

MINUTES OF THE SENATE COMMERCE COMMITTEE.

The meeting was called to order by Chairperson Karin Brownlee at 8:30 a.m. on February 6, 2003 in Room 123-S of the Capitol.

All members were present except:

Committee staff present: April Holman, Legislative Research
Deb Hollon, Legislative Research
Mitch Rice, Revisor of Statutes
Norman Furse, Revisor of Statutes

Conferees appearing before the committee: Steve Kelly, Kansas Department of Commerce and Housing
Jay Kayne, Kansas Department of Commerce and Housing
Tracey Taylor, Kansas Technology Enterprise Corporation

Others attending: See attached list.

Chairperson Brownlee opened the hearing on **SB 65** and welcomed Steve Kelly from the Kansas Department of Commerce and Housing as the first conferee. Mr. Kelly is a proponent of **SB 65**, regarding venture capital, and appeared to propose an amendment to the bill. (Attachment 1) Mr. Kelly explained why he believes changes are needed to the bill. He is attempting to correct previous language that would make it difficult to attract investors. The schedule that requires investment to be made on a certain timeline, which could be a deterrent to investment. The solution is to tie tax credits to the actual investment in Kansas companies. Investors shall be entitled to claim a percentage of the credit proportional to the amount invested by the CFC in a qualified Kansas business, not to exceed 10% of the credit per taxable year, taxable years commencing on or after January 1, 2005. The intent is to make sure Kansans get value for investments in Kansas companies.

Chairperson Brownlee welcomed Jay Kayne to the committee. Mr. Kayne is a private consultant who was asked by the Kansas Department of Commerce and Housing to develop the regulatory framework for implementing the Certified Capital Formation Act and is a proponent of **SB 65**. The current Kansas Act is among the most stringent of any state in the country. The purpose of the Act was to encourage investment in emerging Kansas businesses that will create jobs and add to the state's overall economic growth. The purpose of the tax credits given to investors is to make investment in a certified capital company more attractive than alternative investments. The proposed amendments make the certified capital company program more attractive to potential investors without violating the Legislature's intent under the original language. Mr. Kayne would like to see more clear criteria about who can be the director of a fund. He recommended that the committee clarify the language regarding restrictions on directors with criminal pasts. (Attachment 2)

Charles Ranson, President of Kansas, Inc. appeared briefly before the committee as a proponent of **SB 65**. He believes that **SB 65** is a good and important change to the current act.

Chairperson Brownlee closed the hearing on **SB 65** and asked Norman Furse to look into the criminal past language of the bill, page 5, lines 26-30.

Tracey Taylor, President and CEO of the Kansas Technology Enterprise Corporation (KTEC) gave a brief update on the activities of KTEC. (Attachment 3) His report focused on the role of technology-based economic development in Kansas. KTEC relies on collaboration with outside companies and agencies and has been very successful.

Senator Brownlee announced the formation of a subcommittee on rural economic development consisting of Senators Jordan, Emler, Lee, and Brownlee that will meet on Monday mornings.

The meeting was adjourned at 9:30 a.m.

The next meeting is scheduled for February 7, 2003 at 8:30 a.m. in room 123-S.

Kansas Department of Commerce & Housing

Senate Committee on Commerce

Testimony of Steve Kelly, Business Development Director

Proposed Amendment to Certified Capital Formation Company Act

Thursday, February 6, 2003

Thank you for the opportunity to appear before you today to request introduction of a bill to amend the Certified Capital Formation Company Act. Attached is a document with the Department's suggested changes.

Last week, staff from the Department of Commerce & Housing and the Kansas Technology Enterprise Corporation met with our retained consultant for developing rules and regulations for the Act, Dr. Jay Kayne, to discuss implementation. The meeting focused on provisions of the Act that needed to be addressed in the regulations that will govern the program. As part of this review we focused on two principles. One, the regulation should ensure that the substantive objective of the Act—investment in emerging Kansas firms—is met. Two, the Department meets its fiduciary responsibility, both fiscal and legal.

