CDFIs and Investment Notes Offering

Research Memorandum

Prepared by Wake Forest University School of Law Trade & Development Clinic
for Tern Strategies, LLC – December 2, 2024

Tern

Introduction

The investment landscape for Community Development Financial Institutions ("CDFIs") is rapidly evolving, presenting both opportunities and challenges in raising capital through investment notes. This memo explores the regulatory framework, exemptions, and key considerations for CDFIs looking to issue investment notes as a means of funding their community development initiatives.

Investment notes are general, unsecured obligations issued through securities offerings, recognized by contractual agreements between issuers and investors. The Supreme Court has emphasized that these notes are distributed to create "common trading for speculation or investment" rather than for consumer purposes (i.e., the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good). For CDFIs, investment notes offer a potential avenue to raise capital from both accredited and non-accredited investors, often with fixed-rate returns over specified periods.

The regulatory landscape for investment notes is primarily governed by the Securities Act of 1933 ("Securities Act"), which aims to protect investors by requiring the disclosure of material information necessary for informed investment decisions. However, the Securities Act also provides various exemptions from registration requirements, which can be particularly beneficial for CDFIs seeking to avoid the substantial costs and burdens associated with full registration.

Key exemptions relevant to CDFIs include Rule 506 of Regulation D, which allows for private placements to accredited investors and a limited number of sophisticated non-accredited investors. Rule 504 of Regulation D provides another avenue for smaller offerings up to $10 million in a 12-month period. For broader access to non-accredited investors, Regulation A and Regulation Crowdfunding offer additional options, albeit with their own set of requirements and limitations.

Notably, the Philanthropy Protection Act of 1995 expanded exemptions for organizations operating for benevolent purposes, potentially providing a pathway for certain CDFIs to offer securities exempt from registration requirements. The Philanthropy Protection Act also addressed state-level regulations, generally preempting state registration requirements for securities exempt under Section 3(a)(4) of the Securities Act, with some states opting out of this preemption.

CDFIs considering the issuance of investment notes must navigate a complex regulatory environment while also addressing practical considerations such as developing comprehensive prospectuses and drafting detailed promissory note agreements. They must also be mindful of potential challenges, including the verification of accredited investor status, "bad actor" disqualifications, and integration risks when conducting multiple offerings.

This memo seeks to provide a broad overview of these topics. By understanding these factors, CDFIs may be able to better position themselves to leverage investment notes as a tool for raising capital and furthering their mission of community development. Importantly, the information contained in this memo is not intended to provide legal advice for any particular securities transaction and may not apply to all situations. Ultimately, careful navigation of both federal and state securities laws and regulations with the ongoing advice of legal counsel is crucial.

I. Background on Investment Notes

A. Definition of Investment Notes

An investment note is a general, unsecured obligation, issued through a securities offering, recognized by a contractual agreement between an issuer and investor. The Supreme Court further highlighted that an investment note is a note distributed to others in a manner as to create "common trading for speculation or investment", rather than some other "consumer purpose".[1] In other words, investment notes are used as an

1 *See* Reves v. Ernst & Young, 494 U.S. 56, 66 (1990); *see also* Park McGinty, *What is a Security*, 1993 WIS. L. REV. 1033, 1094 (1993) (Footnote 241 highlights the definition used by the Court in *Reves*).

investment contract in which the issuer can gain capital from the buyer who expects a return, thus fitting into the broad definition of a security under the Securities Act of 1933.[2]

B. Typical Characteristics of CDFI Investment Notes.

CDFIs are in a position in which they might consider the use of investment notes to raise capital to use on a wide array of projects. Under certain conditions, CDFIs may offer these debt securities to the private sector in exchange for funding that otherwise may not have been readily available for the CDFI.[3] CDFIs often use these debt securities to support impact investing.[4] These investment notes typically involve both accredited and non-accredited investors involved in an investment with an often-fixed rate return over a period selected by the buyer.[5] However, because of the unique nature of CDFIs and the ability of CDFIs to acquire both public and private subsidies, CDFIs investment note offerings have been said to have a "financial advantage" over both traditional and subprime lenders that attempt to serve clients.[6]

II. Federal Regulatory Framework

A. Securities Act of 1933 Overview

The Securities Act of 1933 (the "the Securities Act") had the purpose "to eliminate serious abuses in a largely unregulated securities market."[7] In an effort to limit the abuse in the securities market, the Securities Act determined "[i]t shall be unlawful for any person, directly or indirectly,... to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security."[8] In short, the Securities Act makes it illegal to sell or buy any security that has not been registered with the Securities and Exchange Commission (SEC).[9] This seeks to reduce abuses of the market and "protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning public offerings of securities."[10]

Following the Securities Act, the SEC has put into place numerous requirements that must be met in order to register a securities offering.[11] To qualify and to register the securities offering, a company must provide the SEC, among other material information, with a description of the company's properties and business; a brief description of the security to be offered for sale; information about the management of the company; and financial statements certified by independent accountants.[12]

Providing the accurate information (meaning no willful omissions or untrue statements) to investors promotes transparency in financial markets.[13] However, as seen from above, not every piece of information is disclosed, rather securities law focuses on the concept of "materiality". Materiality represents the "dividing line between information reasonably likely to influence investment decisions and everything else".[14] The Supreme Court, when faced with defining the materiality stated that a fact is material if there is "a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[15] While not a bright line definition,

---

2 15 U.S.C. § 77(b); *see also* S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946) (defining an "investment contract" under the Securities Act. Under *Howey*, an investment contract is (1) a transaction, (2) where a person invests his money in a common enterprise and (3) is led to expect profits (4) from the efforts of the promoter or a third party).

