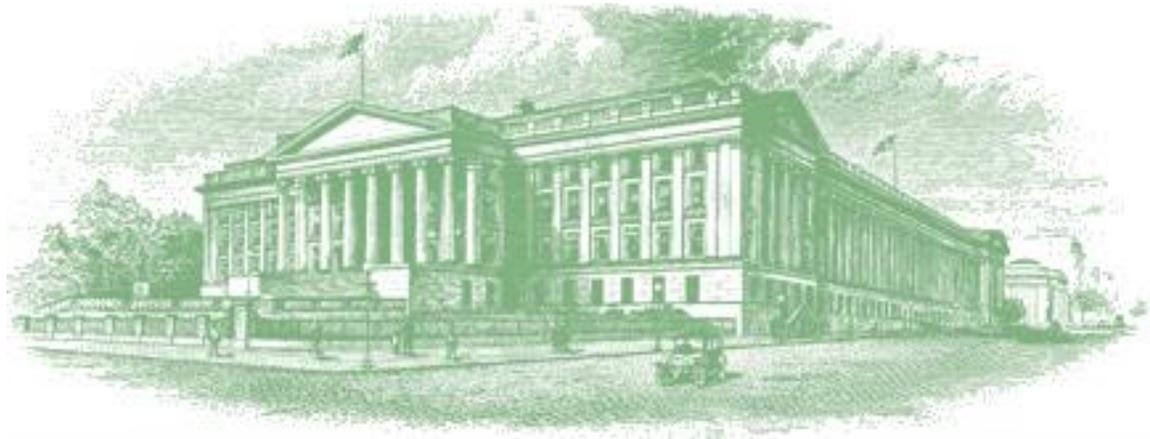




Audit Report



OIG-17-057

STATE SMALL BUSINESS CREDIT INITIATIVE
Rhode Island's Use of Federal Funds for Its Betaspring Fund
100, LLC Venture Capital Program

September 20, 2017

Office of
Inspector General

Department of the Treasury

Contents

Audit Report..... 1

 Background..... 4

 Rhode Island’s Participation in SSBCI..... 5

 Betaspring Entities and Startup Investments, LLC 5

 Finding 1 7

 Betaspring Fund 100, LLC’s Investments in Seventeen Beneficiary Companies
 Constituted an Intentional Misuse of \$803,644 in SSBCI Funds..... 7

 Recommendation 9

 Finding 2 9

 Rhode Island’s Investment in Startup Investments, LLC Was Not Approved
 by Treasury..... 9

 Recommendation 11

 Finding 3 11

 Betaspring Fund 100, LLC Used SSBCI Funds Inconsistent with Its Allocation
 Agreement..... 11

 Recommendation 12

Appendices

Appendix 1: Objective, Scope, and Methodology 14

Appendix 2: Schedule of Questioned Costs 16

Appendix 3: Rhode Island Commerce Corporation Response 17

Appendix 4: Treasury Management Response 21

Appendix 5: State Small Business Credit Initiative Background 22

Appendix 6: Major Contributors to this Report..... 23

Appendix 7: Report Distribution..... 24

Contents

Abbreviations

Act	Small Business Jobs Act of 2010
Betaspring	Betaspring, LLC
Betaspring Managers Corporation	Betaspring Managers 100, LLC
Fund	Rhode Island Commerce Corporation
OIG	Betaspring Fund 100, LLC
RIEDC	Office of Inspector General
SBLFC	Rhode Island Economic Development Corporation
SSBCI	Small Business Loan Fund Corporation
Startup	State Small Business Credit Initiative
Treasury	Startup Investments, LLC
	Department of the Treasury

This Page Left Intentionally Blank.

*The Department of the Treasury
Office of Inspector General*

September 20, 2017

Kipp Kranbuhl
Deputy Assistant Secretary for Small Business, Community
Development, and Housing

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 (the 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.

In this report, we provide our assessment of Rhode Island's investment of nearly \$2 million⁴ of its approximately \$13.2 million⁵ SSBCI allocation, which was approved for the Betaspring Fund 100, LLC (Fund). The Fund is one of two Rhode Island venture capital programs approved to participate in SSBCI. We issued a separate report on Rhode Island's other venture capital program, Slater Technology Fund, in October 2014.⁶ Appendix 1 provides more detail on our audit objective, scope, and methodology.

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.

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.

⁴ Actual amount is \$1,923,391.

⁵ Actual amount is \$13,168,350.

