

# Social Investment Forum

OVERCOMING BARRIERS TO COMMUNITY INVESTMENTS: A PRIMER FOR INSTITUTIONAL INVESTORS ON BEST PRACTICES, METHODOLOGIES AND RESOURCES

This *Primer* is organized into thirteen (13) sections including four (4) appendices, and explores common misconceptions and barriers to community investing. It also provides specific measures institutional investors may exercise to satisfy institutional mandates as prescribed by governing boards, regulatory agencies, and shareowners.

## Introduction

### Section I – Community Investments: Fact and Fiction

Frequently Asked Questions

### Section II - ERISA and the Exclusive Benefits Rule

Advisory Opinions: Department of Labor  
Interpretive Bulletins: Department of Labor  
FAQ: ERISA

### Section III – Prudent Man Standard of Care

### Section IV - Technical Barriers

Barriers 1-9  
Understanding the CARST<sup>TM</sup>® Rating System

### Section V - Regulatory Barriers

### Section VI - Institutional Barriers

### Section VII - Community Investments – Expanding Options

Auction Rate Securities  
Certificates of Deposit  
Collateralized Debt Obligations  
Collateralized Mortgage Obligations  
Commingled Real Estate and Mortgage Accounts  
Direct Investment  
Linked Deposits  
Pooled Investment Funds  
Private Placements  
Real Estate  
Secondary Capital  
SBA 7(a) Loans  
SBA Certified Development Company (504) Loans  
Small Business Investment Company  
SBA New Market Venture Capital  
Variable Rate Demand Notes (VRDN)  
Venture Capital

## **Section VIII - Risk**

Risk Adjusted Rates of Return – Fixed Income Vehicles

Risk Mitigation

Diversification

Hedging

Networking

Credit Enhancements

Risk Adjusted Rates of Return – Community Development Venture Capital

## **Section IX - Institutional Investors**

Public Pension Funds

Private Pension Funds

Mutual Funds

Religious Fund

Taft-Hartley Funds

Corporate Investors

## **Section X - Tax Credits**

New Markets Tax Credit

Low Income Housing Tax Credit

## **Section XI - Secondary Markets**

## **Section XII - Impact Metrics – Assessing Social Impact**

REDF Social Impact Tool

CDVCA Measuring Impacts Toolkit

## **Section XIII – Appendices**

### **Appendix I - Operating Methods & Functions**

Accounting Requirements

Advisor Contracts

Asset management

Benchmarking & Performance Monitoring

Conflict of Interest

Diversification

Document (Plan Design)

Document Management

Due Diligence

Insurance coverage

Investment Strategies & Policies

Minimum Reserves

Partnerships

Portfolio Design

Prudent Man Rule

Reporting Requirements

Shareholder Advocacy

Training

Watch lists

Workout plans

## **Appendix II: Models**

Model Portfolio I – F.B. Heron Foundation  
Model Portfolio II – The Needmor Fund  
Model Portfolio III – Jesse Smith Noyes Foundation

## **Appendix III – Cases**

Case I – Market Creek Plaza  
Case II – First Securities Building – Salt Lake City  
Case III – Portland Armory  
Case IV – Westchester County – Variable Rate Demand Notes  
Case V – Tender Care Learning Center  
Case VI – New Forest Vegetable Project

## **Appendix IV: Web Links and Resources**

### **Introduction**

This primer demonstrates that community investing is legal, profitable, and serves an important function in achieving a healthy financial marketplace. It also provides resources that explain what community investments are and how to engage them.

There is a rapidly growing list of businesses, universities, foundations, pension funds, investment houses, banks, healthcare systems, and faith-based and other organizations that are including community investments in their financial portfolios. They have all discovered that the risks and rewards associated with community investments are not only consistent with generally accepted prudent investing practices, but that they also have a positive social impact that will pay dividends for generations to come.

The growing participation of these institutional investors underscores the fact that community investments are not only legal, but they can be prudent in both an investment and social context. The Social Investments Program, for example, which originates investments for The Prudential Insurance Company of America and its foundation, had by the end of 2003, contributed more than \$945 million in equity and debt investments to nonprofit and for profit ventures benefiting individuals in more than 500 cities and over 40 states. The United Methodist Church continues to make investments in affordable housing loans<sup>1</sup>. Gale Whitson-Schmidt, Treasurer and CFO of the pension plan, said, "The General Board of Pension and Health Benefits of The United Methodist Church has a longstanding commitment to making a positive impact on society." Then there's the Ford Foundation whose program related investments, usually in the form of loans, loan guarantees or equity investments, help meet the credit needs of organizations in low-income communities that lack capital to finance important projects. Mount Holyoke College is committing philosophically as well as financially to the community investment movement, creating a fund exclusively targeted to

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<sup>1</sup> PR Newswire; 7/2/1999. Community Reinvestment Fund Sells United Methodist Pension Fund Participation in Affordable Housing Loans.

community investments. The list goes on and on, and time and again, the return on these investments reflects a positive double bottom line.

As we enter the 21<sup>st</sup> century, many among us have been seduced into thinking double digit gains are not only requisite to sound investment management, but sustainable ad infinitum. We all know, however, that a healthy investment environment offers a reasonable margin of gain above inflation, without triggering a rise in that inflation. The real estate market speaks directly to this point. Housing has become prohibitively expensive to many individuals in communities throughout this country simply as a result of excessive inflation within this sector. Real estate investors cashing out, whether home owners or developers, have come to expect a 10% annual gain, if not significantly more. We all know this is not sustainable.

Among the investors scrambling to grab the low lying fruit of the current season, there will always be those whose baskets are full surrounded by those with little to show. Beyond this rabble stand enlightened investors engaged in a dialog about cultivation, innovation, sustainability, and fair returns on investment. Their sophisticated thinking is marked with a sensibility for the interconnected nature of society, the environment, and the marketplace. They seek financial gain, not at the expense of society, but in deference to it. It is the double bottom line embedded in this thinking that should compel every institutional investor to include community investments in their portfolios. It may very well come to pass in the decades ahead that investors not participating in community investments will be in the minority.

The fruit orchard offers a poignant metaphor. It takes hard work to cultivate, protect and harvest year after year, and if left unattended is ravaged by pests, disease and the passersby who help themselves without recourse. A healthy society gives rise to healthy markets. When housing, jobs, healthcare, or public resources are unavailable, exploited, depleted, or left fallow, productive activities in which investments take root, wither and in extreme cases, disappear. Community investments are essential to the health of society, and therefore are critical to the health of the marketplace. Over the long term, community investments will prove to be both profitable and sustainable. The short term holds promise too, whether in the use of market rate targeted deposits or in specialized mutual funds with open redemption policies.

Community investments have grown 388% since 1999, with more than \$19.6 billion under professional management in 2005<sup>2</sup>. As the community development sector becomes more closely aligned with mainstream financial markets these numbers will continue to grow. Institutional investors will become increasingly familiar with community investment options, and will come to recognize that the community development sector offers outstanding investment opportunities that come with collateral social benefits.

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<sup>2</sup> 2005 Report on Socially Responsible Investing Trends in the United States. SIF Industry Research Program. January 2006. Social Investment Forum. Washington, DC.

Over the last decade the Community Reinvestment Act (CRA) has triggered \$1 trillion in home mortgages, small businesses, and community development lending to low and moderate income communities.<sup>3</sup> Coupled with the rise of Community Development Financial Institutions (CDFIs) and a host of other Community Development Enterprises (CDEs), the community investment landscape is poised for dramatic change in the next decade and beyond. This change will provide thousands of new opportunities for institutional investors looking for growth in their portfolios while enhancing the economic well-being of individuals and communities throughout the world. Advocacy and innovation will characterize this change, as will a fundamental paradigm shift in asset management. Socially motivated investors will have more than cachet, they'll have results.

This *Primer* is designed to encourage institutional investors to improve capital flow from mainstream markets into community investments. Once viewed by community advocates as perpetrators of disinvestment<sup>4</sup>, large institutional investors are emerging as welcome partners in the community development movement.

There are more than 4600 community development enterprises in the United States, of which nearly 1000 are community development financial institutions (CDFIs), collectively offering a wide array of investment opportunities ranging from low yield, low risk instruments to high yield, high risk investments, covering everything from simple deposits to complex variable rate demand notes to equity instruments.

Risk-adjusted financial rates of return and fiduciary responsibilities remain the overwhelming concerns institutional investors convey regarding the management of client portfolios. This primer demonstrates that community investments are a viable investment for institutions, and offers practical information on how to integrate community investments into a well balanced, diversified investment portfolio.

## **Section I – Community Investments: Fact and Fiction**

The need for community investments is growing, as is the opportunity for institutional investors to expand their investment horizon. Yet many institutions do not invest in the community sector, citing lack of familiarity with the options and listing a host of barriers and misconceptions. In a 1992 report from the Department of Labor's Advisory Council on Pension Welfare and Benefits, the Department expressly stated "to the extent that capital markets are judged to be tradition-bound, rigid or incapable of funding all 'worthy' investments, making funds available from the pension investment pool is seen as addressing capital gaps that would otherwise impede local economic development".<sup>5</sup>

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<sup>3</sup> Barr, M. Community Investing Under Attack, Metropolitan Policy Program, Web Exclusive, Oct. 28, 2004

<sup>4</sup> *Id.* p.5

<sup>5</sup> U.S. Department of Labor, Advisory Council on Pension Welfare and Benefit Plans, *Economically Targeted Investments: An ERISA Policy Review* (1992) p. 3-4

Within these capital gaps are viable community investment opportunities in which risk and return are comparable to mainstream investment options. The Department of Labor acknowledges that prudent investments can exist in an inefficient market, where the market's failure to make venture capital or private dollars available to a host of established, well-managed mid-sized companies, let alone small community based businesses is well documented and evidence of this gap. "Economically targeted investments (ETIs), including community investments, are clearly permissible under ERISA provided they do not sacrifice return for collateral benefits."<sup>6</sup>

Many institutional investors are wary of stepping into this gap, for a number of reasons. Zanglein (1996) identifies seven misconceptions about ETIs, including community investments, which help explain investor reticence.<sup>7</sup> Institutional investors willing to address these misconceptions create a good starting point for broadening their investment horizon. Adapted for community investments, the misconceptions are:

- ☒ Community investments are illegal and concessionary.  
Truth: They are not. Many offer market rates and are insured.
- ☒ Community investments are time-consuming.  
Truth: Some are; many are not.
- ☒ Community investments are costly to administer.  
Truth: A rising level of sophistication is reducing transaction costs.
- ☒ Competent managers are unavailable.  
Truth: A growing list of managers and intermediaries is available, see FAQ section below.
- ☒ Convincing trustees and professionals to make community investments is impossible.  
Truth: Legions of investors and plan participants are calling for a more proactive policy regarding community investments.
- ☒ Politics always get in the way.  
Truth: This is not always the case, however, when politics do get in the way, institutional investors and committee members are compromising the integrity of their fiduciary responsibilities and are at risk of litigation for breaching the exclusive benefits rule, the prudent man rule, or other statutory mandates issued by the Department of Labor, IRS, SEC or Department of Justice.
- ☒ Benchmarks are not available to measure community investment performance.  
Truth: Standard benchmarks for measuring the performance of any investment are readily available. Remember: risk-adjusted market rates of return are mandated for portfolios subject to ERISA.

## **FAQ: Education**

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<sup>6</sup> Zanglein, J.E. Overcoming Institutional Barriers on the ETI Superhighway. National Heartland Labor Capital Conference. Washington, DC. 1996 p.6

<sup>7</sup> Id. P.11

**Q:** Are there educational or training opportunities for institutional investors that address fiduciary duties and investment strategies?

**A:** Yes. Training is available through a number of organizations, including:

George Meany Center for Labor Studies

<http://www.georgemeany.org/>

The Center for Working Capital (AFL-CIO)

<http://www.centerforworkingcapital.org/>

U.S. Department of Labor

<http://www.dol.gov/ebsa/regs/fedreg/>

Institute for Fiduciary Education

<http://www.ifecorp.com/>

**Q:** What are some examples of managers and intermediaries in this field?

**A:** A few are:

- Calvert Foundation: <http://www.calvertfoundation.org>
- CRA Fund Advisors: <http://www.crafund.com> (Certified under the *Performance Presentation Standards of the Association of Investment Management and Research or AIMR*);
- National Community Capital Association: <http://www.communitycapital.org>

**Q:** What are the best practices institutional investors can adopt when engaging community investments?

**A:** There are a host of considerations including and beyond best practices that should characterize the institutional process of community investing. Best practices, coupled with a comprehensive list of required operational functions, underscore a prudence and professionalism that should be embedded within fiduciary roles and responsibilities.

