The SSBCI Policy Guidelines and Section 4.9(c) of the Allocation Agreement implement this requirement by specifying that the Participating State has the responsibility to obtain a certification regarding sex-offender status, and that the term "private entity" includes all lenders or investors[10] enrolling a loan or investment in an SSBCI Approved State Program. The definition of "private entity" also encompasses private or non-profit administering entities that make loans or investments directly to borrower/investees through an approved direct lending program, loan participation program, or state-run venture capital program. Certifications are required of private lenders and investors that provide SSBCI funds to a borrower or investee or that receive direct SSBCI support through a guarantee, purchase loan participation, collateral support, or CAP reserve fund. This means that when a Contracting Entity operates an approved direct loan or loan participation program on behalf of a Participating State, two certifications generally are required: one from the borrower (see the section Risk: Inadequate Small Business Borrower/Investee Certifications above) and one from the relevant Contracting Entity that is administering the program as the lender. Similarly, if a Contracting Entity operates an approved direct venture capital program on behalf of a Participating State, two certifications generally are required: one from the investee and one from the relevant Contracting Entity as the investor. The Participating State should contact Treasury with any questions on this issue.

Like with the small business borrower or investee sex offender certification, a certification covering *all principals* of the lender or investor must be obtained by the Participating State. This certification may be made by all principals individually, or may be made by an individual acting in an official capacity (e.g. a Chief Risk Officer, etc.) who is authorized to make the certification on behalf of the principals of the lender or investor. Section 1.1 of the Allocation Agreement defines "principal", for the sole purpose of collecting the sex offender certification:

> *" 'Principal' shall mean, for purposes of Section 4.9, if a sole proprietorship, the proprietor; if a partnership, each managing partner and each partner who is a natural person and holds a 20% or more ownership interest in the partnership; and if a corporation, limited liability company, association or a development company, each director, each of the five most highly compensated executives or officers of the entity, and each natural person who is a direct or indirect holder of 20% or more of the ownership stock or stock equivalent of the entity."*

Participating States may meet their obligation to obtain these sex-offender status certifications in one of two ways. Participating States may either:

- Obtain <u>newly executed</u> sex offender certifications[11] covering all principals of a lender or investor prior to enrolling <u>each</u> loan or investment in an SSBCI Approved State Program; or,
- Obtain sex offender certifications covering all principals of a lender or investor prior to enrolling any loans or investments originated by that lender or investor in the Approved State Programs

[10] As noted above, for the purposes of this document, "investor" refers to any private venture capital, seed stage, mezzanine, or angel fund participating in an Approved State Program. This term does not refer to individual investors in a fund. However, each principal of the private fund must execute a sex offender certification.
[11] While certifications may be scanned PDFs, they must contain a signature.

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and execute a written agreement with the lender or investor (which may be part of a larger lender, or investor, participation agreement) that creates a positive requirement to notify the Participating State if and when an event occurs that renders the prior certifications obsolete. Such event could be a change in principals or a conviction of an existing principal for a sex offense against a minor. The Participating State may also consider adding a requirement to this written agreement for a periodic resubmission of the certifications, perhaps on an annual basis, even absent a material event.

Under either of the options above, it is the Participating State's responsibility to obtain the certification, either electronically or in paper copy, in order to verify that it is complete and duly executed prior to transferring funds. Treasury does not require Participating States (or administering entities, if so designated) to independently verify the certified sex offender status of covered principals. Treasury has provided a sample sex offender certification form as Appendix B to this document.

If the Participating State delegates these responsibilities to an administering entity, the Participating State must exercise oversight to ensure compliance. One means of ensuring oversight would be to conduct an annual audit of the certifications to ensure that the documents are in order and are maintained pursuant to the records retention requirements discussed later in this document.

