

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Chairman William G. Mason at 3:35 p.m. on February 3, 2000 in Room 522-S of the Capitol.

All members were present except: Vice Chair Vickrey - E
Representative Gerald Geringer - E
Representative Broderick Henderson - E

Committee staff present: April Holman, Legislative Research Department
Rena Jefferies, Revisor of Statutes
Bob Nugent, Revisor of Statutes
Lynne Holt, Legislative Research Department
Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee: Randy Speaker, Director of Housing, KDOC&H
Charles Ranson, President, Kansas, Inc.
Mitch Woolery, Partner, Polsinelli, White, Vardeman &
Shalton, K.C., MO.
Dr. David L. Barkley, Professor of Applied Economics
Clemson University, Clemson, S.C.

Others attending: See Attached List

Representative Stone moved, seconded by Representative Campbell that the minutes from the February 1 meeting be approved. The motion carried.

The Chairman introduced Randy Speaker, Director of Housing. He distributed copies of the Governor's Commission report presented to the Governor December 1, 1999 (Attachment 1). He noted that the report was done by the Governor's Commission and not necessarily an endorsement by KDOC&H. He reviewed the background of the Governor's Commission on Housing noting the purpose and methodology of the report. They identified seven trends of the other housing finance agencies and summarized five areas where improvement could be achieved. He spoke of related issues, housing trust fund, quasi-public status and administration's leadership. They suggested five potential solutions, describing four potential models for implementation. The Governor's Commission recommended Model #4, listing 11 key reasons. Using that model, the housing programs and staff would be transferred to the Kansas Housing Development Corporation. They listed five activities in which the Kansas Housing Finance Agency should not participate. The report had attachments of (A) Statistical data on Kansas counties regarding assistance and loans, (B) organizational charts of four models and (C) Housing Activities Analysis and Comments, and Ballots of the Governor's Commission.

Discussion followed regarding the limitations of the current projects. The Chairman appointed a sub-committee: Representative Aday-Chair, Representatives Campbell and Sharp to review the report and come back with recommendations.

The Chairman opened discussion on **HB 2688**. He noted that there were issues and questions that had been raised during the hearing and he introduced Charles Ranson to clarify those concerns and changes that had been made in the bill. Mr. Ranson stated that the issues raised were over the use of the name "Capco". He stated that the Kansas program is a hybrid, not patterned after the traditional Capco programs that use insurance companies for funding. He stated that to solve the problem, hereafter these programs would be called Kansas Capital Formation Companies.

Mr. Ranson recognized Mr. Mitch Woolery, Partner, Polsinelli, White, Vardeman & Shalton, P.C. who testified on his own behalf and not as a representative of the Firm or any of its clients (Attachment 2). He reiterated his support of the bill, referring to the amendment regarding value added agriculture programs. He spoke to four areas of criticisms of **HB 2688**: (1) appropriateness of insurance companies as investors in Capcos, (2) violation of the Commerce Clause of the Federal Constitution (3) size of the Capcos and (4) uniqueness of the Kansas bill. In conclusion he stated that **HB 2688** is in the best interests of the State of Kansas and its businesses. It is drafted for Kansans by Kansans. Discussion followed regarding net worth of qualified investors and he stated that he would be available for further discussion in the Senate if requested.

Mr. Ranson introduced Dr. David Barkley, Professor at Clemson University. He provided information on the research project, completed by a team from five universities, concerning *Public Involvement in Venture Capital Funds* (Attachment 3). The response to the perceived venture capital shortage is increased public involvement in venture capital programs and he stated five goals of those programs. His policy brief described the experiences and

lessons learned of state-assisted venture capital programs and assesses the advantages and disadvantages of three program types: (a) Publicly funded, publicly managed venture capital funds (b) Publicly funded, privately managed venture capital funds and (c) Certified capital companies (CAPCOs). He discussed the reasoning and objections expressed by existing companies regarding the Kansas model, page 11. In summary he stated that the proposed Kansas program addressed all the shortcomings inherent in all the earlier programs, which were programs provided by the Capco industry. Equally important, the Kansas program identified the capital needs within the state, identified seed and pre-seed capital and then designed a program to meet those particular needs. The Kansas program is a hybrid, well-designed experiment. His testimony included a table of Case Study Institutions, by Program Type.

The Chairman shared his conversation with Tom Blackburn, KVCI. Mr. Blackburn said that he was very supportive of the legislation. He also spoke about a conference call he had with Phil Thomas and Scot Sajac, a managing partner of one of the Missouri Capcos. They discussed Capco models used in other states and the incompatibility of the Kansas plan to fit under that umbrella. Upon learning that Kansas would change the name of their program, they were willing to discontinue efforts to lobby as an opponent to the bill.

Chairman Mason reviewed the fiscal note dealing with actual expenses in administering and operating the fund. He advised the committee that he had sent the fiscal note back, questioning the requirement for a legal and investment specialist. It would be appropriate and is included in the bill that fees are allowed to recover costs associated with the program. What is not covered is the loss of revenue coming into the state due to the tax credit but that is expected to turn over due to the nature of the bill.

Bob, Nugent, Revisors, suggested a substitute bill due to the name change. He highlighted changes in the bill: page 1, lines 15-16 - strike *and to support the modernization and expansion of the state's rural economy*, page 1, line 33 - change *manager* to *managing*, page 2, line 25 - add *which is certified by the secretary to have been*, page 2, line 41 - 42, substitute *remitted to equity holders of* with *made by*, page 3, line 28 - strike *in the case of an early stage business*, page 4, lines 22-26 - strike entire section 4, page 4, line 33 - strike *transferable, nonrefundable*, page 4, line 39 and 42 - strike *vested*, page 4, line 41 - change *use* to *claim*, page 5, line 36 - strike *annually*, page 6, line 20 - add a new (e) and reletter accordingly. *The secretary shall not certify any capco if the commissioner's report includes any affirmative findings pursuant to subsection (d)*, page 7, line 11 - add *Total capital investment deemed certified for the purpose of earning tax credits shall not exceed \$10,000,000 in a single capco*, page 8, line 33 - strike *cumulative and to equity holders*, page 9, line 11 - strike *from whom the certified capital investment was received*, page 9, line 42 - add by a capco, page 10, line 3 - change *may* to *shall*, page 10, line 26 - add *or transferees*.

Discussion followed clarifying the changes. Representative Kuether moved that on page 4, section D, line 14-15, be struck, Representative Osborne seconded and the motion carried.

Representative Kuether moved that on page 1, line 16, the statement stands but the word *rural* be struck. Representative Campbell seconded the motion and the motion carried.

Representative Stone moved the rest of the balloons be accepted, Representative Sharp seconded and the motion carried.

Discussion followed regarding the name of the company. Representative Kuether moved, seconded by Representative Campbell that the Kansas Capital Formation Companies be called CFCs. The motion carried

Representative Aday moved that the bill be moved out favorably as amended as a substitute bill for HB 2688. Representative Compton seconded and the motion carried.

The Chairman thanked everyone, especially Kansas, Inc. for the work that had been done. He adjourned the meeting at 4:57 p.m.

HOUSE ECONOMIC DEVELOPMENT COMMITTEE COMMITTEE GUEST LIST

DATE: THUR FEB 3 2000

NAME	REPRESENTING
Randy Speaker	KDOC + H
Mitch Woolery	self (atty @ Pelsinelli White)
David Day	
Kevin Carr	KTEC
Roger Franke	KGC
KEITH Molzer	Entrepreneurial consulting Corp.
Sherry Brown	KDOC + H
Laurie Harrison	Kansas Legal Services, Inc.
Jim Janousek	KDOC + H
Mikel Miller	Kansas Inc
David Bankley	Clemson University
RICH BOWERS	KTEC
Charles Conson	KS, Inc.
MIKE WOJCICKI	KTEC
Vaughn Neora	Rep 57th Dist
Bill Burke	Issue Mgmt. Group, Inc.



INCREASING HOUSING OPPORTUNITIES
FOR KANSANS IN THE 21ST CENTURY

presented to
Governor Bill Graves
and
Lt. Governor Gary Sherrer

December 1, 1999

prepared by
Governor's Commission on Housing



KANSAS DEPARTMENT
of COMMERCE & HOUSING
HOUSING DEVELOPMENT DIVISION

ECONOMIC DEVELOPMENT COMMITTEE
FEBRUARY 3, 2000
ATTACHMENT 1



KANSAS DEPARTMENT
of COMMERCE & HOUSING
HOUSING DEVELOPMENT DIVISION

BILL GRAVES, GOVERNOR
GARY SHERRER, LT. GOVERNOR/SECRETARY

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December 1, 1999

Governor Bill Graves
Kansas State Capitol
Topeka, Kansas 66603

Dear Governor Graves:

On behalf of the Governor's Commission on Housing, I am pleased to present to you, *"Increasing Housing Opportunities for Kansans in the 21st Century."*

This document represents several months of diligent work and careful consideration by the Commission. Fellow Commission members invested a great deal of time in learning about housing programs in other states, while keeping in mind the needs of Kansans. Our recommendation is based upon our observations in other states and what we see as most beneficial to the residents of our state. It is clear to the Commission that the state could be doing more to positively impact housing opportunities in Kansas.

The Commission has appreciated the assistance of the staff of the Kansas Department of Commerce & Housing. I commend Randy Speaker, Housing Development Division Director, and the professionals with whom he serves for exceptional attention to detail so that we could gather information in a timely, accurate manner. Randy's leadership and cooperation has enabled the Commission members to get a clear perspective of the role that other states' governments assume in the implementation of their housing policy.

We appreciate your consideration of the structure through which the housing needs of Kansans are served and look forward to your recommendations for the future of the state's role in housing issues. If I or any of the other Commission members can be of service to your administration as you address future housing issues, please call upon us.

Sincerely,

William Prelogar, Chairman
Governor's Commission on Housing

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leadership's vision is needed by local communities and private businesses to realize how the benefits of affordable housing can be directed for the good of all residents.

POTENTIAL SOLUTIONS

The main purpose for having the Governor's Commission on Housing review the organizational structure and programs of the housing finance agencies in other states was to identify which components would best fit Kansas. The method chosen was to review several potential options. In order to do that, the Commission asked the Director of Housing, Randy Speaker, to prepare a comparison of potential models that he offered before the Joint Committee on Economic Development in Pittsburg, Kansas, on September 28, 1999. To better grasp the full impact of the potential models, he also prepared a chart that analyzed the current housing functions and some of those typically performed by state housing finance agencies. The charts demonstrate how housing activities can be broken down into several functions – Policy, Program Development, Implementation, Compliance and Residual Income Investment. Both the models and the program comparison charts are in the appendix as Attachment B and Attachment C, respectively.

Model #1 – Create a new housing finance agency. – This model represents a classic state housing finance agency. It is a separate, free-standing, quasi-public entity which receives its charter and authorities from the state legislature. The Governor appoints a majority of the board of directors with the consent of the Senate. The Governor appoints the Executive Director without any further consent. In addition, there can be several board positions held by elected officials with ex-officio designations but with full voting powers. The types of elected officials added to the governing boards vary from state to state. Their participation is usually sought to offer some form of technical guidance or to provide for elected representation.

Model #2 – Utilize the Kansas Department of Commerce & Housing (KDOC&H) in its current status. – In this model there would be no structural changes to the KDOC&H. However, it would need to receive additional authority from the Kansas Legislature if it were to perform the duties typically performed by a state housing finance agency.

Model #3 – Utilize the Kansas Development Finance Authority (KDFA) – KDFA currently issues housing bonds for multifamily housing developments. However, it does not have authority to issue bonds for Mortgage Credit Certificates or single-family Mortgage Revenue Bonds. If it were to be given authority to issue single-family Mortgage Revenue Bonds, it would probably add two new positions. In the model depicted, the other housing programs would remain with the Kansas Department of Commerce & Housing.

