# Barriers to Putting Community Bonds into RRSP Accounts

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### About MaRS Centre for Impact Investing
MaRS Centre for Impact Investing MaRS Centre for Impact Investing works to unlock the power of private capital to tackle persistent social challenges. It works with investors, governments, ventures and service providers to create funding solutions for projects that generate social and financial returns.

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## Introduction

Community bonds are small, private market bonds issued by non-profit organizations, co-ops and social enterprises to raise capital for a social or environmental purpose. Issuers sell community bonds to reduce their borrowing costs and to expand impact investing to retail investors. Investors buy community bonds to earn a return while doing good.

Canadians hold more than $1 trillion in Registered Retirement Savings Plan (RRSP) accounts, and they add more money every year.[1] Keen to attract investment from community members who may wish to invest their RRSP savings, community bond issuers have structured some community bonds to qualify for RRSP investment. Yet, despite client requests, financial advisors have hesitated to put community bonds into RRSP accounts.

This paper aims to clear confusion in the market as to why financial institutions rarely process community bonds into RRSP accounts. The paper draws on sixteen interviews with community bond issuers, major banks, credit unions and transfer agents. It begins by describing community bonds and how they can help issuers, investors and financial institutions. It then reviews the barriers to putting community bonds into RRSP accounts. Finally, it concludes that, for retail (non-wealthy) investors, the gap between community bonds and mainstream financial institutions is too wide to bridge. Community bonds issuers should look to strategies other than mainstream RRSP accounts to sell community bonds to retail investors.

# Benefits to Issuers, Investors and Financial Institutions

Community bonds are typically defined by four characteristics: a social or environmental purpose, a non-profit issuer, an accessible minimum subscription price, and better terms than the issuer can negotiate for traditional finance (usually a bank or credit union loan).[2]

SolarShare, a non-profit co-operative, issues community bonds to finance solar energy projects. It sells $1,000 Solar Bonds that pay a 5% annual interest rate and mature after five years.[3] The Centre for Social Innovation (CSI), a non-profit co-working space and a pioneer in community bonds, sold five-year bonds at 4% interest and a $10,000 minimum subscription.[4] CoPower is a for-profit company and so does not technically sell community bonds, but, for RRSP purposes, its Green Bonds are identical to community bonds. CoPower sold five-year bonds at 5% and a $5,000 minimum subscription.[5]

**Benefits to Issuers:** The favourable terms on community bonds help issuers finance projects that otherwise may not go ahead. For example, CSI issued its first community bond to close a $2 million gap between its mortgage loan and the price tag on the building it wanted to buy. Without community bonds, CSI may have had to pass on 720 Bathurst Street, now the thriving home of many non-profits and social enterprises.[6]

Community bonds also more closely connect organizations with their communities. Most people cannot afford to donate thousands of dollars to their favoured organizations. Community bonds let supporters buy into organizations at sums they would never donate. The amounts and the long-term commitment turn community members into stakeholders.

**Benefits to Investors:** Community bonds open the doors to impact investing for those without great wealth. They offer retail investors the chance to match their investments to their values and give young people with lucrative investment years ahead of them the space to explore true double-bottom-line investing. Community bonds' low minimum subscriptions and competitive returns let investors of all types test impact goals and support community projects.

**Benefits to Financial Institutions:** Community bonds stand at the leading edge of ethical investing. Local, small-scale investments combine a steady return with a strong impact thesis to form an excellent (though very niche) example of impact investing's potential. That potential is beginning to show. At the end of 2015, 156 organizations surveyed by the Global Impact Investing Network and J.P. Morgan managed US$77.4 billion in impact assets.[7]

In a 2014 Morgan Stanley survey, the vast majority of wealthy millennials reported an interest in impact investing, and nearly a quarter of millennials reported investing in companies or funds that target social or environmental outcomes.[8] A 2016 poll of high-net-worth investors in the United States found that 78% of millennial respondents were interested in impact investing and 34% had invested in funds seeking positive change.[9] As millennials grow older and accumulate wealth, they will likely continue to mix moral and financial judgments. Financial institutions that have demonstrated the commitment and capacity to advise on impact will attract and keep their business.

*Overview of the Steps to Putting a Community Bond into an RRSP Account*

| | Cost in time, effort and money | |
|---|---|---|
| | **Investor's job** | **Issuer's job** |
| **Open a self-directed account** | Low | |
| **Understand the risk-return profile** | Medium | |
| **Prove Income Tax Act eligibility** | Low | Medium |
| **Calculate fair market value (if necessary)** | | High |
| **Avoid administrative costs** | | High |

## First Steps to Putting a Community Bond into an RRSP Account

### Open a Self-Directed Account

Financial institutions offer two types of RRSP accounts to retail investors: advised accounts and self-directed accounts. A retail client holding an advised account may only purchase from a list of mutual funds, guaranteed investment certificates and other products affiliated with the financial institution. For people without the knowledge or desire to trade in the full range of financial products, an advised account is an easy option.

