



Audit Report



OIG-17-035

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

January 24, 2017

Office of
Inspector General

Department of the Treasury

Contents

Audit Report	1
Background.....	3
New York’s Participation in SSBCI.....	3
Innovate NY Fund.....	4
Finding.....	5
Canrock Innovate’s Investments Constituted a Reckless Misuse of \$1.63 Million in SSBCI Funds.....	5
Recommendation.....	7

Appendices

Appendix 1	Objective, Scope, and Methodology	9
Appendix 2	Treasury Management Response	11
Appendix 3	SSBCI Program Background	12
Appendix 4	Major Contributors to This Report.....	13
Appendix 5	Report Distribution	14

Abbreviations

Act	Small Business Jobs Act of 2010
Canrock Innovate	Canrock Innovate NY Fund, LP
Canrock Ventures	Canrock Ventures, LLC
CAP	Capital Access Program
Innovate Fund	Innovate NY Fund, LP
Treasury	Department of the Treasury
ESD	Empire State Development
OIG	Office of Inspector General
SSBCI	State Small Business Credit Initiative

This Page Left Intentionally Blank.

*The Department of the Treasury
Office of Inspector General*

January 24, 2017

Brian Peretti
Director, Critical Infrastructure Protection and Compliance Policy
(Delegated responsibilities of the Assistant Secretary for Financial
Institutions)

As part of our ongoing oversight of the Department of the Treasury's (Treasury) State Small Business Credit Initiative (SSBCI), authorized by the Small Business Jobs Act of 2010 (Act),¹ we conducted audits of awards made to select States, Territories, and eligible Municipalities (hereinafter referred to as States) to support their capital access and small business credit programs. The purpose of these audits was to assess States' compliance with SSBCI program requirements and prohibitions to identify any reckless² or intentional³ misuse of funds. Regarding SSBCI funds awarded to the State of New York, our audit focused on the State's compliance with respect to funds invested in its venture capital program.

In this report, we provide our assessment of Canrock Innovate NY Fund, LP's (Canrock Innovate) compliance with the SSBCI program requirements and prohibitions with respect to its \$1.67 million

¹ Pub. L. 111-240, 124 Stat. 2568-2582 (September 27, 2010).

² Reckless misuse as defined by Treasury is a use of Allocated Funds that the Participating State or its administering entity/ies should have known was unauthorized or prohibited. A "reckless misuse of funds" is a highly unreasonable departure or willful disregard from the standards of ordinary care, and may be a single instance or a series of instances. As this definition provides interpretive guidance regarding Article IV of the State of New York State Small Business Credit Initiative Allocation Agreement for Participating States, dated September 26, 2011, "Covenants And Agreements of the Participating State", we apply this definition to Canrock Innovate NY Fund, LP, vice the Participating State.

³ Intentional misuse as defined by Treasury is a use of Allocated Funds that the Participating State and/or its administering entity/ies knew was unauthorized or prohibited. An intentional misuse of funds may be a single instance or a series of instances.

venture capital fund.⁴ Canrock Innovate is 1 of 8 venture capital funds created by Empire State Development (ESD) to support its Innovate NY Fund, LP (Innovate Fund). We plan to issue a separate report on the use of SSBCI funds in the other seven venture capital funds. Appendix 1 provides more detail of our audit objective, scope, and methodology.

In brief, we determined that Canrock Innovate's investments did not fully comply with all venture capital program requirements. Specifically, Canrock Innovate's investments in 4 of 5 beneficiary companies constituted a reckless misuse of approximately \$1.63 million⁵ of SSBCI funds because the investments were prohibited related party interests of its general partner, Canrock Innovate Advisors, LLC. Through a related entity, the three managing members of Canrock Innovate Advisors, LLC had a controlling interest in each of the four beneficiary companies' voting shares, which violated the *SSBCI Policy Guidelines*,⁶ regarding conflicts of interest. Accordingly, we recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing declare a specific event of default of its *Allocation Agreement* with New York and recoup the \$1.63 million of SSBCI funds found to be recklessly misused by Canrock Innovate Advisors, LLC.

As part of our reporting process, we provided ESD management an opportunity to comment on drafts of this report. After incorporating comments as appropriate, we requested a written response from ESD to incorporate into this report for Treasury management's consideration, but ESD declined.

In its written response to this report, Treasury management stated that it deferred to our determination that Canrock Innovate Advisors, LLC recklessly misused \$1.63 million of SSBCI funds. However, management noted that in lieu of recoupment, it will not disburse the remainder of New York's allocation. Management had

⁴ In accordance with Annex 1 of the State of New York State Small Business Credit Initiative Allocation Agreement for Participating States, dated September 26, 2011, Article IV, "Covenants And Agreements of the Participating State" and Article VI, "Termination for Cause and Other Remedies" of that Agreement shall be specifically applicable to the individual venture capital fund(s) selected.

