WHITE SUMMERS INTERNATIONAL DEALSHEET

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WHITE SUMMERS, IN PARTNERSHIP WITH **MYSTARTUPCFO, NASSIRI & JUNG, & LA HONDA ADVISORS** IS PLEASED TO PRESENT OUR 1ST EDITION OF THE **WSI DEALSHEET**.

This is our spin on the hottest topics in global tech. DealSheet covers dealmaking everywhere, real-time, with a focus on transactions, dispute resolution, IP ownership, financial / tax developments and the tech exit process. Basically, all you need to know on current trans-border dealmaking around the world. New editions of the DealSheet will circulate every 2nd month consisting of short articles from all of us, and hopefully over time from all of you. Contributions, submissions, observations and alternative views are welcome. Contact our editors Mark James at mjames@white-summers.com and Saurabh Nathany at snathany@white-summers.com.

WHY ARE WE DOING THIS?

Because no one else has, and we thought it was about time for all of us as practitioners in the trenches to share what we are seeing and how we feel about it! More than flag topics, in the DealSheet...

"we say what tech companies and investors need to do to stay ahead of the curve."

If you like what you read here, then it will be even better with your submission. If you don't like what you read here, help us make this better.

With that behind us, now on to our 1st Edition! This time we'll cover the following:

1. Generative AI, Data & How to Protect What's Yours
2. The Evergreen Fund Model – the New Alternative to Closed Funds
3. DeRussification of Russia Related Businesses
4. The New U.S. Corporate Transparency Act – Coming to a Theatre Near You
5. Investor Finder Agreements – How to Stay Out of Jail

OKAY....LET'S GET INTO IT!

TOPIC ONE – GENERATIVE AI, DATA, AND HOW TO PROTECT WHAT'S YOURS

Large language models and other artificial intelligence programs like ChatGPT are unprecedented in their ability to absorb information and generate output that discloses, mimics or is closely tied to that information. Although AI programs have yet to gain widespread adoption, some companies have already connected their applications and datasets to AI systems, unaware that that these systems may collect far more information than they are aware of, and that sensitive information fed into the models as training data could resurface when prompted by the right queries. Some companies, like JPMorgan, Amazon, Microsoft and Wal-Mart, have taken steps to protect their information by restricting employee use of ChatGPT and issuing warnings to take care when using AI.

On the flip side, not only is there risk that a company's proprietary information may be misappropriated by others using AI programs, but companies relying on AI programs to generate output may themselves end up receiving and unwittingly using information that is copyrighted, trademarked, or the intellectual property of another person or entity.

At present, we have only a murky picture of how new and existing law might apply to AI systems. Issues yet to be decided include whether and to what extent the input and output of AI programs is protected under the fair use doctrine (see, e.g., the Getty Images case against Stability and the U.S. Supreme Court case involving Andy Warhol and Prince, whether the use of proprietary information in training AI systems can lead to unfair competition, and whether AI systems violate license agreements restricting the use of data (see class action filed by Github users against Microsoft and OpenAI).

As the law around AI develops, companies can take the following steps to protect their proprietary information and intellectual property:

- Implement technology (such as encryption or firewalls) to prevent AI systems from accessing company networks and data, and block employee access to AI programs.
- Block employee access to AI programs and amend employee confidentiality agreements and policies to prohibit employees from referring to or entering confidential, proprietary or trade secret information into AI programs.
- Add website and metadata tags warning AI companies that they may not scrape or otherwise use your data.
- If you contract with a service provider using AI, insist on robust contractual protections for all data you provide to them, as well as information derived from data you provide; consider if and to what extent the AI service provider may use your data to improve its AI systems.
- If you are using an AI system to generate output, insist that the AI provider bears the risk associated with your use of the AI system by indemnifying you against any third-party claims of intellectual property or privacy violations.

TOPIC TWO – THE EVERGREEN FUND MODEL – THE NEW ALTERNATIVE TO CLOSED FUNDS

Venture funds have historically, and rigidly, operated under a closed-end fund structure with a 10 year life, limiting a fund's ability to continue to support its portfolio companies and forcing pre-mature liquidation of fund holdings.Many VC firms have embraced the open-end "evergreen" fund structures, which offer greater flexibility and a longer-term investment horizon. Although this structure is not new, it appears to be the trend going forward.

