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**Certified Capital Companies Program**

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## TABLE OF CONTENTS

|                                                                                                                                                                              |    |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----|
| EXECUTIVE SUMMARY.....                                                                                                                                                       | i  |
| PURPOSE.....                                                                                                                                                                 | 1  |
| OBJECTIVE, SCOPE, AND METHODOLOGY.....                                                                                                                                       | 1  |
| BACKGROUND.....                                                                                                                                                              | 2  |
| The Department of Insurance, Securities and Banking Failed to Verify<br>Information Presented on Qualified Business Applications.....                                        | 5  |
| The Department of Insurance, Securities and Banking Awarded Qualified<br>Business Status to Businesses That Did Not Meet Requirements<br>of the Act.....                     | 9  |
| The Commissioner of DISB Did Not Conduct Annual Reviews of<br>CAPCOs, as Required by D.C. Act 15-254 § 8(a).....                                                             | 11 |
| Annual Audited Financial Statements were Based on False Assumptions.....                                                                                                     | 12 |
| A CAPCO Qualified Business Obtained \$9 Million in Equity Financing<br>From Investors Yet Claimed in its Application That It Could Not<br>Obtain Conventional Financing..... | 13 |
| CAPCOs Invested Over \$13 Million in Companies That Did Not Consistently<br>Comply with CAPCO's Investment Strategies and Business Plans.....                                | 15 |
| DISB Commissioner Did Not Develop Criteria by Which to Determine<br>Whether Investment in a Qualified Business Would Further<br>Economic Development in the District.....    | 19 |
| CAPCO Set-Up Costs Exceeded CAPCO Investments.....                                                                                                                           | 22 |
| Auditor's Assessment of the Effectiveness of the District's CAPCO Program.....                                                                                               | 28 |
| CONCLUSION.....                                                                                                                                                              | 30 |

## EXECUTIVE SUMMARY

### PURPOSE

Pursuant to Section 455 of the District of Columbia Home Rule Act, as amended, Pub.L.No. 93-198,<sup>1</sup> D.C. Code § 1-204.55, and a request from Councilmembers Mary M. Cheh and Kwame R. Brown, the District of Columbia Auditor (Auditor) examined the operations and administration of the Certified Capital Companies (CAPCO) program.

### CONCLUSION

The purpose of the Certified Capital Companies Act of 2003 (Act) was to stimulate the growth of small and start-up businesses in the District of Columbia. The District sacrificed insurance premium tax revenues in exchange for anticipated economic growth through income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues.

The CAPCO program has fallen short of achieving the desired impact on economic development in the District of Columbia. The District's CAPCO program cost \$76 million, \$54 million in set-up costs and \$22 million in investments. For \$76 million, 31 new jobs were created. The number of District residents employed by businesses that received CAPCO funds decreased by 2.

The CAPCO program was poorly managed by the Department of Insurance, Securities and Banking (DISB). DISB misinterpreted key provisions of the Act and failed to consistently comply with statutory mandates. In addition, DISB did not administer the CAPCO program in a manner that maximized economic development in the District of Columbia.

Many states found CAPCO programs to be inefficient and expensive. In light of disappointing results from CAPCO programs in Colorado, Missouri, Wisconsin, and Florida, DISB should have meticulously managed the District's CAPCO program to avoid similar results. Instead DISB:

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<sup>1</sup>See § 455 of the District of Columbia Home Rule Act ("Home Rule Act"), approved December 24, 1973 (Pub.L.No. 93-198; 87 Stat. 803; D.C. Code § 1-204.55 (2001)). D.C. Code § 1-204.55 (b) states: "The District of Columbia Auditor shall each year conduct a thorough audit of the accounts and operations of the government of the District in accordance with such principles and procedures and under such rules and regulations as he [she] may prescribe." See also D.C. Code § 1-204.55 (c) which states: "The District of Columbia Auditor shall have access to all books, accounts, records, reports, findings, and all other papers, things, or property belonging to or in use by any department, agency, or instrumentality of the District government and necessary to facilitate the audit."

