

# HOUSE BILL REPORT

## HB 1721

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**As Reported by House Committee On:**  
Community & Economic Development & Trade

**Title:** An act relating to the creation of certified capital companies to promote economic development through investment in start-up and emerging Washington businesses.

**Brief Description:** Creating certified capital companies to promote economic development through investment in start-up and emerging businesses.

**Sponsors:** Representatives P. Sullivan, Pettigrew, Kristiansen, Orcutt, Chase, Skinner, Haler, Roach, Morrell, Linville, Eickmeyer, Kessler, Walsh, Dunn, Kenney, VanDeWege and Simpson.

**Brief History:**

**Committee Activity:**

Community & Economic Development & Trade: 2/14/07, 2/27/07 [DPS].

**Brief Summary of Substitute Bill**

- Authorizes the creation of certified capital companies (CAPCOs) to promote investment in Washington's small businesses.
- Allows premium tax credits for insurance companies that make qualified investments in CAPCOs.

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### HOUSE COMMITTEE ON COMMUNITY & ECONOMIC DEVELOPMENT & TRADE

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 8 members: Representatives Kenney, Chair; Pettigrew, Vice Chair; Bailey, Ranking Minority Member; McDonald, Assistant Ranking Minority Member; Chase, Darneille, Haler and P. Sullivan.

**Staff:** Tracey Taylor (786-7196).

**Background:**

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*This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.*

Several states, including Louisiana, New York, and Missouri, have authorized the creation of certified capital companies (CAPCOs) which provide venture capital to small businesses in those states. A CAPCO must make direct financial investments into small businesses and work with entrepreneurs to grow these businesses. Additional capital may be attracted to these small businesses due to the CAPCOs' initial investments, thereby leveraging the original dollars.

Investments in CAPCOs are attractive to insurance companies due to the premium tax credit authorized in return for making qualified investments. In Washington, all insurers except title insurers pay a 2 percent tax on premiums.

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### **Summary of Substitute Bill:**

A new chapter is created in Title 43 related to CAPCO investments. A CAPCO is defined as: a partnership, corporation, trust or limited liability company, organized on a for-profit basis, which has its primary office located or is headquartered in Washington; has as its primary business activity the investment of cash in qualified businesses; and is certified by the Department of Financial Institutions (DFI).

A CAPCO must invest in a qualified business, which is defined as a business that: is independently owned and operated; headquartered in Washington and its principal business operations located in Washington; having at least 50 percent of its employees in Washington; not more than 100 total employees; and is unable to obtain conventional financing. In addition, a qualified business may not be engaged in professional services, banking or lending, real estate development, insurance, oil and gas exploration, direct gambling activities, or making loans to or investments in CAPCOs or an affiliate. A qualified business may not be a franchise of or organized by a CAPCO or CAPCO affiliate. Generally, it is the size and nature of the business at the time it is first classified as a qualified business that is determinative of whether it can continue to receive qualified investments. However, if a business has relocated its headquarters or principal business operation outside of Washington, it will lose its qualified business designation. Also, if the business has expended less than 75 percent of the funds from its prior qualified investments to establish and support its Washington operations, it will lose its qualified business designation.

An insurer earns a vested tax credit against their premium tax liability equal to 80 percent of its CAPCO investment. An insurer is entitled to take the vested tax credit at 10 percent per year beginning in 2009.

The total amount of certified capital for which tax credits may be allowed is \$100 million.

Decertification of a CAPCO causes the disallowance and recapture of the premium tax credit along with interest. The amount of the disallowance depends upon the timing of the decertification. There are also provisions which preclude the tax credit from being taken if the insurer, individually or through its affiliates, manages or controls the CAPCO.

The DFI is authorized to make rules governing the CAPCO certification application procedures. An applicant is required to not only file an application with the DFI, it is also required to pay a nonrefundable application fee of \$20,000, which shall be deposited into the Certified Capital Company Revolving Fund. In addition, a CAPCO applicant must have an equity capitalization of \$500,000 and have at least two principals or two persons employed to manage the funds who have at least two years of money management experience in the venture capital industry or at least two years of private equity fund management experience.