3 Darryl E. Getter, CONG. RSCH. SERV., R47217, Community Development Financial Institutions (CDFIs): Overview and Selected Issues 27 (Aug. 16, 2022).

4 *Id.*

5 *See Making an Impact: How to Invest in Community Development Financial Institutions (CDFIS)*, CNOTE, https://www.mycnote.com/blog/how-to-invest-in-cdfis/ (last visited Nov. 4, 2024).

6 *See* Getter, *supra* note 3 at 3.

7 *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

8 15 U.S.C. § 77e.

9 *Id.*

10 *Pinter v. Dahl*, 486 U.S. 622, 638 (1988).

11 15 U.S.C. §77l.

12 *Registration Under the Securities Act of 1933*, S.E.C, https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933 (Last visited Nov. 4, 2024).

13 Richard C. Sauer, The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws, 62 BUS. LAW. 317,318 (February 2007).

14 *Id.*

15 TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976).

materiality plays an important role in securities offerings. For example, if a person were to sell a security (whether exempted or not) with an untrue statement of material fact or were to willfully omit of a material fact, the seller would be liable to the person purchasing such a security.[16] This buyer may sue to recover consideration paid for the security with interest.[17] Therefore, when offering securities, the issuer must conduct an objective analysis, for which it is common practice to rely on legal counsel, to ensure that any information that may affect a (reasonable) investor is properly and accurately disclosed.[18]

B. Exemptions from Registration

Registering a securities offering under the Securities Act can be intrusive, expensive, and increase exposure to potential securities liability. The costs of disclosure and underwriting in a registered public offering often outweigh the benefits of new capital. Accordingly, the Securities Act provides various exemptions. For CDFIs, these exemptions are a potential route to raise capital without having to pay the often significant and burdensome costs associated with the registration process, especially for those CDFIs whose total securities sale is less than $5-10 million.[19] It is important to note that each of the following exemptions are subject to the "Bad Actor Disqualification," which is described in detail below.[20]

i. Rule 506 of Regulation D

Section 4(a)(2) of the Securities Act exempts from registration any offering "by an issuer not involving any public offering."[21] Although Congress did not provide a statutory definition of "public offering," the SEC and courts have interpreted the § 4(a)(2) "private placement exemption" to embody a congressional intent to make exempt an offering from registration requirements when such requirements are no longer necessary because investors on their own have sufficient sophistication and information to protect themselves. The private placement exemption technically has a statutory exemption that completely exempts qualifying issuers from all the Securities Act registration and disclosure requirements; however, issuers have demonstrated a significantly greater reliance on the regulatory safe harbor exemptions created by Rule 506 of the Regulation D ("Reg D"). The two most commonly relied upon exemptions are Rule 506(b) and Rule 506(c). Finally, Reg D also include Rule 504, which is primarily for small and medium-sized offerings.

ii. Rule 506(b) Exemption

Both private and public issuers can rely on Rule 506(b), sometimes referred to as the "private offering" exemption, to sell an unlimited dollar amount of securities.[22] This exemption, however, is not without its limitations. For securities offered under this section, the securities cannot be freely resold to the public because they were never sold as a part of a registered offering, thus the purchasers of these securities are purchasing "restricted securities."[23] Additionally, for offerings under this exemption of the Securities Act, there can be no general solicitation or advertising to market the securities to any investor.[24] Furthermore, under this exemption, securities may not be sold to more than 35 non-accredited investors.[25] However, these non-accredited investors must meet the level of a "sophisticated investor," which is an investor with such knowledge and experience in financial business matters that

16 15 U.S.C. §771(a)(2).

17 *Id.*

18 See Paul Munter, *Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors*, SEC (Mar. 9, 2022) https://www.sec.gov/newsroom/speeches-statements/munter-statement-assessing-materiality-030922.

19 Currently, the fee for registering a security is $147.50 per million dollars. *See SEC Announces First Fee Rate Advisory for Fiscal Year 2024*, S.E.C (Aug. 24, 2023), https://www.sec.gov/newsroom/press-releases/2023-162.

20 The Bad Actor definition can be found at 17 CFR § 230.506(d). Generally speaking, if an individual has violated any SEC rules with a securities offering in the past and could affect the offering, the bad actor disqualification applies.

21 15 U.S.C. §77(d)(a)(2); also known as Securities Act §4(a)(2).

22 *Private Placements – Rule 506(b)*, S.E.C., https://www.sec.gov/resources-small-businesses/exempt-offerings/private- placements-rule-506b (last visited Nov. 4, 2024).

23 6 Business Organizations with Tax Planning § 93.07 (2024).

24 *See Private Placements*, *supra* note 17.

