



Audit Report



OIG-17-059

STATE SMALL BUSINESS CREDIT INITIATIVE

Wisconsin's Use of Federal Funds for the

Kegonsa Growth Fund, LP

September 28, 2017

Office of
Inspector General

Department of the Treasury

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Abbreviations

Act	Small Business Jobs Act of 2010
Kegonsa	Kegonsa Growth Fund, LP
KCP	Kegonsa Capital Partners, LLC
OIG	Office of Inspector General
SSBCI	State Small Business Credit Initiative
Treasury	Department of the Treasury
WDA	Wisconsin Department of Administration
WHEDA	Wisconsin Housing and Economic Development Authority

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*The Department of the Treasury
Office of Inspector General*

September 28, 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 (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 Wisconsin, 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 Kegonsa Growth Fund, LP (Kegonsa), which invested \$261,000 in two beneficiary companies between March and May of 2016.⁴ Kegonsa is 1 of 5

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 VI of the State of Wisconsin State Small Business Credit Initiative Allocation Letter Agreement, dated July 22, 2013, "Covenants And Agreements of the Participating State", we apply this definition to Kegonsa Growth 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.

⁴ In accordance with Annex 1 of the State of Wisconsin State Small Business Credit Initiative Allocation Agreement for Participating States, dated September 22, 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.

venture capital funds created by Wisconsin Housing and Economic Development Authority (WHEDA) to support its Wisconsin Equity Fund. Audits of the State's other four venture capital funds are being conducted separately, and if reckless or intentional misuse is identified, we plan to report separately on those. Appendix 1 provides more detail of our audit objective, scope, and methodology.

In brief, we determined that Kegonsa's investments did not fully comply with all SSBCI venture capital program requirements and prohibitions. Specifically, Kegonsa's investments in two beneficiary companies constituted a reckless misuse of \$261,000 of SSBCI funds because Kegonsa Capital Partners, LLC (KCP), the general partner of Kegonsa, had a financial interest in the beneficiary companies through prior investments using non-SSBCI funds, which violated Treasury's *SSBCI National Standards for Compliance and Oversight* regarding conflicts of interest. As such, we question \$261,000 of SSBCI funds found to be recklessly misused by Kegonsa. See appendix 2 for the definition of a questioned cost included as part of the schedule of questioned cost.

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 Wisconsin and recoup the \$261,000 of SSBCI funds found to be recklessly misused by Kegonsa.

As part of our reporting process, we provided Wisconsin Department of Administration (WDA) management an opportunity to comment on a draft of this report. In a written response, WDA management accepted our position regarding the investments of SSBCI funds by KCP. Management also noted that WHEDA, which funded Kegonsa, previously notified KCP of Treasury's determination that the use of funds was non-compliant and would have to be returned to the SSBCI program. WHEDA will await guidance from Treasury on the specific mechanisms to re-capture the funds. WDA management's response, in its entirety, is included as appendix 3 to this report.

In a written response, Treasury management stated it will declare a specific event of default under Section 6.3 of Wisconsin's *Allocation Agreement* and recoup \$261,000. Treasury management's response, in its entirety, is included as appendix 4 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. Venture capital programs must target loans or investments with an average principal of \$5 million or less. It cannot extend credit for loans with a principal amount in excess of \$20 million nor participate in any 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 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 5.

Wisconsin's Participation in SSBCI

The State of Wisconsin was awarded approximately \$22.4 million⁵ 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

⁵ Actual amount is \$22,363,554.

two small business development programs: Wisconsin Equity Fund and WHEDA Guarantee.⁶

As of December 31, 2016, Treasury disbursed approximately \$14.8 million⁷ to Wisconsin, which in turn, obligated or spent approximately \$13.7 million,⁸ all of which was invested in the Wisconsin Equity Fund, a venture capital program. The State designated the WHEDA to administer the approved State programs on behalf of WDA. The *Allocation Agreement* also provided that for the purpose of extending and applying Articles IV and VI to the selected fund's administration of specific aspects of the program, Kegonsa would be substituted in reference to the "participating State" in Articles IV and VI.

Kegonsa Growth Fund, LP

KCP entered into a limited partnership agreement with WHEDA to form Kegonsa. As the general partner, KCP was responsible for identifying and approving investments in beneficiary companies, and as such, invested \$261,000 of SSBCI funds in two beneficiary companies. Furthermore, KCP was also required to ensure compliance with SSBCI requirements and prohibitions.

