Enhanced Capital

February 18, 2020

Rhode Island Commerce Corporation
315 Iron Horse Way, Suite 101
Providence, RI 02908

Ladies and Gentlemen:

Enhanced Capital appreciates the opportunity to submit commentary regarding proposed rule 870-RICR-30-00-8, which provides draft rules and regulations for the Rhode Island Small Business Development Fund.

For more than 20 years, Enhanced Capital has proudly invested in small businesses and projects that make a positive difference in communities across the country. To date, Enhanced Capital has deployed over $3 billion of total financing across 600 projects and businesses in 38 states. Through our Small Business Investment Company (SBIC) Fund, a licensure issued by the U.S. Small Business Administration, we provide capital and support to small businesses across the country. Our Community Development Entity, certified by the Community Development Financial Institutions (CDFI) Fund, has received seven awards of federal New Markets Tax Credits, a highly competitive federal program designed to foster economic growth and support organizations located in or supporting low-income communities.

We share your enthusiasm for supporting Rhode Island's small business economy. We believe that the Rhode Island Small Business Fund will play a meaningful role in moving the state forward, and we are eager to start our work.

Please let this letter serve as our official comments on the draft regulations and the accompanying regulatory analysis. We have separated our comments into sections by issue or topic.

Background on Capital Formation Programs:

There have been a variety of comments comparing the Rhode Island Small Business Development Fund to legacy capital formation programs that date back as early as the beginning of the 1980s. While these legacy programs did utilize a stream of insurance premium tax credits to make investments in underserved small businesses, the various models have evolved significantly in the intervening decades. The current model proposed in Rhode Island utilizes best practices, increases safeguards and holds participants accountable to meaningful metrics.

For instance, earlier legacy capital formation programs oftentimes did not:

- require fund applications to include projections on job creation and retention numbers, and direct and indirect impact of investments that will generate a net positive tax revenue impact on the state's economy,
- mandate that all the capital be invested before tax credits can be claimed,

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- ensure that debt investments have certain minimum duration,
- require that fund managers invest their own equity into the fund, and
- mandate that 100% of the capital raised be maintained in qualified investments throughout the compliance term of the fund.

The Rhode Island program mandates all the above. As a result of these safeguards, we believe that the Rhode Island model has become more robust.

In its 2018 annual report, the Connecticut Department of Economic and Community Development states that the Invest CT program (also called the Second Insurance Reinvestment Fund program), which is similar to the Rhode Island Small Business Development Fund program, has created 2,262 jobs, and the program provides an estimated revenue return that is "net positive to the state."[1]

It appears that Connecticut's 2018 report was not included in Corporation's regulatory analysis. We would encourage that the Corporation consider Connecticut's analysis of the program because the Connecticut program includes several safeguards that were not included in other legacy capital formation programs.

Bonding Requirement:

The authorizing law contains significant safeguards designed to ensure that fund managers adhere to program investments requirements and milestones and that investments produce jobs and associated tax revenue back to the state. There is no mention of a bond in any part of the statute authorizing this program, and there was no discussion of a bond during legislative consideration. The bond requirement fundamentally changes the structure of the program and is not contemplated by the law. According to the regulatory analysis accompanying the draft rule, such a bond is estimated to cost each fund manager $193,500 to $967,000 per year.

We appreciate the Corporation's efforts to engage in several discussions on potential structures that would satisfy the bond requirement. As stated in the regulatory analysis:

> [t]his bonding requirement, in conjunction with 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 that taxpayer dollars are protected. The bond or other surety reduces the risk to the state issuing tax credits if the actual return to the state as a result of job creation, retention, or economic performance promised by the applicant does not materialize to the extent projected by an applicant.

