Community Development Venture Capital Alliance CDVCA

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To Whom It May Concern:

The Community Development Venture Capital Alliance ("CDVCA") submits this letter of comment in response to the request for comments regarding the New Markets Tax Credit in the Federal Register, dated November 7, 2011. CDVCA submitted broader comments about regulatory changes that would be necessary to encourage venture capital equity investment in our letter dated September 6, 2011 in response to advance notice of proposed rulemaking REG-114206-11, and our letter dated September 8, 2011 in response to notice of proposed rulemaking REG-101826-11. While some of the information in those submissions is repeated here, please refer to the September 6, 2011 and September 8, 2011 comments for a fuller discussion of how to make the New Markets Tax Credit more workable for venture capital equity investors.

CDVCA is the trade association of community development venture capital ("CDVC") funds. We represent 73 domestic CDVC funds with aggregate capital under management of more than $2 billion. Our member funds provide venture capital financing, mostly in the form of equity and near-equity financial instruments, to rapidly growing operating businesses that create good, permanent jobs for low-income people primarily in low-income areas. CDVCA is both a CDE and a CDFI, as are many of our members and their affiliates.

We strongly commend the Department of the Treasury, the Internal Revenue Service, and the CDFI Fund for your interest in finding ways to facilitate use of the New Market Tax Credit ("NMTC") to encourage financing for operating businesses. In particular, it is important that patient, flexible equity and near-equity financing be made available to rapidly-growing, entrepreneurial businesses, which create most of the net new jobs in our economy, in low- and high-income areas alike. This type of entrepreneurial, high impact business, which the Obama administration has recently expressed a strong interest in encouraging, is the natural market focus of CDVC funds. While the NMTC was originally intended to encourage patient, flexible equity capital investment for such businesses, the mechanics of how the credit was implemented have unintentionally made it virtually impossible to use it for this purpose. The regulatory changes recommended below, and in our earlier comments, would allow the NMTC to be used more effectively for its originally intended purpose, encouraging greater job creation and community revitalization.

The Importance of Rapidly-Growing, Entrepreneurial Small Businesses, of the type that CDVC Funds Finance, to the Creation of New, Permanent Jobs

President Obama has recognized that "high-growth" firms are the "biggest job creators" and thus "a top priority for the Obama Administration".[1] Consequently, the President's latest economic initiatives—"An America Built to Last" and the "Startup America Legislative Agenda" —promote policies specifically in support of these high-growth firms.[2] The Administration has also recognized that many high-growth firms will be located in low-income rural communities,[3] which may precipitate development in areas harshly affected by the recession. Therefore, the NMTC is now particularly relevant to the national dialogue on the economy, making it important that the Department of the Treasury ensure the NMTC program serves high-growth firms effectively.

This White House policy is supported by recent studies from the National Bureau of Economic Research, the Kauffman Foundation, and the U.S. Small Business Administration, which all show that almost all net new job creation in our economy comes from a small group of rapidly growing small businesses, commonly called "Gazelles" or "High-Impact Firms".[4] The SBA study found that these High Impact Firms "represent between 2 and 3 percent of all firms, and they account for almost all of the private sector job growth in the economy."[5] Furthermore, the study found that High Impact Firms

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[1] Gene Sperling, Help Job Creators Get the Capital They Need, THE WHITE HOUSE BLOG, Dec. 8, 2011, http://www.whitehouse.gov/blog/2011/12/08/helping-job-creators-get-capital-they-need.

[2] The White House, Startup America Legislative Agenda (2012), *available at* http://www.whitehouse.gov/sites/default/files/uploads/startup_america_legislative_agenda.pdf; The White House, An America Built to Last (2012), *available at* http://www.whitehouse.gov/sites/default/files/blueprint_for_an_america_built_to_last.pdf.

[3] The White House, Jobs and Economic Security for Rural America 3 (2011), *available at* http://www.whitehouse.gov/sites/default/files/jobs_economic_security_rural_america.pdf.

