



Audit Report



Report Number: OIG-SBLF-14-011

STATE SMALL BUSINESS CREDIT INITIATIVE:
Indiana's Use of Federal Funds for Other Credit Support Programs

June 18, 2014

Office of
Inspector General

Department of the Treasury

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Contents

Results In Brief.....	2
Background.....	4
Investment A Constituted an Intentional Misuse of \$499,986 in SSBCI Funds.....	6
Investment B Was Compliant with Program Requirements, but Could Be Construed as Nepotism.....	9
Recommendations.....	10
Management Comments and OIG Response.....	10
Appendix 1: Management Response	14
Appendix 2: Major Contributors.....	25
Appendix 3: Report Distribution.....	26

Abbreviations

CAP	Capital Access Program
IANF	Indiana Angel Network Fund
IEDC	Indiana Economic Development Corporation
OCSP	Other Credit Support Programs
OIG	Office of Inspector General
SSBCI	State Small Business Credit Initiative
The Act	Small Business Jobs Act of 2010

*The Department of the Treasury
Office of Inspector General*

June 18, 2014

Amias Gerety
Assistant Secretary for Financial Institutions

This report presents the results of our audit of the state of Indiana's use of Federal funds awarded under the State Small Business Credit Initiative (SSBCI). At the request of Treasury SSBCI program officials, we determined whether two investments (hereinafter referred to as Investment A and B), made by the Indiana Angel Network Fund (IANF) under Indiana's Venture Capital Program, complied with *SSBCI Policy Guidelines*. On May 27, 2011, Treasury awarded the state of Indiana approximately \$34.3 million,¹ and as of September 30, 2013,² had transferred to the State approximately \$22.7 million³ of the awarded amount. Of the funds received, Indiana allocated \$21 million to the Venture Capital Program, of which \$9.5 million went to the IANF, and designated Elevate Ventures to manage all program investments. Elevate Ventures approved 15 investments totaling approximately \$2.5 million.⁴

The Act requires the U.S. Treasury Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and to identify any instances of reckless or intentional misuse. Treasury has defined reckless misuse as a use of allocated funds that the participating state or administering entity should have known was unauthorized or prohibited, and which is a highly unreasonable departure or willful disregard from the standards of ordinary care. Intentional misuse is defined as a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.

¹ Rounded down from \$34,339,074.

² September 30, 2013, was the most current data available at the start of audit fieldwork.

³ Rounded up from \$22,663,788.

⁴ Rounded down from \$2,523,475 - the total amount funded as of September 30, 2013.

To test participant compliance for each investment, we (1) compared investment documentation to program requirements regarding the use of proceeds, capital-at-risk, and other restrictions in the *SSBCI Policy Guidelines*, and (2) evaluated the investment oversight process. We also discussed program and investment details with personnel from the Indiana Economic Development Corporation (IEDC), which is responsible for managing Indiana's Venture Capital Program, and its contractor, Elevate Ventures. Finally, we interviewed Elevate Ventures personnel to obtain transactional information.

We performed our audit from July 2013 to June 2014 in accordance with *Government Auditing Standards*. Those standards require that the audit be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained to address the audit objectives provides a reasonable basis for the audit findings and conclusions.

Results In Brief

Both IANF investments involved transactions between the Board Chairman of Elevate Ventures and the investees. Investment A, totaling \$499,986, constituted a misuse of funds because the Board Chairman had a controlling interest and voting stock ownership of more than 10 percent in the investee, which created a "prohibited related party interest." *SSBCI Policy Guidelines* prohibit an investee receiving SSBCI funds from a related interest of any such executive officer, director, principal shareholder or immediate family.

The misuse was intentional because the Elevate Ventures CEO, who certified the investment was compliant with SSBCI rules, including those prohibiting related party interests, was notified prior to investment closing that the Board Chairman's ownership interest could exceed the allowable share, and did not disclose the information to Elevate's Investment Committee, who unanimously approved the investment. In addition, the Elevate Ventures CEO knew that the capitalization tables used to calculate the Chairman's ownership interest at investment closing on November 2, 2012 were diluted with SSBCI funds the investee had not yet received. The diluted tables reduced the Chairman's ownership interest to below the 10-percent threshold. The CEO of Elevate Ventures also sent a letter to the OIG stating

that prior to the investment closing, Elevate evaluated the November 2, 2012 capitalization tables and found them adequate after considering the dilutive effect of SSBCI funds on the Board Chairman's ownership.

Full compliance with program requirements and prohibitions is a condition precedent to the investment closing. That is, the investor's ownership position at the time of closing must be compliant before a specific financial obligation can be entered into with the investee, rather than determined based on an ownership interest after the funds are invested. While Elevate officials defended their position by stating that use of diluted tables is an accepted industry practice, it is not a sufficient practice for purposes of ensuring compliance with the SSBCI program requirement that related party interests be determined prior to investment closing.

Investment B of \$300,000 did not involve a prohibited related party interest because the Board Chairman of Elevate Ventures was not an executive officer or director of the investee. However, both the Board Chairman and his spouse owned shares in the investee, and their son is the investee's Chief Executive Officer. While investment B is technically compliant with the *SSBCI Policy Guidelines*, investing in a company managed by a family member of the Board Chairman created the appearance of potential nepotism. The closeness of relationships between the Elevate Board Chairman and applicant, while not prohibited, may raise the appearance of partiality and should be addressed by *SSBCI Policy Guidelines*.

We recommend that Treasury recoup the \$499,986 of SSBCI funds intentionally misused on Investment A, declare a specific event of default of Indiana's *Allocation Agreement*, and determine whether future funding to the State should be reduced, suspended or terminated. Also, Treasury should require the State to ensure that IEDC reviews each IANF investment decision going forward.

