SEC AND NASAA STAFFS ISSUE STATEMENT AND REGULATORY GUIDANCE FOR OPPORTUNITY ZONE FUNDS: UNDERSTANDING THE APPLICATION OF SECURITIES LAWS TO OPPORTUNITY ZONE FUNDS

Date: 20 August 2019

U.S. Opportunity Zones Alert

By: Ed Dartley, Adam J. Tejeda

INTRODUCTION

On July 15, 2019, the staffs of the Securities and Exchange Commission ("SEC") and the North American Securities Administrators Association issued a joint statement (the "Staff Statement") to assist participants and sponsors utilizing the Opportunity Zone tax incentive (the "OZ incentive") understand the application of federal and state securities laws to the offering of interests in a "qualified opportunity fund" ("OZ Fund"). [1] The SEC staff also provided guidance regarding the ability of so-called "Main Street" investors to participate in OZ Fund offerings. [2]

The OZ incentive was established by the Tax Cuts and Jobs Act in December 2017 ("TCJA"). It represents a unique and bipartisan effort to attract new long-term investment in real estate and operating businesses in thousands of disadvantaged and under-served communities across the United States through the provision of significant tax benefits to investors. The Staff Statement and regulatory guidance represent the first effort by the SEC to formally address and comment on the OZ incentive. In a statement issued along with the Staff Statement, SEC Chairman Jay Clayton commented that "[t]he opportunity zone program has the potential to encourage investment and economic development in many areas across the country that are in need of capital. The staff statement released today will help market participants understand securities laws implications when seeking to raise capital for opportunity zones." [3]

The Staff Statement provides in a summary fashion an overview of the principal securities regulations applicable to fund sponsors in this emerging asset strategy, which has seen significant interest and accelerating growth since it was established less than two years ago. However, fund sponsors and other participants in the private funds industry should not view the observations in the Staff Statement as breaking any new ground. The OZ incentive is typically implemented through private fund vehicles, and the SEC rules and principles that govern the offering of private funds will be familiar to these market participants. At the same time, however, the OZ incentive is drawing the attention of sponsors and investors that may not have traditional experience managing or investing in private funds. The Staff Statement provides useful guidance to those less well-versed in securities offerings and investment adviser considerations.

©2005-2026 K&L Gates LLP. All Rights Reserved.

OPPORTUNITY ZONE INVESTOR BENEFITS

The OZ incentive was established by Congress with the support of the Trump Administration to provide tax benefits for long-term investments in designated economically distressed communities throughout the United States, also known as opportunity zones ("Opportunity Zones"). Qualifying capital gains investments in OZ Funds are eligible for temporary tax deferrals, as well as a step-up of 10% in tax basis for investments held at least five years, and a 15% step-up in tax basis for investments held at least seven years. In addition, capital gains from the sale or exchange of an investment in an OZ Fund will be eligible for a complete exclusion from federal income taxes if the investment is held for at least 10 years.

SEC AND NASAA STAFF STATEMENT ON OPPORTUNITY ZONES

Highlighted below are several key matters addressed by the Staff Statement.

A) Interests in OZ Funds will typically constitute "Securities"

Under the TCJA, OZ Funds are defined as any investment vehicle organized as a corporation or partnership (including alternative business entities classified as partnerships) in order to invest in OZ property. Not surprisingly, the Staff Statement confirms that interests in an OZ Fund structured through such a vehicle and offered and sold to investors will typically constitute securities within the meaning of federal and state laws, and accordingly such Funds must comply with all applicable federal and state securities laws and regulations (in addition to Opportunity Zone-specific tax regulations).

B) OZ Fund offerings may use available exemptions from registration under the Securities Act of 1933

Because interests in OZ Funds will typically be offered as privately placed securities, OZ Fund sponsors generally need to rely on traditional private placement exemptions when offering the interests in an OZ Fund.

The Staff Statement highlighted two commonly-used exemptions under Rule 506 of Regulation D. Under Rule 506(b), interests in an OZ Fund may be exempt from registration so long as the issuer does not use general solicitation or advertising to offer interests of the OZ Fund, and offers and sales are limited to "accredited investors" [4] and up to 35 sophisticated, non-accredited investors, subject to certain additional requirements. Under Rule 506(c), an OZ Fund issuer is permitted to use general solicitation or advertising in connection with the offer and sale of interests in the OZ Fund, but all investors must be accredited investors, and the issuer must take reasonable steps to verify the accredited investor status of all purchasers.

The Staff Statement also addressed Rule 504 and Rules 147 and 147A, two other, lesser-used exemptions that are available to OZ Fund issuers. In a Rule 504 offering, certain OZ Fund issuers may offer and sell up to $5,000,000 of securities of an OZ Fund in a 12-month period. This exemption is available to any OZ Fund that is not (i) subject to public reporting under sections 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), (ii) an investment company under the Investment Company Act of 1940 (the "Investment Company Act"), (iii) an OZ Fund with no specific business plan or that was formed to engage in a merger or acquisition with an unidentified company or companies, or (iv) disqualified under certain "bad actor" disqualification provisions. As to Rule 147/147A, the Staff Statement noted that OZ Fund issuers may qualify for an intrastate offering exemption if they are making offers of securities solely to residents of the same state in which they are doing business, and satisfy several other requirements.

