



**Community Development  
Venture Capital Alliance**  
*Private equity for public good.*

Title: CDFI Certification Application  
OMB Control Number: 1559-0028  
ICR REFERENCE NUMBER: 202211-1559-001  
Type of Review: Revision of a currently approved collection.

December 5, 2022

Ms. Jodie Harris  
Director  
Community Development Financial Institutions Fund  
U.S. Department of Treasury  
1500 Pennsylvania Avenue NW  
Washington, DC 20220

Ms. Tanya McInnis  
Program Manager  
Office of Certification, Compliance Monitoring and Evaluation  
Community Development Financial Institutions Fund  
US Department of Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

RE: Response to Proposed CDFI Certification Application Requirements, Federal Register  
Document Number Vol. 87, No. 213 / Friday, November 4, 2022

Dear Director Harris and Program Manager McInnis:

The Community Development Venture Capital Alliance (“CDVCA”) appreciates the opportunity to comment on the Notice of Information Collection and Request for Public Comment published by the Community Development Financial Institutions Fund (the “CDFI Fund” or the “Fund”) in the Federal Register on November 4, 2022. CDVCA is the national trade association of community development venture capital (“CDVC”) funds, which make equity and quasi-equity investments in businesses in low-income communities to create good jobs, productive wealth, and entrepreneurial capacity that advance the livelihoods of low-income people and the economies of distressed communities.

CDVCA is an active board member of the CDFI Coalition, and we support the comments and recommendations that the Coalition is providing in its comment letter. We focus in our comments on issues that are unique to the CDVC industry or are particularly important to it.

We note with pleasure and approval the following statement in the Notice of Information Collection, stating

**Finally, the CDFI Fund is examining barriers to CDFI Certification that are unique to those CDFIs that are community development venture capital funds (CDVCs). In the coming months, the CDFI Fund will unveil a separate proposal, and request for comments, that address these barriers. While CDVCs may only comprise a small portion of the total number of Certified CDFIs, the CDFI Fund believes there is a vital need for equity in and among CDFI Investment Areas and Targeted Populations, and is working to ensure that mission-driven issuers of equity have equal access to CDFI Certification and associated benefits.**

Largely because of technical issues regarding certification (and not because of a lack of focus on low-income communities), mission-driven CDVC funds are severely underrepresented among certified CDFIs. For example, CDVCA currently operates a network of 155 mission-driven fund managers—70% of whom are members of minority groups—only a handful of whom have opted to submit CDFI certification applications. CDVCA’s former board chair, Ray Moncrief, was chosen by two presidents to serve on the CDFI fund’s official Advisory Board, and yet he did not bother to apply for certification of either of his traditionally structured CDVC funds—the Southern Appalachian Fund and Meritus Ventures, both of which serve very low income rural areas in Appalachia—because he saw no point in doing so.

Rather than provide detailed comments on the proposed application as it stands, we will provide broad recommendations regarding approaches the Fund can take to remove “barriers to CDFI Certification that are unique” to CDVC funds. In the past, we have provided detailed comments and recommendations in the comment letter submitted to Ms. McInnis on November 5, 2020 (the “McInnis Comments”) and in Kerwin Tesdell’s letter to Jeffrey Merkowitz regarding certification issues of CDVC funds, dated April 12, 2019 (the “Merkowitz Letter”). We ask that the Fund refer to these two documents in conjunction with these comments as it considers developing special rules for CDVC funds

### Background

The risky nature of the equity financing that CDVC funds offer to fast-growing, job-creating businesses leads to a number of fundamental differences in the ways in which traditionally-structured<sup>1</sup> CDVC funds are organized and operated. These are discussed in the McInnis Comments and the Merkowitz Letter and are summarized below:

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<sup>1</sup> In these comments, we refer to “traditionally-structured” CDVC funds as those adopting the typical VC fund structure of an investment fund managed by a separately incorporated management company. Unlike CDFI loans, equity investments are relatively much more risky, and it would not be prudent to make such investments from the same balance sheet that pays salaries and the rent. This structure is described more fully, along with a diagram, in the Merkowitz Letter. It should be noted that community development venture capital financing may be carried out in a variety of structures, but the traditional VC structure is the most common.

