

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

- 1) Would provide for exemptions from the CFLL for the following:
 - a) A commercial bridge loan made by a VC company to an operating company; or
 - b) A VC investment made by a VC company in an equity security issued by an operating company.
- 2) Revises the definition of "commercial bridge loan" for purposes of exemption from the CFLL to extend the permitted maturity date to 3 years.

EXISTING LAW

- 1) Provides that the CFLL does not apply to a commercial bridge loan made by a VC company to an operating company, as follows (Financial Code Section 22062):
 - a) "VC company" is defined as a person other than an individual or a sole proprietorship that meets all of the following requirements:
 - i) Engages primarily in the business of promoting economic, business, or industrial development through VC investments or the provision of financial or management assistance to operating companies;
 - ii) At all times maintains at least 50% of its assets in VC investments or commitments to make VC investments, and maintains or will maintain a material equity interest in the operating company;
 - iii) Approves each loan made to an operating company through the VC's board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company; and,
 - iv) Complies with all applicable federal and state laws and rules or orders governing securities transactions when making the loan.
 - b) "Operating company" is defined as a person other than an individual or a sole proprietorship that meets all of the following:

- i) Primarily engages in the production or sale, or the research or development, of a product or service *other* than the management or investment of capital;
 - ii) Uses all of the proceeds of the commercial bridge loan for the operations of its business; and,
 - iii) Approves each commercial bridge loan through its board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company.
- c) “Commercial bridge loan” is defined as a loan that meets all of the following:
- i) Has a principal amount of \$5,000 or more, or any loan under an open-end credit program, whether secured or unsecured, the proceeds of which are intended by the operating company other than personal, family, or household purposes;
 - ii) Has a maturity date not to exceed one year and is made in connection with or in bona fide contemplation of an equity investment in the operating company;
 - iii) Is secured, if at all, solely by the operating company’s business assets, exclusive of any real property; and,
 - iv) Is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655.
- d) “VC investment” is defined as an acquisition of securities in an operating company to which a person, that person’s investment advisor, or an affiliated person of either has or obtains management rights.
- 2) Provides that a VC company may rely on any written statement of intended purposes signed by the operating company for purposes of determining whether a loan is a commercial bridge loan.

FISCAL EFFECT: None

COMMENTS:

VC is a type of equity financing that addresses the funding needs of entrepreneurial companies that for reasons of size, assets, and stage of development cannot seek capital from more traditional sources, such as public markets and banks. VC investments are generally made as cash in exchange for shares and an active role in the invested company. VC differs from traditional financing sources in that VC typically:

- 1) Focuses on young, high-growth companies
- 2) Invests equity capital, rather than debt
- 3) Takes higher risks in exchange for potential higher returns

- 4) Has a longer investment horizon than traditional financing
- 5) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure

Successful long-term growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. A lack of equity limits the debt financing available to businesses. Additionally, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business. VC provides businesses a financial cushion. However, equity providers have the last call against the company's assets. In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment than lenders receive.

VC for new and emerging businesses typically comes from high net worth individuals ("angel investors") and VC firms. These investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk. But VC is long-term or "patient capital" that allows companies the time to mature into profitable organizations.

VC is also an active rather than passive form of financing. These investors seek to add value, in addition to capital, to the companies in which they invest in an effort to help them grow and achieve a greater return on the investment. This requires active involvement; almost all VC investors will, at a minimum, want a seat on the board of directors. Although investors are committed to a company for the long haul, that does not mean indefinitely. The primary objective of equity investors is to achieve a superior rate of return through the eventual and timely disposal of investments. A good investor will be considering potential exit strategies from the time the investment is first presented and investigated.

Arguments in support.