©2005-2026 K&L Gates LLP. All Rights Reserved.

To date, OZ Fund issuers have typically relied on Rule 506(b), the traditional private offering exemption, when offering OZ Fund interests. A smaller number of sponsors of OZ Funds have taken advantage of the exemption under Rule 506(c), which allows a sponsor to promoting its OZ Fund more broadly. While the exemptions under Rule 504 and Rules 147A/147 remain available to OZ Fund issuers, the narrower scope of the Rules will limit their actual use by OZ Fund sponsors.

C) Broker registration requirements need to be considered by OZ Fund sponsors

As with other types of private fund offerings, broker-dealer registration requirements need to be taken into account when structuring and implementing an OZ Fund offering. Whether a person who solicits or refers potential investors to an offering of securities by an OZ Fund is required to register as a broker-dealer depends on an analysis of the particular facts and circumstances of each transaction. The Staff Statement highlights various activities that have traditionally been indicators of broker status, including whether there is transaction-based compensation (i.e., compensation based on the outcome or size of the securities transaction). A sponsor of an OZ Fund should also consider whether its personnel who market and solicit the OZ Fund to prospective investors are acting as brokers. The Staff Statement notes that while there is a safe harbor exemption under the Exchange Act from broker-dealer registration for certain associated persons of a sponsor, the exemption is contingent on, among other things, the person "having substantial duties otherwise than in connection with transactions in securities," participates in no more than one offering every twelve months and does not receive compensation that is based, directly or indirectly, on transactions in securities. The Staff Statement cautions sponsors of OZ Funds, like other private fund sponsors, to be mindful of activities conducted in conjunction with their offerings that may trigger broker registration requirements.

D) OZ Funds need to determine if they can rely on an exclusion from the requirement to register as an "Investment Company" under the Investment Company Act

OZ Funds may be subject to the registration requirements of the Investment Company Act of 1940 unless they can rely on an exclusion from registration. The Staff Statement highlights the fact that OZ Funds are typically pooled investment vehicles that may rely on one of several commonly applicable exclusions including Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act. Section 3(c)(1) OZ Funds may be beneficially owned by no more than 100 persons. A Section 3(c)(7) OZ Fund has no Investment Company Act limitation on the number of investors, but must be owned exclusively by qualified purchasers (i.e., generally, individuals with a net worth of at least $5,000,000 and entities with at least $25,000,000 in investments). [5] The Staff Statement also identified Section 3(c)(5)(C) of the Investment Company Act, which excludes an issuer that is not engaged in the business of issuing redeemable securities and is primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate, as a potential exclusion from registration. However, the Staff cautioned that an issuer that is primarily engaged in holding interests in underlying pooled investment vehicles that in turn invests in real estate may not be able to rely on Section 3(c)(5)(C). [6] The Staff Statement's views are consistent with issuers' practices to-date, as OZ Fund sponsors typically have relied on the exclusions under Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act, likely because they are well understood and mostly free from ambiguity.

E) Advisers to OZ Funds may be subject to the Investment Advisers Act of 1940 (the "Advisers Act") or comparable regulation under State securities laws

©2005-2026 K&L Gates LLP. All Rights Reserved.

The Staff Statement also addresses investment adviser registration requirements, and sponsors of OZ Funds need to consider whether they are providing investment advice in connection with the purchase and sale of securities. Absent an exclusion from the definition of an "investment adviser," the sponsor of an OZ Fund may be required to register as an investment adviser under the Advisers Act, although the sponsor could be exempt from registration with the SEC as an Exempt Reporting Adviser (an "ERA") if it has under $150 million in assets under management and solely serves as an investment adviser to private funds. However, an ERA will still remain subject to certain regulations under the Advisers Act.

Interestingly, the Staff Statement offers no comment on whether the sponsor of an OZ fund that invests *exclusively* in fee interests in real estate (rather than securities) must register as an investment adviser. Such a manager generally would not fall within the definition of an "investment adviser" and not be subject to registration. In practice, however, many OZ Funds and other real estate funds invest in passive interests in projects that may be considered "securities" under applicable law and SEC staff guidance depending on the particular circumstances. Instead of addressing this issue directly, the Staff Statement's comments highlight the staff's view that sponsors of OZ Funds that invest in securities are no different from other firms that provide investment advice in connection with the purchase and sale of securities. Non-traditional participants in the OZ incentive and asset strategy, such as real estate investment firms and developers, should take heed of this warning and carefully consider whether their investment activities may subject them to registration under the Advisers Act.

