



# Audit Report



Report Number: OIG-SBLF-14-012

STATE SMALL BUSINESS CREDIT INITIATIVE:

Tennessee's Use of Federal Funds for its Venture Capital Program

August 20, 2014

Office of  
Inspector General

Department of the Treasury

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## Abbreviations

Act	The Small Business Jobs Act of 2010
INCITE	INCITE Co-Investment Fund
National Standards	SSBCI National Standards for Compliance and Oversight
OCSP	Other Credit Support Program
OIG	Office of Inspector General
OMB	Office of Management and Budget
SSBCI	State Small Business Credit Initiative
Treasury	Department of the Treasury
TTDC	Tennessee Technology Development Corporation

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*The Department of the Treasury  
Office of Inspector General*

August 20, 2014

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

This report presents the results of our audit of the state of Tennessee'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 Tennessee approximately \$29.7 million<sup>1</sup> in SSBCI funds in August 2011, and as of September 30, 2013, the State had received all of the awarded funds. As of September 30, 2013, Tennessee had obligated or spent approximately \$18.8 million<sup>2</sup> of the funds disbursed, including \$18.1 million<sup>3</sup> for the INCITE Co-Investment Fund (INCITE), a Venture Capital Program. The State also incurred \$685,880 in administrative costs.

The Act requires Treasury's Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and 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 from or a willful disregard of the standards of ordinary care. Intentional misuse is defined as a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.

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<sup>1</sup> Rounded up from \$29,672,070.

<sup>2</sup> Rounded up from \$18,763,652.

<sup>3</sup> Rounded up from \$18,077,772.

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Our audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. To accomplish our objective, we reviewed a judgmental sample of 20 investments totaling approximately \$13.5 million<sup>4</sup> in SSBCI funds, which were among the 43 investments made under the approved State program between the signing of the *Allocation Agreement* on October 4, 2011, and September 30, 2013. Of the 20 investments reviewed, all were from the INCITE Venture Capital Program, as Tennessee allocated all of its SSBCI funds to that program.

We reviewed the investments to determine whether they complied with program requirements for use of proceeds, capital at risk, and other restrictions in the Act, *SSBCI Policy Guidelines*, or the *SSBCI National Standards for Compliance and Oversight* (National Standards). In conjunction with the review of investment files, the OIG interviewed management and staff of the Tennessee Department of Economic and Community Development and the Tennessee Technology Development Corporation (TTDC)<sup>5</sup> who administer, account for, and report on SSBCI funding. We also reviewed a judgmental sample of \$483,254 of the \$685,880 in administrative costs the State charged against SSBCI funds to ensure they were allowable, reasonable, and allocable in accordance with *SSBCI Policy Guidelines* and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.<sup>6</sup>

We performed our audit from January 2014 to August 2014 in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient and 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.

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<sup>4</sup> Rounded down from \$13,520,468.

<sup>5</sup> TTDC does business under the trade name Launch Tennessee.

<sup>6</sup> Office of Management and Budget Circular Number A-87, revised May 10, 2004.

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## Results in Brief

Tennessee appropriately used all \$13.5 million in SSBCI funds that we reviewed, but did not comply with all investor assurance requirements. Investor use-of-proceeds assurances were missing for all 20 transactions reviewed, and investor sex offender assurances had not been executed prior to the transfer of SSBCI funds for 12 of the transactions. This occurred because the State did not require TTDC to make or obtain the assurances, and TTDC relied on private co-investors to make the affirmations. Despite the inadequate assurances, Tennessee certified that it was in compliance with all SSCBI requirements for June 2012, September 2012, December 2012, March 2013, June 2013, and September 2013, which was inaccurate.

We recommend that Treasury determine whether Tennessee is in general default of its SSBCI *Allocation Agreement* for its non-compliance with investor assurance requirements, and if such an event has occurred and has not been adequately cured, take the appropriate action.

Treasury officials accepted the audit recommendations, stating that they will determine whether a general event of default has occurred as a result of the State not fully complying with investor assurance requirements. We believe that Treasury's planned actions are fully responsive to all of the audit recommendations. Formal written responses from Treasury and the state of Tennessee are included in their entirety in Appendix 1.

## Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds to strengthen Capital Access Programs (CAPs) and Other Credit Support Programs (OCSPs) that provide financial assistance to small businesses and manufacturers. CAPs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. OCSPs include collateral support, loan

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participation, loan guarantee, direct lending, and venture capital programs.

