

Regulatory Analysis for 870-
RICR-30-00-8

Rules and Regulations for the Rhode
Island Small Business Development
Fund

RHODE ISLAND COMMERCE CORPORATION
January 2020

Executive Summary

The Commerce Corporation (Corporation) proposes to adopt regulations regarding the implementation of the Small Business Development Fund Act (Act), RIGL 42-64.33.

In accordance with the Administrative Procedures Act (APA), RIGL 42-35-2.9, the Corporation has conducted a regulatory analysis for the proposed regulation. The Corporation used the best available information at the time of publication to estimate the benefits and costs of the proposed regulatory provisions. This analysis does not attempt to generate benefit and cost estimates solely attributable to the passage of the Act. The following analysis examines the costs and benefits of the discretionary decisions made by the Corporation.

As part of this analysis, the Corporation calculated a net benefit number per year, as seen in the table on page 12. The anticipated costs and benefits over seven years is a quantifiable net benefit in the range of \$4,940,005 - \$28,081,292. Commerce Corporation then applied a discount rate, which yielded a net present value of \$3,765,649 - \$21,416,039 (7% discount rate).

More information detailing the quantifiable and non-quantifiable costs and benefits can be found at the end of this analysis.

Regulatory Development

In 2019, the Act authorized the Corporation to promulgate regulations to carry out the intent and purpose and to implement the responsibilities under the Act. The Act authorizes a tax credit program that provides a 64.5% tax credit for investors in niche investment funds, known as small business development funds. These funds make investments into small businesses (businesses with up to 250 employees and up to \$15 million in net income). These investments are expected to create or retain jobs and result in a positive economic impact to the state. The Act authorizes the Corporation to certify up to \$65 million in capital investments under the Act, which would yield \$42 million in tax credits to the investors in the funds.

In constructing the regulation, the Corporation considered a range of alternatives, including existing Rhode Island regulations and policies of similar subject matter, departmental experience, and industry best practice.

Analysis of Regulatory Impact

The Corporation drafted the regulation to carry out the tax credit program authorized by the Act, including safeguards to ensure the diligent investment of the State's funds. The regulation incorporates elements intended to reduce risk to taxpayer dollars and ensure that any applicant certified under the Act is capable of successfully executing its obligations under the Act, achieving the predicted results and performing as certified by the Corporation. The Corporation addressed the

following three areas through the regulation: (1) eligibility and application requirements, (2) program exit and reduction of tax credit allocation, and (3) reporting requirements.

Pursuant to the APA, RIGL 42-35-2.9(b)(1), the regulatory analysis must include “an analysis of the benefits and costs of a reasonable range of regulatory alternatives reflecting the scope of discretion provided by the statute authorizing the proposed rule.” In the development of the proposed regulation, consideration was given to: (1) alternative approaches; (2) overlap or duplication with other statutory and regulatory provisions; and (3) significant economic impact on small business. Using information pertaining to the performance of similar programs across the United States, including audits and program reports, the Corporation has completed a quantitative and qualitative analysis that represents the costs and benefits of the regulation.

In preparing this analysis it is assumed that there will likely be three applicants to the program. This assumption is based on the experience of other states with similar tax credit programs. Additionally, the staff cost used in this analysis is based on the mean hourly wage for management occupations as of May 2018 (BLS SOC Occupation Code 11-0000) of \$24.98, rounded up to \$25.00. The analysis quantifies the impact of the regulation over seven years as it is expected most applicants will exit the program in seven year.

I. Eligibility and Application Requirements

A. Business Plan

Sections 8.6 Eligibility and 8.7 Application of the proposed regulation establish the programs application and eligibility requirements. These sections of the regulation clarify the required components of the applicant’s business plan.

1) Applicant Background Information

As a component of the business plan, applicants are asked to submit information detailing the fund’s proposed management team, staffing, and investors. This includes a requirement that a Certification form be signed by the applicant and each investor. It is estimated there will be between 8 and 12 investors per applicant.

Costs: It is expected that it will take 5 hours per applicant to prepare the applicant background materials at a staff cost of \$25 per hour. The total cost of compliance is estimated at \$375 for three applicants participating in the program.