25 *Id.*

they are capable of evaluating the merits and risks of the prospective investment.[26] There is no limit, however, to how many accredited investors may invest in the offering.[27] These accredited investors are any persons who qualify on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets.[28]

iii. Rule 506(c) Exemptions

Another exemption to the Securities Act is Rule 506(c) or the "General Solicitation" rule.[29] For offerings under Rule 506(c), the sales are not limited to any dollar amount and can be freely solicited.[30] Just like rule 506(b), however, there are some limitations to this rule. Most importantly, unlike rule 506(b) offerings, under rule 506(c), all purchasers of the securities sold must be considered "accredited investors."[31]

Furthermore, those that are selling the offering must take "reasonable steps" to ensure that the purchaser of the securities under rule 506(c) are accredited investors.[32] The issuer is deemed to have taken the reasonable steps necessary to verify the accreditation of an investor if they:

(A) Review any Internal Revenue Form that reports the purchaser's income for the two most recent years and obtain a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify an accredited investor during the current year;

(B) Review, on the basis of net worth, documentation such as bank statements, brokerage statements and other securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third party;

(C) Obtain a written confirmation from a registered broker, an investment adviser registered with the securities and Exchange commission, a licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law, or a certified public accountant, that the individual is an accredited investor;

(D) Obtain a certification by any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to September 23, 2013, and continues to hold such securities; or

(E) In regard to any person that the issuer previously took reasonable steps to verify as an accredited investor, obtain a written representation from such person at the time of sale that he or she qualifies as an accredited investor.[33]

The last regulation under rule 506(c) is that the offeror must fill out and file a notice of the sale of the securities with the SEC within 15 days after the sale of securities in the offering.[34]

---

26 17 C.F.R. § 230.506.

27 *See Private Placements, supra* note 17.

28 15 U.S.C. § 77b; the net worth requirement is $1 million. Other categories include certain regulated financial institutions and natural persons who had an income of at least $200,000 in each of the two most recent years (or $300,000 together with their spouse) and have a reasonable expectation of reaching the same income level in the current year. *See "Accredited Investor" Net Worth Standard*, SEC, https://www.sec.gov/resources-small-businesses/small-business-compliance-guides/accredited-investor-net-worth-standard (Last visited, Nov. 4, 2024).

29 *See General Solicitation – Rule 506(c)*, SEC, https://www.sec.gov/resources-small-businesses/exempt-offerings/general-solicitation-rule-506c (last visited Nov. 4, 2024).

30 *Id.*

31 17 C.F.R. §230.506(c).

32 17 C.F.R. §230.506(c)(ii).

33 17 C.F.R. §230.506(c)(2)(ii)(A)-(E).

34 *See General Solicitation, supra* note 26.

iv. Rule 504 Exemption

An additional way that CDFIs and other issuers may offer securities exempt from registration to non-accredited investors is through the use of an exemption under Rule 504 of Reg D. Rule 504 provides a security may be offered to any individual, with an aggregate $10 million limit for each twelve (12) month period.[35] Aside from the limitation on the amount of funds that can be acquired through this rule, the 2012 JOBS act also limits who can use the 504 rule. For example, the issuer may not be subject to reporting requirements under section 13 or 15(d) of the exchange act; an investment company; or a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies.[36] Additionally, a company must file with the SEC a Form D within 15 days after the first sale of securities in the offering.[37]

C. Other Considerations for Offerings to Non-Accredited Investors

i. Regulation A

While the above exemptions allow for an offering to be exempt from filing the offering with the SEC, the exemptions fail to provide a surefire way to allow offerings to non-accredited investors. To reach these non-accredited investors, a securities offering may be offered under Regulation A ("Reg A") exemption.

Reg A provides that a public offer or sale of eligible securities shall be exempt from the registration requirement of the Securities Act.[38] Reg A has two tiers of offerings. Tier 1 of Reg A provides that an issuer may not exceed $20 million in aggregate sales during a 12-month period, while Tier 2 increases the threshold to $75 million in the same 12-month period.[39] For both Tier 1 and Tier 2, before an offering can be sold, an offering statement must be filed with the SEC.[40] This offering statement is the primary document for investors, which must be qualified by the SEC and be given to any possible investors and must be delivered to the SEC 48 hours before the first sale of the security.[41]

One of the most important aspects of Reg A is that the offering may be offered to any investor for any amount. Comparatively, there is an important limitation imposed on an issuer offering a security under Tier 2. Under Tier 2, no sale of a security may be made to a non-accredited investor unless the aggregate purchase price is less than or equal to ten percent (10%) of the purchaser's income, revenue, or net assets for the most recently completed fiscal year.[42]

ii. Regulation Crowdfunding

As a practical matter, the exemptions discussed thus far provide limited options to companies or organizations looking for new investors. The JOBS Act of 2012 aimed to fundamentally alter this reality and allow for small issuers to raise capital from many small investors online. The last way that a CDFI may target non-accredited investors is through securities sales through regulation crowdfunding. Regulation crowdfunding allows for the sale of securities to all investors up to $5 million in a single 12-month period.[43] While regulation crowdfunding does allow for non-accredited investors to purchase the offerings, there are limitations. For the non-accredited investors with an annual income or net worth less than $124,000, the securities sold to such investor shall not exceed the greater of $2,500 or five

35 17 CFR § 230.504(b)(2).

36 *Id.*

37 *See Exemption for limited offerings not exceeding $10 million – Rule 504 of Regulation D*, SEC, https://www.sec.gov/resources-small-businesses/exempt-offerings/exemption-limited-offerings-not-exceeding-10-million-rule-504-regulation-d (last visited Nov. 4, 2024).

38 *See* 17 C.F.R. §230.251(a).

39 *See Id.*

40 *See Id.* at § 230.251(d)(1).

41 *See Id.; see also* 17 C.F.R. §230.251(d)(2)(i)(B)

42 17 CFR § 230.251(d)(2)(i)(C)(1)-(2).