⁶ *State Small Business Initiative: Rhode Island's Use of Federal Funds for the Slater Technology Fund* (OIG-SBLF-15-001; October 31, 2014)

In brief, we determined that the Fund's investments in seventeen beneficiary companies constituted a misuse of \$803,644 in SSBCI funds because at the time the investments were made, there was no private capital at risk. In this case, we determined that the misuse was intentional because Betaspring Managers 100, LLC (Betaspring Managers) knew that 20 percent private capital for each investment was required but made the seventeen investments anyway. As such, we question \$803,644 of SSBCI funds intentionally misused as this was in violation of the Act and *The SSBCI Guidelines*. See appendix 2 for the definition of a questioned cost included as part of the schedule of questioned costs.

We also found that Rhode Island did not seek and receive Treasury's approval to invest all \$2 million of SSBCI funds in Startup Investments, LLC (Startup) instead of directly into the Fund as required by its *Allocation Agreement*. Lastly, the Fund also used some SSBCI Funds to pay Betaspring, LLC (Betaspring) for accelerator program services⁷ rather than make direct cash investments in beneficiary companies, which was inconsistent with Rhode Island's stated use of SSBCI Funds in its application, as referenced in the *Allocation Agreement*.

Accordingly, we recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing do the following: (1) declare a specific event of default of its *Allocation Agreement* with Rhode Island and recoup the \$803,644 of SSBCI funds found to be intentionally misused; (2) determine whether Rhode Island is in default of its *Allocation Agreement* due to the unapproved investment in Startup; and (3) determine whether Rhode Island is in default of its *Allocation Agreement* due to the Fund's use of SSBCI funds to pay Betaspring for accelerator program services rather than make direct cash investments in beneficiary companies. If management finds Rhode Island in default with respect to Startup and the failure to make direct cash investments in beneficiary companies, management should take

⁷ The Fund's accelerator program provided support in the form of space, intensive mentorship, coaching, networking support, and seed investment in participating companies.

action(s) as allowed by Section 6.2 of Rhode Island's *Allocation Agreement*.⁸

As part of our reporting process, we provided Rhode Island Commerce Corporation (Corporation) management an opportunity to comment on a draft of this report. In summary, the Corporation's management responded to each finding. To address private capital at risk, management stated that the Corporation and the Small Business Loan Fund Corporation (SBLFC) have undertaken appropriate measures to ensure that the requirement that the 20 percent private capital at risk threshold in a staged funding transaction is met at the time SSBCI funds are invested. With respect to the investment in Startup, management acknowledged that those responsible for the 2011 investment negotiation should have involved Treasury officials in relation to the structure of the investment as it evolved after the execution of the *Allocation Agreement*.

Finally, the Corporation's management provided its interpretation of the statements made in the State's application regarding the use of SSBCI funds to pay for Betaspring accelerator program services rather than make cash investments in beneficiary companies. That is, the Fund makes payments to the service provider (Betaspring) on behalf of the portfolio company and in return receives an equity stake in the portfolio company. Payment to a separate and distinct entity by the Fund on behalf of a portfolio company that is reflected as paid-in capital is only different in form and not substance over the payment of cash directly to the portfolio company with a requirement that the portfolio company then pay the funds over to this separate entity as a condition to participation in the accelerator program. The Corporation management's response, in its entirety, is included as appendix 3.

In its written response to this report, Treasury management provided details of actions taken in response to our

⁸ Section 6.2 of the *Allocation Agreement* states that "if Treasury finds the Participating State to be in default of the Agreement, Treasury may, in its sole discretion, take any one or more of the following actions: (a) withhold Disbursements pending the Participating State's correction of the default; or (b) wholly or partly reduce, suspend, or terminate the commitment of Treasury to make Disbursements to the Participating State under the Agreement, whereupon the commitment of Treasury to make Disbursements to the Participating State under the Agreement will be reduced, suspended, or terminated, as the case may be."

recommendations. Specifically, management stated that it will defer to our final determination and will not disburse the remainder of Rhode Island's allocation. SSBCI previously withheld \$2 million from Rhode Island's third disbursement pending the results of this audit. This was in direct response to our recommendations that management (1) declare a specific event of default and recoup \$803,664 (recommendation 1) and determine if Rhode Island was in default in the Fund's use of SSBCI funds to pay Betaspring for accelerator program services rather than make direct cash investments in beneficiary companies (recommendation 3). Regarding our recommendation to determine whether Rhode is in default due to its unapproved investment in Startup (recommendation 2), management agreed that Rhode Island did not seek approval for their use of Startup as an investment vehicle into the Betaspring Fund. Management noted that Rhode Island was not required to do so and that States generally determined their own investment structure. As Treasury previously withheld \$2 million from Rhode Island's third disbursement (an amount that covered the full amount of funds invested in Betaspring), management noted that this recommendation was already addressed. We consider Treasury management's response to meet the intent of our recommendations. Management's response is summarized in the finding sections of this report. The response, in its entirety, is included as appendix 4 of 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, direct lending, and state-sponsored venture capital programs.