⁵ Actual amount is \$1,629,787.

⁶ *SSBCI Policy Guidelines* (October 21, 2011)

withheld the amount in question from New York's final disbursement pending the results of this audit. If management determined that the recommended recoupment is not feasible, we consider the decision to withhold and not disburse New York's remaining allocation of \$1.63 million to meet the intent of our recommendation. The response, in its entirety, is included as appendix 2 to this report.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating States funding to strengthen capital access programs and other credit support programs that provide financial assistance to small businesses and manufacturers. Capital access programs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. Other credit support programs include collateral support, loan participation, loan guarantee, credit support, and venture capital programs.

Loans and investments made with SSBCI funds must comply with the program requirements detailed in the Act, *SSBCI Policy Guidelines*, the *SSBCI National Standards for Compliance and Oversight*, and the *Allocation Agreement*. With respect to venture capital programs, investments must have at least 20 percent private capital at risk at the time the investments are made and any one investment must be \$5 million or less. Also, program requirements prohibit the investment of SSBCI funds in related party interests. The Deputy Assistant Secretary for Small Business, Community Development and Housing administers the SSBCI program. Details of the program are provided as appendix 3.

New York's Participation in SSBCI

The State of New York was awarded approximately \$55.4 million of SSBCI funds upon Treasury's approval of its participation in the program in September 2011. The *Allocation Agreement*, among other things, authorized the use of SSBCI funds for the following three small business development programs: the Innovate Fund, the Capital Access Program, and the New York State Bonding Guarantee Assistance Program.

As of December 31, 2015, Treasury disbursed approximately \$53.7 million to New York, which in turn, obligated or spent approximately \$41.3 million. Of this amount, \$35 million was invested in the Innovate Fund, a venture capital program. The State designated the ESD to administer the approved State programs on behalf of the Office of the Governor. The *Allocation Agreement* also provided that for the purpose of extending and applying Articles IV and VI to the selected funds' administration of specific aspects of the Innovate Fund, Canrock Innovate would be substituted in reference to the "participating State" in Articles IV and VI.

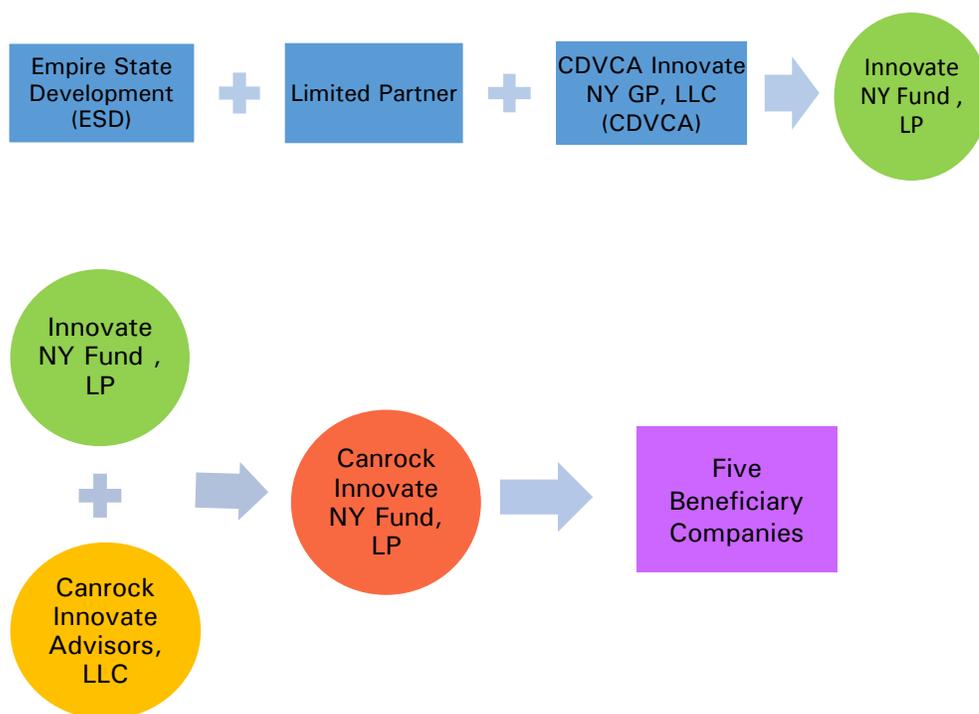
Innovate Fund

ESD, along with another limited partner, entered into a limited partnership agreement with CDVCA Innovate NY GP, LLC (CDVCA) to form the Innovate Fund in 2012. The purpose of the Innovate Fund is to acquire and hold interests in seed funds that were created to invest in beneficiary companies.⁷ The limited partners are primarily responsible for making capital contributions to the Innovate Fund to acquire seed fund interests. As the general partner, CDVCA is responsible for, among other things, issuing common and preferred units to the limited partners, and making capital calls requiring each limited partner to make capital contributions to the Innovate Fund as needed.

