Audit Report

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

July 24, 2013

Office of Inspector General

Department of the Treasury

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Abbreviations

IDEA	Missouri Innovation, Development, and Entrepreneurship Advancement Fund
MDED	Missouri Department of Economic Development
MTC	Missouri Technology Corporation
OIG	Office of Inspector General
OMB	Office of Management and Budget
SSBCI	State Small Business Credit Initiative
National Standards	*SSBCI National Standards for Compliance and Oversight*
The Act	Small Business Jobs Act of 2010

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

July 24, 2013

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and
Community Development

This report presents the results of our audit of the State of Missouri's use of funds awarded under the State Small Business Credit Initiative (SSBCI), which was established by the Small Business Jobs Act of 2010 (the Act). The Department of the Treasury (Treasury) awarded Missouri approximately $26.9 million[1] in SSBCI funding, and as of March 31, 2012, Missouri had received approximately $8.9 million[2] of the awarded funds. As of the same date, Missouri had obligated or spent approximately $7.3 million[3] of the $8.9 million, of which $6.6 million[4] was used by the Innovation, Development, and Entrepreneurship Advancement (IDEA) Fund, and $511,135 was used by the Grow Missouri Loan Fund. Additionally, $151,568 was spent on administrative costs associated with implementing the two programs.

The Act requires the 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.

[1] Rounded down from $26,930,294.
[2] Rounded up from $8,886,997.
[3] Rounded up from $7,293,511.
[4] Rounded down from $6,630,808.

Intentional misuse is defined as a use of allocated funds that the participating state, or its administering entity, knew was unauthorized or prohibited.

We contracted with TCBA Watson Rice LLP, an independent certified public accounting firm, to conduct the audit, which was performed from August 2012 to June 2013. The audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. To test participant compliance with use of proceeds, capital-at-risk, and other requirements in the Act and *SSBCI Policy Guidelines*, the accounting firm reviewed all 17 SSBCI transactions between the date of the Allocation Agreement on May 23, 2011, and March 31, 2012. These included 16 investments made by the IDEA Fund and 1 loan made by the Grow Missouri Loan Fund. Because the audit of the IDEA Fund transactions revealed a prohibited party relationship, the audit scope was expanded to test 7 additional IDEA Fund transactions made between April 1, 2012, and September 30, 2012, to determine whether additional prohibited party relationships existed.

The accounting firm also reviewed administrative costs charged against SSBCI funds to ensure they were reasonable, allocable, and allowable, in accordance with Treasury Guidelines and Office of Management and Budget (OMB) *Circular A-87, Cost Principles for State, Local, and Indian Tribal Government*. Additionally, the firm interviewed officials from the Missouri Department of Economic Development (MDED), which administers the Grow Missouri Loan Fund and reports on SSBCI funding, and the Missouri Technology Corporation (MTC), which administers the IDEA Fund under a contracted awarded by MDED.

In addition to the work performed by TCBA Watson Rice, LLP, we reviewed the Missouri State Auditor's November 2010 audit report on MTC, [5] and met with representatives from that office to determine

[5] Missouri State Auditor report number 2010-148, *Economic Development: Missouri Technology Corporation*, November 2010.

whether the State Auditor's ongoing audit had identified issues regarding MTC's administration of the IDEA Fund.

We conducted quality assurance procedures to ensure that the work performed by TCBA Watson Rice, LLP was completed in accordance with *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 objective. We believe that the evidence obtained to address our audit objective provides a reasonable basis for our findings and conclusions. A more detailed description of the audit objective, scope, and methodology is contained in Appendix 1, and a list of financial transactions tested is contained in Appendix 2.

Results In Brief

We determined that the state of Missouri properly used over 96 percent of the $7.3 million in SSBCI funds expended, and that all related administrative costs were compliant with program requirements. However, we identified a $240,000 venture capital investment made by the IDEA Fund that constituted a reckless misuse of funds, as defined by Treasury. A Director of the MTC Board that approved the investment transaction had a prohibited party relationship with the company that received the investment based on the Director's controlling interest in the investee. The Act and *SSBCI Policy Guidelines* prohibit such relationships between entities that administer SSBCI funds and companies that receive SSBCI financing.

The transaction constituted a "reckless" misuse of funds as MTC should have known that prohibited party relationships were not allowed because the *SSBCI Policy Guidelines* require every borrower and investee receiving funds to certify that such a relationship did not exist. The prohibition applies even in the absence of such certification. MTC officials exhibited an act of omission by not securing the required assurances from an investee, including an assurance that a prohibited relationship did not exist. Also both the state of Missouri and the investee failed to ascertain whether or not they were in compliance with the standards established in the *SSBCI*

Policy Guidelines, regardless of whether Missouri received an official certification to that effect.

Additionally, MTC did not exercise ordinary care in exploring the relationship between the conflicted Board Director and the investee. The amount of information MTC obtained concerning the relationship appeared to consist only of the conflicted party's voluntary recusal. MTC did not obtain any documentation to ascertain whether, even under MTC's conflict of interest rules, there was reason to inquire further into the matter or whether recusal would be a sufficient remedy, given the party's position within MTC and the actual extent of the Director's interest in the investee. MDED's counsel stated that the MTC Director in question followed MTC's *Conflict of Interest Policy* and took recusal action to refrain from voting on funding for the related company. However, we found that MTC did not even fully adhere to its own policy because the material facts of the conflict were not documented in the Board minutes as its policy required.

