SB 70

Department of Legislative Services

Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 70 (Chair, Budget and Taxation Committee)(By Request - Departmental - Business and Economic Development)

Budget and Taxation Ways and Means

Business and Economic Development - Enterprise Fund and Invest Maryland Program

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This emergency departmental bill makes several changes to the Enterprise Fund and Invest Maryland Program within the Department of Business and Economic Development (DBED) including (1) altering the permissible uses and allocation of funds received by venture firms; (2) allowing DBED to acquire greater ownership interests; (3) clarifying insurance company restrictions related to ownership of venture firms; (4) altering certain reporting requirements; and (5) limiting the amount of investments that may be allocated to side car fund affiliates.

Fiscal Summary

State Effect: To the extent the bill decreases net transfers to the general fund resulting from venture firm investment proceeds, general fund revenues may decrease beginning in FY 2014. Enterprise Fund revenues and expenditures may increase beginning in FY 2014.

Local Effect: None.

Small Business Effect: DBED has determined that this bill has a minimal impact on small business (attached). The Department of Legislative Services concurs with this assessment. (The attached assessment does not reflect amendments to the bill.)

Analysis

Bill Summary/Current Law: The bill makes the following changes to the Enterprise Fund and Invest Maryland Program:

Alters Venture Firm Use and Allocation of Program Funds

DBED, in consultation with the Maryland Venture Firm Authority (MVFA), provides funds to private venture firms for the purpose of making investments to support the operations of qualifying companies. After venture firms receive these State funds, current law places certain restrictions on the use of these funds (designated as qualified and nonqualified distributions). The bill alters the definitions of a qualified distribution, the criterion which must be satisfied before a venture firm can make a nonqualified distribution, and how nonqualified distributions are allocated.

Under current law, venture firms can use funds for the specified organizational, professional, and management costs and expenses of the venture firm. These qualified distributions do not include (1) amounts paid to an insurance company or affiliate that contributes funds to the program or (2) lobbying expenses. Before a venture firm can make a nonqualified distribution (use the money for any purpose), it must first remit to the Comptroller the amount of designated capital it received. Any venture firm investment proceeds that exceed the original amount of designated capital and are not otherwise retained by the venture firm are then divided 80% to the general fund and 20% to the venture firm. The Comptroller is required to transfer within 30 days to the general fund any monies received under the program.

The bill specifies that qualified distributions include payment by the venture firm of the State's proportionate allocation of specified costs allowable under current law. The bill removes the restriction that qualified distributions do not include payments to an insurance company or an affiliate that participates in the program. The bill alters the criterion which must be met in order for a venture firm to make a nonqualified distribution. Under the bill, a venture firm can make nonqualified distributions if the venture firm pays to the Comptroller the venture firm's pro rata share of distributions made to all limited partners as provided under applicable partnership documents and any DBED agreement. Any monies received by the Comptroller will be deposited to the general fund within 30 days unless DBED informs the Comptroller that there is an outstanding obligation to the venture firm under applicable venture firm investment documents. In this instance, the Comptroller is required to transfer the amount necessary to satisfy the obligation to the Enterprise Fund. If DBED determines that the obligation is not applicable, the Comptroller may transfer the money to the general fund. The bill expands the sources of funds and permissible uses of Enterprise Fund monies pursuant to these requirements.

The bill also specifies that of the program funds allocated to the Enterprise Fund, a maximum of 20% may be invested in side car fund affiliates of the venture firms. A side car affiliate is defined as an entity controlled by or under common control with a venture firm formed solely for the purpose of investing alongside the venture firm.

Allows DBED to Acquire Greater Company Ownership

In making an Enterprise Fund equity investment, current law prohibits DBED from acquiring an ownership interest in an enterprise that exceeds 25%. The bill states this requirement does not apply if DBED makes an Enterprise Fund equity investment in one or more venture or private equity firms.

Clarifies Insurance Company Restrictions

Current law prohibits an insurance company or affiliate from managing a venture firm, beneficially owning more than 15% of the ownership interest of a venture firm, or controlling venture firm investments. The bill clarifies that these restrictions only apply to an insurance company that purchases tax credits under the program.

Alters Certain Reporting Requirements

The bill delays from January 31 to March 31 annual reporting requirements for venture firms and the Maryland Venture Firm Authority (MVFA).

Under current law, beginning on January 1, 2013, DBED must report annually on the implementation of the program to the Governor and the Senate Budget and Taxation and House Ways and Means committees. The report must be published on DBED's website and the report is not required to include any proprietary or confidential information. DBED must report the annual performance of each investment and the current market value made under the program by (1) a venture firm; (2) MVFA; and (3) the Enterprise Fund. DBED is required to use Financial Accounting Standards Board methods for the Enterprise Fund and Generally Accepted Accounting Principles (GAAP) for the others. The bill will require DBED to report only the aggregate fair market value of all qualified investments for each type of investment, as calculated under GAAP. In addition, the bill alters current law by prohibiting DBED from reporting any proprietary or confidential information.

Adds Additional Venture Firm Qualification

Under current law MVFA certifies venture firms. In reviewing applications, MVFA is currently required to consider the management structure of the venture firm including (1) the investment experience, tenure, and turnover history of its principals; (2) the knowledge, experience, and capabilities of the venture firm relevant to venture-stage businesses in the State; and (3) the venture firm's industry reputation and ability to attract investments in the State. The bill will also require MVFA when certifying a venture firm to consider whether the proposed investment would exceed 15% of the total invested in the applicant by all investors, including any side car fund affiliate investments.