The law firm letter from Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Gunderson Dettmer) is sponsoring SB 1181 to modernize the CFLL as it applies to the VC community. In support of the commercial bridge loan provision of the bill, Gunderson Dettmer writes,

"Today's entrepreneurs in California can do more, for a longer period of time, with less capital. When venture capital firms invest in a start-up company via a cost-effective commercial bridge loan, this further assists the small business in keeping its expenses under control. Unfortunately, the CFLL imposes a 1-year maturity date on such loans under the 2003 safe harbor, which is at odds with the extended time that today's small businesses can operate on such capital. We believe that SB 1181 (Correa) solves this issue by extending the permitted maturity date for a commercial bridge loan under the safe harbor from one year to three years. Requiring that a commercial bridge loan under the safe harbor have a maturity date not to exceed one year is an antiquated, and damaging, limitation."

In support of the provision which clarifies that equity investments should be treated as investments rather than loans, the sponsor explains that VC firms may invest in portfolio

companies through preferred stock financings or through issuance of a streamlined, convertible promissory note.

“In such cases, the principal and interest of the promissory note are convertible into equity of the company. Because these convertible promissory notes represent equity investments rather than loans, we believe that they should be regulated as equity securities subject to applicable state and federal securities laws, rather than as loans subject to the CFL. SB 1181 provides that clarification. The bill makes clear that standard loans are subject to the CFL, while instruments that are considered equity securities are subject to existing state and federal securities laws and not to the CFL. Given California’s well-established securities laws and enforcement resources, we believe that this clarification will result in overall greater protections to industry participants.”

Need for the bill.

This bill updates a provision of law implemented via AB 169, Chapter 163, Statutes of 2003, which established the original exemption for commercial bridge loans that met certain criteria. Then, as now, it is unclear as to whether the exemption is necessary as neither the legislative history of AB 169, nor the background to this bill indicate that the VC companies have faced any potential action or questions for engaging in unlicensed activities.

REGISTERED SUPPORT / OPPOSITION:

Support

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500 Startups
August Capital
Battery Ventures
Charles River Ventures
DCM
Felicis Ventures
Illuminate Ventures
Relay Ventures
Sofinnova Ventures
SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

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Opposition

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 - b) "Operating company" is defined as a person other than an individual or a sole proprietorship that meets all of the following:

- i) Primarily engages in the production or sale, or the research or development, of a product or service *other* than the management or investment of capital;
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 - iii) Is secured, if at all, solely by the operating company’s business assets, exclusive of any real property; and,
 - iv) Is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655.
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- 2) Provides that a VC company may rely on any written statement of intended purposes signed by the operating company for purposes of determining whether a loan is a commercial bridge loan.

FISCAL EFFECT: None

COMMENTS:

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- 5) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure

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Arguments in support.

The law firm letter from Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Gunderson Dettmer) is sponsoring SB 1181 to modernize the CFLL as it applies to the VC community. In support of the commercial bridge loan provision of the bill, Gunderson Dettmer writes,

"Today's entrepreneurs in California can do more, for a longer period of time, with less capital. When venture capital firms invest in a start-up company via a cost-effective commercial bridge loan, this further assists the small business in keeping its expenses under control. Unfortunately, the CFLL imposes a 1-year maturity date on such loans under the 2003 safe harbor, which is at odds with the extended time that today's small businesses can operate on such capital. We believe that SB 1181 (Correa) solves this issue by extending the permitted maturity date for a commercial bridge loan under the safe harbor from one year to three years. Requiring that a commercial bridge loan under the safe harbor have a maturity date not to exceed one year is an antiquated, and damaging, limitation."

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companies through preferred stock financings or through issuance of a streamlined, convertible promissory note.

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Need for the bill.

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REGISTERED SUPPORT / OPPOSITION:

Support

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500 Startups
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Battery Ventures
Charles River Ventures
DCM
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Relay Ventures
Sofinnova Ventures
SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

- 1) Would provide for exemptions from the CFLL for the following:
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- 2) Revises the definition of "commercial bridge loan" for purposes of exemption from the CFLL to extend the permitted maturity date to 3 years.

