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Memo: Legal Structures for Investment Cooperatives in Illinois

The purpose of this memo is to empower Illinois residents to organize investment cooperatives.

What is an investment cooperative? Broadly, it is any organization that raises investments from members and then uses that capital to invest in the community. In a cooperative, membership is open to anyone who has the ability to participate. All members participate in governance and have an equal vote. Organizing as a cooperative makes sense if the goals include community ownership and control. An investment club where each member has one vote could be considered a small investment cooperative.

Investment cooperatives are being used around North America to carry out community development missions, as well as to produce investment income for their members. Here are some real life examples. **Real Estate**: One example is NorthEast Investment Cooperative, "NEIC," in Minneapolis. This co-op purchases commercial real estate, rehabs it, and then leases it to local businesses. To date, NEIC has turned one vacant storefront into a thriving commercial space with a bakery and brewery, and NEIC has a second property available for lease.[1] **Food**: La Mantañita Co-op, a food co-op in Albequerque, New Mexico, raised additional capital from members in order to make loans to food producers.[2] **Housing**: Part of Ujamaa Community Land Trust's mission is to provide stable, affordable housing in Chicago's Englewood neighborhood.[3] (Ujamaa Community Land Trust is a charitable non-profit that is governed cooperatively, so, not quite an investment co-op.)

Why investment **cooperatives**? Investment cooperatives are structurally better for the community than conventional investment mechanisms and the conventional real estate development process, for two reasons. First, because of their governance structure, and because they are usually organized to further a mission, cooperatives tend to make decisions that are meant to benefit the whole community. Second, they create opportunities for people to invest locally, and this spreads the investment income through the community, rather than directing income towards those who already have the most capital. The more capital is provided by co-ops, the more community wealth can grow.

Getting Started. When a group gets together to start organizing an investment cooperative, one of the questions they will have to answer is, what will the co-op's legal structure be? What entity or entities will we form? This memo attempts to serve as a decision guide, to help frame the conversation. Part one addresses the legal entities, and how to choose one. Part two addresses how to avoid being subject to heavy regulation under the Investment Company Act of 1940.[4]

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[1] http://www.neic.coop/ (accessed November, 2016).
[2] See https://marcclifton.wordpress.com/2012/11/15/social-finance-2/; and Michael H. Shuman, "24 Top Tools for Local Investing" (May 2012), available at http://michaelhshuman.com/wp-content/uploads/2013/12/Top-Tools-2.0.pdf
[3] *See* http://ujamaaclt.com/ (accessed November, 2016).
[4] 15 U.S.C. §§ 80a-1 to 80a-64.

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Legal Entities, Compared

What would a good legal entity provide?

- Members need to be able to buy in.
- Ideally the entity's governing statute would require one vote per member, or provide a strong enforcement mechanism for a co-op that has chosen to put that voting system in place.
- Minimize the tax burden for the co-op and for the members.
- Minimize complexity of preparing tax returns.
- Minimize administrative requirements where possible.
- Choose a user-friendly path where possible to avoid complexity and legal fees.
- Bonus: a great securities law exemption that would allow the co-op to sell shares to the public.

Cooperative Corporation

A cooperative corporation is formed under Illinois' Co-operative Act, 805 ILCS 310/1 to 27. A cooperative corporation has stock and a board of directors.

Forming an investment cooperative under this law is possible. One of the purposes for which a cooperative corporation may be formed is "for the operating of a business by [the] shareholders." The term "business" is broad enough to include real estate development or other kinds of investing. Real estate developers and investment firms are considered to be in business. An investment cooperative should be considered a "business," and therefore a cooperative corporation may be formed this purpose.

Summary of Pros and Cons:
The main benefit of organizing as a cooperative *would be* to take advantage of the exemption for co-op stock in Illinois securities law that allows most co-ops to sell membership shares to the public. However, this exemption is *not* available for investment cooperatives. Worse, the Co-operative Act limits how much money any member can invest in the co-op: a cooperative corporation can sell no more than $10,000 worth of stock to each member. To accept additional investments from members, the co-op would have to take loans (debt). Organizing as a cooperative would allow the co-op to use the word "cooperative" in its name, but this seems to be the only advantage.

Benefits of a Cooperative Corporation:

The Co-operative Act supports a cooperative structure by requiring dispersed ownership.
The Co-operative Act provides that no person may own more than 10 shares of the co-op's stock.[5] The more shares a co-op sells, the more dispersed the ownership of the co-op will be.