- They are **separated into multiple corporate entities**: one or more “funds” (typically limited partnerships) that receive investor capital and make investments, and a “management company” that operates the funds. Unlike in other CDFIs, where all activity occurs under a single corporate roof, in traditionally-structured VC funds, the “fund” entity raises capital and holds it on its balance sheet, while the management company employs staff and does all the work, including providing Development Services. The “fund” may be thought of simply as a bank account from which investments are made and investment returns are distributed to investors.
- They **raise all of their capital up front** rather than continuously over time, as other CDFIs do.
- Fund managers typically must raise a **relatively large amount of capital** for each fund—at least \$10-15 million, and preferably at least \$25-50 million. This is driven by the need to diversify risk in a portfolio and to produce a sufficient management fee (calculated as a percentage of capital commitments) to operate the fund effectively. This contrasts with, for example, a CDFI loan fund that might raise a few hundred thousand dollars to begin with, make some loans, gain certification, and then apply for funding in multiple FA rounds over many years.
- They have **limited lives**, typically ten years. When they have invested all of their capital, they raise new capital in a new fund—a new corporate entity. Investment returns from the prior fund are returned to investors as they are collected and not retained for redeployment, as in other CDFIs.
- CDVC funds, like other VC funds, have a **life cycle**, usually defined in their limited partnership agreements. While these stages may overlap, they are generally followed in all traditionally-structured VC funds
  - **Capital raising.** VC fund managers raise all or most of their capital in the form of capital commitments from investors before they begin investing. In this way all investor capital is treated alike and returns are provided to investors on a pro rata basis in relation to their investment amount.
  - **Investment period.** During the investment period, a VC fund calls investor capital and uses it to invest in businesses. The investment period is often defined specifically in the fund’s limited partnership agreement and is typically 3 to 5 years.
  - **Harvesting period.** A VC fund will attempt to “exit” investments three to seven years after they are made, but exit timing is indeterminate and may not come for ten or more years. As soon as investments are exited, capital is returned to investors and not reinvested in new investments.
  - **Windup of fund.** A fund typically ends its life, or “winds up” after all of its investments have been exited and investment returns have been distributed to investors. While limited partnership agreements typically list a 10-year fund life, in practice, funds usually extend their lives well beyond this 10-year period with investor approval, because some investments take a long time to exit.
  - **Raising additional funds.** Because VC funds distribute investment returns to investors as soon as investments are harvested, an individual fund will run out of

capital to make new investments at about the time its Investment Period ends. To obtain additional capital to invest, a VC fund manager must raise another fund, going through the same life cycle described above. With multiple overlapping funds, a fund manager will have capital available on an ongoing basis to continue to make new investments. A successful VC fund manager may raise a series of 5 to 10 or more individual “funds” over several decades.

- **CDVC investments are relatively few and “lumpy.”** An individual VC fund might invest in no more than 10 to 15 companies during its life, typically making multiple rounds of investment in successful companies over time. Much of the work of the fund occurs after an investment is made, sitting on the company’s board, helping it to grow and be successful, and then encouraging or even managing an “exit” process in which the company is sold. (For this reason, we do not have the same level of concern that the other CDFI types have expressed regarding the level of reporting burden the new certification rules will impose. We make relatively few investments and we know them very well.) Because CDVC investments are large and lumpy, a CDVC fund may mathematically run afoul of measures such as the 60% low income test, because they do not have a high volume of investments in any one year. For example, despite the fact that a fund might be meeting the 60% test overall, if it makes one qualifying investment and one non-qualifying investment in a particular year, it might not meet the 60% test.