Loans and investments made with SSBCI funds must comply with the program requirements detailed in the Act, *SSBCI Policy Guidelines*, and the *SSBCI National Standards for Compliance and Oversight*. With respect to venture capital, for example, investments must have at least 20 percent capital at risk at the

time the investments are made. Venture capital programs must target loans or investments with an average principal amount of \$5 million or less and cannot extend credit for loans with principal amounts in excess of \$20 million nor participate in an investment in which the resulting equity investment instrument is in excess of \$20 million. Also, program requirements prohibit the investment of SSBCI funds in related interests. The Deputy Assistant Secretary for Small Business, Community Development, and Housing administers the SSBCI program. Details of the program are provided as appendix 5.

Rhode Island's Participation in SSBCI

Rhode Island was awarded approximately \$13.2 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 the SSBCI funds to support the Small Business Loan Fund (a loan participation program) and two venture capital programs.

As of December 2016, Treasury disbursed approximately \$8.7 million to Rhode Island, which in turn, obligated or spent approximately \$8.3 million. Of this amount, almost \$2 million was invested in Startup, which was an investment vehicle that invested in the Fund. Also included in the \$8.3 million was \$231,024 that the State used for administrative expenses.⁹ In February 2017, Treasury disbursed the third tranche¹⁰ of SSBCI funds to Rhode Island, but withheld \$2 million from the disbursement to account for potential non-compliance pending completion of our audit. The State designated the Rhode Island Economic Development Corporation (RIEDC)¹¹ and its subsidiary, SBLFC to administer its programs, on behalf of the Rhode Island Department of Administration.

Betaspring Entities and Startup Investments, LLC

The Fund was established in April 2011 and operated as a business accelerator program, providing mentorship services to, and cash investments in, participating companies in exchange for ownership

⁹ Administrative expenses were not included in the scope of this audit.

¹⁰ Actual amount of the third tranche was \$4,477,238 before the \$2 million reduction.

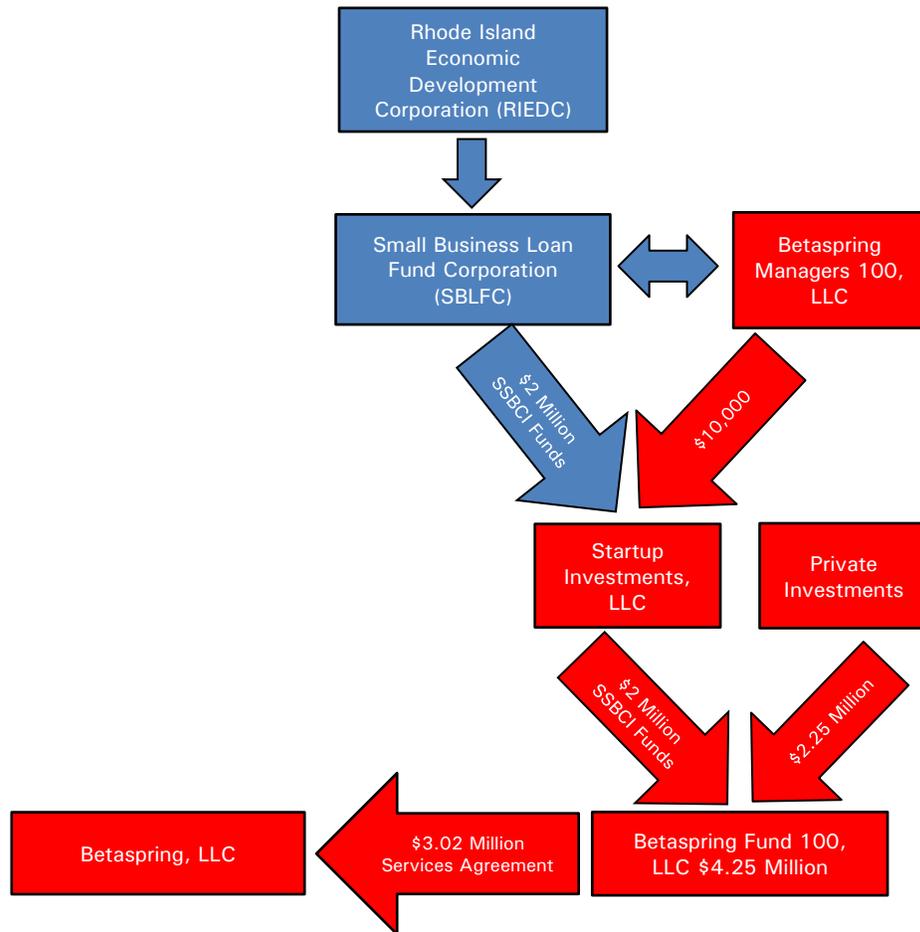
¹¹ RIEDC's name changed to Rhode Island Commerce Corporation in January 2014.