43 17 CFR § 227.100(a)(1).

percent (5%) of a non-accredited investor's net worth.[44] For non- accredited investors whose annual income or net worth is equal to or greater than $124,000 the securities sold to such investor may not exceed the greater of ten percent (10%) of the investor's annual income or net worth, not to exceed an amount sold of $124,000.[45] The issuer must take reasonable steps to ensure that the purchase of the securities does not exceed the limits set forth for each investor, however, they may also rely on the efforts of an intermediary.[46]

One regulation of this crowd funding model is that the transactions that occur through this exempt must occur online through an SEC-registered intermediary.[47] Furthermore, this exemption to the registration requirement does not apply to investment companies and any issuer that is not organized under, and subject to, the laws of a state or territory of the United States or the District of Columbia.[48]

D. Summary Chart

The following chart[49] summarizes the various registration exemptions (as of 2024) available under the Securities Act and the SEC rules:

Type of offering	Dollar Limit	Marketing	Eligible Issuers	Eligible Investors	SEC Filing	Resale Limits	"Blue Sky" Preemption
§4(a)(2)	None	No general solicitations	None	All offerees/ purchasers can "fend for themselves"	None	Yes - restricted securities	None
Rule 506(b) [Reg D]	None	No general solicitations	No "bad actors"	Unlimited AIs / up to 35 non-AIs (90-day period)	Form D	Yes - restricted securities	Yes
Rule 506(c) [Reg D]	None	General solicitations permitted if only AIs	No "bad actors"	Unlimited AIs (verified by issuer)	Form D	Yes - restricted securities	Yes
Rule 504 [Reg D]	$10 million (12 months)	No general solicitation, unless state-registered or only AIs	No reporting, investment, or blank check companies No "bad actors"	No limits	Form D	Yes - restricted securities, unless state-registered or only AIs	None

44 *Id.* at § 227.100(a)(2)(i). It is important to note that a person's annual income and net worth may be calculated jointly with that person's spouse.

45 *Id.* at § 227.100(a)(2)(ii).

46 *Id.* ("Instruction 3 to paragraph (a)(2). An issuer offering and selling securities in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) may rely on the efforts of an intermediary...provided that the issuer does not know that the investor has exceeded the investor limits or would exceed the investor limits as a result of purchasing securities in the issuer's offering.").

47 *See Regulation Crowdfunding*, SEC, https://www.sec.gov/resources-small-businesses/exempt-offerings/regulation-crowdfunding (last visited Nov. 4, 2024).

48 *See* 17 CFR § 227.100(b)(1).

49 Alan R. Palmiter, EXAMPLES & EXPLANATIONS, 9th ed., Securities Regulation, 243-44 (2024).

Type of offering	Dollar Limit	Marketing	Eligible Issuers	Eligible Investors	SEC Filing	Resale Limits	"Blue Sky" Preemption
Reg A+ [Tier 1]	$20 million (12 months)	Can "test the waters" (before and after SEC filing)	U.S. or Canadian issuers (no reporting, investment, or blank check cos) No "bad actors"	None	Form 1-A, exit report	No limits	None
Reg A+ [Tier 2]	$75 million (12 months)			Non-AIs subject to investment limits	Form 1-A, periodic and exit reports	No limits	Yes
§4(a)(6) [Reg CF]	$5 million (12 months)	Testing waters (before Form C filed) General solicitations (after filing Form C) Internet platform (registered intermediary)	No foreign issuers / no blank check, reporting, or investment cos No "bad actors"	None for AIs Investment limits for non-AIs based on annual income and net worth	Form C Progress and annual reports	12-month resale limitation	Yes

III. Federal Exemptions for Charitable Organizations

A. Section 3(a)(4) of the Securities Act of 1933

Section 3(a)(4) provides exemptions from securities registration requirements for "any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes . . . ."[50] Arguably, people do not "invest" in philanthropic organization and therefore are not in need of extensive disclosures about the economic aspects of the operations of such issuers.[51] However, originally this exemption only applied when the net earnings of such a security were not used for the benefit of a private stockholder.[52]

This condition presented problems for charitable organizations that provided donors[53] with a gift annuity or any other form of periodic income in return for their contribution.[54] It would have been very difficult for charitable organizations maintaining funds of this kind to raise and manage capital effectively. Without these exemptions, charitable organizations were textually required to comply with the complex and costly registration and regulatory requirements overseen by the SEC. This regulatory burden would have significantly limited their ability to attract donors, pool resources efficiently, and invest funds in a manner consistent with their charitable purposes.

Recognizing this issue, the SEC published a series of release and no-action letters signaling that it would take no enforcement action against such organizations.[55] This had the effect of nullifying the regulatory burden on these charitable organizations even when they provided donors with some share of net earnings. Decades later codification of these rules expanded this SEC interpretation and provided a wider array of organizations with a possible pathway to exemption.[56]

---

50 15 U.S.C. § 77c.

51 *See* Hemingway, To Be or Not to Be (a Security): Funding For-Profit Social Enterprises, 25 REGENT U. L. REV. 299, 324 (2012).

52 *Id.*; Warfield v. Alaniz, 569 F.3d 1015, at 1025 (9th Cir. 2009).

53 Although, the term "donors" is used throughout this memo, it should not be conflated with the term "investors" because the terms are not always interchangeable. In determining how to refer to persons, entities, or other sources of capital, issuers should closely consider the context of the situation and use terms that most accurately reflect the nature of the transaction.

54 *Warfield*, 569 F.3d at 1025.

