

NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

COMMERCE AND LABOR COMMITTEE SUBCOMMITTEE ON VENTURE CAPITAL

Friday, August 18, 2000
Red River Room, State Capitol
Bismarck, North Dakota

Representative Eliot Glassheim, Chairman, called the meeting to order at 12:30 p.m.

Members present: Representatives Eliot Glassheim, George J. Keiser, Dale C. Severson; Senators Tony Grindberg, Deb Mathern

Others present: Marcia Harris, North Dakota Public Radio, Bismarck

Joy Johnston, Greater North Dakota Association, Bismarck

Dean Reese, North Dakota Development Fund, Bismarck

Kevin Cramer, Randy Schwartz; Department of Economic Development and Finance, Bismarck

Syver Vinje, Securities Commissioner, Bismarck

Neal Whittey, LAS International, Bismarck

Chairman Glassheim said the purpose of the Commerce and Labor Committee Subcommittee on Venture Capital is to address the need for venture capital in North Dakota, focusing on joint private and public responsibility.

Chairman Glassheim called on Mr. Syver Vinje, Securities Commissioner, for comments regarding what other states are doing in the area of venture capital and federal regulations that may impact any state venture capital fund formed. Mr. Vinje said his office is researching what other states are doing regarding the creation of venture capital funds; however, at this time the research is not complete and he is not in a position to provide detailed information regarding this matter. He said an additional concern in creating a state venture capital fund is to avoid conflicts with federal security law. He said he will be attending the annual United States Securities and Exchange Commission convention being held September 10-12, 2000, and will use this opportunity to learn more regarding federal restrictions.

In response to a question from Representative Keiser, Mr. Vinje said areas of possible federal conflicts include the federal mandate for daily valuation of shares and restrictions regarding the number of people able to be approached for potential investment. He said the Securities and Exchange Commission is cognizant of the needs small businesses have for venture capital. Some problems smaller businesses have in daily valuation, he said, occur if shares are not broadly traded.

Mr. Vinje said if full and fair disclosure is provided, there is likely a significant number of North Dakotans who would be willing to invest in a state venture capital fund. He said the minimum investment amount may range from \$5,000 to \$25,000, and could possibly be even less. A way to encourage people to invest, he said, may be to offer a tax incentive in the form of a tax credit.

Representative Keiser said North Dakota investors want to earn money from their investments and there is an expectation of at least a marginal profit return.

Representative Keiser said there is a need for a new product, something that has not already been tried, and the state needs to be aggressive. He said the state may have to be a partner in somehow sharing the possible risk of loss.

In response to a question from Senator Mathern, Mr. Vinje said although formal records have not been kept regarding the number of requests for venture capital, he perceives a big need. He said the Capitol for a Day program has exposed him to a variety of people in need of venture capital. He said one role the state may be able to play in a state venture capital fund is to market the venture capital product.

Chairman Glassheim called on Mr. Neal Whittey, LAS International, Bismarck, for comments regarding a state venture capital fund. He said the Securities and Exchange Commission and the Small Business Administration realize there is a large, growing need for venture capital and seed money. In North Dakota, he said, his personal experience is that nearly all businesses can benefit from capital; however, some businesses may need assistance and education regarding how to appropriately use this money. He said it may be necessary to educate people regarding venture capital and for the state to participate in marketing the investment concept. He said Missouri has helped to educate its residents in part through publishing the *MISSOURI SCOR MARKET MAKER - News for Investors in Young Missouri Companies*. Mr. Whittey provided a copy of the Fall 1999 Missouri document, a copy of which is on file in the Legislative Council office.

Mr. Vinje said one concern he has regarding his office helping businesses with contacting potential investors is that he wants to be careful they do not

violate federal securities laws regarding offer of sale issues. He said in order to avoid problems with federal regulations, it may be necessary for the state to receive a Securities and Exchange Commission "no action letter" in order to ensure a business is not jeopardized.

Mr. Whittey said the minimum requirements for a fund may require \$5 million to begin marketing and \$10 million to actually begin funding projects. He said a fund in this amount would require the use of principal for investment.

He said in evaluating the minimum properties of a state venture capital fund, although a \$50 million fund would be good, this amount is not necessarily required for the fund to get off the ground. He said it may be possible for a fund to begin with \$10 million.

In response to a question from Representative Glassheim, Mr. Whittey said in order to be successful he thinks a state venture capital fund should be a blend of private and public resources.

Mr. Vinje said one issue to consider is whether individuals selling the investment product will require Series 7 registration and whether private brokers and dealers will be selling the product.

In response to a question from Representative Glassheim, Mr. Whittey said some federal agencies have programs that allow for matching federal funds for venture capital.

In response to a question from Representative Glassheim regarding the possibility of having North Dakota roundtables under which several businesses are given the opportunity to make an investment pitch and the top businesses are provided venture capital from investors, Mr. Whittey said if a North Dakota venture capital fund actively networked, the fund could solicit participation by other venture capital funds across the country.

In response to a question from Representative Keiser, Mr. Whittey said requests for venture capital in North Dakota range from large businesses seeking large investments to small businesses seeking small investments. However, he said, even the larger businesses are having problems getting investors unless the business is a dot-com business.