Risk: Inadequate Lender/Investor Adherence to Requirements

In addition to the required certification of sex offender status, Section 4.9 of the Allocation Agreement requires that, prior to providing any financial assistance using Allocated Funds to a lender or investor, the Participating State must obtain the following: (a) a binding agreement regarding Treasury's right to access records related to SSBCI-supported loans and investments and (b) certification that the lender or investor is in compliance with the requirements of the Right to Financial Privacy Act (12 U.S.C. § 3401 et seq.), and 31 C.F.R. § 103.121, if applicable.

Treasury recommends that, prior to enrolling any loan originated by a private lender, and prior to enrolling any investment made by a venture capital investor, the Participating State (or administering entity) should execute a signed lender/investor participation agreement to clarify lender/investor responsibilities and reduce the likelihood of non-compliance. This agreement should:

- Specify lender/investor responsibilities regarding SSBCI's restrictions on use of proceeds;
- Specify lender/investor responsibilities regarding sex offender certifications;
- Require that the lender/investor make all books and records related to the use of allocated funds available to Treasury and/or the Treasury Inspector General;
- Specify all eligibility requirements for loans/investments for each applicable Approved State Program; and
- Specify consequences for non-compliance with the terms of the agreement.

If a lender/investor is specifically identified in Annex 1 of the Allocation Agreement as an administering entity, then this agreement must also adhere to the requirements of Articles IV and VI of the Allocation Agreement, as described in the following section.

Recommended additional provisions may also include:

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- Mandate the use of a transaction enrollment form; and
- Specify any required data reporting elements from the lender/investor to the Participating State (or its administering entity).

These best practices are designed to assist the Participating State in tracking the use of Allocated Funds and gathering data for the required SSBCI quarterly and annual reports.

Participating States should consider adding to this list any additional activities that may be useful to provide additional mitigating controls associated with this risk.

Risk: Inadequate Oversight of Administering Entities and Other Entities Included in Annex 1 of the Allocation Agreement

Note: if none of the Approved State Programs are operated by contracting/administering entities, this risk category may not apply. Regardless of direct applicability, Treasury expects that Participating States will provide due diligence and oversight over all contract entities that may perform work ancillary to an Approved State Program.

Participating States that contract with one or more entities to administer specific aspects of Approved State Programs must execute and maintain a written agreement with each of these entities that requires compliance with the provisions of Articles IV and VI of the Allocation Agreement.

Prior to disbursing any funds to an administering entity, the Participating State must execute a written agreement applying the provisions of Articles IV and VI to the administering entity.[12] Treasury calls special attention the following requirements that must be incorporated into the agreement:

- The administering entity must make all books and records related to the use of allocated funds available to Treasury and/or the Treasury Inspector General;
- The administering entity is prohibited from enrolling any portion of an SBA-guaranteed loan (note: this provision does not apply to venture capital programs);
- The administering entity must comply with all administrative expense requirements, including OMB Circular A-87, and maintain substantiating documentation for all expenses; and
- The administering entity must comply with all data collection and reporting responsibilities. The agreement should specify the respective roles of the administering entity and the Participating State in meeting all data collection and reporting responsibilities, and include the Participating State's transaction enrollment form, if applicable.

Recommended best practices include:

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[12] The Participating State should do so by using the same language that is included in Articles IV and VI of the Allocation Agreement, except for substituting the name of the administering entity for the name of the Participating State.

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- Inserting additional contract provisions that:
    - Specify the administering entity's responsibilities regarding use of proceeds and sex offender certifications;
    - Specify all eligibility requirements for loans/investments for each applicable Approved State Program;
    - Prohibit, or require disclosure of, an administering entity underwriting or approving a loan to, or an investment in, any firm in which the administering entity or any of its principals or affiliates has a direct or indirect financial interest; and
    - Specify consequences for non-compliance with the terms and conditions of the contract.
- Reviewing third-party audits of the administering entity for findings, material weaknesses, or significant deficiencies, and require the administering entity to take corrective actions.
- Performing site visits, requiring periodic status update reports, and/or conducting regular conference calls with the administering entity to monitor progress and provide early warning of any implementation challenges.

