ALTERNATIVE INVESTMENTS QUARTERLY

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Values-Based Investing

Do Good While Doing Well

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ADISA

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Executive Director's Letter

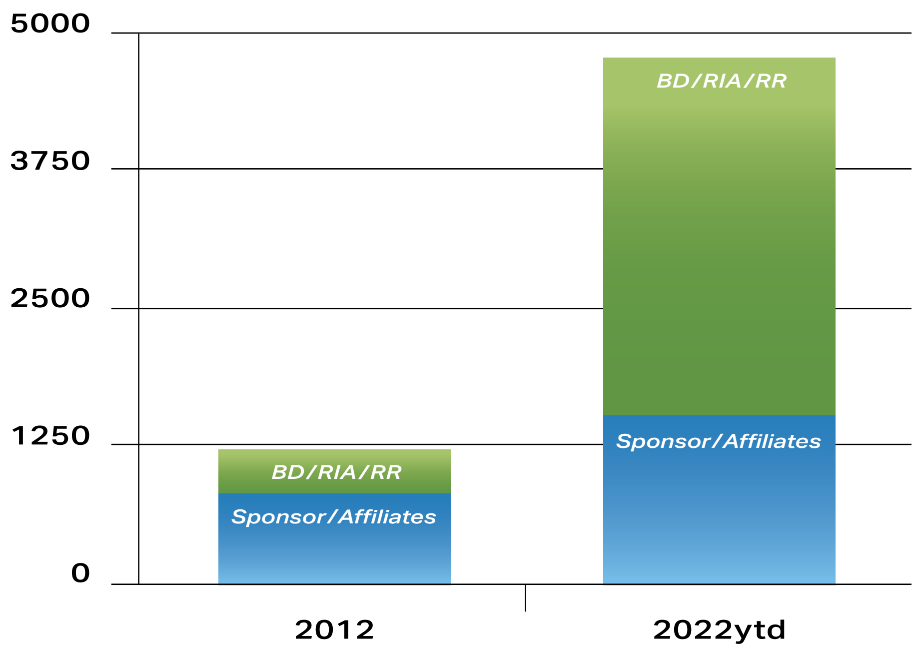
By John Harrison, *DBA*

Executive Director, ADISA

Dear ADISA Members

An amazing success can only describe this past year and the past decade for ADISA. Those of you at the Annual Conference know that we set new records for quality and attendance. In the past decade, ADISA has quadrupled membership and tripled its budget and activities. Our advocacy efforts are second to none, and our magazine, videos, website, and best practices publications write the record for the retail alternatives space. Thanks to our dedicated board and volunteers and our hard-working staff team (full-time plus out-sourced), we daily change this industry for the better.

Membership Growth Over the Decade



The fact that we're on top and growing also resonates in our spirit. ADISA has carved a reputation of excellence and friendliness; we're democratic in our structure and proud of it. Perhaps this is the thing of which I am most proud: we have built an association that truly belongs and is in touch with its members.

This brings me to a more personal note. Next year, 2023, for me will be traditional retirement age; I've had a 40+ year career in association management, more than ten of them at ADISA. While I will certainly help ADISA as needed as an Executive Director Emeritus, I feel it is time for me to sunset out and usher in new staff leadership for the organization. I've asked the Board to consider sometime in 2023 as a great time to effect this transition, and they will begin the process of bringing in the next executive director. To this end, President-elect Underhill and the ADISA Board will start this effort in earnest next year and announce the selection process--stay tuned for further specifics as this develops. Rest assured; a smooth runway will be in the works.

And also rest assured that your association, ADISA—and we do mean your association, for we know that it is you who enable the success—will continue to thrive as it connects this industry to education, to advocacy, and, of course, to each other. Here's to the next great decade!

Kind regards,

John P. Harrison, *DBA, CAE*
ADISA Executive Director

Values-Based Investing: Do Good While Doing Well

Sara Dooley Henning, *Director of Impact at Uplifting Capital*

Uplifting Capital is an investment firm operating at the intersection of wealth management, private equity, and impact investing. The firm builds scalable, personal values-aligned private market portfolio solutions for wealth managers, along with the families and institutions they serve.

Introduction

Across all age ranges, geographic regions, and income levels, many investors are seeking investment opportunities that enable them "to do good while doing well." Values-based investing presents an opportunity for financial advisors to attract and retain clients, showcase their expertise, and provide value.

Interest in values-based investing is increasing. Many advisors, however, feel ill-equipped to speak with their clients about aligning their investment goals with their values. This guide is intended to be a resource for ADISA members, and financial advisors in particular, on how to incorporate values-based investing into their practice.

This resource might be especially useful when working with clients who are:

- Focused on the legacy they are leaving behind
- Interested in philanthropic causes
- Involved in their community and/or with religious institutions
- Concerned about issues such as climate change or sustainable development
- Passionate about social justice

For investors, a few benefits of values-based investing include:

- Aligning investments with values and beliefs can compound positive impact
- Investing in companies that incorporate sustainable environmental, social, and governance factors into their operations can mean lower risk over time
- Opportunity to contribute to global challenges such as poverty, climate change, and access to high-quality education and healthcare
- Realizing competitive financial returns

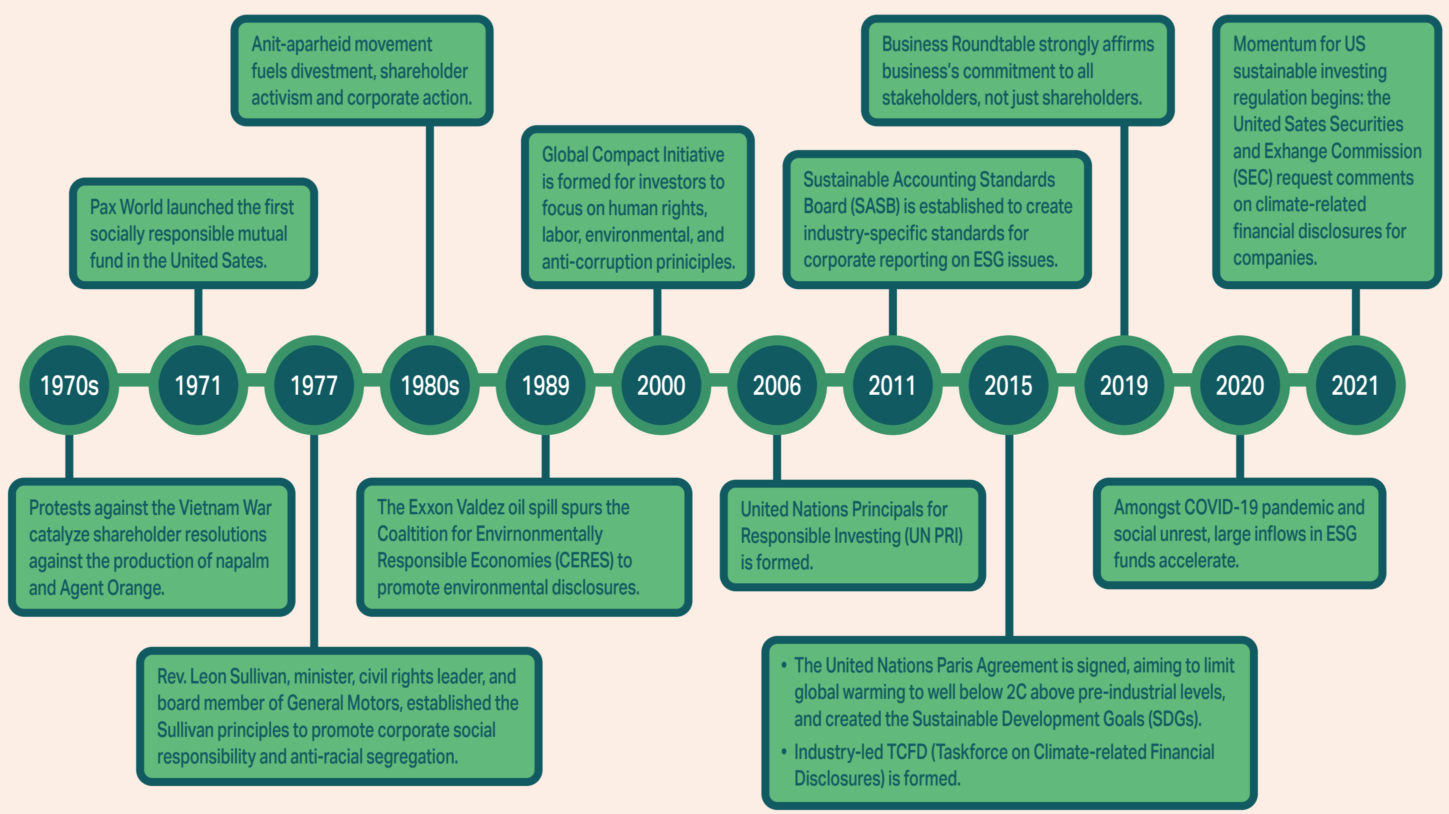
Interest in values-based investing is increasing. Many advisors, however, feel ill-equipped to speak with their clients about aligning their investment goals with their values.