interest in the form of common stock. Between June 2011 and April 2014, the Fund invested in a total of 74 companies. Typical cash investments ranged between \$12,000 and \$20,000 per company. The Fund valued the accelerator program services contract with each company between approximately \$10,000 and \$55,000. The combined investment of cash and services garnered a six percent to eight percent ownership interest in each company by the Fund.

The accelerator program services were provided by Betaspring, an affiliate of the Fund established in 2009. The Fund was managed by Betaspring Managers, another affiliate of the Fund. All three of the Betaspring entities were managed by the same three individuals. In addition to the \$2 million of SSBCI funds, the Fund raised \$2.25 million from private sources, bringing the total fund value to \$4.25 million.

Startup was created in November 2011 as a limited partnership between SBLFC, a subsidiary of RIEDC, and Betaspring Managers. This was done after the *Allocation Agreement* with Treasury was signed in September 2011. The relationship among the Rhode Island entities, Betaspring entities, and Startup is shown in Figure 1.

Figure 1



Finding

Betaspring Fund 100 LLC’s Investments in Seventeen Beneficiary Companies Constituted an Intentional Misuse of \$803,644 in SSBCI Funds

We determined that the Fund’s investments in seventeen beneficiary companies constituted a misuse of \$803,644 in SSBCI funds because at the time the investments were made, there was no private capital at risk. The Act and *The SSBCI Guidelines* require venture capital funds receiving SSBCI funds to have a “meaningful amount” of private capital at risk. Treasury determined that this requirement is met when “private lenders or investors bear 20 percent or more of the risk of loss in any transaction.” In this case, the misuse was intentional because Betaspring Managers knew

about the 20 percent requirement but made the seventeen investments in question anyway.

As noted in the background section of this report, the Fund raised private capital in the amount of \$2.25 million to supplement the \$2 million of SSBCI funds. However, the private capital and SSBCI funds were not received by the Fund at the same time, but at multiple intervals. Consequently, there was a point in time when the Fund only had SSBCI funds to invest in companies accepted into its accelerator program. Specifically, between February and March of 2012, the Fund invested \$803,644 of SSBCI funds in the seventeen beneficiary companies in question where there was no private capital at risk.

We found that the misuse of funds was intentional because Betaspring Managers acknowledged the 20 percent capital at risk requirement during the SSBCI application process. Included as part of Rhode Island's application was a letter dated July 22, 2011, in which a managing member of Betaspring Managers stated, "Betaspring understands the private capital matching requirements for tranching of the SSBCI capital, and projects that we will be able to meet these on a per-deal and overall fund basis...Every deal is invested along these proportional allocations, exceeding the requirement of 20% private capital on a per-deal basis."

In an April 2013 e-mail to Treasury, an SBLFC representative acknowledged the lack of the required capital at risk in the subject investments made in February and March of that year. The email stated that at the time, the Fund was readying for a capital call to private investors as the cash position was very low, and the Fund was preparing for the Spring 2012 accelerator program class. However, the Fund did not initiate the capital call until July 2012. As a result, the February and March investments for the Spring 2012 accelerator program class consisted entirely of SSBCI dollars.

Accordingly, we question \$803,644 of SSBCI funds intentionally misused as it was in violation of the Act and *The SSBCI Guidelines*.

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 Rhode Island and recoup the \$803,644 of SSBCI funds found to be intentionally misused.

Management Response

Management responded that it will defer to our final determination and will not disburse the remainder of Rhode Island's allocation. SSBCI previously withheld \$2 million from Rhode Island's third disbursement pending the results of this audit.

OIG Comment

We consider Treasury's decision to withhold and not disburse Rhode Island's remaining allocation of \$2 million in lieu of recoupment to meet the intent of our recommendation.