Treasury concurred with all three recommendations, stating it would recoup the \$499,986 in intentionally misused funds, determine whether Indiana's funding should be reduced, suspended or terminated, and require Indiana to review each IANF investment decision. We consider Treasury's proposed actions to be responsive to the recommendations. However, although Treasury agreed to recoup the misused funds, it commented that it would

not characterize investment A as an “intentional” misuse of funds because the action did not constitute a knowing effort to violate program rules. Indiana also disagreed with the finding of intentional misuse, asserting that the report’s conclusion is unsupported by the factual record and misstates program rules. Formal written responses from Treasury and Indiana are included in their entirety in Appendix 1.

We believe that Treasury’s disagreement with our characterization of intentional misuse is based on a definition that is different than the one it formally established for the program. The current definition does not state that the misuse must constitute a “knowing effort to violate program rules.” Moreover, even if it did, the misuse would still qualify as “intentional.” Elevate’s CEO, by his own statements, knew that the Board Chairman’s ownership interest was an issue as early as August 2012, which he did not disclose to Elevate’s Investment Committee before it decided to proceed with the investment. He also knew, based on a November 2012 capitalization table, that the only way the Chairman’s ownership share could qualify was by diluting it with almost \$500,000 of SSBCI funding that had not yet been awarded. Based on this knowledge, he knew that the investee’s certification of compliance was inaccurate. Finally, the CEO certified that the investment was fully compliant despite his own knowledge that the related party interest prohibition had not been met.

We disagree with Indiana that the factual record does not support a finding of intentional misuse and that we incorrectly interpreted program rules. As outlined above, we believe the facts speak for themselves. Additionally, contrary to Indiana’s assertions, we relied on Treasury’s *SSBCI Policy Guidelines* and not Regulation O in concluding that the calculation of voting interest has to occur prior to investment closing because the guidelines require the investee certification of compliance *before* the SSBCI funds can be awarded.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds to strengthen programs that provide financial assistance to small businesses and manufacturers. SSBCI disbursements to states are made in three allocations: the first when the

Secretary approves the state for participation, and the second and third after the state certifies that it has obligated, transferred, or spent at least 80 percent of its previous allocation. In addition, the participating state is required to certify quarterly that it has complied with program requirements.

Indiana's Venture Capital Program makes direct investments in high-growth companies through three initiatives, the Indiana High Growth Fund, Indiana Seed Fund Holdings, and the IANF. As of September 30, 2013, Indiana had allocated \$21 million of its SSBCI allocation to the Venture Capital Program, of which \$9.5 million was allocated to the IANF. As of the same date, the IANF used the SSBCI funds to make 15 investments totaling approximately \$2.5 million. Of the \$2.5 million invested by the IANF, approximately 32 percent went to the two investments audited. Investment A, approved on July 27, 2012, totaled \$499,986, and Investment B, approved on January 11, 2013, totaled \$300,000.

Elevate Ventures, Inc., an Indiana nonprofit corporation, administers the State Venture Capital Program under a contract with the IEDC. To manage the program, Elevate Ventures, Inc., formed Elevate Advisors, LLC. The investment committee of Elevate Advisors, LLC (which is comprised of employees from Elevate Ventures, Inc.) approves and executes the IANF venture capital investments.

In July 2013, after the OIG initiated its audit, Indiana's Governor requested a review of the business practices of the IEDC and Elevate Ventures. KPMG was engaged to perform the review and provided a report to Indiana on October 24, 2013. KPMG's review included the two investments we audited, but did not evaluate compliance of the investments with the *SSBCI Policy Guidelines'* prohibition on related party interests. The review noted that the IEDC does not review or approve individual IANF investments, which could lead to related party interest conflict issues not being properly disclosed and addressed. KPMG recommended that the IEDC play a more active oversight role by reviewing the IANF investment decisions and that Elevate Ventures explicitly identify conflicts of interest pertaining to each investment.

Investment A Constituted an Intentional Misuse of \$499,986 in SSBCI Funds

IANF's expenditure of \$499,986, in Investee A (approved and executed by Elevate Advisors, LLC) constituted a misuse of SSBCI funds because the Board Chairman of Elevate Ventures had a prohibited related party interest with the investee due to his controlling interest in the investee, which is a program prohibition. *SSBCI Policy Guidelines* prohibit transactions in which an investee receiving SSBCI funds is a related party interest of any executive officer, director, principal shareholder or member of the immediate family of the SSBCI lender or investor. For the purposes of determining whether a related party interest exists, the *SSBCI Policy Guidelines* refer to Regulation O. As defined in *Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*,⁵ a related interest of a person means a company that is controlled by that person. A presumption of control is established when a person is (1) an executive officer or director of the company or bank, and (2) directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank.

The conflicted Board Chairman is presumed to have control of Investee A because he is (1) the CEO, (2) on the Board of Managers, and (3) owned a voting interest in Investee A of 11.59 percent as of October 31, 2012 (prior to the infusion of SSBCI funds), which is above the 10-percent threshold. In addition, the Board Chairman of Elevate Ventures, (as CEO of Investee A) has documented control and a strong degree of controlling influence over the day-to-day management and policies of Investee A. Specifically;

- According to Investee A's Operating Agreement, its Board of Managers on which the Elevate Board Chairman serves is vested in the day-to-day management of the investee's business.
- The Board Chairman's September 7, 2011, Employment Agreement with Investee A states that he, as CEO, is an owner and member of the Board of Managers and, as such, has a vested interest in the success of the company.

⁵ 12 CFR Part 215, Section 215.2.

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- Weekly Management Meeting Minutes from October 2011 to July 2013 indicate that the CEO has a controlling influence and governance/oversight of (1) contract approval and procurement, (2) financing and investing, (3) personnel/staffing/hiring, (4) marketing and promotion, (5) sales and revenue monitoring, and (6) the structure of employee compensation plans.