Appendix I offers a check list of methods and functions that should comprise investment operations. [Link to Appendix 1.](#)

## **Section II - ERISA and the Exclusive Benefits Rule**

### **Community Investments are Permissible**

The Exclusive Benefits Rule is one of the more widely cited barriers that institutional investors make regarding their concerns and/or refusal to engage community investments.

The Employee Retirement Income Security Act (ERISA) was created to protect private pension fund participants and beneficiaries. It was not created to dictate investment strategy and asset allocation. In fact, the Department of Labor has issued several

statements underscoring its specific purpose to regulate procedure, not investment outcomes. The statements, issued as interpretive bulletins or advisory opinions, reiterate the original language, but in all cases issue the same conclusion: any investment is permissible contingent upon compliance with procedural mandates.

There are two important documents underscoring this point.

**Advisory Opinion 98-04:** The first is an advisory opinion, issued May 1998 by the Department of Labor's PWBA Office of Regulations and Interpretations, in which the Department states that a fiduciary's investment decision "may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments".<sup>8</sup> <http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm>

**Interpretive Bulletin 94-1:** The second document is the Department of Labor's Interpretive Bulletin 94-1 which clarifies that as long as pension funds do not violate section 404(a)(1)(A) and (B) and the exclusive purpose requirements of section 403 they can make investments that have collateral benefits, e.g. community benefits. ERISA Section 404 a (1)(A) states "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries"<sup>9</sup>  
[http://www.access.gpo.gov/nara/cfr/waisidx\\_00/29cfr2509\\_00.html](http://www.access.gpo.gov/nara/cfr/waisidx_00/29cfr2509_00.html)

The Bulletin specifically reiterates that the regulation provides that the prudence requirements of section 404(a)(1)(B) are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly. This includes giving appropriate consideration to the role that the investment or investment course of action plays (in terms of such factors as diversification, liquidity and risk/return characteristics) with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility.

## **FAQ - ERISA & EXCLUSIVE BENEFIT**

**Q:** Are economically targeted investments, including community investments, permissible under federal law?

**A.** Yes. If a risk-adjusted, market rate of return for a community investment is equal to alternative investment activities with similar risk and return profiles, the investment is permissible.<sup>10</sup>

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<sup>8</sup> Department of Labor, PWBA Office of Regulations and Interpretations. Advisory Opinion 98-04 ERISA Sec. 404(c). May 28, 1998

<sup>9</sup> 29 USC 1104 ERISA

<sup>10</sup> Interpretive Bulletin Code of Federal Regulations, Title 29, Volume 9. [Revised as of July 1, 2004]From the U.S. Government Printing Office via GPO Access [CITE: 29CFR2509.94-1]

Q: What recourse do trustees (fiduciaries) have if a majority of an investment committee agree to an investment that a minority deems is not prudent?

A. "Trustees should take great care to document adequately all meetings where actions are taken with respect to management and control of plan assets. Written minutes of all actions taken should be kept describing the action taken, and stating how each trustee voted on each matter. If, as in the case above, trustees object to a proposed action on the grounds of possible violation of the fiduciary responsibility provisions of the Act, the trustees so objecting should insist that their objections and the responses to such objections be included in the record of the meeting."<sup>11</sup>

[CITE: 29CFR2509.75-5]

Q. Does ERISA require diversification?

A. ERISA [29USC1104 A(1)(c)] obligates private pension investors to diversify their portfolio, unless doing so would not be prudent. It is important to underscore the role of diversification across investment classes; it is not enough to diversify on the basis of geographies, companies, or industries. A real estate heavy portfolio, where trustees have subjected a disproportionate amount of the fund to real estate investments, regardless of how diverse the real estate holdings are, is considered imprudent. There are a number of cases in which court decisions define a collection of real estate as being a single asset class, and not diversified. A Plan Document should offer a framework for such diversification. See *Donovan v. Mazzola*<sup>12</sup>, and *Marshall v. Mercer*<sup>13</sup>.

"ERISA allows investments in high risk and/or reduced liquidity vehicles such as venture capital, certain forms of real estate or non-investment grade bonds, as part of an overall investment strategy."<sup>14</sup>

Q: Does the term *exclusive benefit* preclude community investments?

A: No. The statute on exclusive benefits does not prohibit fiduciaries with obligations to pension funds from making community investments. The Department of Labor has on a number of occasions clarified that these investments are permissible as long as the primary investment objective is to make a prudent investment that has a risk adjusted market rate of return for plan participants and beneficiaries. Again, this means that a community investment should generate an equal to or better return than alternative investments with similar risk and reward characteristics.

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<sup>11</sup> Interpretive Bulletin [Code of Federal Regulations] [Title 29, Volume 9] [Revised as of July 1, 2004] From the U.S. Government Printing Office via GPO Access [CITE: 29CFR2509.75-5]

<sup>12</sup> 2 Employee Benefits Cas. (BNA) 2115 (N.D. Cal.1981), aff'd, 716 F. 2<sup>nd</sup> 1226 (9<sup>th</sup> Circuit 1983), cert denied, 464 U.S. 1040 (1984) as cited in J.E. Zanglein, *Overcoming Institutional Barriers to ETIs*.

<sup>13</sup> 4 Employee Benefits Cas. (BNA) 1523 (N.D. Tex 1983), rev'd on other grounds. 747 F 2d 304 (5<sup>th</sup> Circuit 1984) as cited in J.E. Zanglein, *Overcoming Institutional Barriers to ETIs*.

<sup>14</sup> Pension Investments: Public Hearings Before the New York State Pension Investment Task Force 187 (Mar. 3, 1989) (Testimony of David Walker, Assistant Secretary of Labor)

Q: Does ERISA mandate a low to zero risk investment strategy?

A: No. All investments have some degree of risk. Occasionally low risk investments fail, while high risk investments yield very favorable returns. See ERISA section.

Q: Is the prudence rule dependent upon the outcome of an investment decision?

A: No. The prudence rule is more concerned with the decision process. It asks several fundamental questions: did the fiduciaries (trustees, agents, advisors) follow the plan document, were alternative investments evaluated, and how does the risk/reward profile fit the overall investment portfolio. See appendix for legal cases.

Additional information on ERISA, including access to organizational files can be found at Free ERISA <http://www.freeerisa.com>. Access requires free registration.

### **Section III – Prudent Man Standard of Care**

The prudent man standard of care states “that a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”<sup>15</sup>

It’s important to note here that the prudent man rule is different from its more specific cousin the prudent investor rule, in that the prudent man rule is broad in scope, covering all the duties of a fiduciary, whereas the prudent investor rule is germane to the care and maintenance of the principal and the generation of income.

For additional information and a terrific history of the prudent standard of care, see "The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries," Vol. 34, No. 1, *American Business Law Journal*, (Fall, 1996) pp. 39-71 with Percy S. Poon.

### **Section IV -Technical Barriers**

The community investment environment is as dynamic as the mainstream marketplace (capital markets) dominated by large multinational banks and investment firms; the most noteworthy differences are scale and mission. Many of the reasons cited by institutional investors for not being more active with community investments, touch upon three areas of concern: legitimacy, viability and versatility. In detail they are as follows:

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<sup>15</sup> Code of Federal Regulations, Title 29, Volume 9, Revised as of July 1, 1999, U.S. Government Printing Office via GPO Access. P.445-446

☒Barrier 1: The lack of a well-developed investment banking function leads to the absence of structure in financing community investment deals.

☒Solution 1: Utilize existing organizations that are consolidating, aggregating or pooling community investments, including the Opportunity Finance Network <http://www.opportunityfinance.net>, National Federation of Community Development Credit Unions <http://www.natfed.org>, and Calvert Foundation <http://www.calvertfoundation.org>. The Community Reinvestment Fund <http://www.crfusa.com> pioneered a secondary market which provides institutional investors with risk-adjusted market rates of return, as well as professional counsel on structuring deals.

☒Barrier 2: The range of financial products available to investors is insufficient to mitigate risk and provide opportunity for diversification.

☒Solution 2: Institutional investors should view community investments as complementary to capital market investments, and recognize that the availability of community investments expands, rather than restricts, investment opportunities. The spectrum of community investments offers a range of products that can provide market rates of return and/or serve specific community development needs in local community in the U.S. or around the world. See community investment opportunities in this primer and the due diligence primer for a list of investment vehicles. For further information refer to the [Due Diligence Primer](#) and the [Expanding Options](#) section in this primer.

☒Barrier 3: Information about community investments (financial performance, social impact) is scarce and not widely accessible.

☒Solution 3: The Community Investing Center <http://www.communityinvest.org> has information on this. A rating system for community development financial institutions known as CARS™ has been developed by the Opportunity Finance Network that will eventually offer benchmarks to measure community investment performance. The Roberts Enterprise Development Fund has an interactive on-line tool that measures social impact at <http://www.redf.org/download/sroi/SROIExcelModel.xls>.

☒Barrier 4: Community investment brokers, advisors, and agents are not readily accessible.

☒Solution 4: As the field grows, so too does the number of competent professionals available for consultation. Contact QPAM.com <http://www.qpamadvisor.com/> for Department of Labor qualified professional asset managers who specialize in real estate transactions. For fixed income instruments, contact CRAFund Advisors <http://www.crafund.com/>.

☒Barrier 5: Due diligence is too labor intensive and costly.

☑Solution 5: Institutional investors can enter the community investment arena on many different levels, where virtually no due diligence is required to where it can be time intensive. Investments in community development banks, credit unions or mutual funds offer low cost opportunities that satisfy socially motivated investors, and a number of intermediaries like Calvert Foundation <http://www.calvertfoundation.org> and the Opportunity Finance Network <http://opportunityfinance.net> do due diligence for their clients and offer it for sale. Basic info and due diligence purchase opportunities are on the Community Investing Center <http://www.communityinvest.org>.

☑Barrier 6: The efficiency ratios of community development financial institutions are too low, primarily because transaction costs are too high, lending a vulnerability to their competitive place in the market.

☑Solution 6: More and more CDFIs are partnering with conventional lenders and equity investors, which mitigates the “vulnerability” as well as enhances their efficiency in both delivering services and innovating financial solutions.

☑Barrier 7: Nonconforming assets are difficult to assess, manage or liquidate.

☑Solution 7: Although true, many non-conforming assets are pooled; the risks are mitigated and the notion that they are inappropriate investments for institutional investors is simply a misconception. The Community Reinvestment Fund (CRF) <http://www.crfusa.com>, for example, offers simplicity as well as liquidity.

☑Barrier 8: Credit enhancements are not available, too cumbersome, or difficult to understand.

☑Solution 8: Credit enhancements are often built into pooled fund portfolios, as is the case with the CRF. The CRF, for example, offers five (5) tranches – the first three are rated (the top being AAA, as a function of payout and credit enhancements), while the bottom two (2) are unrated.

☑Barrier 9: Community Investment Institutions (CIIs) are not speaking mainstream language regarding the sale, purchase or packaging of their investment vehicles.

☑Solution 9: CIIs are becoming much more sophisticated and they do speak the mainstream language. There are countless examples of community development organizations partnering with mainstream firms to achieve mutually beneficial outcomes. The Social Investment Forum’s 1% or More in Community Campaign invites the mainstream into the community development sector, where progressive and innovative thinking among community development practitioners is rapidly expanding the marketplace for mainstream investors. Further, CIIs not only provide advocacy for these new opportunities, but they bring core capabilities to the niche.

## **Understanding the CARS™ rating system.**

The Community Development Financial Institutions Assessment and Rating System, or CARS™, is an independently administered analysis and rating of CDFIs that has been recently developed by the Opportunity Finance Network <http://www.opportunityfinance.net> to aid investors in their investment decision process. The system looks at *impact performance* as well as *financial strength and performance*, and issues a combined rating between AAA+1 (the highest available) and B 5 (the lowest possible). The letter designation is for impact performance (on a scale of AAA, AA, A, B) and the “+” signifies whether the institution plays a leadership role in policy change. The number is the financial strength and performance rating and is an assessment based on creditworthiness using a CAMEL analysis.