In late 2021, Sequoia Capital announced a shift towards an open-end fund structure, which allows the fund to continue funding promising portfolio companies beyond a fixed horizon and to continue maintain a board seat with such companies. This move aims to help portfolio companies achieve sustainable, organic growth and to manage burn instead of pushing for unrealistic scaling for an early exit.

Open-end fund structures have several other advantages over closed-end funds. Instead of the typical 12-18 month subscription window, open-end funds can raise funds continuously according to the needs of their portfolio and as economic conditions permit. They can re-invest funds into new investment opportunities. They have an unlimited lifespan, which means investors can stay invested for as long as they choose. Additionally, they offer greater flexibility to investors, who can buy and sell fund interests as needed.

However, open-end funds are subject to additional regulatory requirements and are more costly to establish. For newer funds that desire the flexibility to shift to an open-end structure, we generally suggest adopting an election approach that allows the manager and the majority of limited partners to elect a closed-end fund to be treated as an open-end fund.

Some criteria that a fund manager must consider before deciding whether an election approach makes sense:

- Regulatory approval: The conversion must be approved by relevant regulatory authorities, such as the Securities and Exchange Commission (SEC). The fund must meet minimum liquidity and diversification requirements.
- Portfolio restructuring: The fund's portfolio may need to be restructured to meet requirements for an open-end fund, such as increasing liquidity or reducing concentration in illiquid assets.
- Redemption: The fund must have provisions in place to allow investors to redeem their interests. This may require changes to the fund's offering documents, such as its prospectus or private placement memorandum. Calculation of net asset values for redemption can be tricky and expensive.
- Fees and expenses: The fund's fees and expenses may need to be adjusted to reflect the costs of managing an open-end fund. Initial fees may be lower, as they are based on funds raised rather than unfunded capital commitments.
- Distribution channels: The fund may need to establish new distribution channels to sell its shares to a wider range of investors, such as through financial advisors or online platforms.

Converting a closed-end fund to an open-end fund can be a complex process that requires careful planning and execution. It may not be appropriate for all funds, depending on their investment strategies and objectives.

Our recommended read: https://www.toptal.com/finance/venture-capital-consultants/evergreen-funds

TOPIC THREE - DERUSSIFICATION OF RUSSIA RELATED BUSINESSES

The Ukraine-Russia conflict and international sanctions on businesses and trade involving Russia have driven international businesses to take action to divest all ties to Russia. While we do not advise clients on how to do business in Russia, we are routinely approached by US clients who do not do business in Russia but who, historically, have board members or stockholders with Russian roots and/or passports. There are a lot of wholesome companies in that category who are trying to understand how to proceed, how to manage investor perception and how to raise capital going forward.

While it is not permissible to assist a client in evading Russia-related sanctions or export controls, there are various approaches to remove Russia-based influence and manage investor perception. Here are some of the strategies businesses have adopted:

- Removing clear Russian connections: Encouraging non-essential Russian-connected executives and directors to resign. Completely divesting any Russia-based operations.
- Relocating directors outside of Russia: Although this may be acceptable in terms of navigating US sanctions, it does not solve perception issues, particularly with respect to raising capital.
- Working closely with investors to manage investor comfort level with remaining Russian connections: Although investors with Russian roots who have relocated tend to have a strong understanding of navigating the sanction and export control landscape, investors without close knowledge require more aggressive changes and/or creative solutions.
- Divesting/buying out stockholders: This may involve creative arrangements where an investor will buy out another investor using an agreement promising a share in future exit proceeds.
- Restructuring ownership to consolidate Russian-connected stockholders and remove influence on the business. For example, wrapping Russian-connected investors into a US special purpose vehicle (SPV) set up as a passive trust, with no rights to vote or manage the SPV's shareholdings. Under the current sanctions, US and EU persons may not provide management services to Russia-linked investors, so the SPV manager will likely need to be a non-US or EU person. Note that this is not intended to obfuscate ownership or the source of funding, but to remove Russia-connected influence.