The Co-operative Act allows but does not require one vote per member.
The Co-operative Act does not require one vote for each share of common stock. This means that a co-op can provide in its bylaws that each member has one and only one vote, no matter how many shares of stock each member holds. One member = one vote is not required, however.

A business must comply with the Co-operative Act to use the word "Cooperative" in its name.
Only an organization that complies with the Co-operative Act may use the word "cooperative" in its business name.[6] Using the word "cooperative" in the investment co-op's name would be an advantage. An investment cooperative is not a well-known concept in the U.S., and a new investment co-op will have a lot of education to do. Using the word "cooperative" in its name would help it to communicate quickly about the group's goals, and that this particular group of investors is democratic and community-based.

Note: If another entity has no member who owns more than 10 shares or $10,000 in equity, it can "comply" with the Co-operative Act, and therefore can legally use the word "cooperative" in its name. See below, page 6.

The Co-operative Act provides a structure for sharing income on the basis of patronage.
In general, cooperatives share most or all of their net income on the basis of "patronage." "Patronage" generally means the business done with the co-op by its members. For example, in a food co-op, patronage means the members' purchases. In a worker cooperative, patronage means the members' labor, and could be measured in hours. Splitting net income on the basis of patronage means that members share income in proportion to their participation, not their investment or a set ownership percentage. Sharing most or all income on the basis of patronage is a key aspect of operating as a cooperative.

The Co-operative Act allows the cooperative corporation's bylaws to provide that profits will be distributed first as dividends on stock and then on the basis of patronage, or just on the basis of

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[5] 805 ILCS 310/2 and 310/9.
[6] 805 ILCS 310/22.

patronage, and the statute requires that profits be split as provided in the bylaws.[7] In general, this helps co-ops by requiring that profits be split on the basis of patronage if the bylaws so provide, and by making clear that profits are not required to be shared purely in proportion to number of shares owned.

However, proceeds from investments would likely be split on the basis of amounts invested, so an investment co-op would not need the statutory structure.
In an investment cooperative, the business done with the co-op would be investment. Returns on investment would tend to be allocated according to the terms of the investment, and in proportion to the amount invested. For example, if members loaned money to the co-op at the same interest rate, returns would be in proportion to amounts loaned. If members bought shares of stock of the same class (which would have the same dividend), then members would receive returns in proportion to the number of shares purchased. Members will have to figure out whether and how to compensate individuals who do the co-op's administrative work and other work, such as researching potential investments; but if most of the members' business with the co-op is investment, then an investment co-op does not need a statute to provide that income may be split on the basis of patronage, because it naturally would share income in proportion to members' investments.

Limitations of a Cooperative Corporation

Limit of no more than $10,000 in stock per person
No one may invest more than $10,000 in the co-op's stock.[8] This could limit the amount of money that a co-op could raise.

Statutory limit on how much of a cooperative corporation's assets can be invested. A cooperative corporation may invest no more than 25% of its proceeds from sale of common stock and its reserve fund in the stock of another corporation. This could limit the investments that an investment cooperative could make. If a co-op's mission were to invest in local businesses, this would limit the co-op's effectiveness because the Co-operative Act would only allow it to invest 25% of the money it raises.

Tax: Cooperative corporations are taxed as corporations, and investment proceeds can't be subtracted from the co-op's taxable income as patronage dividends. In general, cooperative corporations have access to more favorable tax treatment than non-cooperative corporations. Under Subchapter T of the Internal Revenue Code,[9] cooperatives are not taxed on income passed through to members as "patronage dividends." This way, co-ops can enjoy single-level taxation on most or all of their income, if they mostly do business with their own members (techically, "patrons").

Under Subchapter T, dividends on stock are not deductible from the co-op's taxable income. For this reason, I believe that investment income could not be characterized as patronage-based income. Subchapter T would not benefit a co-op whose sole activity was investing; it would be taxed just like a C-corp, a general corporation.

BUT a cooperative corporation could reduce or eliminate its corporate tax by being a Real Estate Investment Trust. Please see the discussion of Real Estate Investment Trusts below.

Securities Law: Many cooperatives can sell stock to the public under Illinois law, but that exemption would not be available to real estate or other investment cooperatives.

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[7] 805 ILCS 310/19, 310/15.
[8] *See* 805 ILCS 310/2.
[9] 26 U.S.C. §§ 1381 to 1388.

