

Approved: March 17, 2000
Date

MINUTES OF THE SENATE COMMERCE COMMITTEE.

The meeting was called to order by Chairperson Alicia Salisbury at 8:00 a.m. on March 16, 2000 in Room 123-S of the Capitol.

All members were present except:

Committee staff present: Lynne Holt, Legislative Research Department
Jerry Ann Donaldson, Legislative Research Department
Bob Nugent, Revisor of Statutes
Betty Bomar, Secretary

Conferees appearing before the committee:

Janet Gardner, President, Local 6407, Communication Workers of America
Ralph Lagergren,
Gary Sherrer, Lieutenant Governor/Secretary of Commerce and Housing
P. Mitchell Woolery,

Others attending: See attached list

Substitute for HB 2688 - Capital formation company act

Janet Gardner, President, Local 6407 Communication Workers of American (CWA), testified on **HB 2688**, stating support for legislation which creates jobs in Kansas. Ms. Gardner, in response to a question from the Committee, stated she represented her views, not the CWA's. (Attachment 1)

Ralph Lagergren, Rimfire Management, testified **HB 2688** would be helpful to inventors in providing capital through the final production and merchandising phase in the development of a product. Mr. Lagergren, a private entrepreneur, described ideas of inventors for which he has produced prototypes, obtained financing and now manufacturing: the finger pencil in Paola and the Renegade Tool in Parsons. Conventional financing is not available for some projects as the risks are high and banks have a fiduciary responsibility to their customers; however, in order to take risks and create new products it is necessary for an influx of cash to produce and manufacture the product. The passage of **Substitute for HB 2688** would provide the capital to produce and manufacture these products in Kansas and to create jobs for Kansans.

Lieutenant Governor/Secretary Gary Sherrer stated his opposition to **Substitute HB 2688** is based on the following: 1) cannot support a new \$50 million program while core economic development programs continue to be cut; 2) questions whether the establishment of venture capital funds is the highest economic development priority; 3) questions the timing of creating a new economic development program while engaging in a comprehensive study to ascertain the programs and strategies needed for the future; and 4) questions certain public policy elements set out in the legislation. (Attachment 2)

In response to questioning, the Lieutenant Governor/Secretary Sherrer clarified that his opposition is as the Secretary of the Department of Commerce and Housing and he was not speaking for the Governor, that he had stated his concerns about the legislation at numerous meetings, both private and public.

Committee members questioned the advisability of legislation that contains no requirement to stay in Kansas after the initial capital investment of Kansas money.

P. Mitchell Woolery, Securities Lawyer, stated the Securities Exchange Commission (SEC) laws regulate the process by which investors become part of a venture capital fund, and to a lesser extent, how

CONTINUATION SHEET

they exit the fund; generally, the SEC does not regulate the fund itself or its operations. Once a fund is established, it is unlikely the SEC or any state securities commissioners will have ongoing contact with the fund, although either may investigate complaints of fraud.

CFC's are a type of venture capital fund specifically established by state statute. Venture capital funds and persons association with them are regulated by the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act, and other federal securities laws and regulations, as well as by the securities commissioner of each state in which potential investors are located. **Substitute for HB 2688** further provides some regulatory oversight by the Department of Commerce and Housing. The general oversight of the SEC includes exempt offerings, disclosure to potential investors, and compliance with the Investment Compliance Act for which venture capital funds generally limit their investors to not more than 99 direct or indirect investors. (Attachment 3)

Mr. Woolery stated there are only five specific types of exemptions from securities laws registration requirements likely to be used in setting up a venture capital fund like a CFC. Exemptions: 1) Allow the CFC to seek up to \$1 million from "retail" investors. The term "retail investor" is not a legal term but generally used to describe investors who are not "accredited". 2) Allow the CFC to seek up to \$5 million from an unlimited amount of accredited investors or up to 35 "retail" investors; 3) Allow the CFC to seek an unlimited amount of money from an unlimited amount of accredited investors or up to 35 "sophisticated" investors; 4) Allow an unlimited amount of money to be raised from sophisticated investors; and 5) Allow an unlimited amount of money to be raised by the CFC from accredited, sophisticated or retail investors. The CFC, the investors and the businesses in which investments are made would all need to be based in Kansas.

An "accredited investor" includes (1) a natural person with a \$1 million net worth, (2) a natural person with an individual annual income of \$200,000 (\$300,000 with his or her spouse) for the year and the past two years, or (3) an entity like a corporation with total assets of more than \$5 million. A "sophisticated" investor includes persons who are able to have access to all material information, who are able to fend for themselves and bear the risk of total loss of their investment.