The Innovate Fund entered into a limited partnership agreement with Canrock Innovate Advisors, LLC to form the seed fund Canrock Innovate. As the general partner, Canrock Innovate Advisors, LLC was responsible for identifying and approving investments in beneficiary companies according to Innovate Fund's investment strategy, and as such, invested \$1.67 million of SSBCI funds in five beneficiary companies. Furthermore, Canrock Innovate Advisors, LLC was also required to ensure compliance with SSBCI requirements. The relationship among entities associated with Canrock Innovate is shown in Figure 1.

⁷ Defined in the partnership agreement as either limited partnerships or limited liability companies selected by ESD.

Figure 1 Canrock Innovate Entities



Finding

Canrock Innovate’s Investments Constituted a Reckless Misuse of \$1.63 Million in SSBCI Funds

Canrock Innovate did not fully comply with all venture capital program requirements. Specifically, investments in 4 of 5 beneficiary companies constituted a reckless misuse of approximately \$1.63 million of SSBCI funds because the investments were prohibited related party interests of its general partner, Canrock Innovate Advisors, LLC. Through a related entity, the three managing members of Canrock Innovate Advisors, LLC had a controlling interest in each of the four beneficiary companies’ voting shares, which violated the *SSBCI Policy Guidelines* regarding conflicts of interest.

SSBCI Policy Guidelines prohibit transactions in which a beneficiary company receiving SSBCI funds is a related party interest of any executive officer, director, principal shareholder or member of the immediate family of the SSBCI investor. For the purposes of

determining whether a related party interest exists, the *SSBCI Policy Guidelines* refer to *Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*,⁸ (*Regulation O*). As defined in *Regulation O*, a related interest of a person means a company that is controlled by that person⁹. Control is established when a person directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank.

The three managing members and sole owners of Canrock Innovate Advisors, LLC were executive officers of the SSBCI investor, Canrock Innovate, as defined in the *SSBCI Policy Guidelines*. These same individuals managed a related entity, Canrock Advisors LLC, which was the managing member of a separate venture capital fund, Canrock Ventures, LLC (Canrock Ventures). At the time Canrock Innovate invested SSBCI funds in the four beneficiary companies, Canrock Ventures owned between 50.2 percent and 55.1 percent voting securities in all four of them. As defined by Regulation O, the three managing members of Canrock Innovate Advisors, LLC controlled the four beneficiary companies through Canrock Venture's ownership interests in them. The partnership agreement between ESD and Canrock Innovate Advisors, LLC incorporated the *SSBCI Policy Guidelines* prohibiting related party transactions. As such, Canrock Innovate Advisors, LLC should have known that Canrock Innovate's investments in the subject companies were prohibited transactions. Accordingly, we concluded that these transactions were a reckless misuse of SSBCI funds.

In July 2014, CDVCA, as general partner of Innovate Fund, notified Canrock Innovate Advisors, LLC that it had substantially failed to comply with the requirements of the limited partnership agreement regarding conflicts of interest, among other things, when making investments. Accordingly, Canrock Innovate Advisors, LLC was instructed to cease further Canrock Innovate investments.

⁸ 12 CFR Part 215, Section 215.2.

⁹ *Regulation O* defines person as either an individual or a company.

Recommendation

We recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing declare a specific event of default of its *Allocation Agreement* with New York and recoup the \$1.63 million of SSBCI funds found to be recklessly misused by Canrock Innovate Advisors, LLC.

Management Response

In its written response to this report, Treasury management deferred to our determination that Canrock Innovate Advisors, LLC recklessly misused \$1.63 million of SSBCI funds. However, management noted that in lieu of recoupment, it will not disburse the remainder of New York's allocation. Management had withheld the amount in question from New York's final disbursement pending the results of this audit.

OIG Comment

If management determined that the recommended recoupment is not feasible, we consider Treasury's decision to withhold and not disburse New York's remaining allocation of \$1.63 million to meet the intent of our recommendation.

* * * * *

We would like to extend our appreciation for the cooperation and courtesies extended to our staff during the audit. Major contributors to this report are listed in appendix 4. A distribution list for this report is provided as appendix 5. If you have any questions, please contact me at (202) 927-1011.