The biggest benefit to organizing as a cooperative corporation would be the securities law exemption, if it were available. In general, one may not offer or sell unregistered securities to the public. Registration is an expensive and time-consuming process, so finding an exemption is valuable. Most small businesses that raise funds from investors use one or more exemptions.

Illinois securities law exempts "Any offer, sale or issuance of securities for patronage, or as patronage refunds … by cooperative associations organized exclusively for agricultural, producer, marketing, purchasing, or consumer purposes; and the sale of subscriptions for or shares of stock of cooperative associations organized exclusively for agricultural, producer, marketing, purchasing, or consumer purposes," if there are no commissions and if no one owns more than 5% of the co-op's issued stock.[10]

A cooperative that is formed to invest in real estate or small businesses would not be organized exclusively for agricultural, producer, marketing, or consumer purposes. An argument could be made that it is organized for "purchasing" purposes, because it is purchasing real estate or securities (investments). However, this argument seems like a stretch. It appears that the statute was intended to include co-ops that purchase supplies, equipment, or consumer goods, for the co-op members' use. Purchasing real estate in order to develop it and lease it out, or purchasing shares of small businesses in order to support those businesses, seems too different from the intended meaning of this exemption. I would not recommend relying on this exemption to sell investment co-op shares to the public.

General Business Corporation

A business corporation could be used to organize an investment cooperative. Here's how it could work:

A Business Corporation could require One Member = One Vote. Here's How:
The Business Corporation Act of 1983 requires one vote per share of stock,[11] except that the Articles of Incorporation may limit or deny voting rights or may provide special voting rights to any class or series of shares.[12] A corporation could be structured to be democratically governed by all of its members on the basis of one vote per member, like this: the Articles of Incorporation would provide for common stock with the right to vote, and would require that each shareholder who wishes to be a voting member and is admitted to membership purchase one and only one share of common stock. The Articles would provide that the corporation could sell no more than one share of common stock to any person, and that any attempted transfer of more than one share of common stock to any one person would be void.

The Articles would also provide for other classes of stock to be sold to investors (who could be members or others, potentially). The investment stock would be non-voting, or would have appropriate, minimal voting rights, such as the right to vote on a proposed dissolution of the corporation. The Articles could also provide that a specific vote is required to change the provisions discussed above, such as a 2/3 or even a unanimous vote of the holders of common stock. This could provide both a democratic governance structure and strong protection of that structure.

Benefits of a General Business Corporation

Shares may be a little bit easier than "Membership Units" to authorize, issue, and sell to members. The unit of ownership of a corporations is a share of stock. The idea of shares of stock in a corporation is well known. Also, the Business Corporation Act is a statutory framework that allows issuing different classes

[10] 815 ILCS 5/4(K).
[11] 805 ILCS 5/7.40(a).
[12] 805 ILCS 5/6.05, 5/7.40(b).

of stock with different attributes, such as different dividend rates and different voting rights. Organizing documents for corporations with multiple classes of stock have provisions that are somewhat standard and familiar to corporate attorneys (for example, the concept of "common" and "preferred" stock). The invitation to purchase shares of a corporation would be a bit easier to explain to potential members and thus easier to sell. Organizing the corporation and its classes of shares could be easier and could involve lower legal fees, compared with creating a complex limited liability company (LLC).

Corporations may be organized for any lawful purpose and have broad powers. A business corporation can be organized for any lawful purpose (other than banking or insurance); so there is nothing keeping it from being used for cooperative purposes.

A corporation is not limited in how much stock it can sell to any one person, so, unlike an Illinois cooperative corporation, a business corporation could raise more than $10,000 from any of its members.

A business corporation could by managed directly by shareholders, rather than a board.
A Close Corporation is one that has adopted one or more of the restrictions on transfer in Section 6.55 of the Act, 805 ILCS 5/6.55. Two of these restrictions that might be appropriate for an investment cooperative would be the obligation to offer shares to the corporation or other shareholders before offering shares to a third party, and the requirement that the corporation or the holders of a certain class of stock consent to a proposed sale of stock to a third party. An investment cooperative might want these restrictions. If an investment co-op would like to manage itself directly by its shareholders, rather than having a separate board, it may adopt one or more restrictions on transfer of its stock, and elect to be a Close Corporation.