EXISTING LAW

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FISCAL EFFECT: None

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SoftTech VC
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Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

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Opposition

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Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

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 - ii) Uses all of the proceeds of the commercial bridge loan for the operations of its business; and,
 - iii) Approves each commercial bridge loan through its board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company.
- c) “Commercial bridge loan” is defined as a loan that meets all of the following:
- i) Has a principal amount of \$5,000 or more, or any loan under an open-end credit program, whether secured or unsecured, the proceeds of which are intended by the operating company other than personal, family, or household purposes;
 - ii) Has a maturity date not to exceed one year and is made in connection with or in bona fide contemplation of an equity investment in the operating company;
 - iii) Is secured, if at all, solely by the operating company’s business assets, exclusive of any real property; and,
 - iv) Is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655.
- d) “VC investment” is defined as an acquisition of securities in an operating company to which a person, that person’s investment advisor, or an affiliated person of either has or obtains management rights.
- 2) Provides that a VC company may rely on any written statement of intended purposes signed by the operating company for purposes of determining whether a loan is a commercial bridge loan.

FISCAL EFFECT: None

COMMENTS:

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- 3) Takes higher risks in exchange for potential higher returns

- 4) Has a longer investment horizon than traditional financing
- 5) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure

Successful long-term growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. A lack of equity limits the debt financing available to businesses. Additionally, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business. VC provides businesses a financial cushion. However, equity providers have the last call against the company's assets. In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment than lenders receive.

VC for new and emerging businesses typically comes from high net worth individuals ("angel investors") and VC firms. These investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk. But VC is long-term or "patient capital" that allows companies the time to mature into profitable organizations.

VC is also an active rather than passive form of financing. These investors seek to add value, in addition to capital, to the companies in which they invest in an effort to help them grow and achieve a greater return on the investment. This requires active involvement; almost all VC investors will, at a minimum, want a seat on the board of directors. Although investors are committed to a company for the long haul, that does not mean indefinitely. The primary objective of equity investors is to achieve a superior rate of return through the eventual and timely disposal of investments. A good investor will be considering potential exit strategies from the time the investment is first presented and investigated.

Arguments in support.

The law firm letter from Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Gunderson Dettmer) is sponsoring SB 1181 to modernize the CFLL as it applies to the VC community. In support of the commercial bridge loan provision of the bill, Gunderson Dettmer writes,

"Today's entrepreneurs in California can do more, for a longer period of time, with less capital. When venture capital firms invest in a start-up company via a cost-effective commercial bridge loan, this further assists the small business in keeping its expenses under control. Unfortunately, the CFLL imposes a 1-year maturity date on such loans under the 2003 safe harbor, which is at odds with the extended time that today's small businesses can operate on such capital. We believe that SB 1181 (Correa) solves this issue by extending the permitted maturity date for a commercial bridge loan under the safe harbor from one year to three years. Requiring that a commercial bridge loan under the safe harbor have a maturity date not to exceed one year is an antiquated, and damaging, limitation."

In support of the provision which clarifies that equity investments should be treated as investments rather than loans, the sponsor explains that VC firms may invest in portfolio

companies through preferred stock financings or through issuance of a streamlined, convertible promissory note.

“In such cases, the principal and interest of the promissory note are convertible into equity of the company. Because these convertible promissory notes represent equity investments rather than loans, we believe that they should be regulated as equity securities subject to applicable state and federal securities laws, rather than as loans subject to the CFL. SB 1181 provides that clarification. The bill makes clear that standard loans are subject to the CFL, while instruments that are considered equity securities are subject to existing state and federal securities laws and not to the CFL. Given California’s well-established securities laws and enforcement resources, we believe that this clarification will result in overall greater protections to industry participants.”

Need for the bill.

This bill updates a provision of law implemented via AB 169, Chapter 163, Statutes of 2003, which established the original exemption for commercial bridge loans that met certain criteria. Then, as now, it is unclear as to whether the exemption is necessary as neither the legislative history of AB 169, nor the background to this bill indicate that the VC companies have faced any potential action or questions for engaging in unlicensed activities.