We can imagine CDFI Fund staff wondering at this point, “Why can’t they just operate like other CDFIs?” The answer lies in the risky nature of equity investing and the uncertain nature and timing of investment returns, as compared with loans. This is too complex to explain fully in these comments, but we would be happy to do so. Note, however, that in the private sector, almost all VC funds are organized in this way (separate funds and management companies, limited lives, etc.), while banks, credit unions, and other lending institutions are organized with perpetual lives, just as their CDFI counterparts are organized.

### Recommendations

(Again, please note that the McInnis Comments and Merkowitz letter contain additional recommendations about issues not addressed in this comment, such as affiliate ownership and financial return levels. We ask that Fund staff refer to those comments as well as this one.)

Many of the problems created by the CDVC structural differences discussed above can be addressed by taking the simple approach of treating the various corporate entities—management company and funds—as one CDVC CDFI entity for purposes of certification, evaluation, and FA applications. This is consistent with how VC funds are viewed and referred to in the private sector. For example, the venerable Silicon Valley VC fund, Kleiner Perkins, is referred to as *a* venture capital funds, even though it actually comprises many fund entities formed over decades. The approach would work as follows:

- A new definition of a “CDVC Managing Entity” would be created. This would place the focus on the entity that is actually in control and doing the work of raising capital, identifying investments, negotiating and closing deals, nurturing companies (providing

Development Services), exiting investments, and returning capital to investors, rather than which corporate entity is holding the capital. The Managing Entity would also be the entity to which the mission and accountability tests would be applied. The key is that it is the Managing Entity that controls investments and decides how to make them in such a way that low-income people and communities are benefited. While the “fund” is a separate corporate entity, it may be thought of as just a separate bank account.

- One or more CDVC “funds” would be treated as part of the overall CDVC/CDFI managed by the Managing Entity. For purposes of certification, reporting, and award applications, all “funds” managed by the Managing Entity would be consolidated together. For example, the consolidated investments of all funds managed by a Managing Entity would be considered together for purposes of calculating the 60% low-income test. This would address several problems:
  - The management company makes no investments but is the mission-driven, accountable entity that has staff and provides Development Services, while the “fund” holds investments on its balance sheet but doesn’t really “do” anything, so it is difficult for either to meet all requirements on its own. Consolidation would help to solve this problem.
  - This would partially address the “life cycle” and “lumpy investment” problems, because while one fund managed by the same Managing Entity might be in its harvesting period and not making new investments, a subsequent fund might be beginning its investment period and making new investments. Consolidating the two would accurately portray an active fund.
- To address further the “life cycle” and “lumpy investment” issues described above, CDVC funds should be evaluated based on their entire current portfolios, not just recent investments made. This accurately reflects the reality of how VC funds operate. During the harvesting period, a CDVC fund may make few if any new investments, although it is still working very hard with its portfolio companies to help them succeed and grow and ultimately to realize an exit so funds may be returned to investors. To consider such a fund to be “inactive,” because it has not made recent investments would be inaccurate.
- When a Managing Entity raises a new fund, that new fund should automatically have CDFI certification by virtue of the fact that it is being managed by a Managing Entity that is CDFI Certified. This would make the treatment of CDVC funds that raise new capital equivalent to the treatment of other CDFIs that raise new capital. For example, when a lending CDFI raises \$10 million in additional capital to expand its existing lending or create a new lending product, it does not have to separately apply for CDFI Certification for that new \$10 million, assuming it adds the new capital to its current corporate entity and maintains an eligible community development mission while lending that capital. But as described above, when CDVC funds raise new capital, they do not add it to the existing corporate entity but rather they create a new corporate entity—a new “fund” for investors to invest in. They should not be treated differently from other CDFIs simply because their model of organization requires them to raise capital in a new corporate entity.