Use of the name "Cooperative."
An entity doing business in Illinois can use the word "cooperative" in its business name if it "complies" with the Co-operative Act.[13] To comply with the Co-operative Act, one must do all of the following:

- have a board of at least 5 directors, who must be shareholders;
- have certain officers: a president, one or more vice-presidents, a secretary and a treasurer (or one combined secretary-treasurer position), plus a manager who is an officer but not a director, and is under the control of the directors;
- set the par value of stock at least $5 and no more than $1,000 per share;
- not issue stock except at its par value;
- make sure that no shareholder holds more than 10 shares nor more than $10,000 in total;
- make sure that any assignment or transfer of stock from a shareholder to a new shareholder must be approved by a majority of the directors;[14]
- require stock to be paid for within one year of purchase;
- have bylaws that provide for profits to be allocated either based on stock ownership and then on the basis of patronage, or just on the basis of patronage;
- distribute as much of the co-op's earnings as "seem best" to the directors (which could be $0 if all net income is needed for reserve) at least once every 12 months; and
- If buying stock in another corporation, invest no more than 25% of paid-up capital and reserves.

[13] 805 ILCS 310/22.
[14] 805 ILCS 310/23.

The limit of $10,000 per investor is the one rule of the Co-operative Act that an investment co-op might decide to break in order better to fulfill its mission. But if that is not an issue, then an investment co-op could organize under the Business Corporation Act, comply with the Co-operative Act, and legally use the word "Cooperative" in its business name. The choice of general business corporation versus cooperative corporation would make little to no difference in the daily functioning of the co-op.

A Corporation Can be a Benefit Corporation. If a co-op determines that the value of being a benefit corporation is greater than the cost of doing the required yearly evaluation, a co-op organizing as a corporation can elect to be a Benefit Corporation by adding a provision to its Articles of Incorporation, specifying that it will be a benefit corporation.[15]

Limitations of a General Business Corporation

Tax: Corporate profit is taxed twice by the time it reaches a shareholder. If a standard corporation is formed, and if no special tax election is made, the corporation will be a "C corporation," that is, taxed under Subchapter C of the Internal Revenue Code.[16] C corporations pay tax on their net income at the corporate rate, which is graduated and ranges from 15% to 35%. Corporations generally pay profits to shareholders in the form of dividends on stock, and those dividends are then the taxable income of the shareholders. This means that the corporation's profits are taxed twice by the time shareholders have paid their income taxes.

Any business that is taxed as a corporation and meets the IRS's definition of "operating on a cooperative basis" can take advantage of single-level or "pass-through" tax treatment for net income that comes from business with patrons.[17] If the co-op passes that net income through to members on the basis of each member's relative patronage (the value or quantity of business each member does with the co-op), and makes sure to meet a few other requirements, then the money allocated to members can be subtracted from the co-op's taxable income. This means that net income from patronage that is passed through to members is only taxed once.

However, dividends on stock are not deductible from the co-op's taxable income. For this reason, I believe that investment income could not be characterized as patronage-based income. Subchapter T of the Internal Revenue Code would not benefit a co-op whose sole activity was investing; it would be taxed just like a C-corp, a general corporation.

However, real estate investment co-ops could avoid corporate tax by being a Real Estate investment Trust (a REIT). Subchapter M of the Tax Code provides a tax advantage for entities that invest in real estate and return at least 90% of its taxable income as dividends to its shareholders. A REIT can deduct those dividends from its own taxable income. This means that the dividends received by shareholders are taxed only once. In order to qualify, the REIT must meet these requirements:

- Be an entity that would be taxable as a corporation but for its REIT status;
- Be managed by a board of directors or trustees;
- Have shares that are fully transferable;
- Have a minimum of 100 shareholders after its first year as a REIT;
- No group of 5 shareholders can own more than 50% of the REIT's shares,
- No group of 5 shareholders may own more than 50% of the REIT's shares;
- Invest at least 75 percent of its total assets in real estate assets and cash;

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15 805 ILCS 40/2.01.

16 26 U.S.C. §§ 301 to 391.

17 26 U.S.C. §§ 1381, 1382.

- Derive at least 75 percent of its gross income from real estate related sources, including rents from real property and interest on mortgages financing real property;
- Derive at least 95 percent of its gross income from such real estate sources and dividends or interest from any source; and
- Have no more than 25 percent of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.

My conclusion about tax is that organizing as a corporation means the co-op would get the benefit of shares and a standardized structure, but would end up paying more tax and taking home less of the investment income. However, if the co-op can qualify as a REIT, one of those elections could remove most or all of the co-op's tax liability.