Although investors are unlikely to encounter this rating in the near future, as only a dozen or so organizations will initially sustain the rigorous analysis, over time as investors incorporate the rating into due diligence interviews, it will become a recognized benchmark in the community investment arena.

Investors are encouraged to ask prospective recipients of their investments about the CARS™ system, as the practice will both elevate the credibility of community investments, and enhance the measures of prudence in evaluating fiduciary duties.

## **Section V - Regulatory Barriers**

Community investments are permissible under ERISA provided they do not sacrifice the interests of plan beneficiaries.

The Department of Labor identifies the top ERISA violations that precipitate audits to include the following:

1. The failure of fiduciaries to operate the plan prudently and for the exclusive benefit of the plan participants and beneficiaries.
2. Conflicts of interest, including the use of plan assets to benefit parties in interest to the plan, including the trustees, administrators, advisors, sponsors or others related to these individuals.
3. The failure to make benefit payments, either pension or welfare, due under the terms of the plan.
4. Failure to value the plan assets at their current fair market value, or to hold plan assets in trust.
5. Taking any adverse action against an individual for exercising his or her rights under the plan (e.g. being fired, fined, or otherwise being discriminated against).
6. The failure of employers to offer continuing coverage for at least 18 months after leaving their employer. See COBRA <http://www.dol.gov/dol/topic/health-plans/cobra.htm>.

For more information on ERISA Enforcement, please visit: [http://www.dol.gov/ebsa/erisa\\_enforcement.html](http://www.dol.gov/ebsa/erisa_enforcement.html).

## **Section VI - Institutional Barriers**

The community development sector is working to address a number of existing challenges, real and perceived, that prevent institutional investors from accessing viable community investments, such as those embedded in the institutional culture in which investment decisions are made. The real barriers, as outlined in the technical and regulatory sections of this primer can be surmounted through education and advocacy. So too, can the institutional barriers, many of which are based on misperceptions of the community development sector.

These misperceptions lead to an unwarranted reticence to engage community investments. The perceived lack of incentives and cumbersome external requirements attached to funding sources, as well as a concern for absorbing too high a discount from selling below-market-rate loans, and lack of lender product standardization (and therefore higher transaction costs) are challenges even the community development sector wrestle with. Further, the perception that the mechanisms to support securitization of community economic development loans are limited further exacerbates the challenge of redirecting mainstream capital to community investments.<sup>16</sup>

In an address at the Second National Heartland Labor-Capital Conference, Jayne Elizabeth Zanglein outlined three critical steps to removing institutional barriers to economically targeted investments (ETI): education of trustees and their advisors on investment strategies for employee benefit plans, investments in established ETI pooled programs, and the creation of a national center for ETI investments.<sup>17</sup>

There are measures or options available to socially motivated investors to address each of the steps. See [Section I – Community Investments: Fact and Fiction](#) and the Opportunity Finance Network <http://www.opportunityfinance.net> for further information on pooling.

## **Section VII - Community Investments**

### **Expanding Options for Institutional Investors**

In recognizing the dynamic nature of the investment marketplace and the availability of an ever expanding array of viable options, the Department of Labor refuses to issue a list of permissible investments.<sup>18</sup> This speaks directly to the concern institutional investors have about portfolio design: there is no regulatory template mandating asset allocation. Again, the rules address procedural issues, not investment outcomes. The SIF [Due Diligence Primer](#) identifies a host of investment options, including Checking &

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<sup>16</sup> GAO-04-21. Highlights of GAO-04-21, Community Economic Development Loans: Securitization Faces Significant Barriers. A Report to Congressional Requesters

<sup>17</sup> Zanglein, J.E. Overcoming Institutional Barriers on the ETI Superhighway. National Heartland Labor Capital Conference. Washington, DC. 1996 p.38

<sup>18</sup> Zanglein, J.E. Overcoming Institutional Barriers on the ETI Superhighway. National Heartland Labor Capital Conference. Washington, DC. 1996 p.22

Savings Accounts, Money Market Accounts, Certificates of Deposit, Senior Loans, International Guaranty, Subordinated Loans, Equity Equivalent Investments (EQ2), Secondary Capital, and Equity Investments, several of which are discussed in further detail below. Below is a chart and description of investment options that incorporate community development, including information on the type of impact each asset class has upon the target population.

<b>Investment Description</b>	<b>Asset Class</b>	<b>Risk Level</b>	<b>Social Focus</b>
Auction Rate Securities (ARS)	Bond	Low	Jobs, Wealth, Business
Certificates of Deposit (CDs)	Cash	Low	Wealth
Collateralized Debt Obligations	Equity	Medium-High	Jobs, Wealth, Business
Collateralized Mortgage Obligations (CMO)	Real Estate	Medium-Low	Wealth, Housing, Business
Commingled Real Estate and Mortgage Accounts	Real Estate	Low	Wealth, Housing, Business
Direct Investment	Equity	Medium-High	Jobs, Wealth, Business
Linked Deposits	Cash	Low	Wealth
Pooled Investment Funds	Equity	Low	Jobs, Wealth, Business
Private Placements	Equity	Medium-High	Jobs, Wealth, Business
Real Estate	Real Estate	Medium	Wealth, Housing, Business
Secondary Capital	Debt	Medium	Jobs, Housing, Business
SBA 7(a) Loans	Debt	Low	Jobs, Housing, Business
SBA Certified Development Company (504) Loans	Debt	Low	Jobs, Housing, Business
Small Business Investment Companies (SBICs)	Equity/Debt	Medium	Jobs, Wealth, Business
SBA New Market Venture Capital	Equity/Debt	Medium	Jobs, Wealth, Business
Variable Rate Demand Notes (VRDNs)	Bonds	Medium	Jobs, Housing, Business
Venture Capital	Equity	High	Jobs, Wealth, Business

### Auction Rate Securities (ARS)

Auction Rate Securities are short duration assets that aim toward community development. As of 2003 there were around \$120 billion in ARS in the marketplace.<sup>19</sup> ARS are traded at par in a competitive bidding process (Dutch Auction) where the rates are determined on the auction date. The lowest interest rate that equals the cumulative total of securities demanded to the amount auctioned is the winning bid rate. Investors wishing to purchase ARS must submit a bid reflecting a specified rate on the day of the auction. Bond holders are notified of the “market” rate, and then all accepted bids receive the same interest rate. For more information, see: The Bond Buyer Online <http://www.bondbuyer.com/article.html?id=20040624QH0Q92U0&from=home>, or visit the Federal Reserve Bank of San Francisco: <http://www.frbsf.org>

### Certificates of Deposit (CDs)

Certificates of Deposit offer market rates of return in federally insured instruments. A list of community development financial institutions offering CDs can be found on the Community Investment Database <http://www.communityinvest.org>. Calvert Foundation

<sup>19</sup> Van Scoy, B. Variable Rate Municipal Securities. Federal Savings Bank of San Francisco. Community Investments Online, Aug. 2003

<http://www.calvertfoundation.org> and the National Federation of Community Development Credit Unions <http://www.natfed.org> can facilitate larger deposits (clustered jumbo CDs) into multiple community development banks and credit unions.

#### Collateralized Debt Obligations

Instruments in which Special Purpose Companies (SPC) raise money by issuing securities (which become liabilities of the SPC) and then using the proceeds to buy other assets, like bonds, loans, debt, fund of funds, or credit default swaps. See <http://www.ifecorp.com/Papers-PDFs/Clemente604.pdf> for further information on how these work.

#### Collateralized Mortgage Obligations (CMO)

Community-based mortgage and mortgage backed securities (MBS) funds offer a range of investments with returns reflecting the maturity class (tranche) and risk. CMOs are issued in separate classes with different stated maturities. As the underlying mortgage pool experiences prepayments, the pool pays off investors in classes with shorter maturities first. Although more complex and more difficult to find than the underlying MBS, investors seeking shorter term, risk adjusted market rates of return on investments are advised to purchase a CRA eligible CMO tranche. This type of investment supports affordable housing, and it allows banks to leverage investments in affordable housing from non-CRA regulated institutions (as the long term cash flows are sold to insurance companies and pension funds).

#### Commingled Real Estate and Mortgage Accounts

Commingled real estate and mortgage accounts provide liquidity, diversification and in many cases guaranteed returns. Open ended real estate funds operate much like open-end mutual funds. Shares can be purchased through community based real estate investment trusts (REIT) or Umbrella partnership real estate investment trusts (UPREIT). Additional information on community development REITs can be found at <http://www.frbsf.org/community/investments/cdreit.html>. For CRA eligibility, see: [http://www.ffiec.gov/cra/letters/letter\\_19961223.htm](http://www.ffiec.gov/cra/letters/letter_19961223.htm). (Interpretive letter). The Community Development Trust is the only private real estate investment trust in the United States with a public purpose. See <http://www.commdevtrust.com/> for more information. Also see the secondary market section of this primer.

#### Direct Investments

Direct investments require a greater degree of administrative input, and therefore tend to be time consuming and more expensive to hold. They are generally less liquid than their indirect counterparts.

#### Linked Deposits

These are customized certificates of deposit placed with local banks in which specific community objectives are negotiated into the instruments. There are a number of examples in which businesses or State pension funds are placed into FDIC insured jumbo CDs that are then earmarked for job creation, affordable housing loans, or other community based initiatives. Linked deposits give investors greater control over how

their deposits will be used. Banks are generally receptive to these deposits as they help satisfy CRA mandates, as well as nurture banking relationships.

### Pooled Investment Funds

Pooled investments have a number of advantages over direct investments, including the risk mitigating qualities of easy administration, lower transaction costs, easier due diligence and monitoring. They have greater liquidity and are generally more prudent than individual investments. There are a number of organizations that offer pooled funds, including Progressive Asset Management (who has collaborated with the Calvert Social Investment Foundation) to provide PAM Community Investments. See: <http://www.pamboston.com/investment/community/>

### Private Placements

Similar to direct investments, institutional investors can buy stock or bond issues outside of the SEC regulatory environment. They tend to be illiquid, and the bonds are generally amortized, long term, fixed interest loans. This characteristic can work well with pension funds.

### Real Estate

Direct investment in real estate turns an investor into a developer, and should be approached with great care. Trustees of pension plans should make certain that their real estate investment managers are a Qualified Professional Asset Manager (QPAM) as defined by the Department of Labor in their Prohibited Transaction Class Exemption 84-14.<sup>20</sup>

### Secondary Capital

Secondary capital is an uninsured, subordinated, convertible debt instrument. It offers community development credit unions (CDCUs) an opportunity to enhance their net worth, which in turn improves their ability to absorb losses. Institutional investors can use secondary capital to leverage community development impact in the CDCUs while retaining their capital and earning a rate of return (between 3.5 & 5% during the 1993 – 2003 period).<sup>21</sup>

Low Income Credit Unions (LICU) are the only eligible organizations permitted to use secondary capital. There is a five year minimum maturity, they are uninsured, subordinated to all other liabilities, may not be pledged by investors as security on another obligation, and are counted as debt for GAAP, but considered equity when calculating net worth (up until 5 years prior to maturity). The largest users of secondary capital in the country include the Vermont Development Credit Union <http://www.vdcu.org/>, Alternatives Federal Credit Union (NY) <http://www.alternatives.org/>, the Dakotaland Federal Credit Union (SD) <http://site.dakotalandfcu.com>, and the Southern Oregon Federal Credit Union

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<sup>20</sup> Iezman, S. Operating Pension Funds in Compliance with ERISA Procedures: How to Avoid a Department of Labor Audit: A Primer for Lawyers. Real Estate Review, Spring 1999

<sup>21</sup> Bullard, A. High Impact Capital: Using Secondary Capital to Expand Community Development Credit Union Capacity.

<https://www.sofcu.com/>, each of whom has between \$1million to \$3.5million in secondary capital.

### SBA 7(a) Loans

All 7(a) loans are provided by lenders, are only available on a guaranty basis. This means they are provided by lenders who choose to structure their own loans by SBA's requirements and who apply and receive a guaranty from SBA on a portion of this loan. The SBA does not fully guaranty 7(a) loans. The lender and SBA share the risk that a borrower will not be able to repay the loan in full. For information on underwriting parameters and eligibility criteria, see:

<http://www.sbaonline.sba.gov/financing/sbaloan/7a.html>

### SBA Certified Development Company (504) Loans

The CDC/504 loan program is a long-term financing tool for community economic development. The program provides businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. A certified CDC (of which there are about 270 in the US) works with the SBA and private-sector lenders to provide financing to small businesses. A 504 project includes a loan secured with a senior lien from a private-sector lender covering up to 50 percent of the project cost, a loan secured with a junior lien from the CDC (backed by a 100 percent SBA-guaranteed debenture) covering up to 40 percent of the cost, and a contribution of at least 10 percent equity from the small business being helped.