Therefore, the Elevate Ventures Board Chairman's controlling interest and voting stock ownership of more than 10 percent in Investee A created a prohibited related party interest. As a result, the entire \$499,986 investment in Investee A constituted a misuse of funds.

We further determined that the evidence is sufficient to provide a reasonable basis to find that the misuse was intentional. In August 2012, prior to the close of Investment A, an IEDC official alerted Elevate's CFO to the Board Chairman's high ownership interest based upon his review of a July 2012 capitalization table. According to that table, the Board Chairman had a 10.9 percent ownership interest. The IEDC official asked Elevate to address the issue through its due diligence and the applicable certifications. Elevate's CFO, in turn, informed Elevate's CEO. However, instead of acting on this information, the CEO did not disclose the ownership issue at Elevate's October 12, 2012, Board meeting where the decision was made to proceed with the investment. Moreover, Elevate Ventures' CEO told the OIG that he knew the capitalization tables presented by Investee A on November 2, 2012, were diluted with SSBCI funds that were applied for, but not yet received. The tables, which were prepared to determine the percentage of ownership interest the Board Chairman had in the investee, showed that the Chairman's interest would be diluted to 9.91 percent after receipt of nearly \$500,000 in SSBCI funds that had not yet been awarded. Based on the Chairman's diluted interest, the transaction would be eligible for the SSBCI investment. The CEO of Elevate Ventures also sent a letter to the OIG stating that prior to the investment closing, Elevate evaluated the November 2, 2012, capitalization tables and found them adequate after considering the dilutive effect of the SSBCI investment.

The SSBCI program requires a determination of related party interests prior to the investment closing. Under SSBCI guidance, the investee's certification of compliance with program rules on prohibited related party interests is a condition precedent to the investment closing. In fact, the

SSBCI funds can be awarded only if all of the precedent conditions are met prior to closing. Therefore, the certification must be based on the investor's ownership position prior to closing, because without first establishing the investee's actual qualification status for the program, no specific financial obligation can be entered into with the investee. As a result, relying on post investment capitalization tables to establish the investor's ownership position is not appropriate. The fact that the CEO of Elevate was aware of the terms of the contract, not to mention the *SSBCI Policy Guidelines*, as well as his failure to act on the information regarding potential issues identified by IEDC, establishes that his knowing acceptance of diluted capitalization tables as proof of the investee's eligibility was with the intent to process a transaction based upon knowingly false information.

Despite his knowledge prior to and at investment closing that the Board Chairman's ownership interest exceeded the allowable threshold, the CEO, along with the investee, certified compliance with SSBCI rules, including the prohibition against related party interests. While Treasury allows states to rely in good faith on investee certifications, the CEO had knowledge that the investee certification was inaccurate because he personally knew that the Board Chairman's ownership exceeded the allowable threshold without the SSBCI funds. As a result, the investee's certification could not be accepted in good faith.

Because the Act requires that any funds identified as "intentionally misused" must be returned to Treasury, the entire amount disbursed to Investee A must be recouped. In addition, because the Board's conflict-of-interest policy is not sufficient to establish prohibited related party interests and the State does not provide oversight of investment decisions, other IANF investments may not be compliant with prohibitions in the *SSBCI Policy Guidelines*.

On January 10, 2014, Indiana informed the OIG that the Board Chairman resigned his position with Elevate Ventures, effective December 31, 2013. They also advised us that on January 9, 2014, Investee A entered into a *Unit Repurchase and Release Agreement*, whereby Investee A will repurchase IANF's shares in Investee A with proceeds from either its existing investors or with new capital. On February 6, 2014, the originally invested SSBCI funds, including a 15-percent return, were repaid to the IANF.

We also note that the IEDC engaged an independent firm to review all IANF investments, excluding the two investments examined by the OIG. The review did not identify any conflicts of interest or prohibited related party interests.

While we commend Indiana for taking swift action to prevent future conflicts of interest from arising between the now former Board Chairman and investees approved by Elevate Ventures, such action does not reverse or remedy the OIG's finding that the \$499,986 given to Investee A was intentionally misused. The Act provides that Treasury shall recoup any allocated funds transferred to the State if an OIG audit finds that there was an intentional or reckless misuse of the transferred funds. Also, the State will need to ensure that IEDC reviews each IANF investment decision going forward.

Investment B Was Compliant with Program Requirements, but Could Be Construed as Nepotism

Indiana's \$300,000 transfer of funds to Investee B that was approved and executed by Elevate Advisors, LLC was compliant with *SSBCI Policy Guidelines*. Based on the investment documentation provided by IEDC, the Board Chairman of Elevate Ventures did not have a controlling interest in Investee B. While the Board Chairman and his spouse owned approximately 17 percent of the voting shares in Investee B as of February 27, 2013, which exceeded the 10-percent threshold required to establish controlling interest in Investee B, the Board Chairman was not an executive officer or director of the Investee. Additionally, although Investee B's CEO is the adult son of the Board Chairman, the son is not considered an immediate family member because he does not reside with his father nor is he a minor. Therefore, while the investment constituted a related party transaction, it did not meet the criteria needed to establish it as a prohibited related party interest.

The conflict of interest existing for Investment B was disclosed to the Board of Elevate Ventures in accordance with Elevate Venture's conflict-of-interest policy, and the Board approved the investment without any review by the State. While Investment B is technically compliant with *SSBCI Policy Guidelines*, relying on Elevate Venture's conflict-of-interest policy is not

sufficient when determining if a related party interest exists as defined in the *SSBCI Policy Guidelines*.

The closeness of the relationships between the Elevate Board Chairman and applicant, while not prohibited, may raise the appearance of partiality and should be addressed by *SSBCI Policy Guidelines*. In our opinion, the investment gives the appearance that SSBCI funds were steered to Investee B based on family relationships and raises concerns about whether other legitimate companies received fair consideration.