We also identified many instances where members of the MTC Board of Directors had conflicts of interest that required their recusal from voting. However, these conflicts did not constitute related interests prohibited by the Act or *SSBCI Policy Guidelines*, and the Board had adopted a conflict-of-interest policy. Again, it did not appear that the Board fully implemented its policy because it did not document the material facts of the conflicts or disclose in its meeting minutes whether the conflicted members participated in investment discussions affecting the related parties. Missouri's conflict of interest policy also would not have been sufficient, even had it been followed, because it does not include restrictions on or disqualifications based on an entity's controlling interest.

Additionally, MTC had not obtained all of the required borrower or investee assurances by the time of loan or investment closing for 15 (or 88 percent) of the 17 transactions reviewed. Treasury became aware of this issue in March 2012 while reviewing Missouri's second disbursement request. Missouri has since obtained 14 of the 15 missing assurances, but has yet to secure an assurance from the company involved in the prohibited party relationship with the MTC

Board member. Despite the inadequate assurances, the State inaccurately certified in June 2012 that it was in compliance with all SSBCI requirements.

We recommend that Treasury recoup the $240,000 investment from the program. Treasury should also require Missouri to demonstrate that MTC is fully adhering to its conflict-of-interest policy as well as all program requirements when investing SSBCI funds. We also recommend that Treasury determine whether there has been a general event of default under Missouri's Allocation Agreement resulting from the State's non-compliance with lender and borrower assurance requirements and false compliance certifications. If such an event has occurred and has not been adequately cured, Treasury should determine whether it warrants a reduction, suspension, or termination of future funding to the State.

Missouri disagreed that it recklessly misused funds and violated its own conflict of interest policy. However, Treasury agreed to implement all of the recommendations. We believe Treasury's planned actions to be fully responsive. Formal written responses from the state of Missouri and Treasury are included in their entirety in Appendix 4.

Background

SSBCI is a $1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds 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.

Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the funding. The designated state entity distributes SSBCI funds to various 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. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an Allocation Agreement with participants setting forth internal controls and compliance and reporting requirements before allocating SSBCI funds. 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 the previous allocation. In addition, the state is required to annually certify that it has complied with all program requirements.

Missouri's Participation in SSBCI

On March 22, 2011, Treasury approved the State of Missouri's SSBCI application for the Missouri IDEA Fund and the Grow Missouri Loan Fund. On May 23, 2011, Treasury signed an Allocation Agreement with Missouri and awarded the State approximately $26.9 million for the two programs. That same month, Treasury disbursed the State's first allocation of approximately $8.9 million.

As of March 31, 2012, the State had obligated or spent approximately $7.3 million of its first disbursement, of which approximately $6.6 million was used by the IDEA Fund and $511,135 was used by the Grow Missouri Loan Fund. Additionally Missouri spent $151,568 for administrative costs associated with implementing the two programs.

Missouri IDEA Fund

The Missouri IDEA Fund was established in 1994 to promote the formation and growth of jobs through businesses that engage in the transfer of science and technology. The Fund provides seed and venture capital funds to early-stage high-tech companies. The

maximum amount of financing provided to businesses ranges from $100,000 to $3 million, depending upon their state of growth.

MTC, a not-for-profit organization established in 1994, administers the Missouri Idea Fund under a contract with MDED, and is governed by a board of 15 directors.

Grow Missouri Loan Fund

The Grow Missouri Loan Fund was launched with Missouri's SSBCI funding approval in May 2011 and finances expansion projects to create or retain full-time jobs for targeted businesses. Under the Grow Missouri Loan Fund, financing is provided as loans with a fixed interest rate of 2 percent per year.[6] The maximum loan term is 8 years. The amount loaned cannot exceed 10 percent of a company's total private loans and available equity, or $3 million per company, or the total of $75,000 for every job created or retained within 5 years, whichever is lowest. Loan terms are such that lenders can treat the loans nearly like equity, thus allowing more companies to qualify for loans and enabling them to receive higher loan amounts.

MDED administers the Grow Missouri Loan Fund for the State. Its mission is to prepare communities and neighborhoods for sustainable economic growth, with an emphasis on assisting new and expanding existing Missouri companies.

Missouri Spent the Majority of SSBCI Funds Properly, but Recklessly Misused $240,000

Our audit determined that the State of Missouri properly used 96 percent of the $7.3 million in SSBCI funds. Specifically, 16 of 17 transactions reviewed complied with the business purpose, capital-at-risk, and other requirements and restrictions established by the Act and *SSBCI Policy Guidelines*. According to *SSBCI Policy Guidelines*, investment proceeds must be used for a "business purpose." A business purpose includes but is not limited to startup costs, working capital, business procurement, franchise fees, equipment, and

[6] The loans are interest-free for minority or women-owned enterprises.

inventory, as well as the purchase, construction, renovation, or tenant improvements of an eligible place of business that is not for passive real estate investment purposes.

However, we identified a $240,000 IDEA Fund investment that constituted a reckless misuse of funds because an MTC Board member had a relationship with the investee that is prohibited by the Act and *SSBCI Policy Guidelines*. Testing of seven additional investment transactions approved by the MTC Board after April 1, 2012, disclosed multiple conflicts of interests, but no additional prohibited party relationships.