Interest rates on 504 loans are pegged to an increment above the current market rate for five-year and 10-year U.S. Treasury issues. Maturities of 10 and 20 years are available. Fees total approximately three (3) percent of the debenture and may be financed with the loan. For further information on maximum debenture and qualified investments see: <http://www.sbaonline.sba.gov/financing/sbaloan/cdc504.html>

### Small Business Investment Companies (SBICs):

Small Business Investment Companies are privately managed, for-profit investment companies formed to provide equity and/or debt capital to U.S. small businesses. SBICs are licensed by the U.S. Small Business Administration, which partners with the private investors.

Private, well experienced, equity managers must secure minimum commitments of either \$5 million (for a debenture fund) or \$10million in private equity (for an equity fund) from private investors. The SBA offers up to a \$20 million commitment in a 2:1 public-private leverage for every \$10 million in private equity invested in small businesses with a net worth less than \$18 million and an average prior two-years after-tax income of less than \$6 million.

SBICs can secure guarantees of debentures or participating securities up to three times private capital (depending on how the deal is set up) to supplement their own private capital. The capital can be leveraged to significantly enhance returns to fund managers, as the capital generally has a lower cost than traditional limited partner equity investments. Further, the concentration of funding in a single limited partnership (LP) reduces fundraising time and costs, as well as decreases administrative and reporting requirements. Community Reinvestment Act credits can be made available to financial institutions that invest in SBICs.

For additional information on deal sourcing use the existing network of over SBICs across the country. Link by State here: <http://www.sba.gov/gopher/Local-Information/Small-Business-Investment-Companies/>.

How to form an SBIC: <http://www.sba.gov/INV/textonly/howtoformsbictext.html>

Additional Information for the investor considering an investment in an existing SBIC can be found at <http://www.sba.gov/INV/forinvestors.html>

#### Variable Rate Demand Notes (VRDNs)

Variable Rate Demand Notes (aka variable rate demand obligations - VRDO) are long-term (30 year) taxable or tax-exempt bonds that bear a floating interest rate and provide investors with the option to tendering the securities at par on seven days notice; they have community development as their purpose. A remarketing agent then resells the bonds in the secondary market. Issuers may convert VRDNs into a long-term fixed-rate security upon exercising a contractual option and giving appropriate notice.

VRDNs are well suited for investors that require liquidity, flexibility, and competitive short-term (market) rates. Interest rates are reset daily or weekly, depending upon the terms of the security, and are based on comparable securities with similar maturities and credit ratings; supply and demand and demand affected rates, too. Letters of Credit generally need to accompany VRDNs.

Investors earn a market interest rate and are protected against principal loss, as bond holders have the right to tender their bonds for payment at par plus accrued interest. They may exercise this feature at any time with appropriate notice to the remarketing agent. VRDNs are highly rated due to credit enhancements. For further information see: Federal Reserve Bank of San Francisco: <http://www.frbsf.org>

#### Venture Capital

The Department of Labor expressly permits venture capital investments in investment portfolios, contingent upon satisfying the prudence rule. Venture capital investments can be resource and time intensive, so including them in a portfolio requires familiarity with and compliance to strict fiduciary standards. See 29 CFR 2510.3 – 101.

The Department of Labor has repeatedly stated that investments in venture capital can be appropriate pension fund investments.<sup>23</sup> Investors must recognize that venture capital investments are generally illiquid and have a longer-term horizon than other investments. This latter characteristic, however, can be consistent with actuarial needs of a pension fund.

The Community Development Venture Capital Alliance offers a host of resources addressing venture capital investments. [www.cdvca.org](http://www.cdvca.org)

## Section VIII - Risk

### RISK ADJUSTED RATES OF RETURN – FIXED INCOME VEHICLES

Community investments made by pension funds need to achieve risk-adjusted rates of return equal to or better than alternative investments with similar risk characteristics. For example, jumbo CD rates at community banks should reflect a rate of return similar to the rates at large conventional banks, as both are insured. ERISA does not specify that a pension fund cannot take risks with its investments. It does however state that collateral benefits cannot be factored into determining the rate of return.

Standard performance benchmarks are available for each asset class. BanxQuote <http://www.banxquote.com/> issues a national average for two year jumbo certificates of deposit which can be used as a benchmark for deposits. Performance for fixed income securities can employ the Lehman Brothers Aggregate Bond Index: <http://www.lehman.com/>. Other major indices can be found at NASDAQ <http://nasdaq.com/>.

### RISK MITIGATION

Risks associated with loss of investment principal, interest, or equity can be managed using a number of techniques. The following list identifies the most common risk mitigation tools.

Diversification is clearly identified in countless government and industry reports as being essential to exercising sound investment practices, and for pension funds a required measure of prudence by fiduciaries and their advisors. See [Section XIII, Appendix 1](#) for further information on diversifying an investment portfolio.

Hedging is a concept that involves offsetting a risk position by creating buffers or alternative exit strategies in an investment. A common hedging technique is arbitrage, where an investor can buy securities in one market and sell them in another. Although

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<sup>23</sup> See Pension Investments: Public Hearings Before the New York State Pension Investment Task Force 187 (Mar. 3, 1989) (Testimony of David Walker, Assistant Secretary of Labor); also see Pension Investments and Economic Growth, supra note 36 (testimony of Olena Berg, Assistant Secretary of Labor) U.S Department of Labor, Advisory Council on Pension Welfare and Benefits Plans, Economically Targeted Investments: An ERISA Policy Review (1992)

difficult to identify for community investments, opportunities do exist. The use of collateralized debt obligations (CDOs) offers an example, in which Special Purpose Companies leverage securities into other investment vehicles, including hedge funds.

Networking: Access to information is central to making sound investment decisions. Developing a network of investment managers helps mitigate risks, as the flow of information among community investors improves each institutional investors familiarity with prevailing practices and performance indices. Various associations offer lists, memberships, or opportunities for networking, including: Social Investment Forum <http://www.socialinvest.org>, Investor's Circle Network <http://www.investorscircle.net/network.html>, Opportunity Finance Network <http://www.opportunityfinance.net>, Community Development Venture Capital Alliance <http://www.cdvca.org>, National Community Investment Fund <http://www.ncif.org>, Neighborhood Reinvestment Corporation (NRC) <http://www.nw.org>, and many others listed in [Appendix IV](#).

Credit enhancements offer risk mitigation and include external credit enhancements, including government guarantees (SBA 7(a), SBA 504 programs, FDIC), and private guarantees (insurance, letters of credit). Internal credit enhancements, which are often funded by the lenders, include senior/subordinate positions, collateralization, overcollateralization (where the face value of assets in a pool are greater than the face value of securities issued), excess spread (where excess cash flow into an asset pool is set aside in a reserve fund), and loan loss reserves (where money is set aside at the outset of an investment).

There are federal insurance programs for investments in depository institutions, including the NCUA <http://www.ncua.gov> through its Share Insurance <http://www.ncua.gov/ShareInsurance/for> credit unions and the FDIC <http://www.fdic.gov/> for banks. For institutional investors working with brokerage houses, the Securities Investor Protection Corporation <http://www.sipc.org/> provides some protection.

### **RISK-ADJUSTED RATES OF RETURN – COMMUNITY DEVELOPMENT VENTURE CAPITAL**

Investments in a Community Development Venture Capital (CDVC) fund should yield a rate of return similar to returns indicated in vintage year analyses, taking into account such factors as initial capitalization, assets, debt, equity, management and business objectives.

A good benchmark for private equity is the Venture Economics US Private Equity Performance Index [http://www.nvca.org/nvca10\\_16\\_01.html](http://www.nvca.org/nvca10_16_01.html).

All products are tied to the market. As interest rates increase, community development loan funds pay out more. On the down market, CI funds are more attractive to investors; therefore CI has had a negative correlation to the market with an attractive rate of return. For institutional investors, it is important to have a balanced and diversified portfolio.

## SECTION IX – INSTITUTIONAL INVESTORS

Community investments may or may not be prudent depending on a number of factors, including diversification of current holdings, risk tolerance, cash flow needs, plan documents, timing, due diligence and general economic conditions. The type of institutional investor has some bearing on the investment decisions, particularly regarding regulatory compliance. Exercising prudence should characterize all institutional investment activities, and investors are reminded that what may be a prudent investment for one investor, may not be for another. The following table identifies key considerations by investor type.

Investor Type	SEC Compliance Required	ERISA Compliance Required	Diversification Federally Mandated*	State and/or Local Statutes
Public Pension Funds	Yes	Yes, under section J	Yes (State & Federal)	Yes
Private Pension Funds	Yes	Yes	Yes	Yes
Mutual Funds	Yes	No	By prospectus only	Yes
Religious Funds	Yes	Yes (Title 1, Section 3(33))	Yes	Yes
Taft-Hartley Funds	Yes	Yes	Yes	Yes
Corporate Investors	Yes	No	No	Yes
Foundations	Yes	No	No	Yes
Insurance Companies	Yes	No	Yes	Yes

\* Unless imprudent to do so based on the circumstances at the time.

### Notes:

**Public Pension Funds** are not expressly regulated by ERISA except under section J; trustees and investment committees are advised to comply with ERISA guidelines regarding fiduciary duties.

**Private Pension Funds** are regulated by ERISA.

**Mutual Funds** are investor controlled, regulated by the SEC, and offered by prospectus only.

**Religious Funds** Religious organizations are discussed within section 3(33) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA).

<http://www.dol.gov/ebsa/programs/ori/advisory94/94-15a.htm>.

All religious funds are not retirement funds. Retirement funds are not the only driving force behind the community investment movement in the faith community. Religious funds include millions of dollars invested by men and women religious (out of their own investment – not retirement – funds), Roman Catholic healthcare systems, religious denominations, congregations, etc. – in addition to investments generated from retirement funds. The retirement fund community investors are only some of the faith-based investors in low-income communities; the spectrum includes many.

## SECTION X - TAX CREDITS

### New Market Tax Credits – Qualified Investments

The Community Renewal Tax Relief Act of 2000 authorized up to \$15 billion under the New Markets Tax Credit (NMTC) program to stimulate capital investment in low income and economically distressed communities. Investors can claim a tax credit for a qualified equity investment in a qualified community development entity (CDE) made after April 19, 2001.

"The New Markets Tax Credit (NMTC) program was enacted in December 2000 as part of the bipartisan Community Renewal Tax Relief Act. The purpose of the NMTC is to spur private investment in low-income urban and rural communities. The program is based on the idea that there are viable business opportunities in low-income communities, and that a federal tax credit would provide an attractive incentive to increase the flow of investment capital to such areas." (Excerpt from *Making the New Markets Tax Credit Count*)<sup>24</sup>. In his article, Robert Rapoza provides a comprehensive overview about how the credits are intended to work and where they went. He also explains how to become certified as a CDE in order to apply for credits, how the CDE must market the credit to investors, what investments qualify for the credits, and what limitations exist on the use of the credits. The link also provides a detailed chart that provides information on the distribution of the first round of credits by geography and entity.<sup>25</sup> <http://www.frbsf.org/publications/community/investments/0308/article1apf.html>

## **FAQ: NMTC**

### **How the New Markets Tax Credit Works**

Qualified community development entities (CDEs) apply to the U.S. Department of Treasury's Community Development Financial Institutions (CDFI) Fund for an allocation of the new markets credit. A CDE must identify investors willing to make qualifying equity investments in the CDE. The CDE will be required to use substantially all of the qualified equity investments to make qualified low-income community investments in qualified active low-income community businesses (QALICBs). After the CDE is awarded a tax credit allocation, the CDE is authorized to allocate the tax credits to private equity investors in the CDE.

**What is a Qualified CDE?** A qualified CDE is any U.S. corporation or partnership with a primary mission to serve, or provide investment capital for, low-income communities or persons; it must maintain accountability to residents of low-income communities through their representation on any governing or advisory boards of the entity; and, it must be certified by the CDFI Fund of the Department of Treasury.