Benefits: Specifying the applicant background information required of an applicant in the regulation reduces the risk of receiving inadequate or incomplete information and will assist in ensuring the Applicant is capable of successfully executing its obligations and achieving the results it predicts. Requiring applicants to provide a specific list of information in the application ensures the information will be standardized, enabling the Corporation to verify that complete information has been provided by each application during the review process.

Alternative: Alternative forms of background information were considered, including requesting applicant resumes. It is assumed a required submission of resumes would take an equal number of hours to collect and compile and this alternative would not reduce the cost to participate to applicants. Requesting the information as applicant background in the application through the regulation was determined to be the preferred alternative as this method provides the benefit of ensuring applicants submit streamlined application materials.

2) Credible Narrative

The regulation requires applicants include a credible narrative in their business plan, including a plan to make and maintain qualified investments during the applicant's participation in the program. This narrative incorporates the Applicant's planned capital deployment strategy, strategy for identifying and meeting unmet access to capital needs in the state, and job creation and retention projections. The credible narrative section of the regulation also clarifies the standards for the information required in a complete revenue impact assessment and the standards for a nationally recognized firm required to produce the revenue impact assessment.

Costs: It is expected that it will take 8 hours per applicant to prepare the credible narrative at a staff cost of \$25 per hour. The estimated cost of compliance is estimated at \$600 for three applicants participating in the program.

Benefits: This component of the regulation ensures the applicant's business plan, which is an application requirement established under the Act, provides complete information to the Corporation. The regulations provide for a standardized format for the Applicant to provide its plans for participation in the program that can be independently verified by the Corporation. This regulation reduces the risk of receiving inadequate or incomplete information by an applicant. Additionally, the revenue impact assessment requirements in the regulations (i) provide Applicants clarity on the form the revenue impact assessment should take so that it can be reviewed by the Corporation to assess whether the revenue impact assessment, based on the business plan, is accurate, credible and will result in a positive economic return to the state as required by the Act and (ii) clarifies the ambiguity in the Act regarding the information to be included in a completed application and the revenue impact assessment such that the program can be administered the Corporation. Further, the Act requires the Corporation use this portion of the application as a basis for certification, particularly as it relates to determining whether the business plan will result in a positive economic return to the state.

Alternatives: One alternative considered was to require the applicant demonstrate how its business plan would result in a positive economic return to the state without providing detailed guidance. This alternative may have

slightly reduced an applicant's upfront cost; however, this alternative would have increased the risk that the Corporation would have required additional information to verify that the applicant would perform as proposed in the revenue impact assessment, leading to delays in certification and increased costs to applicants.

3) Letter of Support

The regulation includes a provision that allows applicants to submit one or more letters of support from a governmental unit or political subdivision that administered a similar tax credit program in which the applicant or an affiliate has participated.

Costs: This is an optional application component. It is expected that if an applicant were to solicit, receive, and incorporate a letter of support into the application that it would take approximately 1.5 hours per applicant to complete this task at a staff cost of \$25 per hour. The estimated cost of compliance is estimated at \$113 for three applicants participating in the program.

Benefits: Providing a letter of support would provide an independent indication that the Applicant had the capability and track record to successfully execute its obligations and achieve the results it predicts under the program.

Alternative: This is an optional application component. The applicants are not obligated or required to submit this item. The alternative is to not include this as a potential inclusion in the business plan. This alternative reduces the potential costs to the applicant but would remove the benefit of providing the option to include one or more letters of support to verify the applicant's successful participation in similar programs.

4) Pending Litigation Documents

The regulation requires the applicant disclose relevant pending litigation. This regulation will be implemented in the form of a yes/no question on the application form. If the applicant does have litigation to disclose, the application requests the applicant provide a list of all pending litigation in which the applicant, affiliate, principal, manager, officer, or employee is a party and a list of all litigation in which a judgment entered against applicant, affiliate, principal, manager, officer, or employee. This regulation specifically seeks to identify whether principal, managers, officers, or employees of the Applicant have been involved in litigation involving their fiduciary responsibilities.

Costs: It is expected this component of the regulation would take staff approximately 1 hour to complete at a cost of \$25 per hour if there is no litigation to disclose. If there is information that requires disclosure, it is expected this would take staff approximately 3 hours to complete at a cost of \$25 per hour. The estimated cost of compliance is estimated in the range of \$75 to \$225 for three applicants participating in the program.