Investors cannot place community bonds into advised RRSP accounts. Financial institutions do not list small, private market bonds among the options for these accounts. To put a community bond into an RRSP account, the investor must open a self-directed account. Investors open self-directed accounts to expand their options. Self-directed investors want to put together portfolios that more finely reflect their preferences. Today, one of those preferences is often for investments that match the investor's values.

### Understand the Risk-Return Profile

All of the financial institutions interviewed expressed anxiety about putting community bonds into RRSP accounts, even if those accounts are self-directed.

The financial institutions cited two factors to argue that the bonds are too risky relative to their return to suit an RRSP portfolio. First and most important, the bonds' illiquidity—five years is the usual term and, to date, no community bond has traded on a secondary market—means that investors cannot recover their investments if the issuer begins to struggle or if the investor suddenly needs her money. Second, community bonds issue out of small non-profits and usually take a subordinate position on the property against which they are secured. If the property drops in value and the issuer defaults, investors may lose some or all of their money. Other risks include the chance that the issuer requires investors to roll the bond over at the end of its term.

Investors, however, need not hew to their financial institutions' analysis. An investor may see a community bond's mid-single-digit return on secured debt as well within her risk tolerance. An investor with a self-directed RRSP account can ask her financial advisor to process a community bond into her account. Under some circumstances, the financial advisor may explain the risks and ask the investor to sign a risk acknowledgement form. But the financial advisor will not refuse the bond on risk-return grounds.

## Hurdles to Putting a Community Bond into an RRSP Account

The next three steps, and especially the latter two, form the core of mainstream financial institutions' opposition to putting community bonds into the RRSP accounts of retail investors. Financial institutions do not apply special rules to community bonds. Each of the problems below applies to most, if not all, private market securities (securities not traded on public markets, such as a stock exchange). To the extent that community bonds face greater challenges than small business shares and other private market securities, the difficulty lies in the small size of the average bond purchase.

### Prove Income Tax Act Eligibility

Community bond issuers rely on the Income Tax Act's mortgage-backed debt category to qualify their bonds for RRSP investment. With one caveat, described below, s. 4900(1)(j) of the Income Tax Regulations says that a debt obligation fully secured by a mortgage on real property in Canada qualifies as an RRSP investment. SolarShare's Solar Bonds, CSI's 720 Bathurst bonds and CoPower's Green Bond I were or are fully secured by mortgages on real property in Canada.[10] To prove that a mortgage fully secures its bonds, an issuer must produce a valuation of the mortgage. A community bond not fully secured by a mortgage on real property in Canada is unlikely to qualify for RRSP investment.

Section 4900(1)(j)'s caveat says that the issuer cannot be a connected person to the RRSP account.[11] In other words, the issuer must deal at arm's length with the investor. Related persons do not deal at arm's length. People can be related by blood, marriage, common-law partnership or adoption. A person who controls a corporation is related to the corporation. Whether unrelated people deal at arm's length depends on the facts of the transaction.[12]

While most community bond investors likely deal at arm's length with their community bond issuers, the question of arm's length depends on the specifics of the relationship and transaction.[13] A financial advisor may ask a client to sign a document to confirm that the client deals at arm's length with the issuer.

### Calculate Fair Market Value (if Necessary)

The Income Tax Act requires the fair market value of an RRSP portfolio in several circumstances, such as on death (without spousal transfer)[14] or after the RRSP account becomes a Registered Retirement Income Fund.[15] Calculating the fair market value of a portfolio means calculating the fair market value of each security in the portfolio. Putting a community bond into an RRSP account, therefore, may at some point force someone to pay to assess the fair market value of the bond.