Any offering materials put forth by the CAPCO are required to include specific language indicating that by certifying the CAPCO, the state is not endorsing it and is not liable for damages or losses that an investor may sustain.

In order to continue to be eligible for certification, a CAPCO must make qualified investments of at least 25 percent of its certified capital within two years of the allocation date and 50 percent of its certified capital within five years of the allocation date. Prior to making an investment, a CAPCO is required to notify the DFI in order to confirm the investment is being made in a qualified business. A CAPCO must place at least 100 percent of the certified capital allocable to it in qualified investment or it shall no longer be permitted to distribute management fees.

A CAPCO must report to the DFI as soon as practicable after the receipt of certified capital: the name of each certified investor; the amount of each certified investor's investment of certified capital; and the date on which the certified capital was received. Annually, a CAPCO must report to the DFI: the amount of the CAPCO's certified capital at the end of the immediately preceding taxable year; whether or not the CAPCO has invested more than 15 percent of its total certified capital in any one business; all qualified investments that the CAPCO made in the previous year; and other information requested by the DFI. In addition, a CAPCO must provide the DFI with annual audited financial statements and an "agreed upon procedures report."

The CAPCO investments must be consistent with the current Insurance Investment Code requirements. An investment in a CAPCO qualified debt instrument is considered a miscellaneous investment authorized by the Insurance Investment Code.

A CAPCO may make qualified distributions at any time. Qualified distributions include the reasonable costs of formation, management fees, and fees for professional services. Other distributions may only be made if the CAPCO can demonstrate that the aggregate cumulative amount of all qualified investments equals or exceeds 100 percent of its certified capital, of which at least 25 percent must have been invested in qualified business or qualified microenterprise development organizations in rural counties or in a city with a population of less than 30,000, and at least 5 percent of the certified capital has been invested in microenterprise development organizations. In addition to investing in rural counties, small cities and microenterprise development organizations, CAPCOs are encouraged to invest in businesses certified by the Office of Minority and Women's Business Enterprises and set goals regarding such investments.

A CAPCO is required to pay to the DFI an amount equal to 5 percent of all distributions to equity holders of the CAPCO other than qualified distributions and distributions of all equity contributed to the CAPCO by such equity holders. Revenues under this section shall be deposited in the State General Fund and shall be distributed to and supplement state-funded programs which assist businesses with start-up, commercialize research, business education, modernization services, and technical services. This includes Washington Manufacturing Services, Washington Technology Center, Spokane Intercollegiate Research and Technology Institute, and microenterprise development programs.

Certification can be revoked for any material representation that proves to be falsely made or if the application materially violates any of the reporting requirements.

Upon notification by the Joint Legislative Audit and Review Committee (JLARC), the DFI shall report to the Governor: the number of CAPCOs holding certified capital; the amount of certified capital invested in each CAPCO; the cumulative amount that each CAPCO has invested as of September 30, 2012, and the cumulative total each year thereafter; the cumulative amount that the investments of each CAPCO has leveraged in terms of capital invested by other sources in qualified businesses at the same time or subsequent to the CAPCO investment; the total number of tax credits granted for each year; the performance of each CAPCO with regard to the requirements for continuing certification; the classification of the companies in which each CAPCO has invested according to industrial sector and size of company; the total gross number of jobs created by CAPCO investments and the number of jobs retained; the location of the companies in which each CAPCO invested; the total amount invested in qualified microenterprise development organizations, the number of small businesses that received financial assistance from these organizations and the number of jobs created and retained by such businesses; the total amount invested in businesses that are certified minority or women-owned and controlled businesses; those CAPCOs that have been decertified or revoked and the reason for the decertification or revocation; and any other information requested by the JLARC.

It is the intent of the act that the CAPCO fees shall be sufficient to pay the reasonable costs associated with regulating the CAPCOs. In addition to the registration fee, the DFI shall annually estimate the cost of administering the program including the expenses related to the employment of one full-time equivalent. The DFI shall annually assess a fee on each CAPCO to recoup such expenses.

The DFI may develop any rules necessary for the implementation of this program.

