FISCAL IMPACT REPORT

		ORIGINAL DATE	01/21/19		
SPONSOR	Padilla	**LAST UPDATED**	02/04/19	**HB**	
SHORT TITLE	Invest in Tech Research Collaborative			**SB**	30/aSCORC
				ANALYST	Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					**Recurring or Nonrecurring**	**Fund Affected**
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
Indeterminate but likely negative	Indeterminate but likely negative	Indeterminate but likely negative	Indeterminate but likely negative	Indeterminate but likely negative	Recurring	Severance Tax Permanent Fund

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Economic Development Department (EDD)

SUMMARY

Synopsis of SCORC Amendment

The Senate Corporations and Transportation Committee (SCORC) amendment to Senate Bill 30 makes the State Investment Council's (SIC) investment with the Technology Research Collaborative (TRC) discretionary, rather than mandatory. This change eliminates the SIC's concern that this bill would compel the SIC to violate its legal obligations under the Uniform Prudent Investor Act. As amended, this bill encourages the SIC to make certain investments recommended by the TRC, which is something the current statutory scheme authorizes, but does not expressly encourage, the SIC to do.

Even with the amendment, the bill still prohibits the SIC from making any investment pursuant to Section 7-27-5.15(E)(c) NMSA 1978 (for New Mexico businesses involved in "any field of science or technology") unless such investment is approved by the TRC. SIC staff express concern the bill could give the TRC veto authority over every investment (i.e., the entire 9 percent of the STPF) the SIC might make in New Mexico tech companies. SIC staff indicate this result seems inconsistent with the bill's apparent general intent to encourage TRC's involvement in .25 percent of the STPF's investments.

Synopsis of Original Bill

Senate Bill 30 amends Section 7-27-5.15 NMSA 1978 to require the State Investment Council to invest one-quarter of one percent of the severance tax permanent fund (STPF) in New Mexican science and technology businesses, recommended by the Technology Research Collaborative.

This bill repeals Section 21-11-8.6 NMSA 1978, the statutory foundation for the TRC under present law, and replaces it with a new statutory section under NMSA §7-27-5.15. transfers the TRC's fiscal administration from New Mexico Tech to the New Mexico Economic Development Department (EDD) and changes the composition of the TRC and lays out other reporting requirements for the TRC and SIC.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

This bill will provide the TRC with roughly $12.4 in seed money. The cost of that seed money in terms of lost STPF investments and distributions to the general fund, though likely significant, is inherently unknowable.

According to staff at the State Investment Council (SIC), the fiscal impact of SB30 on the STPF is indeterminate, but over time is likely negative, or at minimum, expensive in terms of expected risk-adjusted returns relative to opportunity cost. In other words, risk is likely outweigh reward, at least in the traditional investment sense of financial returns. This bill requires that about $12.4 million be invested in New Mexico-based technology businesses, but the return on this investment cannot be reasonably estimated because the businesses – or proof of concept technology vehicles originating in the national labs or state research universities – in which the funds will be invested, have not yet been identified.

Given the SIC's past experience with various economically targeted investments (ETIs) as a guide, financial investment return will be significantly lower than would otherwise be expected for investments with a similar level of risk, as early stage venture investments are among the riskiest available in terms of financial returns. Furthermore, investments at the seed or start-up level often require substantial follow-up investment participation over multiple rounds and years to successfully recoup initial capital and profit. Early investors who fail to, or are unable to participate in subsequent investment rounds often find their original investment capital de-valued, "crammed down" or washed out completely by new investor capital.

Predicting the revenue impact of this bill is difficult because the SIC's investment results from New Mexico investments have varied significantly depending on the goals of the investments. For example, the performance of the NM Private Equity Investment Program (NMPEIP), which is operated under Section 7-27-5.15 NMSA 1978, changed dramatically when the focus of the program shifted from economic development to seeking market rate returns. Since 2004, when the council hired Sun Mountain Capital to run the NMPEIP with the goal of seeking market rate investment returns, the NMPEIP has produced respectable investment returns on par with the STPF as a whole. However, in the decade prior (1993-2003), where the focus of the NMPEIP was economic development, investment returns were negative -18.2 percent annualized.

SIGNIFICANT ISSUES

EDD notes that this bill does not include the Air Force Research Laboratory (AFRL) in the TRC. However, EDD states the AFRL has a strong technology transfer and commercialization program, and therefore, it may be helpful for this organizations to continue to be represented on the TRC.