Prohibited Relationship Found Between an MTC Director and Investee

In early 2012, the MTC Board of Directors approved an SSBCI investment of $240,000[7] in a Missouri limited liability company (Investee A), through the Missouri IDEA Fund, which is an approved OCSP. Our audit disclosed that one of MTC's Directors had a prohibited party relationship with Investee A due to the Director's presumed controlling interest in the company, which is a program prohibition. The Act and *SSBCI Policy Guidelines* prohibit an investee that receives SSBCI funds from being an executive officer, director, or principal shareholder of the lender in the transaction, among other restrictions. Further, although required by the Act and *SSBCI Policy Guidelines,* the State did not obtain an assurance from Investee A that a prohibited relationship did not exist.

As defined in *Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks,*[8] one criterion that establishes a presumption of control is when a party has the power to vote more than 25 percent of any class of voting stock. The conflicting Director is presumed to have control of Investee A because the Director owns and has the power to vote 30.66 percent of a voting class of Investee A's stock. Specifically:

[7] MTC's funds were equally matched by another investor.
[8] 12 CFR Part 215, Section 215.2.

- According to Investee A's Operating Agreement and MDED's counsel, a limited partnership (Limited Partner) owns 43.19 percent (25,000 shares) of Investee A. A separate limited liability company (Holdings LLC) is the General Partner for Limited Partner, based on a certificate of limited partnership filed with the Missouri Secretary of State's Office.

- The Director is a one-third shareholder in Holdings LLC, and thus the Director controls 33.3 percent of the shares of Holdings LLC. Since Holdings LLC has the power to vote at least 92 percent of Limited Partner, the Director has at least a 30.66 percent[9] voting interest in Limited Partner.

- Limited Partner holds 100 percent of the voting shares of Investee A. Therefore, the Director has at least a 30.66 percent voting interest in the preferred class of shares of Investee A.

Additionally, as a one-third shareholder in Holdings LLC, no other party had the power to vote more shares of Investee A than the Director. Each of the three shareholders had the same 33.3 percent ownership of Holdings LLC. Although the MTC Director's stock was named "Common," it in fact held voting rights. Under Regulation O, a prohibited party relationship is presumed if the party has the power to vote more than 25 percent of *any* class of voting stock.

Therefore, the MTC Director's controlling interest in Investee A created a prohibited party relationship because the Director was a member of the MTC Board and was presumed to have control of the investee in the transaction through the Director's 30.66 percent voting interest in Investee A. A detailed explanation of how we calculated the Director's voting control is contained in Appendix 3.

As a result, the entire $240,000 investment in Investee A constituted a misuse of SSBCI funds. Treasury has defined misuse as any use of

[9] The 30.66 percent voting interest was derived by multiplying 33.3 percent of the First Focus shares controlled by the Director by the Director's 92-percent voting power.

funds by the participating state or administering entity that is not an authorized use or is a prohibited use under the Act, the Allocation Agreement, or the *SSBCI Policy Guidelines*; or any act or omission that enables other parties to misuse funds.

We further found that the misuse was "reckless." Treasury defines 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. We believe that MTC should have known that prohibited party relationships were not allowed because the *SSBCI Policy Guidelines* required **every borrower and investee receiving funds** to certify that such a relationship did not exist. This requirement necessarily means that the underlying fact of the relationship did not exist. MTC officials exhibited an act of omission by not securing the required assurances from Investee A, including an assurance that a prohibited relationship did not exist. When Treasury notified MTC in March 2012 that it needed to obtain the required assurances from Investee A as well as from 14 other companies, MTC obtained all of the assurances except the one from Investee A.

In May 2013, in response to the OIG's notification that there was evidence of reckless misuse regarding Investee A, MTC sent the OIG a letter disagreeing with this characterization. MTC officials contended that MTC is not "a financial institution" investor, and therefore, MTC was not required to obtain the assurances because the related interest prohibition only applies to transactions between a "financial institution" and a borrower. In presenting its argument, MTC pointed to language in the Act and Treasury's *SSBCI Policy Guidelines* that requires the financial institution lender or investor to obtain an assurance regarding compliance with program prohibitions from the borrower or investee.

MTC stated that it reasonably interpreted the guidelines regarding this requirement to apply only to financial institution lenders or investors, and that it was not a financial institution lender or investor.

While we agree that the language specifically cited by MTC might be interpreted ambiguously, we note that the entire sentence reads

> "For each loan or investment resulting from an approved OCSP, the participating state shall require the financial institution lender or investor to obtain an assurance from each borrower or investee stating that the loan or investment proceeds will not be used for an impermissible purpose under the SSBCI Program."

This paragraph establishes three duties: first, for the participating state to require an assurance from each borrower or investee; second, for the financial institution lender to obtain it; and third, that the borrower or investee actually completes the certification. We have not been provided any reason as to why Investee A would not be an "investee." Moreover, the certification is simply the formal acknowledgment that the underlying prohibited conditions do not exist. The underlying prohibited conditions apply to all investees—whether or not a third party must act as go-between for the provision of such certifications does not affect the underlying application of the prohibition.

Even viewing the situation in the light most favorable to MTC, it would require us to accept as reasonable MTC's assertion that first, MTC was not an investor; and second, that because it was not an investor, *no* entity to which it provided funds would be subject to any of the prohibitions set forth in the *SSBCI Policy Guidelines*, Section VII, paragraph d.4.a.-e. Remarkably, MTC does not assert that it would be equally appropriate to disburse funds to an entity relying on wildcatting for its profits; or to an entity engaged in pyramid schemes; or to an entity engaging in unlawful activities or gambling, none of which, under MTC's interpretation, would have been prohibited. MTC, however, does not appear to have considered the resulting gross inconsistency that its interpretation would create in the status of a recipient who had the bad fortune to have a financial institution lender or an investor (vis-à-vis one in which MTC invested). We do not find MTC's interpretation persuasive, and note that no other state has approached its disbursements in such a fashion. MTC should have

known that the relationship was prohibited above and beyond its own conflict of interest provisions.