History and Evolution

Values-based investing (also called sustainable investing) has grown exponentially in recent years, but the practice has a long history. In the United States, values-based investing dates back to the 18th century when faith-based organizations began steering investments away from the slave trade, alcohol, weapons, tobacco, and gambling.[1] Modern social and environmental movements increased its popularity and adoption. Vietnam War protesters boycotted companies that manufactured weapons in the 1960s,[2] and divestment was effectively used as a tool against apartheid in South Africa in the 1980s.[3]

Today, values-based investing has evolved from excluding investments in products or companies that conflict with an investor's values to proactively investing in companies whose values are shared with investors. Investors now have the opportunity to invest in companies that responsibly manage environmental, social, and governance (ESG) issues by, for example, using sustainable materials in their production or treating employees more fairly. Investors also can choose to invest in companies that are addressing some of our world's greatest challenges in which they are particularly interested. The term "impact investing" was coined in 2007 and refers to investments made with the intention to generate positive and measurable social and/or environmental impact alongside financial returns.4

Modern History of Sustainable Investing—A Timeline



Source: https://www.incomeresearch.com/a-primer-on-sustainable-investing-2/

Values-Based Investing 101: Overview of Concepts and Terminology

Once considered a niche market segment, values-based investing is now more mainstream. According to a 2020 report from the US SIF Foundation, U.S. assets under management using sustainable investing strategies grew from $12 trillion at the start of 2018 to $17.1 trillion at the start of 2020.[5] This represents one out of every three dollars of U.S. assets under professional management.

There may arise, however, a disconnect between the awareness or knowledge of financial advisors and interest of their clients when it comes to sustainable investing. An SEI survey of nearly 800 Registered Financial Advisors found that 20% of RIAs remain unfamiliar with sustainable investing, and 40% feel they do not know enough about sustainable investing to make suitable recommendations to clients.[6] Nevertheless, interest in sustainable investing appears to be growing among investors. Morningstar found that 72% of the U.S. population expressed at least a moderate interest in sustainable investing. This interest was stable across age and gender demographics.[7]

Helping clients better align their personal values with their investment goals provides an opportunity for advisors to deepen their relationships with their clients and demonstrate their value, but it is important to understand the terminology. "ESG," "socially responsible investing," "sustainable investing," and "impact" are sometimes used interchangeably, which unfortunately has led to confusion. For purposes of this guide, we have adopted impact investing specialist consulting firm Tideline's labels of ESG-integrated, thematic, and impact to differentiate values-based investment strategies.

Spectrum of Values-Based Investing

ESG-Integrated Investing

ESG-integrated investments incorporate environmental, social, and governance considerations into investment decision-making. This strategy analyze how ESG factors, such as resource use, carbon footprint, diversity, equality, wages, and labor conditions, affect a company's bottom line. ESG primarily focuses on operational issues that are internal to the business and recognizes that ESG factors present both risks and opportunities for financial results. For example, companies that pollute the environment may face legal risks, and those who treat workers unfairly may face strikes or boycotts.

Thematic Investing

Thematic investments target specific themes that are broadly aligned with benefits to society or the environment. While thematic and impact investing are sometimes used interchangeably, thematic may lack the specific impact objectives or measurable outcomes targeted by impact investments. These are, nevertheless, investments that align with investors' values, such as in companies engaged in social justice or environmental sustainability.

Impact Investing

Going beyond how companies operate, impact investing focuses on what companies are producing and who is benefiting from their products and services. Impact investments are made with the intention to generate positive, measurable social or environmental impact alongside a financial return. These are investments in companies that are seeking to create positive change through business opportunities. Broad examples of impact investments include renewable energy and increasing access to quality healthcare.

A Closer Look at Values-Based Investing

The Importance of Labels

A common criticism of values-based or sustainable investing is the lack of clarity in fund labeling. Although progress is being made as a result of both industry and regulatory efforts, inconsistencies and confusion remain. Funds labeled as "ESG," for example, may, and often do, consist of very different types of investments.

In order to properly align investors' goals with their values, advisors must be able to look beyond the name of a fund or project to determine which investment strategy is in fact being deployed. Although this task may at first appear daunting, looking at intention, contribution, and measurement can help differentiate between ESG-integrated, thematic, and impact approaches to investing. In general, higher levels of intention (to generate positive impact), contribution (active engagement by the fund manager), and measurement (degree to which an investment's impact is managed and monitored) indicate that an investment should be labeled impact.

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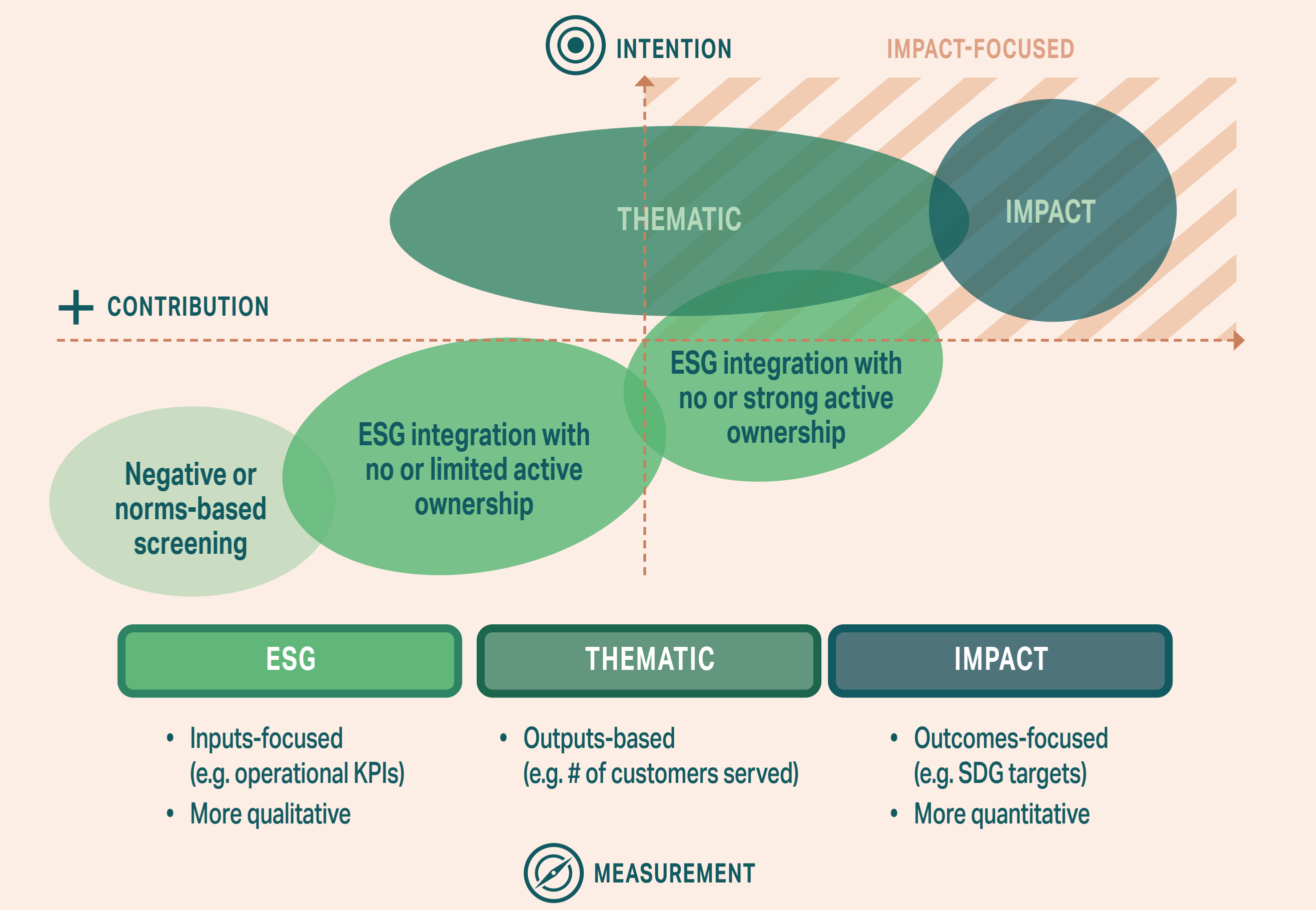
ESG Investing 201

Once thought of primarily as a public market strategy, private market investors have been increasingly integrating ESG factors into their investment decision-making. According to Pitchbook's 2021 Annual Sustainable Investment Survey, 62% of respondents focus their sustainable investment efforts on private equity and venture capital, topping public equities that came in second at 34%.[8] With its focus on active ownership and long-term investment horizon, private capital is well-positioned for ESG-integration.