[4] Dane Stangler and Robert E. Litan, "Where Will All the Jobs Come From?" Kauffman Foundation, November 2009, *available at* http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf; John Haltiwanger, Ron Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," National Bureau of Economic Research, Working Paper No. 16300, August 2010; Small Business Administration, High-Impact Firms: Gazelles Revisited (2008), *available at* http://archive.sba.gov/advo/research/rs328tot.pdf.

[5] *See* Small Business Administration, High-Impact Firms: Gazelles Revisited 2 (2008), *available at* http://archive.sba.gov/advo/research/rs328tot.pdf.

are not limited to the archetypal Silicon Valley start-up, but rather have an average age of 25 years, are distributed geographically throughout the country, and exist in all industries. The study concludes that "economic development officials would benefit from recognizing the value of cultivating high-growth firms versus trying to increase entrepreneurship overall or trying to attract relocating companies when utilizing their resources."[6]

Unlike most jobs created by the real estate and project finance investments that currently dominate the NMTC program, the jobs created by High Impact Firms are *permanent* jobs that provide employment to low-income populations year after year. High Impact Firms also have the potential to create *thousands* of jobs, unlike the typical small business, thus creating a greater economic impact on low-income communities.[7] The type of indigenous job creation encouraged by community development venture capital financing is dependent on home-grown entrepreneurs who have deep roots in their communities. They do not leave these communities to seek tax breaks or other transient incentives elsewhere. The jobs they create are permanent economic drivers of their local economies.

While entrepreneurial High Impact Firms are vital to job creation and our economy, they typically cannot finance their growth with debt, because they consume cash as they grow rapidly. Furthermore, these companies rarely have sufficient collateral or profitability to attract debt capital from a traditional bank, let alone from the risk-averse leverage lenders common in most NMTC deal structures.

Moreover, despite the importance of equity capital in creating and maintaining jobs in low-income communities, equity capital is in short supply for businesses in these communities. Unlike debt, venture capital equity financing is concentrated in just a few areas of the nation. In fact, two-thirds of all mainstream venture capital investments are made in just five areas of the nation (San Francisco Bay Area, Boston, New York, Houston, and Los Angeles), and only a miniscule percentage of venture capital is invested in low-income communities. As for rural areas, a CDVCA study featured in the *Wall Street Journal* found that less than 1% of traditional venture capital investment went to rural areas, while 19% of our CDVC member investments went to these areas.[8] CDVC funds target businesses that provide good employment opportunities to low-income persons, as compared with the high-tech businesses that most venture capital funds target, which often provide employment primarily to highly skilled employees with exceptional educational backgrounds. The incentive provided by the NMTC is needed to drive additional capital into these businesses in low-income communities.

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[6] *Id*. at p.44.

[7] Dane Stangler, High-Growth Firms and the Future of the American Economy 3 Kauffman Foundation, March 2010, *available at* http://www.kauffman.org/uploadedfiles/high-growth-firms-study.pdf.

[8] CDVCA. "Assessing the Availability of Venture Capital in the US: A Preliminary Analysis." (2003); "Most Venture Capital Flows to a Handful of States." *Wall Street Journal* 5 Nov. 2002: B3.

Venture capital fills the financing gap faced by High Impact Firms by providing patient, flexible equity capital. Community development venture capital (CDVC) funds like CDVCA and its members provide this type of financing for high-growth operating businesses in underinvested, low-income markets. CDVC fund investments create entrepreneurial capacity and good, permanent employment opportunities accessible to low-income people.

Nevertheless, the economic downturn has made it more difficult for all venture capital funds to raise money and exacerbated the inequities inherent in the distribution of mainstream venture capital. Although all venture capital investment is risky, CDVCA has found that the perceived risk of investing in low-income community businesses has made it extremely difficult to raise capital explicitly intended for these communities. This perceived risk makes government and nonprofit assistance all the more necessary if High Impact Firms are to succeed in low-income communities.