1 https://portal.ct.gov/-/media/DECD/Research-Publications/Annual-Report/DECD-2018-Annual-Report.pdf?la=en

While an investor earns a vested right to tax credits upon making an investment in the small business development fund, an investor can only utilize tax credits on each credit allowance dates in the fourth, fifth and sixth years after making an investment in the small business development fund. The State of Rhode Island does not incur any cost in terms of tax credits in the first three years; therefore, no bond should be required prior to the first tax credit allowance date.

The small business development fund is required to invest 100% of the fund in eligible small businesses within three years prior to initial credit allowance date, which is expected to generate significant economic impact during that period. Therefore, any bond required should not begin until year four, and the amount of bond should be limited to the cumulative amount of tax credits eligible to be claimed to date, less the cumulative amount of impact already generated, to be measured through a revenue impact assessment. No bond should be required once the small business development fund generates positive economic impact wherein the overall cumulative impact of the investments exceed the amount of tax credits.

The amended rules provide for a bond "or other such surety or bond as may be acceptable to the [Commerce Corporation] Board in its discretion." We appreciate the flexibility provided in the amended rules; however, we request the Corporation to provide an acceptable form of bond. Without such specificity, applicants will likely spend time and resources trying to meet an undefined parameter.

Definition of Debt Investment:

The draft regulations define a debt investment as "a loan with a term of not less than ten years." A debt investment is included as an allowed vehicle for capitalizing a small business development fund. It is unclear to us as to why there is a time period on the term of such a loan.

The program requires approved applicants to fully capitalize their funds within 60 days of their applications being certified by the state. Approved applicants must deploy 100% of their capital into eligible businesses within three years. The entire fund must be invested or maintained through the end of the sixth year. Failure to meet the milestones outlined in the sentences above would result in the applicant either losing its allocation of tax credits or the credits being subject to recapture. An applicant is eligible to exit the program after the end of the sixth year.

Because approved applicants must raise and maintain 100% of the capital investment and because funds are eligible to exit the program after the end of the sixth year, requiring a debt investment in the fund to be of a term of "not less than 10 years" does not make sense and will likely prevent parties interested in investing in small businesses in Rhode Island from doing so. We recommend that the definition of "debt investment" be removed as it is not needed.

Referral/Refusal Letter:

Under the statute and draft regulation, funds are prohibited from issuing "revolving lines of credit and debt secured by a first mortgage on real estate or ground lease with a term of more than one year" unless the business receives a "Referral Letter" or a "Refusal Letter" from a bank that meets the criteria of the draft regulations. Such a letter must be "signed under oath from the Chief Executive Officer" of the bank or an "equivalent officer".

Depending on the size of the bank, it is not realistic for small businesses to receive a refusal or referral letter that is signed by the CEO. In addition, sign off from such a senior officer is not needed. We recommend that this provision be changed to reflect an official letter from a qualified bank. Without such a change, it is very unlikely that small businesses in need of this type of financing will be able to obtain the documentation required to move forward.

Irrevocable Commitments:

The statute contains no requirement that applicants provide investor commitments during the application period. However, the law does state that applicants receiving a certification must "issue the capital investment to and receive cash in the amount of the certified amount from a small business fund investor" within 60 days of the certification and provide evidence of the receipt of such cash within 65 days of the certification.

Failure to meet this timeline will result in the applicant losing its certification. Thus, no tax credits can even be awarded until the applicant proves that the entire fund has been fully capitalized. Therefore, we would recommend that this extra-statutory requirement be removed from the final rules.

References:

The draft regulations require an applicant to include a "letter of support from a governmental unit or political subdivision that administered a similar tax credit program in which the Applicant or an Affiliate participated." This provision could potentially exclude applicants that meet the statutory and other regulatory criteria but have not participated in similar programs

In addition, our experience has been that governmental units or political subdivision are reluctant to supply letters of support to applicants seeking to participate in a program outside of their jurisdiction. Moreover, in our experience, government officials are frequently reluctant to provide written support, out of an understandable concern that it could be viewed as favoring a participant that the official currently regulates.