55 *E.g. Christ Church of Washington*, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 2602, 1974 WL 9979 (May 17, 1974); Pooled Income Funds, Release No. 16478, 19 SEC Docket No. 142, 1980 WL 20766 (Jan. 10, 1980).

56 15 U.S.C. § 80a-51 note.

B. The Philanthropy Protection Act of 1995

Specifically, the Philanthropy Protection Act of 1995 codified these SEC interpretations allowing registration exemption for funds maintained by charitable organizations where some of the net earnings were shared with donors.[57] The law amended both § 3(c)(10) of the Investment Company Act of 1940 as well as section 3(a)(4) of the Securities Act.[58]

Section 3(c)(10) of the Investment Company Act of 1940 excludes certain persons and organizations from the definition of "investment company."[59] The Philanthropy Protection Act amended this section to include any organization operating for "religious, educational, benevolent, fraternal, charitable, or reformatory purposes" that maintains a fund for the investment and reinvestment into certain types of charitable funds.[60] No mention of whether the organization provides a portion of net earnings to donors was included.[61]

Additionally, Section 3(a)(4) of the Securities Act of 1933, was amended to exempt from registration requirements any security issuer excluded from the newly amended definition of "investment company", under § 3(c)(10)(B) of the Investment Company Act.[62] Through these amendments, funds that are excluded from the definition of "investment company" are now included in the exemption under 3(a)(4) of the Securities Act.[63] This meant organizations that operate for primarily "benevolent" purposes and maintain a fund for investment, but still provide portions of net earnings to donors, can be exempt from registration requirements. This codification broadened the previously applied SEC interpretation of the law by allowing registration exemptions for not just "charitable organizations" who shared a portion of net earnings with donors but for any organization operating for "benevolent" purposes who shared a portion of earnings with donors. These amendments, and the broader rule they created, carved a legal pathway now used by certain CDFIs to offer securities exempt from registration requirements.

C. CDFIs Under the Regulatory Framework

Although it is somewhat unclear, CDFIs may qualify for exemption under section 3(a)(4) of the Securities Act due to the amendments imposed by the Philanthropy Protection Act. In fact, some CDFIs have relied on the exemption.[64] There is no requirement that a fund be a registered charitable organization to become a certified CDFI by the Department of Treasury.[65] Instead, CDFIs are required to "[h]ave a primary mission of promoting community development."[66] Often CDFIs will operate as issuers of loans or credit to local

---

57 *Warfield*, 569 F.3d at 1025.

58 15 U.S.C. § 80a-51 note.

59 *Id.*

60 *Id.*; 15 U.S.C. § 80a-3 ("[A] fund is described in this subparagraph if such fund is a pooled income fund, collective trust fund, collective investment fund, or similar fund maintained by a charitable organization exclusively for the collective investment and reinvestment of one or more of the following: (i) assets of the general endowment fund or other funds of one or more charitable organizations; (ii) assets of a pooled income fund; (iii) assets contributed to a charitable organization in exchange for the issuance of charitable gift annuities; (iv) assets of a charitable remainder trust or of aunty other trust, the remainder interests of which are irrevocably dedicated to any charitable organization; (v) assets of a charitable lead trust . . . (vii) assets of a trust not defined in clauses (i) through (v), the remainder interests of which are revocable dedicated to a charitable organization, subject to subparagraph (c); or (viii) such assets as the Commission may prescribe by rule, regulation, or order……..".

61 15 U.S.C. § 80a-3.

62 15 U.S.C. § 77c ("[T]the provisions of this subchapter shall not apply to any of the following classes of securities: . . . any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940………..").

63 15 U.S.C. § 77c; 15 U.S.C. § 80a-3.

64 Elise Balboni, Kathleen Keefe, & Anna Smukowski, CDFIs and the Capital Markets, Enterprise 1, 39 (May 2023), https://www.enterprisecommunity.org/sites/default/files/2023-05/CDFIs-and-the-Capital-Markets-May2023.pdf.

65 *CDFI Certification Application Preview*, U.S. Department of the Treasury Community Development Financial Institutions Fund 1, 2 (December 5, 2012) ("In order to be certified as a CDFI, an entity must meet each of the following criteria: [b]e a legal entity; [h]ave a primary mission of promoting community development; Be a financing entity that predominantly engages in the provision of arm's-length, on-balance sheet Financial Products and/or Financial Services and has done so for at least one full fiscal year; [p]rimarily serve one or more Target Markets with its arm's- length, on-balance sheet Financial Products and, if elected, Financial Services; [p]rovide Development Services in conjunction with its arm's-length, on-balance sheet Financial Products; [m]aintain accountability to each component of its CDFI Certification Target Market; and [b]e a non-governmental entity."), https://www.cdfifund.gov/sites/cdfi/files/2022-10/CDFI_Certification_Application_Preview_Final_10322.pdf.