Mr. Vinje said there are at least two tiers of needs for venture capital in North Dakota, and this may result in requiring two or more strategies for improving venture capital throughout the state.

Representative Keiser said he thinks North Dakota is primarily in need of venture capital investment of the smaller variety such as \$50,000 venture capital projects. He said a North Dakota venture capital fund may be unable to help with the \$3 million to \$5 million projects.

Mr. Whittey said one problem with the North Dakota future fund was its cap at \$300,000. He said if a venture capital fund is going to work in North Dakota, the fund will need to be benevolent and therefore unlike true venture capital funds. He said

venture capital funds traditionally need huge rates of return and in five to seven years expect to sell off or bring the business to public offering. He said North Dakota needs a hybrid venture capital program that would accomplish benevolent goals and make reasonable returns. A benevolent venture capital fund in North Dakota, he said, would also need to teach less sophisticated businesses how to prepare for future business growth.

In response to a question from Representative Keiser, Mr. Whittey said a North Dakota venture capital fund may differ from a traditional venture capital fund and it may treat small businesses differently from large businesses.

Chairman Glassheim called on Mr. Randy Schwartz, Deputy Director, Department of Economic Development and Finance, for comments regarding a state venture capital fund. Mr. Schwartz said some of the same issues the committee is discussing were addressed when the Commerce and Labor Committee met in Dickinson. He said not only does North Dakota lack capital investment, but it lacks the necessary education to prepare businesses to seek venture capital. He said North Dakota businesses need assistance in developing management skills. He said some of the groundwork within the state has been laid, i.e., the North Dakota Development Fund, however, the fund has not been provided the necessary resources.

Chairman Glassheim called on Mr. Kevin Cramer, Director, Department of Economic Development and Finance, for comments regarding a state venture capital fund. Mr. Cramer said in order for the North Dakota Development Fund to continue providing funding at its current rate until the year 2003, the fund will require \$5.5 million in funding. He said he does not think the state should take equity positions in businesses because businesses typically do not think government should make money on the business growing. He said in addition to or instead of creating a state venture capital fund, the state could provide state tax credits to encourage venture capital investment.

Mr. Cramer said based upon interviews of 180 manufacturers within the state, 80 of these manufacturers plan on making capital improvements.

Chairman Glassheim called on Ms. Joy Johnston, Greater North Dakota Association, for comments regarding state venture capital funds. Ms. Johnston said although the partnership in assisting community expansion (PACE) buydown program has been a successful project, the program has run out of funding. She said some manufacturers have sought PACE money, however, were not eligible because instead of creating jobs, the manufacturers were improving existing jobs.

Ms. Johnston asked if the state venture capital fund would specify how investors could sell out and when the investors could sell out.

Mr. Vinje said the investment product would need to be a marketable security; however, it is possible the security may not be worth the initial investment at the time of sale. He said it would be necessary for the fund to have an ongoing funding source of investors so that all the individual investments would not expire at once.

Ms. Johnston asked what would happen under the state's venture capital fund if an investor died. Specifically, she asked whether there would be a secondary market for the investor's interest.

Mr. Schwartz said there are three issues in business development in North Dakota:

1. Nurturing innovation and entrepreneurs;
2. Existing businesses and expansions; and
3. Attracting and recruiting new businesses.

Representative Keiser said if the state creates a benevolent venture capital fund, the state should incorporate some of the successful elements of the PACE program, such as local control.

Representative Keiser expressed his concern that existing businesses are using state funds even though those businesses might be eligible for traditional, nonstate funding.

Mr. Vinje said differences between venture capital investment and PACE funds include the state taking an equity position versus a debt position. He said businesses are unlikely to give the state an equity position unless the funding is unavailable through another source. Additionally, he said, although the committee may want to consider additional statutory limitations on who may be eligible to receive venture capital funding, venture capital funding is beneficial to existing businesses in addition to new business.

Representative Glassheim said the state might want to help provide venture capital through providing staffing, due diligence, and marketing services, without actually paying money into the fund. Mr. Whittey said he recommends the state keep the actual state appropriation to the fund to a low amount.

Representative Keiser said the state should provide money to the fund which could be used to mitigate the risk of investors; otherwise, investors are not going to invest in a state venture capital fund with benevolent purposes.

Representative Glassheim suggested mitigating the risk of investors by providing a state tax credit. Representative Keiser said one limitation to this is that we are only allowed to provide a state tax credit, and this does not affect the amount of the federal taxes.

Representative Glassheim said it might be possible to mitigate the risk of investors by providing a bottom-line tax deduction. Representative Keiser said the fiscal note on providing such a bottom-line tax deduction would result in the bill being killed.

Representative Keiser raised the issue of whether the state should provide tax relief to venture capital investors if the investment is successful.

Mr. Whittey said the committee might want to consider mitigating the investment risk by providing a hybrid approach of including a state tax credit that is available if the fund loses money.