An analysis of the bill that was prepared for our discussion last week raised an issue that goes beyond regulatory language. We believe that KSA 74-8225(a)(1)-(3), which requires a Capital Formation Corporation (CFC) to fully invest its certified capital in qualified Kansas business within five years, when viewed in light of the potential penalties to investors in CFCs identified in KSA 74-8226(d), has a high probability of undermining the substantive objective of the Act. While the eventual rate of return on any individual investment in a venture capital fund is uncertain, the value of the 50 percent tax credit is designed to make investment in the CFC program more attractive than other alternative investments. The potential forfeiture or recapture of that incentive, as prescribed in the current statute, makes the CFC program a significantly less attractive investment.

Precedent in other states suggests that an absolute requirement on a state supported venture fund could place the State of Kansas and a CFC in an adversarial relationship. In the 1990s the State of Iowa and the general manager of a state supported venture capital fund were involved in litigation because the fund managers did not meet the state's investment expectations. The fund managers argued that their responsibility was to raise the fund and to make prudent investments in companies that met the investment criteria. Responsibility for creating sufficient deal flow from which they could make prudent investments was not their responsibility. The court agreed, the fund was dissolved and the fund manager moved its operations to another state.

Senate Commerce Committee

2-6-03

Attachment 1-1

The Department can certainly promulgate a rule under the current language. However, we are concerned that this provision will severely limit the number of applicants for certification as a CFC and inhibit their ability to raise private capital. Therefore, we respectfully request that the Legislature amend the Act early in the 2003 session so that the Department can move quickly to implement a program that will have the desired outcome.

We offer the following suggestions for amending the Act. The proposed amendments meet the two primary principles outline earlier in this memorandum. The central issue associated with these changes is the timetable for state payment of the tax credits. We understand that the Legislature wanted to ensure that moneys raised through state tax credits are actually invested in qualified Kansas businesses. We believe the current forfeiture/recapture provision is necessary only because the tax credits are paid out prior to a CFC's investment. Therefore, we recommend the following changes to the Act that link the actual payout of state tax credits to the timing of the CFC's investment in qualified businesses. This approach would require amendments to the following sections of the current Act.

KSA 74-8222(a)

Instead of being able to claim 10 percent of the allowable tax credit each year, an investor will be entitled to claim a percent of the allowable tax credit proportional to the amount of certified funds a CFC has invested in qualified Kansas businesses not to exceed 10 percent each year. Any unused tax credit will roll over to the next calendar year.

For example, a CFC raises \$10 million. In year one, it invests \$500,000 in a qualified business. All of the investors in that CFC will be entitled to tax credits on five percent of their individual investment in the CFC. For example, an investor who made the maximum \$2.0 million investment will get credit for \$100,000 of his or her funds being invested in a qualified business, and therefore, could claim a \$50,000 tax credit against the subsequent year's tax liability.

[NOTE: The definition of "certified capital" in subsection (1)(g) already includes "legally enforceable commitments of capital subject to call by a capital formation corporation." With this definition, the CFC could call in commitments as needed. Therefore, investors would provide cash only as needed for investments and would only be able to claim tax credits as the CFC invested in qualified businesses.]

KSA 74-8225(1)-(3)

These subsections could be deleted. Since the amount of tax credits in any given year cannot exceed 50 percent of the aggregate amount of investments by all CFCs, the State need not worry that large sums of capital, generated as the result of state tax credits, are sitting idle. We believe it is still in each CFC's self-interest to invest its

committed certified capital as this is the source of their financial return for participating in the program.

KSA 74-8226(d)-(e)

If sections (1)-(3) of KSA 74-8225 are eliminated, references to these sections need to be deleted from this section. We recommend that KSA 74-8226(d) be deleted in its entirety and that subsection (e) be amended to read, "Decertification a CFC shall cause the forfeiture of tax credits commencing with the taxable year of the investor or transferee in which the decertification arose."

We believe that these changes will increase investors' interest in this program, accelerate investment in emerging Kansas businesses, and are consistent with the Legislature's fiscal limits on the program. Each CFC, and individual investors in each CFC, will still be subject to all other provisions of the Act.

Thank you for your attention to this request. In you have questions or need additional information, please do not hesitate to contact me.