With this discussion as context, our answers to the questions posed in the Federal Register are as follows:

Comments

1. Low-Income Communities and Areas of Higher Distress

In the case of financing operating businesses where the goal of the investment is job creation, forcing investments into the lowest income census tract would be counterproductive. Labor markets are regional; most people do not work in the same census tract where they live. For example, while I live in Harlem, I take the subway to work in midtown Manhattan, as do most people in my neighborhood. If the goal is to improve the employment opportunities of low-income people, then the best strategy is to encourage development of financially strong, rapidly growing operating businesses (High Impact Firms) within a reasonable drive or public transportation ride of low-income populations. The strongest, most rapidly growing businesses in an area tend not to locate in the most economically distressed census tracts, because these areas suffer from disadvantages such as low-quality services, crime, and poor infrastructure. Forcing NMTC investment into these areas would deny financing for some of the strongest job-producers for low-income people and would not substantially increase the job prospects of low-income people, who, like other employees, participate in regional labor markets.

If stringent geographic targeting is not the appropriate strategy for increasing the low-income impact of NMTC financing of operating businesses, then what is? The best answer to this question is greater reliance on the Targeted Populations test. Creation of jobs for low-income people, regardless of the census tracts in which they are located, is the most important policy goal of the NMTC. The Targeted Populations test is focused on this person-based—as compared with geography-based—goal. Unfortunately, the Targeted Populations test is difficult to meet from an administrative standpoint, and therefore rarely used. In the absence of a more easily administered Targeted Populations standard, we recommend that the Fund allocate tax credits for applicants financing operating businesses on the basis of the impact narrative in the NMTC allocation application, while maintaining a relatively permissive standard with regard to geographic targeting. The Fund should look for a CDE's business plan and track record of targeting businesses that create good jobs which are appropriate for people with lower incomes.

It may be that a stricter geographic standard is appropriate for certain types of real estate investment. When financing a charter school, for example, there is a strong public policy reason to encourage the financing of schools in districts where lower-income students live, because students tend to go to their neighborhood schools. Likewise, the financing of a commercial real estate development might have a broader place-based community development goal of improving a particular neighborhood. But where the goal is job creation by an operating business, such narrow geographic targeting is counterproductive.

Establishing a different standard with respect to CDEs that exclusively finance operating businesses not only is appropriate from the standpoint of creating the largest number of good jobs, but also would provide a small additional inducement for CDEs to finance operating businesses, an activity that is underrepresented in relation to real estate finance.

2. Treatment of Certain Businesses

(b) Yes. The Fund should provide additional opportunities for applicants to score more highly by committing to invest in:

> (i) Operating businesses, particularly the high-growth, High Impact Firms described earlier in these comments. These are the significant job creators for low-income people in our economy.
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> (ii) Operating businesses that create *permanent*, rather than temporary, jobs.
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> (iii) Operating businesses that create good jobs for low-income people. The Fund should ask for information about job quality, such as whether the jobs pay a living wage and whether they carry such benefits as health insurance and wealth-building opportunities, such as 401(k) and broad-based stock option plans. The Fund should also ask whether the CDE does anything to encourage employers to provide higher quality jobs.
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> (iv) Operating businesses where the NMTC financing provided is unrelated to real estate. The Fund categorizes financing for operating businesses as “non-real estate” financing, even when it is provided in relation to the purchase of new or mortgaging of currently-owned real estate. Very little NMTC financing of any kind is currently provided that is not related in some way to real estate. As an example of why this is true, last week I attended a conference at which a representative of the second largest NMTC investor in the nation spoke. She stated that she strongly encourages CDEs in which her institution invests to tie their financing of operating businesses to real estate in some way, because real estate does not move out of low-income communities (which

minimizes the risk of an investment going out of compliance and resulting in recapture), while numbers of employees and location of assets can change over time, resulting in the possibility of technical non-compliance (a "foot fault" in her words), triggering recapture. Even if an event like this never happens, investors discourage any kind of investment not related to real estate because of the mere possibility of it happening. But rapidly-growing High Impact Firms often do not own real estate that can be used as the basis for an NMTC investment. The Fund should favor in the application process investment not tied to real estate in the application process, because it is so strongly disfavored by the practical mechanics of the NMTC, and because the requirement that a business own sufficient real estate to provide security for a loan of the size typically made using the NMTC (see below) excludes most businesses in low-income communities from consideration.