Finding

Kegonsa's Investments Constituted a Reckless Misuse of \$261,000 in SSBCI Funds

Kegonsa's investments did not fully comply with all SSBCI venture capital program requirements and prohibitions. Specifically, investments in two beneficiary companies constituted a reckless misuse of \$261,000 of SSBCI funds because the investments were prohibited crossover investments. *SSBCI National Standards for Compliance and Oversight* (amended June 2014), states that an independent for-profit entity may not authorize a crossover investment, that is, an investment of SSBCI funds in a company or venture capital fund in which the entity holds any type of financial

⁶ In March 2017, WHEDA reallocated all funds from the WHEDA Guarantee program to the Wisconsin Equity Fund. No SSBCI funds were used for the WHEDA Guarantee program.

⁷ Actual amount is \$14,759,946.

⁸ Actual amount is \$13,748,450.

interest resulting from a prior investment made with non-SSBCI funds.

Regarding Kegonsa's first investment of \$236,000, the general partner, KCP, had a 9.2 percent prior ownership interest in the beneficiary company using non-SSBCI funds. Regarding the second investment of \$25,000, KCP had an indirect prior financial interest in the beneficiary company through its contribution to a related fund, Kegonsa Seed Fund I, LP,⁹ which owned 58.4 percent of the beneficiary company using non-SSBCI funds. KCP was also the general partner for Kegonsa Seed Fund I, LP.

KCP is considered a for-profit entity according to the *SSBCI National Standards for Compliance and Oversight*. As the general partner of Kegonsa, KCP was responsible for authorizing investments using SSBCI funds. Its partnership agreement with WHEDA incorporated the *SSBCI National Standards for Compliance and Oversight* prohibiting crossover investments. As such, KCP should have known that Kegonsa's investments in the subject companies were prohibited transactions. Therefore, we concluded that these transactions were a reckless misuse of SSBCI funds by Kegonsa and question \$261,000 as this was in violation of the *SSBCI National Standards for Compliance and Oversight*.

It should be noted that during its 2017 compliance review, Treasury also found that Kegonsa's investments were crossover investments and did not comply with SSBCI program requirements and prohibitions. As a result, Treasury directed WHEDA to conduct a portfolio review and self-identify any additional non-compliance. According to WHEDA officials, they completed a review of all remaining equity investments that had been placed with non-Kegonsa investment managers and informed Treasury that they did not find additional instances of non-compliance. In addition, WHEDA notified the Kegonsa fund manager of Treasury's finding of non-compliance and that the SSBCI funds would have to be returned to the SSBCI program.

⁹ According to the partnership agreement, KCP was required to contribute \$250,000 to Kegonsa Seed Fund I, LP.

In an April 2017 letter, Treasury informed WHEDA that its portfolio review was insufficient to confirm the Wisconsin Equity Fund's portfolio compliance with SSBCI rules and regulations. In particular, WHEDA had not demonstrated how the structure of Kegonsa's investments complied with SSBCI rules and requirements. The April 2017 letter also informed WHEDA of Treasury's decision not to disburse the remaining award amount of approximately \$7.6 million.¹⁰

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 Wisconsin and recoup the \$261,000 of SSBCI funds found to be recklessly misused by Kegonsa.

Management Response

Management responded that it will declare a specific event of default under Section 6.3 of Wisconsin's *Allocation Agreement* and recoup \$261,000.

OIG Comment

Management's response meets the intent of our recommendation.

¹⁰ Actual amount is \$7,603,608.

* * * * *

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 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. Regarding SSBCI funds awarded to the State of Wisconsin, our audit focused on the State's compliance with respect to funds invested in its venture capital program.

Of the \$22,363,554 in SSBCI funds allocated to Wisconsin, \$13,748,450 was spent on Wisconsin's venture capital program, the Wisconsin Equity Fund, as of December 31, 2016. Of this amount, our audit scope comprised \$261,000 invested by Kegonsa Growth Fund, LP (Kegonsa) in two beneficiary companies between March and May of 2016, which represented 100 percent of Kegonsa's investments using SSBCI funds. Kegonsa is 1 of 5 venture capital funds created by the Wisconsin Housing and Economic Development Authority (WHEDA) to support its Wisconsin Equity Fund. Audits of the State's other four venture capital funds are being conducted separately, and if reckless or intentional misuse is identified, we plan to report separately on those.