Finding **Rhode Island's Investment in Startup Investments, LLC Was Not Approved by Treasury**

Rhode Island's SSBCI application and the *Allocation Agreement* named the Fund as the approved State program and did not disclose that the State would first invest SSBCI funds in Startup and that Startup would invest in the Fund. Nevertheless, Rhode Island invested \$2 million of SSBCI funds in Startup, an entity established in November 2011, after the *Allocation Agreement* with Treasury was signed. Rhode Island did not seek approval from Treasury before making the investment.

According to Section 4.4 of the *Allocation Agreement*, "the Participating State shall not use any Allocated Funds in a manner other than as authorized hereunder, without the prior written approval of Treasury." While we acknowledge that such an undeclared investment vehicle may not in and of itself constitute a material failure to comply with the *Allocation Agreement*, in this case we find that the circumstances under which Startup was

created were questionable and warranted prior approval from Treasury.

Rhode Island officials told us that creating Startup was a solution to address the extra reporting requirements of SSBCI. However, we noted that in its application, Rhode Island acknowledged the specific SSBCI reporting requirements and described the Fund's current processes that would enable it to comply with those requirements.

One of the principal owners of both Betaspring (30 percent ownership) and Betaspring Managers (20 percent ownership) was on the board of directors of RIEDC and served on the board for approximately two years, during the time Rhode Island was applying for SSBCI funds. When created in November 2011, Betaspring Managers and SBLFC, the subsidiary of RIEDC, each obtained 50 percent ownership in Startup. With Startup's investment of all \$2 million of SSBCI funds in the Fund, it obtained the rights to a 20 percent rate of return on Fund investments after the return of its capital investment in the Fund. As such, the board member of RIEDC, through the ownership interest in Betaspring Managers, stood to benefit from this return on Fund investments. This return is in addition to financial interests the board member received as part owner of other Betaspring entities. Specifically, Betaspring received approximately \$3 million of the total \$4.25 million raised by the Fund in the form of accelerator program services fees. Betaspring provided these services to the Fund's beneficiary companies in exchange for ownership interests, and received payments directly from the Fund for performing those services. Further, Betaspring Managers received \$21,250 in management fees, and as the Fund's manager, the rights to another 30 percent rate of return on Fund investments after the return of capital to all investors in the Fund. These terms were stipulated in the Fund's *Private Placement Memo* dated April 2011. This return is in addition to the 20 percent rate of return on the Fund's investments that resulted from Startup's ownership interest in the Fund.

Recommendation

We recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing determine whether Rhode Island is in default of its *Allocation Agreement* due to its unapproved investment in Startup, and if so, take action(s) as allowed by Section 6.2 of the *Allocation Agreement*.

Management Response

Management agreed that Rhode Island did not seek approval for their use of Startup as an investment vehicle into the Betaspring Fund. Management noted that Rhode Island was not required to do so and that States generally determined their own investment structure. As Treasury previously withheld \$2 million from Rhode Island's third disbursement (an amount that covered the full amount of funds invested in Betaspring), management stated that this recommendation was already addressed.

OIG Comment

We consider Treasury's response to meet the intent of our recommendation.

Finding **Betaspring Fund 100, LLC Used SSBCI Funds Inconsistent with Its Allocation Agreement**

During the application process, Treasury communicated to Rhode Island officials that SSBCI funds could only be used for authorized program purposes (i.e. extending credit). In response to Treasury's request for clarification on how the Fund would utilize SSBCI funds, Rhode Island officials amended its application to state that all funds would represent cash investments in the beneficiary companies. Furthermore, Rhode Island's SSBCI *Allocation Agreement* states the Fund would make direct equity investments in eligible small businesses.

The Fund used \$3.02 million of the total \$4.25 million that was raised to pay for accelerator program services. Because only \$2.25 million of the total \$4.25 million was from private sources, some SSBCI funds were used to pay for accelerator program services. As

noted in the background section of this report, the accelerator program services were performed by Betaspring. As such, SSBCI funds were paid directly to Betaspring for those services and did not represent cash investments in the beneficiary companies as stated in Rhode Island's application. Since the Fund was not required to track the use of funds by source (i.e. SSBCI vs. private), it is not possible to quantify the exact amount of SSBCI funds that were used for accelerator program services.

In documentation provided to Treasury, Rhode Island officials stated that the SSBCI application provided a clear and concise description of the Betaspring accelerator program, including the fact that part of the funds would be used to pay for accelerator services. Furthermore, the application was intended to convey that funding would represent an equity investment in each beneficiary company. Nonetheless, paying Betaspring for accelerator program services rather than using all SSBCI funds to make cash investments in the beneficiary companies was inconsistent with Rhode Island's stated use of SSBCI funds in its application, as referenced in the *Allocation Agreement*.