Participating States should consider adding to this list any additional activities that may be useful to provide additional mitigating controls associated with this risk.

Risk: Failure to Submit Timely and Accurate SSBCI Quarterly and Annual Reports

Sections 4.7, 4.8, and Annexes 4, 5, and 7 of the Allocation Agreement set forth SSBCI's reporting requirements. Failure to submit complete and timely reports is an event of default, as described in Section 6.1 of the Allocation Agreement.

In order to improve the accuracy of the underlying data reported in these reports, Treasury strongly recommends that prior to enrolling a loan or investment in an Approved State Program, the Participating State (or administering entity) collects a transaction enrollment form from the lender or investor (or directly from the small business borrower/investee if the Participating State or its administering entity makes direct loans or investments). The Participating State should also verify that all data fields required to record the transaction in the SSBCI annual report template—including small business borrower-provided estimates of job creation and retention—have been provided.

Treasury recommends receiving this enrollment form prior to disbursing funds in order to ensure that each transaction meets the eligibility criteria for enrollment in an Approved State Program. Section II of the SSBCI Policy Guidelines establishes eligibility criteria for small businesses to receive loans or investments.

Treasury recommends that Participating States undertake the following control activities to mitigate the potential for inaccurate data reporting:

- Review the accuracy of transaction enrollment forms by conducting a periodic audit of an appropriately sized sample and confirming that the data on the form matches the data on the underlying loan or investment documents;

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- Perform a quality control check in which an employee not responsible for the Participating State's reporting function compares individual transactions listed on the annual report to the transaction enrollment forms and/or underlying loan or investment documents; and,
- Reconcile each calendar year's four SSBCI quarterly reports to the SSBCI annual report and Federal Financial Report (SF-425).

Participating States should consider adding to this list any additional activities that may be useful to provide mitigating controls associated with this risk. When developing control objectives and control activities, and when designing the testing methodology for these control activities, Participating States should pay particular attention to risks introduced by administering entities, lenders/investors, and small business borrowers/investees in the program.

Risk: Inadequate Control and Retention of Records

Section 4.13 of the Allocation Agreement establishes that Participating States shall retain all financial records, supporting documents, statistical records, and all other records pertinent to the Allocation for a period of three years from the date of submission of the final quarterly report, except as otherwise provided in the grants management common rule at §__.42. Section 42 of the grants management common rule states that if any litigation, claim, negotiation, audit, or other action involving the records has been started before the expiration of the retention period, the records must be retained until the completion of the action and resolution of all issues or the end of the retention period, whichever is later.

Participating States must therefore retain all financial records and supporting documents at least through January 30, 2020. Financial records and supporting documents include, but are not limited to: all loan and investment agreements; loan or investment commitment letters; all sex offender and use of proceeds certifications retained by the Participating State; any transaction enrollment forms; all general ledger entries pertaining to Allocated Funds; all statements for accounts containing Allocated Funds, including bank statements if applicable; any contracts or memorandum of agreement (MOA) with administering entities; any records of all transfers of funds to administering entities; all invoices and receipts for administrative expenses; and, documentation of private leverage and subsequent private financing. Furthermore, if lenders and investors, or an administering entity, are required to retain any records rather than submitting these records to the Participating State or administering entity—the Participating State must have a written agreement in place requiring the maintenance of these records until at least January 30, 2020, and the Participating State must exercise oversight to verify compliance. One means of exercising this oversight would be to conduct an annual audit of a random sample of each lender's or investor's (or the administering entity's) financial records.

Participating States should consider adding any additional activities that may be useful to provide additional mitigating controls associated with records retention.

Risk: Inadequate Documentation of Subsequent Private Financing

Section 4.8 of the Allocation Agreement requires, under circumstances described in Annex 7 of the Allocation Agreement, Participating States to report the amount of additional private financing that occurs after the closing of the original SSBCI-supported transaction. This term of the Allocation Agreement means that the Participating State must maintain documentation of the amount of

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subsequent private financing, as well as the rationale for determining that the subsequent private financing is the "cause and result" of the original SSBCI-supported transaction, when required by Annex 7.