### **How much is the credit worth?**

You claim the credit over a period of 7 years. To find the amount of your credit each year, multiply the amount you paid the qualified CDE for your qualified equity

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<sup>24</sup> Rapoza, R. Making the New Markets Tax Credit Count. Federal Reserve Bank of San Francisco 08/03

<sup>25</sup> Turner, S. Senior Community Investment Specialist, New Markets Tax Credits Hit the Community, Federal Reserve Bank of San Francisco.

investment by a percentage. The percentages are 5% for the year the investment is made and each of the next 2 years, and then 6% for each of the next 4 years.

The credit can be up to 39% of your investment over a 7-year period. To claim the credit for a year, you must hold the qualified equity investment on the credit allowance date for that year. The credit allowance date is the date you make the initial investment and each of the next 6 anniversary dates.

### **What is a Qualified equity investment?**

It is the cost of any stock in a corporation or any capital interest in a partnership in which the corporation or partnership is a qualified CDE, the investment is acquired on the original issue date for cash. The cash may be from borrowed funds, including a non-recourse loan. At least 85% of the cash needs to be used to make qualified low-income community investments, or at least 85% of the entity's total gross assets must be in qualified low-income community investments. The 85% requirement is reduced to 75% for the seventh year of the 7-year credit period. Also, the qualified CDE designates the investment as a qualified equity investment on its books.

### **What is a Qualified low-income community investment?**

It is usually any capital or equity investment in, or loan to, any QALICB, which is any corporation (including nonprofits), partnerships, or sole proprietorships that have at least 50% total gross income coming from the active conduct of a qualified business within a low-income community, and at least 40% of the use of its tangible property (whether owned or leased) is within a low-income community, and at least 40% of its employees' services are performed in a low-income community, and less than 5% of the average of the total unadjusted bases of the property of the entity is from nonqualified financial property (generally, debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, and annuities), or collectibles not held primarily for sale to customers in the ordinary course of its business<sup>26</sup>.

### **What is a Qualified Business?**

It is normally trade or business except that that consists primarily of developing or holding intangibles for sale or license. The rental of real property located in a low-income community is a qualified business only if the property is not residential rental property and there are substantial improvements located on the property.

The purchase from another qualified CDE of any loan made by that entity provided that it was a qualified low-income community investment at the time it made or sold the loan.

- Providing financial advice about organizing or operating a business to QALICBs and residents of low-income communities.
- Any equity investment in, or loan to, any qualified CDE used to make other qualified low-income community investments.

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<sup>26</sup> Internal Revenue Service [http://www.irs.gov/irb/2003-41\\_IRB/ar12.html](http://www.irs.gov/irb/2003-41_IRB/ar12.html).

## **How are the New Markets Tax Credits Allocated?**

They are allocated annually by the CDFI Fund to CDEs under a competitive application process. The maximum amount of qualified equity investments designated by the qualified CDE cannot exceed the amount of the allocation received from the CDFI Fund. The U.S. Department of Treasury awarded to 66 entities on March 14, 2003, the first \$2.5 billion in tax credit allocations under the NMC program. For information about future NMC allocations, see the CDFI fund website at [www.cdfifund.gov/programs/nmtc](http://www.cdfifund.gov/programs/nmtc).

For further information, link to the IRS: New Market Tax Credit Forms and Information [http://www.irs.gov/irb/2003-41\\_IRB/ar12.html](http://www.irs.gov/irb/2003-41_IRB/ar12.html).

See Internal Revenue Bulletin (Feb, 2005) for recent interpretations of the NMTC. <http://www.irs.gov/pub/irs-irbs/irb05-06.pdf> that replace the temporary regulations that expired December 23, 2004.

## **Low Income Housing Tax Credits**

The Low Income Housing Tax Credit (LIHTC), which came out of the Tax Reform of 1986 and made permanent in 1993 has had a significant impact on the nations housing stock, increasing affordable housing by nearly 1 million units.<sup>27</sup> The Act was created to encourage the development of rental housing for low-income households. Costs associated with the development of affordable housing are accrued into a property's eligible basis; exceptions to eligible costs are listed at <http://www.frbsf.org/publications/community/investments/cra02-2/index.html>. Current information on the LIHTC can be found at <http://www.novoco.com/resource.shtml>

The National Equity Fund, Inc. <http://www.nefinc.org/> is the nation's largest nonprofit syndicator of low-income housing tax credits, placing more than \$3.3 billion in investor equity with 500 community development corporation (CDC) partners. NEF's equity initiatives have supported more than 1,000 projects and created around 53,000 units of affordable housing in more than 200 communities across the U.S.

## **International Community Investing**

Community investing is not only a tool for engaging in the development of U.S. communities; it is also a way to become active in other parts of the world. There are a vast number of U.S.-based and non-U.S.-based [Community Investment Institutions \(CIIs\)](#) that invest in the development of small entrepreneurs, families, and communities in other nations. They focus their loans, guarantees, and equity investments abroad to microfinance institutions and small- & medium-size enterprises, often issuing or guaranteeing smaller loans to communities and individuals in need.

While in the U.S. we focus primarily on rebuilding communities, international CIIs have a broader mission as they pioneer individual and community enterprises and neighborhood infrastructure development in countries emerging from years of conflict and war. [Foundation for International Community Assistance \(FINCA\)](#) has provided

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<sup>27</sup> Steinbach, C. The CDC Tax Credit: An Effective Tool for Attracting Private Resources to Community Economic Development. Brookings Institute. Aug 1998

some of the first long-term and sustainable economic development aid to Kosovo, Haiti, Uzbekistan, and Afghanistan, all nations in need of capital to rebuild after political unrest. [Shared Interest](#), a U.S.-based fund, works in South Africa to redress the economic legacy of apartheid, by guaranteeing loans for small- and micro-enterprises and affordable housing to black South Africans, primarily women. Many CIIIs are aiding the people of recently democratized nations in Latin America in their efforts to establish small businesses and become economically independent.

International investments do differ from domestic investments, largely due to foreign exchange rates and the stability of the country's economy and government. Many CIIIs that lend directly overseas integrate foreign exchange risk management measures into their lending strategies, diversify their loans across different organizations, and closely supervise their borrowers. International community investments also differ from domestic investments in that investment dollars go further due to the higher value of the U.S. dollar in other countries. A loan guarantee of \$1,000 for a 2-year period in Africa can leverage local funds to launch 3.16 microenterprises and create 3.59 jobs. This compares to the same investment in the U.S. financing 40% of 1 microenterprise and creating less than one job, according to the [Community Investment Impact Calculator](#) (which can be accessed through <http://communityinvest.org/>).

Microenterprise loans are most often the vehicle for international community investing because they provide the large self-employed population often prevalent in developing nations with the skills, capital, and credit to start and expand their businesses. Small and medium enterprise (SME) loans are another vehicle that helps create small businesses and jobs, as well as develop the middle class, in poorer countries. There are well-established networks that track international CIIIs, and have established benchmarks and other industry enhancements, such as [Microrate](#) and the [Mix Market](#).

## **Section XI - Secondary Markets**

There have been a number of initiatives to create a secondary market for community investments. The field is in its infancy, but early indications strongly suggest secondary markets will continue to grow. The following list contains five of the secondary market initiatives, some of which are for-member organizations only. There is also information on the Local Initiatives Managed Assets Corporation.

The Neighborhood Housing Services of America <http://www.nhsfamerica.org>, the secondary market arm of the NRC, is an experienced secondary market organization for network members of NeighborWorks. Eligible members are located in more than 2300 communities. For further information on NeighborWorks (NW), visit <http://www.nw.org/network/home.asp>.

The Community Reinvestment Fund (CRF) <http://www.crfusa.com> brings capital to both public and private nonprofit community development lenders by creating a secondary

market for community loans. Formed in 1988, CRF has provided hundreds of millions of dollars for low-income and economically disadvantaged communities around the country to help create jobs, stimulate economic development, provide affordable housing, and support community facilities.

CRF issued the first ever note backed by community development loans that was rated by Standard & Poor's. The note, known as CRF – 17, was parceled into classes with the highest class (totaling around \$26 million) receiving an AAA rating from Standard & Poor's. The pool of notes totals \$51.1 million and includes 128 loans made by 37 community-based lenders to small businesses in 19 states.

The loan pool, which is an aggregate of loans made to small businesses and for small affordable rental housing properties, exceeds the amount of the notes offered by \$5 million. This excess collateral (spread) is part of the credit enhancement provided for purchasers of the notes. The rated notes were offered through Piper Jaffray & Co.

Self Help Credit Union <http://www.self-help.org> is a community development lender that has provided over \$3.8 billion in financing to 40,000 home buyers, small businesses and nonprofits. Self-Help purchases portfolios of seasoned mortgage loans and has a flow program for new originations. Lenders holding non-conforming loans on their balance sheet, or those interested in increasing available lending dollars for low and moderate income borrowers, can sell their loans directly to Self-Help for cash or mortgage backed securities (MBS). The flow option connects lenders to take-out investors, and works well with lenders who need an affordable and customized program, or who simply want a secondary market outlet for newly originated loans.

Self-Help offers minorities, women, rural residents, and low-wealth families who are underserved by conventional lenders access to capital, by connecting them to socially-responsible citizens and institutions across the U.S. Lenders can find additional information at <http://www.self-help.org/secondarymarket/lenderinfo.asp>.

Impact Community Capital LLC <http://www.impactcapital.net> makes and manages investments in low-income communities for its insurance company investor-members. Impact Capital pools and securitizes community investment portfolios to meet the needs of both low-income communities and institutional investors required to exercise prudent investment practices. Impact Capital is a certified Community Development Entity and a certified CDFI. They also received an allocation of New Market Tax Credits that they are leveraging to pioneer insurance company investing in community childcare facilities in California. For further information on Impact Capital's community impact and the Securitization and Standard & Poor's Research, visit <http://www.impactcapital.net/invest.html>

Community Development Trust (CDT) <http://www.commdetrust.com> is a real estate investment trust that directs private capital into affordable housing and other community development projects. CDT purchases individual loans and portfolios of seasoned loans on a negotiated basis. CDT is a private, mission-driven REIT that earns attractive

returns for shareholders while preserving and expanding the supply of affordable housing. All CDT investments satisfy Community Reinvestment Act (CRA) requirements. CDT invests in long-term debt capital by purchasing smaller, fixed rate multi-family mortgages from community lenders, and equity capital in cash or by facilitating tax-advantaged transitions for existing properties to new institutional owners with a commitment to long-term, affordable housing.

CDT works closely with the Local Initiatives Support Corporation (LISC) <http://www.lisc.org> which provided the initial seed capital. Visit LISC's website for a list of their partners/investors. Also see National Equity Fund, Inc. in [Section X: Tax Credits](#).

The Local Initiatives Managed Assets Corporation (LIMAC) is an affiliate of the Local Initiatives Support Corporation (LISC). LIMAC purchases loans from community lenders including community loan funds, intermediaries, banks, and bank consortia, and effectively recycles loan funds, and increases lending activity. LIMAC permits lenders to originate loans they otherwise could not offer because of limitations on size, term or loan amount to a single borrower.

LIMAC purchases loans originated for financing the development or acquisition of low- and moderate-income housing; helping to revitalize deteriorating neighborhoods and/or stabilize low-income communities; financing the acquisition and development of property for commercial, retail and community service use benefiting low-income communities; or creating employment opportunities for low-income persons. LIMAC provides a secondary market for low income housing and community development loans.

Prudential <http://www.prudential.com> is known to be focusing on broadening the use of credit enhancements and is reported to be exploring asset securitization for community investments.<sup>28</sup>

## **Section XII - Impact Metrics - Assessing Social Impact**

There are a number of criteria by which community investments can be measured, some of which are readily ascertained and immediate, while others have long-term significance and are difficult to measure. Measurements vary depending upon the type of investment. For example, wealth creation among individuals is a significantly different metric than asset growth of a community development credit union.

The Roberts Enterprise Development Fund offers an interactive resource for measuring social return on investment.<sup>29</sup> Investors can input their data to achieve a host of feedback, including: social purpose value, enterprise value, blended value, social

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<sup>28</sup> Baue, W. (2005) Community Investment Surpasses the \$1 Billion Mark at The Rock, Institutional Shareowner. <http://www.institutionalshareowner.com/news/article.cgi?sfArticleId=1629>. 02/03/05

<sup>29</sup> The Roberts Investment Excel Model is no longer used by REDF, as they have adopted their proprietary OASIS (Ongoing Assessment of Social Impacts) evaluation application. They do acknowledge, however, the sustaining value the Excel system provides individuals and organizations engaged in measuring social impact.

purpose index of return, enterprise index of return, blended index of return, and other data. The social impact tool can be accessed at:  
<http://www.redf.org/download/sroi/SROIExcelModel.xls>

Generally, institutional investors who make community investments do so with the dual purpose of generating financial returns and having a social impact. It must be noted here that a social return on investment does not contribute to assessing the financial return on investment within pension or mutual funds, and remains a soft benefit for investors and plan participants. Nonetheless, measuring social return on investment requires looking at a host of outcomes, including job creation/preservation, wage indices, employee migration (new jobs, promotions, departures, retired, terminated), houses built/refurbished for low and moderate-income individuals (owner occupied, rentals), children and family services created, and number of bank accounts opened and maintained.

