

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in white and light blue.

**K&L GATES**

2019 SAN FRANCISCO INVESTMENT MANAGEMENT  
CONFERENCE

# Private Fund Hot Topics - Critical and Emerging Issues

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# OVERVIEW OF OZ RULES

- The OZ program was created by the Tax Cuts and Jobs Act, enacted in December 2017 to help direct economic resources to low-income communities, spurring economic growth and job creation.
- The Opportunity Zones program provides three main tax incentives to taxpayers who invest capital gains in a Qualified Opportunity Fund (QOF):
  - Temporary Deferral. The taxpayer may defer recognition of eligible capital gains invested into a QOF until the earlier of the date on which the OZ investment is disposed of, or December 31, 2026.
  - Step-Up in Basis.
    - If a taxpayer holds an interest in a QOF for at least 5 years, then no more than 90% of the capital gains will be included in the taxpayer's federal taxable income.
    - If a taxpayer holds an interest in a QOF for at least 7 years, then no more than 85% of the capital gains will be included in the taxpayer's federal taxable income.
  - Permanent Exclusion. If a taxpayer holds an investment in a QOF for at least 10 years, all gains accrued after the investment in a QOF will not be subject to tax when the taxpayer disposes of the investment.



# OVERVIEW OF OZ RULES (CONT'D)

- In order to be eligible, capital gains must have arisen from the sale or exchange of property with an unrelated party before December 31, 2026 and must be invested in the QOF within 180 days of recognizing the gain
- A QOF is any investment vehicle organized for the purpose of investing in OZ property, and may be classified as a corporation or partnership (which can include LLCs).
- At least 90 percent of a QOF's assets, calculated on two semiannual testing dates, must consist of OZ property. OZ property consists of:
  - Stock in an OZ business
  - OZ partnership interest (capital or profits) in an OZ business (includes LLCs)
  - OZ business property
    - Tangible property used in a trade or business of the QOF
    - Acquired by purchase after 12/31/2017
    - Original use in the OZ begins with the QOF
    - Substantially improved property (improvements exceed adjusted basis)
    - Substantially all the use is in an OZ
    - Also includes leased property



# OVERVIEW OF OZ RULES (CONT'D)

- OZ Business:
  - Substantially all the tangible property owned or leased is OZ business property
  - At least 50% of gross income derived from active trade/business
  - Substantial amount of any intangible property is used in the active trade or business
  - Limits on financial property (deter passive investment)
  - No “sin” businesses

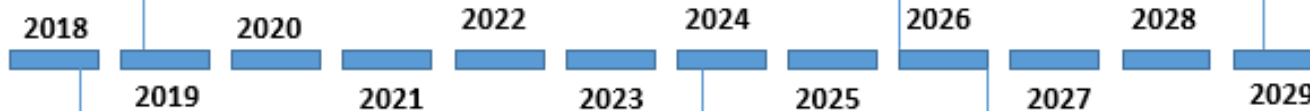


# OZ PROGRAM TIMELINE EXAMPLE

**On or before April 27, 2019**  
 Taxpayer contributes the \$1M of capital gain to a QOF  
  
 QOF makes a timely investment of the \$1M in Qualified Opportunity Zone Property

**On or before April 27, 2026 (7 years)** Taxpayer's basis in investment in QOF increases by another 5% of investment (\$50k)

**April 27, 2029 (10 years)**  
 Taxpayer sells its investment for \$3M and elects to increase its basis to the FMV. No additional tax is owed on the \$2M of appreciation.