Benefits: This component of the regulations is used to evaluate whether the applicant is capable of successfully executing its obligations and achieving the results it predicts as well as to inform the Corporation as to potential issues in regard to the reliability, accuracy and validity of the application materials or the veracity of the individuals responsible for making and managing investments involving a significant public subsidy.

Alternative: There is not a known alternative method of receiving this information, however alternatives to this regulation were considered including limiting the scope of the disclosure to the applicant as an entity. It is assumed this alternative would take slightly less time than the selected option; however, the benefit to requesting broader disclosure ensures the applicant the applicant is capable of successfully executing its obligations and achieving the results it predicts.

5) Bonding Requirement

In the proposed regulation, the Applicant must file a bond, or similar surety approved by the Corporation's Board of Directors.

Costs: A surety of this nature would likely cost between approximately 0.5% and 2.5% per year of the tax credits certified by the Corporation, up to \$12.9 million, where \$12.9 million is the maximum amount of tax credits a single applicant is eligible for under the Act. The cost of compliance of this provision depends on the financial risk of the applicant and its business. It is estimated to be in the range of \$193,500 to \$967,500 per year for three applicants participating in the program. This range represents a high end of costs for the bond requirement. The alternative to the bond requirement provided for in the final rule provides an opportunity for the costs to be reduced.

Benefits: This bonding requirement, in conjunction with the regulatory components on the reduction of tax credit allocation and reporting, ensure that if an applicant does not perform as planned in their application, the cost of the tax credits can be reduced, ensuring the taxpayer dollars at stake are protected. The bond or other surety reduces the risk to the state of issuing tax credits if the actual return to the state as a result of job creation, retention, or other economic performance promised by the applicant does not materialize to the extent projected by an applicant. The total amount of capital investments that can be certified under the program is \$65 million; each individual applicant can be certified for up to \$20 million in capital investments. Applicants would receive 64.5% of the certified capital investment amount in the form of tax credits. These tax credits are vested at the time of initial capital investment in the fund at year 1 of an applicant's participation in the program and paid out in years four through six of an applicant's participation in the program. As the tax credit is vested prior to the applicant's activity in the program and before any positive economic impact can be verified, the tax credits may be issued to an applicant that fails to perform as certified. The total amount of tax credits eligible for distribution under the program is \$42 million. This provision reduces the risk that the state would lose up to \$42 million in taxpayer dollars in years four through six

of the program, should an applicant fail to perform as certified.

A review of programs with similar structures and audits and other reporting on similar programs, demonstrates that while these investment tax credit programs have evolved over their 25 years existence, there is significant risk of failing to produce the full economic impacts projected in an applicant's revenue impact assessment. Audits from programs in Alabama, Missouri, and Washington DC found that the programs did not create jobs or generate state revenues as projected. Regulators in Colorado and New York found similar issues with validating the job creation performance of similar tax credit programs. In Missouri, the auditors found that the program claimed \$140 million in tax credits and generated only \$23.6 million in projected revenues. Only 17% of the value of tax credits issues was returned in revenue generated to the state of Missouri. In Washington DC, auditors found that the program cost \$76 million and created 31 new jobs. In New York, the program lacked adequate oversight and controls, and regulators could not fully verify investments or job creation data. Using the best available information, New York regulators calculated that the state's investment of \$325 million in tax credits yielded only 188 new jobs. The quantifiable risk reduction of this component of the regulation is conservatively estimated at 15-20% or \$6.3 - 8.4 million over the lifetime of the program, calculated as a percentage of the total value of the available tax credits. If similar performance experienced in Missouri occurred in Rhode Island's program, the reduced risk is approximately 83% or \$34,860,000.

Alternatives: In lieu of a bond or other surety as approved by the Corporation board, the alternatives considered included requiring a personal guarantee by the applicant for the value of the tax credits the applicant is eligible to receive under the program. This option would offer similar benefits as the selected option, however the costs of this option could be significant to the applicant as it would require the applicant demonstrate that it holds assets equal to the value of the tax credits (up to \$12.9 million each) and those assets would be available should the applicant fail to perform as certified.