In its Policy Statement on Business Equity Valuations, the Canada Revenue Agency defines fair market value as "the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact."[16]

The fair market value of a community bond is not the price of the bond or the principal and interest remaining to be paid to the investor. Instead, the fair market value is the price for which the investor could sell the bond today to another self-interested person.[17] That price depends on the probability of uninterrupted repayment, which in turn depends on the financial strength of the community bond issuer. Calculating the fair market value of a community bond therefore requires a valuation of the issuer's business.[18]

Valuators measure a company's value by investigating a) the economic environment, b) the company's industry, c) the company's management and other non-financial information, and d) the company's financial statements and other financial information. Valuators produce three types of valuation reports: calculation (the least rigorous), estimate (the middle ground) and comprehensive (the most rigorous).[19] While the Canada Revenue Agency does not name a minimum valuation standard, it likely requires more than a calculation valuation.[20]

Most estimate and comprehensive valuations cost between $5,000 and $15,000, with some up to $40,000 (quotes vary widely). Financial institutions do not want to accept $5,000 or $10,000 bonds (common sizes for community bond purchases by retail investors) into RRSP accounts when a valuation may cost the investor, the investor's estate or the financial institution far more than the investor would earn in interest. Financial institutions feel that, even if an investor accepts the risk of paying for a valuation, the disproportionate cost should the risk come to pass could threaten their reputations. Community bond issuers likely must guarantee the costs of any required valuation before financial institutions will accept community bonds into RRSP accounts.

### Avoid Administrative Costs

Financial institutions process almost all securities electronically through book entries. Community bonds are paper bonds recorded on a certificate. To process a certificated bond into an RRSP account, the financial institution must manually enter the bond's information. It must also file the certificate in the vault, a secure area that holds valuable paper. To transfer the bond, it must pull the certificate from the vault. All of these steps take time and permit error. The administrative costs rise very quickly (up to $500) relative to the interest on a $5,000 or $10,000 community bond. Rather than charge fees that would absorb a large portion of a bond's return, financial institutions choose not to offer RRSP placement for retail investors.

To avoid the administrative costs of paper bonds, community bond issuers could switch to a book-entry system. The Direct Registration System is a relatively low-cost book-entry system. Under the Direct Registration System, an electronic entry records a bond's ownership. A transfer agent sends investors statements in lieu of certificates. The transfer agent also manages interest and principal payments, distributes information to investors, and otherwise intermediates between issuers and investors. A transfer agent costs between $5,000 and $6,000 upfront, and between $6,000 and $8,000 per year (though quotes vary widely).

Community bond issuers interested in processing bonds electronically should contact a transfer agent to explore their options and, if pursuing RRSP investment, determine which book-entry method will best serve the needs of financial institutions. Issuers can find a list of transfer agents on the website of the Canadian Depository for Securities.

## Overcoming Hurdles to Putting a Community Bond into an RRSP Account

### Overcoming Hurdles for Retail Investors

Community bond issuers must overcome a series of expensive and complicated hurdles to put community bonds into the RRSP accounts of retail investors. Few, if any, community bond issuers will find that the costs outweigh the benefits.

**The community bond issuer must:**

1) Retain a lawyer to write an opinion on RRSP eligibility of the bond. To complete that opinion, the lawyer will need a valuation of the property on which the bond is secured. Issuers should check with valuation firms to learn the cost of a real estate valuation, which can vary a great deal. A legal opinion will likely cost between $1,000 and $2,000.

2) Likely guarantee that it will pay the cost of a bond valuation should an investor require a valuation. A valuation will likely cost between $5,000 and $15,000.

3) Switch bond registration from certificates to the Direct Registration System or another book-entry system. A transfer agent costs between $5,000 and $6,000 upfront, and between $6,000 and $8,000 per year. The issuer may have to pay additional costs to install a book-entry system.

Even a community bond issuer who completes each step may not improve the rate at which its retail investors successfully put bonds into their RRSP accounts. Community bonds lie far outside the comfort and experience of most financial advisors at mainstream financial institutions. To them, the bonds appear risky and difficult. Those concerns do not stop at the advisors. Financial institutions worry about the reputational risks of putting illiquid, subordinate, unrated bonds into accounts meant to save for retirement. The perceived mismatch between the attributes of the investment and the purpose of the account will hinder even well-organized attempts to put community bonds into the RRSP accounts of retail investors.

Community bond issuers set on helping their retail investors move bonds into RRSP accounts should direct their investors to financial institutions that specialize in the private market. Computershare, for example, accepts private market securities into its RRSP accounts. Computershare charges $125 per year on a client's first registered account and $100 per transaction.[21] Of course, many investors already have RRSP accounts at major financial institutions and may not want to open additional accounts.

### Overcoming Hurdles for Wealthy Investors

Some financial institutions have processed community bonds into some clients' RRSP accounts but not into other clients' accounts. This seeming inconsistency has confused issuers. Most of the financial institutions interviewed explained that the difference lies in the size of the financial institution's relationship with the client.