We also found the error to constitute a highly unreasonable departure from the standards of ordinary care. MTC did not sufficiently explore the relationship between the conflicted Board Director and the investee, because, according to MTC, it did not believe the provision applied. Yet, as explored above, MTC offered no rationale other than its belief that it was not a financial institution lender or investor due to a perceived ambiguity. We reason that a prudent person engaged in a Federal program disbursing nearly a quarter million dollars to an entity would recognize that, even if they perceived an ambiguity, the underlying prohibitions would apply to an investee, and, if there were a bona-fide question, it would be prudent to ask it of the administering office. Yet Treasury has no record of such an inquiry, and MTC said it did not make one. The consequences of failing to adhere to program guidelines are severe for the state and the investee. We determined that continuing with the investment without (1) a certification, (2) questioning Treasury about the ambiguity, and (3) a carefully administered conflict of interest program, constituted recklessness.

MTC asserts that it had a conflict of interest policy in place but the policy does not include restrictions akin to those in Regulation O, or an absolute disqualification of any entity whose controlling interest exceeded a certain threshold. Moreover, the existence of the policy did not excuse MTC's reckless behavior in the Investee A investment. For instance, in theory it would be fine for MTC to make a large award to an entity wholly owned by one of the Directors, provided that the conflicted Director recused himself or herself from the actual vote. But, because MTC failed to actually establish the extent of ownership or discussions related to such conflict, it is impossible to determine whether such policy was enforced by anything other than the Director's own integrity. MTC's conflict-of-interest policy, which was established in 2009 in response to a board member's concerns about conflicts involving former MTC employees and board members, requires that the material facts of each conflict be documented in the minutes of MTC's meetings, and that members recuse themselves from decisions on the related investments. Therefore, it is disturbing

that none of this information was so documented. Although the Director took recusal action and did not vote based on the Director's assertion of a small interest in Investee A, the minutes did not indicate how the Director contributed to the investment discussion before the vote.

Because by law any funds identified as recklessly misused must be returned to Treasury, we recommend that Treasury recoup the entire $240,000 investment. We also recommend that Treasury take appropriate action to address MTC's continued failure to gather the required assurance related to the Investee A investment.

Other MTC Directors Had Conflicts of Interest that Are Not Prohibited

We also identified many instances where members of the MTC Board of Directors had conflicts of interest that required their recusal from voting. These conflicts did not constitute related interests prohibited by the Act or *SSBCI Policy Guidelines,* and the Board had adopted a conflict-of-interest policy, as recommended by the *SSBCI National Standards for Compliance and Oversight (*National Standards). Treasury's *National Standards* say that conflicts of interest other than prohibited relationships could arise, and that participating states should consider it a best practice to require all individuals involved in evaluating and executing lender/investor participation agreements to disclose any potential or actual conflicts in accordance with the State's conflict-of-interest policy, and to recuse themselves if a conflict of interest occurs.

As discussed previously, while MTC had adopted a conflict-of-Interest policy in 2009*,* it did not appear that it was being fully adhered to. MTC's policy requires that the material facts of each conflict be documented in the minutes of MTC's meetings, and that members recuse themselves from decisions on the related investments. However, a review of the MTC board minutes revealed that the material facts of each conflict had not been documented, and it is unclear what contributions, if any, conflicted members made to discussions of potential investments. Therefore, it is unclear whether

conflicts of interest are being adequately mitigated when making SSBCI investment decisions. For this reason, Treasury will need to require the State to demonstrate that the MTC Board is fully adhering to its conflict-of-interest policy when making investment decisions financed by the SSBCI program.

Missouri Did Not Obtain Required Assurances from Investees

For 88 percent, or 15, of the 17 transactions reviewed, MTC did not obtain adequate assurances from the borrower or investee by loan or investment closing dates. The Act and *SSBCI Policy Guidelines* require that lenders and investors obtain borrower or investee assurances affirming that (1) loan or investment proceeds will be used for approved business purposes, (2) loan or investment proceeds will not be used for specifically prohibited purposes, (3) the borrower or investee does not have a prohibited relationship with the lender or investor, (4) the borrower or investee is not engaged in specifically prohibited activities, and (5) the principals of the borrower or investee have not been convicted of a sex offense against a minor.

Additionally, under the *SSBCI Policy Guidelines*, each state must obtain an assurance from the financial institution investor affirming that (1) the loan is not for prior debt or investment that is not covered under the approved state program or that was owed to the investor or an affiliate of the investor, (2) the loan or investment is not a refinancing of a loan or investment previously made to the borrower or investee by the lender or investor or an affiliate of the lender or investor, and (3) no principal of the lender or investor has been convicted of a sex offense against a minor.[10]

MTC said it did not obtain adequate assurance certifications because it did not believe that MTC was a "financial institution," and thus was not subject to the assurance requirements. However, as noted

[10] Under Treasury's October 2011 guidelines, "principal" is defined as: the proprietor of a sole proprietorship; each partner in a partnership; each of the five most highly compensated executives, officers, or employees of a corporation, limited liability company, association, or a development company; or each direct or indirect holder of 20 percent or more of the ownership stock or stock equivalent of that entity.

previously, Treasury's *National Standards* advise that when a state makes a direct loan or investment, the participating state is a lender or investor.