This bill defines the purpose of the TRC is to establish advanced technology centers based on the wealth of scientific and technical talent that exists in the participating institutions; foster the development and creation of new intellectual property for the state, encourage new opportunities for business and increase jobs, commercialize the intellectual property created; and help create a workforce to support enterprises based on the intellectual property that is created.

The following analysis was provided by SIC staff:

> "[This bill] would require that the TRC review and approve or disapprove all equity investments in NM businesses to be made by the State Investment Council under [Section 7-27-5.15 NMSA 1978]. While it would be understandable that TRC would approve its own investments, [this bill] takes the concept a step farther, effectively giving 'veto power' to the TRC over the State Investment Council and its fiduciary authority regarding the full 9 percent of the STPF currently authorized for NM private equity. Considering the Governor will actually appoint six of the 11 members to the TRC board, and that the Governor is chair of the SIC, this aspect of [the bill] at best, severely complicates and jeopardizes the process of making investments in New Mexico companies, and at worst, marginalizes the other elected officials and legislatively-appointed members of the SIC, displacing their key role as gatekeepers, investors and fiduciaries. SIC questions whether the intent of the drafter is truly to give such massive authority to the TRC regarding the current 9 percent potential NM venture capital investment of the STPF, or is seeking to make the distinction that SIC is allowed to make fund investments, but not direct NM business investments as would the TRC. The problem with this would be that many New Mexico venture funds in which the SIC invests are also NM-based "businesses", and arguably would now fall under the purview of the TRC. Lack of clarification on this language potentially results in the unstated consequence of the tail wagging the dog."

Additional concerns by SIC staff are as follows:

- The new TRC board would have an unspecified degree of investment and entrepreneurial expertise, depending on who are the university presidents, lab directors, or their designees at any given time. The five Governor's appointees "…include persons that have expertise in the law, investment banking and venture capital" is vague, and does not quantify the level or years of experience expected. It is unclear whether members of the board be fiduciaries with fiduciary responsibilities and the (potential) personal financial liabilities that can accompany an investment that later proves imprudent.

- While TRC board members are required to attest annually to any personal, financial or other conflict of interest in carrying out their monthly duties, there is no stated penalty should a conflict become apparent. Potential conflicts may or may not be covered by applicable penalties under the state Governmental Conduct Act, the Gift Act or similar provisions in law.

- Without investment professionals driving the investment process, there may be an increased potential for undue political or other inappropriate influence to enter the investment award process.

- EDD would appear to be the new fiscal agent and administrator for the TRC. Under Governor Richardson a similar program called "Invest New Mexico" was created to funnel business investments sourced by the EDD into the NM private equity program, with EDD essentially having power to green light investments. The SIC disagreed with this concept, and after three very unsuccessful investments sourced by EDD and vetted by SIC staff (Eclipse, TCI Medical & Earthstone), the Council restructured how these types of investments were to be made, hiring an outside professional manager to act as fiduciary and to coordinate all future NM private equity commitments.

- It is unclear whether there are proper protections to the investment process that will protect confidential and competitive business strategies or technologies held by the funded projects discussed at SIC and TRC meetings in the reporting requirements. This bill exempts TRC meetings from the Inspection of Public Records Act (IPRA). This leaves an apparent gap where IPRA may require TRC staff to produce documents of a confidential nature. Further, the TRC meetings would still be subject to the Open Meetings Act, which might lead to inadvertent disclosure of confidential information. Consideration should be given to adding express language allowing the TRC to protect documents and discussions that might have economic consequences if revealed to the public. Finally, the a new layer of reporting on the profitability of individual investments requires company-specific detail that would undoubtedly reveal proprietary trade information, and competitive valuation data, which could result in potentially fatal damage to any early stage company, as well as actionable damages incurred by co-investors and other shareholders due to loss of trade secrets.

- The state investment officer is tasked with providing an annual report detailing how each investment "enhances the economic development objectives of the state." As TRC would be under the supervision of EDD, it may be that EDD, rather than the state investment officer, would likely be in a better position to articulate these results, apply economic impact multipliers and the like, which currently fall outside SIC's core mission and expertise.

EDD states the ability to achieve the bill's stated purpose is predicated on the amount of funding available to the TRC and support of New Mexico's technology entrepreneurs and companies. Without funding at early stages, EDD argues that New Mexico's growing technology companies struggle to succeed and the TRC is unable to achieve its statutory purpose.

