Sunday, December 16, 2018

Comment from William Michael Cunningham
Creative Investment Research

DEPARTMENT OF TREASURY
Internal Revenue Service
26 CFR Part I
[REG-115420-18]
RIN 1545-BP03
Investing in Qualified Opportunity Funds
AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Notice of proposed rulemaking and notice of public hearing.

On Friday, October 19, 2018, the Treasury Department issued highly-anticipated draft regulations for the Opportunity Zones Program. The Program allocates up to $6 trillion in capital gains for investment in "under-served" communities, under-served communities defined and as selected by governors in all 50 states, territories and the District.

We expect to see rapid growth in the number of Qualified Opportunity Funds ("QOFs") and in the deployment of capital to Opportunity Zones. This means many communities of color are at risk for rapid dislocation. This initiative is basically gentrification on steroids.

The Proposed Regulations cover the following issues:

1. Who is the taxpayer?

As noted, "either a partnership or a partner can be the 'taxpayer' for purposes of investing in a Qualified Opportunity Fund....the partnership (or other pass-through entity) must first make an election with respect to making a qualified Opportunity Zones investment, and only if the partnership declines to make a qualified Opportunity Zones investment can individual partners use gain attributed to them to make a qualified Opportunity Zones investment." This grants significant corporate benefits to investors: Qualified Opportunity Fund investors will use corporate entities as a liability shield.

2. Which Gains Qualify for Deferral?

As noted in the regulations, "only capital gains are eligible for deferral under the Opportunity Zones legislation."

3. Who Can Be a Qualified Opportunity Fund?

Qualified Opportunity Funds must be "classified as a corporation or partnership (created or organized in one of the 50 states, the District of Columbia, or a U.S. possession) for Federal income tax purposes, and the entity must be created or organized in one of the 50 states, the District of Columbia, or a U.S. possession."

4. How are Qualified Opportunity Funds certified?

Qualified Opportunity Funds self-certify. The Internal Revenue Service has created a form for that purpose.

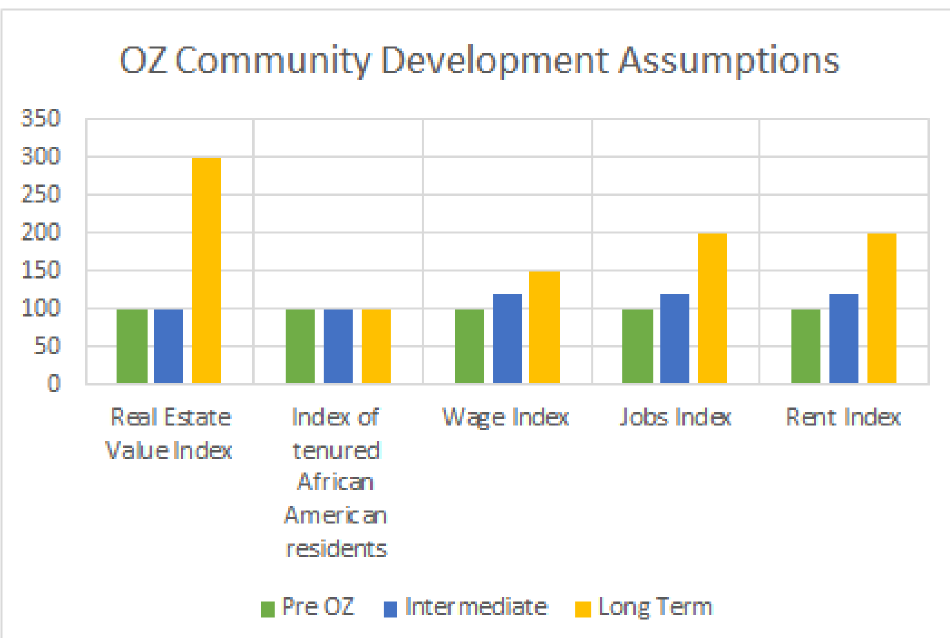
5. Initial Funding Requirements

"Qualified Opportunity Funds that have been created and funded after July 1, 2018 must deploy 90% of their assets by December 31, 2018." As we said, gentrification on steroids.

