SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: Commerce and Consumer Services Committee

BILL: CS/SB 2668

SPONSOR: Commerce and Consumer Services Committee and Senator Atwater

SUBJECT: Capital Formation Act

DATE: April 5, 2006 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Barrett	Cooper	CM	**Fav/CS**
2.			GO	
3.			GE	
4.			TA	
5.				
6.				

I. Summary:

This committee substitute creates the Florida Capital Formation Act (act), which is designed to increase the amount of venture capital investment in Florida, by providing an unspecified amount of state funds to be invested in private venture capital funds.

This committee substitute provides that Enterprise Florida, Inc. (EFI), must establish the Florida Opportunity Fund as a wholly owned, private, not-for profit, limited liability company. The Florida Opportunity Fund must invest in venture capital funds focusing on investment opportunities in Florida. The Opportunity Fund may only invest in venture capital funds that are able to match, on a one-to-one basis, the Opportunity Fund's investment.

For purposes of implementing this act, this committee substitute appropriates an unspecified dollar amount from the General Revenue Fund to the Economic Development Trust Fund (EDTF) within the Office of Tourism, Trade, and Economic Development (OTTED). At the request of OTTED, funds may be released to carry out the provisions of the act. The program will be dissolved July 1, 2020, at which time the unspecified dollar amount that is appropriated to the EDTF must be returned to the General Revenue Fund. Any proceeds in excess of the unspecified dollar amount may be retained for continuous reinvestment by the Opportunity Fund.

This committee substitute creates section 288.996 of the Florida Statutes.

II. Present Situation:

Venture Capital Industry

Venture capital industry refers to the early-stage financing of new companies with high growth potential. Venture capital investments typically have several characteristics, including an investment in a start-up or expansion-oriented company that has a higher level of risk than is typically associated with traditional bank lending activities; equity participation in the business by the venture capitalist; long-term investments with a 5 to10 year time horizon[1]; and an established mechanism for the payout of the venture capitalist at the end of that time period.[2]

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for startup companies.[3]

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards; and
- Have a long-term orientation.[4]

Venture capitalists actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges. A venture capitalist may invest before there is a real product or company organized (so called "seed investing"), or may provide capital to a company in its first or second stages of development known as "early stage investing."

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund.

State Investments in Venture Capital

Over the past decade, a number of states have adopted programs targeting the formal venture capital industry.[5] Programs fall into five basic categories[6]:

[1] While the initial public offering may be the most glamorous type of exit for the venture capitalists and owners of the company, most successful exits of venture investments occur through a merger or acquisition of the company by either the original founders or another company.
[2] OPPAGA Report on the Cypress Equity Fund, Report No. 98-33. For more information, see the National Venture Capital Association (NVCA) website at http://www.nvca.org/def.html. The NVCA is a trade association that represents the U.S. venture capital industry. It is a member-based organization, which consists of venture capital firms that manage pools of risk equity capital designated to be invested in high growth companies.
[3]Available at the National Venture Capital Association (NVCA) website, http://www.nvca.org/def.html, last visited March 2006.
[4] Id.

- Direct Investment by state agencies to individual businesses. This type of program may be problematic, because it is difficult to find state agency staff with appropriate expertise.
- Investment by state agencies or pension funds into privately managed funds that have extensive geographical limitations (such as enterprise zone location requirements).
- Investment by state agencies or pension funds into a portfolio of privately managed funds. Investments are made in several private partnerships along with other investors. This model is effective at diversifying risk and helping focus a variety of experienced investors on legitimate capital needs of businesses.
- Private investment spurred by offering state tax credits for qualifying investments; Programs include: direct tax credits for investment in qualified businesses and direct tax credits for investment in qualified venture capital funds.
- Private investment spurred by offering contingent state tax credits used as a source of value for guaranty of investment. The tax credits are contingent because they are not claimed unless the venture capital investment fails to meet a guaranteed rate of return.

Venture Capital in Florida

Enterprise Florida, Inc. (EFI) reports that in Florida, total venture capital spending was more than $555 million for 114 deals in 2003 and 2004, and that 27 venture capital firms have headquarters in Florida.[7]

EFI also reports that:

> Since the late 1990's, venture capital investment in Florida has fallen sharply both in absolute dollar terms and as a share of the U.S. total. Despite being the 4th most populous state, Florida ranks 13th in the U.S. in terms of venture capital investment in 2004. In 2004 Florida accounted for only $300 million, or 1.42% of the total venture capital funding in the U.S. [8]

To date, Florida has promoted the investment of state funds in venture capital through two programs: the Cypress Equity Fund and the Certified Capital Company Act (CAPCO).