The Governor's Commission on Housing respectfully recommends Model #4 as the vehicle that will increase housing opportunities for Kansans in the 21st Century. If implemented fully, this model will help produce the following results:

- **Reduce the fragmentation of housing resources and programs.**
- **Eliminate the need for future funding from the State General Fund or any other state source of revenue thus expecting the Kansas Housing Finance Agency to be self-sufficient.**
- **Eliminate 23 Full Time Equivalent (FTE) positions from the state budget by transferring them to the Kansas Housing Development Corporation at an approximate savings of \$998,199.**
- **Improve the distribution of housing resources so that there is equitable distribution throughout our rural and urban areas.**
- **Expand available resources without creating liability for the state.**
- **Improve the ability to respond to changing markets more expeditiously.**
- **Ensure that residual funds from housing activities are reinvested into housing programs.**
- **Prepare the state for the devolution of authority and funding that will accompany the restructuring of the 12,000 housing units in Kansas that have expiring Section 8 rental assistance contracts.**
- **Position the state to preserve affordable rents in approximately 1,500 Housing Tax Credit units annually beginning in 2002.**
- **Accomplish housing goals with a minimal amount of change and minimal cost.**
- **Centralize the housing efforts and programs without diminishing local input or resources.**

Under this model, the housing programs and staff would be transferred to the Kansas Housing Development Corporation. Although under the administrative wing of the Secretary of Commerce & Housing, it would operate in some cases as a quasi-public entity. The employees would be similar to those of KDFA in that they would participate in KPERS, but would not be subject to the Civil Service employment structure. The Kansas Housing Development Corporation (KHDC) would have the

benefit of utilizing the existing administration division's resources including accounting, marketing, research, information technology and human resources. The KHDC would be given authority to issue single-family Mortgage Revenue Bonds and Housing Bonds for multifamily developments in conjunction with the issuer's consortium that would consist of KHDC, KDFFA and the existing local issuers. If needed, the current authority of the KHDC could be ratified by the Kansas Legislature.

The Need for Intergovernmental Participation

The Governor's Commission on Housing feels that there is a valuable role that can be played by both the Kansas Development Finance Authority and the existing local Mortgage Revenue Bond issuers. Both have developed staff expertise and experience that would be beneficial to all housing efforts. Furthermore, the existing issuers have resources they can utilize to enhance a statewide effort in the form of refunded proceeds from previous bond issues. In fact they have been one of the highest leveraged issuers in the Midwest with their 1999 offering of \$70 million that required only \$23 million of new Private Activity Bond authority. Through this model, the Commission feels that the resources of KDFFA and the local issuers will be maximized through collaboration yet they will still be able to retain some of their autonomy. The Commission believes that it would be counterproductive to allow new local issuers to participate since this would work against the efforts to consolidate the housing delivery system.

Activities in Which the Kansas Housing Finance Agency Should Not Participate

While most of the Commission's time was spent in identifying additional activities and functions, there was very clear consensus as to where the line of authority should be drawn. These items can be summarized as follows:

- 1) **The state housing finance agency should not originate single-family loans. That function is best left to the existing mortgage lending institutions.**
- 2) **The state housing finance agency should not originate multifamily first mortgages except as a last resort where no other local lender will offer the financing. However, efforts should be made, to the extent feasibly possible, to promote risk sharing or second mortgages as the focus for the state housing finance agency. In the event the state housing finance agency has the opportunity to acquire mortgages at a substantial discount, it should do so as long as it is the only entity eligible to do so. Furthermore, it should do so only when the intent is to restructure the developments for the betterment of the residents and the community.**

- 3) **The state housing finance agency should not own property for the long term. A short-term period (18 months or less) for the purpose of restructuring the debt and stabilizing the financial nomenclature of a housing development so it can be transferred to private ownership is acceptable.**
- 4) **The state housing finance agency should not participate in the construction process as a general contractor or as a subcontractor.**
- 5) **The state housing finance agency should not participate in any housing function that can be done more economically and efficiently by the private sector. However, it should participate in functions such as program compliance that would eliminate identities of interest or conflicts of interest by virtue of the parties involved.**

Private Activity Bond (PAB) Allocation Process

PABs are becoming more vital to the acquisition and rehabilitation of affordable housing developments. This is especially true in the urban areas. The Commission suggests that a more structured approach be devised so that the predictability of potential allocation amounts is communicated to the public. For example, \$100 million of the \$150 million could be reserved for specific activities, including housing, based upon historical usage and widespread geographic distribution, for the first six months. After that period, unused balances would revert to a first-come, first-serve basis, along with the undesignated \$50 million. This would provide structure for development planning and accountability, yet maintain flexibility for large economic development allocations.

Other Housing Issues

In the past, there has been some confusion as to when federal funds are subject to mortgage registration taxes. The Commission would like to recommend that the Governor's office investigate the possibility of encouraging state legislation that exempts all federal funds from state mortgage registration tax. It appears that, if the mortgage is direct funding from the federal government, it is exempt. However, if the state or a local community makes the mortgage with federal funds, the exemption is lost.

A re-occurring theme observed at the states visited was that when any housing funds generate interest, they are credited back into housing programs. This is a general movement to ensure there are future resources as the federal government reduces its annual investment into local housing programs. The Commission would like to request that the Governor's office identify and initiate what actions are needed to

guarantee all interest generated by housing funds are directed to the Housing Trust Fund.

PENDING ISSUES

There are several issues that have not been addressed in this report. Many of them are details that will have to be worked out as this process for change unfolds. Also, there are several of the stakeholders with whom we have not had a chance to consult. We viewed our role as that of helping to create a vision of what Kansas should do to address affordable housing in the 21st Century. Obviously, there will be several legal issues that will have to be researched. However, we feel confident that a good start toward preparing Kansas for the future can be accomplished by initiating efforts toward the changes we have discussed at our meetings and as summarized in this report.

FUTURE ACTIONS & CONCLUSION

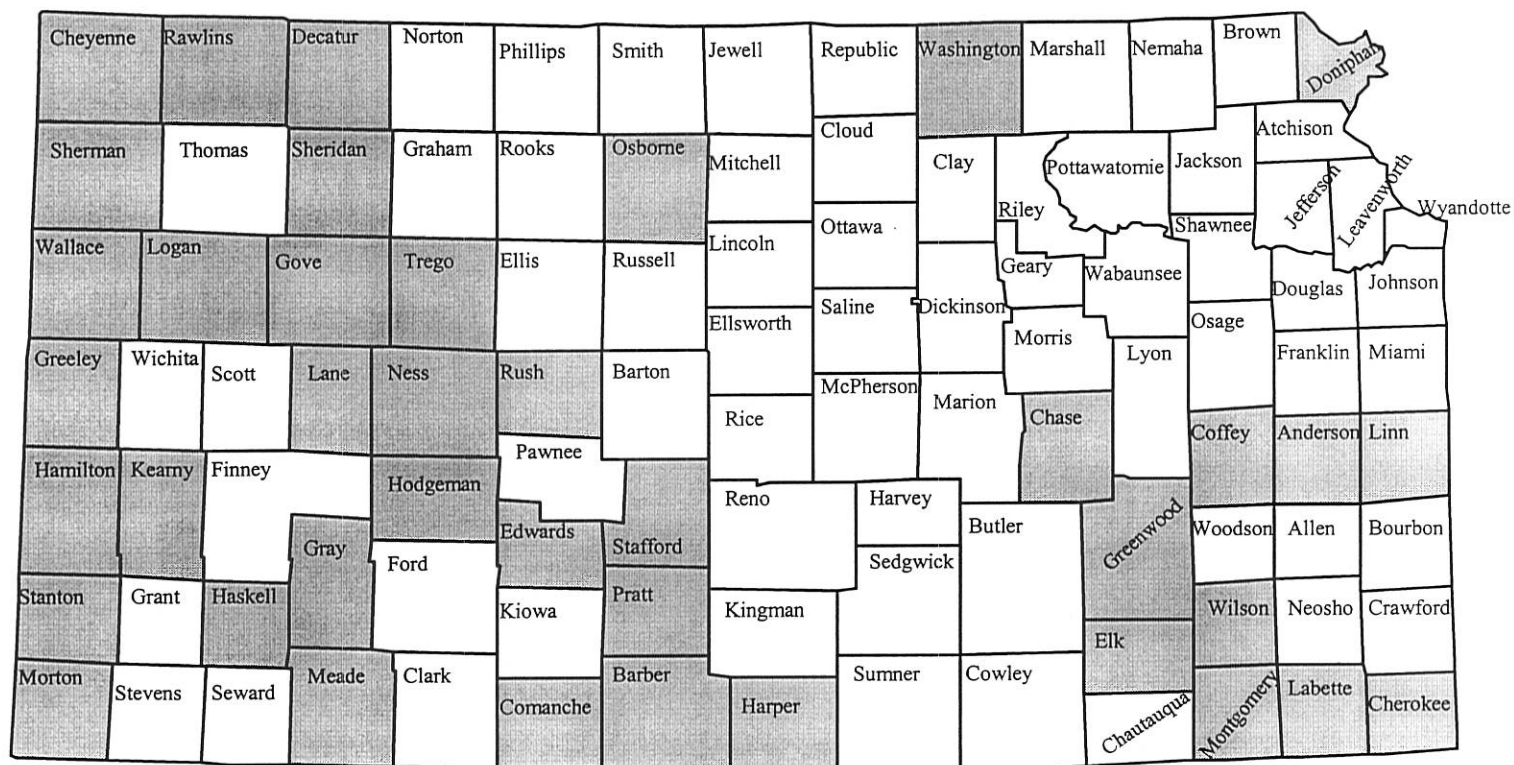
In the appendix, we have submitted our individual votes and comments for your review. We recognize that this is the beginning of the process for change. Should you and the Lieutenant Governor decide to pursue the Commission's recommendations, we would gladly work toward creating a strategy to maximize the collaboration between all of the stakeholders. Stakeholders include, but are not limited to - licensed real estate brokers, city and county officials, builders, mortgage lenders, and other members of the financial systems currently in place. Change does not come easily. However, to continue the state's efforts to address affordable housing in an efficient, equitable manner, we feel that change is necessary. We stand ready to invest our time and effort for the betterment of all Kansans.