**Oct. 30, 2018**  
 Taxpayer enters into a sale that generates \$1M of capital gain

**On April 27, 2024 (5 years)**  
 Taxpayer's basis in investment in QOF increases by 10% of investment (\$100k)

**December 31, 2026**  
 \$850k of the \$1M of initial capital gains are taxed and the basis in QOF investment increases to \$1M

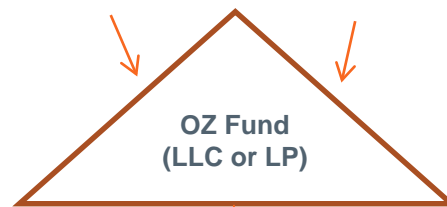
**NOTE:** For this example, the Taxpayer's initial basis is \$0 in the QOF investment and that the Taxpayer's basis in its QOF interest is not adjusted for any reason other than as a result of the steps shown above. Please note that a Taxpayer's basis in its QOF interest may be increased or decreased for other reasons under generally applicable rules of U.S. federal income tax law.



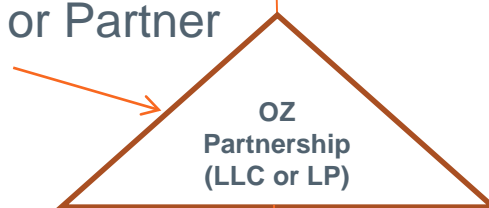
# FUND STRUCTURING FOR SINGLE AND MULTIPLE INVESTMENT FUNDS

- Basic OZ Fund Structure
- Single asset, or multiple assets using mirrored structure
- Asset specific or blind pool

Investors with Capital Gains



Second Member or Partner



## Benefits

- Provides for exit event flexibility
- Offering can be pursuant to a subscription program and allow for multiple projects under mirrored structures
- Tiered structure provides for better OZ qualification flexibility

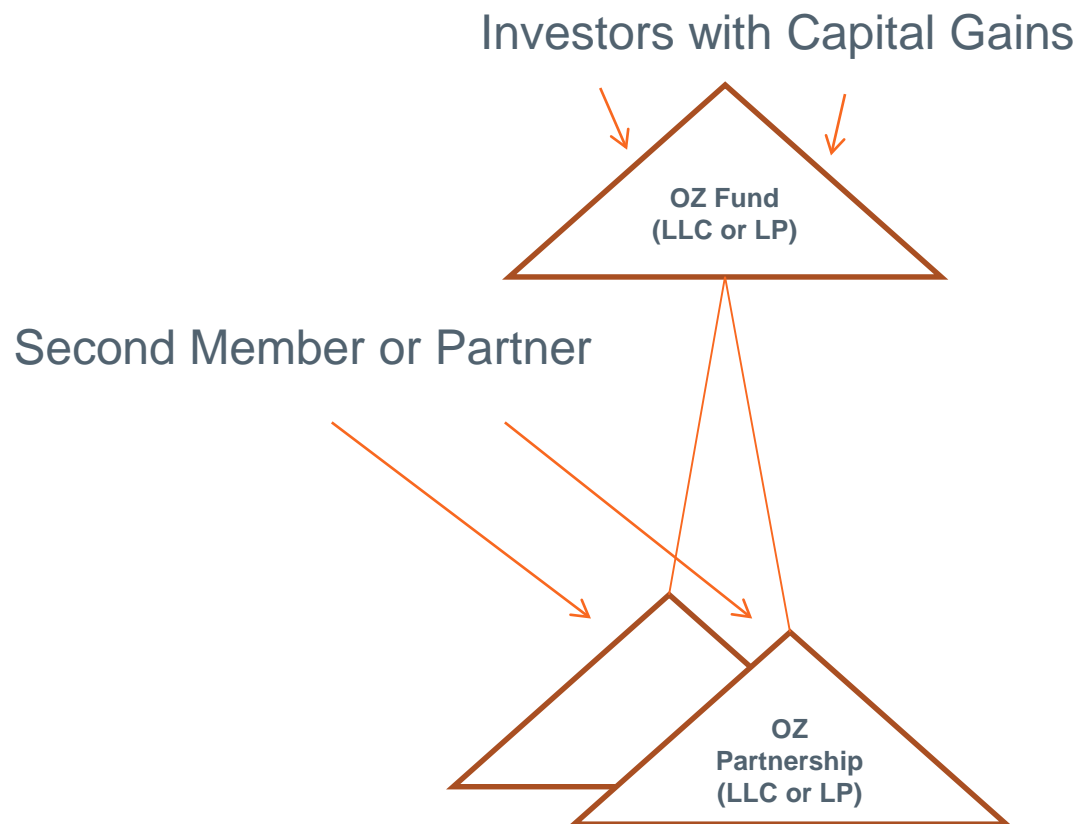
## Limitations

- K-1s at both OZ Fund and OZ Partnership levels
- If long offering period with multiple projects, managing capital calls and rebalancing could be challenging