6) Certificate and Letter of Good Standing

Under the proposed regulation, Applicants must include a Certificate of Good Standing dated within thirty days of the date of submission of the Application to the Corporation as well as a Letter of Good Standing for the Applicant and each Small Business Fund Investor seeking an allocation of tax credits dated within thirty days of the date of submission of the Application to the Corporation

Costs: It is expected that it would take approximately 0.25 hours to complete this task at a staff rate of \$25 per hour. The estimated cost of compliance with this component of the regulation is estimated at \$20 for three applicants participating in the program.

Benefits: This component of the regulation ensures that applicants verify they are in good standing with the state of Rhode Island. As the applicant is

applying to participate in a government program and receive tax credits, the Corporation must verify that an applicant is in good standing with the State. This regulation is the most efficient way to verify an applicant's status.

Alternative: An affidavit or notarized statement could serve as an alternative form of verification in lieu of a certificate and letter of good standing. An affidavit or notarized statement would require independent verification by the Corporation, reducing the benefit of the proposed regulation.

7) Evidence of Investment in Nonpublic Companies

The Applicant or Affiliates are required by the Act to have invested at least one hundred million dollars (\$100,000,000) in Nonpublic Companies. In order to ensure that applicants or affiliates meet this statutory requirement, the Corporation included in the regulation a list of evidence demonstrating investment history including the audited financial statements for the applicant and for each affiliate for the past ten years.

Costs: It is expected that it would take approximately 3 hours to complete this task at a staff rate of \$25 per hour. The estimated cost of compliance for this component of the regulation is estimated at \$225 for three applicants participating in the program.

Benefits: This component of the regulations ensures that the applicant investment track record, as required by the Act, can be verified in such a way as to indicate that the applicant is capable of successfully executing its obligations and achieving the results it predicts, by requiring verification that the applicants meet the statutorily required investment threshold. As this regulation provides a standardized list of evidence, all applicants will submit the same information, allowing the Corporation to independently verify the information submitted by applicants.

Alternative: Alternative evidence of investment would be to require evidence of each individual loan made to the \$100,000,000 threshold, such as a term sheet and executed loan agreement for each individual loan. This alternative would have a significantly higher cost to the applicants but would not realize any greater benefit than the selected alternative. A second alternative considered was accepting an affidavit from each applicant and affiliate certifying their investment history. This second alternative could reduce the cost of this component of the regulation to the applicant. This second alternative would not provide the same level of benefit as the selected option, in that the selected option, inclusive of the audited financial statements, provides independent verification of the applicants' investment history.

8) Criminal Background Checks

Under the proposed, criminal background checks must be conducted for all executives and managers of the Applicant.

Costs: It is expected that it would take approximately 1 hours to complete

the task of requesting criminal background checks at a staff rate of \$25 per hour. The estimated cost of compliance for this component of the regulation is estimated at \$758 for three applicants participating in the program.

Benefits: This component of the regulations is used to evaluate whether the applicant is capable of successfully executing its obligations and achieving the results it predicts as well as to inform the Corporation as to potential issues in regard to the reliability, accuracy and validity of the application materials or the veracity of the individuals responsible for making and managing investments involving a significant public subsidy.

Alternative: An affidavit or notarized statement from the Applicant could be accepted in lieu of a criminal background check; however, this reduces the benefits associated with the selected alternative regulation.

9) Evidence of Compliance with 2020 Global Investment Performance Standards

Under the proposed regulation, Applicants must demonstrate compliance with the 2020 Global Investment Performance Standards (GIPS) published by the CFA Institute, except to the extent these standards conflict with the applicant's existing licensing. This demonstration of compliance would take the form of a brief narrative in the application describing how the applicant achieves ethical standards at the level contemplated by GIPS.

Costs: It is expected that writing a response to this component of the business plan would take approximately 1 hour at a staff cost of \$25 per hour. The estimated cost of compliance for this component of the regulation is estimated at \$75 for three applicants participating in the program.