Each participating state is required to designate specific departments, agencies, or political subdivisions to administer the funds. 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 participating state. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an *Allocation Agreement* with each participating state, setting forth internal controls and compliance and reporting requirements before allocating SSBCI funds. SSBCI disbursements to participating 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 participating state is required to certify that it has complied with all applicable program requirements.

### **Tennessee's Participation in SSBCI**

On August 10, 2011, Treasury approved the state of Tennessee's application for participation in SSBCI, awarding it approximately \$29.7 million. The *Allocation Agreement* between Tennessee and Treasury was signed on October 4, 2011, and authorized use of the SSBCI funds to support Tennessee's INCITE, a Venture Capital Program. In August 2011, Treasury disbursed the State's first allocation of approximately \$9.8 million,<sup>7</sup> and in April 2013, Treasury approved a second allocation, equal to the first, after the State certified it had obligated over 80 percent of its first disbursement.

In September 2013, Treasury approved a third allocation of

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<sup>7</sup> Rounded up from \$9,791,783.

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approximately \$10.1 million<sup>8</sup> after the State certified it had obligated over 80 percent of its second disbursement. As of September 30, 2013, Tennessee had obligated or expended approximately \$18.8 million of the three allocations. The State designated TTDC to administer the approved state programs on behalf of and in conjunction with the Tennessee Department of Economic and Community Development.

### **Tennessee's Venture Capital Program**

The INCITE Co-Investment Fund was established in May 2011 to create and retain high-quality jobs, provide Tennessee companies with venture capital, leverage private capital investment, and commercialize technology developed by Tennessee research institutions. INCITE makes capital available to approved investors across three funding tiers (seed, early, and expansion) for co-investment with private sector capital in a qualifying company. As of September 30, 2013, the State had obligated or expended \$18.1 million in SSBCI funds on 42 investments enrolled in the INCITE Co-Investment Fund.

### **Tennessee Used \$13.5 Million in SSBCI Funds Appropriately, but Did Not Comply with All Investor Assurance Requirements**

We determined that the state of Tennessee properly used all \$13.5 million of the SSBCI funds sampled. Also, all 20 transactions we sampled were compliant with program requirements and prohibitions related to prohibited relationships, maximum transaction amounts, capital at risk, and other restrictions noted in the Act and *SSBCI Policy Guidelines*.

However, none of the 20 transactions were compliant with all of the investor use-of-proceeds assurance requirements. The *SSBCI Policy Guidelines* state that each participating state must obtain a use-of-proceeds assurance from the lender/investor affirming that: (1) the loan or investment is not for a prior loan or investment that is not

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<sup>8</sup> Rounded up from \$10,088,504.



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covered under the approved state program or that was owed to the borrower or investee or an affiliate of the lender or 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. Additionally, the *National Standards* state that it is the participating state's responsibility to obtain the use-of-proceeds assurances as part of its compliance monitoring procedures, determine whether the assurances have been adequately documented, and to verify that they are completely and duly executed prior to transferring SSBCI funds.

However, the State had not obtained or required the investor, TTDC, to complete the investor use-of-proceeds assurances for the 20 transactions. A TTDC official stated that TTDC did not believe this requirement was applicable to TTDC because TTDC takes a passive co-investor role in the Venture Capital Program and relies on private investors to take the lead in evaluating investees for the eventual approval or rejection by TTDC. In practice, TTDC required the private sector lead investor on the transactions to complete the use-of-proceeds assurance affirmations and to retain those records as part of the investment file.

Additionally, 12 of the 20 transactions were not compliant with investor sex offender assurance requirements in the *National Standards*. The *National Standards* state that the participating state is responsible for obtaining and verifying that the investor sex offender assurances have been completed and duly executed prior to transferring SSBCI funds. While sex offender assurances for the 12 transactions were documented, all of them were signed and dated after the transfer of SSBCI funds. This occurred because TTDC assumed a passive role in ensuring program requirements were met and relied on other co-investors to ensure the assurances were obtained prior to the transfer of SSBCI funds. However, TTDC officials attended an SSBCI conference and became aware of Treasury's documentation requirements. This prompted TTDC to perform a quality control review. The review identified the deficient investor sex offender assurances, and TTDC subsequently obtained

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the assurances after the SSBCI funds had been transferred. Although Tennessee did not fully comply with all investor assurance requirements, the State certified that it was fully compliant with all program requirements when it filed its quarterly reports in June 2012, September 2012, December 2012, March 2013, June 2013, and September 2013. As a result, these certifications, which are required by Treasury's *Allocation Agreement* with Tennessee, were inaccurate.