# FUND STRUCTURING FOR SINGLE AND MULTIPLE INVESTMENT FUNDS (CONT'D)

- Comingled OZ Fund Structure



## Benefits

- Traditional fund structure
- Easier to manage offering/commitment process
- Less administrative burden
- Diversification

## Limitations

- Potential exit issues

# FUND STRUCTURING FOR SINGLE AND MULTIPLE INVESTMENT FUNDS (CONT'D)

- Issue: Statute provides that exit can only result from the sale of an interest in a QOF.
  - Proposed regs allow a QOF to sell its assets.
  - Lower-tier QOZB can't sell its assets.
- Notwithstanding the proposed regs:
  - Concerns about reliance
  - Differences in depreciation recapture
  - Projects that become unqualified could taint the QOF/other projects, require a restructuring





# FUND STRUCTURING FOR SINGLE AND MULTIPLE INVESTMENT FUNDS (CONT'D)

- Single asset: Provides the most flexibility
- Notwithstanding the proposed regs:
  - Can't rebalance/manage traditional capital structure
  - Need to appropriately allocate capital
  - Better for one or limited closings with small offering periods
  - Crossing and calculating an aggregate preferred return problematic





# CFIUS

- The Foreign Investment Risk Review Modernization Act ("FIRRMA") clarifies when U.S. private equity funds with foreign limited partners are not considered foreign for purposes of the Committee on Foreign Investment in the United States ("CFIUS") and expands the reach of CFIUS to include noncontrolling investments in "critical infrastructure" and "critical technology" companies, as well as companies that maintain or collect sensitive data of U.S. citizens (collectively "Sensitive U.S. Businesses").



# CFIUS – U.S. PRIVATE FUNDS WITH FOREIGN LP'S

- To not be considered foreign, and thus outside the jurisdiction of CFIUS:
  - A fund with foreign limited partners must be managed exclusively by a general partner, managing member, or equivalent that is not a foreign person;
  - An advisory board or committee on which a foreign person participates may not have the ability to approve, disapprove, or otherwise control: (i) investment decisions of the fund or (ii) decisions made by the general partner, managing member, or equivalent related to entities in which the fund is invested;
  - The foreign person may not otherwise have the ability to control the fund, including the authority to: (i) approve, disapprove, or otherwise control investment decisions of the fund; (ii) approve, disapprove, or otherwise control decisions made by the general partner, managing member, or equivalent related to entities in which the fund is invested; or (iii) unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general partner, managing member, or equivalent; and
  - The foreign person may not have access to material nonpublic technical information.



# CFIUS – INDIRECT NONCONTROLLING INVESTMENTS BY FOREIGN PERSONS

- An indirect investment by a foreign limited partner in a Sensitive U.S. Business through an investment fund is subject to CFIUS jurisdiction if the fund is foreign (either because of a foreign general partner or foreign limited partner whose rights are not restricted, as described above), or if the foreign limited partner obtains:
  - Access to any “material nonpublic technical information” in the possession of the U.S. business;
  - Membership or observer rights on the board of directors or equivalent governing body of the U.S. business or the right to nominate an individual to a position on the board of directors or equivalent governing body; or
  - Any involvement, other than through voting of shares, in substantive decision-making of the U.S. business regarding: (i) the use, development, acquisition, safekeeping, or release of sensitive personal data of U.S. citizens maintained or collected by the U.S. business; (ii) the use, development acquisition, or release of critical technologies; or (iii) the management, operation, manufacture, or supply of critical infrastructure.