Benefits: This requires the applicant describe the ways in which they comply with high ethical standards as an investment fund, in comparison to a globally-accepted standard. This reduces the risk that an applicant would not be able to successfully executing its obligations and achieving the results it predicts

Alternatives: A regulatory alternative to requiring a narrative demonstrating compliance with GIPS standards would be to require the applicant provide evidence of being GIPS verified by the CFA institute. This requirement would likely take a minimum investment of 20 to 25 hours of staff time and yield a similar benefit to the selected option.

II. Program Exit and Reduction of Tax Credit Allocation

The proposed regulation includes a reduction of tax credit allocation provision. This component of the regulation describes an enforcement mechanism that would allow the Corporation to offset the tax credit received by an investor if the applicant's investments fail to result in the positive economic impact outlined in the application materials submitted and under which the applicant has been certified. Failure to perform based on the plan approved by the Corporation will be enforced

against a bond or other surety that applicants are required to file as part of the certification process.

1) Reduction of Tax Credit Allocation

Costs: There is no direct cost to the application of this provision, if the applicant performs as certified. See section I.6 above regarding the costs and benefits of the bonding requirement.

Benefits: Assuming an applicant performs as certified, this provision would not be implemented. The benefit of this provision is that it provides a safety net, ensuring that if the applicant fails to perform as certified, the state would be able to recoup against its losses through a reduction of tax credit allocation.

Alternative: Alternative mechanisms for recouping the loss value of tax credits from applicants who fail to perform are discussed in section I.6 above.

III. Reporting Requirements

The regulations clarify the reporting requirements (section 8.18) to ensure that the regulated community can predictably and uniformly submit information to the Corporation that meets the reporting requirements under the Act (R.I. Gen. Laws 42-64.33-7) so that the corporation has adequate information to report on the program and to administer the tax credit recapture and exit provisions (R.I. Gen. Laws 42-64.33-5). The requirements under section 8.18 of the regulations are intended to ensure that the Corporation can administer the program and provide timely communication to the regulated community should the investments made under the program fail to meet the required parameters.

1) Investment and Qualified Loan Reporting

The proposed regulation requires the applicant report each Equity Investment and Qualified Loan made to the Corporation within thirty (30) business days after such investment is made, providing information on the investment including the date of the investment and amount of the investment

Costs: It is expected that it would take approximately 0.5 hours per applicant to complete this task at a staff rate of \$25 per hour. It is anticipated applicants would make between 8 and 12 loans once certified. The estimated cost of compliance is in the range of \$300-450 for three applicants' participation in the program over 3 years.

Benefits: The reporting requirements in this section of the regulation ensure applicants submit streamlined, clear information, providing Commerce with information required to administer provisions R.I. Gen Laws 42-64.33-5(a)(1) and (2) and (d). As Commerce requires this information to administer the program, this regulation provides a method for applicants to submit the information.

Alternative: An alternative to requiring applicants report each investment would be to require a Corporation staff regularly contact applicants to request

the submission of this information. This alternative would yield similar costs to the selected alternative; however, it would reduce the benefits of providing a clear method for reporting qualified investments.

2) Quarterly Reporting

The regulation also requires the Small Business Development Fund report to the Corporation during the term of each Equity Investment or Qualified Loan on a quarterly basis.

Costs: It is expected that it would take approximately 1 hour to complete this task at a staff rate of \$25 per hour. The estimated cost of compliance is \$300 per year for three applicants.

Benefits: This section of the regulation ensures applicants regularly report investment information to the corporation, reducing the risk of an applicant not complying with the Act. Reducing the risk of non-compliance through regular reporting is a cost-effective mechanism to receive regular, standardized information from the applicant.

Alternative: The alternative considered would be to regularly contact applicants to request the submission of this information, which would be significantly more time-consuming for the applicant and Corporation. It is estimated that responding to communications for data from the Corporation under this alternative would take approximately two hours per quarter at a staff rate of \$25 per hour. This estimated cost of compliance for three applicants per year would be approximately \$600.