We recommend that the draft regulations be amended to allow applicants to supply names and contact information of regulators with whom they have worked with in the past and that this

provision not be used to prevent a qualified applicant that has not participated in such a program from being accepted into the Rhode Island program.

Affiliate Information:

The draft regulations require a "list of each investment made by each listed Affiliate over the past fifteen years ..." and the "audited financial statements for the Applicant and for each Affiliate for the past ten years." We read this language to restrict the required affiliate information to the affiliate being referenced in the application and not every affiliate of the firm. We recommend that, if this is the case, such clarification be made in the regulations.

Compliance with 2020 Global Investment Performance Standards (GIPS):

The draft regulations require applicants to provide "[e]vidence of compliance with the 2020 Global Investment Performance Standards" or "[s]atisfactorily demonstration of ... adherence to a high standard ...". We appreciate the Corporation's willingness to engage on this subject.

As we have stated previously, the statute does not require program applicants to demonstrate compliance with GIPS. There is absolutely no mention or suggestion in the law that applicants must comply with the "2020 Global Investment Performance Standards" as published by the CFA Institute. Such a standard was not discussed or mentioned during any of the four legislative hearings on the authorizing bill or during the debates on the floor of the Rhode Island House or Senate.

That said, Enhanced – which is audited by Ernst & Young – has a detailed track record and performance data from its 20 years of impact investing. For two decades, Enhanced Capital has invested in small businesses underserved by traditional sources of capital. Our company has made such investments through our Small Business Investment Company, a federal licensure issued after thorough review by the U.S. Small Business Administration; our Community Development Entity--a designation granted by the U.S. Treasury--which has received multiple awards from the highly competitive federal New Markets Tax Credit program; and through more than a dozen state capital formation programs. Enhanced Capital is also a Registered Investment Adviser regulated by the U.S. Securities and Exchange Commission.

The Corporation's regulatory analysis states that compliance with this provision "would take approximately 1 hour at a staff cost of $25 per hour."

We have had conversations with several independent third-party compliance firms providing GIPS verification services, and they concur that Enhanced Capital is not a typical LP/GP investment firm. Enhanced Capital has several tax credit-driven, impact-oriented funds regulated by relevant federal or state governments, and therefore GIPS verification is not applicable at firm level. However, compliance firms are willing to provide a non-GIPS investment performance verification letter as evidence of compliance with high standards, which may cost up to $30,000. We request that the Corporation allow us to submit a generic form of such non-GIPS

performance verification letter for their approval and confirm that it will satisfy the requirement under the rules before we initiate the process and incur costs to obtain such verification letter.

Approval of Qualified Investments:

The draft rules provide the Corporation Board with the authority to potentially review and approve individual investments made by fund managers. In the section outlining "Board Consideration of the Application," the draft rules state "[t]he Board may condition approval of an Application in its discretion including, but not limited to, requirements for the ongoing review and approval of proposed Qualified Investments for compliance with this Part."

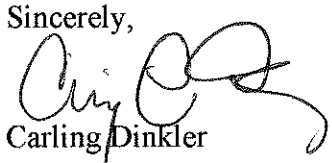
While we normally communicate with regulators to ensure that an investment meets programs standards, this model includes investment parameters created by policymakers and tasks experienced fund managers with the job of finding qualified, growth-oriented businesses that can benefit from capital made available under the program. Requiring every investment to be reviewed by the Corporation Board could create logistic and underwriting challenges.

As the law and the rules already provide for recapture of tax credits for investments that do not meet program requirements, we recommend that the "approval of proposed" investments be stricken from the final rules.

In every state in which we have had the opportunity to provide capital and support small businesses, we have worked in close partnership with policymakers and regulators, and we look forward to same relationship with the Commerce Corporation in Rhode Island. Enhanced Capital shares your goal of supporting the job creating small businesses that sustain communities and grow economies.

We look forward to the issuing of final rules that will allow small businesses in the state to receive the investments that they need.

Sincerely,



Carling Dinkler
Vice President