If the enrollment of loans or investments is handled by an administering entity, the Participating State may delegate the responsibility for obtaining and retaining this documentation to the administering entity pursuant to a written contract, provided that the Participating State exercises oversight of the administering entity to ensure compliance with this requirement. One means of exercising this oversight would be to conduct an annual audit of a random sample of loans or investments for which subsequent private financing has been recorded.

Treasury recommends that Participating States undertake the following additional control activities based on the guidance provided in Annex 7 of the Allocation Agreement:

- Verify that no subsequent private financing for loans enrolled in a loan guarantee or collateral support program is recorded, unless the Participating State has received documented permission from Treasury;
- Verify that subsequent private financing is recorded only when the initial loan/investment is a form of subordinate, mezzanine, or equity financing.

Participating States should consider adding to this list any additional activities that may be useful to provide additional mitigating controls associated with this risk.

Risk: Improper Usage of, and Accounting for, Allocated Funds

Section 4.2 of the Allocation Agreement establishes that the Participating State shall only "use" the Allocated Funds for the purposes and activities specified in the Allocation Agreement and in accordance with the cost principles set forth in OMB Circular A-87 (*Cost Principles for State, Local, and Indian Tribal Governments*) and codified in 2 C.F.R. Part 225. These cost principles stipulate that administrative costs must be allowable, allocable, reasonable, and documented, and that all indirect costs be in accordance with the indirect cost rate proposal approved by the Participating State's cognizant agency[13].

It is also important to note that the Allocation Agreement includes Annex 1, which specifies the administering entities and the Approved State Programs authorized by Treasury, and Annex 3, which establishes the maximum amount available to the Participating State to pay for direct and indirect administrative costs pertaining to the Approved State Programs. Additionally, Section 8.2 of the

[13] The cognizant agency for all Participating States and most municipalities is the Department of Health and Human Services.

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Allocation Agreement also incorporates a number of other documents and representations, including the Participating State's Application, by reference.[14]

For the purposes of Section 4.2 of the Allocation Agreement, the phrase "use" means any expenditure, obligation or transfer of Allocated Funds for the purpose of carrying out the Approved State Programs, as described in Annex 1 of the Participating State's Allocation Agreement, as well as the Participating State's Application.

As such, Allocated Funds may not be used, under any circumstances, to provide services or make loans, grants, or investments under any program other than those specifically listed in Annex 1 of the Allocation Agreement, or to pay for direct or indirect administrative expenses related to any non-SSBCI program. Treasury cautions Participating States to pay particular attention to the requirement in OMB Circular A-87 that costs be allocable. If, for example, staff assigned to the Approved State Program also work on other non-SSBCI programs, the Participating State must ensure that staff accurately record the number of hours spent on the Approved State Program and only use Allocated Funds to pay salaries and benefits in proportion to the number of hours worked. For example, if an employee spends 45 percent of her time on an SSBCI Approved State Program, the Participating may only charge 45 percent of her salary and benefits to Allocated Funds.

Furthermore, Section 4.6 of the Allocation Agreement requires Participating States to comply with the standards of financial management systems outlined in the grants management rule at §__.20, with the exception of the cash management requirements. (See Appendix D for the excerpted Section 20 of the grants management common rule.) Treasury draws Participating States' attention to the accounting requirements set forth in §__.20(b)(2) of the grants management common rule. According to this term, Participating States must keep detailed records of its receipt of Allocated Funds, and be able to trace the use of these funds to specific expenditures, obligations, or transfers for the purposes of carrying out an Approved State Program.

Allocated Funds that have been disbursed to the Participating State, but not yet expended, obligated, or transferred for allowable program purposes, should be maintained as cash or a cash equivalent[15]. The movement of Allocated Funds in and out of the implementing entity's bank account must be tracked separately from the remainder of the funds in this account. Participating States may not expend Allocated Funds for any non-allowable purpose and then "reimburse" the Allocated Funds at a later date.