Recommendation

We recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing determine whether Rhode Island is in default of its *Allocation Agreement* due to the Fund's use of SSBCI funds to pay Betaspring for accelerator program services rather than make direct cash investments in beneficiary companies, and if so, take action(s) as allowed by Section 6.2 of the *Allocation Agreement*.

Management Response

Management responded that it will defer to our final determination and will not disburse the remainder of Rhode Island's allocation. SSBCI previously withheld \$2 million from Rhode Island's third disbursement pending the results of this audit.

OIG Comment

We consider Treasury's decision to withhold and not disburse Rhode Island's remaining allocation of \$2 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 6. A distribution list for this report is provided as appendix 7. If you have any questions, please contact me at (202) 927-1011.

/s/

Theresa A. Cameron
Audit Director, Financial Assistance Programs

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. The objective of this audit was to assess Rhode Island's compliance with SSBCI program requirements and prohibitions with respect to its investment of SSBCI funds in the State's venture capital program, Betaspring Fund 100, LLC (Fund).

Of its \$13,168,350 of SSBCI funds allocated, our audit scope comprised \$1,923,391 used by the Fund for 56 venture capital investments. We tested all 56 investments made by the Fund between June 2011 and November 2013. To accomplish our audit objective, we performed the following steps.

- We reviewed applicable laws, regulations, and other relevant documents as follows:
 - Small Business Jobs Act of 2010 (Public Law 111-240; September 27, 2010);
 - Rhode Island's SSBCI application (July 28, 2011);
 - SSBCI *Allocation Agreement* between the Department of the Treasury and the State of Rhode Island and Providence Plantations (September 6, 2011);
 - *Operating Agreement* of Betaspring, LLC (October 19, 2009);
 - *Certificate of Formation of Betaspring Fund 100, LLC* (April 26, 2011);
 - *Limited Liability Company Agreement of Betaspring Managers 100, LLC* (April 26, 2011);
 - *Services Agreement* between Betaspring Fund 100, LLC and Betaspring, LLC (January 1, 2012);
 - *Startup Investments, LLC Operating Agreement* (November 29, 2011);
 - *Reporting Agreement* between the Small Business Loan Fund Corporation and Startup Investments, LLC (December 2011);

- SSBCI Quarterly Reports (2011 – 2016);
 - SSBCI Annual Reports (2011 – 2015);
 - “Compliance Assessment Rhode Island State Small Business Credit Initiative (SSBCI) Programs,” dated August 14, 2013 by Lyon Park Associates; and
 - email and other correspondence between the SSBCI program office and Rhode Island Economic Development Corporation’s officials.
- We interviewed key officials within the SSBCI program office and the Rhode Island Economic Development Corporation to obtain information and documentation.

Our fieldwork was conducted at the Treasury Office of Inspector General office in Washington, D.C., between May 2014 and April 2017.

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.

A questioned cost is a cost that is questioned by the auditor because of an audit finding: (1) which resulted from an alleged violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances. Questioned costs are to be recorded in the Joint Audit Management Enterprise System (JAMES). The questioned cost will also be included in the next Office of Inspector General Semiannual Report to Congress.

<u>Recommendation Number</u>	<u>Questioned Cost</u>
Recommendation 1	\$803,644

The questioned cost relates to funds that Department of the Treasury awarded to Rhode Island under the State Small Business Credit Initiative (SSBCI). The amount questioned was found to be an intentional misuse of SSBCI funds by Rhode Island's venture capital program, Betaspring Fund 100, LLC (Fund). As discussed in the audit report, the Fund invested SSBCI funds in seventeen beneficiary companies when there was no private capital at risk in violation of the Small Business Jobs Act of 2010 and *The SSBCI Guidelines*.



315 Iron Horse Way, Suite 101
Providence, RI 02908
Phone: 401.278.9100
Fax: 401.273.8270
CommercoRI.com
info@commercoRI.com

August 2, 2017

Theresa Cameron
Audit Director, Financial Assistance Programs
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Cameron:

Thank you for the opportunity to review and respond to the Office of Inspector General's (OIG) draft report (Report) entitled *State Small Business Credit Initiative: Rhode Island's Use of Federal Funds for Its Betaspring Fund 100 Venture Capital Program*. This correspondence shall serve as the official response of the Rhode Island Commerce Corporation (Corporation).