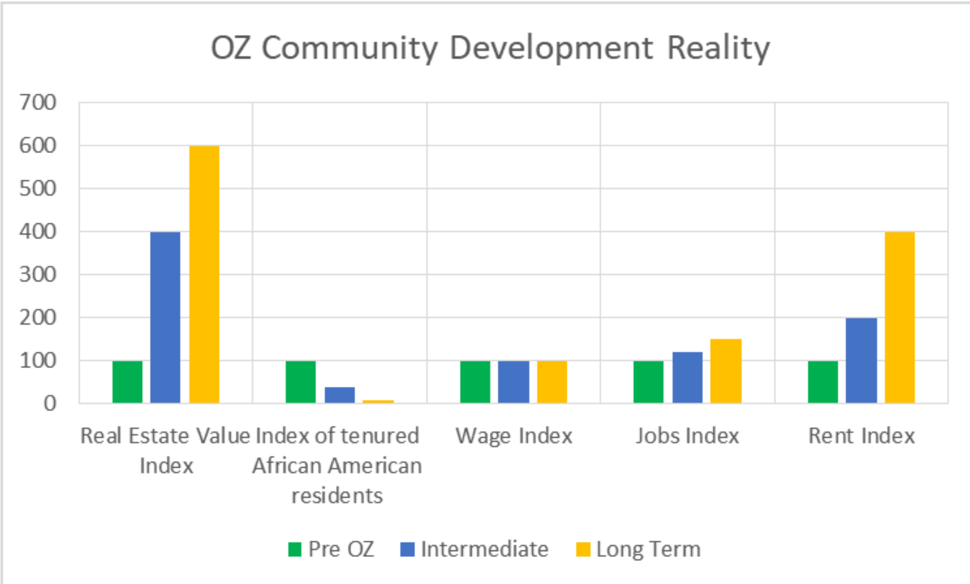
6. What Do You Mean By "Substantially All"

According to the regulations, "a trade or business can own or lease no more than 30% of its total tangible property that is not used in an Opportunity Zone."

In 1993, at the First Annual Greenlining Institute Conference on Community Development, we suggested the creation of government backed venture capital funds to take first risk position in the provision of equity capital to small, minority businesses on Georgia Avenue in NW Washington, DC. This morphed into the New Markets Tax Credit program, a real estate focused "community development" program that has fueled gentrification.



Most analysts assume positive outcomes from the Opportunity Zone program. Real estate values, as indicated by the Real Estate Value Index, as seen to rise gradually. The ethnic makeup of the community stays stable, as indicated by the index of tenured African American residents. Wages, jobs and rents gradually increase.



The reality is likely to be very different, however. Real estate values increase dramatically. The percentage of neighborhood residents who are African American plummets. Wages are stagnant, possibly decreasing. Jobs increase, but at very modest rates. Rents increase dramatically.

As we have over the past 30 years, Creative Investment Research has developed high social impact investment vehicles to allow residents in communities of color to take advantage of the Opportunity Zones activity and to mitigate some of the negative social impacts noted. See: https://opportunityzones.eventbrite.com

APPENDIX

Background

William Michael Cunningham holds a Master's in Economics and an MBA in Finance, both from the University of Chicago, and is a graduate of Howard University.

Mr. Cunningham manages an impact investment research firm, Creative Investment Research. The firm researches and creates socially responsible investments and provides socially responsible investment advisory services. He is also Managing Partner at National Crowdfunding Services, LLC.