The Cypress Equity Fund [9]

In 1995, the Enterprise Florida Capital Partnership, Inc.,[10] created the Cypress Equity Fund as part of a strategy to help improve Florida businesses' access to venture capital. The Cypress Equity Fund's purpose is to facilitate initial venture capital investments by Florida private financial institutions and institutional investors, and provide a means to encourage national

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[5] EFI reports that 39 states have adoped programs to deliver or facilitate the formation of local seed and venture capital resources. Ibid, p. 3.
[6] Adapted from "Florida Early Stage Venture Capital Porposal: Business Case", EFI.
[7] http://www.eflorida.com/businessadvantages/1/venturecapital.asp?level1=29&level2=159
[8] Page 6, "Florida Early Stage Venture Capital Proposal, Fueling Florida's Next Bright Ideas", EFI.
[9] This summary was taken from the Office of Program Policy Analysis and Government Accountability (OPPAGA) Report on the Cypress Equity Fund, Report No. 98-33.
[10] In 1996, the Legislature replaced Enterprise Florida Capital Partnership, Inc., with the Capital Development Board.

venture capital managers to consider investment opportunities in Florida. This program invests both public and private funds into privately managed venture capital funds.

The Cypress Equity Fund was designed as a "fund of funds" to invest in national private venture capital funds that, in turn, would invest in companies with high growth potential. However, investments may be made in venture capital funds located anywhere in the country and therefore are not required to target in-state companies.

The Cypress Equity Fund obtained $35.5 million in commitments from five private financial institutions ($20.5 million) and one public institutional investor, the Florida State Board of Administration (SBA) ($15 million). The Cypress Equity Fund Management Corporation, an entity established by the Capital Development Board, is responsible for overall management of the fund. The corporation, in turn, contracts with a private equity manager to invest fund assets with national venture capital firms.

In its report on the Cypress Equity Fund, OPPAGA concluded that the fund has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital because its investments were not targeted to in-state companies.

EFI staff report that the Cypress Equity Fund's net compound annual internal rate of return, since inception, is 22.9 percent. The Cypress Equity Fund is set to expire at the end of 2006.[11]

Certified Capital Companies [12]

The 1998 Florida Legislature enacted the Certified Capital Company Act.[13] This program encourages private investment in venture capital by providing direct tax credits for investment in qualified businesses. The stated purpose of this act is to stimulate a substantial increase in venture capital investments in Florida by providing an incentive for insurance companies to invest in state-certified capital companies (CAPCOs) which, in turn, will invest in new or expanding businesses. Eligible insurance companies are granted insurance premium tax credits in amounts equal to investments in CAPCOs. The increase in investment capital is intended to contribute to employment growth, create high-paying jobs, and expand or diversify Florida's economy.

To date, the insurance industry has invested $150 million in three state certified CAPCOs. The insurance companies may claim insurance premium tax credits totaling $15 million each year for ten years.[14]

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[11] EFI staff, March 3, 2006.
[12] Unless otherwise noted, this summary was taken from Report No. 2005-030, Office of the Auditor General of the State of Florida. The CAPCO program is codified in s. 288.99, F.S.
[13] Codified as s. 288.99, F.S.
[14] Program Two was repealed by ch. 2005-91, L.O.F.

According to information in the most recent annual report on the CAPCO program,[15] there were 47 qualified businesses in which the CAPCOs had invested as of December 31, 2004. Examples of industries represented by the qualified businesses are electronic imaging, medical technology, boat manufacturing, credit card payment processing, vehicle fleet management systems, an internet portal for fishermen, and a cookie manufacturer. Most recent investments include businesses predominantly in the child daycare, landscaping and restaurant industries. The total number of full-time jobs in qualified businesses at the time of the initial investments in the 47 companies was 1,218. The total number of full-time jobs in all qualified businesses as of December 31, 2004, was 1009.

While as many as nine states have created CAPCOs, this type of program is increasingly viewed as the more "problematic" of the Venture Capital Funds (VCF) programs, in terms of

> "…its high cost, poor design and target-inefficiency. Unlike any other VCF program, the CAPCO program provides a 100% premium tax credit to insurance company investors. In effect, the government underwrites the entire investment risk."[16]

III. Effect of Proposed Changes:

Section 1 creates s. 288.996, F.S., the Florida Capital Formation Act (act), which is designed to increase the amount of venture capital investment in Florida, by providing General Revenue funds to be invested by the Opportunity Fund in private venture capital funds.

The Florida Opportunity Fund

EFI must organize the Florida Opportunity Fund as a wholly owned, private, not-for-profit limited liability company. The Opportunity Fund is granted all powers under ch. 608, F.S., which relates to limited liability companies. The Opportunity Fund must select an allocation manager who has demonstrated expertise in the successful management of investments in venture capital funds. In selecting a manager, the Opportunity Fund must also consider a candidate's expertise, quality of management, investment philosophy, prior investment fund results, and potential to meet the goals of this act.

Board of Directors

The Opportunity Fund will be governed by a five-member board of directors. The board of directors of the Opportunity Fund will be selected by a five member appointment committee[17] made up of members of EFI's board of directors. In selecting members, the appointment

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[15] Section 288.99(12), F.S., requires OTTED to report annually on the performance of the CAPCO program. The following Information was compiled from the latest annual report issued in 2004. "Certified Capital Company Act Annual Report on Performance", by the Executive Office of the Governor, Office of Tourism, Trade & Economic Development, June, 2005.

