculture: The Greening of a Rural American Community" (www.financialpermaculture.com) in Hohenwald, Tennessee. We will grapple with these and other issues in simulations designed to help participants find ways to finance small business projects involving ethanol, a green business incubator and natural homebuilding businesses.

If you can, please join us there. For those who can't come for the entire time, there will be sessions open to the public. For those of you are not close by, participating blogs will be covering the event. See: Financialpermaculture.org

So in person or virtually, join the conversation! Let's make our communities a safe haven for both our families and our capital.