The State's failure to fully comply with the assurance requirements and inaccurate compliance certifications may constitute a general event of default under its *Allocation Agreement*. Treasury, in its sole discretion, may find a participating state to be in general default of its *Allocation Agreement* if the state materially fails to comply with, meet, or perform any term, covenant, agreement, or other provision contained in the agreement. Further, Treasury may also find a state to be in default under the *Allocation Agreement* if any representation or certification made to Treasury is found to be inaccurate, false, incomplete, or misleading in any material respect. Therefore, Treasury will need to consider whether Tennessee is in default of its *Allocation Agreement* and whether it has satisfactorily cured the non-compliance.

### **Administrative Costs Charged to SSBCI and Reviewed by OIG Were Reasonable, Allowable, and Allocable**

OIG sampled costs totaling \$483,254 of SSBCI funds expended by Tennessee for administration of its SSBCI programs as of September 30, 2013, and found the expenditures were reasonable, allowable, and allocable in accordance with *SSBCI Policy Guidelines* and the Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*. Section 4.2 of the Tennessee *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 principles set forth in OMB Circular A-87 and codified in 2 C.F.R. Part 225.

Tennessee provided supporting documentation for the sampled administrative costs charged to the SSBCI program, which showed

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that all sampled expenses were allowable, reasonable, and allocable to the program. Additionally, the OIG noted that TTDC identified \$3,637 in unallowable costs as part of an internal quality-control review, which TTDC undertook before the start of our audit. The review found that some expenses were charged fully to SSBCI, instead of divided among multiple programs that used the funds, and that supporting documentation for some expenses was illegible or missing. The OIG reviewed Tennessee's supporting documentation and verified that TTDC reimbursed the SSBCI account for the unallowed portion.

## **Tennessee Exhibited Best Practices in Its Administration of SSBCI Funds**

Tennessee's success in ensuring compliance with SSBCI requirements, other than investor assurances, was attributable to best practices the State employed that enhanced its program oversight. Chief among them was TTDC's implementation of background checks of all applicant owners, directors, officers, and executives of the small businesses during the investment application processing, even though Treasury does not require them. TTDC submits the information to the Tennessee Department of Economic and Community Development for criminal and securities violation background checks, reviews the results, and maintains a hard copy in the investment file. The implementation of this level of due diligence ensured that investments were evaluated for compliance with SSBCI requirements and policy guidelines prior to funding, mitigating the risk of non-compliance.

## **Recommendations**

We recommend that the Acting Assistant Secretary for Financial Institutions:

1. Determine whether there has been a general event of default under Tennessee's *Allocation Agreement* resulting from the State's non-compliance with the investor assurance requirements.

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2. 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 the report to Treasury on July 28, 2014, and received formal written comments on August 19, 2014, from Tennessee and on August 18, 2014, from Treasury. Treasury accepted the audit recommendations, stating that it will determine whether a general event of default has occurred as a result of the State not fully complying with investor assurance requirements. Tennessee acknowledged inadequacies in its assurance process and was first made aware of this after attending the SSBCI annual training conference in 2012. As a result of the annual training conference and the OIG audit, Tennessee has continued to strengthen internal controls and processes and instituted a firm policy of collecting assurances for all investments once an application is completed. Lastly, Tennessee states that its assurances are now 100 percent complete.

We believe that Treasury's planned actions are fully responsive to all of the audit recommendations. Formal written responses from Treasury and the state of Tennessee are included in their entirety in Appendix 1.

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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 Clayton Boyce, Audit Director, at (202) 927-5642.

/s/

Debra Ritt  
Special Deputy Inspector General for  
Office of Small Business Lending Fund Program Oversight

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## Appendix 1: Management Response



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

August 18, 2014

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

Dear Ms. Ritt:

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

We appreciate the Report's finding that Tennessee used State Small Business Credit Initiative (SSBCI) funds appropriately and complied with SSBCI program requirements. However, the Report also identifies instances of non-compliance involving incomplete or inadequate investor assurances.

With your consent, Treasury transmitted a copy of the Report to Tennessee program officials on July 28, 2014. Treasury asked Tennessee to provide a narrative response describing measures it has taken or plans to take to address the issues noted in the Report. Tennessee's reply, enclosed, agrees that all sampled transactions complied with program requirements.

Tennessee's reply confirms that the state was made aware of possible inadequacies in their assurances after attending the SSBCI annual training conference in 2012, and has since corrected their process to ensure that assurances meet program guidelines. Tennessee states that its assurances are now 100 percent complete. Treasury accepts the Report's recommendations and will determine whether a general event of default has occurred.

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 that reads "Jessica Milano".