APPENDIX

ATTACHMENT A

Counties Not Receiving Recent First Time Homebuyer Assistance

40 Counties (38.09%)

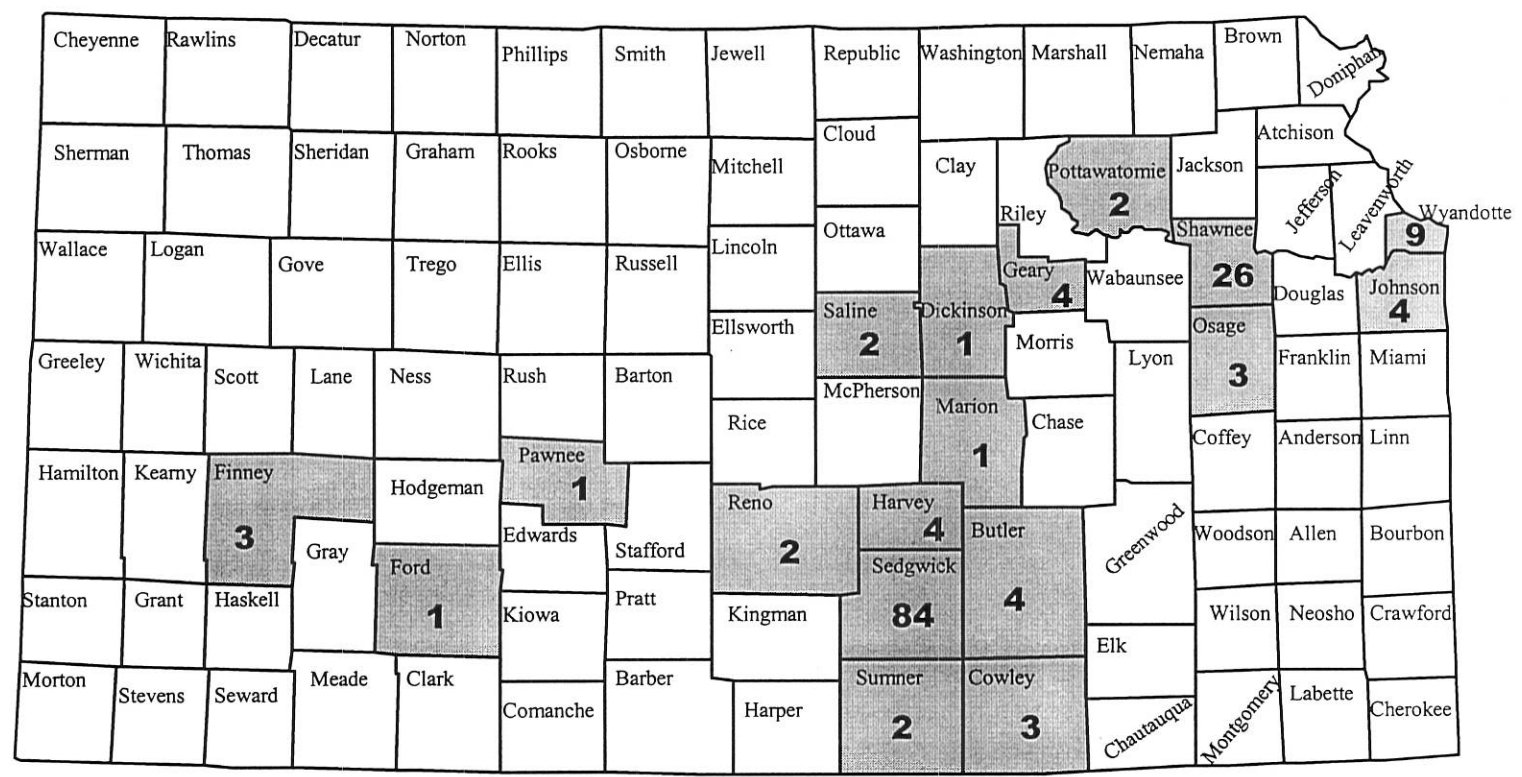


Counties That Have Not Received Assistance From MCC, MRB, or HOME FTTHB Programs

1999 Series A Mortgage Revenue Bond Program

18 Counties (17.14%)

(Number of Loans, January 1, 1999, through October 25, 1999)



Number of Loans

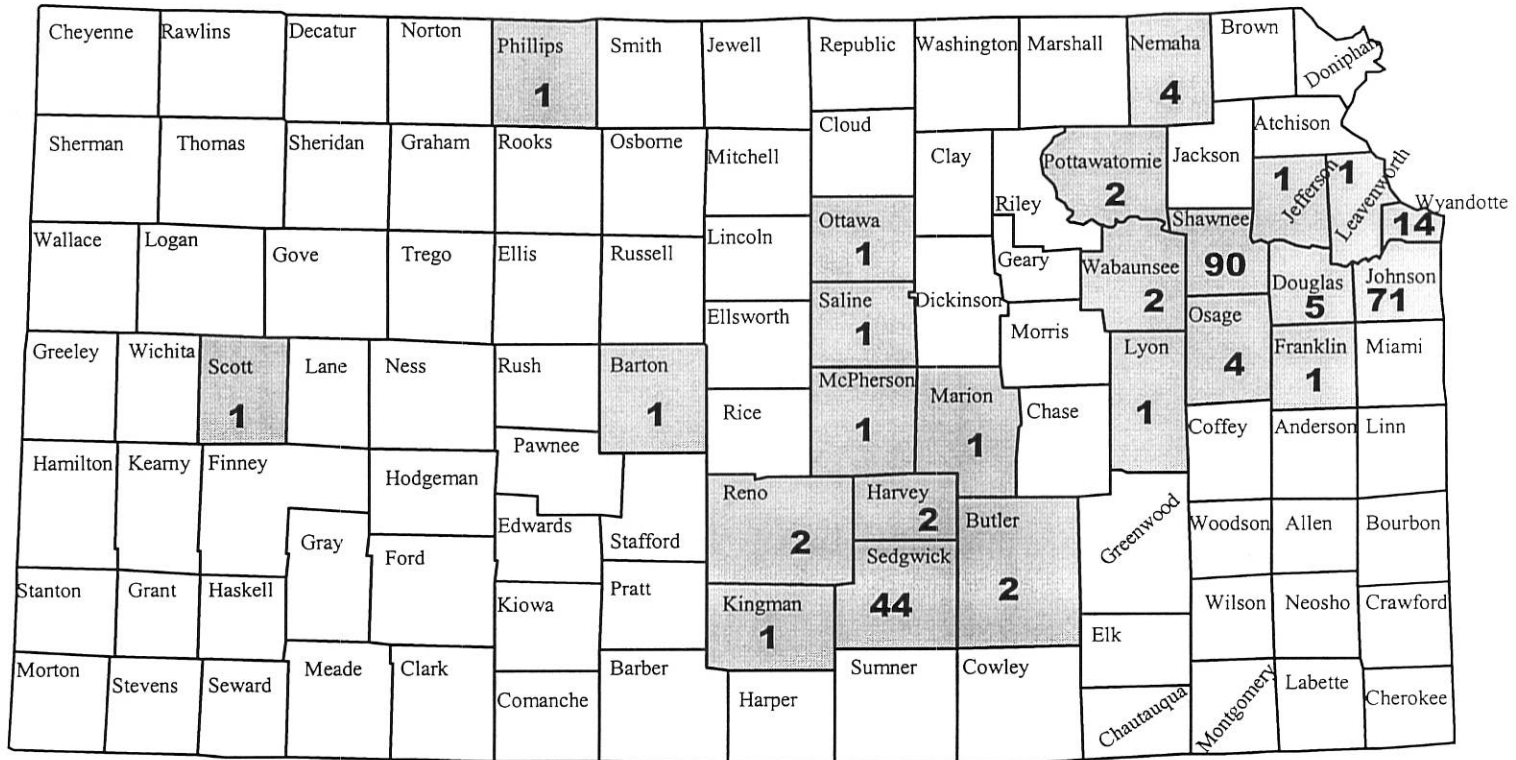
Participating Counties
 Number inside = # of Loans

*Information provided by Sedgwick County,
Kansas, Division of Community Development*

1999 Kansas Mortgage Savers Programs (Mortgage Credit Certificates)

24 Counties (22.85%)

(Number of Loans January 1, 1999, through October 8, 1999)



Number of Loans

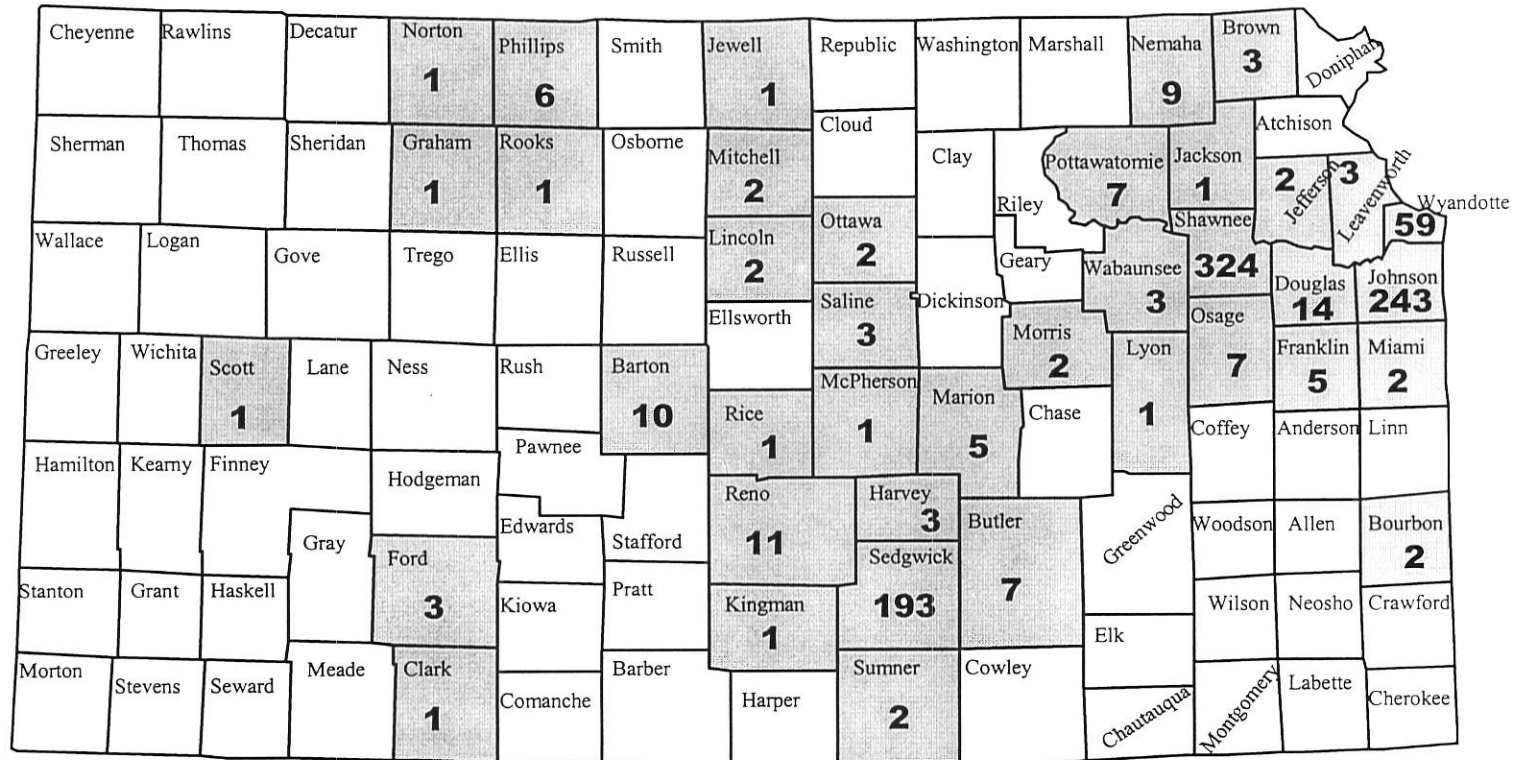
Participating Counties
 Number inside = # of Loans

*Information provided by Sedgwick County,
Kansas, Division of Finance*

1997-1999 Kansas Mortgage Savers Programs (Mortgage Credit Certificates)

39 Counties (37.14%)

(Number of Loans April 1, 1997, through October 8, 1999)