David Frankland, President, Digital Archaeology, submitted written testimony in support of **Substitute for HB 2688**. (Attachment 4)

The meeting adjourned at 9:00 a.m.

The next meeting is scheduled for March 17, 2000.

SENATE COMMERCE COMMITTEE GUEST LIST

DATE: March 16, 2000

NAME	REPRESENTING
Jerry Aday	State Rep
BUD BURKE	VENTURE CAP. COALITION
Bill Brown	State Rep
Ralph Jurgens	Profile Mgmt.
Michael Miller	KANSAS Inc
Mitch Woolery	Kutak Rock LLP
RICH. BANDIS	KTEC
MIKE WOSICKI	KTEC
FRED SCHWITZ	KDOC&H
Sherry Brown	KDOC&H
Christy Caldwell	Topeka Chamber of Commerce
JAMES JANOUSEK	Ks Dept of Commerce/Neering
Steve Kelly	KDOC&H
Joe A. de la Torre	GOVERNOR'S OFFICE

Testimony of Janet Gardner
Communication Workers of America
Kansas, Inc. Board of Directors
Before the Senate Commerce Committee
on March 16, 2000

Greetings, Madam Chairman and Members of the Committee.

I am Janet Gardner, president of Local 6407 Communication Workers of America. In this position, I am a chief advocate for the interests of our 170 employees.

I am also the member of the board of directors of Kansas, Inc. appointed by the Governor to represent the interests and concerns of the working men and women of Kansas.

Having worked in the labor force for 32 years, I am dedicated to insuring that there are good paying jobs to offer future generations of Kansans. Training and retraining are necessary to insure skilled workers, however, all the training and retraining are for naught if we are not creating, retaining and attracting companies to Kansas. We must focus on creating adequate seed and venture capital in Kansas where it does not exist today. This investment in our state's future will enable companies to start up, survive and grow in Kansas. As a result, new and higher-paying jobs will be created for today's and tomorrow's workers.

I urge you to vote in favor of HB 2688.

Thank you.

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**TESTIMONY OF LIEUTENANT GOVERNOR/SECRETARY OF
COMMERCE AND HOUSING**

March 16, 200

Before the Senate Commerce Committee

Members of the Committee:

I come today to share my perspectives on H.B. 2688. I first want to acknowledge the strong efforts of Charles Ranson of Kansas, Inc. and of Rich Bendis of KTEC. They clearly have a deep commitment to passage of this bill. I truly wish I could join my economic development colleagues in this effort but after a long period of analysis and deliberation I have concluded that as Secretary of Commerce and Housing for Kansas, I cannot support H.B. 2688. The basis for my decision is founded on 4 points.

First, I cannot support a new \$50 million program while core economic development programs continue to be cut. Second, I do not believe that establishing venture capital funds is the highest economic development priority for Kansas. Third, it seems confusing that this legislature is creating a new economic development program while at the same time suggesting we engage in a comprehensive study to ascertain the programs and strategies we need for the future. Fourth, I believe the bill has certain public policy elements that are not the direction we should go, or are so ambiguous that we do not have clear public policy direction. Let me give you my rationale for these four positions.

First, I cannot support a new \$50 million program while core economic development programs continue to be cut. In just 3 fiscal years my core programs and

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Attachment # 2-1 thru 2-5

operations have been cut 23%. How can I justify saying that I believe we need to create a new \$50 million program when:

- We acknowledge that a trained workforce is critical to the future yet we are cutting funding for Kansas Industrial Training and Kansas Industrial Retraining Programs.
- We haven't given Certified Development Companies and Small Business Development Centers the increases they have asked for, but instead have begun cutting their budgets.
- We are asked to do more in the International Trade area while at the same time cutting funding from the Kansas Trade Show Assistance Program and restricting our ability to expand our international presence by cutting operating funding.
- In the middle of an outstanding climate for recruiting new jobs to Kansas, the past three fiscal years show a cut of over \$1 million from our most effective program, the Kansas Economic Initiatives Fund (KEOIF).
- As we continue to talk about the economic value of tourism, we continue to limit an advertising budget that is one of the nations lowest.

Some may argue that we should take what we can get, and if we can get venture capital funded, then we should. I maintain that we should get what we need and not

take what we can get. Our focus should be on restoring the KDOCH, KTEC and Kansas, Inc. budgets to a level that can support further developing our successful programs.