Mr. Vinje said there are a variety of benefits related to providing venture capital investment, including increasing the number of jobs created, creating new wealth, increasing the taxes paid by businesses, and increasing sales taxes. Additionally, he said, a refundable tax credit would be successful in attracting investors. Mr. Vinje said he is a proponent of the refundable tax credit and he thinks there will be more revenue generated than revenue lost through this approach.

Mr. Cramer said in looking at the state's track record in improving economic development, Technology Transfer, Inc., failed in part because recipients of the funding were on the board. In contrast, he said, the North Dakota Development Fund is successful in part because he is the only state official on the board. He said in order to be successful, an economic development tool such as a venture capital fund needs to be private-sector driven.

Representative Keiser said another reason for economic development failures in the past is because some attempts have been too benevolent and high risk. He said in order for a new program to work, there needs to be some method of mitigating risk.

Chairman Glassheim called on Senator Grindberg who joined the committee discussion via teleconference. Senator Grindberg said he had recently attended the Council of State Governments annual meeting, which spent a great deal of time addressing economic development and work force development. A copy of Senator Grindberg's proposal for a state venture capital fund was provided to the committee members, a copy of which is on file in the Legislative Council office. Senator Grindberg's proposal provides for a public/private partnership for state investment, with a \$50 million revolving fund established by the year 2005. Under this proposed plan, the fund would invest in professional, privately managed seed and venture capital partnerships that meet specific standards.

Senator Grindberg discussed pending federal legislation that would provide a federal tax credit for certain venture capital investments. He said he would report back to the committee as developments arise.

Senator Grindberg said that under his proposed plan there would be private sector management of the fund with public oversight.

Mr. Schwartz questions how many investment projects a venture capital fund could undertake if a member of the management team played the traditional role of serving on the board of the company receiving investment funds.

Mr. Whittey said ideally a North Dakota venture capital fund would include a blend of traditional and benevolent. He said one possibility is to offer a

privately operated fund with resources used to secure venture capital professionals to do due diligence.

In response to a question from Representative Glassheim regarding target industries, Mr. Schwartz said generally a targeted approach is better if it is disciplined enough to actually follow through. He said it is important to be careful not to be too narrow because it may have the result of being too exclusive.

Senator Grindberg said he supports the target approach. He said a target approach is one small step in implementing a venture capital fund in the state.

Mr. Schwartz said the committee may want to consider focusing on certain industries for purposes of a venture capital fund.

Mr. Schwartz said if there were a target approach to high tech, high tech cuts across all industries.

Mr. Whittey said a fundamental marketing issue for a venture capital fund is whether North Dakota has the ability to draw high-tech businesses. He said there is not much drawing high-tech businesses to North Dakota so the committee will want to be careful not to be too exclusive in limiting who is eligible for venture capital funds.

Senator Mathern said she supports a partial target approach.

Mr. Vinje said the venture capital needs within the state include large and small businesses, and the demand for venture capital includes value-added agriculture and agriculture manufacturing. Mr. Schwartz said value-added agriculture and agriculture manufacturing are both declining industries within the state.

Chairman Glassheim called on Mr. Dean Reese, Director, North Dakota Development Fund, for comments regarding a state venture capital fund. Mr. Reese said the North Dakota Development Fund has recently been taking preferred stock in North Dakota companies. He said it might be helpful to provide for a benevolent exit strategy that would not require the business to leave the state or make a public offering. Additionally, he said, the North Dakota Development Fund may be well suited for smaller offerings.

Senator Grindberg said one thing missing with the services provided the North Dakota Development Fund is seed capital and venture capital.

Mr. Vinje said the former Myron G. Nelson Fund has been successful in returning investment moneys to investors; however, it has not been successful in returning the money to the state.

Senator Grindberg said although the former Myron G. Nelson Fund has not been successful in returning money to the state, North Dakota investors who receive a return on their investments are likely to reinvest in the state.

Mr. Reese said under the former Myron G. Nelson Fund, North Dakota industries were not directly benefited.

In response to a question from Representative Glassheim regarding the need for venture capital in the state, Senator Grindberg said he has a hunch there is the need for venture capital in this state but research from the University of North Dakota and North Dakota State University is leaving the state.

Mr. Vinje said he will perform additional research on how to guarantee investors' money, including whether it is appropriate to use tax credits.

Representative Keiser said ultimately the state wants a healthy, thriving business environment.

Representative Severson said he would like to see the Department of Economic Development and Finance run some models of the impact of providing venture capital to businesses within this state.

Representative Keiser said the committee needs to be careful to do something different from what the state has done in the past. He said they need to be careful not to blindly copy what other states are doing because North Dakota is unique.

It was moved by Representative Keiser, seconded by Senator Mathern, and carried on a voice vote that the Legislative Council staff be requested to prepare a venture capital bill draft that is based on the Ohio bill and which attempts to incorporate some of the subcommittee's ideas.

Representative Glassheim suggested the committee meet one more time before the Commerce and Labor Committee meets on September 11, 2000. He said he would request permission from the Legislative Council chairman, Senator Gary J. Nelson, for an additional meeting. He proposed that, if approved, the committee would meet in Fargo.

No further business remaining, Chairman Glassheim adjourned the meeting at 4:10 p.m.

Jennifer S. N. Clark
Committee Counsel