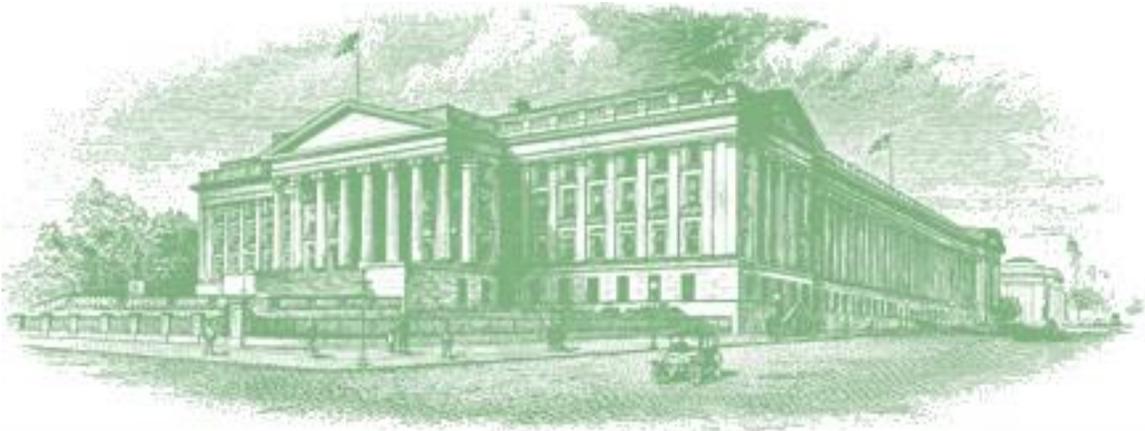




Audit Report



OIG-17-056

STATE SMALL BUSINESS CREDIT INITIATIVE

New York's Use of Federal Funds for Six of Innovate Fund's
Venture Capital Funds

September 18, 2017

Office of
Inspector General

Department of the Treasury

Contents

Audit Report	1
Background.....	2
New York’s Participation in SSBCI.....	3
Audit Results.....	4
Six of Innovate Fund’s Venture Capital Funds Generally Complied with SSBCI Program Requirements and Prohibitions.....	4

Appendices

Appendix 1: Objective, Scope, and Methodology	7
Appendix 2: Empire State Development Corporation Management Response	10
Appendix 3: Treasury Management Response	11
Appendix 4: SSBCI Program Background	12
Appendix 5: Major Contributors to This Report.....	13
Appendix 6: Report Distribution.....	14

Abbreviations

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

This Page Left Intentionally Blank.

*The Department of the Treasury
Office of Inspector General*

September 18, 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 New York, our audit focused on the State's compliance with respect to funds invested in its venture capital program, Innovate NY Fund, LP (Innovate Fund).

In this report, we provide our assessment of 6 of Innovate Fund's 8 venture capital funds, which invested approximately \$18.1 million⁴ of SSBCI funds between December 4, 2012 and December 10, 2014. We issued a separate report on one other Innovate Fund, Canrock Innovate NY Fund, LP.⁵ Investments made by Innovate

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

² Reckless misuse as defined by Treasury is a use of Allocated Funds that the Participating State or its administering entity/ies should have known was unauthorized or prohibited. A "reckless misuse of funds" is a highly unreasonable departure or willful disregard from the standards of ordinary care, and may be a single instance or a series of instances.

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

⁴ Actual amount is \$18,056,152.

⁵ *State Small Business Credit Initiative: New York's Use of Federal Funds for Other Credit Support Programs* (OIG-17-035; issued January 24, 2017)

*The Department of the Treasury
Office of Inspector General*

Fund's eighth venture capital fund were made after December 31, 2014, and therefore, were not within the scope of our audit. Appendix 1 provides more detail of our audit objective, scope, and methodology.

In brief, we determined that Innovate Fund's six venture capital funds generally complied with the SSBCI program requirements and prohibitions, and as such, we make no recommendations in this report.

As part of our reporting process, we provided Empire State Development Corporation (ESD) management an opportunity to comment on a draft of this report. In a written response, ESD concurred with our audit results. ESD's response, in its entirety, is included as appendix 2 of this report.

In its written response to this report, Treasury management stated it was pleased the report found that Innovate Fund's six venture capital funds generally complied with SSBCI program requirements. Treasury management's response, in its entirety, is included as appendix 3 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*, *SSBCI National Standards for Compliance and Oversight*, *SSBCI Frequently Asked Questions*, and the *Allocation*

*The Department of the Treasury
Office of Inspector General*

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 amount of \$5 million or less and cannot extend credit for loans with principal amounts in excess of \$20 million nor participate in an investment instrument 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 4.