Treasury became aware of this issue in March 2012 while conducting a review of Missouri's second disbursement request. At Treasury's direction, Missouri agreed to retroactively obtain the required assurances, and as of the date of this report had obtained 14 of the 15 that were missing. Only the Investee A assurances remain outstanding.

Additionally, Missouri incorrectly certified to Treasury on June 30, 2012, that its programs were being implemented in accordance with all program requirements. This certification was inaccurate because complete borrower and lender assurances had not been obtained at loan closing or at the time of the certifications. The inaccurate certification also demonstrates that the State had not performed its due diligence in collecting the information needed to support its certifications to Treasury that it was administering its SSBCI funds in accordance with program requirements.

The State's failure to collect all assurances prior to loan closing and its inaccurate compliance certification may have triggered a general event of default of its SSBCI Allocation Agreement. Under Section 6.1 of the agreement, Treasury, in its sole discretion, may find a participant to be in default if the participant materially fails to comply with, meet, or perform any term, covenant, agreement, or other provision contained in the agreement. Further, the participant may be in default of its agreement if it made any representation or certification to Treasury that is found to be inaccurate, false, incomplete, or misleading in any material respect.

Therefore, Treasury should determine whether a general event of default has occurred, and if such an event has occurred and not been adequately cured, whether future funding to Missouri should be suspended, reduced, or terminated.

Administrative Costs Charged to SSBCI Were Reasonable, Allowable, and Allocable

All costs comprising $151,568 in SSBCI funds expended by Missouri for administration of its two SSBCI programs were allowable and allocable in accordance with Treasury Guidelines and OMB Circular A-87. Section 4.2 of the Missouri Allocation Agreement states that the participating state shall only use the allocated funds for the purposes and activities specified in the agreement and for paying allowable costs of those purposes and activities in accordance with the cost principals set forth in OMB Circular A-87 and codified in 2 C.F.R. Part 235. Missouri provided supporting documents for all individual administrative expenses charged to SSBCI showing that the expenses were allowable, reasonable, and allocable to the program.

Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing and Community Development:

1) Recoup the $240,000 investment that MTC recklessly misused by investing in a company controlled by a member of the MTC Board of Directors and for failing to gather required assurances related to the transaction.

2) Require Missouri to demonstrate that MTC is fully adhering to its conflict-of-interest policy when investing SSBCI funds.

3) Recommend to Missouri that its conflict-of-interest policy include restrictions congruent with Regulation O where practicable.

4) Determine whether there has been a general event of default under Missouri's Allocation Agreement resulting from the State's non-compliance with the related party prohibition and with lender/borrower assurance requirements and false compliance certifications. If such an event has occurred and has not been adequately cured, determine whether it

warrants a reduction, suspension, or termination of future funding to the State.

Management Comments and OIG Response

We provided a draft of this report to Treasury on June 13, 2013, and received formal written comments on July 15, 2013, in which Missouri disagreed with the finding of reckless misuse of funds and MTC's violation of its conflict-of-interest policy. Treasury accepted each of the report's recommendations.

With respect to the first recommendation, Treasury stated it will recoup from Missouri the $240,000 transaction that constituted reckless misuse of funds. To implement recommendation 2, Treasury will ask Missouri to confirm that MTC is adhering to its conflict-of-interest policy. Regarding recommendation 3, Treasury will recommend to Missouri that its conflict-of-interest policy should include restrictions that conform with the relevant provisions of Regulation O when SSBCI funds are concerned. Treasury also plans to determine whether Missouri has adequately cured its non-compliance with the related party prohibition, requirements for assurances, and certification filings in response to recommendation 4. Finally, Treasury stated that it will determine whether additional action is warranted.

We believe that Treasury's planned actions are fully responsive to the recommendations.

* * * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. 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: Objectives, Scope, and Methodology

The objective of our audit was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. As of March 31, 2012, the State of Missouri had obligated or spent approximately $6.6 million[11] of the first disbursement for the Missouri Innovation, Development, and Entrepreneurship Advancement (IDEA) Fund and $511,135 for the Grow Missouri Loan Fund, for a total of approximately $7.3 million.[12] Additionally, Missouri spent $151,568 for administrative expenses.

Our audit scope included all State Small Business Credit Initiative (SSBCI) small business loan enrollment and investment activity from the date of Missouri's approval as an SSBCI participant on May 22, 2011, to March 31, 2012. During this period, Missouri IDEA Fund enrolled 16 loans and investments and Grow Missouri Loan Fund enrolled 1 participating loan (see Appendix 2).

We contracted with TCBA Watson Rice LLP, an independent certified public accounting firm, to conduct the audit, which was performed from August 2012 to June 2013. After the accounting firm reviewed these 17 transactions, they reviewed an additional 7 transactions to identify any reckless or intentional misuse of funds through transactions with prohibited related parties (see Appendix 2). We expanded the scope of our audit to add all board-approved and funded SSBCI loan enrollment and investment activity in the Missouri IDEA Fund and the Grow Missouri Loan Fund programs from April 1, 2012, through September 30, 2012. During this period, the Missouri IDEA Fund enrolled seven additional investments while the Grow Missouri Loan Fund had no additional transactions. The accounting firm reviewed those seven transactions only for prohibited relationships.

The accounting firm interviewed the management and staff responsible for administering, managing, accounting for, and reporting on the Missouri IDEA Fund and Grow Missouri Loan Fund. These interviews were conducted to understand and assess:

[11] Rounded down from $6,630,808.
[12] Rounded up from $7,293,511.