Number of Loans

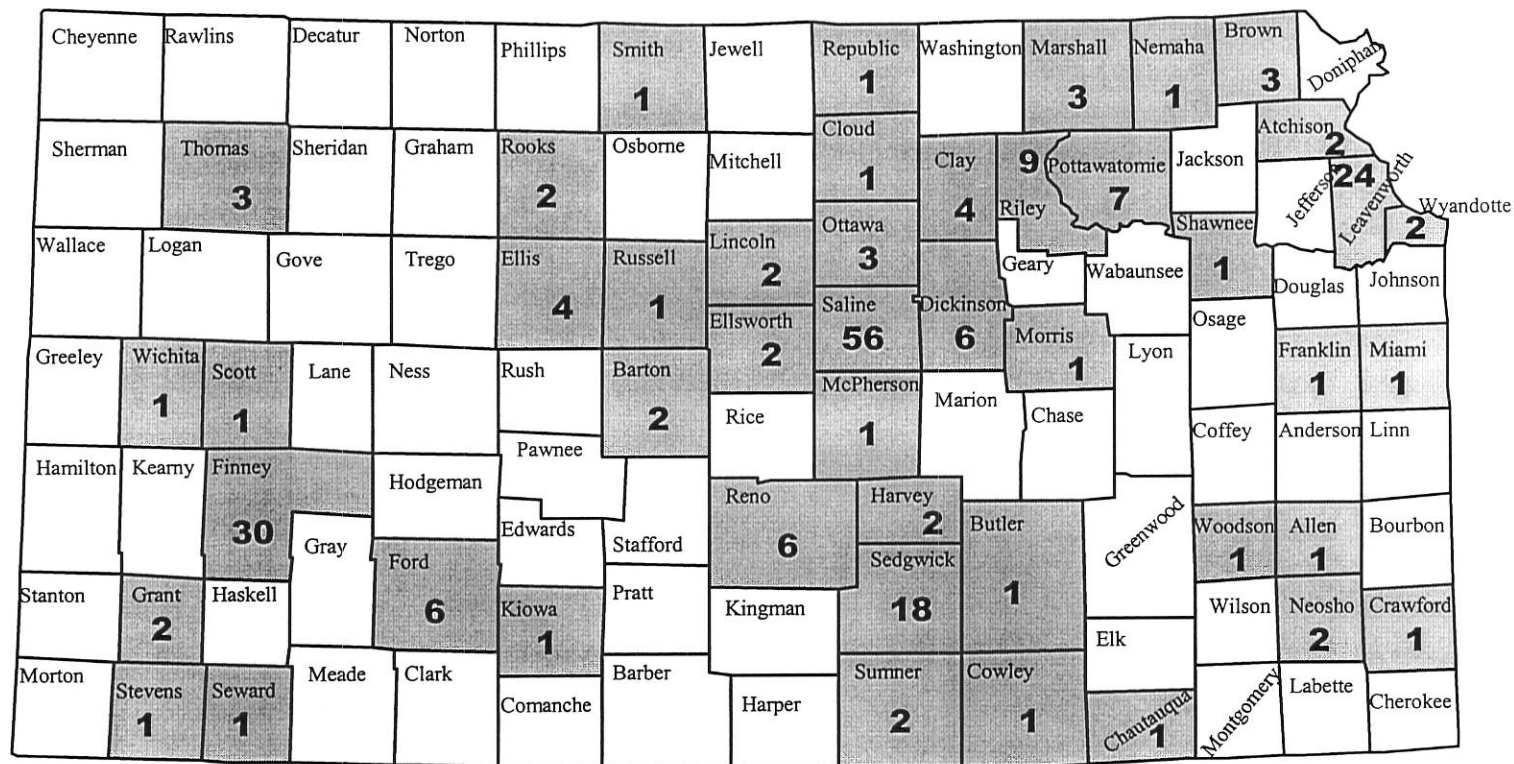
Participating Counties
 Number inside = # of Loans

*Information provided by Sedgwick County,
 Kansas, Division of Finance*

FY 98 HOME First Time Homebuyer Program Home Locations

45 Counties (42.85%)

(Number of Loans July 1, 1998, through June 30, 1999)



Number of Loans

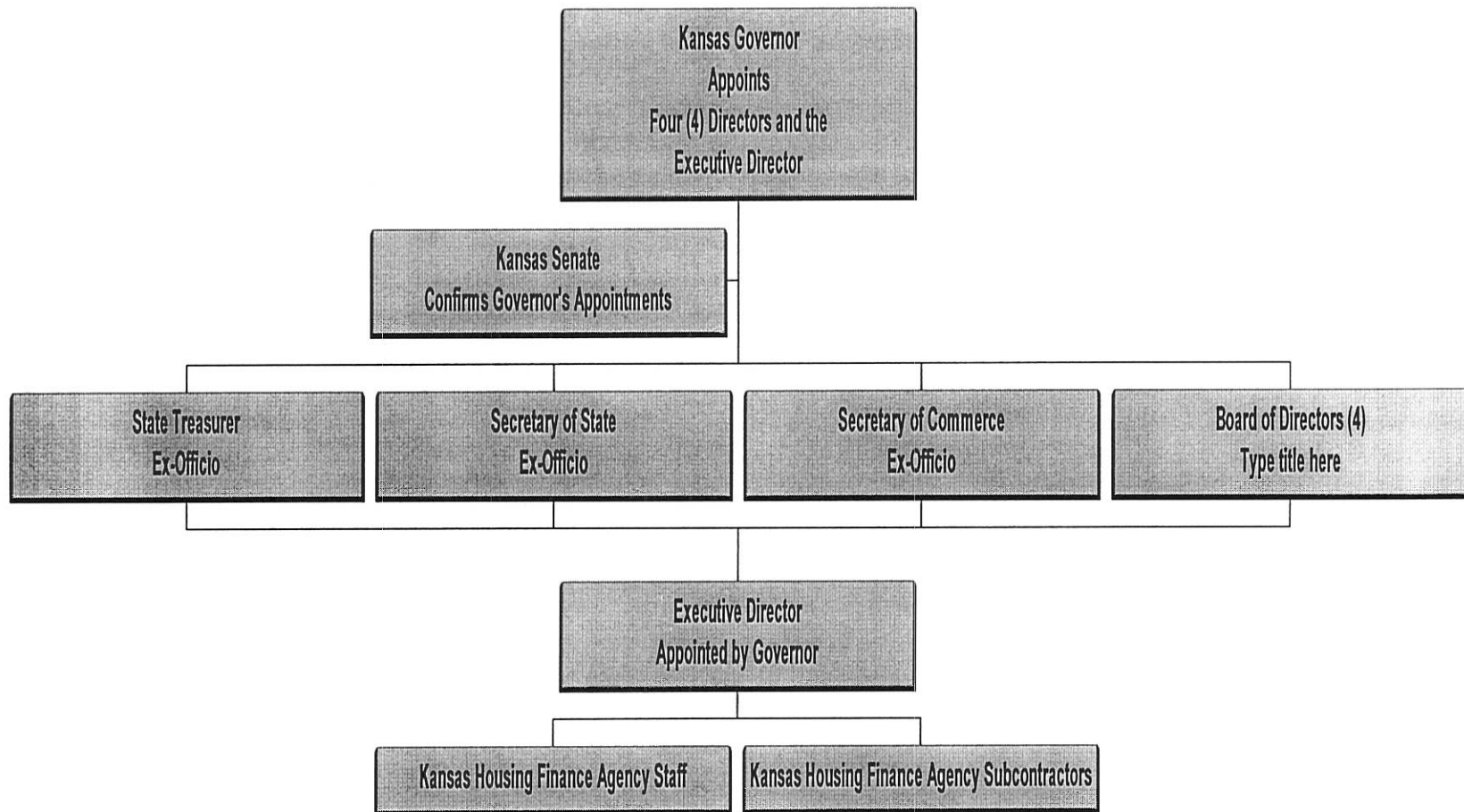
Participating Counties
 Number inside = # of Loans

Information provided by the Department of Commerce & Housing, Housing Development Division