New York's Participation in SSBCI

The State of New York was awarded approximately \$55.4 million⁶ of SSBCI funds upon Treasury's approval of its participation in the program in September 2011. The *Allocation Agreement*, among other things, authorized the use of SSBCI funds for the following three state approved programs: the Innovate NY Fund, the New York Capital Access Program, and the New York State Bonding Guarantee Assistance Program. As of December 31, 2016, Treasury disbursed approximately \$53.7 million⁷ of the original allocation to New York, which in turn, obligated or spent approximately \$45.9 million.⁸ Of this amount, \$35 million was invested in the Innovate Fund. The State designated the ESD to administer the approved State programs on behalf of the Office of the Governor.

In December 2016, Treasury disbursed an additional \$250,358⁹ to New York in accordance with Section 3008(b) of the Act, which provides for the deallocation and reallocation of funds across the States participating in the SSBCI program.

⁶ Actual amount is \$55,351,534

⁷ Actual amount is \$53,721,747.

⁸ Actual amount is \$45,851,624.

⁹ The additional allocation was not within the scope of this audit.

*The Department of the Treasury
Office of Inspector General*

Audit Results

Six of Innovate Fund's Venture Capital Funds Generally Complied with SSBCI Program Requirements and Prohibitions

We found that six of Innovate Fund's venture capital funds generally complied with SSBCI program requirements and prohibitions. ESD, along with another limited partner,¹⁰ entered into a limited partnership agreement with CDVCA Innovate NY GP, LLC (CDVCA) to form the Innovate NY Fund in 2012. The purpose of the Innovate Fund was to acquire and hold interests in seed funds that were created to invest in beneficiary companies.¹¹ The limited partners were primarily responsible for making capital contributions to the Innovate Fund to acquire seed fund interests. As the general partner, CDVCA was responsible for, among other things, issuing common and preferred units to the limited partners, and making capital calls requiring each limited partner to make capital contributions to the Innovate Fund as needed.

The Innovate Fund entered into limited partnership agreements with six companies to form the seed funds. The general partners in each of the funds were responsible for identifying and approving investments in beneficiary companies according to Innovate Fund's investment strategy, and as such, invested approximately \$18.1 million of SSBCI funds in 58 beneficiary companies between December 4, 2012 and December 10, 2014. Table 1 lists the six

¹⁰ The limited partner was a private investor who had no impact on our audit.

¹¹ Defined in the partnership agreement as either limited partnerships or limited liability companies selected by ESD.

*The Department of the Treasury
Office of Inspector General*

seed funds and general partners in each fund within the scope of our audit.

Table 1: Innovate NY Fund, LPs as of December 31, 2014

Seed Funds	General Partners	Amount of SSBCI Funds Used	Number of SSBCI Investments
CVF IV Innovate NY Fund, LP	CVF Partners Innovate IV, LLC	\$4,522,188	12
Stonehenge Innovate NY Fund, LP	Stonehenge Growth Equity Innovate NY Partners, LLC	\$3,304,225	6
Excell Innovate NY Fund, LP	Excell Technology Ventures, Inc.	\$3,155,103	15
ffRose Innovate NY Fund, LP	ffRose Innovate NY Fund General Partner, LLC	\$3,050,927	11
SCP Buffalo Innovate NY Fund, LP	Z80 LABS, LLC	\$2,208,171	11
Golden Seeds Innovate NY Fund, LP	Golden Seeds Fund 2GP, LLC	\$1,815,538	3
Total		\$18,056,152	58

We tested all 58 investments and found that at least 20 percent private capital was at risk at the time the investments were made. Furthermore, the investments did not exceed the maximum dollar amount of \$20 million. Our testing did not identify any prohibited use of SSBCI funds or related party interests. As such, we make no recommendations.

*The Department of the Treasury
Office of Inspector General*

* * * * *

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 5. A distribution list for this report is provided as appendix 6. If you have any questions, please contact me at (202) 927-1011.