Creative Investment Research is an independent investment research firm, founded in 1989. For clients, our services save millions, if not billions: on December 22, 2003, December 22, 2005, and February 6, 2006, we warned the S.E.C. and other regulators that statistical models using our proprietary Fully Adjusted Return® Methodology signaled the probability of system-wide economic and market failure (see below). Clients who heeded our warning adjusted their investment portfolios in a manner that allowed them to escape much of the damage caused by the crisis. The firm was formerly in the pool of Corporate Governance Advisors and Diversity Investing Advisors to CalPERS.

On November 16, 1995, he launched one of the first investment advisor websites at www.ari.net/cirm (now www.creativeinvest.com).

Track Record

On July 3, 1993, Mr. Cunningham wrote to US Securities and Exchange Commissioner (SEC) Mary Schapiro to notify the Commission about a specific investing scam, the "Nigerian letter scam." A timely warning was not issued to the investing public, members of the public were damaged, and the SEC launched retaliatory regulatory actions against Mr. Cunningham.

He designed the first mortgage security backed by home mortgage loans to low and moderate income persons and originated by minority-owned institutions. (See: *Security Backed Exclusively by Minority Loans*, The American Banker Newspaper. Friday, December 2, 1994.)

Mr. Cunningham opposed the application, approved by the Federal Reserve Board on September 23, 1998, by Travelers Group Inc., New York, New York, to become a bank holding company. In October 1998, in a petition to the United States Court of Appeals (Case Number 98-1459) concerning the Travelers Group Inc./Citicorp merger, Mr. Cunningham cited evidence that growing financial market malfeasance greatly exacerbated risks in financial markets, reducing the safety and soundness of large financial institutions.

From October 1999 to March 2002, Mr. Cunningham was responsible for proxy voting activity for a major pension fund. He voted on 1395 issues impacting 401 companies. In 2000, he voted on 1903 issues impacting 422 companies. He managed fund efforts and corporate governance matters related to Talisman Energy and its' operations in the Sudan. He researched the issue, contacting various groups involved in the process. For the fund, his efforts also included researching fund policies and procedures. Our collaborative, risk controlled strategy helped lead the firm out of the Sudan. On February 1, 2000,

On June 15, 2000, Mr. Cunningham testified before the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (GSE's) of the U.S. House of Representatives and suggested that GSEs Fannie Mae and Freddie Mac be subject to a Social Audit. A social audit is an examination of the performance of an enterprise relative to certain social return objectives. It includes a review of ethical practices. Had the GSE's been subject to this audit, certain flaws in their operation, including ethical shortcomings, would have been revealed earlier, in a better market in which to make corrections.

In 2001, Mr. Cunningham participated in the first wide scale home mortgage loan modification project. The Minneapolis-based effort helped 50 families victimized by predatory lending practices. See: Property Flipping Remediation Yields Investment-grade Security.

On December 22, 2003, he warned US regulators that statistical models he created using the proprietary Fully Adjusted Return® Methodology signaled the probability of system-wide economic and market failure. See Page 6.

In 2005, Mr. Cunningham served as an expert witness in a case that sought to hold Credit Suisse First Boston, Fairbanks/SPS, Moody's and Standard and Poor's, US National Bank Association, and other parties legally responsible for supporting and facilitating fraudulent subprime lending market activities. Had this single case been successful, we believe the credit crisis would have been less severe.

On December 22, 2005, he issued a strongly worded warning that system-wide economic and market failure was a growing possibility in a meeting at the SEC with Ms. Elaine M. Hartmann of the Division of Market Regulation.

On February 6, 2006, he again warned regulators that statistical models created using the proprietary Fully Adjusted Return® Methodology confirmed that system-wide economic and market failure was a growing possibility. He stated that: Without meaningful reform there is a small, but significant and growing, risk that our (market) system will simply cease functioning. This is, of course, exactly what happened. See pages 2 and 8.