Comprehensive assessments include collecting data on a regular basis on everything from community and individual assets to the number of employees, customers, or clients that a particular initiative generates. This data can be analyzed to determine a social return on investment index that can be then be benchmarked.

Most regulatory agencies mandate certain outcomes for investments and/or grants made. The Pennsylvania Treasury Department, for example, has a linked deposit program that evaluates and allocates funds based on the number of jobs created, the ratio of jobs created (or saved) to dollars loaned, and the economic need of a particular region. The program demonstrates the need for funding recipients to acknowledge the link between performance and sustained investments.

Projects that have a high impact are championed by private and public investors, not only for their operational efficacy, but also for their potential replication. The Low Income Housing Tax Credit is considered by many to have had a high social impact, generating more than 100,000 new housing units annually and spawning hundreds of millions of dollars in community investment.

Finally, organizations with an expertise in community audits can provide an objective analysis of community assets and needs prior to an investor making an investment, particularly regarding the work force. Community audits can include a review of housing stock, work force (supply and demand), and of other community assets. There are several organizations that can provide additional information on community audits, including The WorkPlace, Inc. <http://www.workplace.org/asp/TheWorkPlace.asp> and the Southern Illinois Workforce Investment Board <http://www.siwib.org/comaudit.asp>.

Community development venture capital investors also seek an understanding of social impact. The Community Development Venture Capital Alliance <http://www.cdvca.org> has developed the Measuring Impacts Toolkit (MIT), a tool designed to create an efficient and practical social impact assessment program that institutional investors could readily adopt. The instrument is available at no cost from the CDVCA.

## Section V – Appendices

### Appendix I – Operating Methods & Functions

Management of assets, particularly pension and institutional funds, requires familiarity with the regulatory environment, the market place and the needs and interests of the fund shareholders. Given their fiduciary responsibilities, institutional investors are advised to adopt best practices in the management of client or plan participant assets.

The following list identifies operating methods and functions. The table provides information on the type of function, who is responsible, and the suggested frequency for executing the function. Further information is available for each topic in a description below.

Operating Topic	Function / Facilitation	Execution
Accounting Requirements	Operations / Committee / Staff	Ongoing
Advisor Contracts	Operations / Committee	Quarterly
Asset management	Operations / Committee / Advisors	Ongoing
Benchmarking & Performance Monitoring	Executive / Committee / Staff	Monthly
Compliance reviews	Executive / Committee / Staff	Quarterly
Conflict of Interest	Governance / Board	Annually
Diversification	Operations / Committee / Advisors	Ongoing
Document (Plan Design)	Executive / Committee / Board	Annually
Document Management	Operations / Committee / Staff	Ongoing
Due Diligence	Operations / Committee /	Ongoing
Investment Strategies & Policies	Governance / Committee / Board	Quarterly
Minimum Reserves	Executive / Committee / Board	Annually
Partnerships	Operations / All	Ongoing
Portfolio Design	Executive / Committee / Advisors	Quarterly
Prudent Man Rule	All/All	Ongoing
Reporting requirements	Operations / Committee / Advisors	Quarterly
Shareholder Advocacy	Operations / Committee / Staff	Ongoing
Training	Operations / All	Ongoing
Watch lists	Operations / Staff / Advisors	Ongoing
Workout plans	Operations / Staff / Advisors	Ongoing

**Accounting Requirements:** Familiarity with Generally Accepted Accounting Principals (GAAP) is fundamental to regulatory compliance and fulfillment of fiduciary responsibilities. Tax consequences, disbursements, asset appreciation/depreciation, valuation, and a host of other factors affecting an investment portfolio must be well managed. Audits should be conducted no less than annually by a certified public accounting firm. The American Institute of Certified Public Accountants offers links to additional resources. <http://www.aicpa.org/index.htm>. For an interactive database of CPAs by community, see firms at <http://www.cpafrms.com/Firmlist/firmlist.cfm>.

**Advisor Contracts:** Fiduciaries for private pensions have a legal obligation to exercise prudent judgment in selecting financial advisors or agents. It is important to employ qualified investment professionals to assist in the design and administration of an

investment plan, and periodically have an investment panel review their performance. Investment managers (for pension funds) should be appointed under ERISA 29CFR Section 1102 (c)(3), thereby protecting trustees from liability for the acts or omissions of the investment manager. Trustees may be found liable for the negligence or dereliction of duty of advisors appointed outside the ERISA guidelines. See ERISA guidelines below. Also see Department of Labor Fiduciary Responsibilities: <http://www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf>, and the Securities Exchange Commission Statement of Ethics <http://www.sec.gov/rules/final/ia-2256.htm>.

**Asset Management:** Asset managers must periodically review their individual investments against industry standards, prevailing trends, and financial ratios on a case-by-case basis to assess performance and determine changes in risk to the overall portfolio. Institutional investors (including committees, boards, staff, and advisors) should enlist personnel with a familiarity and expertise in a particular area of investments. Community investments are by nature geographically confined, therefore asset managers with local or regional knowledge should be enlisted when possible. For a list of community investment asset managers link to: [http://www.investing-sites.com/Socially\\_Responsible/Advisers\\_Fee\\_Only/](http://www.investing-sites.com/Socially_Responsible/Advisers_Fee_Only/)

**Benchmarking & Performance Monitoring:** Keeping with sound asset management practices, pension fund investors are expected to achieve reasonable returns consistent with standard industry benchmarks. Accepting a below-market rate of return may be a violation of statutory fiduciary duties, depending on investor type and prevailing diversification practices. Non-pension investors are not bound by the same statutory restrictions, and have greater flexibility to invest in below market options, of which there are a number.

Standard performance benchmarks are available for each asset class. BanxQuote <http://www.banxquote.com/> issues a national average for two year jumbo certificates of deposit which can be used as a benchmark for deposits. Performance for fixed income securities can employ the Lehman Brothers Aggregate Bond Index: <http://www.lehman.com/>. A good benchmark for private equity is the Venture Economics US Private Equity Performance Index [http://www.nvca.org/nvca10\\_16\\_01.html](http://www.nvca.org/nvca10_16_01.html). Other major indices and economic indicators can be found at NASDAQ <http://nasdaq.com/>, the U.S. Department of Commerce – Bureau of Economic Analysis <http://www.bea.doc.gov/>, Stat-USA <http://www.stat-usa.gov/>, FTSE <http://www.ftse.com/>; Standard & Poors <http://www2.standardandpoors.com/>, and Reuters <http://www.reuters.com/financeWorldMarkets.ihtml>. Also see Appendices: [Model Portfolios](#).

**Compliance Reviews:** There are countless federal, state, and local statutes affecting investment activities. The exclusive benefits rule, the prudent man rule, and disclosure laws are just a few of the regulatory mandates that pension fund and other investors and fiduciaries must adhere to. The regulatory environment does not preclude participating in community investments. A host of resources referenced throughout this

primer, and listed in the Appendix, offer invaluable information regarding regulatory compliance. A couple of these include the Securities Exchange Commission <http://www.sec.gov/> and the Department of Labor <http://www.dol.gov/ebsa>.

**Conflict of Interest Policy:** It is very important to have a policy that helps identify, avoid and mitigate conflicts of interest among trustees, agents, employees, plan beneficiaries, and other parties in interest. The policy should be explicit on the following points: any individual with fiduciary duties owes a legal duty of good faith, full disclosure, fair dealing, and undivided loyalty to the organization in which they serve in a fiduciary or management capacity; self dealing in which a director or officer benefits to the detriment of the corporation is a breach of the policy; in the event of a dispute resulting from such a clause, the policy should specify who may act as an arbiter and how a final recommendation should be made to the Board of Trustees or to the Directors. In the event that a conflict is identified, organizational minutes should show that the board or committee member fully disclosed the potential conflict, that a full discussion occurred about how the decision was determined to be in the best interest of the corporation, and that the member with the conflict abstained from the vote.

**Diversification:** Diversification is the process of spreading risk by employing multiple asset classes in an investment portfolio. Asset categories include stocks, bonds, money market instruments, and a host of other options. Diversification is recognized as central to prudent investing. Asset allocation is fundamental to diversification.

Investment portfolios should be well diversified, have liquidity that reflects a realistic actuarial profile, and have a projected return consistent with plan documents and fund objectives. For more information on ERISA visit <http://www.dol.gov/ebsa/>. [see ERISA 1101 (a) (1c)]

Also see sections below on Community Investment Options and ERISA.

**Document Management:** Institutional investors should develop, maintain and periodically review plan documents consistent with local, state and federal statutes to ensure compliance by trustees and their agents. Non-compliance, including allocation of assets, can lead to breach of fiduciary duty, and result in litigation, regardless of the performance of the portfolio. See *Martin v. Harline*.<sup>30</sup>

**Document (Plan Design):** A plan document outlining the purpose, scope, management, administration, and investment objectives should be well researched, well drafted, heavily scrutinized, and maintained with the highest level of prudence and professionalism possible. All policies should be reviewed by an investment committee and appropriate outside legal and financial counsel. The plan document is both a legal instrument as well as a blueprint for managing the investment process. The document should clearly identify the role, rights, and privileges of plan participants or shareholders, and reflect regulatory mandates and prevailing industry practices. It

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<sup>30</sup> 15 Employee Benefits Cas. (BNA), on remand, 755 F. Supp.85 (S.D.N.Y. 1991) as cited in J.E. Zanglein, *Overcoming Institutional Barriers to ETIs*.

should spell out procedures for disbursements, asset allocation, and provide provisions for risk mitigation, losses, and terminal contingencies.

**Due Diligence:** Institutional investors should thoroughly investigate every investment decision and their alternatives. Due diligence should be an ongoing function of every investment committee member. They should know what the investments are, and ask how they complement the portfolio. The SIF offers a [Due Diligence Primer](#) for Community Investing, and includes underwriting guidelines for community investments.

**Investment Strategy & Policies:** Pension plans and institutional portfolios should have a well-defined investment strategy, including specific philosophies, policies, guidelines, and protocol for making investment decisions. These should reflect a plan's overall portfolio strategy, including liquidity, return, funding objectives, risks, fees and how to employ investment counsel. The development of an investment strategy should, at a minimum, include consideration of the four major investment classes (stocks, bonds, cash, and real estate) and establish allocation guidelines. Investment policies should address the role of alpha (value adding activities) and beta (portfolio management functions), and clearly delineate these functions to enhance the prudence of investment decisions,<sup>31</sup> and reflect the comfort level and expertise of the investment committee members. The investment strategy should be embedded in the plan documents.

**Minimum Reserves:** There are a number of techniques, including the use of excess spreads, loan loss reserves funded by investors and/or community organizations, and cash management accounts, which should be considered when making community investments. Although very few community investments have defaulted, the use of reserves can help offset losses should they occur. Higher risk community investments, including venture capital, small business lending, and some real estate deals should include overcollateralization or other cash-based credit enhancements as a measure of protection against unexpected losses.

**Partnerships:** Community development financial institutions can play an enormous role in expanding the capital marketplace by linking economically disadvantaged people to opportunities that help create assets. The late 1990s demonstrated the significance of forging partnerships between mainstream institutions and community development enterprises. Large, well-established financial institutions benefited from an expanding marketplace, while community development enterprises increased capacity as a result of greater access to capital. It's a win-win scenario.

### **Portfolio Design:**

Modern portfolio theory asserts that every single investment within a portfolio should be viewed within the context of the portfolio, not as independent investments. Well managed portfolios are designed around a host of factors, including general economic conditions (inflation, deflation), tax law, actuarial and liquidity factors, statutory directives, and the prudent investor rule, which among several mandates, calls for

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<sup>31</sup> Cummings, S. Institute for Fiduciary Education. My Big Ideas: Futures Themes and Trends. Market Makers. 2004

mitigating risk through diversification. A well-designed portfolio identifies investment goals and objectives, including the anticipated return of income and capital, as well as the disclosure of reasonable fees associated with managing the portfolio. The Prudent Investor Rule requires that the risk and return objectives of each investment be evaluated in the context of its impact on the overall investment strategy.