Limited Liability Company

A limited liability company (LLC) could be used to organize an investment cooperative. Here's how.

LLCs govern their internal affairs using an operating agreement. Cooperatives organized as LLCs adopt an operating agreement that provides for one vote per member. Also, one vote per member is the default rule in the Limited Liability Company Act.[18]

A member generally invests in an LLC by making a capital contribution (which can be cash, property, or services, or the promise of any of those). For an investment cooperative, members could make an initial capital contribution of the amount of their initial investment, and they could keep adding capital contributions if they wish to invest more. The LLC's operating agreement would need to tell members exactly how to determine how much of the LLC's income goes to each member.

LLC's often divide their ownership interest into "membership units." Membership units can be sold to new members like shares of stock. The operating agreement describes the attributes of membership units. In this way, LLCs can imitate corporations and create equity units with a set cost, "dividend" rate, and liquidation preference.

Benefits of an LLC

Co-op Friendly Governance: one member, one vote is normal for LLCs. An investment cooperative organized as an LLC will want to provide in its operating agreement that each member has one vote (or that decisions require the consent of all members). This is not out of the ordinary for LLC's; it is the default under the Limited Liability Company Act.

(The operating agreement should also provide for any special decision-making power, such as decisions that affect the rights of members with a certain class of investments might need to be approved separately by that class.)

Flexibility could be a benefit. An LLC has the freedom to create classes of members and classes of "membership units" with customized rights and duties, by describing each class of members or units in its operating agreement. Some co-ops may want to take advantage of this flexibility.

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[18] 805 ILCS 180/1-1 to 180/60-1

LLCs don't pay their own taxes. Instead, they allocate all items of income and loss to the members. This is both a benefit and a limitation. The benefit is that there is never a corporate income tax in addition to the members' individual income tax on the company's net income (unless the LLC chooses to be taxed as a corporation!). So if a member's investment produces dividends, those dividends will be greater, because the entity did not pay tax on them first. The other benefit is that if the LLC has losses, the members will be able to subtract those losses from their taxable income in some cases.

In an LLC, all items of income and loss must be allocated to the members, even if they are not paid out. This can produce some unwanted consequences. Complexity: allocation is relatively simple if each member has a percentage of all income and loss. Cooperatives with many members may want to avoid any other method of calculating member's shares of income and loss that would require significant work by an accountant. "Phantom income:" A co-op may decide to keep its investment income and use it to make more investments, rather than paying it out to members. The investment income will be allocated to members, and members will owe tax on it. Folks tend not to like having to dig into their pockets to pay taxes on money they did not receive; LLCs often try to distribute enough cash to cover the tax liability of members, but this takes some work and planning. Phantom income is a challenge of LLCs that does not affect corporations.

Limitation of an LLC

An investment co-op LLC will have to sell LLC "units," not shares of stock. Equity in an LLC can be expressed as a percentage of the total, or it can be divided into "units." Units can act like shares of stock. Membership units are described by the LLCs operating agreement, which sets out the cost, right to income, liquidation preference, and voting rights associated with each type of unit. The drawback of LLC membership units is that they are not as well known as shares of corporate stock. The co-op's organizers would have to work harder to explain what they are offering, which could make the units less appealing. An experienced business lawyer would be able to help the co-op create and describe LLC units. But offering shares may seem simpler and more straightforward and could make it easier for the co-op to raise money.

Taxes. LLCs are taxed as partnerships, which pass all items of income and loss through to their members. This could be both a benefit and a limitation. The main limitation is that if the LLC does not distribute all of its income, members will owe tax on income they did not receive. Please see above for a full discussion.

Decisionmaking Guide:

There is not one entity that is always right for investment cooperatives. A cooperative corporation, general business corporation, or LLC could be the best choice, depending on the circumstances. The questions below are meant to help groups determine which entity would be right for them. It can be very helpful to have a lawyer make a recommendation after learning about all of your circumstances, so I recommend writing down your answers and taking them to your lawyer before you make a decision.

How many members do you foresee having in the near future?

> Many members (e.g. hundreds) indicates corporation. That is mostly to avoid the learning curve of how to organize an LLC and keep its organization simple enough to be easily transferrable. Just a few members indicates LLC, which can be less formal (no annual meeting requirement, no board of directors).

Will your co-op have more than 100 members and invest almost exclusively in real estate?