Analysis

Quantifiable Costs and Benefits

The following charts outline the ranges of costs and benefits described in sections I-III above by item and over seven years participation in the program.

| | Range of Initial Costs to Comply (Low end) | Range for initial costs to comply (High end) | Renewal/ Ongoing Costs (low end) | Renewal/ Ongoing Costs (high end) |
|----------------------------------------------------------------------------|---------------------------------------------------|-----------------------------------------------------|-----------------------------------------|------------------------------------------|
| Eligibility and Application Requirements | | | | |
| Applicant Background Information | \$375 | \$375 | | |
| Credible Narrative | \$600 | \$600 | | |
| Letter of Support (optional) | \$0 | \$113 | | |
| Pending Litigation Requirements | \$75 | \$225 | | |
| Bonding Requirement | | | \$193,500 annually in years 1-7 | \$967,500 annually in years 1-7 |
| Certificate and Letter of Good Standing | \$20 | \$20 | | |
| Evidence of Investment in Nonpublic Companies | \$225 | \$225 | | |
| Criminal Background Checks | \$75 | \$75 | | |
| Compliance with 2020 Global Investment Performance Standards | \$75 | \$75 | | |
| Reporting Requirements | | | | |
| Equity Investment and Qualified Loan Reporting (full participation) | | | \$300 annually in years 1-7 | \$450 annually in years 1-7 |
| Quarterly Reporting | | | \$300 annually in years | \$300 annually in years |

| | | | | |
|--------------------------------------|--|--|-----------------------------------|------------------------------------|
| (annual) | | | 1-7 | 1-7 |
| Total for a Certified SBDFs | | | | |
| Recapture Risk and Mitigation | | | | |
| Recapture Risk Mitigation | | | \$2,100,000 annually in years 3-6 | \$11,620,000 annually in years 3-6 |

Summary of Costs and Benefits

| | <i>Year 0</i> | <i>Year 1</i> | <i>Year 2</i> | <i>Year 3</i> | <i>Year 4</i> | <i>Year 5</i> | <i>Year 6</i> | <i>Year 7</i> |
|-----------------------------------------------|-------------------|---------------------------|---------------------------|------------------------------|----------------------------|----------------------------|---------------------------|---------------------------|
| Costs | | | | | | | | |
| Eligibility and Applicant Requirements | (\$1,444-\$1,708) | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 | (\$193,500) -\$967,500 |
| Program Recapture and Exit | - | - | - | - | - | - | - | - |
| Reporting Requirements | - | (\$750) - (\$900) | (\$750) - (\$900) | (\$750) - (\$900) | (\$450) | (\$450) | (\$450) | (\$450) |
| Benefits | | | | | | | | |
| Recapture Risk Mitigation | - | - | - | \$2,100,000 -\$11,620,000 | \$2,100,000 - \$11,620,000 | \$2,100,000 - \$11,620,000 | - | - |
| Quantifiable Net Benefit | (\$1,444-\$1,708) | (\$194,250) -\$968,400 | (\$194,250) -\$968,400 | \$1,905,750 -\$10,652,050 | \$1,905,750 - \$10,652,050 | \$1,905,750 - \$10,652,050 | (\$193,950) -\$967,950 | (\$193,950) -\$967,950 |
| Range of Net-benefits over Seven Years | | | | | | | | \$4,940,005- |

| | |
|--|------------------|
| | \$28,081,2 92 |
|--|------------------|

(Quantifiable Costs and Benefits, continued)

As part of this analysis, Commerce Corporation calculated a net benefit number per year, as seen in the table above. The anticipated range of costs and benefits over seven years is \$4,940,005 - \$28,081,292. Commerce Corporation then applied a discount rate, which yielded a net present value of \$3,765,649 - \$21,416,039 (7% discount rate).

Non-Quantifiable Costs and Benefits

The proposed regulation provides non-quantifiable benefits as detailed in sections I-III above. These benefits include reducing the risks of receiving inadequate or incomplete information by applicants, helping ensure applicants are capable of successfully executing their obligations and achieving the results it predicts, and helping reduce the risk of applicants not complying with program requirements after certification.

Determination

The Corporation's analysis indicates that the proposed regulation generates quantifiable costs of \$1,359,919 - \$6,778,669 and quantifiable benefits of up to \$6,300,000 - \$34,860,000. This is limited in scope to the quantifiable costs and benefits and does not fully account for all relevant costs and benefits. The impacts of non-quantifiable costs and benefits are likely to drive the true net benefit of the regulatory options under consideration. This lack of data prevents the Corporation from predicting the full positive economic impacts of the regulation in a comprehensive way and with high confidence.