Recommendations

We recommend that the Assistant Secretary for Financial Institutions:

1. Recoup the \$499,986 of federal funds “intentionally” misused for Investment A and declare a specific event of default of its *Allocation Agreement* with Indiana.
2. Determine whether the State’s funding should be reduced, suspended or terminated as a result of the specific event of default.
3. Require the State to ensure that IEDC reviews each IANF investment decision going forward.

Management Comments and OIG Response

We provided a draft of the report to Treasury on May 9, 2014, and received formal written responses from Treasury and Indiana on May 30, 2014.

Treasury concurred with all three recommendations, stating it would recoup the \$499,986 in intentionally misused funds, determine whether Indiana’s funding should be reduced, suspended or terminated, and require Indiana to review each IANF investment decision. We consider Treasury’s proposed actions to be responsive to the recommendations.

However, although Treasury agreed to recoup the misused funds, it commented that it would not characterize investment A as an “intentional” misuse of funds based on the facts set forth in the report. Treasury stated that intentional misuse requires knowledge that the use of the funds is contrary to the program rules, and action taken must be in a knowing effort

to violate those rules. In addition, Treasury stated that its policy as published in the FAQs and the *National Standards for Compliance and Oversight* allows states to rely in good faith on an investee certification – absent a reason to believe the certification is inaccurate – without such actions being an “intentional” misuse. Indiana also disagreed with the finding of intentional misuse, asserting that the report’s conclusion is unsupported by the factual record and misstates program rules. Officials suggested that the OIG’s finding is based on the reliance by IEDC and Elevate on post-investment capitalization tables that reduced the Chairman’s ownership interest and their knowledge that the Board Chairman held an interest in Investee A—neither of which, separately or collectively, demonstrate that the IEDC knew the Board Chairman’s interest exceeded 10 percent. The State also commented that the OIG’s entire basis for the finding is predicated on its conclusion that reliance on a post-investment capitalization table diluting the Board Chairman’s ownership interest was improper when Regulation O, which sets out the requirement, is ambiguous on the matter.

Treasury’s response to the report reflects a disagreement with the OIG’s characterization of the misuse as “intentional.” We believe that Treasury’s disagreement is based on a definition of “intentional misuse” that is different than the one it formally established for the program. Treasury issued guidance defining “intentional misuse” as “a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.” This is the definition we applied to our audit of Indiana. Yet, Treasury’s formal comments to this audit report expand that definition by suggesting the action taken must also constitute “a knowing effort to violate those rules.” Nevertheless, even if the expanded definition were applied, the OIG would still characterize the misuse as “intentional.” The audit established that the Elevate CEO knowingly accepted the inaccurate investee certification because he had knowledge, based on the notification from IEDC and the November 2012 capitalization table, that the Board Chairman’s ownership interest would qualify only if it was diluted with the SSBCI funds. He also was aware of the program rules making full compliance a condition precedent to the investment of SSBCI funds.

Additionally, we note that in April 2014 Treasury released new program guidance expressly prohibiting an “SSBCI insider” or an affiliate in which the insider has a personal interest from receiving investments or financial support

from SSBCI funds. Treasury defined an SSBCI insider as any individual who had a role in approving the SSBCI investment and who exercised a controlling influence on State policy decisions. In summary, Treasury's guidance targets the very type of "SSBCI insider" transaction that the OIG concluded had occurred, which evidences its support for our finding.

Regarding Indiana's comments, the factual record does indeed support a finding of intentional misuse and the OIG has correctly interpreted program rules. Additionally, Indiana is incorrect in its interpretation of the basis of our conclusions and the program rules upon which they are based. Contrary to what Indiana asserts, the intentional misuse finding is not based solely on the reliance by IEDC and Elevate on the November 2012 capitalization tables showing an ownership interest that was just below 10 percent. The finding is also based on confirmations from IEDC and Elevate's CEO that the CEO was aware of the Board Chairman's high ownership interest as early as August 2012, and had not disclosed it to the Investment Committee. He also knew that the investee's compliance certification was inaccurate because he had knowledge of the November 2012 capitalization tables prepared at investment closing that showed the Board Chairman's interest was nonqualifying without the SSBCI funds. Despite this knowledge, the CEO also certified that the transaction was compliant despite having knowledge that it was not. Therefore, we find the State's argument that the Board did not know of the Chairman's interest until long after the transaction was consummated to be unpersuasive.

Further, our findings do not suggest that participating states cannot rely on investee certifications regarding prohibited related interests. Treasury intended for a participating state to rely on investee certifications of their compliance. However, where the state has knowledge that the certification is inaccurate, and moreover takes it upon itself to certify the truth of the statement, as did Elevate, further inquiry is required. In fact Treasury stated in its response to this report that "the FAQs and the *National Standards for Compliance and Oversight* allow states to rely in good faith on an investee certification – absent a reason to believe the certification is inaccurate – without such actions being an "intentional" misuse. In this case, there was certainly a reason to believe that the investee's certification was inaccurate.

Indiana's response to the report also indicates that the State may be confused about the relevant program rules used to form our conclusions. To

clarify, we relied on Treasury's *SSBCI Policy Guidelines*, which require an investee to certify compliance with program requirements and prohibitions, including the prohibition on related party interests, before the SSBCI funds can be awarded. Therefore, establishing that a prohibited related party interest does not exist is a condition precedent to the investment closing. We did not predicate our conclusion on our interpretation of Regulation O, as Indiana suggests. The calculation of voting interest has to occur prior to investment closing because the *SSBCI Policy Guidelines* require the investee certification of compliance *before* the SSBCI funds can be awarded.

Based on the formal responses received, we have made language changes throughout the report to further clarify the basis of our finding of intentional misuse. Responses from Treasury and from the state of Indiana are included in their entirety in Appendix 1.

* * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/

Debra Ritt

Special Deputy Inspector General for

Office of Small Business Lending Fund Program Oversight

Appendix 1: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 29, 2014

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report entitled *State Small Business Credit Initiative: Indiana's Use of Federal Funds for Other Credit Support Programs* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

With your consent, Treasury transmitted a copy of the Report to Indiana program officials on May 12, 2014. Treasury asked Indiana to provide a narrative response describing the measures it has taken or plans to take to address the deficiencies noted in the Report.

In its reply, Indiana expresses its commitment to ensuring the SSBCI Program is implemented properly, but disagrees with the conclusion that one of its venture capital investments constituted an intentional misuse of funds. Indiana asserts that the Report's conclusion is unsupported by the factual record and misstates the program rules. Additionally, Indiana says it acted in good faith in an effort to operate the SSBCI Program in a compliant manner. Indiana believes that if OIG's conclusion stands, it could dissuade investors from participating in the program due to uncertainty over the standards for misuse of funds. Indiana also describes the measures it has taken to remedy the situation and prevent similar issues in the future. Finally, Indiana indicates that it has unwound the noncompliant investment, recaptured the misused funds, and commissioned an independent auditor to review processes and help guide future investment decisions. Indiana's reply is enclosed with this letter.

In response to recommendation 1, Treasury will defer to the OIG's final determination and will recoup the \$499,986 of federal funds. We note, however, that Treasury also would not characterize the investment as an "intentional" misuse of SSCBI funds based on the facts set forth in the Report. In Treasury's view, as set forth in Treasury's FAQs on the SSBCI program, intentional misuse requires knowledge that the use of the funds is contrary to the program rules, and action taken must be in a knowing effort to violate those rules. Treasury's National Standards for Compliance and Oversight (National Standards) clarify that Treasury does not require Participating States to independently verify the certifications made by the small business borrower (or investee) with respect to the use of proceeds. The National Standards state that Treasury expects Participating States – or their administering entities – to obtain, review, and maintain a copy of each small business borrower's (or investee's) certification. The Report notes that the investee had certified to Indiana that it was in compliance with the SSCBI program rules. Treasury's policy expressed in the published FAQs and National Standards was intended to allow a State to rely in good faith on an investee certification – absent a reason to believe the certification is inaccurate – without such actions being an "intentional" misuse.

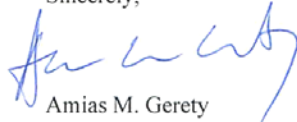
Page 2

Regarding recommendation 2, Treasury will determine whether Indiana's funding should be reduced, suspended or terminated as a result of the specific event of default.

Regarding recommendation 3, namely, that Indiana should ensure that the IEDC reviews each IANF investment decision going forward, Treasury accepts recommendation 3 and will require Indiana to review each IANF investment decision.

Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,



Amias M. Gerety
Acting Assistant Secretary
Office of Financial Institutions

Enclosure



May 19, 2014

Department of the Treasury
Office of Financial Institutions
1500 Pennsylvania Ave.
Washington, DC 20220
Attn: Arias Gerety, Assistant Secretary

Re: Draft Audit Report Number: OIG-SBLF-14-OXX

Dear Assistant Secretary Gerety:

The Indiana Economic Development Corporation writes in response to the Department of the Treasury, Office of Inspector General's ("OIG") Formal Draft Audit Report entitled *State Small Business Credit Initiative: Indiana's Use of Federal Funds for Other Credit Support Programs* ("Report"). IEDC understands the absolute need for compliance and appreciates the Department of Treasury's ("Treasury") commitment to ensuring the State Small Business Credit Initiative ("SSBCI") is implemented properly. Indeed, IEDC has always made every effort to comply with the letter and spirit of all SSBCI requirements and guidance.

Since 2011, IEDC has supported job creation and venture capital throughout Indiana by disbursing \$21 million in SSBCI funds. At all times, IEDC has acted in good faith in an effort to make the SSBCI Program a success. For the first time, OIG now characterizes a reasonable interpretation of an ambiguous regulatory requirement by the Investee as the sole basis of intentional misconduct by the investor. That finding rests on a misunderstanding of the definition of intentional conduct, the *SSBCI Policy Guidelines*, Regulation O and the facts at issue. Furthermore, after a thorough investigation we can confidently state that this was a singular event that has not occurred in any prior or subsequent SSBCI Program transaction in Indiana.

What is more, if OIG's conclusion stands, it could have a substantial chilling effect on the use of SSBCI funds and could likely do damage to the entire SSBCI Program.

THE SSBCI PROGRAM AS IMPLEMENTED IN INDIANA

Shortly after the SSBCI Program was enacted, IEDC created a public/private partnership—Elevate Ventures ("Elevate") and the Indiana Angel Network Fund ("IANF")—to responsibly administer the SSBCI Program and to meet the needs of Indiana businesses. This kind of arrangement is specifically sanctioned and approved by Treasury as reflected in the published Treasury FAQs regarding the SSBCI Program. Under this arrangement, investment decisions are made by individuals with years of venture capital experience; not by politicians. This arrangement was, of course, reviewed and approved by Treasury and Elevate became a

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IEDC Letter to Treasury
May 19, 2014

party to the Allocation Agreement between Treasury and IEDC. *See Attachment A, Revised Annex 1 to the Allocation Agreement.* Under this agreement, the regulatory requirements of the SSBCI Program are also imposed on Elevate. Treasury knew the parties would operate at arms-length and approved the relationship. Treasury has also authorized similar arrangements in other states.

Investment A, at issue here, has led to the creation of numerous new jobs for the people of Indiana and generated a 15% return on investment for Indiana taxpayers. Further, a prominent venture capital firm recently validated the merits of Investment A by completing a transaction in which it provided \$7 million to expand Investee A's operations in Indiana.