> If yes, the most advantageous structure would probably be a business corporation taxed as a real estate investment trust (REIT).

For larger co-ops that invest in things other than real estate, which seems more important to you: not paying corporate income tax, or having an established, familiar structure with easily transferred shares?

> Co-op organizers may choose to take on the work of shaping an LLC to meet its needs, in order to avoid corporate tax. I would recommend doing some back-of-the-napkin math to see how much money the co-op might pay in taxes.

Does it matter to you whether you sell “shares” or “membership units” to your members?

Do you want members to be able to invest more than $10,000 in the co-op’s shares?

> If yes, do not organize as an Illinois cooperative corporation.

What percentage of the co-op’s revenue do you think you’ll need to retain?

> The more you plan to retain, the more this factor leans towards choosing a corporation.

Do you want a customized governance or income-sharing structure? How important is this to you?

> A customized governance or income-sharing structure might indicate LLC.

Can you make sure to distribute enough income to cover everyone’s tax liability? Do any of your members have high passive income, so that they would appreciate a loss to set off that income?

> If your co-op will experience loss at first, and if some co-op members have taxable income that can be set off by this loss, and if you are otherwise comfortable with being taxed as a partnership, then this answer would indicate LLC.

Summary

Small, private investment clubs tend to organize as LLCs. A larger investment co-op that does not plan to raise more than $10,000 from any member could organize as a cooperative corporation, in order to use the word “cooperative” in its name. A larger co-op whose only business is to invest in real estate could organize as a general business corporation and elect to be taxed as a REIT. This kind of co-op would have the benefit issuing corporate shares, without most or all of the corporate tax. A larger investment co-op that can’t qualify as a REIT would choose either a corporation, to avoid unwanted complexity, or an LLC, to avoid corporate tax at the cost of having to do more work with the co-op’s operating agreement.

Notes on Other Entities

I looked through other entities available in Illinois. Several are not applicable – professional services and medical corporation do not apply. These ones deserve some notes and explanation.

Illinois Development Credit Corporation

Illinois has a Development Credit Corporation Act, 805 ILCS 35/1 et seq. The purpose of this act is to support economic development by establishing "a source of credit not otherwise available through conventional commercial channels for the promotion, development and conduct of new and expanded business activities in this State."[19]

This statutory purpose suggests that a development credit corporation might be an appropriate legal entity for an investment co-op. However, this entity is subject to many limitations. The statute requires that the development credit corporation be organized for the specific purpose set out in the statute.[20] The development credit corporation must have the approval of the Director of Financial Institutions before it can incorporate, and it must have raised at least $50,000 in cash in order to incorporate. The statute prohibits the development credit corporation from making a loan to someone unless that person shows proof that her application for a loan was rejected by a conventional lending institution. This means that for a development credit corporation, simply preferring to do business with a co-op, or preferring to offer a lower interest rate in order to help a local business to succeed, cannot be reasons to decide to make a loan. This limitation alone would likely keep the co-op from being able to take the actions it deems best to carry out its purposes. For a co-op that wants to set its own criteria for lending, and avoid being subject to several other limitations, I would recommend a general business corporation instead.

Cooperative Corporation Under the Law of Another State

Investment cooperatives doing business in Illinois should organize under Illinois law, to make it easier to sell memberships and raise money.

All companies that raise money from investors, including cooperatives, need to watch out for securities law. A rough definition of a "security" is: any investment opportunity where a person invests money, and that money is at risk and/or the investor expects a passive return. State and federal securities laws prohibit offering and selling *unregistered* securities to the public. Cooperative membership stock is considered a security under Illinois state law and the laws of many other states. Corporate stock is a security, and LLC membership units are often considered securities.

When a company offers and sells securities, it must comply with federal law, the law of the state of its principal office, and the law of the state(s) where each of its investors reside.

[19] 805 ILCS 35/2.
[20] See purposes listed at 805 ILCS 35/4. They include: "to promote, stimulate, develop, and advance the business prosperity and economic welfare of the State of Illinois and its citizens; to encourage and assist, when usual, customary credit is not available, through loans, investments, or other business transactions, the location of new business and industry in the State; to rehabilitate and assist existing business and industry in this State…."

Federal securities law contains an exemption from the registration requirement for offerings made in just one state. If a company is organized in Illinois, does most of its business in Illinois, and raises money only from residents of Illinois, then the company enjoys the intra-state exemption from federal registration, and need only comply with Illinois offering rules. But if the company is organized under the law of another state, that federal intra-state exemption is no longer available.