This leads to my second point that establishing venture capital funds is not the highest priority for Kansas. I have already stated that our highest priority is to fund and expand existing successful programs. However, if we did have those programs funded would we still use the next \$50 million for venture capital? My concerns with venture capital are many. For instance, I think it inherently has an urban bias to it. While we need to serve all Kansans, including those in urban counties, we need also to ensure our limited resources can be distributed equitably throughout the state. Venture Capital tends to stimulate wealth creation, not job creation. Don't let the low unemployment statistics fool you -- we need jobs in Kansas. Jobs that have decent pay and benefits. As I travel the state, I have become more and more convinced that we need job creation, particularly for our small and rural communities.

I can honestly say to you that if you brought the practitioners together, those working in the economic development field, and asked them what to do with \$5 million a year for the next 10 years, I don't believe it would be venture capital.

My third concern is the mixed message that I hear from the legislature. A very clear message is being sent with HCR 5059 that after a decade and a half of economic development success we need to do a comprehensive study to determine a

new/century strategy and to develop programs to implement that strategy. I am pleased to report that the Presidents of KTEC and Kansas Inc. and myself have met, have identified funding and are awaiting the draft RFP from Kansas, Inc. for such a study. Private funding is already being committed as well. Why then are we in such a rush to create a new \$50 million initiative? Shouldn't we see what the study suggests before we lock the state into a 10-year commitment? Will a one-year delay make that much difference? We will have a comprehensive look by next session, so I suggest we wait until then before creating a new economic development initiative.

My fourth and final concern is the bill itself. It contains public policy that I do not think is appropriate; but more troubling is that it remains silent on important public policy issues. Let's look at a few examples:

- The bill does not set priorities. I know the Secretary of Commerce & Housing is to establish rules and regulations, but what is your vision? With 100% tax credit I assure you the \$50 million will be oversubscribed. Under this bill only the largest and the fastest to raise money will participate. There are no specific targets for investment. There are no priorities for type or geography.
- There are no "claw back" or restrictive provisions on companies leaving the state after they receive investment dollars. In fact, they can continue to receive dollars generated by Kansas Tax Credits after they move to another state. Is this the public policy you intend to enact?

- Why after an initial investment, no matter how small, do we take off all the rules as to what is a qualified business?

- Why do you not set a minimum time for the CFC to be in existence? Under this bill the CFC can invest the amount necessary to obtain 100% of the tax credits and then dissolve, assigning equity positions and excess capital (if any) to the original investors. This could easily take place in less than 3 years. The venture capital bill the state passed more than a decade ago gave 25% tax credits but required the venture capital company to exist for seven years.

- On the other end of the extreme, this bill allows the CFC to invest 75% of its money for 3 years in non-venture capital activities, 60% of its funds in non-venture capital activities for 4 years, 50% for 5 years, and 30% for 7 years. This would not provide incentive to the CFC to focus on venture capital investing, as the bill seems to want to allocate.

Members of the Committee, I am sorry to be out of step with my colleagues on this issue. While the bill could possibly be amended to answer my specific concerns, I question that my philosophical concerns regarding a priority on adequately funding what we have, considering better ways of using \$50 million and wanting a study before we initiate new programs can be allayed. Therefore, I reluctantly am not able to support H.B. 2688.

**Testimony of
P. Mitchell Woolery¹
Before
Senate Commerce Committee
March 16, 2000**

Re: H.B. No. 2688 (Kansas certified capital formation company act) and Discussion of Federal Securities Laws

Introduction. This memorandum will discuss the federal securities laws which are likely to apply to the venture capital funds ("CFC's") to be set up by H.B. No. 2688. In particular, I will discuss the types of persons who are eligible to invest in a CFC. The federal securities laws are complex and this report greatly oversimplifies and generalizes the application of these laws. Should the Committee desire greater depth or coverage, I am happy to provide it.

CFC's. CFC's are a type of venture capital fund specifically established by state statute. All venture capital funds and persons associated with them, whether they are CFC's or are private investment funds, are regulated by the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act, as well as other federal securities laws and regulations. These venture capital funds are also regulated by the securities commissioner of each state in which potential investors in the fund are located. In addition, H.B. 2688 provides some regulatory oversight by the Kansas Department of Commerce.

General Overview of Regulation. Securities regulation usually takes the following forms:

1 . Exempt offerings: Offer and sales of investments in the CFC need to be exempt from registration. Generally these exemptions will focus on the type of investors and the amount of total money sought by the CFC within a specified period.

2. Disclosure. Adequate disclosure of all material facts about the CFC must be provided in writing to potential investors. This serves to satisfy the anti-fraud requirements of the securities laws (for example, Rule 106-5).

3 . Not more than 99 investors in the CFC. To comply with the Investment Company Act, venture capital funds generally limit their investors to not more than 99 direct or indirect investors.