# CFIUS – NVCA COMMENTS

- National Venture Capital Association has sent two comment letters requesting clarity in the regulations for private fund sponsors on a number of issues:
  - Definition of “principal place of business” and applicability to offshore entities formed for tax reasons but managed by U.S. entities and individuals;
  - Ownership of U.S. general partner entities by persons with dual citizenship or long-term residents;
  - Applicability to particular foreign countries;
  - Whether an LP’s direct investment in a portfolio company that is independent of a fund investment in that company might trigger a mandatory filing;
  - Scope of “material nonpublic technical information”;
  - Changes in ownership with respect to various rounds of venture capital investments;
  - Applicability to corporate venture capital arms of various U.S. and non-U.S. businesses that may be focused on investing outside of the U.S.



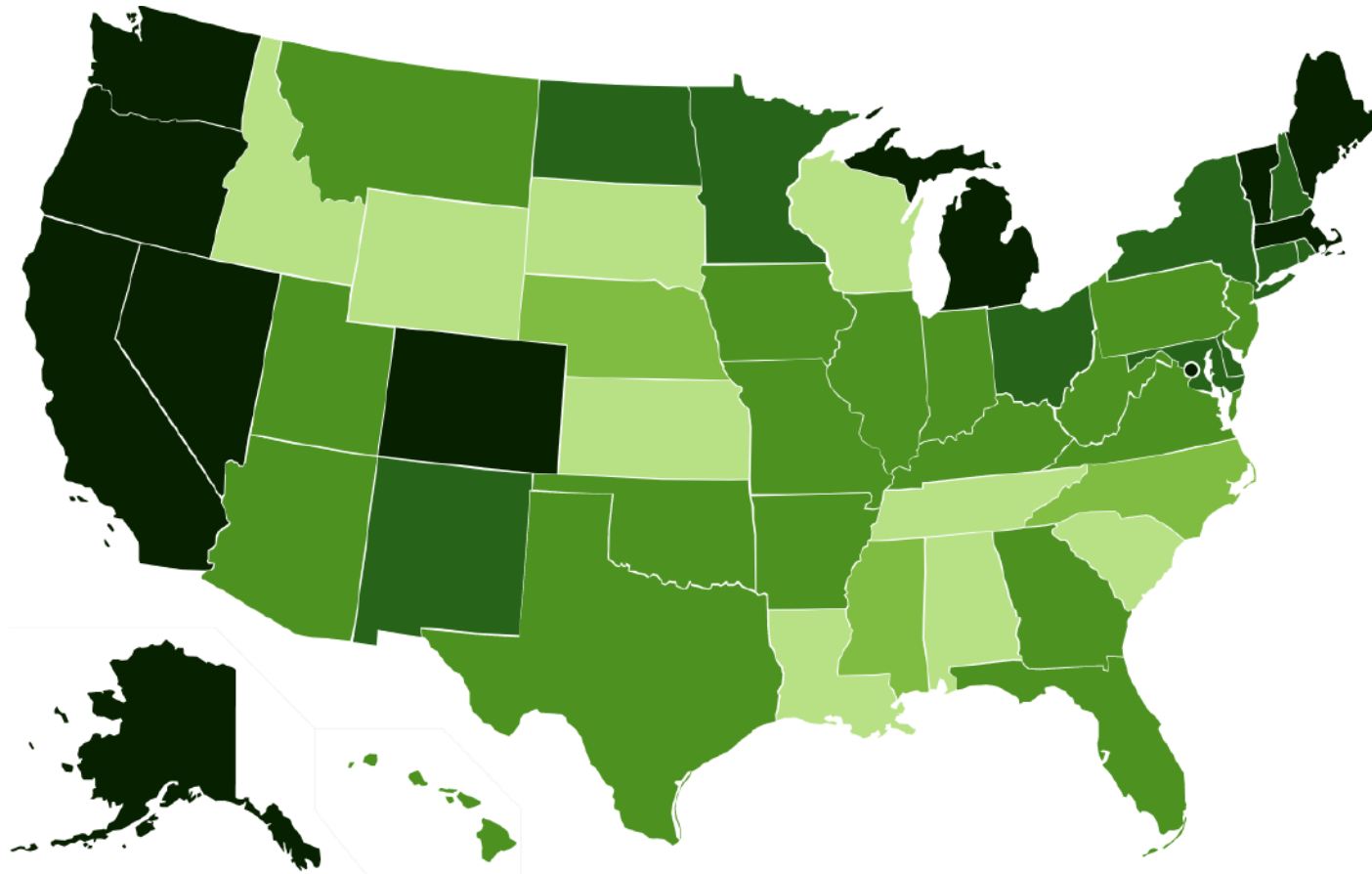
# CFIUS ENFORCEMENT

- Failure to notify can result in a penalty on each non-compliant party up to the value of the investment or transaction.
- In 2018, CFIUS imposed \$1 million civil penalty for a 2016 breach of a mitigation agreement.
- In April 2019, CFIUS:
  - Forced Beijing Kunlun Tech Co. Ltd. to divest its 2016 acquisition of the dating app company Grindr LLC;
  - Required iCarbonX — another Chinese investor — to divest its majority stake in PatientsLikeMe Inc., an online network for discussing health conditions;
  - Pressured a partially Russian-backed investment fund, Pamplona Capital Management, to divest its minority stake in a U.S. cybersecurity firm.



# CANNABIS

Legalized   Medical and decriminalized   Medical   Decriminalized   Fully illegal



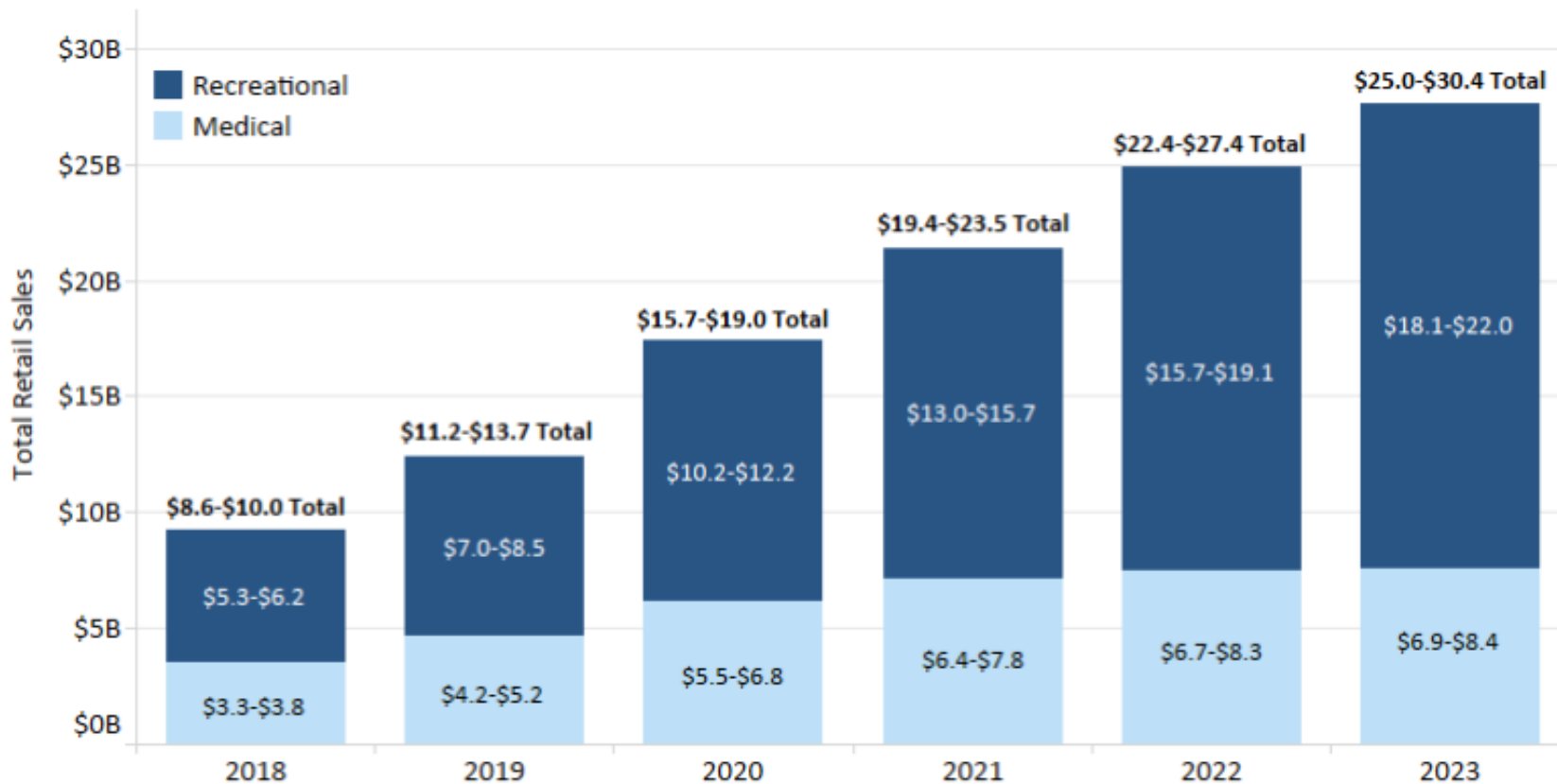
Source: DISA Global Solutions, September 2019