- Whether the State used its allocated funding under the program in accordance its approved application;
- Procedures in place to process small business loans and investments and ensure compliance with the requirements of the Act and associated *SSBCI Policy Guidelines*; and
- Accounting and reporting processes, including methodologies for calculating and reporting administrative expenses.

The accounting firm reviewed policies, procedures, and other written guidance provided by the Missouri Department of Economic Development (MDED) and the Missouri Technology Corporation. In addition, the accounting firm conducted an on-site visit at MDED during August 2012 and compared documentation for loans and investments enrolled in the Missouri IDEA and Grow Missouri Loan Fund as of March 3, 2012 to specific requirements and prohibitions of the Act and *SSBCI Policy Guidelines*. A listing of transactions tested is contained in Appendix 2.

We conducted quality assurance procedures to ensure the work was completed in accordance with *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 to address our audit objectives provides a reasonable basis for our findings and conclusions.

Appendix 2: Transactions Tested for Compliance

Program	Business Type	SSBCI $	Total $
Group 1			
TechLaunch	Biotechnology	$50,000	$101,000
	Medical device creator	$100,000	$467,000
	Business software	$50,000	$200,000
	Electric vehicle battery technology	$100,000	$271,250
Seed Capital Co-Investment Fund	Health screening	$200,000	$400,000
	Medical devices	$250,000	$602,000
	Prescription drug research	$250,000	$500,000
	Natural gas technology	$240,000	$480,000
	Software	$100,000	$200,000
	Prescription drug research	$205,810	$515,451
	HR technology	$335,000	$1,335,000
Venture Capital Co-Investment Fund	Cybersecurity	$749,999	$2,891,804
	Biopharmaceuticals	$250,000	$1,127,730
	Medical technology	$1,000,000	$3,090,000
	Audio equipment	$750,000	$2,750,000
High-Tech Industrial Expansion Fund	Electric vehicles	$2,000,000	$4,850,000
Loan Participation Fund	Storage tanks	$511,135	$5,111,350
Group 2			
TechLaunch	Veterinary medicines	$50,000	$100,000
	Medical technology	$25,000	$50,000
	Medical equipment	$45,000	$100,000
	Medical research	$31,250	$62,500
	Biotechnology	$90,000	$187,000
Seed Capital Co-Investment Fund	Prescription drug research	$150,000	$300,000
Venture Capital Co-Investment Fund	Internet publishing	$199,997	$1,084,251

Appendix 3: Calculation of Director's Voting Control of Investee A

The conflicted MTC Board Director identified in the report is a 33.3 percent shareholder of a limited liability company (LLC). There are two other 33 percent shareholders.

The LLC is the General Partner of a separate limited partnership (Limited Partner) and controls or has the power to vote at least 92 percent of Limited Partner. Limited Partner owns 25,000 or 100 percent, of Investee A's preferred units; and 82,500, or 36.84 percent, of Investee A's common units.

Due to these facts, the Director is presumed to have at least 30.66 percent voting control of Limited Partner (92 percent voting power of Limited Partner times 33.3 percent ownership of the LLC). The Director has 30.66 percent voting control over Investee A's preferred units (30.66 percent voting control x 100 percent ownership of the preferred units); and 11.3 percent voting control over Investee A's common units (30.66 percent voting control x 36.84 percent ownership of the common units).

Per Regulation O (12 CFR 215.2 (c)(1)(i), control of a company or bank means that 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.

Therefore, because Limited Partner owns 100 percent of the preferred shares of Investee A and the Director has voting control over 30.66 percent of the LLC, the Director is presumed to have the power to vote more than 25 percent of Investee A's preferred units.

Appendix 4: Management Response

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 12, 2013

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: Missouri'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).

We appreciate the Report's finding that Missouri generally used State Small Business Credit Initiative (SSBCI) funds appropriately and that all but one of the sampled transactions complied with SSBCI program requirements. With your consent, Treasury transmitted a copy of the Report to Missouri program officials on June 17, 2013. Treasury asked Missouri 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, enclosed, Missouri states that the State appreciates many of the Report's findings, but that the State disagrees with the conclusion that one of the Missouri Technology Corporation's (MTC) venture capital investments constitutes a reckless misuse of funds and that MTC may have violated its own conflicts of interest policy. Missouri asserts that the State was unaware that the requirements of "Regulation O" applied to MTC and that MTC complied at all times with its own conflicts of interest policy. Missouri also specifies the measures it has taken to remedy the situation and prevent similar issues in the future, including that MTC has replenished the SSBCI program account in the amount of misused funds and un-enrolled the transaction, amended its conflicts of interest policy to require a "Regulation O" analysis for each transaction supported by SSBCI funds, and created a "Regulation O" checklist for each transaction supported by SSBCI funds.

Treasury accepts each of the Report's recommendations. With respect to the first recommendation, Treasury will recoup from Missouri $240,000 for enrolling a transaction that the OIG characterized as a reckless misuse of funds. Regarding recommendation 2, Treasury will ask Missouri to confirm that MTC is adhering to its conflicts of interest policy. Regarding recommendation 3, Treasury will recommend to Missouri that its conflicts of interest policy should include restrictions that conform with the relevant provisions of Regulation O when SSBCI funds are concerned. Finally, with respect to recommendation 4, Treasury will determine whether Missouri has adequately cured its non-compliance with the related party prohibition,

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requirements for assurances, and certification filings. Treasury also will determine whether additional action is warranted.