The primary factor in ESG-integrated investing is financial performance, but this investment strategy can take many forms. ESG investments allow investors to exclude companies they wish to avoid, and target those with the best environmental, social and governance (ESG) practices as judged by some reasonable criterion. Developing a clear understanding of both a fund manager's ESG-related strategy and your client's goals is vital.

- Is the manager using ESG primarily to manage risk and enhance potential financial performance? If so, this may mean that less environmentally friendly business decisions may result in greater financial profitability.
- Or does the fund manager identify companies engaging in less desirable ESG practices and actively engage with its investments to advance positive ESG-related outcomes? By pursuing improvements in ESG outcomes, these types of investments may include "dirty companies" that the manager believes have the potential to incorporate significant positive changes.

Value-Based Investing Labels



Source: https://tideline.com/truth-in-impact-a-tideline-guide-to-using-the-impact-investment-label/

- Or does the fund manager target companies who have adopted best-in-class ESG approaches? These are investments in companies that are already leaders in terms of adopting environmental, social, and governance criteria.

Unpacking E, S, and G Areas

Environmental: The "E" in ESG refers to environmental criteria—the measurement of the environmental impact and sustainability of a company. The E considers how a company performs as steward of its physical environment and includes issues such as carbon footprint, natural resource management, pollution, and supply chain emissions.

For many investors, environmental protection is the most important consideration when it comes to ESG. Some recognize the risk of climate change to the global economy and want to ensure that their investments have sustainable strategies designed to mitigate environmental risks. Some investors will want to only invest in "green" companies that likely set net zero emission targets and are committed to transparent sustainability disclosures. Others, however, will prefer to invest with fund managers who are actively engaging with companies to improve their environmental outcomes, by, for example, helping companies reduce emissions.

Social: The "S" refers to the social aspect of ESG—how a company interacts with its employees and the communities in which it operates. Social considerations include a company's health policies; labor relations; commitment to diversity, equity, and inclusion; and social factors which extend outside the company itself to include product safety, human rights issues within the supply chain, and community relations.

Although environmental criteria have traditionally been the primary focus in ESG, social issues have been garnering more attention in recent years. Investors are increasingly attracted to companies who embrace diversity and inclusion, pay a living wage, and prioritize employee health.[9]

ESG has recently faced backlash from both sides of the political aisle. Although most of the political backlash has focused on ESG in the public markets, the current media attention could raise concerns for investors in the private markets by association.

Governance: The "G" refers to corporate governance—how a company is managed and supervised. Governance looks at issues like the composition of the board of directors, executive compensation, and the quality of management within a company. Corporate governance is related to the E and S as well-managed companies experience fewer environmental and social problems.

As with environmental and social considerations, governance issues may pose both financial risks and opportunities in attempting to align with an investor's values. For example, focus on board diversity has accelerated in recent years,[10] and good governance has the potential to reduce risks through increased transparency with regulators and avoidance of violations.[11]

Emerging issues in ESG investing

ESG Backlash: ESG has recently faced backlash from both sides of the political aisle. Although most of the political backlash has focused on ESG in the public markets, the current media attention could raise concerns for investors in the private markets by association. Some of the criticism stems from a misunderstanding of what ESG means for a particular investment. Again, it is important to look at whether the investment is integrating ESG considerations primarily to mitigate risk or targeting best-in-class companies with respect to ESG.

Greenwashing: Greenwashing refers to providing misleading information that claims investments are more environmentally sustainable or "green" than they actually are. As ESG investing has gained popularity, the label has been used more liberally. Transparency and data help mitigate greenwashing. Investor and regulatory pressure to mandate and standardize ESG reporting and the use of ESG labels will likely also lead to industry improvements.

Potential ESG Due Diligence Questions

- Is ESG a core component of your mission?
- How do ESG risks and opportunities affect your investment decision-making process?
- How do you engage with portfolio companies around ESG?
- What ESG key performance indicators (KPIs) do you monitor and measure?
- How do you verify ESG-related data?
- Do you measure the greenhouse gas (GHG) emissions associated with your investments?
- Do you require your portfolio companies to sign a code of business ethics or anti-corruption policy?
- Do you report on ESG performance? If so, how?
- Do you incorporate ESG factors into your exit strategy?

Thematic Investing 201

The category of investments that fall between ESG-integrated and impact lacks clarity and consistency with respect to terminology. To encourage shared frameworks and definitions, we have adopted Tideline's labels and refer to these investments as thematic. As demonstrated in the figure above, thematic investments often have a great deal of intentionality but may lack the degree of contribution (active engagement by the fund manager) or measurable outcomes found in impact investments.

Thematic investments offer passionate clients the opportunity to select investments aligned with their specific interests or values. For example, investors who are interested in clean water may direct their capital towards companies who are involved with water management and treatment. A potential downside of a targeted thematic strategy, however, is increased risk due to less diversification.

Potential Thematic and Impact Due Diligence Questions

- What is your mission? Do you have mechanisms in place to protect against mission drift?
- Do you have an impact thesis? If so, what is it?
- Are you working to address a social or environmental need(s)? If so, what need(s)?
- How do you incorporate impact expertise on your team?
- Are any Sustainable Development Goals (SDGs) aligned with the fund or project?
- How do you assess and monitor the expected impact of each investment?
- What metrics are you using to monitor and measure impact?
- What external factors might affect your ability to deliver the expected impact? How do you mitigate against impact risk?

- How do you report on impact performance?
- How do you engage with portfolio companies on ESG and impact issues?
- How do you approach exits from an impact perspective?

Impact Investing 201

The term "impact investing" can be used quite broadly. Impact investing, however, is officially defined by the Global Impact Investing Network as investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments offer clients the opportunity to leverage their financial assets for significant potential impact and the closest alignment with their values.

Impact Areas

Impact investments can be made across numerous sectors, and a few of the most popular impact areas are highlighted below.

Education: Although we often think of education as a public service, private capital has the power to fill in some of the current gaps in the education system. Education currently makes up only 4% of assets under management for impact investing, but the sector is growing. Private capital can offer alternative educational services and support innovations that increase equitable access and enhance quality.

There are many ways to advance education through private investment, with a wide range of intended outcomes including increased learning outcomes, increasing social-emotional skills, and improved economic mobility. Education technology ("EdTech"), in particular, has the power to tackle many of our most significant education challenges. The COVID-19 pandemic accelerated innovation, and the market for online degree-focused higher education is expected to more than double in value to $74 billion by 2025.[12]

Health & Wellness: According to the World Health Organization, "more than one billion people cannot obtain the health services they need because those services are either inaccessible, unavailable, unaffordable, or of poor quality."[13] Investing in health is one way to close these gaps.

Advances in innovative healthcare technologies in particular provide impactful investment opportunities and lead to more equitable health outcomes. Impact capital directed towards Healthtech surged during the COVID-19 pandemic, and the sector continues to experience significant growth. Telehealth, for example, has increased 38x since before COVID, and virtual healthcare models continue to evolve.[14]

Renewable Energy: Investments in renewable energy grow the share of renewable and efficient energy in the global energy mix, increase access for affordable and sustainable energy, and improve energy infrastructure and technologies.