(v) Smaller operating businesses in which smaller investments are made. Because of high transaction costs, $5 to $6 million is commonly considered to be the minimum investment size of an NMTC transaction, but most High Impact Firms in low-income communities do not need such large amounts of capital. CDEs should be rewarded in the allocation process for bearing the higher transaction costs involved in providing financing in smaller amounts and for using such structures as blind pools of funds (pools in which the recipients of the financing are not identified to the tax credit investor in advance), which allow both for smaller financing rounds and for the ability to meet the financing needs of businesses on a more timely manner.

(c) The greatest impediment to doing the types of financing described above is the perception among investors of recapture risk. The recapture penalty is so severe, that even the slightest possibility of recapture occurring discourages investors from investing. Investments in operating businesses that are not tied to real estate inevitably suffer from an increased possibility of a business going out of compliance, resulting in recapture. To address this problem requires a radical rethinking of compliance requirements. We propose that investors be provided a broad safe harbor for investments in blind financing pools administered by CDEs that make investments in non-real estate-based operating businesses. The safe harbor would be available if the CDE represented in a document, similar to a private placement memorandum, that it would follow certain policies and procedures to minimize the likelihood of noncompliance. If those representations were made, investigated, and reasonably believed by the investor, then the investor would receive a broad safe harbor protecting it against recapture. The CDE's representations would be made part of its operating agreement with the Fund. If the CDE did not follow through properly on its representation, it would be out of compliance with its operating agreement and risk never receiving another allocation of tax credits again. This would provide substantial incentive for a CDE to run an investment program in compliance with NMTC regulations. It would place responsibility for making compliant investments squarely with the entity in the best position to govern its own work, the CDE, rather than making a third party investor—along with a small army of expensive lawyers, accountants and consultants—responsible for looking over the shoulder of the CDE at every step.

This was the original vision of the tax credit: that the CDE rather than the tax credit investor would generate deal flow, perform due diligence, and make investment decisions. The draconian treatment of recapture has perverted this model, forcing investors to play this role, *de facto*, rather than the CDE, in order to protect their credits from recapture. As noted earlier, this arrangement would have the added benefit of (1) driving down transaction costs, (2) allowing smaller investments in smaller businesses, and (3) making possible much quicker investment decisions, made by the CDE alone, to provide more responsive financing to struggling businesses.

3. Community Accountability

4. Transaction Costs

(a) & (b) In the case of investments in operating businesses, and particularly venture capital equity investments, a greater focus on minimizing fees would be counterproductive, strongly discouraging innovative financing for High Impact Firms. Venture capital investments are extremely time-intensive and expensive to make. Market rate investors in venture capital recognize this fact, as they provide much higher compensation per dollar invested to venture capital managers than to those who make other types of investments. Furthermore, the NMTC can play an important role in compensating CDEs and investors for additional risk. Forcing down fees would have the unintended and adverse consequence of driving NMTC investments to the easiest, most straight-forward and least risky loans, as compared with more complex and risky financing, such as venture capital equity investment.

Furthermore, in the case of financing for operating businesses, such as High Impact Firms, there is not a good public policy reason to drive the subsidy provided by the NMTC away from the CDE and into the hands of business owners and investors. The owners of any business that can qualify for a loan or investment of more than $5 million is not a low-income person, but is probably quite wealthy, or at least will be if the investment and the business succeed. The public policy interest in providing subsidized NMTC financing is not to make the business owner wealthier but to allow the business to maintain and create jobs for its employees. Therefore, the public policy interest in the case of operating business finance, particularly venture capital finance of High Impact Firms, is to provide *access* to financing, not to provide inexpensive financing. The factor that most severely limits *access* to financing in low-income communities is the higher transaction costs associated with financing businesses there. It is the transaction costs of the investors, rather than the capital costs of the company, that should be subsidized to maximize access. Fees and other compensation are needed to underwrite these transaction costs.