# CANNABIS

**U.S. Cannabis Retail Sales Estimates: 2018 - 2023**  
(In Billions Of U.S. Dollars)



Source: 2019 Marijuana Business Factbook

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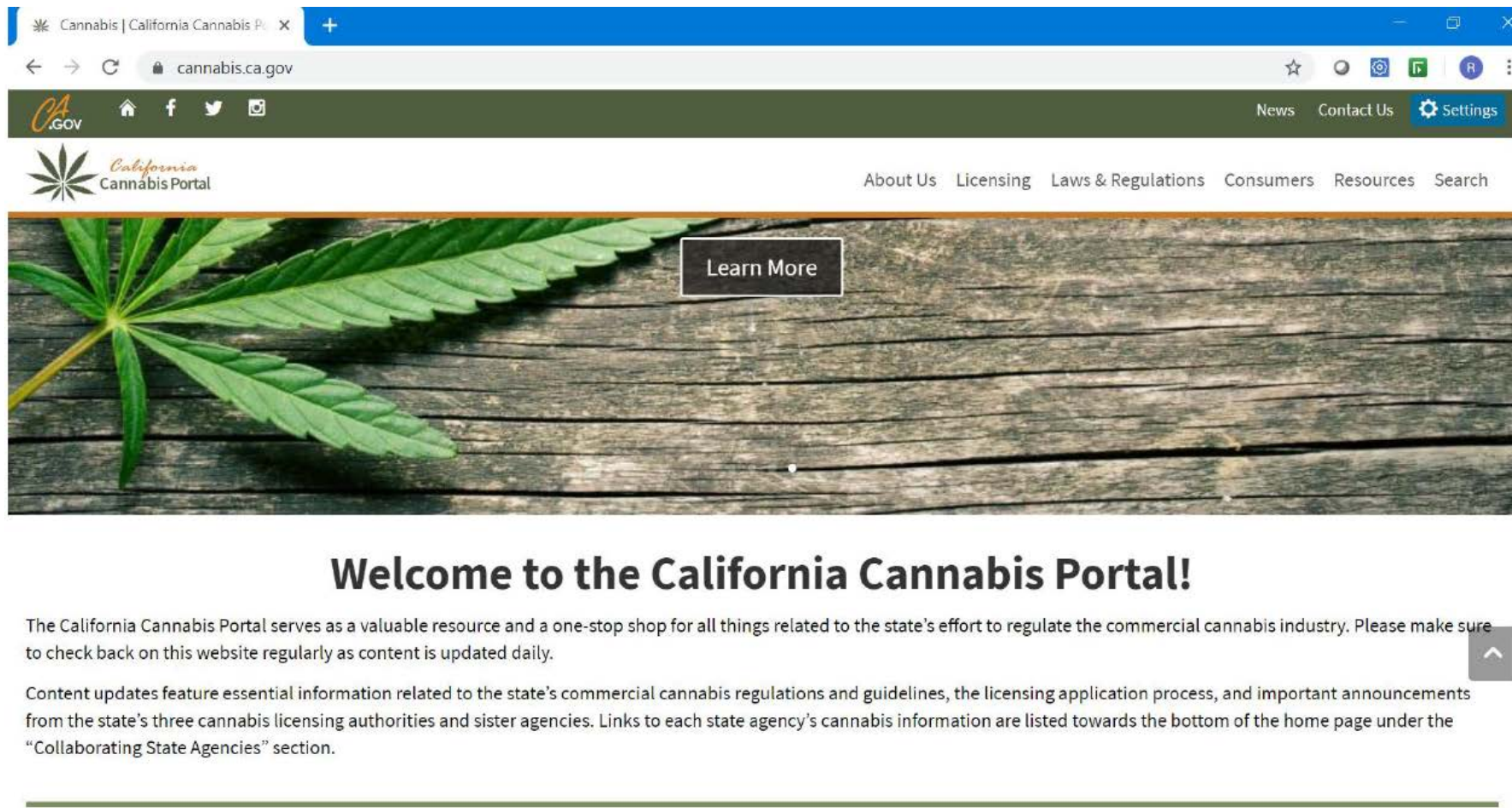