Financial institutions will put community bonds into the RRSP accounts of their wealthy clients. They will accept the risks and costs described above because they wish to maintain the business of those clients. The size of the relationship—and sometimes the size of the community bond purchase—means that risks and costs that are otherwise out of proportion to the return become, from the financial institution's point of view, reasonable. Financial institutions also feel more comfortable dealing in community bonds on behalf of clients who can afford a loss in their retirement accounts.

Community bond issuers do not need to change their practices to assist wealthy investors. Issuers and investors should keep in mind, however, that the rules differ between financial institutions.[22]

## Conclusion

Mainstream financial institutions hesitate to process community bonds into the RRSP accounts of retail investors because, from the financial institution's perspective, the risks and costs—especially the administrative expense and the risk of a fair market value event—outweigh the return on the bond. Financial institutions also hesitate to put illiquid, unrated bonds into retirement accounts. For community bond issuers, the difficulty of overcoming these concerns appears far greater than the benefit, at least at this moment in the community bond market. Community bond issuers should turn their attention to other fundraising tools rather than attempt to put community bonds into the RRSP accounts of retail investors.

# Appendix A: Securities Law

Securities law sets the conditions under which companies and other entities can issue securities. Two of the most important conditions concern the information an issuer must give to prospective investors and the dealer category into which an issuer must register. The conditions differ for different types of issuers.

### Non-Profit Issuer

1) Investor Information. A non-profit issuer does not need to file a prospectus (National Instrument 45-106, s. 2.38).

2) Dealer Registration. A non-profit issuer does not need to register as a dealer (National Instrument 45-106, s. 3.38).

### Co-operative Issuer

1) Investor Information. An Ontario co-operative issuer with more than 35 security holders (or a co-operative where sale of the securities would increase its security holders to more than 35) must file an offering statement (Co-operative Corporations Act, R.S.O. 1990, c. C.35, s. 34(1); Co-operative Corporations Act, R.S.O. 1990, Reg. 178, s. 11.1).

2) Dealer Registration. An Ontario co-operative issuer does not need to register as a dealer (Ontario Securities Commission Rule 45-501, s. 3.4).

### For-Profit Issuer (Not a Co-operative)

1) Investor Information. A for-profit issuer must file a prospectus unless it sells its securities under one of the prospectus exemptions (Securities Act, R.S.O. 1990, c. S.5, s. 53(1)). National Instrument 45-106 lists most prospectus exemptions. A review of the prospectus exemptions is beyond the scope of this paper.

2) Dealer Registration. A for-profit issuer in the business of trading securities must register as a dealer (Securities Act, R.S.O. 1990, c. S.5, s. 25). National Instrument 31-103 lists the registration categories. A review of the "business trigger" or the dealer registration categories is beyond the scope of this paper.

# Appendix B: Costs

*All prices vary widely. Issuers should take these prices as rough approximations only.*

| CATEGORY | WHY | COST |
|---|---|---|
| Legal Opinion | To prove bond eligibility under the Income Tax Act. Does not necessarily speak to arm's-length requirements. | $1,000 to $2,000 |
| **Valuations** | | |
| Mortgage Valuation | To show that the bonds are fully secured by a mortgage. | Request quote from valuator. |
| Business Valuation | To establish the fair market value of bonds. | $5,000 to $15,000 (up to $40,000) |
| **Book Entry Services** | | |
| Transfer Agent | To track bonds electronically by book entry. | $5,000 to $6,000 upfront and $6,000 to $8,000 per year |

# Appendix C: Glossary

**Issue**
To sell a security to finance one's operations.

**Issuer**
An organization that sells a security to finance its operations.

**Transfer agent**
An intermediary between issuers and investors. Transfer agents can record securities in book-entry systems, such as the Direct Registration System.

**Certificate**
A formal paper recording a security's ownership.

**Book entry**
An electronic entry recording a security's ownership.

**Retail investors**
Non-wealthy investors. The cutoff depends on the financial institution. For example, one of the big banks will only permit a client to put private market securities in her RRSP account if she holds at least $200,000 in public market securities in her RRSP account.

# Footnotes

1. CBC News. (January 2, 2016). RRSP deadline and FAQ 2016. CBC News. Retrieved from http://www.cbc.ca/news/business/rrsp-deadline-and-faq-2016-1.3368634

2. For a nearly identical definition, see Surman, T. and Hughes, S. (2012). The Community Bond: An Innovation in Social Finance. Toronto, Ontario: Centre for Social Innovation.

3. High Return Green Bonds Do Exist! (February 14, 2017). Retrieved from https://www.solarbonds.ca/invest/invest

4. Surman, T. and Hughes, S. (2012). The Community Bond: An Innovation in Social Finance. Toronto, Ontario: Centre for Social Innovation.