First, we would like to thank the U.S. Department of Treasury (Treasury), State Small Business Credit Initiative (SSBCI) staff for their assistance in the successful implementation of the SSBCI programs and their guidance in relation to potential deficiencies to ensure compliance with SSBCI guidelines. In addition, we would like to thank the OIG personnel for their cooperation and professionalism during the audit of this program.

The Corporation and the Small Business Loan Fund Corporation (SBLFC), which administers the SSBCI programs, are committed to ensuring that these programs are implemented properly and in accordance with Treasury guidelines. As part of this commitment, the SBLFC undertook its own compliance assessment to ensure its conformity with Treasury guidelines. The compliance assessment identified specific areas in need of improvement and resulted in certain corrective measures that were implemented by the SBLFC. The SBLFC, in cooperation with the Corporation, has taken proactive measures to strengthen its compliance and oversight to ensure that it is fully compliant with Treasury requirements. Following, you will find a response addressing the issues raised in the Report.

1. Private Capital at Risk.

The Corporation acknowledges that analyzing the investments of the last cohort in the Betaspring accelerator program from a conventional lending perspective as opposed to the staged funding model used in this program, a conclusion can be drawn that there was a lack of private capital at risk. However, the structure of the Fund provides for a proportional ownership stake and this was emphasized in the application process as the mechanism by which the Betaspring Fund 100 (Fund) would remain compliant with the private capital matching requirements. As indicated in the application process, Betaspring LLC (Betaspring) provided correspondence that indicated "Betaspring understands the private capital matching

requirements for tranching of the SSBCI capital, and projects that we will be able to meet these on a per-deal basis, as the makeup of our fund is 53% private (\$2.25M) and 47% public (\$2M SSBCI). Every deal is invested along these proportional allocations, exceeding the private capital on a per-deal basis.” (*emphasis added*). At the time of the investments in the final cohort of portfolio companies, Bestaspring was not fully cognizant of the relevant timing issues and that the staged funding mechanism utilized would be interpreted as being contrary to program requirements. At the time of the investments, Treasury had not issued guidance clarifying that staged funding requires that 20% of the capital-at-risk must be from a private source when SSBCI funds are invested. As indicated in the Report, the Fund ultimately met the program requirements with private investment of \$2.25 million and the \$2 million of SSBCI funds as was set forth in the application and no additional funding is available for the Betaspring program under SSBCI.

The Corporation and SBLFC have undertaken appropriate measures to ensure that the requirement that the 20% private capital at risk threshold in a staged funding transaction is met at the time SSBCI funds are invested in relation to the other Rhode Island SSBCI programs.

Given that Treasury has withheld the final tranche of SSBCI funding pending publication of the Report and to the extent OIG maintains a finding of reckless misuse by Betaspring, the Corporation would note that an appropriate remedy would be to reduce future funding consistent with prior practice.

2. The Investment in Startup Investments, LLC was not Approved by Treasury.

As indicated in the Report, the OIG does not take issue with the investment in a special purpose entity, Startup Investments LLC (Startup), as the mechanism to invest in the Fund, rather it is the lack of communication with Treasury at the time of the proposed ownership structure of Startup, which forms the basis of this finding.

Startup serves a legitimate purpose and has provided the mechanism by which the SBLFC invested in the Fund and enabled SBLFC to meet the reporting requirements of the SSBCI program. However, the lack of discussion with Treasury in relation to the ownership structure of Startup was an oversight on the part of the individuals involved in the negotiation process with the Betaspring Managers LLC during the fall of 2011. The undertaking whereby SBLFC invested in Startup was put before the SBLFC board at open, public meetings and there was never any intent to mislead any person or agency as to the nature of the investment being made or the ownership structure of Startup.

With the benefit of hindsight, it is reasonable to note that the individuals responsible for the negotiation of the investment in 2011 should have involved Treasury officials in relation to the structure of the investment as it evolved after the execution of the Allocation Agreement. However, the funding of \$2 million was invested into companies that participated in the Betaspring accelerator program consistent with the Allocation Agreement. Also, it is noteworthy, that the ownership interests of the members of Startup were all subordinated to the repayment of the \$2 million investment of SSBCI funds. As such, no benefit could

accrue to either the SBLFC or Betaspring Managers LLC until all of the SSBCI funds were repaid.