Theresa Cameron
Director, Financial Assistance Audits

Pursuant to Section 3003 of the *Small Business Jobs Act of 2010* (Act), we conducted audits of awards made to select States, Territories, and eligible Municipalities (hereinafter referred to as States) as part of our ongoing oversight of the Department of the Treasury's (Treasury) State Small Business Credit Initiative (SSBCI), authorized by the Act, to support their capital access and small business credit programs. The objective of these audits was to assess States' compliance with SSBCI program requirements and prohibitions to identify any reckless or intentional misuse of funds. Regarding SSBCI funds awarded to the State of New York, our audit focused on the State's compliance with respect to funds invested in its venture capital program.

This report assessed Canrock Innovate NY Fund, LP's (Canrock Innovate) compliance with the SSBCI program requirements and prohibitions with respect to its \$1.67 million venture capital fund. Canrock Innovate is 1 of 8 venture capital funds created by Empire State Development (ESD) to support its Innovate NY Fund, LP (Innovate Fund). We plan to issue a separate report on the use of SSBCI funds in the other seven venture capital funds.

To accomplish our objective, we reviewed five investments made by Canrock Innovate between January and August 2013. We conducted fieldwork at the ESD headquartered in New York, New York; and the Treasury Office of Inspector General office in Washington, D.C., between December 2013 and March 2016. We performed the following steps.

- We reviewed the following documents:
 - *SSBCI National Standards for Compliance and Oversight* (May 15, 2012);
 - *SSBCI Policy Guidelines* (October 21, 2011);
 - SSBCI Frequently Asked Questions;
 - SSBCI Fact Sheet;
 - *Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*;
 - ESD beneficiary intake forms;
 - Beneficiary capitalization tables and stock purchase agreements;
 - SSBCI Quarterly Reports;
 - SSBCI Annual Reports (2012, 2013, and 2014); and
 - SSBCI Investee and Investor Certifications.

- We interviewed key officials at ESD and a managing member of Canrock Innovate Advisors, LLC.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit 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 provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix 2
Treasury Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 9, 2017

Theresa Cameron
Department of the Treasury
Office of Inspector General
875 15th Street, NW
Washington, DC 20005

Dear Ms. Cameron:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report regarding Canrock Innovate NY Fund, LP's use of SSBCI funds (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

It is our understanding that OIG transmitted a copy of the Report to New York program officials and they provided comments, but chose not to submit a response for publication.

In response to the OIG's recommendation, Treasury will defer to the OIG's final determination and in lieu of recoupment will not disburse the remainder of New York's allocation. SSBCI had withheld the amount in question from disbursement pending the results of this audit.

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

Sincerely,

A handwritten signature in blue ink that reads "Jessica Milano".

Jessica Milano
Deputy Assistant Secretary for Small Business,
Community Development, and Housing

Enclosure

Under the State Small Business Credit Initiative (SSBCI), States were allocated funds based on formulas that measured the States' unemployment rates between 2007 and 2009. The Department of the Treasury (Treasury) disburses SSBCI funds allocated to each participating State in three increments referred to as tranches. The first tranche was disbursed upon Treasury's approval for participation in the SSBCI program. Disbursements of the second and third tranches are dependent upon the participating State's certification that it has obligated, transferred, or spent at least 80 percent of the previous tranche and has complied with all applicable program requirements.

Each participating State is required to designate specific departments, agencies, or political subdivisions to administer the funding. The designated entity distributes SSBCI funds to public and private institutions, which may include a subdivision of another State, a for-profit entity supervised by the State, or a non-profit entity supervised by the State. These entities use funds to make loans or provide credit access to small businesses.

Primary oversight of the use of SSBCI funds is the responsibility of each State's designated entity. To ensure that funds are properly controlled and expended, the Act required that Treasury execute an Allocation Agreement with participants setting forth internal controls and compliance and reporting requirements before receiving SSBCI funds.

Appendix 4
Major Contributors to This Report

Nadine L. Forgenie, Audit Manager
Lynette M. Feliciano Del Valle, Auditor
Kevin A. Guishard, Referencer

Department of the Treasury

Director, Critical Infrastructure Protection and Compliance Policy
(Delegated responsibilities of the Assistant Secretary for
Financial Institutions)
Office of Strategic Planning and Performance Improvement
Office of the Deputy Chief Financial Officer, Risk and Control
Group

Office of Management and Budget

OIG Budget Examiner

New York Empire State Development

President and Chief Executive Officer



Treasury OIG Website

Access Treasury OIG reports and other information online:

<http://www.treasury.gov/about/organizational-structure/ig/Pages/default.aspx>

Report Waste, Fraud, and Abuse

OIG Hotline for Treasury Programs and Operations – Call toll free: 1-800-359-3898

Gulf Coast Restoration Hotline – Call toll free: 1-855-584.GULF (4853)

Email: Hotline@oig.treas.gov

Submit a complaint using our online form:

<https://www.treasury.gov/about/organizational-structure/ig/Pages/OigOnlineHotlineForm.aspx>