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New Venture Capital Funding Pool of $10 Billion Created Under Rescue Act

By **Peter Rothberg** | June 07, 2021

Discretely tucked into the recently signed $1.9 trillion federal Rescue Act of 2021 (the Rescue Act), are amendments to the existing State Small Business Credit Initiative Act of 2010 (the SSBCI). While news of the Rescue Act's enactment has been heavily promoted nationwide, the SSBCI amendments have received little public notice.

The SSBCI

The SSBCI includes benefits for what are defined as "State Other Credit Support Programs" (SOCSPs). A SOCSP is a state administered program that:

(1) uses public resources to promote private access to credit; and

(2) meets the eligibility criteria in Section 3006(c) of the SSBCI.

An eligible SOCSP includes state programs that provide funding to "State-run venture capital fund programs." But rather than directly invest in small businesses, many SOCSPs invest their federal funds through venture investments in "funds-of-funds" which in turn make venture investments in small businesses.

Under §3006(c) of the SSBCI, to be approved for receipt of federal funds, an SOCSP must:

(1) meet the specified investment leverage criteria (e.g., $1 of public investment by the state program will result in $1 of other private investment);

(2) demonstrate use of the federal contributions to cause and result in specified minimum amounts of new small business "lending";

(3) if providing support through financial institutions, require the financial institutions to their own capital resources at risk in their small business investment activities; and

(4) target allocations to small businesses in maximum specified amounts.

The considerations used by the Secretary of the Treasury (the Secretary) to make SOCSP allocation decisions must allow such federal funding to target expansion of economic opportunities for small businesses.

New York state has supported, and benefited from, the SSBCI's financing of SOCSPs. In 2012 New York launched its SOCSP—the Innovate NY venture capital fund—to receive funding under the SSBCI. Innovate NY is managed by New York Ventures, the venture capital investment arm of an agency of New York state government. To date, rather than make its own direct investment in seed-stage companies, Innovate NY has taken a "fund of funds" through seven separate venture capital funds. Innovate NY has awarded funding to these identified funds on a ratio of 2:1 private-public investment, with every $2 of funding received by such investment managers from private sources being matched with $1 of SSBCI funding by New York state.

The Rescue Act Amendments

As stated above, the Rescue Act amends the SSBCI. These amendments create new SSBCI programs (the "Programs") for the benefit of businesses owned and controlled by Socially and Economically Disadvantaged Individuals (the "SEDIs"). The Rescue Act added a new Subsection 15 to SSBCI definitions: "Business Enterprise owned and Controlled by [SEDIs] means: (A) if privately owned, 51 percent is owned by one or more [SEDIs]; (B) if publicly owned, 51 percent of the stock is owned by one or more [SEDIs]; and (C) in the case of a mutual institution, a majority of the Board of Directors, account holders, and the community which the institution services is predominantly comprised of [SEDIs]."

In order to participate in the Programs, an applicant business must be "a business enterprise owned and controlled by" SEDIs (an "SEDI Business"). Socially disadvantaged individuals are defined as "individuals who have been subjected to racial or ethnic prejudice or cultural bias because of their identity as a member of a group without regard to their individual qualities." Members of the following groups are specifically deemed to meet the definition: Black Americans, Hispanic Americans, Native Americans, Asian Pacific Americans, and Subcontinent Asian Americans. Individuals not members of one of the listed designated groups may also establish social disadvantage based on personal experiences of substantial and chronic social disadvantage in American society. For example, the definition for SEDIs has been interpreted to include "gender" bias as part of "cultural bias", making the Programs available to women-owned and LGBTQ-owned businesses.

"Economically disadvantaged individuals," the other necessary SEDI characteristic, are defined as "socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same business area who are not socially disadvantaged." For example, materials published by the SBA state that to establish initial eligibility an applicant cannot have a net worth (as defined) of $250,000 or more, but applicants can be considered economically disadvantaged even if they have total assets (without adjustments for indebtedness) of as high as $4,000,000. Notwithstanding other numeric formulas, an individual's economic disadvantage can be established "by comparing the personal income attributable to the Individual to IRS statistical data of high-income wage earners."

The Rescue Act also allows longer periods of time for States to expend their funding allocations on Programs. Before the Rescue Act, States needed to allocate their full participation amounts within 2 years following acceptance into the SSBCI program ("Acceptance Date"). The Rescue Act has extended that period to allow the second 1/3 of a State's allocation to be expended within 3 years following its Acceptance Date and the last 1/3 to be expended within 6 years following its Acceptance Date.

The Rescue Act also sets aside Ten Billion ($10,000,000,000) Dollars to be expended:
(i)"to provide support to small businesses responding to and recovering from the economic effects of the COVID-19 pandemic";
(ii)"[to] ensure business enterprises owned and controlled by [SEDIs] have access to credit and investments"; and
(iii)"[to] provide technical assistance to help small businesses applying for various support programs".

The Secretary is specifically directed to make special allocations to the Programs for fiscal 2021. Moreover, although the basic process by which States can apply for SSBCI allocations has not materially changed, the Rescue Act changes how State allocations are meted out.

A new Section 3003(d) entitled “ADDITIONAL ALLOCATIONS TO SUPPORT BUSINESS ENTERPRISES OWNED AND CONTROLLED BY SOCIALLY AND ECONOMICALLY DISADVANTAGED INDIVIDUALS” was added to the SSBCI, under which One and One-half Billion ($1,500,000,000) Dollars allocated under the Programs for the 2021 fiscal year (the “Set Aside”) is allocated outside the legislation’s strict formula. The Secretary is directed to “allocate such amounts to States based on the needs of business enterprises owned and controlled by [SEDIs], as determined by the Secretary, in each State,” rather than on the regular allocation formula. This provision allows the Secretary to make allocations under the Programs based upon the real needs demonstrated by each State.

In addition, a new Section 3003 (e) has been added as a further incentive for State performance, by directing the Secretary “to set aside One Billion ($1,000,000,000) Dollars for an incentive program under which the Secretary shall increase the second 1/3 and last 1/3 allocations for States that demonstrate robust support… for business concerns owned and controlled by [SEDIs] in the deployment of prior allocation amounts.”

The Rescue Act mandates additional federal allocations to benefit “Very Small Businesses” having fewer than 10 employees. To fund this new program, the Secretary is obligated to allocate at least Five Hundred Million ($500,000,000) Dollars to be payable to the States for use only to benefit Very Small Businesses.

Finally, new Section 3009 (e), “TECHNICAL ASSISTANCE”, was added to create the “Technical Assistance Program” which permits up to $500,000,000 of 2021 fiscal year funding to be allocated by the Secretary:
(i) to the States to carry out technical assistance plans providing legal, accounting, and financial advisory services to Very Small Businesses and to businesses owned and controlled by SEDIs. These services can either be provided directly to SEDIs or (y) through contracts with legal, accounting, and financial advisory firms-- with priority given to firms owned and controlled by SEDIs; and
(ii) directly to legal, accounting, and financial advisory firms-- with priority given to firms owned and controlled by SEDIs-- under direct contracts with the federal government for provision of such technical assistance to business owned and controlled by SEDIs.

The Technical Assistance Program is novel in that it recognizes the importance of professional advisory services to SEDI Businesses and creates a means to provide those valuable services to SEDI Businesses without depleting the funds they directly receive under the Programs. Although the Rescue Act prioritizes funding for advisors and advisory firms which themselves are SEDIs, the mechanics on how to effect such priority is left for either later US Treasury Department regulations or for the States themselves to decide. Finally, whether or not the Technical Assistance Program will be continued beyond the 2021 fiscal year is not addressed in the legislation.

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