3. Betaspring Fund 100, LLC Used SSBCI Funds Inconsistent with its Allocation Agreement.

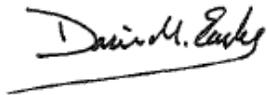
As discussed at length with the OIG and as previously indicated by the Rhode Island Department of Administration in its September 2013 response to the report authored by Lyon Park, the portion of the SSBCI application related to the Betaspring accelerator program does provide a clear and concise description of that program. The opening paragraph of the application indicates that SSBCI funds will be used for equity investments. The application then states that “[a]ll funds will represent a cash investment in the portfolio companies and will be shown as paid-in capital to the companies’ balance sheets.” The application goes on to disclose that “via the Fund, Betaspring provides each team with approximately \$42,500 in seed capital. Part of this funding will help pay for services including mentorship, legal counsel, incorporation filing and other legal work necessary to complete the business model.” By use of the word “including” it is obvious that the application intended to provide some examples but not a complete list of some of the services that would be funded with the investments from the Fund. Furthermore, the opening paragraph indicates that all funds (not just SSBCI funds) “will represent cash investments” and “will be shown as paid-in capital”.

These descriptive statements do not support the conclusion that the application required all SSBCI funds to be paid in cash directly to the portfolio company in which an investment is being made. Rather, a more appropriate interpretation is that in using the term “will represent cash investments” in tandem with the statement “will be shown as paid-in capital”, the application intended to convey that funding would represent an equity investment in each portfolio company. If the intention were to pay the entire investment directly to the investee in cash there would be no need to further state that the payment would “be shown as paid-in capital.”

Also, the conclusion contained in the Report that payment for services instead of paying cash to the portfolio company ignores the substance of the transaction at issue in the Betaspring accelerator model. In essence, the Fund makes payment to the service provider (Betaspring) on behalf of the portfolio company and in return receives an equity stake in the portfolio company. The portfolio company receives a services contract for the payment made on its behalf by which Betaspring is bound. Certainly, payment to a separate and distinct entity by the Fund on behalf of a portfolio company that is reflected as paid-in capital is only different in form and not substance over the payment of cash directly to the portfolio company with a requirement that the portfolio company then pay the funds over to this separate entity as a condition to participation in the accelerator program. The substance of these transactions is the same; however, the Report concludes without any analysis that this is contrary to the application.

Again, thank you for the opportunity to respond to the Report and to identify the policies and procedures that have been implemented to ensure future compliance. We look forward to continuing our collaboration with Treasury to further improve Rhode Island's small business climate.

Sincerely,

A handwritten signature in black ink that reads "Darin M. Early". The signature is written in a cursive style with a horizontal line underneath.

Darin Early
President & COO



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 08, 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 Betaspring Fund 100, LLC's use of SSBCI funds. 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 Rhode Island program officials and they provided you with a response.

In response to OIG's first and third recommendations, Treasury will defer to the OIG's final determination and will not disburse the remainder of Rhode Island's allocation. SSBCI previously withheld \$2 million from Rhode Island's third disbursement pending the results of this audit.

In response to the second recommendation, Treasury agrees that Rhode Island did not seek approval for their use of Startup as an investment vehicle into the Betaspring Fund. However, Treasury notes that Rhode Island was not required to do so and that states generally determined their own investment structure. However, as Treasury previously withheld \$2 million from Rhode Island's third disbursement (an amount that covered the full amount of funds invested in Betaspring), this recommendation was already addressed.

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 black ink, appearing to read "Kipp Kranbuhl".

Kipp Kranbuhl
Deputy Assistant Secretary for Small Business,
Community Development, and Housing

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) disbursed 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 were dependent upon the participating State's certification that it had obligated, transferred, or spent at least 80 percent of the previous tranche and had complied with all applicable program requirements.

Each participating State was required to designate specific departments, agencies, or political subdivisions to administer the funding. The designated entity distributed SSBCI funds to public and private institutions, which could 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 were to 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 Small Business Jobs Act of 2010 required that Treasury execute an Allocation Agreement with participants setting forth internal controls and compliance and reporting requirements before receiving SSBCI funds.

Appendix 6
Major Contributors to This Report

Theresa Cameron, Audit Director
Anita Smith, Auditor
Adelia Gonzales, Referencer
Usman Abbasi, Referencer

Department of the Treasury

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

Rhode Island Commerce Corporation

President

United States Senate

Committee on Agriculture, Nutrition, and Forestry
Committee on Appropriations
Committee on Banking, Housing, and Urban Affairs
Committee on the Budget
Committee on Finance
Committee on Small Business and Entrepreneurship

United States House of Representatives

Committee on Agriculture
Committee on Appropriations
Committee on the Budget
Committee on Financial Services
Committee on Small Business
Committee on Ways and Means



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>