TESTIMONY
JOSEPH A (JAY) KAYNE
KANSAS SENATE COMMITTEE ON ECONOMIC DEVELOPMENT
FEBRUARY 6, 2003

TOPIC:
SB 65—REVISIONS TO CERTIFIED CAPITAL COMPANY FORMATION ACT

Madam Chair and members of the Senate economic development committee, thank you for this opportunity to comment on the pending revisions to the Certified Capital Company Formation Act.

My name is Jay Kayne. I am a private consultant based in Leawood, Kansas. Until December of this past year I served as Vice President for Community and Policy for the Kauffman Center for Entrepreneurial Leadership. Prior to coming to Kansas City, I held the position of Director of Economic Development and Commerce Policy Studies at the National Governors Association in Washington, DC. My responsibilities in both these positions included research and analysis of publicly supported financial assistance programs, including those associated with venture capital.

Last December I was asked by the Kansas Department of Commerce and Housing to develop the regulatory framework for implementing the Certified Capital Company Formation Act, enacted during the previous session of the Kansas Legislature.

The first task under my contract with the Department of Commerce was an analysis of the Act to determine the key issues that needed to be addressed in the regulation. As I reviewed the Act and the supplemental notes attached to HB2505, I was struck by the provisions in Subsections

5(a)(1)-(3) related to the timeframe for investment of certified capital in qualified Kansas businesses. The Act, as enacted, requires that:

- 33 percent of the certified capital be invested at the end of three years,
- 66 percent be invested at the end of four years, and
- 100 percent be invested by the end of five years.

A review of 47 programs in 28 other states that encourage or provide equity capital investments, conducted as part of my contract with the Department confirmed my initial belief that these are among and perhaps the most stringent investment requirements of any state program. Equally important are the penalties imposed on individual investors if a certified capital company fails to meet these targets contained in Subsection 6(d) of the Act. Under this provision, the investor is subject to forfeiture of future tax credits and recapture of past tax credits.

These findings therefore beg the question, "What impact would these requirements have on the legislative intent of raising and investing venture capital in qualified Kansas businesses?" Because the language is so straightforward, I believe that the legislative concern that prompted these provisions is very clear and justifiable. Members of the legislature wanted to ensure that pools of venture capital funds raised through the offering of state tax credits were, in fact, being used for the intended purpose, providing needed capital to emerging and growing Kansas businesses. The program has no benefit to the state or the economy if the funds raised through the tax credits sit idle or are placed in passive investments. Some incentive for a certified capital company to invest the funds in qualified Kansas businesses is warranted.

However, the current language may not be the proper vehicle for addressing this concern. This conclusion is based on the potential impact of these provisions on both the investors in the certified capital companies and the funds themselves. I will address each of these audiences separately.

From the investor's perspective, the purpose of the tax credits is to make the investment in a certified capital company more attractive than alternative investments. An investment becomes more attractive for one of two reasons. Either the return on investment (ROI) is higher than that provided by alternative investments or the risk associated with a given ROI is lower. The best way to explain the value of a tax credit to the investor is by example.

Let's say that the average investor in a venture capital fund is expecting an annual return on investment of 20 percent over five years. In order to meet that target, the portfolio must have a total ROI approaching 110 percent of the original investment. However, the guaranteed 50 percent ROI associated with the tax credit means that the fund portfolio need only provide an ROI approaching 60 percent to satisfy the investor's target. This equates to lower risk. On the other hand, if the fund does perform above the 60 percent ROI, the return to the investor can significantly exceed the 20 percent annualized target. Either of these outcomes enhances the attractiveness of investing in a certified capital company.

However, if the tax credit is subject to recapture, the certified capital company's portfolio must perform at or above the industry standard to attract investors. The history of targeted public venture capital funds

suggests that this will not be the case. The fact that these dollars must be invested in qualified Kansas businesses (meeting the statutory age and revenue criteria) limits a capital company's ability to seek out investments that represent the highest potential return on investment. In other words, the more a public program restricts the investment options for a venture capital fund, the higher the probability that it will not reach the same ROI of an unrestricted fund. Without the tax credit or with the potential recapture of past tax credits, an individual investment in a Kansas certified capital company becomes significantly less attractive.