REGISTERED SUPPORT / OPPOSITION:

Support

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500 Startups
August Capital
Battery Ventures
Charles River Ventures
DCM
Felicis Ventures
Illuminate Ventures
Relay Ventures
Sofinnova Ventures
SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

- 1) Would provide for exemptions from the CFLL for the following:
 - a) A commercial bridge loan made by a VC company to an operating company; or
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- 2) Revises the definition of "commercial bridge loan" for purposes of exemption from the CFLL to extend the permitted maturity date to 3 years.

EXISTING LAW

- 1) Provides that the CFLL does not apply to a commercial bridge loan made by a VC company to an operating company, as follows (Financial Code Section 22062):
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FISCAL EFFECT: None

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SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

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EXISTING LAW

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FISCAL EFFECT: None

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Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

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 - iv) Is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655.
- d) “VC investment” is defined as an acquisition of securities in an operating company to which a person, that person’s investment advisor, or an affiliated person of either has or obtains management rights.
- 2) Provides that a VC company may rely on any written statement of intended purposes signed by the operating company for purposes of determining whether a loan is a commercial bridge loan.

FISCAL EFFECT: None

COMMENTS:

VC is a type of equity financing that addresses the funding needs of entrepreneurial companies that for reasons of size, assets, and stage of development cannot seek capital from more traditional sources, such as public markets and banks. VC investments are generally made as cash in exchange for shares and an active role in the invested company. VC differs from traditional financing sources in that VC typically:

- 1) Focuses on young, high-growth companies
- 2) Invests equity capital, rather than debt
- 3) Takes higher risks in exchange for potential higher returns

- 4) Has a longer investment horizon than traditional financing
- 5) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure

Successful long-term growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. A lack of equity limits the debt financing available to businesses. Additionally, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business. VC provides businesses a financial cushion. However, equity providers have the last call against the company's assets. In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment than lenders receive.

VC for new and emerging businesses typically comes from high net worth individuals ("angel investors") and VC firms. These investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk. But VC is long-term or "patient capital" that allows companies the time to mature into profitable organizations.

VC is also an active rather than passive form of financing. These investors seek to add value, in addition to capital, to the companies in which they invest in an effort to help them grow and achieve a greater return on the investment. This requires active involvement; almost all VC investors will, at a minimum, want a seat on the board of directors. Although investors are committed to a company for the long haul, that does not mean indefinitely. The primary objective of equity investors is to achieve a superior rate of return through the eventual and timely disposal of investments. A good investor will be considering potential exit strategies from the time the investment is first presented and investigated.

Arguments in support.

The law firm letter from Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Gunderson Dettmer) is sponsoring SB 1181 to modernize the CFLL as it applies to the VC community. In support of the commercial bridge loan provision of the bill, Gunderson Dettmer writes,

"Today's entrepreneurs in California can do more, for a longer period of time, with less capital. When venture capital firms invest in a start-up company via a cost-effective commercial bridge loan, this further assists the small business in keeping its expenses under control. Unfortunately, the CFLL imposes a 1-year maturity date on such loans under the 2003 safe harbor, which is at odds with the extended time that today's small businesses can operate on such capital. We believe that SB 1181 (Correa) solves this issue by extending the permitted maturity date for a commercial bridge loan under the safe harbor from one year to three years. Requiring that a commercial bridge loan under the safe harbor have a maturity date not to exceed one year is an antiquated, and damaging, limitation."

In support of the provision which clarifies that equity investments should be treated as investments rather than loans, the sponsor explains that VC firms may invest in portfolio

companies through preferred stock financings or through issuance of a streamlined, convertible promissory note.

“In such cases, the principal and interest of the promissory note are convertible into equity of the company. Because these convertible promissory notes represent equity investments rather than loans, we believe that they should be regulated as equity securities subject to applicable state and federal securities laws, rather than as loans subject to the CFL. SB 1181 provides that clarification. The bill makes clear that standard loans are subject to the CFL, while instruments that are considered equity securities are subject to existing state and federal securities laws and not to the CFL. Given California’s well-established securities laws and enforcement resources, we believe that this clarification will result in overall greater protections to industry participants.”