66 *Id.*

businesses or affordable housing developers.[67] They provide donors with a fixed interest rate, usually selected by the donor, by which their debt is refunded. These returns are almost always lower than traditional investment options available to lenders, and lenders understand the primary purpose of the fund is to promote community development.[68] CDFIs cognizably fit under the exemption of section 3(a)(4) of the Securities Acts so long as they are organizations that operate for primarily "benevolent" purposes and maintain a fund exclusively for investment, even though they provide portions of their net earnings to donors. However, whatever the policy justifications may bolster the exemption, significant interpretative difficulties with the exemption arise due to its requirement that no part of the profits of the organization "inures to the benefit" of any individual.[69]

IV. State Law and Regulations

A. Preemption under the Philanthropy Protection Act

The Philanthropy Protection Act also considered how these types of securities should be handled under state law.[70] Generally, securities exempt under section 3(a)(4) of the Securities Act are also exempt from state statutes and regulations requiring registration of securities.[71] However, the Philanthropy Protection Act expressly allowed states a three-year period to enact their own law, which would be afforded supremacy over the federal law.[72] States that opted out of federal preemption were Arkansas, Connecticut, Florida, Mississippi, Nebraska, Pennsylvania, Tennessee, and Virginia.[73]

B. Filing and registration requirements

Offerings in states that have passed laws opting out of preemption under the Philanthropy Protection Act must be compliant with state laws dealing with filing and registration requirements for securities. CDFI issuers should ensure they are compliant with these filing and registration requirements before making offerings in such states. Potential investors from such states should also be made aware by the CDFI of these compliance requirements.

V. Key Considerations for Nonprofit Issuers

A. Developing a comprehensive prospectus

Capitalization is one of the key considerations for CDFIs.[74] Often a comprehensive prospectus is created to help raise capital for the fund.[75] The comprehensive prospectus is intended to educate potential investors and usually includes background on the organization and CDFIs in general, an offering summary and description of the note, risk factors and investment considerations, lending policy, financial reporting, and capitalization.[76]

---

67 Susan R. Jones, *Small Business and Community Economic Development: Transactional Lawyering for Social Change and Economic Justice*, 4 Clinical L. Rev. 195, 198 n.7 (1997) (citing Rochelle E. Lento, *Community Development Banking Strategy for Revitalizing Our Urban Communities*, 27 U. Mich. J. L. Ref. 773, 776 (1994)).

68 E.g. Prospectus for Enterprise Community Impact Notes, Enterprise Community Loan Fund Inc. 1, 17 (Jul. 30, 2010), https://www.cdfifund.gov/sites/cdfi/files/documents/enterprise-impact_note_prospectus.pdf; Prospectus, The Reinvestment Fund 1, 2 (Feb. 17, 2010), https://www.cdfifund.gov/sites/cdfi/files/documents/trf-prospectus_2010.pdf; Investment Note Prospectus, Genesis Community Loan Fund 1, 1 (June 2023).

69 *See, e.g., SEC v. Children's Hosp*. 214 F.Supp. 883 (D. Ariz. 1963) (exemption not available for the sale of bonds to construct a hospital because promoters were to receive a profit from the organization and promotion of the institution).

70 15 U.S.C. 80a-3a.

71 *Id.*

72 *Id.*

73 Joseph O. Bull, *Philanthropy Protection Act of 1995 - Time for a Review*, American Council on Gift Annuities (Nov. 9, 2020, 5:28 PM), https://www.acga-web.org/philanthropy-protection-act-of-1995—time-for-a- review#:~:text=Nine%20states%20%E2%80%93%20Arkansas%2C%20Connecticut%2C,regulate%20gift%20annuities%20as%20securities.

74 *CDFI Capitalization*, U.S. Department of the Treasury Community Development Financial Institutions Fund (December 5, 2012), https://www.cdfifund.gov/programs-training/training-ta/resource-banks/cdfi-capitalization.

75 *Id.*

76 *E.g. Prospectus for Enterprise Community Impact Notes*, Enterprise Community Loan Fund Inc. (Jul. 30, 2010), https://www.cdfifund.gov/sites/cdfi/files/documents/enterprise-impact_note_prospectus.pdf; *Prospectus*, The Reinvestment Fund (Feb. 17, 2010), https://www.cdfifund.gov/sites/cdfi/files/documents/trf-prospectus_2010.pdf; *Investment Note Prospectus*, Genesis Community Loan Fund (June 2023).

Background information on the organization will include the formation history of the entity, including that it is a certified CDFI under the U.S. Department of Treasury's Community Development Financial Institutional Fund.[77] The purported purpose of the fund must be described, including the types of projects that the funding is intended to target.[78] Details on the board of directors, officers, employees, and affiliates will also be included in this section.[79]

A summary of the offering will include which investors are eligible for investment (accredited and/or non-accredited, individuals and/or institutions).[80] This section also usually informs potential investors that the offering is exempt under section 3(a)(4) of the Securities Act.[81] The description of the note must include the available interest rates, the minimum investment size, the minimum investment term in years, and a description of the payout plan.[82]

Often risk factors highlighted for potential investors will include risks relating to the fund's finances and operations, risks relating to the terms of the notes, and legal and regulatory risks.[83] Risks relating to the fund's finances and operations may include the fund's reliance on grants.[84] Risks relating to the terms of the note include the non-transferability of the note and the limited financial return of the note.[85] Legal and regulatory risks include tax treatment and compliance issues with state securities law for those states that have opted out of preemption as discussed previously.[86]

B. Drafting detailed promissory note/loan agreements

When drafting a promissory note, several components must be included. An investment note offered by a CDFI will include the names of the borrower and the lender, the principal investment, the interest rate, the maturity date, and the annual date on which payments are to be made.[87] The note will also indicate under which laws the agreement shall be governed. There are also promises included on behalf of the borrower that the investment will be used for the purpose advertised. Finally, both parties must sign the note.

VI. Potential Challenges and Important Considerations

There are various challenges and risks associated with relying on an exemption. A few of these considerations are discussed below.

A. Confirming (and Counting) Accredited Investors

77 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 17; The Reinvestment Fund, *supra* note 19, at 2; Genesis Community Loan Fund, *supra* note 19, at 2.