Although diversification is expected, there are no regulatory mandates that specify what a portfolio should look like. Plan documents, risk tolerance, and other characteristics unique to shareholder interests make such templates impractical. [Appendix II](#) of this document offers model portfolios.

### **Prudent Man Rule**

In 1974 Congress issued the Employee Retirement Income Securities Act (ERISA) which included (among other dictates) a summary of investment duties and responsibilities. Title 29, Chapter 25, Part 2550, Section 404(a)(1) is commonly referred to as the prudent man standard of care. (b) Investment duties. (1) With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in subsection (a) of this section are satisfied if the fiduciary: (i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (ii) Has acted accordingly. (2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to, (i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan."<sup>32</sup>

**Reporting Requirements:** Institutional investors are required to file reports to shareholders, government agencies, and their contracted partners. Maintaining accurate and timely information is critical to this function. Under ERISA, pension funds are required to file Form 5500 <http://www.irs.gov/instructions/i5500/index.html>.

**Shareholder Advocacy:** Empowering beneficiaries with investment decisions that have collateral benefits is cited throughout investment and government literature as being consistent with best practices for portfolio design. The AFL-CIO includes, for example, language in their guidelines that specifically identifies objectives in generating collateral benefits, most notably in their call for making investments that protect and/or create jobs. Plan participants were instrumental in getting this language adopted. Litigation against trustees or advisors often originates from plan participants citing

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<sup>32</sup> Code of Federal Regulations, Title 29, Volume 9, Revised as of July 1, 1999, U.S. Government Printing Office via GPO Access. P.445-446

breach of fiduciary duties. Keeping shareholders well apprised, soliciting their feedback and publishing the plan document for their review are the best practices trustees and advisors can exercise.

**Training:** Pension fund investors and trustees should be familiar with ERISA legislation, including the *prudent man standard of care*. Investors, trustees and their agents should also be familiar with generally accepted accounting principals (GAAP), as well as local, State and Federal statutes governing investment activities. It is well advised for investment committees, Boards of Trustees and others charged with fiduciary duties to periodically attend conferences, or other educational sessions, to stay apprised of prevailing practices. The Corporate Library <http://www.thecorporatelibrary.com> offers access to a host of educational resources. There are also a number of organizations that offer training on an ongoing basis, including: the George Meany Center for Labor Studies <http://www.georgemeany.org/>, The Center for Working Capital (AFL-CIO) <http://www.centerforworkingcapital.org/>, and the Institute for Fiduciary Education <http://www.ifecorp.com/>. The Department of Labor (Employee Benefits Security Administration) also provides information on prevailing practices [www.dol.gov/ebsa/fiduciaryeducation.html](http://www.dol.gov/ebsa/fiduciaryeducation.html)

**Watch Lists:** Institutional investors should develop and maintain a list of community investments in which irregularities or emerging opportunities can be identified and singled out for their potential value to the institution's investment portfolio.

**Workout Plans:** An investment committee must be prepared to identify poorly performing and at-risk investments, and engage activities that mitigate the risk or terminate the investment. This process should be clearly articulated in the plan document.

## Appendix II - Model Portfolios

### Model Portfolio I

The F.B. Heron Foundation <http://www.fbheron.org> has pioneered mission-related investing by stepping beyond the wall that separated program from investment management. Foundation leadership effectively bridged its dual purposes – its philanthropic mission with its fiduciary duty of asset preservation – to enhance their efficacy as a social change agent.

In 2003, assets held by all US private foundations totaled almost \$500 billion. Less than 6% of this was dispensed as grants, just over the federally mandated minimum of 5%. The balance (corpus) was invested in diversified portfolios across all asset classes, with capital preservation and growth comprising the primary investment objectives.

The Heron Foundation recognized the potential of leveraging their assets under management (\$258 million) toward greater social benefit by constructing a mission-related portfolio. Through staff training, networking, and Board education the Foundation was able to deploy more than 12% of their corpus into mission-related investments. Coupled with the 6.5% invested in program-related investments as well as the 3.3% issued in grants, the Heron Foundation has committed more than 22% of its assets for public benefit.

The shift toward a more mission-centric investment philosophy did not precipitate a change in the way the Board or the Investment Committee viewed their responsibilities as fiduciaries and stewards of the Foundation's assets. Nor did it affect the Foundation's asset allocation: they continue to allocate 65% in equities, 25% in fixed-income, and 10% in alternative assets. The mission related portfolio includes market rate investments in cash (12%), fixed income (60%), and equities (28%). The Foundation realized a total return of 21.07% in 2003, placing it at or above the median for foundations and endowments.

The F.B. Heron Foundation views their early success as promising, although recognizes their pioneering efforts are "a work in progress". Nonetheless, they offer an interesting, if not model portfolio, for other institutional investors seeking to expand their reach toward socially beneficial activities.

## **Model Portfolio II**

The Needmor Fund <http://www.needmorfund.org> is a trust aiming to work with others to bring about social justice. Its mission is to support people who work together to change the social, economic, or political conditions which bar their access to participation in a democratic society. To this end, the Fund has recently engaged a community investment program in which they are making below-market loans to initiatives within disadvantaged communities that generally do not have access to traditional sources of capital. They are currently investigating loan funds and community development credit unions, which provide low-interest loans and technical assistance to help low-income people start their own business, or buy or rehabilitate a home.

Their investment philosophy includes a specific call for making community investments that advance the mission of the foundation. Their investment decisions take into account the impact of corporate behavior, primarily through screening. The policies also identify a host of prohibited investments including those in organizations engaged in predatory lending.

## **Model Portfolio III**

The Jesse Smith Noyes Foundation <http://www.noyes.org/> provides grants for a host of initiatives, including community development organizations. Their interest in sustainable communities is embedded in their statement of investment policies, in which they articulate their mission to address issues of social justice, among other interests.

They apply the underlying principles of their mission to both their grant making and their investment management by employing a mission-related investing policy. The investment policies expressly state, “We believe it is essential to reduce the dissonance between philanthropic mission and endowment management.”

To this end, the foundation invests its endowment assets in organizations that provide commercial solutions to major social and environmental problems, as well as those in which concerns for environmental impact, equity and community are nurtured by the corporate culture.

Foundation assets are diversified by asset class and within each asset class. The endowment is allocated into the following asset classes within the range given: equities (50% - 60%), fixed income (25% - 30%), and alternative investments including venture capital/private equity (5% - 20%) and absolute returns/hedge funds (10% - 20%).

Performance benchmarks include comparison with the peer group universe, as well as market indices. The Foundation cites the blended target peer group (endowments and foundations) universe with 48% equity (10% international, 28% US large Cap, 10% US Small Cap), 25% fixed income, 12% venture capital and 15% hedge funds (US Equity Combined for both).

They use the following market indices for the blended target: 10% MSCI EAFE (Net) Index, 25% S&P 500 Index, 10% Russell 2000 Index, 24% Lehman Bros. Aggregate Bond Index, 1% US 91-Day T-Bills Index, and 27% Wilshire 5000 Index. For the fixed income class only they use 95% Lehman Bros. Aggregate Bond Index and 5% U.S. 91 Day T-Bills Index. Domestic Equity holdings are measured against the Domini Social Index, Russell 1000 Growth Index, and the Russell 2000 Index. International Equities are measured against the MSCI EAFE (Net) Index, while the Alternative Investments use a blended hedge fund index, including 52% that are HFR Market Neutral Driven, 32% HFR Event-Driven Index, and 16% Ibbotson Small Cap Index.

## **APPENDIX III - CASES**

### **Case I**

#### **Market Creek Plaza**

The Jacobs Center for Neighborhood Innovation (JCNI) <http://www.jacobscenter.org/> received a \$15 million dollar permanent loan from the Clearinghouse CDFI <http://www.clearinghousecdfi.com/> to fund the new Market Creek Plaza shopping center in the Lincoln Park area of San Diego. Wells Fargo Bank <http://www.wellsfargo.com/> was the tax credit investor and will open a branch at the Plaza. The project was conceived, designed, built, and will eventually be partially owned by over 2,000 local neighborhood residents. Market Creek Plaza is a 20-acre commercial and cultural center that will serve 88,000 residents in ten surrounding neighborhoods. The Market Creek Plaza Project is already revitalizing the neighborhoods surrounding the project.

## **Case II**

### **First Security Building – Salt Lake City**

Salt Lake City sustained the revitalization of a 12-story historic steel and glass office tower, the First Security Building, through a \$21 million financing package that included a \$13 million construction/permanent loan, some developer equity, and a \$2.8 million historic and New Markets Tax Credit equity investment. The construction loan and tax credit equity is being provided by Bank of America <http://www.bankofamerica.com/>. Debt financing is from Commercial Real Estate Lending Group of Las Vegas, NV. The Fund is being managed by the National Trust Community Investment Corp. <http://www.nationaltrust.org/>

## **Case III**

### **The Portland Armory**

The Portland Armory is among Portland, Oregon's finest 19<sup>th</sup> century buildings. Originally constructed in the 1890's, the building fell into disrepair and required significant work. The US Bancorp Community Development Bank in St. Louis invested in the project, using New Markets Tax Credits with Historic Rehabilitation Tax Credits, and Business Energy Tax Credits. The Portland Family of Funds <http://www.portlandfunds.com> structured the deal, which will yield 300 new jobs, a payroll of \$11 million, and the addition of \$9 million of new equity into Portland's economy.

## **Case IV**

### **Westchester County – Variable Rate Demand Notes**

The County of Westchester, New York issued industrial development bonds to renovate the Levister Towers <http://www.westchestergov.com>, a Section 8 and low income housing tax credit project. The bonds were used for acquisition and construction, and were structured as a tax-exempt variable rate demand note (VRDN) with a maturity of August 2033. The security is rated Aa2/VMIG1 with a letter of credit provided by the Bank of New York <http://www.bankofny.com/>.

## **Case V**

### **Tender Care Learning Center**

Annie Hall received a loan from Self-Help <http://www.self-help.org/> to fund a daycare center in Durham, North Carolina. Within three months of receiving the loan, Hall transformed the health hazard into a beautiful house. This house is now the location of the Tender Care Learning Center, which provides daycare for about 20 children, some

whom have special needs or come from low-income and “high-risk” households. Hall plans to continue her services, with the goal of opening a 65-child facility in the area.<sup>33</sup>

## **Case VI New Forest Vegetable Project**

In the rural northern province of Limpopo, South Africa, 16 women received a loan guarantee from Shared Interest [www.sharedinterest.org](http://www.sharedinterest.org) to start their own commercial farming project. A local community development institution called the Bushbuckridge Local Business Service Center (BLBSC) secured a commercial bank loan for the women in combination with an international guarantee fund established by Shared Interest. Shared Interest helped BLBSC provide a \$709,000 loan, which enabled the women to begin the New Forest Vegetable Project. The project was instantly successful, and the women now each own a greenhouse and employ four other women, so that 80 women are earning a living from the project, which will benefit the entire community.<sup>34</sup>

## **APPENDIX IV - Links**

The following list of internet addresses is inclusive, not exhaustive, and does not reflect an endorsement of products that may be associated with a particular link. The list offers institutional investors quick access to resources regarding community investments.

American Enterprise Institute: [www.aei.org](http://www.aei.org)

Article: Socially Responsible Investing & Pension Funds:

<http://www.aei.org/events/filter.all,eventID.832/summary.asp>

American Federation of State, County and Municipal Employees, AFL-CIO:

[www.afscme.org](http://www.afscme.org)

Financial Standards Codes, Article 2 Custody of Funds

<http://www.afscme.org/about/afsc03.htm>

Aspen Institute, The: <http://www.aspeninstitute.org>

Economic Opportunities Program

<http://www.aspeninstitute.org/Programt1.asp?i=66>

Best Practices: <http://www.bestpractices.org/>

searchable database with over 2150 proven solutions from more than 140 countries to the common social, economic and environmental problems of an urbanizing world

Brookings Institute: [www.brookings.edu](http://www.brookings.edu)

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<sup>33</sup> Rysavy, Tracy Fernandez. “Community Investing at Work.” *Investing in Communities*, a publication of the Social Investment Forum Foundation and Co-op America. Fall 2002. P. 2-4.