- Failed to verify information presented in Qualified Business applications.
- Failed to conduct mandated annual reviews of CAPCOs.
- Certified businesses to participate in the program that did not meet CAPCO requirements.
- Failed to encourage CAPCOs to invest in businesses that complied with CAPCOs' investment strategies.
- Failed to establish a standard to measure the economic impact of the CAPCO program.

In conclusion, DISB did not effectively manage the CAPCO program. As a consequence, the CAPCO program failed to achieve the goal of stimulating local business development through job creation, increasing income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues. The CAPCO program will not produce enough tax revenue to offset insurance premium tax credits. The CAPCO program had a negligible impact on economic development in the District. Clearly, the costs of the CAPCO program outweigh the benefits.

The Council of the District of Columbia should terminate the CAPCO program.

### **MAJOR FINDINGS**

1. The Department of Insurance, Securities and Banking failed to verify information presented on Qualified Business applications.
2. The Department of Insurance, Securities and Banking awarded Qualified Business status to businesses that did not meet requirements of the Act.
3. The Commissioner of the Department of Insurance, Securities and Banking did not conduct annual reviews of CAPCOs, as required by D.C. Act 15-254 § 8(a).
4. CAPCOs invested over \$13 million in companies that did not consistently comply with CAPCO's investment strategies and business plans.
5. The Commissioner of the Department of Insurance, Securities and Banking did not develop criteria by which to determine whether investment in a Qualified Business would further economic development in the District.

### **MAJOR RECOMMENDATIONS**

1. The Department of Insurance, Securities and Banking should specify the type of residency information that must be submitted and verify employee residence information presented on Qualified Business applications, before awarding Qualified Business status.

2. The Department of Insurance, Securities and Banking should consistently apply the Qualified Business requirements of the Act and only certify a business as a Qualified Business if it meets all of the Qualified Business requirements.
3. The Commissioner of the Department of Insurance, Securities and Banking should promptly conduct annual reviews of all CAPCOs, as required by D.C. Act 15-254 § 8(a).
4. The annual review of CAPCOs by the Department of Insurance, Securities and Banking should include an analysis of CAPCO investments in Qualified Businesses to determine consistency with the CAPCO's stated Investment Strategy and Business Plan.
5. The Department of Insurance, Securities and Banking should not certify a business as a Qualified Business if the business differs from the CAPCO's stated Investment Strategy and Business Plan.
6. The Commissioner of the Department of Insurance, Securities and Banking should establish objective, outcome oriented standards to measure economic development impact and use these standards to make determinations of whether or not to grant waivers of compliance with the Qualified Business requirements of D.C. Act 15-254 § 2(12)(C).
7. The Council of the District of Columbia should require the Commissioner of the Department of Insurance, Securities and Banking to develop and implement objective, outcome oriented standards by which to measure economic development impact.

## **PURPOSE**

Pursuant to Section 455 of the District of Columbia Home Rule Act, as amended, Pub.L.No. 93-198,<sup>2</sup> D.C. Code § 1-204.55, and a request from Councilmembers Mary M. Cheh and Kwame R. Brown, the District of Columbia Auditor (Auditor) examined the operations and administration of the Certified Capital Companies (CAPCO) program.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

The objectives of the audit were to determine whether:

1. the CAPCO program complied with applicable rules, regulations, and laws;
2. policies and procedures established by the Department of Insurance, Securities and Banking (DISB) complied with applicable rules, regulations, and laws; and
3. the CAPCO program effectively stimulated the growth of small and start-up businesses in the District of Columbia.

The scope of the audit covered a review of the operations and effectiveness of the District's CAPCO program during the audit period from March 10, 2004, through April 30, 2008.

In conducting the audit, the Auditor reviewed: (1) relevant provisions of the D.C. Official Code (D.C. Code) and D.C. Municipal Regulations (DCMR); (2) literature on CAPCO programs; and (3) relevant written materials from public agencies in other jurisdictions. Additionally, the Auditor interviewed the Deputy Mayor for Planning and Economic Development, the Director of the Department of Small and Local Business, the Commissioner of DISB, and CAPCO executives to gain their perspectives on the CAPCO program and determine the impact the CAPCO program had on economic development in the District of Columbia.