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

Sincerely,

Don Graves
Deputy Assistant Secretary
Small Business, Community Development, and
Affordable Housing Policy

Enclosure

Jeremiah W. (Jay) Nixon
Governor

MISSOURI
Department of Economic Development

Mike Downing, CEcD
Acting Director

July 5, 2013

Department of the Treasury
Small Business, Community Development, and Housing Policy
1500 Pennsylvania Avenue
Washington, D.C. 20220
Attn: Don Graves, Jr., Deputy Assistant Secretary

Re: **Draft Audit Report No. OIG-SBLF-13-00x**

Dear Deputy Assistant Secretary Graves:

The State of Missouri appreciates the opportunity to respond to your letter dated June 17, 2013 and the draft report by the Treasury Office of the Inspector General ("OIG") entitled *State Small Business Credit Initiative: Missouri's Use of Federal Funds for Other Credit Support Programs* (the "Report"). As you are aware, Missouri has been an early adopter and leader in deploying State Small Business Credit Initiative ("SSBCI") funds through the Missouri IDEA Funds program. To date, Missouri through the Missouri Technology Corporation ("MTC") has made 36 investments totaling $10.7 million. These investments have allowed early-stage, innovative companies to raise nearly $50 million in private capital investment. As an early participant, MTC has assisted Treasury in identifying issues and addressing problems in the roll-out of the SSBCI program. During the course of OIG's audit, MTC already had begun working with Treasury staff to respond to the Report's findings.

We appreciate OIG's findings in the Report that: (1) Missouri's expenditure of SSBCI funds for administrative expenses was allowable, reasonable and allocable to the SSBCI program; (2) Missouri's staff fully cooperated during OIG's audit without any constraints on the audit's scope or procedures; and (3) except for one instance – OIG's characterization of which we dispute – MTC properly used the funds it received under the SSBCI program. We strongly disagree, however, with OIG's conclusion that MTC's venture capital investment in Electrochaea, LLC, a Missouri limited liability company ("Electrochaea"), was a reckless misuse of funds and that MTC in any way violated its Conflicts of Interest Policy. At your request, we have summarized below our key factual disagreements with OIG along with an explanation for MTC's actions taken with respect to the Report.

- MTC was not aware that Treasury took the position that the Regulation O prohibition applied to MTC. MTC, as a state-affiliated participant in the SSBCI program, participates in an "other credit support program" or OCSP. As a government agency and a non-profit economic development corporation, MTC clearly does not meet the definition of a "financial institution" as set forth in the Small Business Jobs Act of 2010 (the "Act"). Both the Act and the SSBCI Policy Guidelines published on October 21, 2011 (the "Guidelines") by their express terms impose different requirements on financial institutions and governmental OCSP participants, including certain prohibitions on

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financial institution lenders that the Report alleges MTC failed to comply with in making the Electrochaea investment.

The Act's and Guidelines' different treatment of financial institutions and government agencies is logical. Financial institutions are for-profit business accountable to private shareholders and are subject to banking regulations, including 12 C.F.R. 215 ("Reg O"). The imposition of Reg O requirements would not increase financial institutions' compliance costs or unduly restrict their activity. Alternatively, governmental OCSP participants are non-profit entities accountable to their governmental sponsors, but are not subject to Reg O. The Act and the Guidelines constitute the only written guidance available prior to the closing of the Electrochaea transaction[1] and MTC fully complied with all requirements imposed on governmental OCSP participants.

- MTC was not on notice of Treasury's after-the-fact determination that the Electrochaea investment was unauthorized. Treasury first provided guidance imposing financial institution requirements on governmental OCSP participants in the SSBCI National Standards for Compliance and Oversight (the "National Standards"), circulated in draft form on March 6, 2012 and effective as of May 15, 2012. As MTC has communicated to both OIG and Treasury, the Electrochaea investment closed in February 2012 before either the draft or final National Standards were released.

  From the beginning of Missouri's participation in the SSBCI program, MTC required each borrower and investee to make general representations and warranties that the award recipient complied with all the requirements of the SSBCI program. Once MTC became aware of Treasury's requirements for more specific certifications, MTC promptly began contacting all of its SSBCI fund recipients to request specific certifications and required specific certifications for subsequent investments on an ongoing basis. As the Report notes, MTC has obtained all such specific certifications with the sole exception of Electrochaea which has requested clarification of how the certification requirement applies to it.

- Contrary to the characterization in the Report, MTC's investment activities are consistent with MTC's position on the financial institution issue. The Report states that if MTC's position on the meaning of the term financial institution is correct, such interpretation would create a loophole allowing MTC to invest in pyramid schemes and unlawful activities. OIG's observation ignores the express IDEA Fund requirements and restrictions to the contrary, included in Missouri's application for participation in the SSBCI program. Those requirements and restrictions were derived from Treasury's written program guidelines made publicly available on the SSBCI website and which Missouri downloaded in December 2010. Those guidelines prohibit many types of

[1] Missouri notes that other ancillary documents and Missouri's communications with Treasury reinforced MTC's understanding of the differences in requirements imposed on financial institutions and governmental OCSP participants. The Allocation Agreement dated as of May 23, 2011, by and between Treasury and the State of Missouri pursuant to which SSBCI funding through MTC was authorized distinguishes between "non-profit entities supervised by the state" and "financial institution or any other private entity" (emphasis added). In February of 2013, and one year following the closing of the Electrochaea investment, Treasury provided guidance to Missouri on the permissible use of proceeds from realized investments. That guidance is only consistent with the Act and the Guidelines if the financial institution requirements are not applicable to MTC.

transactions, including pyramid schemes and unlawful activities, but omit any reference to the Reg O prohibition. As a component of Missouri's SSBCI program application, MTC's use of SSBCI funds is restricted by the IDEA Fund program limitations. In essence, OIG criticizes MTC for relying upon Treasury's own guidelines in applying for SSBCI participation through the IDEA Fund.