# CANNABIS – FEDERAL STATUS

- Remains Schedule I drug, same as heroin and LSD (i.e., deemed to have a high potential for abuse, no currently accepted medical use, lack accepted safety for use under medical supervision, and may not be prescribed or sold in the United States).
- Concerns re:
  - Banking - Secure and Fair Enforcement (SAFE) Banking Act (2019)
  - Bankruptcy / Enforcement of Contracts
  - Obtaining Insurance
  - Criminal Sanctions
  - Tax Deductions



# CANNABIS – CALIFORNIA



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## Welcome to the California Cannabis Portal!

The California Cannabis Portal serves as a valuable resource and a one-stop shop for all things related to the state's effort to regulate the commercial cannabis industry. Please make sure to check back on this website regularly as content is updated daily.

Content updates feature essential information related to the state's commercial cannabis regulations and guidelines, the licensing application process, and important announcements from the state's three cannabis licensing authorities and sister agencies. Links to each state agency's cannabis information are listed towards the bottom of the home page under the "Collaborating State Agencies" section.



# ILPA PRINCIPLES 3.0

- First update of the Principles since June 2011.
- New principles address new and emerging issues, including:
  - Fee and Expense Reporting
  - Subscription Lines of Credit
  - Co-Investment Allocations
  - ESG Integration
  - GP Ownership and Succession Issues
  - GP-led Secondaries Transactions
- ILPA not seeking official endorsements.



# ILPA PRINCIPLES 3.0 – FUND ECONOMICS

- Management Fees:
  - Should be based on reasonable expenses related to the normal operating costs of the fund.
  - During the investment period, a bifurcated fee reflecting a blended percentage of amount of capital committed and invested may be appropriate.
  - Following investment period, fee should be based on a percentage of unrealized cost.
  - No management fee should be payable in any fund extension without LP consent.
  - Any fees charged to portfolio companies should be 100% offset by against the management fee.