Clean energy is arguably the fastest-growing "green" sector, due in part to government targets. In fact, green electricity is on track to become the largest power source in 2025.[15] According to the International Energy Agency, investment in renewable energy needs to triple by 2030 in order to effectively fight climate change and meet the world's future energy needs.[16] As demand for renewable energy continues to accelerate, investment opportunities include solar and wind energy, battery storage, grid modernization, and decarbonization.

Sustainable Food Systems: In theory, there is currently enough food being produced to feed the world's 7 billion people, but as many as 828 million people still go to bed hungry every night.[17] Waste is a big part of the problem, but other factors including supply chain challenges, exploitation of natural resources, and inequitable access also play a role. There is a large and growing demand for sustainable food systems, which presents opportunities for impactful investments. The Business and Sustainable Development Commission estimates that business opportunities in the implementation of food-related SDGs could be worth more than $2.3 trillion a year by 2030. There is an estimated $165-$255 billion to be made in meeting the increasing food requirements of those emerging out of extreme poverty, $155-$405 billion in reducing food waste in the value chain, and $110-$205 billion in reformulating products for increased nutritional value.[18]

Impact Alpha: Using Impact to Drive Financial Value for Investors

Many investors choose impact investing because they are motivated by the desire to align their investments with their values. Other investors, however, avoid such investments due to concerns about the financial ramifications.

It is a common myth that impact investments necessarily sacrifice financial returns. Incorporating an impact objective might actually **improve** financial performance.[19] Consumer demand, and in turn expenditures, for impactful products and services is increasing.[20] Moreover, new technologies have the power to tackle many of the world's most pressing challenges and continue to experience significant growth.[21] Sustainable, impactful companies also attract talented employees. These factors, among others, may contribute to successful businesses that drive financial value for investors.

It is a common myth that impact investments necessarily sacrifice financial returns. Incorporating an impact objective might actually improve financial performance. Consumer demand, and in turn expenditures, for impactful products and services is increasing.

Evidence of Impact as Alpha

- 70% of employees in a survey conducted by McKinsey and Company said that their sense of purpose is defined by their work.[22]
- 68% of people are more likely to accept positions from environmentally sustainable companies.[23]
- Companies in the top-quartile for gender diversity on their executive teams were 21% more likely to have above-average profitability than companies in the fourth quartile. For ethnic cultural diversity, top-quartile companies were 33% more likely to outperform on profitability.[24]
- According to McKinsey & Company, disruptive healthcare technologies that expand and optimize service delivery while lowering cost will gain mass adoption.[25]
- There is an $18 billion market demand from low-income families in emerging markets for microcredit loans to pay for improved water and sanitation services.[26]
- The International Finance Corporation estimates a climate investment opportunity of $24.7 trillion in green buildings.[27]

Industry Standards and Frameworks

Principles of Responsible Investment (PRI): The PRI is the United Nations' framework for responsible investment and works to promote the incorporation of environmental, social, and governance factors into investment decision-making. PRI signatories agree to adhere to six principles with the aim of developing a more sustainable global financial system.

Operating Principles for Impact Management (OPIM): The Operating Principles are a global initiative established by the International Finance Corporation (IFC) to provide a framework for investors to guide the design and implementation of their impact management system. The Operating Principles go beyond the incorporation of ESG factors found in the PRI to require a credible thesis demonstrating how an investment contributes to positive impact outcomes.

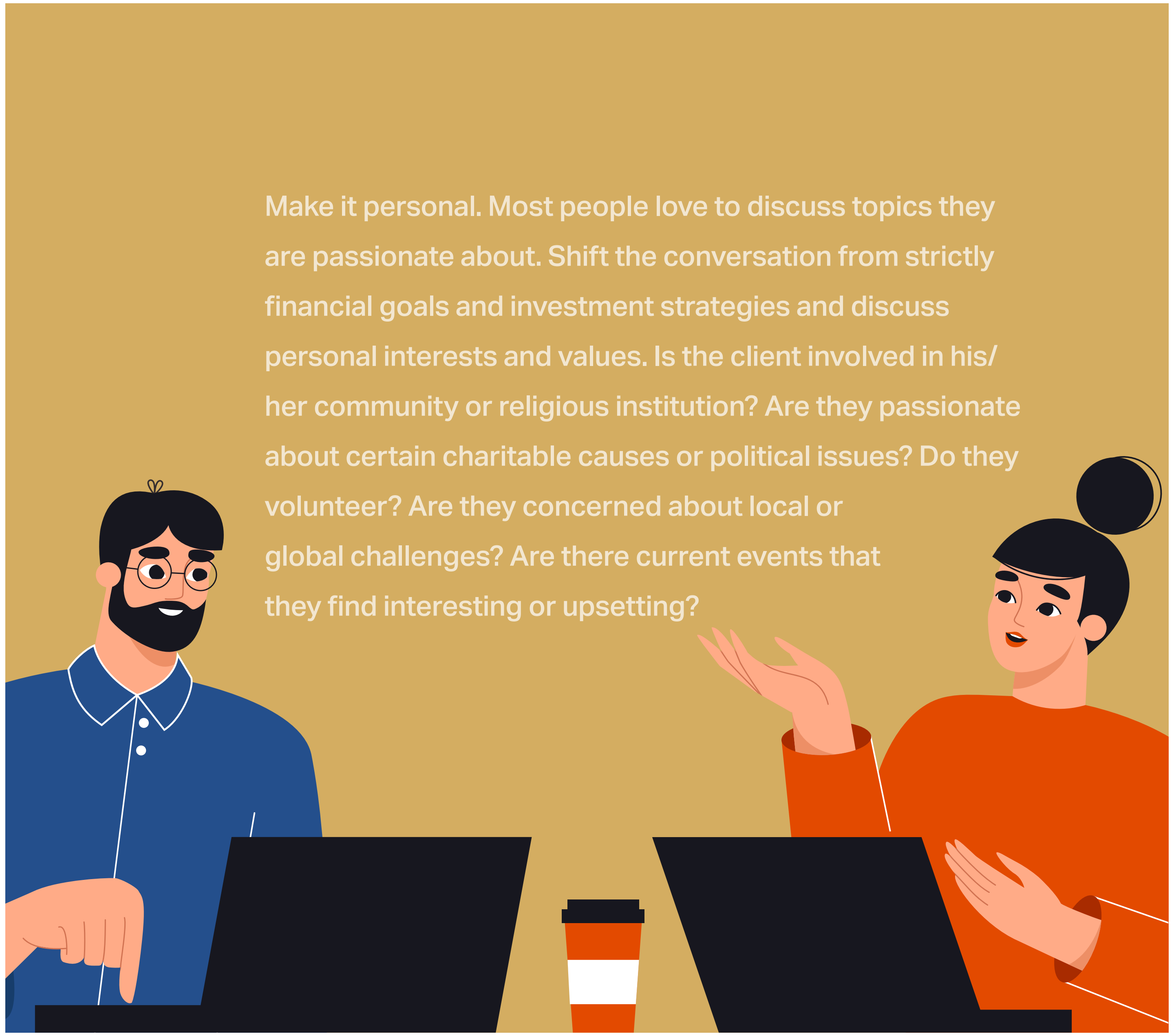
Sustainable Development Goals (SDGs): Often referred to as "SDGs," the Sustainable Development Goals were adopted by the United Nations in 2015 as a global call to action. These 17 goals have rallied the world to reduce poverty and inequality, improve health and economic opportunity, and mitigate the harmful effects of climate change. There is a vast gap, however, in the level of investment needed to realize these ambitions, currently estimated at $4.2 trillion annually. Investments in socially and environmentally impactful enterprises can help close that gap.

IRIS+: Created by the Global Impact Investing Network (GIIN), IRIS+ is an impact management and measurement system containing standardized metrics designed to measure the social, environmental, and financial performance of an investment. IRIS+ helps investors optimize their impact by promoting transparency, clarity, and accountability in the use of impact data.

Tips for Talking to Clients about Values-Based Investing

A few tips that may help advisors deepen their relationships with clients and open dialogue about values-based investing opportunities include:

- **Be prepared.** Educate yourself on values-based investing and the spectrum of opportunities available to investors. This guide is intended to help facilitate conversations between investors and advisors and additional resources are provided in the last section. You don't need to be an expert, but you should have enough knowledge to lead a conversation and create an offering for interested clients.
- **Make it personal**. Most people love to discuss topics they are passionate about. Shift the conversation from strictly financial goals and investment strategies and discuss personal interests and values. Is the client involved in his/her community or religious institution? Are they passionate about certain charitable causes or political issues? Do they volunteer? Are they concerned about local or global challenges? Are there current events that they find interesting or upsetting?