Jessica A. Milano  
Deputy Assistant Secretary  
Small Business, Community Development, and Housing  
Policy

Enclosure



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Department of Economic and Community Development

William F. Hagerty  
Commissioner

Bill Haslam  
Governor

August 19, 2014

Ms. Jessica Milano  
Deputy Assistant Secretary  
Small Business, Community Development and Affordable Housing Policy  
U.S. Department of Treasury  
Washington, D.C. 20220

**Subject:** State Small Business Credit Initiative Audit: Tennessee's Use of Funds for its Venture Capital Program

Dear Ms. Milano,

The State of Tennessee has received the audit report from the Office of Inspector General (OIG) and appreciates the recommendations and the opportunity to respond.

We submit the following responses:

**Tennessee Used \$13.5 Million in SSBCI Funds Appropriately, but Did Not Comply with All Investor Assurance Requirements**

**Investor Assurances**

Regarding the investor assurances, as was discussed with OIG during their in-office audit, TTDC dba Launch Tennessee, operates a matching co-investment fund where Launch Tennessee plays a passive role in investing the proceeds, not an active role. Therefore, Launch Tennessee does not make working capital decisions, but instead defers to the lead investor and company management, both of which sign legally-binding use of proceeds certifications, using language provided by Treasury. For this reason, Launch Tennessee did not initially sign use of proceeds certifications at the time of investment, but collected them from the lead investors. However, after attending the annual training conference in October of 2012, but prior to OIG's audit, staff recognized the need to address certain compliance items.

As a result, a single form containing the use of proceeds assurance and sex offender certification language was created and approved for use by Treasury. All investors who had been approved to participate in the Fund and who have closed one or more co-investment transactions were required to complete and return the form to Launch Tennessee. In addition, Launch Tennessee began signing the use of proceeds assurances at that point. The forms were also completed for all prior investment transactions. Therefore, the use of proceeds assurances are 100% complete. The State and Launch Tennessee have continued to strengthen internal controls and processes and instituted a firm policy of signing use of proceeds assurances for all investments once an application is complete.

**Sex Offender Certifications**

The State and Launch Tennessee learned of Treasury's policy update regarding the collection of sex offender certifications during the SSBCI conference held in October of 2012. Then, as part of its annual quality review (prior to OIG's audit), the State and Launch Tennessee enhanced the current policy to align with Treasury's policy update. The State and Launch Tennessee have obtained the updated sex offender certification forms from all investors. Sex offender certification compliance is now 100% complete.

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William R. Snodgrass Building/Tennessee Tower, 27<sup>th</sup> Floor • 312 Rosa L. Parks Avenue North • Nashville, TN 37243  
PH: 615.741.1888 • Fax: 615.741.7306

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**Tennessee Exhibited Best Practices in Its Administration of SSBCI Funds**

**Best Practices in Administration of SSBCI Funds**

The State of Tennessee and Launch Tennessee are appreciative of the relationship we have with U.S. Treasury and the purpose of the SSBCI program. Additionally, we are committed to the program's success and impact and intensely focused on being good stewards of tax payer resources. For example, as part of Tennessee's internal controls, Launch Tennessee processes background checks on all key principals of both the investment firm and the qualified business. Cited by the OIG as a best practice, our process is rigorous and done to ensure the program achieves Treasury and State of Tennessee objectives. As a result of our process, we have blocked one potential investor who violated rules of the US Comptroller of the Currency. Tennessee would be happy to share with other states how our background check process is conducted and how the State has been able to achieve compliance with the use of SSBCI funds.

Regards,

A handwritten signature in black ink, appearing to read "William F. Hagerty", with a long horizontal flourish extending to the right.

William F. Hagerty  
Commissioner  
Department of Economic and Community Development

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## **Appendix 2: Major Contributors**

Debra Ritt, Special Deputy Inspector General

Clayton Boyce, Audit Director

Andrew Morgan, Audit Manager

Safal Bhattarai, Auditor

Diane Baker, Program Analyst

Steve Encomienda, Referencer



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## Appendix 3: 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

Chairman and Ranking Member  
Committee on Small Business and Entrepreneurship

Chairman and Ranking Member  
Committee on Finance

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

Chairman and Ranking Member  
Committee on Homeland Security and Governmental Affairs

Chairman and Ranking Member  
Appropriations Subcommittee on Financial Services and General  
Government

### United States House of Representatives

Chairman and Ranking Member  
Committee on Small Business

Chairman and Ranking Member  
Committee on Financial Services

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Chairman and Ranking Member  
Committee on Oversight and Government Reform

Chairman and Ranking Member  
Appropriations Subcommittee on Financial Services and General  
Government

**Government Accountability Office**

Comptroller General of the United States