78 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 17; The Reinvestment Fund, *supra* note 19, at 2; Genesis Community Loan Fund, *supra* note 19, at 1.

79 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 21-22; The Reinvestment Fund, *supra* note 19, at 10- 19; Genesis Community Loan Fund, *supra* note 19, at 3.

80 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 12; The Reinvestment Fund, *supra* note 19, at 8; Genesis Community Loan Fund, *supra* note 19, at 5.

81 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19; Genesis Community Loan Fund, *supra* note 19, at 1.

82 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 11-13; The Reinvestment Fund, *supra* note 19, at 7; Genesis Community Loan Fund, *supra* note 19, at 8.

83 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 19, at 5-11; The Reinvestment Fund, *supra* note 19, at 3-6; Genesis Community Loan Fund, *supra* note 19, at 6.

84 *E.g.* Enterprise Community Loan Fund Inc., *supra* note 16, at 10-11.

85 *E.g.* Loan Agreement, Genesis Community Loan Fund; Loan Agreement with Investor, The Reinvestment Fund; Promissory Note, The Reinvestment Fund.

86 *E.g.* Genesis Community Loan Fund, *supra* note 34; Loan Agreement with Investor, *supra* note 34.

87 *E.g.* Loan Agreement, Genesis Community Loan Fund.

INSTITUTIONS	
Institutional investors	Banks, savings institutions, brokerage firms, registered investment advisers, insurance companies, investment companies (mutual funds), rural business investment trusts, state pension funds, and certain ERISA employee benefit plans.
Government entities	Indian tribes and foreign governmental entities owning investments of more than $5 million.
Big organizations	Tax-exempt organizations and for-profit corporations, LLCs, partnerships, and business trusts with more than $5 million in assets.
Venture-capital firms	Firms that invest in start-up companies to which they make available "significant managerial assistance."
Sophisticated trusts	Trusts with over $5 million in assets and run by a sophisticated manager.
Family offices and clients	Privately held companies that manage family wealth, with more than $5 million in assets and under direction of sophisticated manager.
INDIVIDUALS	
Key insiders	The directors, executive officers, and general partners of the issuer.
Millionaires	Individuals who have a net worth (along with their spouse or spousal equivalent) of over $1 million, not counting the value of their primary residence.
Affluent investors	Individuals who have had for two years, and expect to have, an annual income of $200,000 (or $300,000 with their spouse or spousal equivalent).
Securities professionals	Individuals with securities/investing credentials by virtue of passing having passed an exam administered by FINRA or NASAA — in particular, holders in good standing of a Series 7 license (securities rep), a Series 65 license (investment adviser), or a Series 82 license (private placement rep).
Private equity employees	Individuals who are "knowledgeable employees" of a private equity fund (limited to investments in the fund).
ACCREDITED-OWNED ENTITIES	
Accredited-owned entity	An entity in which all the equity owners are accredited investors.

A central concept in Reg D is the "accredited investor," which refers to individuals or entities presumed to have sufficient financial sophistication or resources to participate in certain unregistered securities offerings. Accredited investors are defined by Rule 501(c). As of 2020, the SEC defines accredited investors in three basic categories:

i. Burden of Verification

An investor is deemed accredited by either falling into one of the enumerated categories of Rule 501(c) or if the issuer reasonably believes the investor was accredited. It is crucial to emphasize that the burden of establishing an investor's accredited status falls squarely on the issuer of the securities. This responsibility is particularly stringent under Rule 506(c) of Reg D, which permits general solicitation but requires issuers to take "reasonable steps to verify" that all purchasers are accredited investors. Accordingly, issuers and their financial advisers often demand that purchasers supply "suitability letters" warranting their qualifying characterizes. Additionally, issuers can use two primary approaches to verify accredited investor status:

1. Principles-based approach: This method requires the issuer to use their best judgment to determine if an investor meets the legal requirements. It involves collecting and reviewing various financial documents and information from the investor.

2. Non-exclusive "safe harbor" approach: This method allows issuers to take specific steps that are deemed "reasonable" for verification, such as:

   a. Reviewing recent tax returns to verify income

   b. Examining credit reports, bank statements, and other documents to confirm net worth

   c. Obtaining verification from third-party licensed professional.

ii. Importance of Accurate Verification

The significance of proper verification cannot be overstated. If an issuer fails to adequately verify the accredited status of investors, they risk losing the exemption provided by Reg D, potentially leading to liability. Courts vary in how they evaluate the issuer's claims that they have satisfied an exemption's accredited investor requirements.[88] Ultimately, the accredited investor definition is a cornerstone of private capital markets and the burden of ensuring compliance and verifying investor status rests firmly with the issuers, making it essential for them to implement robust verification processes and maintain thorough documentation of their efforts.

B. "Bad Actor" Disqualification

Regulation D prohibits issuers from using the exemption if they or certain associated persons are considered "bad actors." This rule applies to offerings under Regulation A+ and Regulation Crowdfunding as well. Disqualification occurs due to specific criminal convictions, regulatory or court orders, or other disqualifying events involving the issuer or related parties that took place after September 23, 2013, for Rule 506 and January 20, 2017 for Rule 504. Events prior to these dates, although may not disqualify an issuer from relying on the exemption, must still be disclosed to investors.[89]

The rule covers the issuer, insiders (e.g., directors, executives, major owners), investment managers, and intermediaries involved in soliciting investors.