On December 9, 2013, Mr. Cunningham filed a "Friend of the Court" brief in the United States District Court, Central District of California in a case concerning an action that the U.S. Department of Justice, acting on behalf of the United States of America (Plaintiff), brought against McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, et. al., (Defendants) under 12 U.S.C. § 1833a; 18 U.S.C. §§ 1341, 1343 & 1344. My comments led to a significant change in enforcement strategy, including the first ever, albeit temporary, rating firm suspension.

On February 3, 2015, he commented on an effort by Apple Computer to utilize women and minority-owned brokerage firms: http://www.usatoday.com/story/tech/2015/02/03/apple-debt-offering-minority-firms-jesse-jackson-diversity-silicon-valley/22805673/

For more background information, please see: Global Market Turmoil Graphic and Financial Crisis Calendar Graphic, Creative Investment Research, Inc., December, 2008 and November, 2009.

Please see the following reports on ResearchandMarkets.com:

Bank of China (BOC) - Fall, 2018. https://lnkd.in/ewEqsKS

Survey: Most Appropriate Applications for Blockchain Technology. https://lnkd.in/engZgDE

Creative Investment Research (CIR) Economic Forecast for 2019. https://lnkd.in/euVvkyP

Report on Chinese Banks - Fall, 2018. https://lnkd.in/ey3TzMi

China Construction Bank Corporation. https://lnkd.in/e4MsFgg

September 2018 - 10 Questions

William Michael Cunningham on Impact Investing, Blockchain, and Crowdfunding

Interview by Carly Schulaka

WHO: William Michael Cunningham

WHAT: Economist, impact investing specialist, founder of Creative Investment Research

WHAT'S ON HIS MIND: “Any finance professional in the U.S. should learn how to code in blockchain.”

1. You are an economist, an inventor, and an impact investing specialist. I’ve heard you say: “True innovation happens in a way that is independent of monetary returns.” How does this statement influence your work?

WMC: It’s really about finding an interesting problem and applying financial technology to solving that problem or to dealing with that problem.

You know, the people who invented the alphabet didn’t do so to make money. They had an interesting problem—communication on both a local and a grand scale—and if you were to calculate the social return for the invention of that technology or technique, it’s almost infinite.

So, that really influences what we decide to work on. We’re not looking at the money side first and foremost. There’s nothing wrong with making money, but it’s not the driving force in true innovation. The thing about true innovation is there’s always money down the road.

We are working on an investment vehicle that deals with homelessness and another that deals with HIV/AIDS, mainly because we think these are interesting problems with interesting applications of financial technology; not for the money side.

There’s a cultural phenomenon in Western society, I’d say in American society—the dominance of the free market school of thought, which reduces everything to monetary values. I think we’re at the beginning of a cycle where that dominance is going to be challenged. This is what we’re seeing with impact investing. It’s looking at factors that aren’t explicitly part of the conventional schools of economic thought. We now know that there are social impacts that cut across all companies, all industries, and that impact a broader community, and you have to account for that within your financial models. That’s what we’re doing.

2. I've also heard you say that the firm you founded, Creative Investment Research, creates investment vehicles that are "honest." What do you mean by that?

WMC - I mean "honest" with respect to the financial returns and the social impacts. Certain investments—coal in the 1950s, for example—were solid from a financial perspective, but they failed to account for the long-term social impacts of their product.

It's the same thing with cigarettes. In the 1920s, Philip Morris was a great investment, but it didn't fully account for the social costs, and there was a reckoning. We think it's important to think about those social factors and make them part of your financial and investment model. To not do so is dishonest.

3. Tell us about the Diversity Fund.

WMC - We think diversity and inclusion are leading indicators of management competence and therefore should lead to a portfolio with higher alpha.

Common sense will tell you that in an environment, a culture, and an economy that is getting more diverse all the time, that the diverse company is going to have more customers, and this should lead to higher revenue and higher profits, assuming their costs are under control. They should do better over the long term than the non-diverse company.