From the certified capital companies' perspective, the provisions send the message that it is more important to invest the money as quickly as possible than it is to make the most prudent investments in the right companies. The only penalty imposed on a certified capital company is decertification. And what does that mean? There are no provisions that require the fund managers to return funds to the individual investors. Therefore, one can argue that following decertification a capital company, once the tax credits to its investors are forfeited or recaptured, could to continue to operate without the restrictions imposed by the Act to invest in qualified Kansas businesses.

Under a different scenario, the capital company could meet the investment targets by lowering its investment standards. Under this scenario, one would expect that the portfolio would perform below industry norms and that the investments would not provide the business growth in terms of job creation or revenues that is the clear purpose of the program.

When I presented this analysis to officials at the Department of Commerce, including Lieutenant Governor-Elect John Moore, I suggested that there were two options. One, the Department could promulgate regulations based on the current language, authorize a number of applicants to begin raising funds, and see if the assumptions about the investment targets and investor penalties did restrict the applicants' ability to attract investors. If we were correct, the annual report to the Legislature, required under the Act, would document the underutilization of the tax credits. At that time, the Department could then seek amendments to the Act that would increase the attractiveness of investment in certified capital companies.

The second option was to accept that the analysis was correct, and rather than wait a year to resolve these issues, present the findings and recommend that the Legislature amend the Act during the current session.

The consensus among those who reviewed the analysis was that the Act was an important new tool for promoting economic development in Kansas. Therefore, Secretary-designate Moore agreed to discuss possibly amending the act with the chairs of the Senate and House economic development committees. As we discussed the nature of the amendments, we agreed that any changes to the Act had to be consistent with the following principles.

- The primary purpose of the Act was to encourage investment in emerging Kansas businesses that will create jobs and add to the State's overall economic growth.

- The entitlement and timing of tax credits should be directly tied to the Act's primary purpose.
- The payout of tax credits should remain over the 10 year period provided for in the Act.

The solution appeared to be an amendment to the Act that tied the payout of tax credits directly to investments in qualified businesses. In other words, investors who commit funds a certified capital company would only receive the "opportunity" to receive tax credits equal to 50 percent of the investment commitment. However, the tax credits would only be earned when the capital company actually invested funds in a qualified business. This "proportional" payout means that there would not any prepayment of tax credits and, therefore, the need for recapture is eliminated.

But what happens if the capital company successfully invests in qualified businesses at a rate of more than 10 percent per year. The proposed amendment limited the payout at any one time to the "sum total of an average of 10 percent per year." Therefore, if an investor becomes entitled to more than 10 percent in a given year, the amount of the credit in excess of the 10 percent payout would carry over to subsequent tax years.

The following table demonstrates how the amendment would work for an investor who has committed \$1,000,000 toward a total certified capital company pool of \$10,000,000. In other words, this investor's commitment represents 10 percent of the total pool. And the investor has the potential of receiving a total of \$500,000 in tax credits over 10 years.

YEAR	TOTAL CCC INVESTMENT	TAX CREDIT EARNED	TAX CREDIT PAYOUT	TAX CREDIT CARRYOVER
1	\$500,000	\$25,000	\$25,000	\$0
2	\$3,000,000	\$150,000	\$75,000	\$75,000
3	No Investment	\$0	\$50,000	\$25,000
4	\$2,000,000	\$100,000	\$50,000	\$75,000
5	\$2,000,000	\$100,000	\$50,000	\$125,000
6	No Investment	\$0	\$50,000	\$75,000
7	\$2,500,000	\$125,000	\$50,000	\$150,000
8			\$50,000	\$100,000
9			\$50,000	\$50,000
10			\$50,000	\$0
TOTAL	\$10,000,000	\$500,000	\$500,000	n/a

This approach to payout of the tax credits has one additional benefit. Realization of the tax credit is dependent on the ability of the certified capital company to actually invest in qualified businesses. Therefore, an investor's decision to contribute or not contribute to a specific certified capital pool should include an assessment of the fund managers' ability to turn the pool into qualified investments.