Participating States should also consider it a best practice to develop the following controls:

- Segregate Allocated Funds in a separate bank account;

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[14] Section 8.2 of the Allocation Agreement states that the "application including any attachments, exhibits, appendices and supplements thereto, any attachments, schedules, annexes, appendices, and supplements to the Allocation Agreement, and said Allocation notice letter are incorporated in and made a part of this Agreement."

[15] Cash equivalents are very low risk, highly liquid assets, such as money market holdings, short-term government bonds or Treasury bills, marketable securities and commercial paper. The maturity period must be no more than 3 months.

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- Require dual control for the approval of all expenditures, obligations, or transfers of Allocated Funds. For example, one individual may prepare and track these expenditures, obligations or transfers, and a second individual may approve them. These employees should not be in each other's supervisory chain of command;
- Conduct a monthly reconciliation of all invoices, receipts, loan and investment agreements, and other documentation of SSBCI expenditures, obligations, and transfers; general ledger entries; and bank account statements. Verify that all deposits and withdrawals of Allocated Funds match general ledger entries, and that these general ledger entries are supported by the substantiating documentation. To ensure segregation of duties, this reconciliation should be performed by an employee that is neither the individual responsible for cash transactions, nor in the supervisory chain of the individual responsible for cash transactions;
- Require an employee other than the employee recording and tracking administrative expenses to verify that each direct expense is accompanied by an invoice or receipt, that the amount shown on the invoice or receipt matches the expense recorded, and that the service or item purchased is directly related to an Approved State Program;
- Require all employees to maintain time records showing the number of hours spent on SSBCI Approved State Programs each pay period; and
- Require that purchase requests and contracts be approved only after staff verified that the purchase or contract will not cause total administrative expenses to exceed the maximum amounts set forth in Annex 3 of the Allocation Agreement, unless administrative expenses will be paid for using non-Allocated Funds.

Risk: Prevention of Fraud, Waste, and Abuse

Preventing fraud, waste, and abuse is an important part of preventing the misuse of Allocated Funds. Participating State should consider it a best practice to develop the following controls:

- Require all loans or investments to be approved by a board or committee, with meeting minutes documenting the basis for the underwriting/enrollment decision;
- Require all contracts to be awarded pursuant to a formal Request for Proposals, with clearly established evaluation criteria and a transparent bidding and award process;
- Maintain strict controls over access to bank accounts;
- Maintain strict controls over access to documents, records, and assets;
- Maintain strict information technology security protocols to prevent unauthorized access to IT systems and unauthorized manipulation of data;
- Require all staff to complete anti-fraud and ethics training;
- Require staff overseeing administering entities to verify that work was performed before paying an administering entity's invoice;
- Maintain segregation of duties (e.g., employees who perform cash functions should not reconcile bank account statements);
- Reconcile invoices to purchase orders and contracts; and

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- In the event of cash transactions, compare cash receipt transactions to a cash receipt log and bank deposit records to minimize the possibility of theft, fraud or abuse

Participating States should consider adding to this list any additional activities that may be useful to provide additional mitigating controls associated with this risk.

Risk: Conflicts of Interest for CAPs and OCSPs except Venture Capital Programs

Preventing conflicts of interest in underwriting, enrollment, contracting, and lender/investor participation decisions is important to prevent the misuse of allocated funds as well as any appearance of impropriety. The Allocation Agreement and SSBCI Policy Guidelines address certain conflict of interest issues. For example, Section 4.4 of the Allocation Agreement specifically prohibits using Allocated Funds for lobbying, or for making a loan, investment, or contract to a member of Congress or a resident U.S. Commissioner. In addition, Section VI and VII of the SSBCI Policy Guidelines prohibits funds from being used to make loans to borrowers who are executive officers, directors, or principal shareholders of the lender or investor, or a family member of related interest of an executive officer, director, or principal shareholder of the lender of investor. However, Treasury believes that additional conflicts of interest could arise, and that Participating States should carefully assess whether other conflicts of interest should be identified, monitored, and mitigated.