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- **Meet your clients where they are**. Some may be familiar with and interested in values-based investing, while others may have little exposure to the space or hold common misconceptions.
- **Take the time to understand priorities**. While some clients will likely be passionate about aligning their values with their investment goals and have strong opinions about the types of companies they invest in, others will be more interested in how to use the approach to mitigate sustainability risks or enhance financial returns. A good place to start may be asking a client want they don't want exposure to.
- **Keep it simple**. It is easy to get wrapped up in jargon and acronyms. Make sure to use relatable language, ask clients if they need clarification or have questions, and prioritize educating and empowering clients.

FAQs

Do impact investments sacrifice financial returns?

While some investments target below-market returns (sometimes referred to as concessionary returns or patient capital), the majority of impact investors look for, and achieve, market-rate returns. The GIIN's 2020 Annual Investor Survey reported that 92% of impact investors seeking market-rate returns stated that their investments were performing in accordance with their market expectations.[28]

Who are impact investors?

Impact investments reach across numerous alternative asset classes, including private equity, venture capital, debt, real estate, and infrastructure. Development finance institutions, foundations, family offices, pension funds, insurance companies, government institutions, and high-net-worth individuals are the most active limited partners for impact investments, but the popularity of impact investing is increasing across all demographics.

How can advisors and investors guard against greenwashing and impact washing in their investments?

Two important ways to ensure that an investment is in fact sustainable or impactful are through due diligence and data. An investment may be labeled ESG, sustainable, or impact, but taking a deeper dive into a fund manager's objectives (what is their mission or formal commitment to sustainability?), expertise (do they employ ESG or impact specialists?), and data (how do they manage and verify ESG or impact data?) can mitigate against greenwashing and impact washing risks.

Will or should impact investing replace philanthropy?

Impact investing and philanthropy play complementary but different roles in addressing global challenges. By reinvesting returns, investors can leverage their money and compound their impact. Some global challenges, however, cannot (or should not) be addressed by market-based solutions and will continue to rely on philanthropy. Natural disasters and other catastrophes, for example, require immediate philanthropic response and are unlikely to be effectively addressed by impact investments.

What is net zero?

Net zero refers to achieving a balance between the amount of greenhouse gas produced and the amount removed from the atmosphere. Investments in net zero aim to reduce greenhouse emissions across an investment portfolio while also making investments to build a carbon-free economy.

Additional Resources

Principles for Responsible Investment (https://www.unpri.org/): The PRI offers a wide range of resources from introductory materials to in-depth technical and policy guides. Their website includes information on alternative investments as well as numerous free webinars covering topics such as investing in human rights and adapting ESG for venture capital.

The Forum for Sustainable and Responsible Investment (https://www.ussif.org/education): Resources include online and live courses, fact sheets, and research publications.

Global Impact Investing Network (https://thegiin.org/): The GIIN works with investors to accelerate the scale and effectiveness of impact investing, and their website provides a number of tools and resources.

IRIS+ (https://iris.thegiin.org/): Created by the GIIN, IRIS+ is an impact measurement and management system. IRIS+ is a free, publicly available resource that helps investors optimize their impact by providing evidenced-based metrics around key themes.

Sustainable Development Goals (https://sdgs.un.org/goals): The SDG website provides information about the 17 Sustainable Development Goals, including their history, targets, and implementation progress. ▲

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Top Ten Reasons New Sponsors Fail

By Jan Ryan, *JCC Capital Markets*

Jan Ryan is the Senior Vice President, Product Development, for JCC Capital Markets, a managing broker-dealer working with sponsor clients to bring quality investments to the independent broker-dealer community. She has over 40 years of experience in the financial services industry with expertise in due diligence, product development, analytics, sales, national accounts and marketing.

The direct participation program industry can be extremely lucrative, but a high percentage of new sponsors fail. Even sponsors with a history of private offerings can fail when entering the independent broker dealer market. Successful sponsors are those who are prepared, bring the right product to market at the right time, presented in the right way, and have the stamina to stay the course. Here are the top ten reasons new sponsors fail.

1. Undercapitalization

This is listed as number one for a reason. This is the most common problem for new sponsors. Even the best products with the best pedigree will fail if they do not have the staying power to get through the first offering. Sponsors need to have the funds available BEFORE entering the market. Sponsors attempting to raise money for the sponsor entity at the same time they are raising money in product offerings have too much distraction just trying to keep the doors open.

2. Unrealistic Expectations

Have reasonable expectations on what you can accomplish in the first three years. Have goals and stretch goals, but make sure your financials still work with more modest targets. A recent product sponsor had an expectation of $200 million for their first year sales. They hit $100 million, which for most would be a huge success, but for them, it nearly meant the end as they had run out of money.

3. Undifferentiated Product

A new "me too" product will not sell. There must be a compelling reason that YOUR product is needed in the marketplace. Another product means more work for the due diligence professionals and more to learn for their representatives. If all your offering does is cannibalize their existing sales, there is no need to add your product. That will be the base position most firms will have. It will be up to you to clearly articulate why there is nothing else in the marketplace quite like what you have, or if there is, why yours is vastly (not just a little) superior.

4. Lack of Distribution

This is a small industry with players who mostly all know each other. If no one knows you, they are unlikely to want to get to know you. Chicken and the egg? Yes. Many of the independent broker dealers have a firm policy of not signing a firm's first offering. If you do not know the industry, hire people who do. Go to the industry association meetings and get known. Get the advice of some of the key decision makers and include their suggestions in your offering. They are more likely to sign your product if they had a hand (or think they had a hand) in its design.

5. Lack of Track Record

Even a strong track record may not be enough, but without one, the odds are stacked against you. A long-term track record in your core asset class is essential. A track record without any blemishes is ideal, but a track record that shows you have overcome adversity and kept the interests of the investors as your primary motivation speaks volumes. Moving from 1031s to REITs, or private offerings to publics provides additional challenges relating to scale and compliance that will need to be addressed.

6. Inexperienced Principals

The securities business is complicated. Even if the principals understand their core business, if they do not understand the securities business, or hire people who do, they can run into difficulty. Things as simple as knowing who needs to be registered and with which licenses, the intricacies of escrow, and staying under the 10% guideline seem obvious to those in the business, but all three of these areas have led to significant fines for product sponsors who have been in the industry for years. With new sponsors, getting the basics right and keeping up with the changing compliance landscape is essential. Then there is the business itself. This can be an expensive way to raise capital. Inexperience can lead to poorly constructed pro formas and unrealistic return models.

7. Poorly Structured Product

There is a delicate balance between investor safeguards and sponsor latitude. There are specific items that due diligence officers require and others that are strong sales features important to representatives. Do your homework. Look at the structure of other products. Get the advice of experienced attorneys with expertise in your specific niche. Ask the attorneys what their experience has been with the various states and how long it has taken them to get product through the process. It isn't just the SEC and FINRA that can hold up your offering. That said, you still need to be able to run your business with enough discretion to allow you to be nimble in changing circumstances. A recent product offering had a $10 million escrow. The feeling of the principals was that it would take no time to raise that kind of money. They were wrong. The deal is no longer on the street. This was an established product sponsor who was entering a new side of the business.

8. Unsupportable Cash Flow/Noncompetitive Cash Flow

Cash flow is critical in most product offerings. Striking the right balance is essential. A high cash flow that must later be cut as unsustainable will brand you as someone who does not keep promises. Don't do it. On the flip side, having a 4% product in a 6% world is a nonstarter. You do not have to have the highest cash flow, but you need to be in the ballpark. At the very least, you need a distribution that is sustainable on the stabilized portfolio and a demonstrable plan on how you plan to achieve coverage.

9. Weak or Lack of Audited Financials

Small independent broker dealers may not insist on audited financials, but most of the serious players will. If you do not provide them, they will assume you have something to hide. That said, you do not need to be profitable as a company in the beginning. They know that ramp up takes time and capital. They will give you time to mature but they want to know where you stand.

10. 10% Expense Cap

Distribution expenses must fit under a 10% cap for public offerings and no, you cannot just eat the expenses associated with your first program to get it started. You must stay under the cap for wholesaler comp, rep commissions, conference costs, BD overrides, everything. Check out the footnotes in the Use of Proceeds table in the prospectuses of your competitors for guidance. An experienced product sponsor offered their first REIT and pushed some of their conference expenses into offering and organization expenses (not in the 10%). They got caught and got fined by the SEC.