<sup>34</sup> Strohm, Chris. “Shared Interest’s Community Development Fund.” *Investing in Communities*, a publication of the Social Investment Forum Foundation and Co-op America. Fall 2002. P. 8-10.

Article: Bringing Unbanked Households into the Banking System

<http://www.brookings.edu/es/urban/capitalxchange/article10.htm>

Article: New York City Investment Fund: An Emerging Model for Corporate Engagement in Urban Development

<http://www.brookings.edu/es/urban/capitalxchange/article7.htm>

Also see Capital Xchange below.

Business for Social Responsibility: [www.bsr.org](http://www.bsr.org)

is a global organization that helps member companies achieve success in ways that respect ethical values, people, communities and the environment.

Calvert Social Investment Foundation: <http://www.calvertfoundation.org/>

Institutional Investors: [www.calvertfoundation.org/institution/index.html](http://www.calvertfoundation.org/institution/index.html)

Capital Xchange (Brookings Institute): [www.brookings.edu/es/urban/capitalxchange.htm](http://www.brookings.edu/es/urban/capitalxchange.htm)

A journal about transforming markets and transforming places.

Center for Working Capital (AFL-CIO): <http://www.centerforworkingcapital.org/>

CEOs for Cities: <http://www.ceosforcities.org/>

Community Development Financial Institutions Fund (CDFI Fund): See U.S. Department of Treasury

<http://cdfifund.gov>

Community Development Venture Capital Alliance: [www.cdvca.org](http://www.cdvca.org)

Article: Community Reinvestment Act

<http://www.cdvca.org/index.cfm?fuseaction=Page.viewPage&pageID=304>

Community Development Banking List, The: Blogs, Message Board & Listserv

<http://www.lightlink.com/cdb-l>

Community Reinvestment Fund: <http://www.crfusa.com/>

Corporate Library, The: <http://www.thecorporatelibrary.com/>

An independent research firm providing corporate governance data, analysis, and risk assessment tools.

Corporation for Economic Development: <http://www.cfed.org/>

CFED is a nonprofit, nonpartisan organization that works to expand economic opportunity

Corporate Social Responsibility Newswire Service: <http://www.csrwire.com/>

CRA Fund Advisors, Inc.: <http://www.crafund.com/>

Domini Social Investments LLC: <http://www.domini.com/community-investing/index.htm>

Economic Policy Institute: <http://www.epinet.org/>

The Economic Policy Institute is a nonprofit, nonpartisan think tank that seeks to broaden the public debate about strategies to achieve a prosperous and fair economy

Employee Benefit Research Institute: <http://www.ebri.org/>

Employee Retirement Income Security Act (ERISA):  
[www.dol.gov/ebsa/programs\\_initiatives.html](http://www.dol.gov/ebsa/programs_initiatives.html); Also see U.S. Treasury below

Enterprise Foundation, The: <http://www.enterprisefoundation.org/>  
Enterprise has raised more than \$5 billion in 22 years, investing in communities nationwide

Equity Trust, Inc.: <http://www.equitytrust.org/index.html>  
Promotes equity in the world by changing the way people think about and hold property

Fannie Mae Foundation: <http://www.fanniemaefoundation.org/>

Federal Deposit Insurance Corporation: <http://www.fdic.gov/>

Federal Financial Institutions Examination Council (FFIEC):  
<http://www.ffiec.gov/default.htm>  
Community Reinvestment Act: <http://www.ffiec.gov/cra/>  
UPREIT Interpretive Letter: [http://www.ffiec.gov/cra/letters/letter\\_19961223.htm](http://www.ffiec.gov/cra/letters/letter_19961223.htm)

Federal Reserve Board: <http://www.federalreserve.gov/>  
Directory of Community Development Investments:  
<http://www.federalreserve.gov/DCCA/Directory/>  
Community Reinvestment Act Performance Ratings:  
<http://www.federalreserve.gov/dcca/cra/crate.cfm>

Federal Reserve Bank of Chicago: [www.chicagofed.org](http://www.chicagofed.org)  
Article: Community Development Venture Capital by Julia Sass Rubin  
[http://www.chicagofed.org/cedric/files/cfmacd\\_rubin.pdf](http://www.chicagofed.org/cedric/files/cfmacd_rubin.pdf)

Federal Reserve Bank of San Francisco: [www.frbsf.org](http://www.frbsf.org)  
Article: New Markets Tax Investment Credit Deals  
<http://www.frbsf.org/publications/community/investments/0409/newmarket.html>

Financial Innovations Roundtable (FINIR): <http://www.finir.org/>

Government Accountability Office (GAO):  
1995 Evaluation of ETI (Economically Targeted Investments):  
<http://161.203.16.4/t2pbat1/154006.pdf>  
2004 New Market Tax Credit Program: Implementation & Monitoring Brief  
<http://www.gao.gov/htext/d04326.html>

Heartland Labor Capital Network, The: [www.heartlandnetwork.org/index2.htm](http://www.heartlandnetwork.org/index2.htm)  
Conference Proceedings: <http://www.heartlandnetwork.org/conference.htm>

Interfaith Center on Corporate Responsibility (ICCR): <http://www.iccr.org>  
Aims to expand access to capital and credit to underserved communities, domestically and globally, among other goals.

Internal Revenue Service (U.S.): [www.irs.gov](http://www.irs.gov)  
Form 5500: <http://www.irs.gov/instructions/i5500/index.html>  
Pension Funding Equity Act of 2004:  
<http://www.irs.gov/retirement/article/0,,id=129503,00.html>  
New Markets Tax Credit: [http://www.irs.gov/irb/2003-41\\_IRB/ar12.html](http://www.irs.gov/irb/2003-41_IRB/ar12.html)  
Publication 954: Community Development:  
<http://www.irs.gov/publications/p954/ar02.html#d0e2654>

Investors' Circle: <http://www.investorscircle.net>  
Network: <http://www.investorscircle.net/network.html>

KLD Research & Analytics, Inc. (Social Investment Solutions):  
<http://www.kld.com/resources/legal.html#top>

Local Initiatives Support Corporation (LISC): <http://www.lisc.org/>

MicroFinance Network: <http://www.mfnetwork.org/>  
A global association of leading microfinance institutions committed to improving the quality of life of the poor through the provision of credit, savings, and other financial services

National Community Development Center (NCDC): <http://www.ncdaonline.org/>

National Community Investment Fund: <http://www.ncif.org/>  
Aims to increase the number and capacity of domestic, insured, depository institutions that are both effective agents of local community development and sound financial institutions

National Community Reinvestment Coalition: <http://www.ncrc.org/>

National Credit Union Administration: <http://www.ncua.gov/>  
Share Insurance: <http://www.ncua.gov/ShareInsurance/>

National Federation of Community Development Credit Unions: <http://www.natfed.org>

National Trust For Historic Preservation, Main Street: <http://www.mainstreet.org/>  
A pioneering Main Street approach to commercial district revitalization

Neighborhood Housing Services of America (NHSA): <http://www.nhsofamerica.org/>  
Provides a secondary market for NeighborWorks<sup>®</sup> organizations.

Neighborhood Reinvestment Corporation (NRC): [www.nw.org](http://www.nw.org)  
Social Investor Information:  
<http://www.nw.org/network/aboutus/partnerships/social.asp>

NeighborWorks (NW): <http://www.nw.org/network/home.asp>

Novogradac & Company LLP (Affordable Housing Resource Center):  
<http://www.novoco.com/resource.shtml>

Opportunity Finance Network (formerly National Community Capital Association):  
<http://www.communitycapital.org/>

A network of more than 160 private-sector community development financial institutions (CDFIs) that provides financing, training, consulting, and advocacy for CDFIs.

Roberts Enterprise Development Fund (REDF): <http://www.redf.org/>  
Social Return on Investment Excel Model:  
<http://www.redf.org/download/sroi/SROIExcelModel.xls>  
Social Return on Investments Publications:  
<http://www.redf.org/publications-sroi.htm#excel>

Self-Help: <http://www.self-help.org/>  
Self Help Secondary Market Information:  
<http://www.self-help.org/secondarymarket/lenderinfo.asp>

Small Business Administration:  
SBA 504 Loan Program:  
<http://www.sbaonline.sba.gov/financing/sbaloan/cdc504.html>  
SBA 7(a) Loans: <http://www.sbaonline.sba.gov/financing/sbaloan/7a.html>  
List of SBICs:  
<http://www.sba.gov/gopher/Local-Information/Small-Business-Investment-Companies/>  
Model Debenture agreement of limited partnership  
[www.sba.gov/INV/modeldebenture.doc](http://www.sba.gov/INV/modeldebenture.doc)

Social Funds: [www.socialfunds.com](http://www.socialfunds.com)  
Community Investing: [www.socialfunds.com/news/articles2.cgi?categoryid=4](http://www.socialfunds.com/news/articles2.cgi?categoryid=4)

Social Science Research Network (SSRN): Financial Economics Network  
<http://www.ssrn.com/fen/index.html> (perform search "community investments" for list of relevant articles.

State of Connecticut, Office of the State Treasurer: [www.state.ct.us/ott](http://www.state.ct.us/ott)  
Annual Report (2003): <http://www.state.ct.us/ott/publications/Annual2003.pdf>

Trillium Asset Management Corp. (aka Franklin Research & Development):  
<http://www.trilliuminvest.com>

Unitarian Universalist Association: <http://www.uua.org/finance/invguide.html#c>  
Offers a good example of comprehensive investment policies and guidelines.

U.S. Census Bureau: <http://www.census.gov>

Economic Statistics: <http://www.census.gov/econ/www/>

U.S. Department of Commerce – Bureau of Economic Analysis:

<http://www.bea.doc.gov/>

Stat – USA: <http://www.stat-usa.gov/> (Free log-in required)

U.S. Department of Housing and Urban Development (HUD): <http://www.hud.gov/>

U.S. Department of Labor, Employee Benefits Security Administration:

[www.dol.gov/ebsa](http://www.dol.gov/ebsa)

Publications: <http://www.dol.gov/ebsa/publications/>

ERISA Enforcement: [http://www.dol.gov/ebsa/erisa\\_enforcement.html](http://www.dol.gov/ebsa/erisa_enforcement.html)

Fiduciary Responsibilities: <http://www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf>

Filing ERISA Form 5500: A Troubleshooters Guide:

<http://www.dol.gov/ebsa/pdf/troubleshootersguide.pdf>

Code of Federal Regulations (pertaining to 29CFR 25 - Labor):

[http://www.dol.gov/dol/allcfr/Title\\_29/Chapter\\_XXV.htm](http://www.dol.gov/dol/allcfr/Title_29/Chapter_XXV.htm)

Interpretive Bulletins:

[http://www.access.gpo.gov/nara/cfr/waisidx\\_00/29cfr2509\\_00.html](http://www.access.gpo.gov/nara/cfr/waisidx_00/29cfr2509_00.html)

Report to Congress 1998:

<http://www.dol.gov/ebsa/PDF/artc98.PDF>

U.S. Department of the Treasury, Office of the Comptroller of the Currency:

[www.occ.treas.gov](http://www.occ.treas.gov)

Community Reinvestment Act: [www.occ.treas.gov/crainfo.htm](http://www.occ.treas.gov/crainfo.htm)

Community Reinvestment Act [12 CFR Part 25] (Implementing Regulation):

[www.occ.treas.gov/fr/cfrparts/12CFR25.htm](http://www.occ.treas.gov/fr/cfrparts/12CFR25.htm)

Community Development Financial Institutions: <http://cdfifund.gov>

Certified Organizations as of March 2005:

<http://cdfifund.gov/docs/certification/cdfi/CDFI-type.pdf>

U.S. Government Printing Office: Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974:

[http://www.access.gpo.gov/nara/cfr/waisidx\\_04/29cfr2509\\_04.html](http://www.access.gpo.gov/nara/cfr/waisidx_04/29cfr2509_04.html)

Economic Indicators:

<http://www.gpoaccess.gov/indicators/>

29CFR25:2550 – Rules & Regulations Fiduciary Responsibility:

[http://www.access.gpo.gov/nara/cfr/waisidx\\_99/29cfr2550\\_99.html](http://www.access.gpo.gov/nara/cfr/waisidx_99/29cfr2550_99.html)

Wall Street Without Walls: [www.wallstreetwithoutwalls.com/](http://www.wallstreetwithoutwalls.com/)