I believe that the proposed amendments make the certified capital company program more attractive to potential investors without violating the Legislature's intent under the original language. I would welcome any questions or requests for additional information.

The Role of Technology-Based Economic Development in Kansas

K T E C

Kansas Technology Enterprise Corporation

Presented by Tracy B. Taylor, President & CEO

KTEC is ...

- ... an outcome of the Redwood-Krider report, a study conducted in 1986 that emphasized the need to strengthen the Kansas economy by focusing on entrepreneurship and technology-based economic development.
- ... governed by a board of 20-member, industry-led board of directors comprised of stakeholders representing the legislature, government, universities and the private sector.
- ... funded by the Economic Development Initiatives Fund, which consists of revenues from the Kansas Lottery & Gaming Commission.

KTEC Areas of Focus

Research

Centers of Excellence

- HBC, *Univ. of Kansas*
- ITTC, *Univ. of Kansas*
- NIAR, *Wichita St. Univ.*
- AMI, *Kansas St. Univ.*
- KPRC, *Pittsburg St. Univ.*

Experimental Program to Stimulate Competitive Research (EPSCoR)

Business Assistance

Incubators

- MACC, *Manhattan*
- LRTC, *Lawrence*
- ECJC, *Lenexa*
- KUMCRI, *Kansas City*
- ATC, *Pittsburg*
- WTC, *Wichita*
- WKTC, *Great Bend*
- Quest, *Hutchinson*

Mid-America Manufacturing Technology Center (MAMTC)

Technology Acquisition Development and Commercialization (TADAC)

Investments

KTEC Incubator Seed Funds:

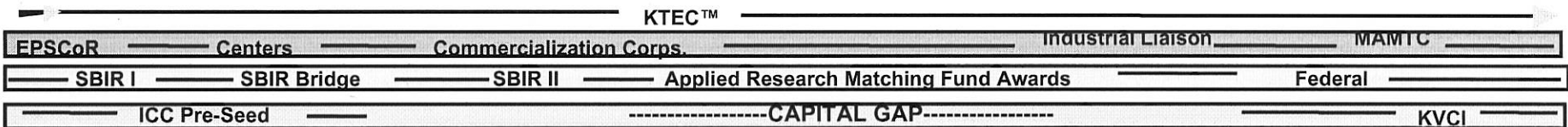
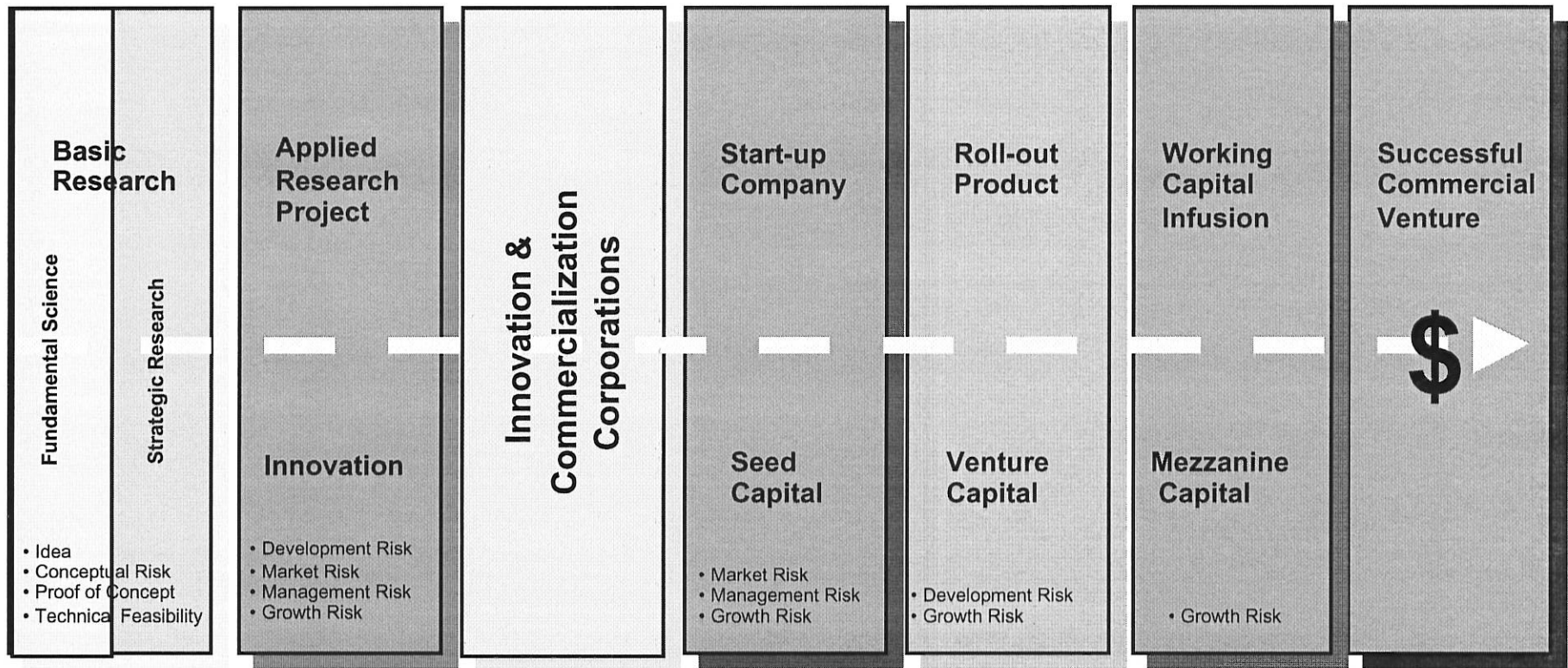
- Manhattan Holdings (MACC)
- Kaw Holdings (LRTC)
- Wichita Ventures (WTC)
- Prairie Investments (ECJC)
- Precede Fund (KUMCRI)
- Quest Ventures (Quest)
- Milestone Ventures (ATC)