- MTC complied at all times with its Conflicts of Interest Policy. Contrary to the Report's erroneous recitation of facts and conclusions, MTC consistently applied its Conflicts of Interest Policy in its review and approval of all applicants under the IDEA Fund, including Electrochaea. The relationship between the potentially interested director (the "Director") and Electrochaea was disclosed repeatedly in the application materials which were provided to the Board of Directors and its committees. The materials provided to the Director specifically omitted all Electrochaea materials. Contrary to the statements in the Report, the Director recused herself from all discussions and votes regarding the Electrochaea investment and left the meetings during the same. MTC believes that the recusal is a very conservative approach to addressing a Director conflict. MTC's decision to make the Electrochaea investment was made on the merits through a rigorous and independent process.

  Finally, MTC notes that the Director is a principal of a venture capital fund that had invested in Electrochaea and, in connection with such investment, the Director serves a member of Electrochaea's Board of Managers. The Director does not have a direct, personal financial interest in Electrochaea, but instead has a financial interest in the general partner of a limited partnership that has a minority position in the common equity issued by Electrochaea. Moreover, OIG does not dispute the fact that the Director did not receive any improper personal benefit from MTC's investment.

  With respect to the disclosure in the minutes, the purpose of such disclosure is to evidence the basis on which the Board or its committee determined the significance of a potential conflict. Where, as in the Electrochaea case, the facts were set forth in the supplemental materials and the conflict of interest was resolved by reason of the recusal, there is no reason for additional disclosure. The Director's recusal was expressly noted in the minutes. OIG is seeking to turn a subjective judgment on the level of detail that it believes should be included in the minutes into substantive non-compliance with a regulatory requirement.

  Finally, the Report notes that OIG identified many instances where conflicts of interest required recusal but did not identify any such instances. Under statute, MTC's Board includes representatives of a number of Missouri institutions, including representatives of various campuses of the University of Missouri system and business development groups. These organizations may have relationships that appear to be conflicts even though there is no financial interest. For this reason, MTC has adopted a multi-tiered approval process that involves evaluation and approval by multiple independent bodies prior to any applicant receiving approval for funding. The Conflicts of Interest Policy also grants broad authority to the Board to take such action as is deemed necessary to determine if a conflict of interest exists. Electrochaea, along with all other recipients, was subject to identical approval procedures and the consistent application of the Conflicts of Interest Policy. OIG would now penalize MTC for positions it has taken out of an abundance of conservatism.

Notwithstanding the foregoing, Treasury has requested the State of Missouri provide a list of measures that MTC has taken and plans to take in response to the findings of the Report. Below are the actions that MTC has taken or plans to take:

1. Reallocation of Electrochaea Investment. MTC's Board has acted to cause MTC to (a) replenish the IDEA Fund in the amount equal to $240,000 from the Lewis and Clark Discovery Initiative, which was funded by the State of Missouri, and (b) un-enroll the investment from the IDEA Fund. Upon request, MTC will provide such documentation as Treasury determines is reasonably necessary to evidence these actions.
2. Amendment of the Conflicts of Interest Policy. On June 28, 2013, MTC's Board of Directors voted to amend MTC's Conflicts of Interest Policy (the "Amended Policy"). The Amended Policy requires that MTC staff conduct a Reg O analysis prior to the approval of any investment by MTC using SSBCI funds and prohibits MTC from making investments with SSBCI funds where a Reg O relationship is found to exist. Article III of the Amended Policy includes further clarification that with respect to IDEA Fund and similar investments with numerous safeguards for disinterested consideration, disclosure of an actual or potential conflict of interest and recusal by the potentially conflicted person is sufficient to comply with the Amended Policy. Finally, Article IV of the Amended Policy further clarifies that notation of a recusal in the minutes satisfies the records of proceedings requirements of the Amended Policy. We would be pleased to provide a copy of the Amended Policy upon your request.
3. Reg O Checklist. As noted above, going forward MTC staff will conduct a Reg O analysis for each SSBCI-fund recipient. MTC has created a checklist that will be included in the recipient's file. The checklist identifies each potential prohibited relationship and will document MTC staff's compliance with the National Standards interpretation of the SSBCI program. As noted above, the relevant information is required as a part of each application for SSBCI funding. We would be pleased to provide a copy of the checklist upon your request.

* * * * *

Missouri hopes that these actions will alleviate any concerns Treasury has with respect to the Report's conclusions and enable MTC to pursue its mission and the goals of SSBCI, the Act, the Guidelines and that National Standards.

Sincerely,

Mike Downing, CEcD
Acting Director

Appendix 5: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

Clayton Boyce, Audit Director

John Rizek, Audit Manager

Andrew Morgan, Auditor-in-Charge

Safal Bhattarai, Auditor

Diane Baker, Program Analyst

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Appendix 6: Distribution List

Department of the Treasury
Deputy Secretary
Office of Strategic Planning and Performance Management
Risk and Control Group

Office of Management and Budget
OIG Budget Examiner

United States Senate
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Committee on Small Business and Entrepreneurship

Chairman and Ranking Member
Committee on Finance

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

United States House of Representatives
Chairman and Ranking Member
Committee on Small Business

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office
Comptroller General of the United States