We researched that [premise] and found that that is the case, but there is a but; it really depends upon the industry you're in. If you're in a consumer-products type of industry, of course, more customers is better than fewer customers, and that's all it boils down to.

We did some of this initial work for the magazine, DiversityInc. We did the statistical and investment analysis and found that our thesis about the higher alpha for a portfolio comprised of companies that are top performers within the sector diversity/inclusion was correct. So we put together a portfolio and posted it on Folio Investing, Steve Wallman's online platform that allows you to create and monitor portfolios of stocks and bonds. It's been a paper portfolio; we don't have any real investments in it, but we continue to monitor its performance.

When we started out in 2005 to 2007, returns for diversity were huge. Those returns have shrunken a little bit. What we think is happening is that American corporations have gotten the diversity message. In 2006, it was easy to stand out. We were just at the beginning of understanding how diversity and inclusion led to higher returns. Now, in 2018, more and more companies get it. So, the differential in returns has gone down—which is a good thing from a social perspective—but a bad thing from the perspective of a portfolio manager.

4. How do you calculate social return?

WMC - We started out in 1989, looking at banks owned by women and minorities. We wanted to be the Moody's, the Standard & Poor's for these banks, because there was a class of institutional investors who wanted to deal with women and minorities in banks, but they couldn't find any credible, real-time information, so, we created it. We created something called the Fully Adjusted Return Methodology, which is a way of calculating and capturing both financial and social return data. Our methodology is trade secret protected, so I won't go into detail, but let me share what I can.

The financial return data was straightforward; it's standard CAMEL: capital, assets, management, earnings, and liquidity out of FDIC reports. For social return data, we turned to the CRA, or Community Reinvestment Act database, and HMDA, or Home Mortgage Disclosure Act database. Using those two data sets, we could come up with an estimate of social returns.

We discovered we could apply this methodology to non-minority banks, to other industries, and to entire economies.

When calculating social returns, there are two things to keep in mind: cardinal and ordinal, or a ranking and a precise calculation. Ranking is easier to do. For example, we know that the social return for hospitals is higher than the social return for guns. It just is. That's easy, but that's what you need to start. So we start with hospitals and guns, then we look at every other industry, or every other company in the economy along a scale. Where do they fit in, relatively speaking? We look at the relative social value between companies, sectors, industry, and economy, and all of that is doable now in part because of the data.

This approach of looking at both social and financial factors and looking where you can generate abnormally high returns comes through in all our work. And yes, we make point estimates of social return.

5. Research shows that Black female entrepreneurs are only able to raise a fraction of the venture funding that white males do. How do we remedy this?

WMC - That's absolutely true. What that means is that global investment returns are lower than they should be, because you are excluding from investment consideration an entire segment of the population—that is very talented and has good ideas—based on racial and gender discrimination, and that is lowering your overall returns—both social returns and financial returns.

You have to acknowledge what's going on. And then you have to develop efforts to address those gaps with respect to capital access.

We've seen a number of [new] funds that are focused on African-American women entrepreneurs. What they're finding is exactly what we predicted: that there's a large group of very talented entrepreneurs with good companies that are well-positioned to make abnormally high financial returns that have been locked out of the market because of the irrelevant factors. Now that they are beginning to get capital, they are going to do well.

We just rebroadcast our webinar, "How to Finance an African-American Woman-Owned Business in 2018," and on the initial broadcast, we had about 40 African-American women entrepreneurs on the call, all doing very interesting stuff. So, we've helped uncover the demand for capital there, and we will continue to develop new tools that will flow capital resources into that space, because we think the returns are going to be higher than average.

6. What impact has the financial crisis had on communities of color?

WMC - Census data has shown that Black median net worth decreased 61 percent from 2005 to 2009, and a white family lost 21 percent of their wealth. Both are devastating declines in wealth, but whenever you have a 61 percent decline impacting a specific community over a very narrow window of time, it leads to greater social cost.