Please note that the securities laws regulate the process by which investors become part of a venture capital fund and, to a lesser extent, how they exit the fund; generally, they do not regulate the fund itself or its operations. Once the fund is established, it is unlikely the SEC or any state securities commissioners will have ongoing contact with the fund, although either may investigate complaints of fraud. Most of the regulation of a fund is by the contract setting up the

¹ Woolery is an attorney with Kutak Rock LLP of Kansas City, Missouri. 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.

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Attachment # 3-1 thru 3-2



**Presented to
Senate Commerce Committee
March 16, 2000**

in support of HB 2688

I am David Frankland, President and Chief Executive Officer of Digital Archaeology, a technology start-up company now in its 5th year of existence.

Our Kansas-based Company was founded by a group of software industry veterans seeking to commercialize a new software architecture we call X-Set. X-Set radically simplifies the process of transforming data into usable customer knowledge. Since its beginning Digital Archaeology has enjoyed considerable success in developing this new technology that enables businesses to implement flexible "just in time" decision support systems. In simple terms, we help businesses better understand and manage their customers thereby adding to their bottom line profitability.

Beginning in 1998, I had the pleasure to serve as one of 20 Kansans on Kansas, Inc.'s technical advisory group. As you know this group was created to guide a best practices study of seed and venture capital and to develop alternatives to direct state equity investment in high risk, high reward companies such as ours.

Last year, I was pleased to present testimony before the Senate Commerce Committee in support of SB 315, the companion measure to this bill. And, in November 1999, I once again had the pleasure of submitting written testimony in support of SB 315 to the Interim Joint Economic Development Committee. I would have gladly presented that testimony in person had I not just returned from attending a technology fair in Osaka, Japan as one of a small group of companies chosen world-wide to demonstrate and discuss their technology and business plan to a select group of Japanese investors. I passionately support HB 2688 and its counterpart (SB 315) as essential to the long-term success and competitiveness of the Kansas economy.

Need for Capital

Digital Archaeology would not and could not exist without venture capital. When my written testimony was presented in November, we had raised \$8.5 million in equity investments from groups including Kansas City Equity Partners, Gateway Associates (out of St. Louis) and other private investors. While this may seem like a substantial sum of money, it pales in comparison to our competitors, some having raised in excess of \$30 million when they were at our stage of development.

You may remember my earlier testimony. At that time we were seeking additional equity funding to support ongoing operations. To our continuing dismay, our hopes of securing adequate financing have rested almost entirely on entities outside the state of Kansas. As a result I have spent the bulk of my time traveling outside the State making presentations to potential investors when I should be managing and growing our business. In Osaka, Japan, through the help of KTEC, we presented our investment proposition to a number of large Japanese companies. This

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was a terrific opportunity and we are very grateful to KTEC for their assistance, but I think you will all agree that 6,600 miles is too far to travel for investment capital.

I am here today to tell you that we have been successful in achieving our goal of raising \$15 million in new venture capital to enable Digital Archaeology to continue to grow.

I am also here to tell you that because the Kansas Legislature did not enact SB 315 in 1999, and did not establish the mechanism that could have met my company's pressing need, Digital Archaeology was forced to find capital where it was available. The State of Missouri made the final piece of our \$15 million financing package available through its CapCo program. To obtain the nearly \$2 million in equity investment that is tied to this program, Digital Archaeology has agreed to relocate the company from Kansas to Missouri. The move will be effective no later than June of this year.

Digital Archaeology presently employs over 50 people at an average salary well in excess of \$70,000. With new funding we will add at least another 50 people in the next 6-12 months, and that we hope will only be the beginning of our growth. When I spoke to you before, I mentioned that the single greatest fear I had as a CEO of a high technology company in Kansas was the lack of available local capital to fuel our growth. In that testimony, I posed to you the critical question: will Digital Archaeology be able to remain a Kansas company or, will the financial terms and conditions of an outside investor force the company and its large and growing number of high paying jobs to move elsewhere.

The answer to that question is now clear, at least for Digital Archaeology. Unfortunately, we will not be able to remain a Kansas company. But our example is not unique. There are many other companies going through the same process that we have gone through - searching for capital, trying to survive and grow, trying to create more and higher paying jobs and, as a result, strengthening the image and the revenue base of this state.

Unless this Legislature acts now, in this session, to meet the need of companies like Digital Archaeology, ours will not be the last company to pull up stakes and move to where the money is. We will simply be the next in a continuing exodus of companies that together have the potential to revolutionize the economy of Kansas and to prepare it to compete successfully in the 21st Century.

Thank you Madam Chairman.