We recommend that all service providers working with clients with historical Russian roots, and clients with board members or stockholders with Russian roots and/or passports, screen such parties through the Consolidated Screening List maintained by the US Department of Commerce's International Trade Administration (https://www.trade.gov/consolidated-screening-list) and the Sanctions List maintained by the US Department of the Treasury's Office of Foreign Assets Control's (https://home.treasury.gov/policy-issues/financial-sanctions/faqs/topic/1636).

Our recommended read: https://home.treasury.gov/policy-issues/office-of-foreign-assets-control-sanctions-programs-and-information.

TOPIC FOUR – THE NEW U.S. CORPORATE TRANSPARENCY ACT – COMING TO A THEATRE NEAR YOU

After the Corporate Transparency Act (CTA) Act was passed in Jan 2021, FinCEN issued its final rule on Sep 29, 2022, implementing the requirement for most US companies and foreign companies registered to do business in the US to provide information regarding persons with at least 25% ownership (a "beneficial owner") or substantial control.

This is effective from Jan 1, 2024, and reporting companies are allowed one year to file initial reports. New companies formed after Jan 1, 2024 will have 30 days to file an initial report. It is estimated that about 30 million businesses will come under the radar.

Applicability:

- This rule applies to Corporations, LLCs, and similar business entities registered to do business with a Secretary of State within the US - domestic or foreign.
- The rule requires sharing owner information like name, DOB, address, and identifying document image for each beneficial owner or person with substantial control over the entity.
- Penalties will be applied for failure to report or disclose beneficial ownership. Willfully providing false information to FinCEN or failing to report complete information to FinCEN can result in fines up to $10,000 and imprisonment for up to two years.
- The database is not publicly accessible but is for law enforcement, national security, intelligence agencies, and federal regulators enforcing anti-money-laundering laws.
- Reporting companies:
- Domestic and foreign companies - Corp, LLC, sole owner, any other entity registered within SoS of the US States or under the law of foreign countries and registered to do business in any State by filing a document with SoS
- There are 23 exempt types of companies. This can be viewed in this link.

Reporting details:

- Company details; beneficial owners (own or control 25% or exercises substantial control) details, senior officers, and key people details are to be disclosed, including a photocopy of the individual's identification (typically a state driver's license or passport).
- Applicants - attorneys, tax preparers, etc., who perform the filing should disclose details, including their photo IDs. Exemption - only about 851 accounting firms are registered under Sec 102 of the Sarbanes-Oxley Act of 2002.
- Applicants can apply to get an FinCEN identifier, which will ask for the same personal information for the first time, and use that in the forms filed.

More details are available on the FinCEN website here.

Our recommended read: https://www.americanbar.org/groups/business_law/publications/blt/2021/02/corp-transparency-act/

TOPIC FIVE – INVESTOR FINDER AGREEMENTS – HOW TO STAY OUT OF JAIL

In the seemingly endless search for startup capital, founders frequently seek to engage "finders" to identify prospective investors and facilitate investments, often in return for a success-based commission. Engaging finders who are not registered as broker-dealers with the SEC, the Financial Industry Regulatory Authority and/or state securities regulators can be a risky affair.

Engaging a finder who is in violation of state and federal broker-dealer registration rules can result in an investment being voidable by the investor (effectively giving the investor a put right or right of rescission), subject the issuer and finder to civil and criminal fines, or make the issuer's financing activities subject to court injunction (halting the issuer's ability to raise capital).

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 generally defines a "broker" broadly as "any person engaged in the business of effecting transactions in securities for the account of others." While the ultimate determination of whether a finder is a broker is a factual determination based on a number of factors, the most relevant and common factors at play are:

1. whether the finder receives compensation based on the size of the funds raised,
2. whether the finder does this as a business (do they provide similar services to other issuers), and
3. whether the finder is actively involved in activities "effecting" the investment, which may include providing investment advice, negotiating transactions, performing diligence services, delivering investment information, providing valuation advice and similar activities.

While we generally advise clients to avoid engaging unregistered finders, this is not always possible. When asked to help navigate agreements for unregistered finders,

- We primarily <u>focus on compensation structures which are not success-based commissions</u> and restricting finders from activities which could be construed to be "effecting" the transaction.
- <u>Engaging finders as employees or exclusive service providers can also help</u> avoid a determination that the provider is in the business of being a finder.

Our recommended read: https://www.sec.gov/about/reports-publications/investor-publications/guide-broker-dealer-registration