So what's the bottom line? In order to enter this business, make sure you have an attractive product, enough capital and the right people to make it happen. ▲

Oil and Gas Tax Subsidies: Historical Perspective and Current Applications

By Jack Hollander, *JD, LLM* and Bradford Updike, *JD, LLM, Mick Law*

Jack Hollander, *JD, LLM*

Over the course of his career, Hollander has been involved in the development, management and fund raising of alternative and tax advantaged investment programs, as well as assisted companies in their financial needs. He has worked extensively with financial and tax advisors to strategically position specialized alternative investments for high-net-worth individuals, raising over $3 billion in capital.

Bradford Updike, *JD, LLM, Mick Law*

Bradford Updike, Director at Mick Law, manages the firm's energy and tax-oriented practice. Other areas of practice include securities law, oil and gas, private equity, conservation real estate, DPP due diligence, taxation analysis relating to securitized financing, and securities advertising

Many advisors will continue working with clients reviewing their investments, rebalancing their portfolios, and implementing year-end tax planning through December 31. Stating the obvious, there's quite a lot to think about too. The Mid Term elections, winding down phase of COVID, Russia's continued occupation of the Ukraine, inflation, climate change, gas prices, and transition to renewable energy are among just a few of today's fun topics.

Against this backdrop, financial advisors are left to make sense of these developments when planning the next steps for clients. Despite the background noise, advisors must continue to look for ways to balance risk with reward from an income, growth, and income tax savings perspective. These pieces to the financial planning puzzle remain consistent.

Politically, it is a truism that President Biden has an agenda that does not favor fossil fuels. Rather, the President's desired goal is to transition away from fossil fuels and to replace them with renewable energy. However, replacing oil/gas with renewables "on a dime" isn't realistic due to the intermittency of sun and wind. That's not to say that some alternative sources of energy won't become more reliable over time. Notwithstanding, fossil fuels are expected by the Energy Information Administration and many others to account for a significant majority of the world's energy through 2040. **As such, oil/gas is HERE TO STAY for many years to come.**

For understandable public policy reasons, the tax benefits of oil/gas investing have been part of our Internal Revenue Code ("**Tax Code**") for years. Lodged within the Revenue Act of 1913 were federal income tax incentives for oil and natural gas development, which covered both exploration and production. Three years later (2016), a statute that was placed into federal tax law that ensured U.S. drillers

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could immediately expense intangible drilling costs ("**IDCs**"), such as those incurred when a company drills a new oil/gas well. The IDC deduction was justified because lawmakers said it would attract needed investments in U.S. hydrocarbon production.

The oil/gas tax incentives increased during the 1920s. In 1926, Congress passed the oil depletion allowance, allowing producers to deduct more than a quarter of their gross revenues. Acknowledging that the justifications for IDC expensing and deletion allowances have been argued back and forth among certain administrations for years, these tax incentives remain as a part of our Tax Code (with these deductions surviving through the passage of the latest and greatest Infrastructure Bill this year). As stated prudently by President Dwight Eisenhower in 1957, *"there must certainly be an incentive in this country if we are going to continue the exploration for gas and oil that is so important to our economy."* Given the severity of energy inflation across the entire globe, the justification continues to keep such oil/gas tax incentives in place.

Albeit begrudgingly, even President Biden has been forced to rethink his position on fossil fuels for the moment based upon the supply disruptions for oil/gas across the globe. While more oil/gas supply is needed, what we've unfortunately observed for a few years now is that an insufficient amount of capital was deployed within the upstream and midstream sectors. Understandably, this has set back U.S. oil/gas production, which hasn't kept pace with demand for most of this year. This is also the reason why commodity prices have risen over the last 24 months. Due to the world's long-term need for crude and natural gas, market fundamentals within these commodities appear to be positioned favorably going into 2023. This could also bode well for those making direct investments in E&P projects.

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Aside from the recent oil/gas supply crunch and today's favorable market fundamentals, direct investments in oil/gas produce a plethora of federal income tax incentives. For the remainder of this article, we'll revisit some of these.

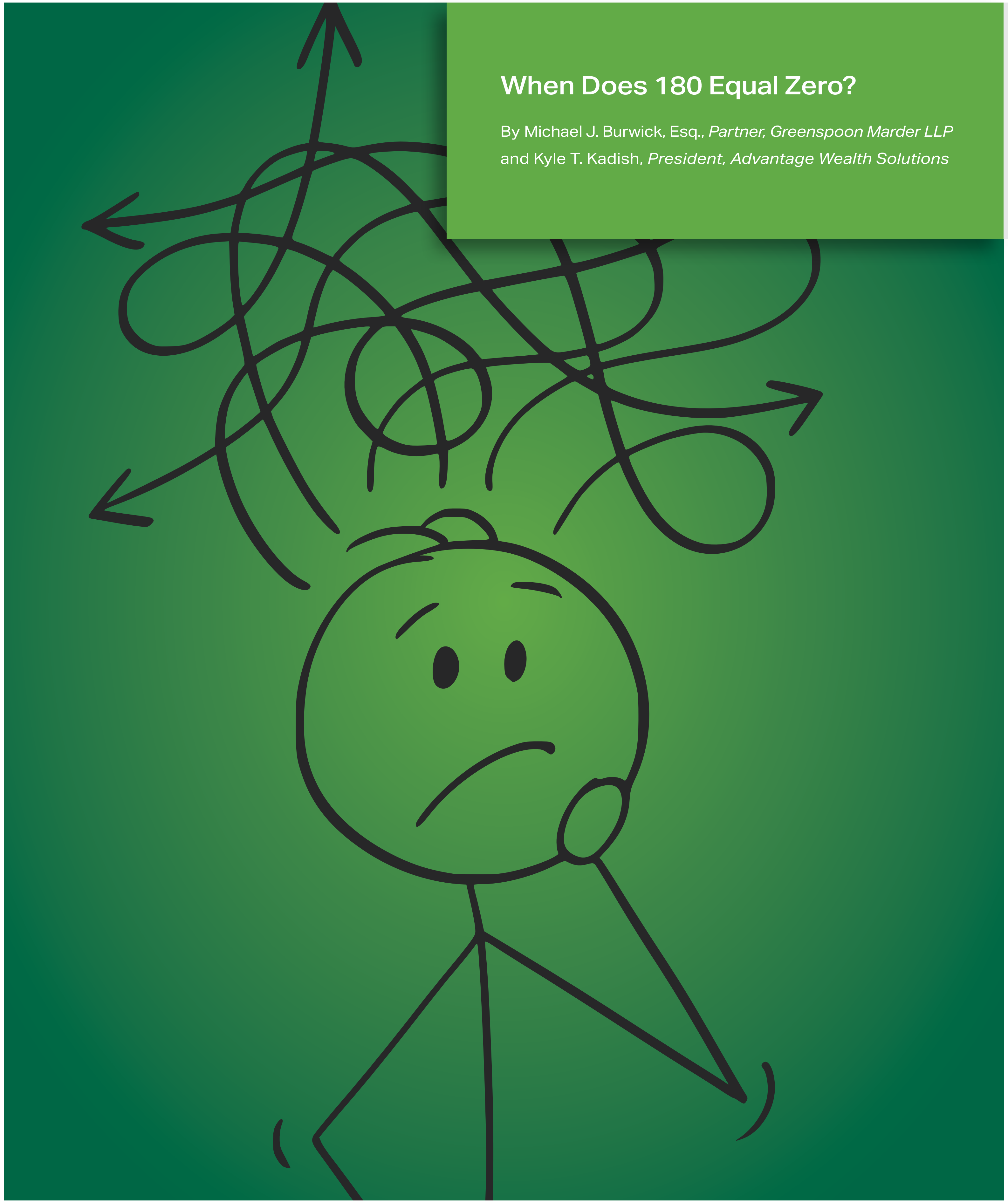
First, many advisors that recommend drilling oriented investment programs for their clients understand that these pass-through investments can provide a significant "investment year" deduction that offsets ordinary income from wages, bonuses, and self-employment (with the IDC deduction ranging from 60-80% of the subscription in many programs). In some cases, advisors will recommend a drilling investment for those converting a traditional IRA to a Roth IRA to help offset the phantom income resulting from the conversion. Another investment strategy includes the use of allocated IDCs and tangible equipment deductions to help reduce income taxes from pension distributions and capital gains. Since the enactment of the Tax Cuts and Jobs Act ("*TCJA*") in September of 2017, advisors can also recommend an oil/gas investment as a way to replace the tax deductions previously associated with state and local taxes (i.e., "*SALT*" deductions, which are now limited to $10,000 for taxpayers that itemize deductions). This is especially helpful to those investors that reside in states with high income taxes and cities with high real estate taxes. Also, it should be remembered that the deduction from the pass-through of IDCs is an "above the line" deduction. Thus, it doesn't matter if the client takes the standard deduction or itemizes deductions.

