

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: Governmental Oversight and Productivity Committee

BILL: CS/CS/SB 2668

SPONSOR: Governmental Oversight and Productivity and Commerce and Consumer Services Committee, Senator Atwater and others

SUBJECT: Capital Formation Act

DATE: April 20, 2006

REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Barrett</u>	<u>Cooper</u>	<u>CM</u>	<u>Fav/CS</u>
2.	<u>Rhea</u>	<u>Wilson</u>	<u>GO</u>	<u>Fav/CS</u>
3.	_____	_____	<u>GE</u>	<u>Withdrawn</u>
4.	_____	_____	<u>TA</u>	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

I. Summary:

This bill 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 bill 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 Fund may only invest in venture capital funds that are able to match, on a one-to-one basis, the Fund's investment.

For the 2006-2007 fiscal year, the sum of \$300,000 is appropriated from the General Revenue Fund to the Economic Development Trust Fund in OTTED to be used for start-up activities necessary to implement the act. Additionally, \$35 million is transferred from nonrecurring moneys in the General Revenue Fund to the Economic Development Trust Fund in OTTED for investment in the Florida Opportunity Fund as described in the bill.

This committee substitute creates section 288.9621 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 to 10 year time horizon¹; 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 categories⁶:

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

⁵ EFI reports that 39 states have adopted 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 Proposal: 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

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:

The bill creates s. 288.9621, F.S., the Florida Capital Formation Act (act). Definitions are created in this section. The bill requires Enterprise Florida, Inc. (EFI), to organize the Florida Opportunity Fund (the “Fund”) as a wholly owned, private, not-for-profit limited liability company. EFI is designated as the sole owner of the Fund, but the Fund is declared not to be a public company or instrumentality of the state. EFI is required to annually report to the Governor, the President of the Senate, and the Speaker of the House of Representatives whether the company is being operated and state funds are being invested in the best interest of the state.

The Fund is granted all powers under ch. 608, F.S., which relates to limited liability companies. The Fund is governed by a board of directors consisting of five members who have expertise in the area of the selection and supervision of early-stage investment managers or in the fiduciary management of investment funds or who have expertise in other areas considered appropriate by the appointment committee. The vice chair of EFI must select from among the board of directors of EFI a five-person appointment committee to appoint the company’s initial board of directors. Directors serve staggered 3-year terms in accordance with the company’s organizational documents. After selection of the initial board of directors, vacancies are filled by appointment by EFI.

Board members may be indemnified to the broadest extent permissible under state law. Board members, officers, and employees must have a fiduciary duty with respect to the management of

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”).

company assets and selection and oversight of the allocation manager and must discharge their duties in the best interest of the state.

Board members serve without compensation, but members, officers, and employees may be reimbursed for all reasonable, necessary, and actual expenses, as determined by the board and approved by EFI.

The 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 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.

The 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 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 staffed with a full-time, professional venture investment executive in order to be eligible for investment.

The Fund must invest in private venture capital funds and may not invest in individual businesses. The Fund must invest in venture capital funds with experienced managers or management teams with demonstrated expertise in the investment of venture capital funds.

The 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 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 Fund such that the total invested in Florida-based companies receiving venture capital funds totals at least twice the investment of the Fund.

The bill also requires the 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 must include the following:

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

Under the bill, 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.,¹⁷ 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 Fund to fund its investments and operational expenses. SBA must also invest and reinvest any funds returned to them by the Fund in accordance with s. 215.47, F.S., and any trust agreement.

An appropriation of \$300,000 for fiscal year 2006-07 from the General Revenue Fund is provided 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.

An appropriation for fiscal year 2006-07, from the General Revenue Fund to the Economic Development Trust Fund (EDTF) within OTTED is provided for subsequent investment in the 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.

The bill is effective July 1, 2006.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

The Fund is subject to open government requirements and the bill expressly notes that it is subject. Further, Senate Bill 2656, a linked bill, provides a public records exemption for certain information held by the Fund.

C. Trust Funds Restrictions:

None.

¹⁷ 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:

For the 2006-2007 fiscal year, the sum of \$300,000 is appropriated from the General Revenue Fund to the Economic Development Trust Fund in OTTED to be used for start-up activities necessary to implement the act. Further, for the same fiscal year, the sum of \$35 million is transferred from nonrecurring moneys in the General Revenue Fund to the Economic Development Trust Fund in OTTED for subsequent investment in the Florida Opportunity Fund as described in the bill.

VI. Technical Deficiencies:

None.

VII. Related Issues:

The bill provides that the vice-chair of Enterprise Florida, Inc., is to select from among the board of directors of Enterprise Florida a five-person appointment committee to appoint the Florida Opportunity Fund initial board of directors. After selection of the initial board of directors, vacancies are filled by appointment by Enterprise Florida, Inc. Thus, no original member of the board of the Florida Opportunity Fund or successor board member is directly appointed by the Governor, the President of the Senate, or the Speaker of the House.

The bill provides that members of the board of directors are subject to any restrictions on conflicts of interest specified in the organizational documents and may not have an interest in the Florida Opportunity Fund Allocation Manager or in any investments made by the company.

Board members are specifically prohibited from having an interest in the Florida Opportunity Fund Allocation Manager or in any investments made by the company. Board members of Enterprise Florida, Inc., staff of Enterprise Florida, Inc., and staff of the Florida Opportunity Fund are not subject to the prohibition on having such an interest.

Members of the board serve without compensation. Instead of standard per diem rates, board members and the president and staff “may be reimbursed for all reasonable, necessary, and actual expenses, as determined by the board and as approved by the EFI.”

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.

VIII. Summary of Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.