In fact, making cheap capital available to operating business can actually cause harm by both making a business reliant on subsidy and discouraging the healthy functioning of local capital markets. While there is no compelling case to drive NMTC subsidy to wealthy business owners and other existing investors in a business, there is good reason to allow a CDE to capture a significant portion of the subsidy. As noted above, this will provide compensation for the extensive work involved in structuring more complex, smaller, and riskier transactions. But even if not all of the subsidy is used for this purpose in every case, it is still preferable that subsidy wind up in the hands of a CDE engaged in the business of investing in low-income communities—particularly a mission driven CDE that may be tax exempt and required to use all of its assets for charitable purposes—rather than a wealthy entrepreneurs and other business investors who will ultimately extract the subsidy for personal gain.

The case may be different for certain real estate investments. For example, there is a strong public policy case to be made to drive subsidy to a charter school that is a recipient of an NTMC investment so that more resources will be available for teaching. Likewise, it may be important to minimize the financing costs of a mixed-use real estate development, to allow the owner to charge lower rents to both commercial and residential tenants. Non-real estate related operating businesses are different.

(c) Encouraging the creation by CDEs, and the investment by NMTC investors, in blind pool investment vehicles would both drive down transaction costs and increase the diversity and quality of financing available in low-income communities. This could be accomplished by creating the safe harbor discussed in 2(c) above and by providing extra points on the allocation application for CDEs investing in operating businesses and forming such pools.

5. Evaluation of Financial Products

(a) At least with respect to equity and equity-like (e.g. subordinated debt with warrants or royalties) investments in operating businesses, we believe it would be a mistake to adopt stricter standards regarding interest rates or other costs charged to investee businesses. As discussed above in our answer to question #4, we believe an emphasis on driving down the cost of financing to operating businesses is misplaced and could, in fact, stifle the availability of more innovative and complex financing.

(b) CDVCA has provided numerous suggestions of specific administrative and regulatory changes that would facilitate the provision of venture capital financing to High Impact firms in our letter dated September 6, 2011 in response to advance notice of proposed rulemaking REG-114206-11, and our letter dated September 8, 2011 in response to notice of proposed rulemaking REG-101826-11. We will not repeat those recommendations here.

However, we will comment that the way in which the NTMC is currently administered strongly disfavors the provision of risk capital to high-growth companies. The leverage model, in particular, discourages risk taking, because the leverage lender is compensated only by an interest rate and has no incentive to accept risk. The CDE typically receives a flat fee and the tax credit investor receives its full compensation in the form of tax credits. Because no party to the transaction enjoys a financial upside if the business succeeds, no one involved in the transaction has incentive to provide risk capital to High Impact Firms or to work to help the investee business become successful, as a venture capital investor does. The Fund should offer extra points in the application process to CDEs that provide venture capital-type financing, taking investment risks as well as upside returns.

6. Use of Other Federally Subsidized Financing in Conjunction with NMTCs

(a) & (b) It is rare that other federal subsidies are coupled with non-real estate NMTC financing of operating businesses, but we would caution against a blanket prohibition or disfavoring through a point system of additional subsidy. As discussed above, transaction costs for equity investment in smaller businesses can be quite high. Investors often need more, rather than less, subsidy to make such investments. Eliminating coupling of additional sources of subsidy with the NMTC could drive NMTC investment exclusively to larger, more simple, less risky deals.

(c) One source of federal dollars that is not typically used with the NMTC is debenture leverage provided by the Small Business Investment Company (SBIC) program operated by the Small Business Administration. When congress first created the NMTC, it also created a similarly-named New Markets Venture Capital program operated by the Small Business Administration. NMVC funds operate under virtually identical rules as SBICs. The intent was that the NMTC would provide incentive for private investors to invest in NMVC funds, which would be leveraged two to three times by SBA debentures. While Congress has not recently appropriated funds for the NMVC program, the SBA under the Obama Administration has recently created a similar program called the Impact Investment Fund program. We encourage the CDFI Fund to work with the SBA to make their regulations compatible so that the original vision of the NMTC providing incentive for private investors in SBA leveraged funds can be realized. CDVCA would be happy to be helpful in that process.

Thank you for the opportunity to submit comments on this important subject.

Sincerely yours,

Kerwin Tesdell

Kerwin Tesdell