ATTACHMENT B

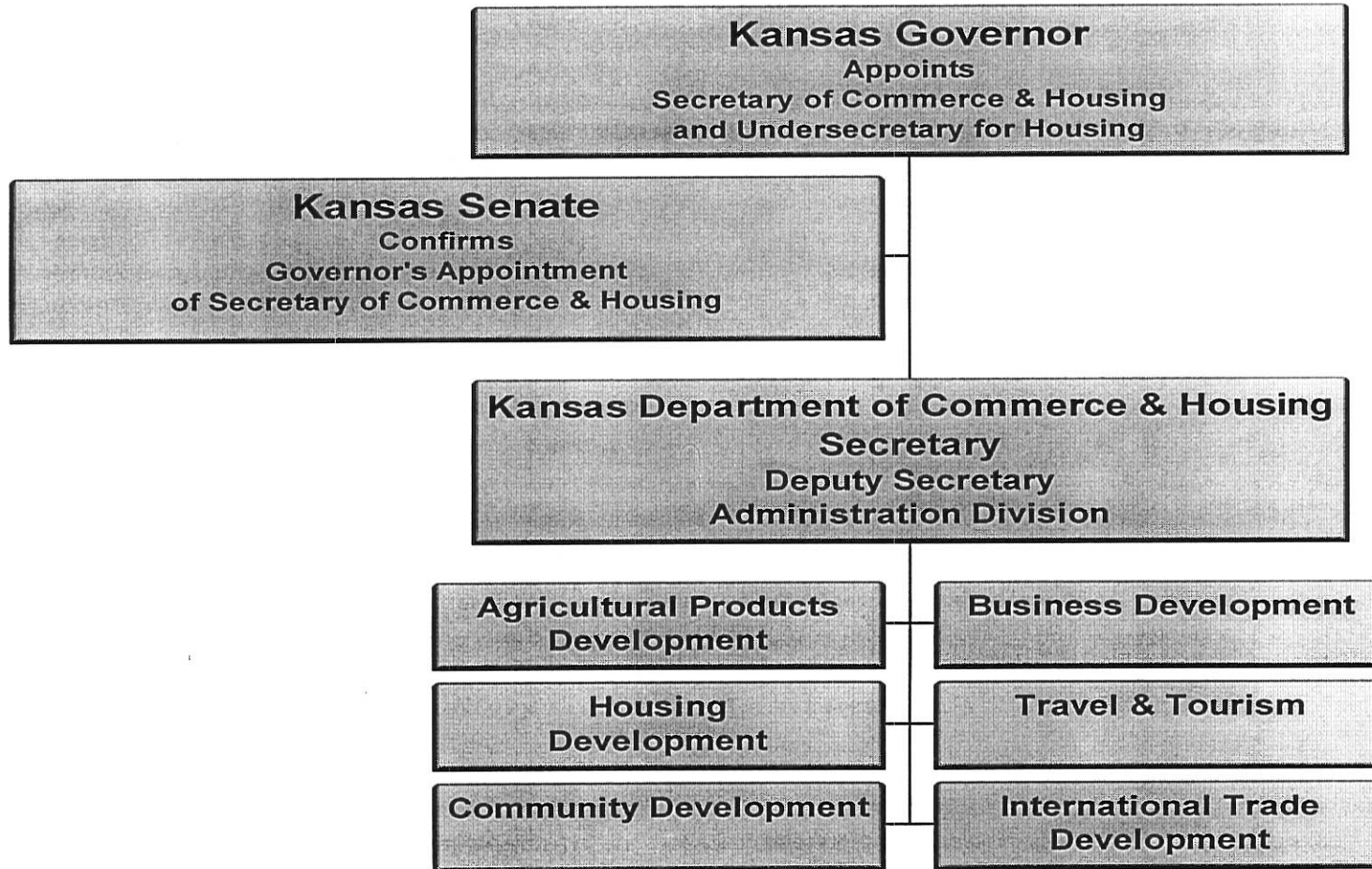
Kansas Housing Finance Agency

Model #1



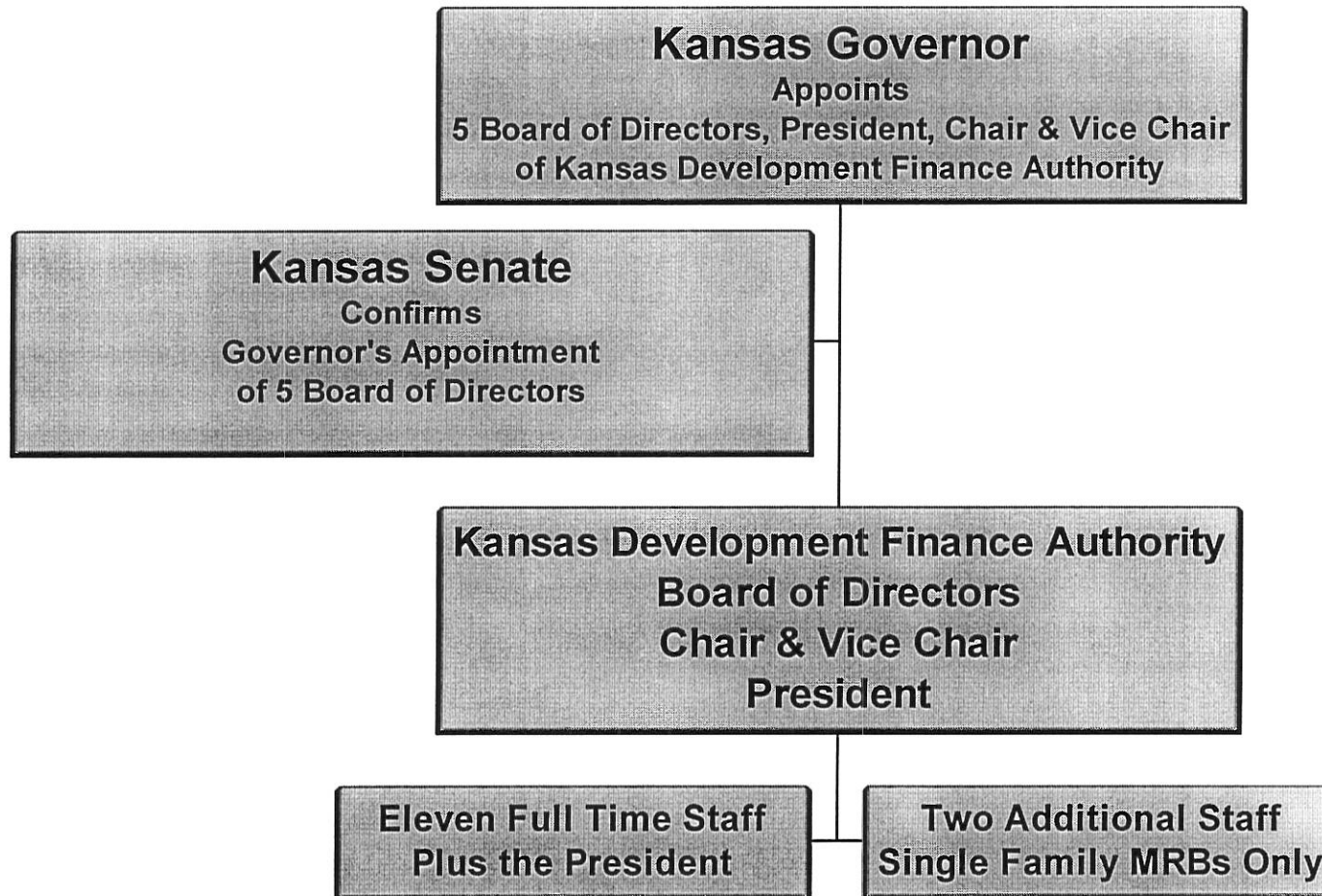
Kansas Housing Finance Agency

Model #2

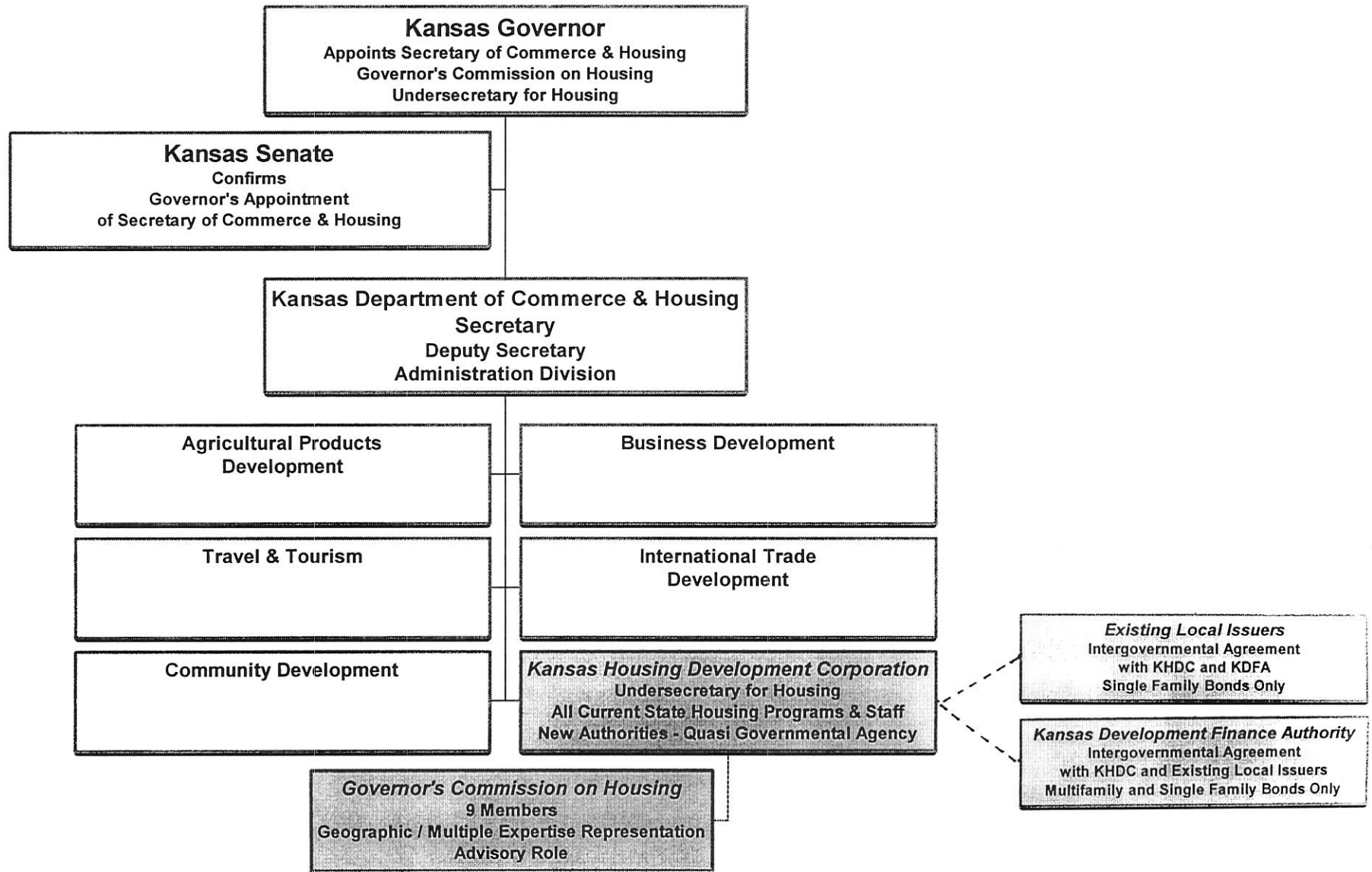


Kansas Housing Finance Agency

Model #3



Kansas Housing Finance Agency Model #4



ATTACHMENT C

Governor's Commission on Housing Housing Activities Analysis

HOMEOWNERSHIP

Note: Shaded areas signify a potential housing activity

<i>Current Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Downpayment Assistance – 1 st Time - 80% & Below	HUD – HOME Funds	KDOCH	KDOCH	Local Lenders	KDOCH / HUD	Future HOME Activity
Accessibility Adapt. 1 st Time Homebuyers - Disabilities	HUD – HOME Funds	KDOCH	KDOCH	Local Lenders	KDOCH / HUD	Future HOME Activity
Downpayment Assistance – 1 st Time - 80% to 115%	Trust Fund	KDOCH	KDOCH / Local Partners	KDOCH / Local Partners	KDOCH	Trust Fund
Downpayment Assistance – 80% to 115%	Trust Fund	KDOCH	KDOCH / Local Partners	KDOCH / Local Partners	KDOCH	Trust Fund
Homeowner Rehabilitation	HUD – HOME Funds	KDOCH	KDOCH	KDOCH / Sub-Grantees	KDOCH	Future HOME Activity
Kansas Housing Cost Analysis Program	HUD–HOME Funds/LIHTC Fee Fund /Trust Fund	KDOCH	KDOCH	KHDCorp / Local Partners	KDOCH / HUD	Future HOME Activity / Additional Non-HUD Homes
<u>Homeowner Emergency Rehabilitation Opportunity</u>	HUD – HOME Funds	KDOCH	KDOCH	KDOCH / Sub-Grantees	KDOCH	Future HOME Activity
Mortgage Revenue Bonds	PABs	KDOCH / Local Issuer	Local Issuer	Local Issuer	Local Issuer	County
Mortgage Credit Certificates	PABs	KDOCH / Local Issuer	Local Issuer	Local Issuer	Local Issuer	County

Governor's Commission on Housing Housing Activities Analysis

1-30

HOMEOWNERSHIP

<i>Potential Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
FNMA Downpayment Notes	FNMA/ Trust Fund	KDOCH / FNMA	KDOCH / FNMA	KDOCH	KDOCH / FNMA	Trust Fund
Mortgage Revenue Bonds	PABs	KsHFA / Local Issuers	KsHFA / Local Issuers / KDFA	KDFA / Local Lenders	KsHFA / KDFA	Trust Fund
Federal Home Loan Bank – Non-member Borrower – Downpayment Assistance	FHLB of Topeka	KsHFA	KsHFA	Borrowers	KsHFA / FHLB	Trust Fund
Homebuyer Training	Trust Fund	KsHFA	KsHFA / Local Lenders	KsHFA / Local Lenders / Realtors	KsHFA	Add. Training Programs

Governor's Commission on Housing

Housing Activities Analysis

1-31

RENTAL HOUSING

<i>Current Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Housing Tax Credits	Treasury Department	KDOCH / IRS	KDOCH	KDOCH	KDOCH / IRS	Interim Dev. Loan Fund
Community Housing Development Organizations	HUD – HOME Funds	KDOCH	KDOCH	KDOCH / Sub-Grantees	KDOCH	Future HOME Activity
Interim Development Loan Fund	Housing Tax Credit Fees	KDOCH	KDOCH / Borrowers	Borrowers	KDOCH	Interim Dev. Loan Fund

RENTAL HOUSING

<i>Potential Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
FHLB – Non-member Borrower - Risk Sharing	FHLB of Topeka	KsHFA	KsHFA	Borrowers	KsHFA / FHLB	Trust Fund
Interim Ownership of HUD Properties	Trust Fund	KsHFA	KsHFA	KsHFA / New Owners	KsHFA	Trust Fund
Purchase of HUD-Held Mortgages	Trust Fund	KsHFA	KsHFA	KsHFA / Existing Owners	KsHFA	Trust Fund
Mortgage Revenue Bonds – Multifamily	PABs	KsHFA / Local Issuers	KsHFA / Local Issuers / KDFA	KDFA / Local Lenders	KsHFA / KDFA	Trust Fund
Landlord / Tenant Training	Trust Fund	KsHFA	KsHFA/Subcont.	KsHFA/Subcont.	KsHFA	Addtl. Training
PHA Stabilization Fund	Trust Fund	KsHFA	KsHFA/PHAs	KsHFA/PHAs	KsHFA	Trust Fund

Governor's Commission on Housing

Housing Activities Analysis

HOUSING WITH SUPPORTIVE SERVICES

<i>Current Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Weatherization	Dept. of Energy	KDOCH	KDOCH	Sub-Grantees	KDOCH / DOE	Additional Weatherization Projects
<u>Community Service Block Grants</u>	HHS	KDOCH	KDOCH	Sub-Grantees / CAPs	KDOCH	Additional CSBG Activities
<u>Emergency Shelter Grants</u>	HUD	KDOCH	KDOCH	Sub Grantees	KDOCH	Additional ESG Projects
Kansas Energy Star	Dept. of Energy / KCC	KDOCH	KDOCH	KDOCH / Certified Energy Raters	KDOCH	Additional Energy Activities

HOUSING WITH SUPPORTIVE SERVICES

<i>Potential Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Housing Accessibility Fund	Trust Fund	KsHFA	KsHFA	Homeowner/Renter with Disabilities	KsHFA / Subcontractor	Housing Access. Fund
Shelter Plus Care	HUD	KsHFA	KsHFA	KsHFA / Local Service Providers	KsHFA	Additional SPC Programs