/s/

Theresa Cameron
Audit Director, Financial Assistance Audits

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

Of the \$55,351,534 in SSBCI funds allocated to New York, \$35,000,000 was invested in New York's venture capital program, Innovate NY Fund, LP (Innovate Fund) as of December 31, 2016. Of the amount spent, our audit scope comprised \$18,056,152 invested by 6 of 8 seed funds that were created by the Empire State Development (ESD) within the Innovate Fund to support its venture capital program. All SSBCI funds within our audit scope were invested between December 4, 2012 and December 10, 2014. We issued a separate report on the use of \$1,674,439 of SSBCI funds by Canrock Innovate NY Fund, LP. Innovate Fund's eighth venture capital fund made investments between June 15, 2015 and December 18, 2015, and therefore, was not within the scope of our audit.

To accomplish our audit objective, we performed the following steps.

- We reviewed applicable laws, regulations, and other relevant documents as follows:
 - Small Business Jobs Act of 2010 (Public Law 111-240; September 27, 2010);
 - *SSBCI National Standards for Compliance and Oversight* (January 23, 2014, and June 20, 2014);
 - *SSBCI Policy Guidelines* (October 21, 2011, January 23, 2014, and April 16, 2014);
 - SSBCI Frequently Asked Questions;

- SSBCI Fact Sheets;
 - *Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*;
 - *SSBCI Application* by the State of New York;
 - State of New York *SSBCI Allocation Agreement* for Participating States;
 - ESD beneficiary intake forms;
 - Beneficiary capitalization tables and stock purchase agreements;
 - SSBCI Quarterly Reports;
 - SSBCI Annual Reports (2011, 2012, 2013, and 2014); and
 - SSBCI Investee and Investor Certifications.
- We tested documentation supporting all 58 investments made by the following six seed funds: (1) CVF IV Innovate NY Fund, LP; (2) Excell Innovate NY Fund, LP; (3) Golden Seeds Innovate NY Fund, LP; (4) ffRose Innovate NY Fund, LP; (5) SCP Buffalo Incubator Innovate NY Fund, LP; and (6) Stonehenge Growth Equity Innovate NY Fund, LP to determine that:
 - 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 New York 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 ESD, CDVCA Innovate NY GP, LLC; and at the following seed funds: (1) CVF IV Innovate NY Fund, LP; (2) Excell Innovate NY Fund, LP; (3)

ffRose Innovate NY Fund, LP; (4) Golden Seeds Innovate NY Fund, LP; (5) SCP Buffalo Incubator Innovate NY Fund, LP; and (6) Stonehenge Innovate NY Fund, LP.

We conducted fieldwork at ESD headquartered in New York, New York; and the Treasury Office of Inspector General office in Washington, D.C., between December 2013 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.

Appendix 2
Empire State Development Corporation Management Response



August 22, 2017

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

Dear Ms. Cameron,

Thank you for the opportunity to review and comment on the Office of Inspector General's draft audit report (the "Report") of the State of New York's (the "State") compliance with the program requirements of the U.S. Department of the Treasury's State Small Business Credit Initiative ("SSBCI"). We concur with the Report's findings regarding the State's compliance with the SSBCI program requirements and prohibitions governing the Innovate NY Fund, LP, one of its venture capital programs.

We appreciate the professionalism shown to our staff during the audit process. We support the intent and the opportunities provided by SSBCI in providing assistance to small businesses throughout the State and look forward to the continued success of the Program.

Sincerely,

A handwritten signature in cursive script that reads "Elizabeth R. Fine".

Elizabeth R. Fine
Executive Vice President
Legal and General Counsel
Empire State Development

Empire State Development
633 Third Avenue, New York, NY 10017
(212) 803-3100 | www.esd.ny.gov

Appendix 4
State Small Business Credit Initiative Background



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 08, 2017

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

Dear Ms. Cameron:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report regarding New York's use of SSBCI funds for six of Innovate Fund's Venture Capital Funds (the Report). This letter provides the official response of the Department of the Treasury (Treasury). We are pleased with the Report's finding that Innovate Fund's six venture capital funds generally complied with SSBCI program requirements.

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

Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,

A handwritten signature in cursive script, appearing to read "Kipp Kranbuhl".

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

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

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

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

Appendix 5
Major Contributors to This Report

Nadine Forgenie, Audit Manager
Lynette Feliciano Del Valle, Auditor
Dionne Smith, 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

New York Empire State Development

President and Chief Executive Officer

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



Treasury OIG Website

Access Treasury OIG reports and other information online:

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

Report Waste, Fraud, and Abuse

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

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

Email: Hotline@oig.treas.gov

Submit a complaint using our online form:

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