IEDC HAS TAKEN EXTRAORDINARY, VOLUNTARY STEPS TO ADDRESS COMPLIANCE

IEDC has always prided itself on its culture of compliance and is upset that a prohibited party transaction may have occurred; even though, as discussed below, it occurred only because of a reasonable interpretation of an ambiguous regulatory requirement by the investee. Once this was brought to IEDC's attention, IEDC took and will continue to take extraordinary, voluntary steps to address Investment A and to make sure such a situation does not happen again.

- **Confirmed this was a singular occurrence.** IEDC has completed an independent audit of all SSBCI investments made by Elevate, except Investment A and Investment B. The auditor's scope of work included a review for compliance with the *SSBCI Policy Guidelines*. We are pleased to report the auditor did not find any other prohibited party transactions or other violations. *See Attachment B, February 25, 2014 Sponsel Group Audit Letter.* IEDC shared the audit findings with the OIG, as noted in its Draft Audit Report. It is certainly significant that IEDC has now confirmed that Investment A was a singular occurrence.
- **The investment funds have been returned: there was no injury to the public.** All IEDC SSBCI investments are subject to a recapture provision. This includes Investment A. Because of IEDC's absolute commitment to a culture of compliance, IEDC has relied on this provision to unwind Investment A. It was not required to do so. The investment has been repaid to IANF with a 15% return. *See Attachment C, Unit Repurchase and Release Agreement; and Attachment D, Unit Assignment.* There is no need for an "intentional" finding to recoup the money from Investee A, or, frankly, any finding of misuse.
- **IEDC has voluntarily submitted the funding process to independent review.** In the spirit of continuous improvement, IEDC will independently review any future potential investment conflict. When the Investment A issue came to light, Indiana commissioned an independent KPMG study to review processes and help guide future investment decisions. Based on that study, KPMG made recommendations for improved processes in its October 24, 2013 Final Report entitled "Review of Elevate Ventures' Business Practices." *See Attachment E.* Continuous

IEDC Letter to Treasury
May 19, 2014

improvement has resulted in a stronger conflict of interest policy for Elevate and greater involvement by IEDC Management in the investment process. Best practices proposed by KPMG and the independent auditor relative to Investment A are now in effect and operational; those practices exceed requirements under the *SSBCI Policy Guidelines*.

Additionally, Treasury has proposed changes to the *SSBCI Policy Guidelines and SSBCI National Standards* that will further prohibit certain conflicts of interest. IEDC supports this initiative and will fully implement the new policies.

AT THE TIME OF CERTIFICATION, ALL PARTIES BELIEVED IN GOOD FAITH THAT THE TRANSACTION WAS COMPLIANT

In November 2012, IEDC, through Elevate and IANF, disbursed SSBCI funds to a promising young company—Investee A. Before the investment decision was made, Elevate’s Board Chairman disclosed that he was an officer of Investee A and held an ownership interest in the company. This type of relationship is permitted, so long as it meets the requirements of the current SSBCI Policy Guidelines, which adopt the requirements of Part 215 of Title 12 of the Code of Federal Regulations (“Regulation O”). Specifically, the Board Chairman must not have “control” of the investee. Pursuant to Regulation O, “control of a company” is presumed where, in pertinent part, the Board Chairman has a greater than 10% voting ownership interest in the investee. The presumption is rebuttable.

IEDC was aware of the Board Chairman’s voting stock interests in Investee A. In August 2012, an IEDC employee assigned to oversee the SSBCI program reviewed Investee A’s July 2012 capitalization table in connection with a different IEDC program. The table listed the Board Chairman’s vested interests in Investee A, as well as unvested interests that would vest in the following 3 to 4 years. If all the interests had vested at the time, they would have exceeded the 10% threshold. But it was not clear when, if, or under what circumstances the unvested interests would actually vest. Thus, IEDC and Elevate did not know whether the interests actually exceeded or would ever exceed 10%. But, since it was possible that the 10% threshold might be exceeded, IEDC flagged the issue and Investee A was advised to review it, which it did. Elevate’s CEO was unaware of this fact until well after Investment A was consummated.

Before the investment was consummated, Investee A reviewed the Board Chairman’s ownership percentage to insure that the 10% threshold had not been breached. Investee A determined that the *SSBCI Policy Guidelines* were satisfied, and signed a required certification to that effect. IEDC, at all times, believed and understood that the investee understood the requirements of Regulation O and had calculated the Board Chairman’s ownership interest properly. As it turns out, Investee A miscalculated the interest and the Board Chairman’s voting interest barely exceeded the 10% threshold.

Based on the investee’s certification and the knowledge and belief that Investee A understood the Regulation O requirements, Elevate’s CEO signed a similar certification. Elevate’s CEO did not know the Board Chairman’s ownership percentage in fact exceeded the

IEDC Letter to Treasury
May 19, 2014

10% threshold. Nor did anyone else within Elevate or IEDC. Indeed, Elevate contemporaneously reviewed a post-investment capitalization table provided by Investee A to understand the post-investment ownership interests. This is a common practice for equity investors. And it was necessary to ensure 1-to-1 investment match requirements were satisfied. On the face of the capitalization table, it clearly appeared that the Board Chairman's total interest was below 10%. There was, at the time, no reason to believe Investee A's certification was incorrect based on the materials provided.

After OIG began its investigation in July 2013, Investee A re-examined its prior calculation. It then determined, for the first time, that it had not considered that some of the stock did not carry voting rights and as a result had miscalculated the Board Chair's voting interest, which was actually 11.59%. This meant that Investment A may have been a prohibited party transaction under Regulation O and may not have been compliant with *SSBCI Policy Guidelines*. The investee then notified IEDC and Elevate.