While the tax benefits associated with IDC expensing are notable, **there is a trade-off that needs to be understood.** From a **liability exposure standpoint**, many investments made by retail investors into drilling programs are made as "*investor general partners*." The investor general partner election enables investors to receive pass throughs of IDCs and tangible equipment that can be claimed as *active* losses *based upon* the investor's exposure to the program's operational liabilities during the drilling phase of the investment (aka the working interest exception). Depending upon the nature of an investor's income, those with passive income can alternatively subscribe as limited partners, in which case the pass-through of IDCs and other deductions will be characterized as losses that offset passive income.

Another strategy with oil/gas is for those with interests in Closely Held C Corporations. These are corporations in which more than 50% of the ownership is held be five or fewer shareholders. These businesses can invest in a drilling program as limited partners and can offset their business incomes with the allocated IDCs.

Finally, there may be some planning benefits for self-employed investors that need to make estimated quarterly income tax payments in January 2023 (i.e., for Q4 2022). An investment into an oil/gas program can help reduce the tax payment obligation considerably. This is especially useful for self employed professionals (i.e., doctors, lawyers) with incomes taxed at the 37% rate and business owners with significant year-end revenues.

In concluding, we'd be remiss not to remind you of the need to engage in careful due diligence when considering the viability of oil/gas investments. While the tax benefits of oil/gas investing are noteworthy, these investments require successful drilling to achieve a total return that is commensurate with the undertaken investment risk. ▲



When Does 180 Equal Zero?

By Michael J. Burwick, Esq., *Partner, Greenspoon Marder LLP* and Kyle T. Kadish, *President, Advantage Wealth Solutions*

Kyle Kadish is President of Advantage Wealth Solutions, where his practice focuses on tax mitigation for business owners, real estate investors, and high-income individuals. Kadish is also the due diligence officer for AGES Financial Services (Broker-Dealer) and Trust Advisory Group (RIA). Originally registered in 2005, Kadish has held product and distribution roles with asset managers with both domestic and global interests.

Michael Burwick is a tax, corporate and securities attorney focusing on tax deferral, tax mitigation and tax minimization. Burwick has developed and successfully implemented numerous tax strategies taken directly from heretofore sparsely used sections of the Internal Revenue Code.

A record number of attendees gathered in early October for ADISA's Annual Conference and Tradeshow. The three-day affair included industry updates, keynote presenters, and over 20 breakout panel session. The primary purpose of the panel discussions are to educate; secondarily, we hope the topics presented will stimulate idea sharing and create deeper conversations. One panel did just that.

During a session titled 'Opportunity Zones: Maintaining the Opportunity', Kyle Kadish tossed out the idea that day 180 of a failed 1031 exchange is day 0 for a Qualified Opportunity Zone. Other panelists questioned the statement. Further dialogue post-conference among the panel led to sponsors running the idea past their outside counsel. One sponsor now has marketing pieces promoting the concept.

As we state below, neither the IRS nor any court have opined on either side of this discussion. As an industry trade group, we should continue to drive the conversation based on the known rules and procedures benefiting every stakeholder.

The tax timelines for 1031 exchanges and Qualified Opportunity Zones (QOZ) require investments to be made within 180 days of realizing a gain. The rules are clear on what needs to happen within each strategy that a taxpayer is pursuing, but there is little guidance on whether both timelines run concurrently or consecutively. While the Internal Revenue Code (IRC) remains silent on this issue, investors can take cues from specific existing procedures. These breadcrumbs give investors great latitude in deferring gains through a QOZ after a 1031 exchange fails. The critical issue at stake, and the thesis of this article, is "when does a taxpayer recognize the gain from a failed 1031 exchange?"

The Background of IRC Sec. 1031

A 1031 exchange allows a real estate investor to defer the capital gains taxes on the sale of investment property when he or she "replaces" the sold or "relinquished" property with new property or properties of equal or greater value. Exchange procedures are well documented and are outlined in the Internal Revenue Code with additional guidance provided in Revenue Procedures and Revenue Rulings. The taxpayer must engage a Qualified Intermediary (QI) (sometimes called an "accommodator") to hold the sale proceeds immediately upon the property's sale or relinquishment. Furthermore, the taxpayer must identify (in writing) replacement property(ties) within 45 days and complete the purchase(s) of identified property(ties) (the "replacement") within 180 days of the relinquished property sale. The exchange fails if the taxpayer is unsuccessful in identifying replacement property(ties) or in closing on the transactions within the given timelines.

When conducting a 1031 exchange, every exchange agreement between a QI and the taxpayer must contain prohibitive language restricting the taxpayer's access to funds. Often referred to as the G6 restrictions, the vocabulary is taken from 1031k-1(g)6 of the code and cites explicitly when and if the exchanger may access the exchange funds. The tax deferral safe harbor provided under Sec. 1031 is only permitted when the taxpayer is prevented from receiving, pledging, borrowing, or obtaining benefits from the sale proceeds. In other words, the client cannot have access to the funds.

Sellers entering an exchange after July fifth of any year might have an exchange cross into the following year. When an exchange straddles a calendar year and then fails, the taxpayer has the option to report the gain received in the latter calendar year. Specifically, if the funds held by the QI are not returned to the taxpayer until after December 31, the attempted exchange carries into the following year. This situation would create an Installment Sale under IRC Section 453 (and the 1031 regulations) offered by 1031(k)-1(j)(2). The taxpayer could report gains from the real estate sale in the following calendar year.[1]

The taxpayer wishing to conduct a 1031 exchange must have the exchange in place before selling the relinquished property. Failing to make a timely QOZ investment cannot be reversed through a 1031 exchange.

QOZ Basics

In the Tax Cuts and Jobs Act of 2017, Qualified Opportunity Zone legislation created an economic development tool that permits investors to invest, in a tax preferential manner, in distressed communities nationwide. The bipartisan efforts of New Jersey's Senator Corey Booker and Senator Tim Scott from South Carolina incentivized investors with tax benefits to create economic growth in communities identified as economically challenged. Governors from all 50 states nominated neighborhoods and counties to qualify, with the U.S. Department of Treasury certifying those areas. An investment into a QOZ can be made into more than 8,500 census tracts throughout the country. As a result, commercial growth and real estate development stimulate the economy for each federally designated area as intended.

Unlike a 1031 exchange, taxpayers can receive the sale proceeds directly after selling property. Generally, taxpayers have 180 days to invest gain proceeds into a QOZ investment to defer the immediate tax liability. The taxpayer reports his or her QOZ investment with their annual tax filing; if the QOZ investor's 180-day period extends beyond his or her tax filing deadline, the taxpayer should file an extension until after making the QOZ investment.

The QOZ investment defers capital gains through 2026—payable in 2027. After a ten-year holding period, the QOZ investment's basis adjusts to equal the sale price. Together with eliminating capital gains taxes, taxpayers investing through QOZs are also not subject to depreciation recapture.

QOZs are part of the federal tax code. An overwhelming majority of states align with QOZ rules; only eight states are nonconforming.[2] Taxpayers should consider conformity with the federal provisions. Residing in nonconforming states may reduce a taxpayer's state tax deferral on the initial gains invested in opportunity zones. Additionally, taxpayers investing in nonconforming states may also be required to recognize capital gains for state tax purposes on their ultimate sale of the QOZ investment.

When is the gain recognized?