Governor's Commission on Housing Housing Activities Analysis

ASSET MANAGEMENT

<i>Current Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Administer Sec. 8 HAP Contracts for HUD	HAP Contracts	HUD / KDOCH	KDOCH	KDOCH	KDOCH / HUD	State Housing Activities
Administer Sec. 8 HAP Contracts for 7 Projects Financed by KDOCH	HAP Contracts	HUD / KDOCH	KDOCH	KDOCH	KDOCH / HUD	Trust Fund
Administer Projects for FDIC	FDIC	FDIC / KDOCH	KDOCH	KDOCH	KDOCH / FDIC	Trust Fund
Tenant Based Rental Assistance (TBRA)	HUD – HOME Funds	HUD / KDOCH	KDOCH	KDOCH / Sub-Grantees	KDOCH / HUD	Future HOME Activity

ASSET MANAGEMENT

<i>Potential Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Administer all of HUD Sec. 8 HAP Contracts	HAP Contracts	HUD / KsHFA	KsHFA	KsHFA	KsHFA / HUD	State Housing Activities

Governor's Commission on Housing Housing Activities Analysis

1-34

OTHER HOUSING ACTIVITIES

<i>Current Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>
Kansas Housing Partners	HUD – HOME Funds	KDOCH	KDOCH / Partners	KDOCH / Partners	KDOCH	None

OTHER HOUSING ACTIVITIES

<i>Potential Housing Activity</i>	<i>Source of Revenue</i>	<i>Policy Authority</i>	<i>Program Development</i>	<i>Program Implementation</i>	<i>Program Compliance</i>	<i>Resd. Income Investment</i>

COMMENTS AND BALLOTS

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As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

I agree

I disagree

William H. Preloger, Jr. Chairman
Signature

William H. Preloger, Jr., Chairman
Printed Name

COMMENTS:

job well done - Report is succinct but accurately represents, I think, the opinions and preferences expressed during our several days of research and visits as well as the opinions of the commission members at our last commission meeting.

WHP

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

I agree
 I disagree

Roy Dudark
Signature
Roy Dudark
Printed Name

COMMENTS:

Excellent report!

Maybe it's just me but I don't understand Sec. D on p. 12. Is the \$100 million being reserved for housing? Could this be clarified some?

Post-it* Fax Note	7671	Date	11/30/99	# of pages	1
To	RANDY SPRAKER	From	Roy Dudark		
Co./Dept.	KDOCH	Co.	CITY OF SALINA		
Phone #	785-296-5865	Phone #	785-826-7260		
Fax #	785-296-8985	Fax #	785-826-7224		

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

X I agree

 I disagree

Deena Hallacy
Signature

Deena Hallacy
Printed Name

COMMENTS:

I am pleased with the
model presented and ask that
it be reviewed with an
open mind. We must provide
the citizens of KS with all
resources available to improve
the quality of life in KS.

Deena Hallacy

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

I agree

I disagree

Irene Hart

Signature

Printed Name

COMMENTS:

Post-it® Fax Note	7671	Date	11-30	# of pages	3
To	Randy Speaker	From	Irene Hart		
Co./Dept.		Co.			
Phone #		Phone #			
Fax #	296-8985	Fax #	383 7696		

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

X I agree w/ changes verbally made to
I disagree *Randy*

P. M. Nohe
Signature

P. Martin Nohe
Printed Name

COMMENTS:

[Lined area for comments]

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

I agree

I disagree

Linda Yonon

Signature

LINDA YONON

Printed Name

COMMENTS:

As I was not available to attend tours & discussions I have no comments other than I do feel this ^{proposal} will open up additional financing and better address our housing needs. Housing availability in communities is viable to economic development and sustainability of the community.

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."

I agree

I disagree

Rick C. Jackson
Signature

Rick C. Jackson
Printed Name

COMMENTS:

Lined area for handwritten comments, currently blank.

As a member of the Governor's Commission on Housing, I support the December 1, 1999, report to the Governor titled, "Increasing Housing Opportunities for Kansans in the 21st Century."



I agree



I disagree

Ronald D. Cobb

Signature

Ronald D. Cobb

Printed Name

COMMENTS:

Good Report - 2nd paragraph of page 1 especially lines 8 thru 10 - in my estimation sums up the need for a housing finance agency

KLENDAMITCHELL, AUSTERMAN & ZUERCHER, L.L.C.

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February 3, 2000

House Committee on Economic Development
 Attn: Rep. Bill Mason
 Kansas State House
 Topeka, KS

VIA FACSIMILE
785-368-6365

Re: House Bill No. 2688

Dear Rep. Mason:

Our firm wanted to take this opportunity to voice our support for your serious consideration of House Bill No. 2688 as presently drafted. We believe that passage of this bill will enable private business to expand the Kansas economy by providing an effective method for financing start-up companies. Specifically, the tax credits will be an effective mechanism for providing badly needed capital to entrepreneurs as they build the next generation of Kansas businesses. We believe that passage of the bill will encourage existing Kansas-based venture capital funds and successful entrepreneurs to support new business development. In addition, passage of the bill will also encourage new participation in the funding of start-up enterprises from new financing sources, and from existing businesses and business people who have not traditionally invested in start-up companies. Based upon our firm's practice areas, we believe that the private sector will view this legislation positively and act upon it enthusiastically and promptly.

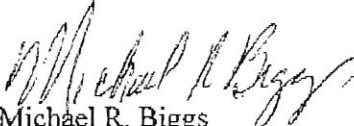
Kansas has a rich tradition of entrepreneurship. We possess an unique opportunity in this State. The existing commercialization corporations located within the state have the experience and management depth necessary to effectively participate in this program. The state's population of successful businessmen and professionals fully understand not only the rewards of entrepreneurship but also the risks. Both will be good stewards of the tax credits. Passage of the bill will accelerate the entrepreneurial process for a new generation of innovative Kansas-based businesses.

02/03/00

Page 2

Thank you for your efforts to date. Again, we would encourage you to support passage of House Bill No. 2688 as drafted.

Very truly yours,



Michael R. Biggs

Testimony of P. Mitchell Woolery¹

Before: Committee on Economic Development, House of Representatives,
State of Kansas

Date: February 3, 2000

Re: H.B. No. 2688 (Kansas certified capital company act) ("capco's")

Introduction. Previously, I have appeared before this committee to discuss the federal securities laws which are likely to apply to the venture capital funds ("capco's") to be set up by H.B. No. 2688. I am happy to provide additional clarification if necessary but I want to address certain criticisms of H.B. No. 2688 which have been levied in the past week. Let me state that I enthusiastically support this bill, as written, with the technical modifications suggested by committee members last week (e.g., expanding to include investments in value-added agriculture).

H.B. No. 2688 addresses the important need in Kansas of encouraging investments in start-up Kansas companies. Otherwise, there is the danger that they will leave Kansas (as we've heard).

Criticisms of H.B. No. 2688. Despite near uniform praise for the bill, others have denounced it as "a failure," "fatally flawed," and "a disaster." I respectfully disagree.

The basic arguments of the critics and my responses:

1. CRITICS: ONLY INSURANCE COMPANIES ARE APPROPRIATE INVESTORS IN CAPCOS; INDIVIDUALS HAVE "NO IDEA" WHICH FUND MANAGERS ARE QUALIFIED.
 - This assertion is nonsense. Are they saying Lamar Hunt and Bill Esrey (Sprint's CEO) are not qualified?
 - I know and work with many fine Kansas business men and women who have invested in Kansas businesses and are interested in forming capco's. These include many current Kansas venture capitalists. They have experience and are knowledgeable about what's in the best interests of Kansas and its businesses.

¹ Mr. Woolery is a partner with the Kansas City, Missouri-based law firm of Polsinelli, White, Vardeman & Shalton, P.C. He is testifying on his own behalf and not as a representative of the Firm or any of its clients. The views expressed in his testimony do not necessarily reflect the views of the Firm or its clients.

2. CRITICS: H.B. No. 2688 VIOLATES THE COMMERCE CLAUSE OF THE FEDERAL CONSTITUTION.
 - I doubt that the Commerce Clause is violated but I'm not an expert.
 - The Committee should not rely upon the opinion of the North Carolina Attorney General's office for an interpretation of Kansas law. Seek Kansas Attorney General's opinion if necessary.
3. CRITICS: THE CAPCO'S SET UP BY THE BILL ARE TOO SMALL.
 - In reality, the bill's capco's are a good size for start-up companies.
 - Statistics regarding nationwide venture capital (e.g., \$24mm average investments) are irrelevant to what Kansas start-ups need. By definition, a start-up couldn't even use \$24mm.
4. CRITICS: THE KANSAS BILL IS "NOVEL" AND "EXPERIMENTAL"; IT'S NOT LIKE THE OTHER CAPCO BILLS IN THE NATION.
 - Other capco statutes are limited to insurance companies only.
 - H.B. No. 2688 addresses start-up companies in Kansas. This is a real need. Other capco bills have not had that as their goal. They've been addressed at larger, more mature companies.
 - No one – not even the critics – can guarantee their bill will work.

Conclusion. H.B. No. 2688 is in the best interests of the State of Kansas and its businesses. It is drafted for Kansans by Kansans. Please let me know if you have need for further questions or comments.

Respectfully submitted,

P. Mitchell Woolery



rural policy research institute

IOWA STATE UNIVERSITY • UNIVERSITY OF MISSOURI • UNIVERSITY OF NEBRASKA

ECONOMIC DEVELOPMENT COMMITTEE
FEBRUARY 3, 2000
ATTACHMENT 3.

Rural Policy Research Institute
IOWA STATE UNIVERSITY • UNIVERSITY OF MISSOURI • UNIVERSITY OF NEBRASKA

**Public Involvement in Venture Capital Funds:
Lessons from Three Program Alternatives**

PB99-2

November, 1999

David L. Barkley - Clemson University

Deborah M. Markley - Policy Research Group

Julia Sass Rubin - Harvard University

**Funding provided by the USDA's Fund for Rural America
A Policy Brief Prepared for the
Rural Policy Research Institute**

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concerning public policy impacts on rural people and places.*

Introduction

Access to venture capital is recognized as important for new business creation and rapid business expansion. Consequently, the economic development prospects for communities and states are linked to the availability of venture capital for local entrepreneurs and businesses. Yet venture capital investments in the U.S. are concentrated in a few regions, i.e., California and Massachusetts, and in a few industries, i.e., software and information, communications, and healthcare services.¹ A common public policy response to the perceived venture capital shortage is increased public involvement in venture capital programs.

The goals of these public programs may be one or more of the following:

- Encourage general economic development by encouraging business creation and/or expansion and, as a result, job creation.
- Enhance economic opportunities for geographically isolated regions or economically disadvantaged populations, for example, by investing in rural or minority-owned businesses.
- Enhance availability of early stage or seed capital investments.
- Create or enhance venture capital infrastructure and management capacity within the state, including demonstrating the potential for venture capital investments.
- Increase the supply of venture capital, both to fill perceived gaps and as a means of retaining existing businesses as they expand.

The organizational structure of public venture capital programs depends to a large extent on these goals. In general, however, public involvement occurs along a continuum, where the state makes tradeoffs between control over investment decisions and a share in both the upside and downside of investment returns. At one extreme, publicly funded and managed programs provide the greatest public control over

investment decisions, thus permitting the targeting of investments to achieve explicit economic development objectives. However, the state also bears total responsibility for any financial losses or gains that occur. At the other extreme, the state may create enabling legislation that provides a framework within which private sector venture capital funds operate. Public control is limited in this model to the restrictions placed in the enabling legislation. The state does not, however, share in the financial losses these funds may incur (or in the gains unless specified by legislation.) The state may also take on a purely facilitative role by supporting angel networks and venture fairs. Again, the state exercises no control over investment decisions and has limited financial risk.