Small Business Innovation Research (SBIR) assistance

Applied Research Matching Fund (ARMF)

KTEC Holdings Inc.

Technology Commercialization Life Cycle



Kansas is a small business state

- **73,716 businesses in the state**
- **64,888 of those have 19 or fewer employees**
- **Only 161 companies have more than 500 employees**

Technology-Based Economic Development Initiatives

So What?

- Emerging entrepreneurial growth companies are responsible for 67% of new jobs (more in economic downturns) and 95% of all radical innovations since WWII *
- Created 2/3 of all net new jobs in the '90s *
- Jobs created by tech companies pay about \$50,000 – two times the average salary of non-technology jobs (approx. \$26,000)
- Reduces brain drain
- Diversifies tax base

*National Commission on Entrepreneurship, 2001

Life Sciences Initiative

- Kauffman and Stowers Foundations (collectively worth about \$5B)
 - Focused on life science and entrepreneurial habitat
- Gov't research funding focused on IT, life sciences and nanotechnology

TADAC: Technology Acquisition, Development and Commercialization

- Jointly sponsored by KTEC and Mid-America Commercialization Corporation, a KTEC incubator
- Leads the nation in acquisition and management of patent donations
- Portfolio includes nearly 500 patents in 31 fields of technology



CATERPILLAR®



Procter & Gamble

KTEC Client Companies

CritiTech
precision by design

LivingNaturally.com

CyDex™

QVIS®

VasoGenix
Pharmaceuticals

AEROCOMM
INSTANT WIRELESS

Nutri-joy
Nutrition to Enjoy

Environmental Compliance Consultants, Inc.
services

KNOWLEDGE COMMUNICATION™

NanoScale.
Serving Customer Needs Through Advanced Chemistry

HARPER INDUSTRIES INC.
THE HEALTH SITE AUTHORITY

NMI
NANOSCALE MATERIALS INC.

VITALSEEK™

AFIX Tracker

BeyondNow
Technology

Information. When and Where You Need It.
HANDSIGNAL

MOTIONWATCH®

FilterLogix

Redemption
Plus.