Need for the bill.

This bill updates a provision of law implemented via AB 169, Chapter 163, Statutes of 2003, which established the original exemption for commercial bridge loans that met certain criteria. Then, as now, it is unclear as to whether the exemption is necessary as neither the legislative history of AB 169, nor the background to this bill indicate that the VC companies have faced any potential action or questions for engaging in unlicensed activities.

REGISTERED SUPPORT / OPPOSITION:

Support

Gunderson Dettmer Stough Villeneuve Franklin & Hachigian LLP (Sponsor)
500 Startups
August Capital
Battery Ventures
Charles River Ventures
DCM
Felicis Ventures
Illuminate Ventures
Relay Ventures
Sofinnova Ventures
SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

- 1) Would provide for exemptions from the CFLL for the following:
 - a) A commercial bridge loan made by a VC company to an operating company; or
 - b) A VC investment made by a VC company in an equity security issued by an operating company.
- 2) Revises the definition of "commercial bridge loan" for purposes of exemption from the CFLL to extend the permitted maturity date to 3 years.

EXISTING LAW

- 1) Provides that the CFLL does not apply to a commercial bridge loan made by a VC company to an operating company, as follows (Financial Code Section 22062):
 - a) "VC company" is defined as a person other than an individual or a sole proprietorship that meets all of the following requirements:
 - i) Engages primarily in the business of promoting economic, business, or industrial development through VC investments or the provision of financial or management assistance to operating companies;
 - ii) At all times maintains at least 50% of its assets in VC investments or commitments to make VC investments, and maintains or will maintain a material equity interest in the operating company;
 - iii) Approves each loan made to an operating company through the VC's board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company; and,
 - iv) Complies with all applicable federal and state laws and rules or orders governing securities transactions when making the loan.
 - b) "Operating company" is defined as a person other than an individual or a sole proprietorship that meets all of the following:

- i) Primarily engages in the production or sale, or the research or development, of a product or service *other* than the management or investment of capital;
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FISCAL EFFECT: None

COMMENTS:

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SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

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SoftTech VC
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Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

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- 2) Invests equity capital, rather than debt
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- 4) Has a longer investment horizon than traditional financing
- 5) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure

Successful long-term growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. A lack of equity limits the debt financing available to businesses. Additionally, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business. VC provides businesses a financial cushion. However, equity providers have the last call against the company's assets. In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment than lenders receive.

VC for new and emerging businesses typically comes from high net worth individuals ("angel investors") and VC firms. These investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk. But VC is long-term or "patient capital" that allows companies the time to mature into profitable organizations.

VC is also an active rather than passive form of financing. These investors seek to add value, in addition to capital, to the companies in which they invest in an effort to help them grow and achieve a greater return on the investment. This requires active involvement; almost all VC investors will, at a minimum, want a seat on the board of directors. Although investors are committed to a company for the long haul, that does not mean indefinitely. The primary objective of equity investors is to achieve a superior rate of return through the eventual and timely disposal of investments. A good investor will be considering potential exit strategies from the time the investment is first presented and investigated.

Arguments in support.

The law firm letter from Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Gunderson Dettmer) is sponsoring SB 1181 to modernize the CFLL as it applies to the VC community. In support of the commercial bridge loan provision of the bill, Gunderson Dettmer writes,

"Today's entrepreneurs in California can do more, for a longer period of time, with less capital. When venture capital firms invest in a start-up company via a cost-effective commercial bridge loan, this further assists the small business in keeping its expenses under control. Unfortunately, the CFLL imposes a 1-year maturity date on such loans under the 2003 safe harbor, which is at odds with the extended time that today's small businesses can operate on such capital. We believe that SB 1181 (Correa) solves this issue by extending the permitted maturity date for a commercial bridge loan under the safe harbor from one year to three years. Requiring that a commercial bridge loan under the safe harbor have a maturity date not to exceed one year is an antiquated, and damaging, limitation."