# ILPA PRINCIPLES 3.0 – FUND ECONOMICS

- Distribution Waterfall:
  - Recommends whole-fund, rather than deal-by-deal distribution waterfalls.
  - In a deal-by-deal waterfall, all costs of a given investment should be returned first, along with all fund fees and expenses to date. An escrow also should be implemented with significant reserves for potential clawbacks (e.g., 30% of carry distributions or more).
  - Carried interest should be based on after tax net profits.
  - Preferred return should be calculated when capital is invested, rather than when called from LPs, to mitigate the effect of subscription facilities.
  - GP clawback should be gross of taxes and payable within two years unless excessively burdensome or impractical.
- Subscription facilities specifically addressed:
  - Recommends that quarterly and annual reporting of fund-level leverage and performance information (i.e., IRR, TVPI and/or MOIC figures) with and without the use of subscription facilities.
  - Subscription facility terms should be disclosed or made available to LPs on request.
  - LPs should be offered the option to opt out of a facility at the outset of the fund.



# ILPA PRINCIPLES 3.0 – FUND ECONOMICS

- Expenses:
  - Travel related to sourcing deals, networking and preliminary due diligence should be paid by the manager, but that when a potential investment advances beyond the initial term sheet, those costs should be borne by the fund.
  - GP's travel policy should have parameters addressing use of private planes and entertainment expenses.
  - Where a co-investment vehicle participates in a broken deal, broken deal expenses should be shared on a pro rata basis.
  - Expenses specific to implementing technology for cybersecurity and software upgrades should be borne by the GP out of the management fee.
  - ESG-related due diligence, management and reporting should be paid by the GP.



# ILPA PRINCIPLES 3.0 – GOVERNANCE

- Standard of Care:
  - LPA should clearly disclose the standard of care. At a minimum, GP should be held accountable for fraud, gross negligence, willful misconduct and breach of the LPA.
  - Indemnification should be capped at a percentage of total fund size.
  - Individuals removed for serious misconduct should forfeit any carried interest or other residual economic interests to which they would otherwise have been entitled.
- Conflicts of Interests – GP should not undertake any conflict of interest without the prior approval of the LPAC, even if the potential conflict is disclosed in the offering documents.
- Disclosure of Fund Investors – GP should provide each LP with a list of all fund LPs as well as names and contact information for all LPAC members.
- Removal of the GP – A super majority in interest of LPs should be able to dissolve the fund or remove the GP without cause.







# Developments in Seeding Arrangements



# DEVELOPMENTS IN SEEDING ARRANGEMENTS – OVERVIEW

- Seeding Arrangements Fall Along a Spectrum, with Features Including:
  - Making a Significant Capital Commitment to a Fund Manager at the Initial Closing of the Fund
  - Assisting with Fund Structuring Issues and Proposing Market Terms and Conditions
  - Assisting with Fundraising and LP Introductions
  - Providing Financing to the Manager for Startup Costs or Working Capital
  - Receiving Certain Economic Benefits in the Initial Fund and in Certain Subsequent Funds



# DEVELOPMENTS IN SEEDING ARRANGEMENTS – ECONOMICS AND GOVERNANCE

- Economic and Governance Rights Can Include:
  - The Right to Invest in the Initial Fund and Certain Subsequent Funds on a No-Fee, No-Carry Basis
  - The Right to Receive a Share of the Management Fee and Other Income of the Management Company
  - The Right to Receive a Share of Carried Interest Payable to the General Partner
  - Governance Rights (including LP Advisory Board and Investment Committee Participation as well as Decision making at GP and Manager Level)



# DEVELOPMENTS IN SEEDING ARRANGEMENTS – ADDITIONAL ISSUES

- Commitments from Seeding Investors may be Subject to a Sliding Scale or “Ratchet”
- Seeding Investors may have the Right to bring in Additional “Introduced Investors” upon Preferential Terms
- Seeding Investors may have Put Options, Drag and Tag Rights and other Similar Rights with respect to their Interests in the GP and Manager



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