NEON
POWER
PRO™

Control Vision

Results Via the 3 C's

•Collaboration

- KDOCH / Legislature / Administration
- Stowers and Kauffman Foundations
- Kansas State, University of Kansas, Pittsburg State and Wichita State
- Federal government – EDA, Department of Commerce

•Commercialization

- Innovation Centers/Incubators (KU, KSU, PSU and WSU)
- Centers of Excellence

•Capital

- Venture Capital Tax Credit Bill
- InvestMidwest
- Local incubator seed funds and KTEC Holdings Inc.

How does KTEC work?

- Private sector leadership
- Functions as a business
- Successfully manages a technology investment portfolio for return on investment
- Integrated science & technology management for Kansas
- Accountability with measurable outcomes

Rural Initiatives

- **Kansas ElectroRally – sponsor**
- **Kansas High School Business Plan Competition – founder/organizer**
- **Supporter of TelePower initiative**
- **Mid-America Manufacturing Technology Center**
- **Western Kansas Technology Corporation – Dick Sidles**
- **Harper Industries – KTEC client, largest employer in Harper County**

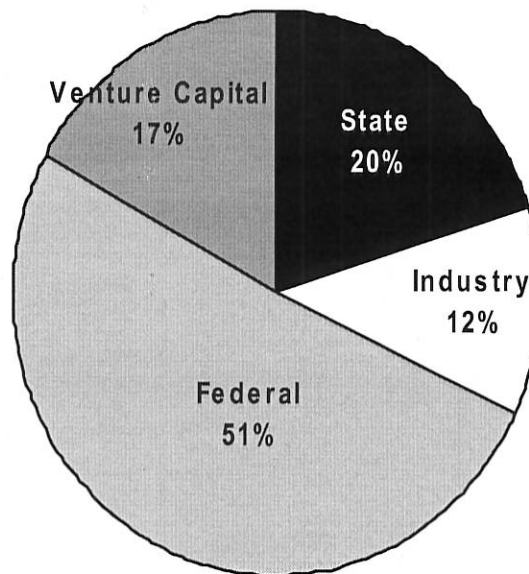
Keys to attracting outside capital to Kansas

- Leaders in a developing technological niche
- Strong management team/work force
- Good understanding of the market
- Continuum of product development and enhancement
- Companies that do not rely on a single product

KTEC Cumulative Results

- \$1.14 billion in increased sales
- \$723.5 million in investments leveraged
- 337 company start-ups
- 13,230 jobs created or retained
- 579 technologies developed
- 220 patents issued
- 3,160 inventors assisted
- \$9.64 million in royalty/equity returns