SEC REGULATORY GUIDANCE

To date, the OZ incentive has garnered significant interest from sponsors of private investment funds, often targeting investments in real estate to larger sophisticated institutional investors, family offices, and high net worth individuals. Perhaps recognizing this, SEC Chairman Jay Clayton is seeking comment on how to best facilitate investment in Opportunity Zones by so-called Main Street investors (i.e., non-accredited investors). As a partial interim step, the SEC has issued guidance regarding capital-raising options for OZ Fund issuers that seek to allow non-accredited investor participation. Specifically, the SEC identified several offering mechanisms that can accommodate these types of investors, indicating that Regulation A, Regulation Crowdfunding, and the intrastate offering exemptions in Rules 147 and 147A can each, either alone or together, permit financing for Opportunity Zone projects while providing an exemption from registration. A hypothetical scenario outlined by the SEC included an OZ Fund relying on Rule 506(c) to offer and sell securities to accredited investors to fund a portion of the project, and using a Regulation Crowdfunding offering to non-accredited investors to fund the remainder of the project (but at the same time cautioning that an issuer should seek legal advice in structuring the offerings to comply with federal securities laws).

While the SEC staff's observations regarding the use of mechanisms such as crowdfunding are encouraging from the perspective of seeking greater investor participation, the offering size limitations ($1.07 million for crowdfunding, for instance) and significant legal and other costs associated with such mechanisms may limit their utility.

CONCLUSION

The OZ incentive has been hailed as a unique opportunity to bring meaningful new investment to low-income and under-served communities across the United States, and the guidance provided in the Staff Statement reflects the goal of strengthening investments in low-income communities while working "collaboratively to address new

©2005-2026 K&L Gates LLP. All Rights Reserved.

compliance issues raised by an innovative program." [7] As with any new and innovative initiative, the OZ incentive may attract a new class of managers who lack deep experience with the federal and state securities laws, and the attendant requirements and considerations. Given the interest in Opportunity Zones and the Opportunity Zone asset strategy, the Staff Statement and accompanying materials are a useful guide and overview of the regulatory landscape for managers in this space.

If you have questions about the items discussed above, our K&L Gates cross-practice Opportunity Zones team is prepared to help clients understand and implement the OZ incentive and maximize its benefits and provide input to Treasury and Capitol Hill, whether you are an investor, a developer, or an entrepreneur, or are interested in setting up a fund. We invite you to contact us for assistance. Please see our Opportunity Zones website for more information.

The authors would like to thank Edgar Mkrtchian and Amanda Katlowitz Strickler, associates in the New York office, for their contributions to this Client Alert.

NOTES

[1] *See* Securities and Exchange Commission and North American Securities Administrators Association, Staff Statement on Opportunity Zones: Federal and State Securities Laws Considerations, (July 15, 2019), https://www.sec.gov/2019_Opportunity-Zones_FINAL_508.pdf.

[2] *See* Securities and Exchange Commission, Regulation Crowdfunding Compliance and Disclosure Interpretation: Question 204.05, (July 15, 2019), https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm#204.05.

[3] *See* Securities and Exchange Commission, SEC and NASAA Explain Application of Securities Laws to Opportunity Zone Investments, (July 15, 2019), https://www.sec.gov/news/press-release/2019-132.

[4] Generally, an "accredited investor" is (a) an individual who, either individually or jointly with his or her spouse, has a net worth of more than $1,000,000 excluding the individual's primary residence, (b) an individual whose annual individual income exceeded $200,000 for each of the two most recent years and who reasonably expects an individual income in excess of $200,000 in the current year, or whose joint income with his or her spouse exceeds $300,000 for each of the two most recent years and who reasonably expects joint income with his or her spouse in excess of $300,000 in the current year and (c) an entity with total assets in excess of $5,000,000.

[5] Rule 3c-5 under the Investment Company Act allows a fund sponsor to exclude certain "knowledgeable employees" from the requirements of Sections 3(c)(1) and 3(c)(7).

[6] The Staff Statement cited SEC guidance from 1960, *Real Estate Investment Trusts*, Investment Company Act Release No. 3140 (Nov. 18, 1960), in support of this position. This guidance noted in relevant part that "a REIT [or any other fund seeking to rely on the exclusion] might not qualify for the exclusion if it 'invested to a substantial extent in other real estate investment trusts . . . or in companies engaged in the real estate business or in other securities.'" Whether this concern will in fact be present with respect to any given OZ Fund will depend on the facts and circumstances of the OZ Fund in question.

[7] *See supra* note 4.

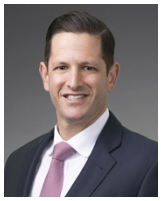
©2005-2026 K&L Gates LLP. All Rights Reserved.

KEY CONTACTS



ED DARTLEY
PRACTICE AREA LEADER - ASSET MANAGEMENT AND INVESTMENT FUNDS

NEW YORK
+1.212.536.4874
ED.DARTLEY@KLGATES.COM



ADAM J. TEJEDA
LEAD PRACTICE AREA LEADER - CORPORATE

NEW YORK
+1.212.536.4888
ADAM.TEJEDA@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.