Participating State should also consider it a best practice to develop the following controls:

- Require all individuals involved in the underwriting or approval process to disclose any potential or actual conflicts of interest, in accordance with the Participating State's written conflict of interest policy, and to recuse him or herself if a conflict of interest occurs;

- Require all individuals involved in the contracting process to disclose any potential or actual conflicts of interest, in accordance with the Participating State's written conflict of interest policy, and to recuse him or herself if a conflict of interest occurs; and

- Require all individuals involved in evaluating and executing lender/investor participation agreements to disclose any potential or actual conflicts of interest, in accordance with the Participating State's written conflict of interest policy, and to recuse him or herself if a conflict of interest occurs.

Participating States should consider adding to this list any additional activities that may be useful to provide additional mitigating controls associated with this risk.

Risk: Conflicts of Interest for Venture Capital Programs

Effective as of July 1, 2014.

The U.S. Department of the Treasury (Treasury) strives to maintain high standards of conduct in connection with the use of SSBCI funds, including preventing conflicts of interest. Treasury recognizes that the decision to invest equity in a company depends to a greater degree than commercial lending

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does on an assessment of qualitative factors such as how a company's products, management, competitors and regulators will act in business conditions that are nascent and evolving. Given the necessary reliance on more qualitative judgments in venture capital investing, Treasury believes the appearance of conflicts of interest can raise questions about the fairness of the decision-making.[16]

Compliance issues with SSBCI Venture Capital Programs have arisen when SSBCI funds were used to invest in a company or venture capital fund in which a program insider from a Participating State or Participating Municipality (collectively referred herein as "Participating State") had a personal financial interest. Participating States should be most alert for situations where those involved in or with control over SSBCI investment decisions have a personal financial interest in venture capital funds, companies or subcontractors that receive SSBCI funds. These situations must be avoided to maintain the program's integrity, both real and perceived.

Within 60 days of the publication of this Treasury policy, Participating States with SSBCI Venture Capital Programs should adopt a conflict-of-interest policy consistent with the principles below where practicable. Treasury believes that every Participating State can meet this requirement. However, should the adoption of such a policy conflict with state law or impose an extreme hardship on the SSBCI Venture Capital Program, Treasury reserves the right to waive this requirement.

I. <u>SSBCI Venture Capital Program Conflicts of Interest Principles:</u>

A. *General Rule*. SSBCI funds may not be used by SSBCI Venture Capital Programs to make or support investments in a company or venture capital fund when an SSBCI insider, or a family member or business partner of an SSBCI insider, has a personal financial interest in the company or venture capital fund. An individual cannot avoid the prohibitions of these conflict of interest rules by disclosing the conflict of interest or recusing herself or himself from the vote to approve a transaction that creates the conflict of interest.

B. *Rule Applicable to Governmental Entities and State-Sponsored Non-Profit Entities that Invest SSBCI Funds for Follow-On Investments.* A governmental entity or a State-sponsored non-profit entity may use SSBCI funds for follow-on investments in companies or venture capital funds when the entity has an existing ownership or voting interest resulting from a prior investment of SSBCI funds or non-SSBCI funds. Furthermore, the entity may authorize investments where an SSBCI insider serves on the board of directors of the company or venture fund provided that the entity's prior financial interest is

[16] The new Treasury policy set forth in this section applies only to investments made 60 days after publication. Treasury is aware that up until now, a State could only have operated its venture capital program in good faith and consistent with its originally approved application and the conflict of interest rules then in effect. Treasury believes States that operated in this way made acceptable and sound decisions. Treasury will deem all decisions that a State made about individual investments or the design of their program based on its approved application and the previous rules to be compliant.