**Substitute Bill Compared to Original Bill:**

The regulatory agency overseeing the CAPCO program is changed from the Department of Community, Trade and Economic Development (DCTED) to the Department of Financial Institutions. The definition of "affiliate" is changed to have the same meaning as in the Insurer Holding Company Act and the Health Carrier Holding Company Act. A qualified debt instrument must be the highest rating category of the Securities Valuation Office of the National Association of Insurance Commissioners. Investments by CAPCOs must be

consistent with the current Insurance Investment Code requirements, and investments in CAPCOs are an authorized miscellaneous investment under the Insurance Investment Code. The CAPCO management qualifications are expanded to include persons with two years of experience in private equity funds management. The requirements for the continuance of certification are simplified. The redemption of the premium tax credit is delayed until 2009. The premium tax credit is increased from 75 percent of the qualified investment in a CAPCO to 80 percent. The premium tax credit redemption schedule is changed to be 10 percent per year.

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**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date of Substitute Bill:** The bill contains an emergency clause and takes effect immediately.

**Staff Summary of Public Testimony:**

(In support) This bill will promote the investment of millions of dollars in Washington's small and emerging businesses statewide. Other states that have implemented CAPCO programs with success have provided an excellent resource to improve upon for Washington's program. Unlike some of the other CAPCO states, this bill has a great deal of accountability to ensure the state gets a return on its investment. Access to capital is a huge challenge for Washington's small and emerging businesses. This bill creates a mechanism to fill in the financing gap between the mega deals and the first investments by family and friends.

The CAPCO program is about job creation. Venture capital is a parochial business. This provides a mechanism to encourage increased investment in Washington's small businesses, especially rural or economically disadvantaged firms. The CAPCOs also leverage out-of-state money. Typically for every \$1 of CAPCO investment in a firm, there are an additional \$5 to \$6 of private investment. In addition, CAPCOs put capital where it does not already go by making smaller investments in firms than a typical venture capitalist. Forty-two other states have some sort of program promoting venture capital investment in their states.

Also, this CAPCO program would allow investments in microenterprise development organizations. These microlending organizations will ensure that the state's investment reaches the smallest and most capital challenged businesses.

(Opposed) This bill raises a number of concerns. First, it allows insurer investments outside the Insurance Investment Code that directly conflict with current law and could jeopardize the state's continued accreditation. Second, investments in CAPCOs should be part of the miscellaneous investments allowed under the Insurance Investment Code. Third, authorization to invest in CAPCOs should be limited to insurers that are financially able to withstand losing any investment, possibly those insurers that have annual written premiums of at least \$250 million and capital and surplus of at least \$125 million. Fourth, investments by

any one insurer in CAPCOs should be limited to 1 percent of its capital and surplus. Fifth, the definition of "affiliate" in this bill directly conflicts with the definition of the term in current law. Sixth, the bill allows for the transference of premium tax credit but does not provide a reliable mechanism for tracking credits and their transfer.

In addition, the initial investment and terms of the guaranteed bonds offered to the insurers need to be modified. A higher rate of return for the state should also be specified. The oversight agency needs to be changed from the DCTED to an agency with more investment experience, such as DFI or the State Investment Board. The applications fee is high and may deter local insurers from participating; therefore, the application fee should be reduced. The bill should cap the amount of organizing costs reimbursement for CAPCOs. Given the need to increase investments in smaller businesses, the definition of "qualified business" should be expanded to include firms that have found it difficult to attract equity investment. The qualifications for CAPCO managers should be licensed investment professionals. Also, the bill should specify a percentage of the funds for minority and women business investments. The bill is silent as to how a CAPCO obtains its certified capital.

**Persons Testifying:** (In support) Representative P. Sullivan, prime sponsor; Ron Newbry and Clif Finch, AEQUUS Corporation; Ryan Brennan, Advantage Capital; Patti McKinnell Davis, Washington Biotechnology and Biomedical Association; Rita Chew, Essoula, Inc.; and Tim Black, Integra Ventures.

(Opposed) Jim Odiorne, Office of the Insurance Commissioner; and Glenn Gregory, Coalition for Investing in Washington Jobs and Tabor 100.

**Persons Signed In To Testify But Not Testifying:** None.