This policy brief describes the experiences of state-assisted venture capital programs and assesses the advantages and disadvantages of three program types:

- Programs where the public sector controls both investment decisions and financial risk and rewards—**publicly funded, publicly managed venture capital funds.**
- Programs where the public sector has less control over investment decisions and also bears less financial risk—**publicly funded, privately managed venture capital funds.**
- Programs where the public sector creates enabling legislation for private sector venture capital institutions, minimizing both state control and state financial risk and rewards—**certified capital companies (CAPCOs).**

The experiences of twelve state-assisted venture capital programs are presented as examples of these three general types.² The twelve programs represent a variety of organizational models and are meant to be illustrative of the program types, not exhaustive. They are not an attempt to document “best practices;” indeed three of these programs are no longer active. Instead, the goal of our analysis is to better

understand the advantages and shortcomings associated with alternative program structures. In addition, many of these examples are drawn from what we refer to as “small market states,” states that typically have small metro centers, large and dispersed non-metro populations, and greater isolation from centers of venture capital investing. Because such environments are more challenging ones for making successful venture capital investments, these programs can offer insights that will help policy makers in other places consider the value of creating specific institutional arrangements to address public sector goals related to venture capital availability.

Publicly Funded, Publicly Managed Venture Capital Funds

Publicly funded, publicly managed venture capital funds are likely to have goals related to the economic development of the state or region. These goals may be general, focusing on job creation statewide through business investment, or targeting different groups within the state economy, e.g., specific industries, regions, populations, or stages of business. These programs are generally not well suited to achieving a goal of creating venture capital infrastructure, since private investors are reluctant to invest in public funds and private, return driven funds may be reluctant to co-invest with public funds. Case studies of three institutions—Minnesota Technology Corporation Investment Fund, Small Enterprise Growth Fund, Iowa Product Development Corporation/Iowa Seed Capital Corporation—highlight, by example, the strengths and limitations of this organizational model. From these case studies, we draw the following “lessons learned.”

- Be clear and explicit about the objectives of the fund and set up performance measurements that relate to those objectives. A fund that is focused on job creation and economic

development should not also be expected to maximize profit. Indeed, funds that have industry, stage, or geographic restrictions on investments are not likely to generate market rates of return. This was particularly problematic for Iowa Seed Capital Corporation, which was created with an economic development objective, was expected to make developmental investments, but was ultimately held accountable for not being sufficiently profitable.

- Insure that the fund has sufficient up-front capitalization or a guaranteed and reliable source of incoming capital. All three funds were confronted with insufficient or unpredictable capitalization. Because publicly funded, publicly managed programs are perceived as vulnerable to state influence in the investment process, they are unable to leverage state funds with private capital. Publicly funded, publicly managed funds are also vulnerable to loss of political support in their early years because investment losses often precede positive investment returns. Thus, program capitalization through annual budget appropriations invites political interference.
- Hire full-time, professional management with the experience appropriate for a specific fund’s mission and do not rely on volunteers. The three case study funds had very different approaches to what was required to run a developmental venture capital fund. Minnesota Technology believed that the job called for an individual who combined economic development and venture capital skills. The Small Enterprise Growth Fund is trying to get by with a volunteer board, an arrangement that makes it difficult to insure consistency or the preservation of an institutional memory. The Iowa Seed Capital Corporation began with an inexperienced fund manager, but was

able to bring on a more seasoned person when it became a nonprofit organization. Although part of the Iowa fund's early problems were attributed to its inability to pay salaries high enough to attract a traditional venture capitalist, this did not prove to be an issue for Minnesota Technology's fund.

Furthermore, experience with other developmental funds indicates that many qualified individuals are motivated by social convictions and geographic preferences and are willing to take lesser financial compensation.

- Limit the state's ability to influence investments by restricting its role. Publicly funded, publicly managed funds are very vulnerable to political interference in the investment process. The structures of all three funds allowed for significant state influence, or at least the perception of such influence, over the investment process. This may lead not only to poor investments but it may also contribute to a lack of credibility that makes it difficult for funds to find co-investors and leverage the state's capital. Restricting the state's role to oversight of how well the fund fulfills the stated objectives can minimize such interference.
- Institute programs to develop or ensure adequate deal flow for the fund. Deal flow was identified as a problem by all three funds. Minnesota's strategy of creating an angel capital network designed to feed deals to the fund from all over the state may prove to be an effective, proactive approach to developing deal flow. It is important for publicly funded, publicly managed funds, particularly those focused on economically depressed regions, to devote resources to identifying potential deals or creating deal flow should that become necessary.

Publicly Funded, Privately Managed Venture Capital Funds

Publicly funded, privately managed venture capital funds can be designed to meet a broad range of goals. The public sector may invest in private, for-profit, rate of return driven funds as a way of increasing the supply of professionally managed venture capital in the state or region and/or enhancing the venture capital infrastructure and management capacity. Alternatively, the public sector may invest in developmental venture funds, both for-profit and nonprofit, that target specific groups (e.g., minority firms), regions (e.g., rural areas), or types of firms (e.g., start-up or early stage firms) and consider both social and financial rate of return objectives in investment decisions. In both cases, the advantages of private, professionally managed venture funds is recognized. The state gives up control over investment decisions in return for the more limited financial risk involved in these partnerships with private funds. However, the choice of private institutional partner reflects the public sector goals for the program.

Five case studies—Kansas Venture Capital, Inc., Oklahoma Capital Investment Board, Northern Rockies Venture Fund, Colorado Rural Seed Fund, Magnolia Venture Capital Corporation—provide a number of useful observations for states that are interested in using public resources to leverage private equity capital investment. These lessons point out the tradeoff that often exists between achieving traditional venture capital rates of return on a private fund and achieving goals established by the state.

- Recognize the tradeoffs between geographic restrictions on investments and fund rate of return. There appears to be a tradeoff between the goal of increasing venture capital in a state through geographic restrictions on investments and maximizing rate of return to a fund. The case of the Colorado Rural Seed Fund suggests that

when geographic restrictions are too limiting, success of the fund is less likely. Kansas Venture Capital, Inc. is a fund that made successful investments while being geographically restricted. However, investment returns did not reach the level of a more traditional venture capital fund. In the absence of geographic restrictions, however, it is not clear how well the goal of increasing venture capital investment within a state is achieved. An evaluation of the long run performance of the Oklahoma program would help us better understand these relative tradeoffs.

- Minimize the role of the state in order to avoid even the appearance of political influence with private funds. Having the state as a limited partner can affect a private fund in at least two ways. First, political influence over investment decisions may occur. In Oklahoma, the state share of any private fund is restricted to 10-20% in order to minimize the influence of state politicians on fund managers' investment decisions. Second, private investors may be reluctant to invest in a fund when the state is a limited partner, particularly when there are geographic restrictions on investment as well. Northern Rockies Venture Fund had problems raising private funds because of their focus on Montana investments.
- Define an explicit role for the state in monitoring the performance of private funds. Monitoring can serve two functions. One, better monitoring can help minimize the possible misuse of public funds, as occurred in Mississippi. Two, monitoring can provide the information needed to evaluate how well a particular public-private partnership is achieving the state's goals
- Insure that private funds have professional venture capital managers and that the incentive structure encourages sound investments. The case of the Magnolia Venture Capital

Corporation points to the importance of professional managers whose compensation, at least in part, is tied to the performance of the fund.

- Insure that fund size is consistent with fund goals and potential market size. The funds described in the case studies ranged from \$14 million down to \$500,000. The smaller funds were designed as demonstration projects, with some expectation that more private funds would be attracted to the state to support the activities these funds initiated. Fund size can be a limiting factor, as suggested by the experience of Northern Rockies Venture Fund. NRVF's \$2 million capitalization restricts the size of initial investments, limits follow-on investments, and restricts the resources available to support marketing and deal flow development. NRVF fund managers suggest a minimum fund size of \$5 million. However, the case of the Colorado Rural Seed Fund suggests that it is possible to have a fund size that is too large if geographic restrictions limit the potential market. In this case, the geographic restrictions were relaxed in order to identify sufficient deal flow for a \$1 million fund.
- Allocate resources for deal flow and entrepreneurial development. The more geographically restricted a fund, the more resources must be devoted to developing and identifying deals. The Colorado Rural Seed Fund was not successful, in part, because of limited deal flow, lack of an entrepreneurial culture in the region, and limited understanding of venture financing on the part of business owners. The state can be involved in supporting entrepreneurial education and development activities as part of the partnership with private funds.
- Expect an evolution in the state's role over time. With fund success may come an opportunity to reduce the state's role

in a private venture fund. For example, through successful venture investing within the state, Kansas Venture Capital, Inc. has grown the fund to the point where repayment of the state's initial investment is possible. This "privatization" will return resources to the state and allow Kansas Venture Capital, Inc. to attract other private capital and extend its investment activities to its broader geographic region, while continuing to do deals in Kansas. In Oklahoma, returns from successful investments in private funds are expected to support additional partnerships in the future, diminishing the state's role in the process.

Certified Capital Companies (CAPCOs)

Public involvement in venture capital programs can occur in a more passive way, through enabling legislation that encourages private sector investment. To this end, one program that has received increased attention by states in the past 10 years is the Certified Capital Companies (CAPCOs) Program. This program allocates tax credits to encourage investment in private venture capital firms certified under the legislation. This approach is promoted as a means of increasing the supply of privately managed venture capital in a state and creating a pool of experienced venture capital managers that can become part of a state's permanent venture capital infrastructure.

Although individual state legislation varies, typical CAPCO legislation provides a 100% tax credit (over 10 years) to insurance companies in return for investments in capital companies certified by the state. Most often, insurance company investments are structured as a guaranteed security, rather than the more traditional limited partnership arrangement found in most venture capital funds. CAPCO models vary from state to state, particularly in terms of the requirements for certification, the schedule for making investments, how qualified businesses are defined, and

whether or not the state participates in the returns to CAPCO investments.

As the CAPCO program has been adopted by different states, the legislation has evolved to better focus on the economic development objectives of each state and to address perceived shortcomings observed in previous legislation. In general, the changes have attempted to target CAPCO investments to particular types of businesses identified by the state and/or to increase the potential return to the state via some profit sharing arrangement. Other issues considered include limiting the total amount of credits allocated per CAPCO to improve the competitive environment for new CAPCOs relative to existing CAPCOs. From the CAPCO experiences of four states—Florida, Louisiana, Missouri, New York—we can draw a number of observations that may be useful to states as they consider CAPCO legislation in the future.

- The financial incentives provided by the 100% CAPCO tax credits encourage insurance companies to capitalize venture funds. CAPCOs have been successful in attracting significant resources from insurance companies through the use of tax credit incentives. These resources, in turn, have contributed to an expansion of venture capital resources and investments in those states with CAPCO legislation.
- The investment milestones included in CAPCO legislation ensure timely initial deployment of certified capital in the state via investments. All states establish investment timetables, e.g., 25% of certified capital invested within 2 years, that CAPCOs must meet in order for their insurance company investors to retain their tax credits. These benchmarks help ensure that at least 50% of certified capital is invested quickly in qualified businesses.
- CAPCOs are a costly way of increasing equity capital in the state. State sponsored venture capital programs

result in new costs (state appropriations or tax revenues foregone) and new revenues (returns from investments) for the state treasury. The net cost of CAPCOs to the state treasury (costs - revenues) is smaller than that of alternative programs if the investments by the two programs decline in value by 25% or more. In all other investment return scenarios, however, CAPCOs have a higher net cost to the state treasury than a comparable investment in a privately managed venture capital fund. Even those programs, like Missouri and Florida's, that recapture some profits by the state do not eliminate the relative cost disadvantage of the CAPCO model. At every level of return, the state receives a smaller return on the investment from CAPCOs than from a similar private venture capital investment.