If the 180-day timelines for 1031 exchanges and QOZ investment overlap, taxpayers cannot access exchange funds for QOZ purposes. This interpretation of gain recognition has caused some investors to struggle or be creative in completing the QOZ investment when funds were delivered to a QI upon the property sale. Some taxpayers have funded QOZ investment(s) with cash on hand or accessed a credit line because exchange funds were tied up. Other taxpayers have aggressively fought their QIs to release funds before the 180-day exchange deadline to fund a QOZ investment, placing undue risks on the QI's business. As with most new legislation and the rules attendant thereto, no challenges have been made as to the issue of whether the two periods run concurrently or consecutively. The most crucial element is understanding when the 1031 exchange taxpayer realizes his or her gain. Accepting the "simultaneous timeline theory" since the advent of QOZs, taxpayers have made QOZ investments before their exchanges have failed.

The IRC clearly outlines when a taxpayer realizes a gain on a failed exchange where the exchange straddles calendar years. However, missing from the Code is language on when the taxpayer recognizes a gain during an unsuccessful exchange occurring within a calendar year. The elusive answer defines a taxpayer's options for deferring taxes with IRC Sec. 1400Z. For example, does the 180-day clock reset for QOZ investments on all failed exchanges?

The straddled exchange has become an installment sale. According to IRC Sec. 453, the taxpayer does not recognize the gain until he or she receives funds from the installment. For the failed exchange straddling calendar years, the installment causes the capital gain to be recognized in the following year—on Day 180 of the exchange. The taxpayer has another 180 days to make the QOZ investment.

The question remains open for discussion without any comment from the IRC or Internal Revenue Service as to the issue of a failed exchange occurring in a single calendar year. Attorneys and accountants could build an argument using the rules discussed above. Consistent application of the known tax law would suggest that the taxpayer does not recognize the gain in a properly structured exchange until after the exchange fails. Utilizing the same thought process for an area where the Code is silent generates a unique opportunity for taxpayers to defer capital gains while contributing to the economic growth intended when Senators Booker and Scott first wrote QOZ legislation.

Does day 180 of all failed exchanges equal day zero for QOZ purposes? Unfortunately, no definitive answer exists today. However, there is substantial evidence that supports the proposition that decisions will favor the taxpayer and that the 1031 exchange timeline and the QOZ timeline run consecutively. Under this theory, taxpayers involved in a failed 1031 exchange should have an additional 180 days to complete their QOZ investment.

Of course, every investor should seek guidance and review their specific situation with his or her tax and/or legal advisor(s). ▲

Portions of this article were recently published in The Tax-Stringer, a publication of the New York State Society of CPA's

1— Key language states that the taxpayer must intend to complete an exchange and not simply straddle for a tax advantage.

2— California, Massachusetts, Mississippi, and North Carolina have specifically decoupled from QOZ provisions at the state level. Alabama, Arkansas, Hawaii, and New York only conform with 1400Z in limited circumstances.

ADISA 2022 Year in Review

Within the industry, ADISA is known for our best-in-show conferences, and for the first time since 2019, ADISA hosted all three of our signature events—our Spring Conference in Orlando, our Alts Research & Due Diligence Forum in Atlanta, and our Annual Conference & Trade Show in Las Vegas. This year's Annual Conference was our most successful to date, bringing in a record attendance of more than 1,100 attendees—37% sponsors, 22% affiliates and 41% associates.

While ADISA is known for great networking at our events, our committees have been active this year producing educational content, strengthening our DE&I efforts, and advocating for the industry.

- **The Standards, Education and Publications Committee has published:**
  - The RIA Guide to Alts this summer;
  - Four AI Quarterly magazines which include 20+ purely educational articles;
  - And a newly released white paper on DST/1031 Best Practices
- **ADISA has also hosted a number of webinars, and topics included:**
  - 1031 End-of-Year Report
  - Opportunity Zones and Best Practices
  - Alts Industry Mid-Year Update
  - Affordable Housing
  - 1031 Best Practices
- **And we once again produced our sixth season of "Focus on Alts" video series, which will be distributed well into 2023. New topics were discussed, including 506b vs 506c, DST Best Practices, etc.**

ADISA has also strengthened our DE&I efforts through our Diversity and Next Generation, partnering with InRoads, a non-profit that creates pathways to careers for diverse high school and college students nationwide, last spring and invited students to attend our Spring Conference. We also partnered with Florida Memorial University, the only historically Black university in South Florida, to bring students to our Annual Conference. These partnerships aid in expanding the students' knowledge of the alts space, while bringing diversification into this industry.

ADISA's advocacy work continued, thanks to our Legislative & Regulatory Committee. In addition to numerous comment letters to the SEC and FINRA on issues such as share repurpose disclosures, private fund investor protections, cybersecurity and ESG, ADISA was successful in bringing about a closer look by NASAA of the industry's concerns on the non-traded REIT concentration limit proposal. We will also resume our Meet Your Regulator program in 2023, where ADISA members are invited to educate a group of state regulators regarding the alternative investment industry—a valuable opportunity for ADISA members to effectively explain the structure and purpose of the various investment products. ▲

ADISA Announces 2023 Board of Directors

The members of ADISA (Alternative & Direct Investment Securities Association), the nation's largest trade association serving the alternative investment and securities industry, have chosen new directors for its 2023 board. ADISA holds democratic elections hosted by a neutral online vendor, and the elections are open to all member categories (with a maximum of three votes per firm).

The five newly elected (or re-elected) board directors are:

Angela Barbera, *NexPoint Securities*

Mat Dellorso, *WealthForge*

Sylvia Kwan, *Ellevest*

Stephen Lovell, *Lovell Wealth Management*

Amanda Teeple, *CoastalOne*

Additionally, two directors-at-large were appointed:

Greg Mausz, *Skyway Capital Markets*

David Wilson, *Equifinancial*

They join the returning 2022 board members, who were elected or appointed last fall to two-year terms, and include:

Michael Underhill, *2023 President, Capital Innovations*

Sherri Cooke, *2023 Immediate Past President, iCapital*

Catherine Bowman, *The Bowman Law Firm*

Matthew Iak, *U.S. Energy Development Corporation*

Karlton Kleis, *Arete Wealth Management*

Mark Kosanke, *Concorde Investment Services*

Jade Miller, *Bourne Financial Group*

Ann Moore, *International Assets Advisory*

David Pittman, *Cottonwood*

Jeff Shafer, *CommonGood Capital*

Brad Updike, *Mick Law*

Darryl Steinhause of *DLA Piper* also serves as a non-voting, volunteer general legal counsel, and Thomas Voekler of *KVCF* serves as volunteer hospitality counsel.

ADISA board elections occur in the fall; each new director was elected to a two-year term through 2024. At the first board meeting of 2023 in January, the board will elect its 2023 officers and its president-elect to take office in 2024. ▲

2023 Spring Conference
April 24-26
Marriott Marquis
San Diego Marina

2023 Alts Research & Due Diligence Forum
July 25-26
The Grand America Hotel
Salt Lake City

2023 Annual Conference & Trade Show
October 9-11
The Cosmopolitan of Las Vegas

Exhibitor Benefits

- Complimentary and discount event registration
- Attendee contact list usage
- Extensive brand recognition onsite and in ADISA pre-event marketing materials
- Educate industry professionals on your products and services

Registration

- Multiple event discount
- Commit to two 2023 ADISA events and receive a 5% discount on the second event. Commit to all three 2023 ADISA events and receive a 10% discount on the third event.
- Registration is easy! Go to adisa.org and reserve your booth, table or sponsorship opportunity today.

2023 Event Pricing

April 24-26
2023 Spring Conference
Marriott Marquis San Diego Marina

Sponsorship Level	*Member Price*	*Non-member Price*
Diamond	$36,000	$46,000
Platinum	$24,900	$34,900
Gold	$17,900	$27,900
Silver	$14,200	$24,200
Bronze	$8,700	$18,700

July 25-26
2023 Alts Research & Due Diligence Forum
The Grand America Hotel
Salt Lake City

Sponsorship Level	*Member Price*	*Non-member Price*
Gold	$16,900	$26,900
Silver	$14,100	$24,100
Bronze	$8,200	$18,200

October 9-11
2023 Annual Conference & Trade Show
The Cosmopolitan of Las Vegas

Sponsorship Level	*Member Price*	*Non-member Price*
Diamond	$39,900	$49,900
Platinum	$31,500	$41,500
Gold	$19,200	$29,200
Silver	$15,300	$25,300
Bronze	$9,900	$19,900

For more information on exhibit opportunities, including what your exhibit or sponsorship package includes, go to **adisa.org**

**Booth/table selection is based on the date and time ADISA receives your company's exhibitor registration.*

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