

NVCA SSBCI WORKING GROUP RECOMMENDATIONS FOR SSBCI 2.0 IMPLEMENTATION

NVCA is convening member funds that are interested in the State Small Business Credit Initiative (SSBCI) for a working group to identify best practices and challenges facing state equity programs and to facilitate communication between the industry and policymakers and provide education for our members. Below is a list of issues that this working group has identified as priorities to address in designing effective equity programs. We share the goal of expanding access to economic opportunity through innovation and look forward to working together to maximize the impact of SSBCI on accomplishing this objective.

Background on Venture Capital

VCs generally provide minority equity investment into young companies that are often technology focused. Venture capital is critical to the commercialization and scaling of new technological concepts because this model depends on long-term equity investment. In the VC model, in return for minority ownership stakes capital is provided to young companies that can be used for research and development (R&D), hiring, and other company scaling activities with no expectation of short-term returns or debt payments.

The use of equity investment means that VC funds take more significant downside risk (if the company fails, VCs lose their money) and are aligned with the long-term success of the company as the economic incentive for participation is long-term capital gains, as opposed to fees or bonuses. A recent [survey](#) of VC-backed companies highlighted the power of VC investment. The survey found that four out of five respondents spent at least 70 percent of their budgets on two activities: wages and compensation and R&D.

This model fuels the growth of the most innovative companies in the world. The survey also found that over half of VC-backed companies spent more than 30 percent of their budgets on R&D. Looking to a public company comparison, the most innovative companies in the Fortune Global 500 spent 26 percent of revenues on research. And about one in six VC-backed companies spend an astounding 80 percent or more of their budgets on R&D.

Technology-focused entrepreneurial activity is particularly important to creating economic opportunity for American workers. A recent report from the University of North Carolina's Kenan Institute of Private Enterprise found that total high-technology employment in the U.S. grew by around 20 percent from 2007-2016, and that these jobs both paid higher median wages and were created faster coming out of the financial crisis than non-high-technology jobs in states across the U.S. This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through technological progress and long-term investment.

Issues for Treasury Policy Guidelines:

We recommend that Treasury include proposals to address these issues in the regulatory process:

Create 90-day safe harbor post first close to count matching dollars.

- The contemporaneous close requirements in SSBCI 1.0 made financing rounds with SSBCI dollars more complex and expensive. Treasury could provide a 90-day safe harbor from the date of an SSBCI investment to close a financing round and count matching dollars for funds raised

from non-federal sources to count as matching funds. Companies can provide a certification that the funds were secured within the permitted timeframe.

Allow eligibility to continue for businesses led by socially or economically disadvantaged individuals (SEDI) whose share of ownership falls under 50%.

- Ownership percentages held by founders of VC-backed companies often fall to less than 50% as the company grows and scales due to financings and employee incentives. Requiring that majority ownership be retained by SEDI founded enterprises will disadvantage those enterprises from securing the equity capital needed to scale. It is not a restriction being imposed upon non-SEDI founded enterprises and will trigger an unintended consequence of limiting the growth of those enterprises. SSBCI should allow the ownership percentages of SEDI-led enterprises to fall below 50% in order to avoid an unintentional barrier to capital formation.

Treasury could clarify that for SEDI companies receiving investment from an equity program, the ownership threshold can fall after initial financing. Companies should be deemed SEDI owned if the company founders were the majority owners of the enterprise when formed, such date to be the date of the secured EIN, and at the time application for SSBCI funds is made. Alternative metrics or some sort of pro rata formula could be used for judging whether a startup continues to be eligible.

Allow broader utilization of SSBCI technical assistance resources.

- Utilize technical assistance resources to support fund managers who desire accessing SSBCI capital resources with a particular focus on managers who have a focus on providing capital to firms led by socially disadvantaged Americans.

Treasury could use some of their limited discretionary resources for TA for small funds. Treasury could also ask states to provide a plan for technical assistance to support emerging fund managers and SEDI-led VC funds.

Match market standard for management fees.

- Smaller funds get particularly squeezed by lack of management fees, with many going years without salary to build their businesses. SSBCI 1.0 offered below market management fees. A sliding scale based upon fund size with terms closer to current commercial practices would make the program more accessible. This could include 2% annual fees for funds over \$50 million in assets under management (AUM), and 2.5% for funds with less than \$50 million AUM, with fees beginning to decline after five years. Treasury could also match current market practices by requiring that fees be repaid before funds can access carried interest.

Treasury could request that states provide a plan for the use of funds to support fees for smaller and emerging funds or allow higher fees as the outset of the fund if there's a pledge to pay back fees in order to access carried interest.

Standardize and clearly define reporting requirements and conflict of interest practices, and other disclosures.

- With the knowledge gained from SSBCI 1.0, Treasury can more clearly define reporting and conflict of interest requirements, ideally matching to the extent possible current commercial practices.

Ensure in the policy guidelines that the use of funds is explicitly for SEDIs in a manner that avoids the need for states to conduct any disparity study.

Issues for Treasury FAQ's:

We recommend that Treasury include FAQs to provide clarity on these issues:

Allow VC and debt tranches to be replenished based upon the circumstances of each program.

- Because debt and equity financing function differently, allowing states to replenish either program regardless of the status of the other program, or to let states transfer funds between programs, will provide flexibility and help the program more efficiently allocate capital in a timely fashion.

Treasury can clarify that states have the flexibility to lend between programs to remove any uncertainty through an FAQ.

Match market standard for management fees.

- Treasury could release an FAQ to give states confidence in using state funds to address the issue of below market fees for equity managers.

Encourage regional and multi-state partnerships.

- Often, regional startup ecosystems are based upon the geography of a city, as opposed to state lines. For instance, startup participants in the Kansas City region may be in Missouri or Kansas but are all part of the same regional ecosystem. Encouraging regional and multi-state partnerships will allow greater collaboration across a region that can drive better outcomes.

Treasury could provide an FAQ to help states understand Treasury's position as they create their own plans. This could include highlighting that states are allowed to invest a small percentage of capital outside of their state to benefit the local ecosystem.

Clarify that commitments to third party funds be considered deployed capital.

- A commitment to a third-party managed fund should meet the definition of funds obligated or transferred. Treasury could provide an FAQ clarifying this.