Background: Chapter 409 of 2011 (HB 173) established a State-supported venture capital program and increased funding for the Enterprise Fund and Maryland Small Business Development Financing Authority (MSBDFA) within DBED. Funding is provided through tax credits against the insurance premium tax for insurance companies that make qualified contributions to the program. MVFA solicits cash (designated capital) from insurance companies through a competitive process overseen by an independent third party. In exchange for the cash received from the insurance companies, DBED provides insurance companies with tax credits that can be used to offset insurance premium taxes over a five-year period. DBED can award a maximum of $100.0 million in tax credits, which can be claimed beginning in tax year 2014. The cash or designated capital received from insurance companies is to be deposited into the Enterprise Fund within DBED in three annual installments, with the first installment made in 2012. Of the auction proceeds, 24.75% will be retained by the Enterprise Fund, 67.0% will be distributed to eligible private venture firms, and 8.25% will be distributed to MSBDFA.

Program Implementation

Fiscal 2014 marks the second of three years in which DBED is using funds acquired from the auction of tax credits to make venture capital investments under the program. The auction was held in March 2012 and netted $84 million. As a result, the State will forgo $100 million in general fund revenues beginning in fiscal 2014 and paid a premium of $16 million to do so. DBED dispersed its first award in September 2012 and currently reports a pipeline of over $5 million in potential deals with early stage companies. The fiscal 2014 allowance for the Enterprise Fund includes $25.6 million in special funds, reflecting the second year of funding for the program. This is an increase of approximately $520,000. Of the total funding, $4.6 million will stay in the Enterprise Fund for departmental investments, and $2.3 million is allocated to MSBDFA. The remaining $18.7 million will be allocated to private venture firms.

DBED has contracted with a consultant to identify qualifying private venture firms. The consultant was responsible for receiving and reviewing applications, conducting due diligence, developing an investment strategy consistent with statutory requirements, and presenting a recommended list of venture firms for final approval. In December 2012, MVFA approved its first private venture partner. The venture firm will receive $12 million to invest in early stage companies. To the extent that the early stage companies post positive returns, the venture firm will return the principal to the State as well as 80% of the profits. Subsequently, two other firms have been approved; the total commitment to date is $25 million. MVFA expects to approve between six and eight venture firms in total.

DBED announced in September 2012 that it has made its first award from the State's share of program funds. In the subsequent months, DBED announced several other awards; approximately $4.7 million has been committed to date.

State Fiscal Effect: The bill will not impact the amount of funds expended to implement the program. In addition, the foregone $100 million in general fund revenues resulting from the tax credit auction will not be impacted.

DBED estimates that it will make between 10 and 20 investments under the program annually. If qualified investments made under the program are successful, money will be returned to the State. Qualified investments are fully at risk, however, and the State will not receive returns if investments fail. Investment proceeds from MSBDFA and the Enterprise Fund will be retained by DBED. Under current law, a venture firm that receives designated capital must reimburse the State for 100% of the designated capital provided before the firm can make a nonqualified distribution. However, venture firms are not compelled to repay the designated capital at any point. Current law provides that any venture firm investment proceeds that exceed the original amount of designated capital and are not otherwise retained by the venture firm will be divided 80% to the general fund and 20% to the venture firm.

The bill alters the criterion which must be met in order for a venture firm to make a nonqualified distribution. Under the bill, a venture firm can make nonqualified distributions if the venture firm pays to the Comptroller the venture firm's pro rata share of distributions made to all limited partners as provided under applicable partnership documents and any DBED agreement. In addition, the bill provides that the Comptroller transfer to the Enterprise Fund certain investment proceeds received by venture firms if DBED determines that there are outstanding obligations to the venture firm. As a result, general fund revenues may decrease beginning in fiscal 2014 and Enterprise Fund revenues and expenditures may increase beginning in fiscal 2014.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Business and Economic Development, Comptroller's Office, Department of Legislative Services

Fiscal Note History: First Reader - January 29, 2013
ns/jrb Revised - Senate Third Reader - March 21, 2013
Revised - Enrolled Bill - May 16, 2013

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Business and Economic Development – Maryland Enterprise Fund and InvestMaryland Program

BILL NUMBER: SB 70

PREPARED BY: Department of Business and Economic Development

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

__X__ WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

___ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

Invest Maryland was established by the legislature in 2010 to create a funding source for early, mid and late stage growth companies. Through a premium insurance tax credit auction sale, the State raised $84 million to invest in early stage technologies in areas including software, communications, cyber-security and life sciences. Two thirds of the funds are to be invested by the Enterprise Fund in venture funds that commit to invest in the State, and the remaining third is to be invested directly into Maryland companies by the Enterprise Fund (Maryland Venture Fund) and MSBDFA.

This bill proposes clarifications and technical amendments designed to (i) eliminate that confusion and uncertainty, (ii) ensure that the investments made under the InvestMaryland Program are properly authorized, and (iii) facilitate the negotiation of investment terms with undue complexity or restructuring.

The legislative proposal would not exert a significant impact upon a significant share of Maryland—based small business. It would not impose a burden or confer a benefit upon most Maryland—based small business. **However it would ensure more effective**

operation of the Invest Maryland program which will drive a big infusion of new capital into early stage companies, which by their very nature are small businesses. DBED estimates the number of investments to range between 10 and 20 annually.