It should be noted that simply offering the new fund the opportunity to apply for certification *after* raising capital and starting to invest is not an adequate answer. The main reason to get CDFI certification, for any type of CDFI, is to help in raising capital, either directly through CDFI Fund Awards or indirectly through CRA credit or the “good housekeeping seal of approval” regarding mission that certification affords. As described above, CDVC funds raise all of their capital up front, so once they’ve raised their capital commitments and started making investments there is no reason to go through the trouble of getting certified—a Catch 22 situation. This is a primary **reason why so few CDVC funds currently bother applying for certification**. They see no benefit. If this problem is not fixed there will continue to be few certified CDVC funds,

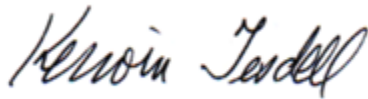
- The previous point addresses the issue of gaining certification for subsequent funds, once a Managing Entity is established and has already operated at least one fund. It does not, however, address the issue of a new fund manager (Managing Entity) raising its first fund and desiring CDFI certification to help it raise capital. Of course the largest challenge in expanding the CDVC industry to serve new regions and new populations is helping new fund managers to successfully raise their first funds, so this is an important issue.
  - One solution, though not a good one, is to say that new fund managers must simply work around this problem by raising a small amount of capital, perhaps on the balance sheet of the fund manager, make some investments, gain certification, and then, if the recommendation in the previous point above is accepted, it could raise a subsequent larger fund under its CDFI certification umbrella. But, as noted above, this is difficult, because investors typically do not want to invest in a VC fund that is not large enough to provide diversification and an adequate management fee.
  - A better solution is to create a mechanism for providing certification or provisional certification prior to a CDVC fund making its first investment. We explore this idea more fully in the McInnis Comment and the Merkowitz Letter. CDVC funds would be provided CDFI status during their fundraising period. Such provisional status would be analogous to the way the IRS provides 501(c)(3) status to new organizations before they have an operating history, based on their stated plans of operation. In the interim, donors can rely on the provisional 501(c)(3) status to take tax deductions. Likewise, we suggest that a bank could rely on provisional CDFI status when applying for CRA credit for an investment. Ironically, even though most SBICs are not mission-driven, many CDVC funds are becoming SBICs to get CRA credit for their investors, rather than applying for CDFI status. This is because the SBIC program provides advance designation during the crucial fundraising period, after the fund receives its “green light letter” from the SBA.

One obvious concern is the potential for abuse of such an advance certification arrangement, but we believe the potential for abuse is very small in the case of CDVC funds. When raising a traditionally-structured CDVC fund, a fund manager

is selling securities and is therefore subject to US securities laws. A fund manager typically writes a private placement memorandum (PPM) on which investors rely in making investment decisions. Making inaccurate statements in a PPM is a serious infraction of the securities law and can result in a felony conviction. CDVC funds therefore offer a plethora of documentation about how they will operate in the future that the CDFI Fund can examine and base certification determinations on, including PPMs, other offering documents and statements, and limited partnership agreements. If a fund does not follow through on what it states in its certification application, PPM, and other organizational documents, in addition to securities law penalties, the Fund could revoke certification.

Thank you for the opportunity to offer comments on this important change in CDFI Fund policy and procedure. We hope our comments are helpful to the Fund as it considers how to provide for CDVC funds in the certification process. We welcome the opportunity to explore these and other possible improvements to CDFI certification in the future. In fact, we strongly urge the Fund to sponsor a listening session for the CDVC industry to provide feedback before special rules for the industry are developed. As this letter shows, the structure of CDVC funds is quite different from that of other CDFIs and is quite complicated. Fashioning rules that work for CDVC funds will be a challenge and we would welcome the opportunity to help the Fund to meet that challenge.

Sincerely yours,

A handwritten signature in blue ink that reads "Kerwin Tesdell". The signature is written in a cursive, flowing style. To the right of the signature is a vertical line.

Kerwin Tesdell  
President