In support of the provision which clarifies that equity investments should be treated as investments rather than loans, the sponsor explains that VC firms may invest in portfolio

companies through preferred stock financings or through issuance of a streamlined, convertible promissory note.

“In such cases, the principal and interest of the promissory note are convertible into equity of the company. Because these convertible promissory notes represent equity investments rather than loans, we believe that they should be regulated as equity securities subject to applicable state and federal securities laws, rather than as loans subject to the CFL. SB 1181 provides that clarification. The bill makes clear that standard loans are subject to the CFL, while instruments that are considered equity securities are subject to existing state and federal securities laws and not to the CFL. Given California’s well-established securities laws and enforcement resources, we believe that this clarification will result in overall greater protections to industry participants.”

Need for the bill.

This bill updates a provision of law implemented via AB 169, Chapter 163, Statutes of 2003, which established the original exemption for commercial bridge loans that met certain criteria. Then, as now, it is unclear as to whether the exemption is necessary as neither the legislative history of AB 169, nor the background to this bill indicate that the VC companies have faced any potential action or questions for engaging in unlicensed activities.

REGISTERED SUPPORT / OPPOSITION:

Support

Gunderson Dettmer Stough Villeneuve Franklin & Hachigian LLP (Sponsor)
500 Startups
August Capital
Battery Ventures
Charles River Ventures
DCM
Felicis Ventures
Illuminate Ventures
Relay Ventures
Sofinnova Ventures
SoftTech VC
VantagePoint Capital Partners

Opposition

None on file.

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081

Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1181 (Correa) – As Introduced: February 20, 2014

SENATE VOTE: 34-0

SUBJECT: Finance lenders.

SUMMARY: Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies. Specifically, this bill:

- 1) Would provide for exemptions from the CFLL for the following:
 - a) A commercial bridge loan made by a VC company to an operating company; or
 - b) A VC investment made by a VC company in an equity security issued by an operating company.
- 2) Revises the definition of "commercial bridge loan" for purposes of exemption from the CFLL to extend the permitted maturity date to 3 years.

EXISTING LAW

- 1) Provides that the CFLL does not apply to a commercial bridge loan made by a VC company to an operating company, as follows (Financial Code Section 22062):
 - a) "VC company" is defined as a person other than an individual or a sole proprietorship that meets all of the following requirements:
 - i) Engages primarily in the business of promoting economic, business, or industrial development through VC investments or the provision of financial or management assistance to operating companies;
 - ii) At all times maintains at least 50% of its assets in VC investments or commitments to make VC investments, and maintains or will maintain a material equity interest in the operating company;
 - iii) Approves each loan made to an operating company through the VC's board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company; and,
 - iv) Complies with all applicable federal and state laws and rules or orders governing securities transactions when making the loan.
 - b) "Operating company" is defined as a person other than an individual or a sole proprietorship that meets all of the following:

- i) Primarily engages in the production or sale, or the research or development, of a product or service *other* than the management or investment of capital;
 - ii) Uses all of the proceeds of the commercial bridge loan for the operations of its business; and,
 - iii) Approves each commercial bridge loan through its board of directors or similar governing body, based on a reasonable belief that the loan is appropriate for the operating company.
- c) “Commercial bridge loan” is defined as a loan that meets all of the following:
- i) Has a principal amount of \$5,000 or more, or any loan under an open-end credit program, whether secured or unsecured, the proceeds of which are intended by the operating company other than personal, family, or household purposes;
 - ii) Has a maturity date not to exceed one year and is made in connection with or in bona fide contemplation of an equity investment in the operating company;
 - iii) Is secured, if at all, solely by the operating company’s business assets, exclusive of any real property; and,
 - iv) Is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655.
- d) “VC investment” is defined as an acquisition of securities in an operating company to which a person, that person’s investment advisor, or an affiliated person of either has or obtains management rights.
- 2) Provides that a VC company may rely on any written statement of intended purposes signed by the operating company for purposes of determining whether a loan is a commercial bridge loan.

FISCAL EFFECT: None

COMMENTS:

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