OIG now finds that because IEDC realized that the Board Chairman's voting stock interests *might* reach 10% prior to the transaction, and because IEDC ultimately reviewed the transaction for Regulation O compliance purposes using a November 2, 2012 (the day the transaction closed) capitalization table, IEDC's funding of Investment A was an "intentional misuse" of SSBCI funds. This is a misapplication of "intentional" and skews the plain language requirements of the SSBCI program.

OIG DOES NOT ALLEGE ACTUAL KNOWLEDGE OF A RELATED INTEREST; ITS FINDING OF INTENTIONAL CONDUCT IS PLAINLY ERRONEOUS

At issue here is whether the SSBCI Program requirements concerning related interests were intentionally violated. They were not because:

1. IEDC and Elevate did not know there was a related interest after review of the July 2012 capitalization table because the vesting schedule was unclear;
2. IEDC and Elevate did not know there was a related interest after review of the November 2, 2012 capitalization table because it appeared that the Board Chairman's voting stock interests were less than 10%; and
3. Investee A, with the assistance of counsel, certified that the SSBCI requirements had been satisfied and IEDC and Elevate relied on that certification in accordance with SSBCI requirements.

Treasury defines intentional misuse as a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited. The related interest requirements are included below:

[I]n an approved State capital access program, the financial institution lender—
(i) shall obtain an assurance *from each borrower that*—
[...]

IEDC Letter to Treasury
May 19, 2014

- (III) the borrower is not—
[...]
(cc) a related interest of any such executive officer, director, principal shareholder, or member of the immediate family...

State Small Business Credit Initiative Act of 2010, Sec. 3005(e)(7) (emphasis added). This requirement is repeated in the *SSBCI Policy Guidelines*.

There was no requirement that an *investor* provide a similar certification. The critical component of the OIG's report asserts that an investor's certification "is a condition precedent to the investment closing," but, there is no basis in law or fact for this statement. It was the *borrower's* certification, as stated above, that was a condition precedent. Because an investor certification regarding related interests was not an SSBCI requirement, it cannot be used as the basis for a finding of intentional misuse by either Elevate or IEDC.

As evidence of OIG's inconsistent position, we can look to its July 24, 2013 Audit Report entitled *State Small Business Credit Initiative: Missouri's Use of Federal Funds for Other Credit Support Programs*. There, OIG found that a participating state failed to obtain adequate assurances from an investee and, thus, recklessly misused SSBCI funds. OIG's Audit Report clearly stated the requirements for both investee and investor certifications. Nowhere does it suggest that an investor is also required to certify there is no prohibited relationship as a condition precedent to an investment. OIG now contradicts its own prior statement of the certification requirements. What is more, OIG found the failure to get proper assurances was a reckless misuse, while now finding that getting the proper assurances amounts to intentional misuse. On both points, OIG's findings are remarkably inconsistent.

In the context of this Report, the question is whether IEDC knew there was a related interest when the transaction was consummated. In other words, did IEDC know the Board Chairman's interest in Investee A exceeded 10%. OIG has determined that it did because: (1) Elevate and IEDC reviewed post-investment capitalization tables instead of pre-investment tables; and (2) it knew the Board Chairman held an interest in Investee A. Neither of these facts—separately or collectively—demonstrate that IEDC knew the Board Chairman's interests in Investee A exceeded 10%.

OIG's entire basis for finding an intentional misuse of funds is predicated upon its conclusion that it was improper to calculate the Board Chair's ownership interest based upon his voting interest in Investee A, as it existed on November 2, 2012, immediately following the close of Transaction A. OIG believes, rather, that the calculation of voting interest needed to be made based upon the voting interests as they existed immediately prior to the transaction's closing. But OIG is unable to cite any authority to support its view that this was the correct and only way to calculate the voting interest.

Rather, this is a completely open and unanswered question regarding Regulation O compliance. OIG simply cannot now, after the fact, impose its unilateral interpretation of Regulation O to support a finding of intentional misuse. This is especially true, when, as here,

IEDC Letter to Treasury
May 19, 2014

the Investee, advised by very capable counsel, concluded, in good faith, that it was appropriate to calculate the Board Chair's voting interest as it existed at the moment the transaction closed—a standard practice in early stage venture capital investments. A fact that Elevate and IEDC became aware of after the transaction. A serious finding of intentional misuse can never be based upon a good faith interpretation—whether right or wrong—of an ambiguous regulatory requirement.

The requirement in question is found in Regulation O, which defines presumptive control to exist when a 10% voting threshold is exceeded. However, neither Regulation O nor any SSBCI or other guidance directs when that calculation is to be made. This is not surprising. Regulation O is a banking regulation dealing with insider loans where, because equity is not at issue and only debt is involved, the percentages of equity ownership immediately before and after the transaction remain the same. By imposing this requirement, and without providing any regulatory guidance, there is no way to know if the calculations are to be made prior to investment or immediately upon investment. It may very well be appropriate for Treasury to issue guidance on this issue, but it would be completely inappropriate for OIG to make a finding of "intentional misuse" in the absence of any such guidance and based only on its unilateral interpretation of when the calculation should have been made.

OIG does not explain how the review of a capitalization table prepared by Investee A shows that Elevate or IEDC knew there was a related interest. Further, because OIG mistakenly believes that there is an SSBCI requirement that an investor is to certify an investee's compliance with a transaction, it finds that Elevate's CEO had a duty to second-guess the Investee's certification—a position expressly refuted by the *SSBCI National Standards*:

Treasury does not require Participating States (or administering entities, lenders, or investors, if so designated) to independently verify the representations made by the authorized representative of the small business borrower or investee with respect to the use of proceeds...

SSBCI National Standards, pg. 7.

Additionally, it alleges that Elevate's CEO knew the investee's certification was based on diluted capitalization tables. There is absolutely no evidence that supports that conclusion. What Elevate's CEO knew was that Investee A had made its certification, which satisfied the SSBCI Program requirements.