Long-term, we know that this decreases the economic activities for the economy overall, because if you lose 61 percent of your wealth, that means that you don't have the money to invest in houses, invest in new businesses, invest in sending your children to school, all of which generate additional economic activity. It has been, and continues to be, devastating economically on the communities involved.

And it's not just that one time period. From 1983 to 2013, the median wealth of Black and Latino households declined by 75 percent and 50 percent, respectively, and median white household wealth rose by 14 percent.

You may think: well, that's on them, that's their fault, that doesn't affect me. Eventually, it will affect you. That's the reason why you should care. No matter where you fall along the wealth distribution, our contention is that everybody is better off with a fairer, broader wealth distribution. The reason is purely economic; if everybody has more money, then everybody spends more.

7. You'll be speaking at the FPA Annual Conference on the future of blockchain. Can you give an example of how blockchain technology is being used for social impact?

WMC - One of the most interesting ways we've seen blockchain being used for social impact is to enhance food safety—basically, tracking the path of food from its origin to its consumption point in a much more efficient way than has been done in the past.

IBM, Walmart, and a number of other companies came together on Capitol Hill earlier this year to talk about how they are using blockchain technology to enhance food traceability and transparency. When you have something like an E. coli outbreak, the current response of the food industry is to throw everything out, because you don't know where it came from. Blockchain allows you to narrow that down. It allows you to say, we're throwing out this pallet because it came from that farm, but we're not going to throw out this other pallet. Blockchain technology can tell you where to look so you can run the analysis and determine faster and with much greater efficiency, which food products are contaminated.

If you're really interested, I encourage you to look up Hyperledger and Solidity. Get involved and learn the software. Any finance professional in the U.S. should learn how to code in blockchain. If you really want to protect your job 20 years down the road, you will learn this.

8. You've been tracking Bitcoin since 2011. Is there anything wrong with Bitcoin as an investment?

WMC - No. I think it's a fine investment, as long as it's done in moderation and as long as you understand the risks that are embedded in the system. You should have some—a minimum $100 position—in Bitcoin, just so you can see how it works.

We like a number of tools, including Coinbase, which is a platform where you can buy small amounts of Bitcoin and other cryptocurrencies. It's very elementary, but it's a good way to get introduced.

9. You also serve as managing partner for National Crowdfunding Services. What role does crowdfunding play in society's economic success?

WMC - This idea of social finance is a powerful one. The Statue of Liberty was crowdfunded. People sent in a dollar here and a dollar there. The civil rights movement was crowdfunded. Martin Luther King Jr. would go around to churches and they'd pass the hat to pay bail for people arrested during the civil rights movement. All of the digital currencies are crowdfunded. Some of the new financial technologies based on digital currencies—I'm thinking about ICOs—they all are crowdfunded.

This idea of pooling money together is a very positive and very powerful approach. We've seen what's happened with sharing cars and sharing apartments and sharing scooters. We think we're just at the beginning stage of applying this way of thinking in terms of crowdfunding and shared resources. We think it's the future. Social financing is going to be a key part of the new economy.

10. In June 2016 you predicted Trump would win the presidency. How did you get it right when so many others got it wrong?

WMC - Our independence allows us to be objective. A lot of people were forecasting based on their preferences or based on their institutional ties.

MSNBC was forecasting Hillary Clinton to win, because they really, really wanted her to win and their ties to that kind of social network didn't allow them to look around the corner for other evidence that might run counter to what everybody was predicting.

Independence and objectivity are our specialty. And having this level of objectivity is not costless. There are people, clients, institutions, and others who won't deal with you because they think, this guy doesn't toe the party line, he's not saying what we want everybody to say.

In June 2016, looking at social returns, social data, as well as financial data, our models were saying, there's something going on here; everybody's undervaluing this candidate and this approach, and our model is quite clear in saying that he's going to win.

Online at: https://www.onefpa.org/journal/Pages/September-2018%20-%2010-Questions.aspx