[16] Daniel Sandler, Professor at the Faculty of Law, The University of Western Ontario, London; senior research fellow of the Taxation Law and Policy Research Institute, Melbourne; associated with Minden Gross Grafstein & Greenstein LLP, Toronto. See Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States* (Toronto: Canadian Tax Foundation, 2004) ("Sandler VC Study").

[17] The appointment committee will be selected by the Vice Chair of EFI.

committee must consider a candidate's expertise in the management of investment funds, the selection or supervision of investment managers, or any other relevant expertise. Members of the Opportunity Fund's board of directors must serve terms in accordance with its organizational documents. Vacancies on the board will be filled by appointment by EFI. Members of the board of directors are subject to any restrictions on conflicts of interest specified in the Opportunity Fund's organizational documents, and may not have an interest in the fund manager or in any investments made by the Opportunity Fund. Members of the board will serve without compensation, but may be reimbursed for all reasonable expenses, as determined by the board.

Investments

The Opportunity Fund must invest in seed and early stage venture capital funds focusing on opportunities in Florida. While not precluded from investing in funds with a wider geographic spread of portfolio investment, the Opportunity Fund must require an investment fund to have a record of successful investment in Florida, be based in Florida, or have an office in Florida.

The Opportunity Fund must invest in private venture capital funds and may not invest in individual businesses. The Opportunity Fund must invest in venture capital funds with experienced managers or management teams with demonstrated expertise in the investment of venture capital funds. The Opportunity Fund may negotiate any and all terms and conditions for its investments, including claw back of management fees and other provisions that maximize investment in seed and early-stage Florida-based companies. Investments must be made in Florida-based companies in the following industries: life sciences, information technology, advanced manufacturing processes, aviation and aerospace, and homeland security and defense.

The Opportunity Fund may not invest in a venture capital fund unless that fund has raised capital from other sources in an amount equal to or greater than the investment of the Opportunity Fund such that the total invested in Florida-based companies receiving venture capital funds totals at least twice the investment of the Opportunity Fund.

Annual Report

This section also requires the Florida Opportunity Fund to provide an annual report on its activities to the Governor, the President of the Senate, and the Speaker of the House of Representatives. The report shall include the following:

- A copy of the independent audit of the Opportunity Fund;
- A valuation of the assets of the Opportunity Fund;
- A review of the progress of the manager in implementing the Opportunity Fund's investment plan;
- The benefits to the state resulting from this program;
- A list of venture capital funds that the Opportunity Fund has invested in;
- The number of businesses created and their associated industry; and
- The number of jobs created.

Florida Capital Investment Funds

This section provides that OTTED must account for funds transferred under this act separately within the Economic Development Trust Fund. OTTED must make all funds available for investment by the State Board of Administration (SBA) or its investment manager. The SBA or its investment manager must invest and reinvest the monies in accordance with s. 215.47, F.S.,[18] and any trust agreement between the SBA and OTTED. SBA may deduct fees and expenses as provided in a trust agreement. Upon the request of OTTED, SBA may release funds to the Opportunity Fund to fund its investments and operational expenses. SBA must also invest and reinvest any funds returned to them by the Opportunity Fund in accordance with s. 215.47, F.S., and any trust agreement.

Section 2 provides an appropriation of $300,000 for fiscal year 2006-07 from the General Revenue Fund to the Economic Development Trust Fund in OTTED to be used for start-up activities necessary to implement this act, including costs associated with the creation of the Florida Opportunity Fund and the selection of a fund manager.

Section 3 provides an appropriation for fiscal year 2006-07, from the General Revenue Fund to the Economic Development Trust Fund (EDTF) within OTTED for subsequent investment in the Opportunity Fund. The dollar amount of the appropriation is not specified. Any balance remaining at the end of any fiscal year will be available for carrying out the purposes of this act until July 1, 2020. On that date, the unspecified dollar amount appropriated to the EDTF for purposes of this act must be returned to the General Revenue Fund and any proceeds in excess of that amount may be retained for continuous reinvestment by the Florida Opportunity Fund. If at any time the Florida Opportunity Fund dissolves, all of its assets, and any funds remaining for the purpose of this act, must revert to the General Revenue Fund.

Section 4 provides an effective date of July 1, 2006.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

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[18] Section 215.47, F.S., provides that monies invested in trust funds may be invested in certain ways, for example - in bonds, savings accounts, CDs, etc.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

Venture capital funds and the seed and early stage businesses they invest in will benefit from the increased amount of venture capital available in Florida.

C. Government Sector Impact:

An unspecified dollar amount is appropriated from the General Revenue Fund to the Economic Development Trust Fund within OTTED, to be invested by the Opportunity Fund in venture capital funds.

OTTED and SBA may incur administrative costs related to implementation of this act.

VI. Technical Deficiencies:

None.

VII. Related Issues:

Senate bill 2656 provides a public records exemption for trade secrets held by the Opportunity Fund and the Corporation, as well as information related to portfolios of venture capital funds investments under the act.

VIII. Summary of Amendments:

None.