The intra-state exemption allows companies to use any state law exemption that applies, or to register their offering under state law. If the intra-state exemption is not available, the next most appropriate federal exemption is Rule 504. Offerings under Rule 504 can be registered under state law; can be private, or can be done pursuant to a state law exemption that allows public offerings *to accredited investors* only. In short, losing the intra-state exemption could make securities compliance more challenging, and could keep a co-op from being able to use some state law exemptions, including Illinois intra-state crowdfunding. Also, Illinois intra-state crowdfunding is only available for businesses organized under Illinois law.

Conclusion: An Illinois business corporation or Illinois LLC can be adapted to the needs of an investment cooperative, and would keep the co-op's options open for raising money from Illinois residents. Therefore, for a co-op operating in Illinois, that does not want to organize as an Illinois cooperative corporation, the co-op would be better served by organizing as an Illinois corporation or LLC rather than a cooperative under the law of another state.

An Investment Co-op Might Unwittingly Become an Investment Company

The Investment Company Act of 1940 is a law that investment co-ops will need to deal with, either by registering or finding an applicable exemption. Being regulated as an investment company is costly. Regulated companies must comply with a host of very detailed rules in the 1940 Act, covering everything from minimum capitalization and asset coverage ratios to related party transactions and investment policies. Attorney Brian Beckon writes: "While it is perhaps not impossible for a small micro-equity fund to comply with all these requirements, the cost of compliance would likely absorb so much of its profits that it would be an unattractive investment."[21]

Regulation under the Investment Company Act of 1940 kicks in when a company issues securities (offers and sells investments, like stock or loans), and then uses that money to invest, reinvest, or trade in the securities of other businesses. It also applies to a company that is not primarily in the business of investing, reinvesting, or trading in securities if the company does in fact own or propose to acquire investment securities having a value of more than 40% of the company's total assets. A co-op that pools members' money to buy real estate would not be subject to the 1940 Act, because real property is not a security. **However, if folks were to organize a co-op, sell shares of the co-op, and then use the co-op's money to invest in other co-ops or other local businesses, they could unwittingly become subject to extensive, very expensive regulation.**

Unfortunately, there is no exemption from the 1940 Act that would allow an investment co-op to raise money from the public. A successful investment co-op might grow and eventually decide to register, but start-up co-ops will need to find an exemption. Below is a list of all the strategies (that I could think of)

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[21] Brian Beckon, "Exemption for Microequity Funds Under the 1940 Act," February 18, 2016. Available upon request from sarah@sarahkaplanlaw.com or brian@cuttingedgecapital.com.

that could potentially be the right fit for an investment co-op, in order from lowest to highest cost of compliance.

Partner with a larger cooperative.
This could allow people to invest cooperatively without forming an "investment company." If an entity does not hold itself out as primarily in the business of investing, is not primarily in the business of investing, and does not invest more than 45% of the total value its assets in other businesses, then it is not an investment company and is not subject to this regulation.

<u>What this means</u>: One inexpensive approach would be to partner with an existing cooperative with significant assets, such as an established food cooperative. A group of food co-op members, for example, could form an investment project within the food co-op, if the food co-op's members or board approved (as appropriate). Incubating local farms or food businesses might be within the co-op's mission. Members could buy a special class of stock to raise money for this project. The food co-op could make the investments in the companies selected by the investment project participants. As long as those investments total less than 45% of the total value of the co-op's assets, and as long as the investment project does not produce more than 45% of the co-op's income, the co-op will not be considered an Investment Company, and regulations will not apply.

<u>Major advantage</u>: IF the co-op in this example is allowed to have shareholders who do not shop at the Co-op's store regularly, it could offer investments to the public, through state or federal crowdfunding, under Illinois' exemption for co-op stock, or by registering the offering.

For example:
Let's say an established food co-op in Illinois is organized as an Illinois cooperative corporation. It can create as many classes of shares as it wants, as long as no one person owns more than 10 shares or more than $10,000 of stock. Ten members propose a local food business investment fund, and the general membership gets excited about it. The authorization to move forward with the project is approved. The co-op's assets total $3 Million, and the co-op makes $2 Million a year in revenue.

The co-op now issues a new class of non-voting investor stock. It could offer the stock to the public under Illinois' exemption for the stock of cooperatives, or through a federal or state crowdfunding platform. The co-op gets ready to use the newly raised capital to fund local food businesses. It forms a committee to handle decision-making for the new fund, perhaps taking into account the opinions of the investors.