5. CNW. (February 1, 2016). CoPower Issues First Green Bond for Canadian Investors. CNW. Retrieved from http://www.newswire.ca/news-releases/copower-issues-first-green-bond-for-canadian-investors-567194981.html

6. Surman, T. and Hughes, S. (2012). The Community Bond: An Innovation in Social Finance. Toronto, Ontario: Centre for Social Innovation.

7. Mudaliar, A., Schiff, H. and Bass, R. (2016). 2016 Annual Impact Investor Survey. Global Impact Investing Network. Retrieved from https://thegiin.org/assets/2016%20GIIN%20Annual%20Impact%20Investor%20Survey_Web.pdf

8. Morgan Stanley Institute for Sustainable Investing. (2015). Sustainable Signals: The Individual Investor Perspective. Retrieved from https://www.morganstanley.com/sustainableinvesting/pdf/Sustainable_Signals.pdf

9. Morgan Stanley Wealth Management. (2016). Investor Pulse Poll. Retrieved from http://www.morganstanley.com/pub/content/dam/msdotcom/ideas/investing-in-the-future/Investor-Pulse-Sustainability-2016.PDF. See also U.S. Trust. (2016). 2016 U.S. Trust Insights on Wealth and Worth Survey. Retrieved from http://www.ustrust.com/publish/content/application/pdf/GWMOL/USTp_AR9R6RKS_2016-05.pdf

10. SolarShare posts its RRSP legal opinions on its website. Registered Accounts Introduction Package. (February 14, 2017). Retrieved from http://www.solarbonds.ca/invest/solar-bonds-in-rrsps/sd-accounts

11. A connected person is a holder of the RRSP account or an annuitant, beneficiary, employer or subscriber under the account, or a person who does not deal at arm's length with one of those people. Income Tax Regulations, C.R.C., c. 945, s. 4901(1).

12. Income Tax Act, R.S.C. 1985, c. 1, s. 251(1) and (2); Canada Revenue Agency. (2015). S1-F5-C1, Related Persons and Dealing at Arm's Length. Retrieved from http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s1/f5/s1-f5-c1-eng.html

13. Investors in for-profit enterprises must also note the prohibited investment rules. Income Tax Act, R.S.C. 1985, c. 1, s. 207.01(1). A debt of a company in which the investor (and other persons not at arm's length from the investor) holds a significant interest is a prohibited investment. The Canada Revenue Agency considers a 10% equity stake a significant interest. Canada Revenue Agency. (2016). S3-F10-C2, Prohibited Investments – RRSPs, RRIFs and TFSAs. Retrieved from http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f10/s3-f10-c2-eng.html

14. Income Tax Act, R.S.C. 1985, c. 1, s. 146(8.8).

15. Income Tax Act, R.S.C. 1985, c. 1, s. 146(8.8).

16. Canada Revenue Agency. (1989). Policy Statement on Business Equity Valuations. Retrieved from http://www.cra-arc.gc.ca/E/pub/tp/ic89-3/ic89-3-e.html

17. For bonds that trade frequently in a secondary market, the bond's fair market value is its trading price. Community bonds and other bonds that do not trade frequently cannot rely on a secondary market to give a fair market value.

18. A valuation of the property on which a bond is secured cannot alone give a fair market value for the bond. A self-interested person will pay a smaller amount for a bond whose nominal value she can only recover after sale of a property than she will pay for a bond whose nominal value she will receive on schedule. The property on which a bond is secured will, of course, form an input into the fair market value calculation.

19. The Canadian Institute of Chartered Business Valuators. (2012). Practice Bulletin No. 3: Guidance on Types of Valuation Reports. Retrieved from https://cicbv.ca/wp-content/uploads/2010/10/Practice-Bulletin-No-3-E-2012.pdf

20. Spence Valuation Group. (April 24, 2012). Does the Low-Risk Tax Valuation Still Exist? Retrieved from http://spencevaluation.com/does-the-low-risk-tax-valuation-still-exist/

21. SolarShare investors can put Solar Bonds into a Canadian Worker Co-op Federation RRSP account (administered through Concentra Financial). Solar Bonds in Registered Accounts through CWCF. (February 14, 2017). Retrieved from https://www.solarbonds.ca/invest/solar-bonds-in-rrsps/cwcf

22. For example, the definition of wealthy depends on the financial institution. To give a sense of the cutoff, one of the big banks will only permit a client to put private market securities in her RRSP account if she holds at least $200,000 in public market securities in her RRSP account.