- Most insurance companies invest in CAPCOs in exchange for a guaranteed, fixed debt instrument; thus the incentive to select CAPCOs that have the most qualified venture capital investors is diminished. Insurance companies do not benefit from any upside in the CAPCOs performance or risk losing capital should the CAPCO investments fail to perform. As a result, they make investments in CAPCOs based on familiarity and the CAPCO's ability to design a debt instrument that the insurance company finds attractive.
- Existing CAPCOs have an advantage over new CAPCOs when obtaining commitments of capital. Venture capitalists in a state often are unsuccessful in starting new CAPCOs (to compete with existing or out-of-state CAPCOs). There are several reasons why this may occur. First, existing CAPCOs have an established relationship with insurance companies. Second, established CAPCOs also have a ready-made debt investment instrument that is attractive to the

insurance industry and difficult to imitate. Third, state legislation does not always provide sufficient time for new CAPCOs to develop a competitive debt investment instrument and market it to insurance companies. Fourth, developing such a debt instrument is expensive, excluding some of the smaller in-state funds from participation. Finally, even those in-state funds that are able to obtain some capital commitments may not be able to meet the minimum capitalization stipulated in some state legislation (for example, the \$15 million minimum that was included in the Florida legislation). The result has been that established CAPCOs have received the majority of capital appropriated in Florida, Louisiana, Missouri, and New York.

- CAPCOs and insurance companies devote considerable resources to lobbying for additional appropriations in states with existing CAPCO programs and for new CAPCO legislation in states where CAPCOs do not already exist. In all the states that currently have CAPCO legislation except Louisiana, the legislation was introduced through the efforts and financial investment of the existing CAPCO industry. In general, CAPCOs identified champions in the state legislature to promote the concept and hired lobbyists to push for the legislation's passage. The advantage existing CAPCOs have in obtaining new capital commitments and the program's profitability also encourage them to devote their resources to lobbying for additional rounds of appropriations.
- CAPCOs can offer more favorable terms to portfolio companies because of their cost advantage over other venture capital firms in a given state. However, this advantage may lead to the crowding out of other in-state venture capital providers and may ultimately

discourage new venture capital formation in the state.

- CAPCOs make limited seed and start-up investments. CAPCOs try to maximize profitability within the parameters allotted by individual state requirements. As such, they tend to invest at the upper end of the size limit permitted by state law because such investments generally have lower risk and cost than seed and start-up investments.

Conclusions—Advantages and Disadvantages of Three Program Alternatives

State policy makers can use the information provided here as they begin to assess the rationale for public involvement in venture capital markets. However, these program alternatives must be evaluated within the context of the state political environment and the goals the state hopes to achieve through its involvement in venture capital markets. Each alternative has distinct strengths and limitations, particularly in terms of achieving specific objectives, such as investing in early stage businesses or maximizing return on investment. For all these programs, if the funds are economically successful, there is a strong demonstration effect for others in the venture capital industry. If, in turn, the programs are not economically successful, it may prove difficult to encourage more public and/or private sector venture investing in the future. With this in mind, we conclude with a comparison of the advantages and disadvantages of each program type, including ways that public policy might mitigate the disadvantages associated with each. Policy makers can use this information, in conjunction with an understanding of their state economy, the availability of venture capital resources, and the political environment, to develop models for public involvement in venture capital markets that are appropriate for their state.

Publicly Funded, Publicly Managed Venture Capital Funds

Advantages

- Program can be designed to encourage the meeting of policy objectives, such as economic development, or the targeting of specific geographies, industries or stages of investment (pre-seed, seed or expansion).
- Policy objectives (economic and social impacts) are more likely to be considered when making all decisions, including the impacts of exit strategies.
- The program's positive economic performance directly benefits the state's treasury.

Disadvantages

- Fund may be pressured to make investments in specific firms or communities, interfering with the fund manager's ability to make the most appropriate investments.
- Program may lose political support if it experiences the early losses typical of venture capital investments (portfolio failures usually precede successes). Short-term policy orientation and lack of experience with venture capital on the part of state policy makers could lead to pressure to make premature changes in the program.
- Private investors may be reluctant to invest in publicly managed funds, making it more difficult to leverage the state's capital with private capital.
- Private venture capital funds may be reluctant to co-invest with publicly managed funds because of the public fund's vulnerability to political influence or perceived lack of competence.
- States find it politically difficult to pay the high salaries that may be necessary to attract the most talented fund managers.
- Some state constitutions may not permit equity investments by state agencies.

Public Policy Options

- *Hire professional managers for these programs and design an incentive structure that rewards fund managers for making sound investment decisions, e.g., profit sharing arrangements.*
- *Find sources of funds, other than annual appropriations, to capitalize the venture capital fund and make a long-term funding commitment so resources can be devoted to investing rather than lobbying for new appropriations.*
- *Consider establishing a publicly funded and managed fund with a limited life, after which the fund must convert to private management, similar to the Minn-Corp experience.*

Publicly Funded, Privately Managed Venture Capital Funds

Advantages

- Political pressure to make specific investments is diminished or eliminated relative to publicly funded, publicly managed funds.
- Program can be designed to encourage the meeting of policy objectives, such as economic development, or targeting of specific geographies, industries or stages of investment.
- Program can be designed to benefit the state's treasury if the fund produces a positive economic rate of return.
- Fund may be able to offer higher salaries, benefits, and profit sharing, making it easier to attract experienced fund managers.
- Greater likelihood of experienced management may increase the fund's economic performance, also increasing the returns to the state's treasury.
- Private investors may be more willing to invest in privately managed funds, making it easier to leverage the state's capital with private capital.
- Private venture capital funds may be more willing to co-invest with other privately managed funds, increasing the fund's ability to participate in syndicated deals.

Disadvantages

- Political pressure may be present when selecting the private venture capital fund(s) in which the state will invest.
- For profit maximizing funds, the state's economic development policy objectives may be undermined by fund managers' focus on maximizing rate of return.
- Profit maximizing funds tend to focus on specific industries and investment stages, possibly leaving many worthy in-state businesses without a source of equity capital.

- The most experienced private profit maximizing venture capital firms are reluctant to manage funds that have geographic or other restrictions on their investments. This may force the fund to hire less experienced management and affect the fund's performance.
- Economic performance of the fund may be limited by state restrictions regarding geographic location or characteristics of acceptable portfolio companies.
- Developmental funds may have difficulty raising private capital because of the need to match investors' goals with fund's developmental objectives.

Public Policy Options

- *Balance requirements to target investments to particular sectors against the private sector's reluctance to invest under these restrictions, e.g., require that some percent of investments go to specific sectors, while other investments are less restricted.*
- *Establish specific qualifications that fund managers must have in order to receive state investments, e.g., require that fund managers meet the same requirements that the SBA uses in approving SBIC managers.*
- *Provide some insulation from political influence by establishing a quasi-public agency that can invest state monies in qualified venture capital funds.*
- *Choose evaluation criteria that recognize that the economic performance of these funds may be constrained by state-imposed restrictions on investments.*

Certified Capital Companies (CAPCOs)

Advantages

- Programs capitalized via tax credits, such as CAPCOs, do not require current state budget expenditures or bond sales.
- The actual cost (present value) of the CAPCO program to the state is reduced by the allocation of tax credits over a ten-year period.
- For states that are constitutionally restricted from making direct equity investments, tax credit programs may provide the only opportunity for states to support venture capital programs.
- Political pressure to make investments in specific businesses is diminished (or eliminated) relative to publicly funded, publicly managed funds.
- Political pressure to place state monies in specific private venture capital firms is eliminated since the state's role is limited to certifying capital companies. Insurance companies individually select in which of the CAPCOs to place their funds.
- CAPCOs are able to offer higher salaries and benefits, making it easier to attract experienced fund managers.
- Private venture capital funds may be more willing to co-invest with other privately managed funds, such as CAPCOs, increasing the fund's ability to participate in syndicated deals.

Disadvantages

- CAPCOs are a relatively costly way of increasing equity capital in the state.
- Insurance company investors in CAPCOs have reduced incentive to select the most competent fund managers since the insurance companies are compensated via an insured debt instrument as opposed to compensation based on the CAPCOs investment performance.
- Reliance on insurance company investments gives existing CAPCOs a significant advantage over new

CAPCOs when obtaining commitments of capital. This advantage results from their existing relationships with the industry and their experience in structuring investment instruments. This advantage may inhibit newly formed CAPCOs from participating in the pool of tax credits available in a state.

- CAPCOs tend to invest at the upper end of the size spectrum permitted by state law in order to minimize risk and cost; thus, they do relatively little seed or start-up investing.
- The high state subsidy rate in the CAPCO program lowers the cost of capital for CAPCO funds, giving them a competitive advantage versus other in-state venture capital providers. This may disadvantage other funds in competing for deals versus CAPCOs and may ultimately discourage new venture capital formation in the state.
- Given the advantage existing CAPCOs have in obtaining new capital commitments, the program's profitability encourages such funds to devote resources to lobbying for additional appropriations in states with existing CAPCO programs and for new CAPCO legislation in those states where it does not already exist. Thus CAPCO resources are diverted from making and monitoring investments.
- CAPCOs are allowed to keep up to 40 or 50% of their funds in secure instruments such as zero coupon bonds, in order to guarantee a specific rate of return to their insurance company investors, reducing by half the amount of certified capital available for investment at any given time. As a result, CAPCOs must roll over their investments quickly to meet the 100% investment milestone required for liquidating distributions.
- The generally large capital appropriations of the CAPCO program lessen state willingness to initiate or support other venture capital programs.

Public Policy Options

- *Expand qualified CAPCO investors to include corporations and individuals. This change encourages CAPCO investors to participate as equity rather than debt providers, increases the amount of capital the CAPCOs can invest at any given time, and reduces the incentive for lobbying by one special interest group.*
- *Increase the state’s due diligence in certifying CAPCO managers, e.g., require that managers meet standards established by SBA for the SBIC program.*
- *Encourage new, in-state CAPCOs by expanding the number of qualified investors, providing a longer time for fundraising, placing no minimum on certified capital raised, and creating a cap on total certified capital raised per CAPCO. In addition, allocate tax credits equally, e.g., Louisiana, rather than on a pro rata basis based on insurance company commitments per CAPCO, e.g., Florida.*
- *Place an annual and total cap on tax credits allocated, for the program as a whole and per CAPCO, to limit overall program costs and to encourage the creation of smaller CAPCOs that may target earlier stage deals.*
- *If the state wants to target investments to particular sectors or stages, require CAPCOs to place a specified percent of investments in these targeted areas.*
- *Provide for significant state profit sharing in the legislation.*
- *Require that 100% of certified capital be invested before liquidating distributions are allowed and before voluntary decertification can occur.*

Table 1. Case Study Institutions, By Program Type

Publicly Funded, Publicly Managed Venture Capital Funds	Publicly Funded, Privately Managed Venture Capital Funds	Certified Capital Company Programs
Iowa Product Development Corporation/Iowa Seed Capital Corporation	Colorado Rural Seed Fund	Florida CAPCO Program
Minnesota Technology Corporation Investment Fund	Kansas Venture Capital, Inc.	Louisiana CAPCO Program
Small Enterprise Growth Fund (Maine)	Magnolia Venture Capital Corporation (Mississippi)	Missouri CAPCO Program
	Northern Rockies Venture Fund (Montana)	New York CAPCO Program
	Oklahoma Capital Investment Board	

Endnotes

¹ Interested readers may refer to the PriceWaterhouseCoopers Web site (<http://www.pwcglobal.com>) for results of the National Venture Capital Survey.

² For more detailed information about these case studies, visit www.rupri.org or contact RUPRI to obtain a copy of "Public Involvement in Venture Capital Funds: Lessons from Three Program Alternatives," A Research Report Prepared for the Rural Policy Research Institute, October 1999. These case studies were selected as part of a broader project on innovations in rural equity capital markets, RUPRI's Rural Equity Capital Initiative, funded by USDA's Fund for Rural America. Reports from this broader project will be available, beginning in spring, 2000, by contacting RUPRI or visiting www.rupri.org. For more information on these site visits or other aspects of RUPRI's Rural Equity Capital Initiative, contact Deborah M. Markley via E-mail at dmmarkley@cs.com, or contact RUPRI at (573) 882-0316.



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