FY 2002 Percent of Total Investment



**Total FY 2002 investment:
\$64.1 million**

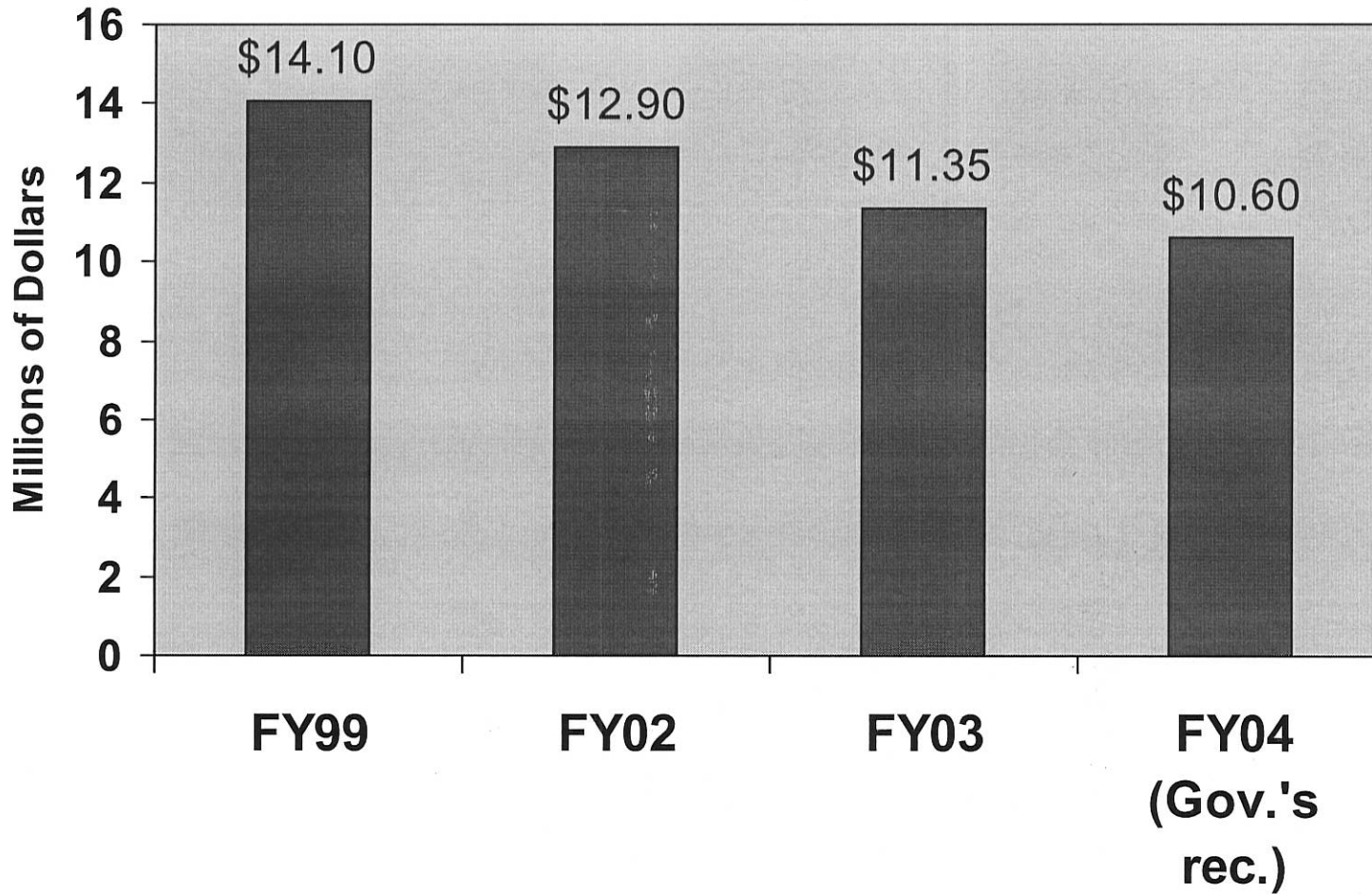
Leverage: \$4:1

What can the Legislature do to support economic development in Kansas?

- **Carefully analyze the potential effects of changes to gaming laws on the Economic Development Initiatives Fund.**
- **Support SB 65 (revisions to the venture capital bill). There are no incremental costs associated with passage of this bill.**
- **Support entrepreneurship in Kansas.**

State Appropriations

KTEC Funding FY99 - FY04



25% reduction from FY99 to FY04

KTEC Voluntary FTE Reductions

Early FY03 – 19

Current FY03 – 15 (3 vacant)

KTEC Salary & Wage Cuts

FY03 - \$132,530

Equal to:

13.5% of total salaries & wages

7.8% of operations

FY04 - \$195,215

Equal to:

19.2% of total salaries & wages

11.6% of operations

37

FY03 Cut

Base (new appropriations only)	\$11,596,888	
Allocated Reduction	\$ 231,938	2.0%
Additional Salary & Wage Cut	\$ 132,530	1.1%
	<hr/>	
	\$11,232,420	3.1%

FY04 Recommended Cut

Base	\$11,382,000	
Allocated Reduction	\$ 582,597	5.1%
Additional Salary & Wage Cut	\$ 195,215	1.7%
	<hr/>	
	\$10,604,188	6.8%

KTEC Holdings Inc.

- **Source of funds is returns on KTEC investments.**
- **The policy of the KTEC Board and the intent of the fund is to provide follow-on seed capital to companies KTEC has previously assisted.**
- **KTEC's ability to provide this capital improves the success rate of its early-stage programs.**
- **The fund generates its own revenues for reinvestment.**
- **FY04 budget recommendations call for KTEC Holdings to be used to support cuts in the EDIF.**

QUESTIONS

K T E C

Kansas Technology Enterprise Corporation

Tracy B. Taylor, President & CEO