Disqualifying Events Include:

- Recent securities-related criminal convictions (in the last 5-10 years)
- Active securities-related court injunctions or restraining orders (in the last five to ten years and still in effect)
- Certain regulatory orders from financial regulators (in the last ten years)
- Active SEC disciplinary orders (while order is still in effect)
- Active SEC cease-and-desist orders related to fraud (while order is still in effect)
- Recent SEC orders suspending Reg A exemptions (in the last five years)
- Active suspensions/expulsions by self-regulatory organizations (while order is still in effect)
- Recent U.S. Postal Service false representation orders (in the last five years)[90]

---

88 *Compare* Wright v. Nat'l Warranty Co., 953 F.2d 256, 260 (6th Cir. 1992) (reasonable belief existed because investors "specifically warranted and represented in the subscription agreement. . .that they were accredited") with *SEC*.

89 https://www.sec.gov/resources-small-businesses/small-business-compliance-guides/disqualification-felons- other-bad-actors-rule-506-offerings-related-disclosure-requirements; https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2021/06/on-point--bad-actors-june-2021.pdf.

90 https://sdcorporatelaw.com/business-newsletter/bad-actors-rule-504/.

Notably, issuers can avoid disqualification by demonstrating they were unaware and could not reasonably have known about a covered person's disqualifying event, or by obtaining a waiver.[91]

C. Integration Risk

Integration risk is a significant concern for issuers conducting multiple securities offerings. This risk arises when separate offerings could be viewed as a single, integrated offering, potentially violating exemption requirements and leading to unintended securities law violations. To mitigate this risk, issuers need to understand the SEC's current approach to integration, which was substantially revised in 2020 under Rule 152.

Prior to 2020, the SEC used a more restrictive integration principle. This principle held that for an offering to be exempt from registration, the entire offering had to meet all conditions of a particular exemption. Issuers could not "slice and dice" an offering to fit different parts into different exemptions if the offering as a whole did not fit any single exemption. The SEC used a five-factor test to determine if multiple offers and sales constituted an integrated offering, along with various safe harbors that identified time windows outside of which different offerings would not be integrated. The new approach under Rule 152 significantly relaxes these restrictions, providing issuers with greater flexibility to conduct concurrent offerings using different exemptions. The general principle now is that offerings will not be integrated if each one independently complies with registration requirements or qualifies for an exemption. This generally allows issuers to conduct multiple exempt offerings simultaneously, provided they adhere to specific conditions.

Key Points For Compliance And Risk Mitigation:

1. General Solicitation Prohibition: For offerings that prohibit general solicitation, issuers must have a reasonable belief that each purchaser was either not solicited through general means or had a pre-existing relationship with the issuer.
2. Offering Materials: For concurrent offerings where general solicitation is permitted, issuers must ensure that offering materials comply with the restrictions and conditions of both offerings. This includes adhering to legend requirements and communications restrictions.
3. Safe Harbor Provisions: Issuers might consider taking advantage of the four non- exclusive safe harbors provided in Rule 152:
    a. 30-Day Window: Offerings separated by at least 30 calendar days will not be integrated.
    b. Rule 701 and Regulation S: Offerings under employee stock ownership plans (Rule 701) or to foreign investors (Regulation S) will not be integrated with other offerings.
    c. General Solicitation Offerings: Certain offerings that permit general solicitation (like Rule 147, 147A, Reg A, Reg CF, Rule 504(b)(1), Rule 506(c)) will not be integrated with prior completed offerings.
4. Concurrent Offerings: Issuers can potentially conduct concurrent offerings under different exemptions. For example, an issuer could simultaneously conduct an intrastate offering, a private placement to out-of-state accredited investors, and an online crowdfunding campaign, provided they adhere to the specific requirements of each exemption and the general principles of Rule 152.
5. Avoid Evasion Schemes: While the new rule provides more flexibility, issuers must ensure that their offerings are not part of a plan or scheme to evade registration requirements. The SEC will still scrutinize offerings that appear to be structured solely to circumvent regulations.
6. Documentation: Issuers should maintain thorough documentation of its offering process, including how each offering has complied with the requirements of each exemption and the non-integration

91 See Rule 506(d)(2).

principles of Rule 152. Additionally, for offerings restricting general solicitation, issuers should carefully manage and document any pre-existing relationships with investors.

By carefully structuring offerings to fit within these guidelines, issuers can seek to reduce integration risk while maintaining flexibility in their capital raising activities. While Rule 152 provides more leeway, the fundamental goal remains to protect investors and maintain the integrity of the securities markets. Issuers should approach their offerings with this principle in mind, ensuring that their capital raising activities are conducted in a manner that is both compliant and well documented.

Conclusion & Opportunities for Further Research

In conclusion, CDFIs have multiple possible avenues for raising capital, each with its own regulatory considerations and potential exemptions. Furthermore, as discussed above, some of these routes allow access to non-accredited investors; however, no route is without its limitations (e.g., dollar caps, marketing tactics, etc.). Specifically, the extent to which the Philanthropy Protection Act has provided a pathway for certain CDFIs to offer securities exempt from registration requirements remains an open question. Accordingly, further research opportunities include:

1. Analyzing the specific applicability of the Section 3(a)(4) exemption to different CDFI structures and missions.
2. Exploring state-level regulations in jurisdictions that have opted out of federal preemption under the Philanthropy Protection Act.
3. Investigating best practices for CDFIs in verifying accredited investor status and managing “bad actor” disqualification risks.