To accomplish our 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);
 - *SSBCI National Standards for Compliance and Oversight* (June 20, 2014);
 - *SSBCI Policy Guidelines* (April 16, 2014);
 - SSBCI Frequently Asked Questions;
 - SSBCI Fact Sheet;
 - *State of Wisconsin SSBCI Allocation Agreement for Participating States*;
 - Beneficiary capitalization tables and stock purchase

- agreements;
 - SSBCI Quarterly Reports;
 - SSBCI Annual Reports (2012, 2013, and 2014);
 - SSBCI Investee and Investor Certifications; and
 - Correspondence from Kegonsa.
- We reviewed Kegonsa’s two investments and tested documentation supporting them to determine:
 - at least 20 percent capital was at risk for each investment;
 - each investment was not greater than \$20 million;
 - investee and investor certifications were obtained prior to the investment; and
 - no conflicts of interest existed between the investor and beneficiary company.
 - We also reviewed the Sex Offender Registry for Wisconsin to verify that no principal of the beneficiary companies was convicted of a sex offense against a minor (as such terms are defined in section 111 of the Sex Offender Registration and Notification Act (42 U.S.C. 16911)).
 - We interviewed key officials at WHEDA and the SSBCI program office.

We conducted fieldwork at WHEDA headquarters in Madison, Wisconsin, and the Treasury Office of Inspector General office in Washington, D.C., between April 2016 and June 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 a 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	\$261,000

The questioned cost relates to funds that the Department of the Treasury (Treasury) awarded to the State of Wisconsin under the State Small Business Credit Initiative (SSBCI) program. As discussed in the audit report, the questioned cost of \$261,000 consisted of prohibited crossover investments made by Kegonsa Growth Fund LP (Kegonsa) in two beneficiary companies. The general partner of Kegonsa had a financial interest in both beneficiary companies through its prior investments using non-SSBCI funds. The two investments were found to be a reckless misuse of funds because they were in violation of Treasury's *SSBCI National Standards for Compliance and Oversight* regarding conflicts of interest.

Appendix 3
Wisconsin Department of Administration Management Response



WISCONSIN DEPARTMENT OF
ADMINISTRATION

SCOTT WALKER
GOVERNOR
SCOTT A. NEITZEL
SECRETARY

Office of the Secretary
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Madison, WI 53707-7864
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September 18, 2017

Ms. Theresa Cameron, Audit Director
U.S. Department of the Treasury
Office of the Inspector General
Office of Audit
875 15th Street NW
Washington, DC 20005

RE: Wisconsin's SSBCI Venture Capital Program

Dear Ms. Cameron:

We received the revised discussion draft report on the U.S. Department of the Treasury (Treasury) Office of the Inspector General's (OIG) audit of Wisconsin's State Small Business Credit Initiative (SSBCI) Venture Capital Program on September 11, 2017. Specifically, OIG reviewed Kegonsa Growth Fund, LP (Kegonsa), a venture capital fund funded by the Wisconsin Housing and Economic Development Authority (WHEDA) to support its Wisconsin Equity Fund.

We accept OIG's position regarding the investment of SSBCI funds by Kegonsa Capital Partners, LLC (KCP). WHEDA previously notified KCP that the use of the funds was determined to be non-compliant by Treasury and they would, therefore, have to be returned to the SSBCI program. WHEDA will await guidance from Treasury on the specific mechanisms that should be followed to re-capture the funds.

Sincerely,


Scott A. Neitzel
Secretary

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Wisconsin.gov

Appendix 4
Treasury Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 26, 2017

VIA ELECTRONIC MAIL

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 Wisconsin's use of SSBCI funds for the Kegonsa Growth Fund. This letter provides the official response of the Department of the Treasury (Treasury).

It is our understanding that the OIG transmitted a copy of the report to Wisconsin program officials and they provided you with a response.

In response to the recommendation in the report, Treasury will declare a specific event of default under section 6.3 of Wisconsin's Allocation Agreement and recoup \$261,000.

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

Sincerely,



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

Enclosures

cc: Katherine Reilly, Office of General Counsel, Banking and Finance
Jeff Stout, Director of the State Small Business Credit Initiative

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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 has obligated, transferred, or spent at least 80 percent of the previous tranche and has 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 could distribute SSBCI funds to public and private institutions, which could also 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

Nadine Forgenie, Audit Manager
Dennis Orsini, Auditor
Jeffrey Hawkins, 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

Wisconsin Department of Administration

Secretary

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
Financial Services Committee
Small Business Committee
Committee on Ways and Means



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

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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>