La Mantañita Co-op, a food co-op in Albequerque, New Mexico, raised money from members and makes loans to food producers.[22] It is not subject to Investment Company Act of 1940 regulation as long as the amounts invested are below 45% of the value of its assets.

Partner with a Bank
How this works: your organized group offers to buy a special class of certificates of deposit (CDs) that will serve as collateral for loans to small businesses. The bank is then willing to make loans it otherwise would not have made. An example of this approach: Ithaca's Alternatives Credit Union has created CDs that collateralize loans to high-priority businesses. Another example: Eastern Bank in Boston has a CD that collateralizes a line of credit to Equal Exchange, a fair-trade worker cooperative coffee company.[23]

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[22] See this secondary source: https://marcclifton.wordpress.com/2012/11/15/social-finance-2/; and this one: Michael H. Shuman, "24 Top Tools for Local Investing" (May 2012), available at http://michaelhshuman.com/wp-content/uploads/2013/12/Top-Tools-2.0.pdf

[23] See Michael H. Shuman, "24 Top Tools for Local Investing" (May 2012), available at http://michaelhshuman.com/wp-content/uploads/2013/12/Top-Tools-2.0.pdf

This approach involves organizing investors, and negotiating with bankers (or credit union-ers). Because the institution is regulated under banking or credit union regulations, it is exempt from the 1940 Act.[24] Investors/cooperators, themselves, are not really forming a fund. And the CDs can be offered to the public! This is a way to avoid all regulation and all or most legal fees.

Small and Private
An investment club is exempt from 1940 Act regulation if it is owned by no more than 100 people, and if it does not offer its investment opportunities to the public. This means that the investment opportunities can only be offered and sold to people with whom the organizers have a substantial, pre-existing relationship. This exemption works for small investment clubs. And in fact there are resources such as sample documents for small, private investment cooperatives. There is an opportunity to network these clubs to help them share information. However, small, private investment clubs cannot not consolidate into one legal entity and remain exempt. They must remain small (no more than 100 owners), and private (no public advertising, ever).

Non-profit loan fund:
Any company that is "organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes … no part of the net earnings of which inures to the benefit of any private shareholder or individual" is exempt from 1940 Act regulation. 15 U.S.C. § 80a-3(b)(10). This entity would have to be organized as a not-for-profit corporation. Non-profits do not have shareholders, and cannot split the profits among the owners (because there are no owners). Investors/members could make loans to the non-profit; the non-profit could then invest that money to further its purpose.

A non-profit investment co-op might end up operating similarly to a community loan fund; community loan funds typically offer low interest rates to their investors. To me, this seems limiting. A possibility might be to use a revenue-share based loan.

Make "Small Loans"
An investment company is exempt from regulation if "substantially all" of its business is "confined to making small loans, industrial banking, or similar business." If an investment co-op decides to make loans, and not to invest in equity, then this 1940 Act strategy could work.

The question here is, What is a "small loan" for the purpose of this law? I believe there is no guidance on this. Making "small loans" generally refers to the business of consumer lending. However, it is not clear that "making small loans, industrial banking, or similar business" could not include lending to businesses. And if this is true, the question is, how big can a "small loan" be? I do not believe there is any guidance on this issue. If an investment co-op wishes to rely on this exemption, then more research on this question would be worthwhile, and potentially a request for a No Action letter.

Closed-End, Intra-State Fund
A fund will be exempt if it meets all of these requirements: it is "closed-end," which means that it has a limited number of shares or equity units. Once those shares are sold, it cannot sell more, although a member can transfer shares to someone else who becomes a new member. The fund must raise no more than $10 Million. If the fund sells securities to the public, all purchasers of those publicly-sold securities must be residents of the state where the fund is organized.

In order to use this exemption, the company must apply for and receive an exemptive order from the SEC. The SEC can choose to apply some or all of the 1940 Act requirements to this kind of company.

Ask for an Exemptive Order

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[24] *See* 15 U.S.C. §80a-3(c)(3).

The SEC can exempt a company from 1940 Act regulation by order. More research is needed on what are the reasons the SEC generally grants an exemption. This could be a path to consider if the easier, cheaper strategies do not work.

Register as a public Investment Company

Finally, if a fund became big enough, registration could make sense, allowing the fund to register securities for sale to the public.