OIG combines its post hoc view that there is some unexplained regulatory requirement that control be analyzed on a pre-transaction basis, with IEDC's awareness that there was a *potential* for a prohibited party transaction. Based on this, OIG infers that the post-investment capitalization table was accepted to avoid concluding that there was a related interest. OIG believes this rises to the level of intentional conduct. This is not enough. In order to find an intentional or even reckless misuse, OIG must point to evidence and law to establish that IEDC or Elevate must have known before the transaction that the Board Chairman's' voting stock

IEDC Letter to Treasury
May 19, 2014

interests exceeded the 10% threshold. The related interest was not known until long after the transaction was consummated. Further, IEDC and Elevate could not have detected the ownership details despite the fact that Elevate and the Investee shared an officer—the Board Chairman—because he was walled off from the transaction, per Elevate’s conflict of interest policy.

OIG does not contest that IEDC or Elevate lacked knowledge of the Board Chairman’s actual ownership interest. Instead, it attempts to broaden the definition of intentional misuse by relying on non-existent guidelines, and inference. OIG has not satisfied the definition of intentional misuse; its finding is plainly erroneous.

IEDC AND ELEVATE VENTURES ACTED REASONABLY, IN ACCORDANCE WITH SSBCI GUIDELINES

As described above, IEDC knew the Board Chairman owned voting stock interests before the transaction was consummated. And, accordingly, Investee A was advised to review the transaction for compliance with Regulation O, which it did.

It was reasonable for IEDC and Elevate to rely on representations by Investee A and reputable professionals. Since IEDC or Elevate knew that the investee understood its compliance obligations, there was no requirement or reason to second-guess Investee A. The investee’s obligation to certify the transaction manifests a recognition that the investor does not have access to the information that would allow this kind of verification: that information resides peculiarly with the investee. And so long as the investor makes sure that the investor company understands its compliance and certification responsibilities, the investor/State has fulfilled its obligations.

Further, this division of responsibilities is common in business transactions. The party with access to the information is responsible for making certifications relating to that information. So too here the investee had unique access to the capitalization tables and other information needed to calculate the Board Chair’s voting interest and it did exactly that. Elevate, not privy to that information, relied on the investee’s efforts and certification. If there were an error by the investee, Elevate and IEDC had a remedy—it could recapture the SSBCI funds. And it voluntarily did, as noted above.

What is more, pursuant to Elevate’s own conflict of interest rules, the Board Chairman was walled-off from the transaction because of his relationship with Investee A. Even if Elevate or IEDC was required to second-guess the certification—which it was not—the Board Chairman could not have been consulted. And even if he had been consulted, he too would have deferred to the lawyers and professionals within Investee A that would have been uniquely positioned to calculate his voting interest. (An individual knows his or her own ownership interest, not those of others, which, of course, is what is needed to calculate percentage of voting interest; only the investee company has that information). Further, it is the company’s representation and certification to make to the investor, not that of the individual. The factual information regarding stock ownership is uniquely in the possession of the investee, was provided to Elevate, and showed on its face that the Board Chairman’s ownership was below the 10% Regulation O

IEDC Letter to Treasury
May 19, 2014

threshold. It was not determined that a calculation error had been made until well after the transaction.

OIG's finding suggests that Elevate's CEO had a personal obligation to verify the representation. That by relying on Investee A's certification, he acted inappropriately. In other words, OIG wants an investor to be a guarantor for all information provided by the investee. This is patently unreasonable and certainly not required by *SSBCI Policy Guidelines*. To impose new rules after the fact makes it impossible for participating states to do business with any degree of certainty. For the program to work efficiently, the participating states and the business community must have clear rules to rely upon.

OIG'S TREATMENT OF INVESTMENT B

OIG includes a discussion of Investment B in its Draft Report, notwithstanding OIG's clear conclusion that the transaction is "compliant." Nonetheless, OIG offers its observation that it "can be construed as nepotism and "should be addressed by *SSBCI Policy Guidelines*." The IEDC can only conform its behavior to Treasury's rules as they exist. In all regards, IEDC complied with its lawful obligations.

OIG'S INTENTIONAL FINDING COULD LIKELY HAVE A CHILLING EFFECT ON THE SSBCI PROGRAM

The public-private partnerships used in Indiana and elsewhere work because they are efficient, advantageous and founded on well-defined requirements. It is a promising arrangement. To date, the SSBCI Program in Indiana has supported 23 businesses that have estimated will create almost 275 high-paying jobs over the next two years. IANF investments alone have attracted significant co-investment capital to Indiana—almost 2x the amount of SSBCI funding.

OIG's intentional finding may, unfortunately, cause state policy-makers to rethink such partnerships. Also, Indiana's venture capital community is small and tends to be reputational risk averse. Further, as discussed above, OIG seeks to apply inconsistent standards between the participating states. Unclear and arbitrarily enforced regulations likely will drive businesses and participating states away from the SSBCI Program instead of attracting them. The ultimate outcome could be a chilling effect on venture capital in Indiana and fewer jobs for Americans; a lose/lose proposition

IEDC respectfully asks that Treasury clarify that IEDC did not intentionally misuse SSBCI funds and requests that Treasury ask OIG to modify its findings accordingly, before the Audit Report is finalized. Given the demonstrated commitment to compliance and continuous improvement, the IEDC further requests that the SSBCI Program remain viable in Indiana.

Above all, IEDC wants the SSBCI Program to succeed. We look forward to a constructive dialogue.

IEDC Letter to Treasury
May 19, 2014

Sincerely,

A handwritten signature in cursive script that reads "Eric R. Doden". The signature is written in black ink and is positioned above the typed name.

Eric R. Doden
President

Attachments

Appendix 2: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

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Steve Encomienda, Auditor

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Appendix 3: Report Distribution

Department of the Treasury

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Office of Strategic Planning and Performance Management
Risk and Control Group

Office of Management and Budget

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