EDD provided the following additional input:

> "Many other states have implemented funding initiatives (grants; loans; and direct investment. e.g. Ohio's 3rd Frontier Initiative) to commercialize new technology and support diverse technology businesses. These states have invested in bridging the gap between research and development and the market. These initiatives yield strong diversified technology based economies, lead to public/private collaborations between industry and academia, create private investment, attract new businesses, and generate high wage jobs. Over 30 states--like Ohio, Oklahoma, Michigan, Colorado, New Hampshire, and Utah--have acknowledged that investment in seed and early stage science and technology businesses

> yields more than just financial returns. The Kaufman Foundation reports that startups play an outsized role in job creation. The implications of fostering startups in New Mexico will lead to an increase in job opportunities created by local startups and startups that will grow into a larger company hiring more New Mexicans. Some of these local startups spin-out of the innovation infrastructure that comes out of New Mexico's three national laboratories and from New Mexico's universities.
>
> These investments lead to capacity building. Metrics employed by other states to track the benefits of these somewhat financially risky investments include: jobs, wages, student intern opportunities, acquisitions, total payroll, gross sales, GRT, PIT, company longevity, follow-on investment, use of other state resources such as incubators, and patents generated. All of the foregoing are economic development indicators and increasing these outcomes are economic development objectives."

EDD states that funding is necessary to create a pipeline that takes innovation from research to market. New Mexico has large research and development assets (3 national labs and 3 research universities), but without early stage funding, the technologies created remain in the lab, never reaching the market and their economic rewards and impact go unrealized and remain untapped. Further, EDD states that "without seed and early stage funding (at a risky point in a company's existence) there is no connection between New Mexico's research and development assets and the market."

ADMINISTRATIVE IMPLICATIONS

EDD states that, in the past, the TRC has met on a quarterly basis, but this bill requires the board to meet monthly. Further, EDD states that the TRD has previously not had enough funding appropriated to cover the cost of the board members' per diem and mileage.

Currently, the SIC employs private equity fund managers by making commitments to their fund through the NM Private Equity Investment Program (NMPEIP). The Council and its staff, while responsible for closely monitoring investment decisions made by these NM-based private equity managers, remain passive investors in the process, who rely significantly on the professional managers they have hired to make quality investments. The manager is, in-turn, financially incentivized to make the best investments possible, as if ultimately successful, the manager will share in the profits, or carried interest ("carry"), of a company's exit via sale, merger or initial public offering (IPO).

As referenced earlier, the Council no longer makes "direct" investments in New Mexico companies, but instead invests only with private equity managers, relying on their abilities and expertise. This bill would seem to remove the SIC's experts from the equation however, replacing them with the TRC, which may or may not prove to be a suitable exchange.

If the SIC would still be allowed to employ its private equity advisor in this capacity, in tandem with TRC, suitable compensation and/or profit sharing would have to be arranged by the Council or EDD. Such payments and costs are not contemplated by the bill.

OTHER SUBSTANTIVE ISSUES

SIC staff note that under current law, the SIC has the authority to indirectly co-invest in promising New Mexican technology businesses and does so frequently. In 2016, the SIC assisted in the formation of the New Mexico Catalyst Fund, LP, which is expected to provide at least $40 million capital to small New Mexico start-up companies. Accordingly, SIC staff state that failing to enact this bill will not prevent SIC from continuing its efforts to invest STPF assets in such seed and early-stage technology business.

SIC staff note this bill does not explore costs related to staffing, document production, auditing, investment monitoring, governmental oversight or any other administrative functions associated with TRC authorized investments. Without specific statutory guidance or legislative direction, there is greater chance for abuse or corruption of the processes involved.

While there is a reporting requirement placed/maintained at the SIC level, SIC staff indicate there does not appear to be substantive methodology in how TRC is to record, document or report company-level or investment valuation data.

ALTERNATIVES

SIC staff provide the following alternatives for consideration:

> "As the legislature did when it created the Small Business Investment Corporation (SBIC), the legislature has the authority to "carve out" the 0.25 percent STPF allocation without including the SIC as fiduciaries in this process, leaving the investments solely in the hands of the TRC, as it did with the SBIC board.
>
> In fact, the SBIC's legislation is the only ETI language that – like this bill – explicitly requires investment through the use of the words 'shall invest', versus all other ETI legislation which is permissive, allowing the SIC to make prudent investments only at its discretion. Changing 'shall be invested' to 'may be invested' on page 2 line 6 of the bill would allow the Council greater fiduciary discretion regarding TRC investments."

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

DI/gb/al