The Florida Senate

PROFESSIONAL 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 Operations Committee

BILL: CS/CS/SB 1762

INTRODUCER: Governmental Operations Committee, Commerce Committee and Senator Ring

SUBJECT: Capital Formation

DATE: April 18, 2007 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Pugh	Cooper	CM	**Fav/CS**
2.	Rhea	Wilson	GO	**Fav/CS**
3.			FT	
4.			TA	
5.				
6.				

I. Summary:

The bill creates the Florida Capital Formation Act (the Act), which is designed to promote venture capital investment in Florida. The bill directs Enterprise Florida, Inc., to incorporate the Florida Opportunity Fund, a private, not-for-profit, corporation. The fund is required to conduct a national solicitation for investment plan proposals from qualified venture capital investment managers to raise and invest capital. The Fund is authorized to invest directly only in seed and early stage venture capital funds that have managers with specified experience and the fund is prohibited from making direct investments in individual businesses. An annual report to the Governor, the Senate President and the Speaker of the House of Representatives is required.

The bill appropriates the nonrecurring sum of $30 million for FY 2007-2008 from the General Revenue Fund to Enterprise Florida, Inc. Of this amount, $500,000 is authorized for start-up costs.

II. Present Situation:

The Venture Capital Industry[1]

"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.

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

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[1] The primary source for information in this section is the National Venture Capital Association website, available at http://www.nvca.org/def.html . Last visited March 11, 2007.

capitalist; long-term investments with a 5- to10-year time horizon; and an established mechanism for the payout to the venture capitalist at the end of that time period.

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.

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, known as "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 their risks by developing a portfolio of young companies into a single venture fund.

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

- 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.

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 fourthmost populous state, Florida ranked 13th in the U.S. in terms of venture capital investment in 2004. In 2004 Florida accounted for only $300 million, or 1.42 percent of the total venture capital funding in the U.S. [2]

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

In 1995, the Enterprise Florida Capital Partnership, Inc., 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 other investors, and provide a means to encourage national 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 is 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 began with a total of $35.5 million in commitments: $20.5 million from five private financial institutions, and $15 million from the Florida State Board of Administration. 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 a 1998 report on the Cypress Equity Fund, OPPAGA concluded that the fund has not contributed to achieving the goal of improving Florida businesses' access to venture capital, because its investments were not targeted to in-state companies.[3]

As of Dec. 31, 2006, the Cypress Equity Fund portfolio is valued at $10.3 million. Since the program's inception, distributions and realized gains to investors have totaled $49.5, and the net compound internal rate of return is 22.5 percent.[4]

CAPCO

In 1998, the Florida Legislature enacted the Certified Capital Company Act. 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

[2] "Florida Early Stage Venture Capital Proposal." Prepared by Enterprise Florida, Inc. in 2006 and updated March 9, 2007. Page 6.

[3] "Review of The Enterprise Florida, Inc. Capital Development Board's Cypress Equity Fund," Report No. 98-33. Available at http://www.oppaga.state.fl.us/monitor/reports/pdf/9832rpt.pdf

[4] Letter from Abbott Capital to Enterprise Florida, Inc., dated Feb. 15, 2007. On file with the Commerce Committee.

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.

A 2005 review of the CAPCO program by the Governor's Office of Tourism, Trade, and Economic Development (OTTED) indicated that $3 million was invested in 12 new investee companies, ranging from a business that specializes in transportation of construction materials, to child-care centers, to pool and spa installation.[5] Another $1.8 million was invested in existing companies. As of December 31, 2005, a total of $153.4 million has been made available to the 59 investee companies, which have created 1,028 jobs.

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."[6]

III. Effect of Proposed Changes:

The bill creates the Florida Capital Formation Act. The intent of the bill is to mobilize venture equity capital for investment to result in a significant potential to create new businesses and jobs in the state which are based on high growth potential technologies, products, or services and which will further diversify the economy of the state.

The bill defines a number of terms for the act. "Board" is defined to mean the board of directors of the Florida Opportunity Fund. "Fund" means the Florida Opportunity Fund.

The bill creates the Florida Opportunity Fund. Pursuant to the bill, Enterprise Florida, Inc., must facilitate the creation of the fund, which is described as a private, not-for-profit corporation organized and operated under ch. 617, F.S. The fund is expressly found not to be a public corporation or instrumentality of the state. The fund must manage its business affairs and conduct business consistently with its organizational documents and the purposes set forth in the section. The corporation is not authorized to amend, modify, or repeal a bylaw or article of incorporation without the express written consent of Enterprise Florida, Inc. (EFI).

The vice-chair of EFI is directed to select an appointment committee of five members of EFI's board of directors. The appointment committee must select five initial board members for the fund. Persons selected must include persons who have expertise in the area of the selection and

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[5] "Certified Capital Company Act" (CAPCO) Annual Report, January 1-December 30, 2005. Prepared by OTTED. Copy on file with the Commerce Committee

[6] 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; and 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").

supervision of early state investment managers or in the fiduciary management of investment funds and other areas of expertise as considered appropriate by the appointment committee.

After selection of the initial board members, vacancies on the board must be filled by vote of the board of EFI. Fund board members are subject to any restrictions on conflicts of interest specified in the organizational documents and may not have an interest in any venture capital investment selected by the fund under ss. 288.9621-288.9624, F.S. Further, members serve without compensation though they may be reimbursed for ". . . all reasonable, necessary, and actual expenses as determined and approved by the board pursuant to s. 112.061, F.S.

Upon organization, the board is required to conduct a national solicitation for investment plan proposals from qualified venture capital investment managers for the raising and investing of capital by the Florida Opportunity Fund. Any proposed investment plan must address the applicant's level of experience, quality of management, investment philosophy and process, provability of success in fundraising, prior investment fund results, and plan for achieving the purposes of the act. The board is only authorized to select venture capital investment managers that have demonstrated expertise in management of and investment in companies.

The bill permits the fund to invest directly only in seed and early stage venture capital funds that experienced managers or management teams with demonstrated experience, expertise, and a successful history in the investment of venture capital funds, focusing on opportunities in the state. It is not authorized to make direct investments in individual businesses.

The fund is required to negotiate for investment capital or loan proceeds from private, institutional, or banking sources and negotiate any and all terms and conditions for its investments.

Further, the fund is authorized to invest only in funds that have raised capital from other sources so that the amount invested in an entity in this state is at least twice the amount invested by the fund.

The board is required by December 1 of each year to issue a report to the Governor, the Senate President, and the Speaker of the House of Representatives concerning the activities of the fund. The report must include an accounting of the amount of investments disbursed by the fund, a description of the benefits to Florida resulting from the fund, including the number of businesses and jobs created. Further, the report must include independently audited financial statements.

The bill also appropriates a nonrecurring sum of $30 million from the General Revenue Fund to Enterprise Florida, Inc., for the 2007-2008 fiscal year. The bill only permits $500,000 of this amount for start-up costs.

The bill provides an effective date of July 1, 2007.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

None.

C. Government Sector Impact:

The bill also appropriates a nonrecurring sum of $30 million from the General Revenue Fund to Enterprise Florida, Inc., for the 2007-2008 fiscal year. The bill permits $500,000 of this amount for start-up costs. Actual start-up costs are unknown.

VI. Technical Deficiencies:

None.

VII. Related Issues:

While the bill prohibits the fund from modifying, amending or repealing any of its bylaws or articles of incorporation without written approval of Enterprise Florida, Inc., it does not expressly state what the legislative requirements for board bylaws and articles should be.

VIII. Summary of Amendments:

None.