The audit was conducted 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

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<sup>1</sup>See § 455 of the District of Columbia Home Rule Act ("Home Rule Act"), approved December 24, 1973 (Pub.L.No. 93-198; 87 Stat. 803; D.C. Code § 1-204.55 (2001)). D.C. Code § 1-204.55 (b) states: "The District of Columbia Auditor shall each year conduct a thorough audit of the accounts and operations of the government of the District in accordance with such principles and procedures and under such rules and regulations as he [she] may prescribe." See also D.C. Code § 1-204.55 (c) which states: "The District of Columbia Auditor shall have access to all books, accounts, records, reports, findings, and all other papers, things, or property belonging to or in use by any department, agency, or instrumentality of the District government and necessary to facilitate the audit."

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.

## **BACKGROUND**

A Certified Capital Company (CAPCO) program is an economic development tool designed to encourage growth of small businesses. Under a CAPCO program, insurance companies invest in certified capital companies. A CAPCO program permits an insurance company to invest in CAPCOs and earn premium tax credits equal to the amount of the insurance company's total debt and equity investment in the CAPCO. For example, in the District insurance companies can earn a maximum of \$50 million in insurance premium tax credits with a \$12.5 million per year limit.

CAPCO programs target insurance companies because they have large amounts of cash as a consequence of the gap between when premiums are received and when claims are made and paid.<sup>3</sup> In general, insurance companies lend 99% to 100% of the total capitalization of most CAPCOs. CAPCOs pay an unusually high interest rate on these loans, making them very attractive to insurance companies.<sup>4</sup>

By allowing insurance companies to claim premium tax credits, states generate a pool of investment capital. CAPCOs borrow the investment capital from insurance companies to invest in businesses.

In exchange for premium tax credits, a state sacrifices future tax revenues. Although premium tax credits issued to insurance companies diminish revenue to the state, in theory, CAPCO investments in businesses should yield compensating economic growth through job creation, tax revenues, increased income, and sales of goods and services.<sup>5</sup>

The Certified Capital Companies Act of 2003 (Act) established the CAPCO program in the District. The Act became effective March 10, 2004. According to the Fiscal Impact Statement, the purpose of the Act was to stimulate the growth of small and start-up businesses.<sup>6</sup> The Act allows a maximum of \$50 million in insurance premium tax credits with a \$12.5 million per year limit on the use of the tax credits. According to the Chief Financial Officer of the District, the revenue impact of the CAPCO program will begin in Fiscal Year 2009 with a loss of \$12.5 million in tax revenue resulting from insurance premium tax credits.<sup>7</sup> The loss of revenue, due to insurance premium tax

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<sup>3</sup> The Colorado CAPCO Programs: An analysis, Prepared for Growth Capital Alliance by the Adams Group, Inc., December 23, 2003.

<sup>4</sup> Understanding CAPCOs, Chip Cooper, page 6.

<sup>5</sup> Understanding CAPCOs, Chip Cooper, page 4.

<sup>6</sup> Memorandum from the Chief Financial Officer to Chairman of the Council of the District of Columbia, November 25, 2003.

<sup>7</sup> Letter from Chief Financial Officer, Natwar M. Gandhi, to District of Columbia Auditor, dated July 21, 2008.

credits, will occur in each succeeding fiscal year between fiscal years 2009 and 2012 until the maximum \$50 million in tax credits are claimed.

Approximately three CAPCOs submitted applications to participate in the District's CAPCO program. DISB licensed three (3) Certified Capital Companies. The District's 3 CAPCOs are Advantage Capital Partners (Advantage), Enhanced Capital District Fund, LLC (Enhanced), and Wilshire DC Partners, LLC (Wilshire).

- Advantage was founded in 1992 and Advantage has offices in Missouri, Louisiana, New York, Texas, Florida, Mississippi and Washington, D.C. with affiliated offices in Alabama, Colorado, and Wisconsin.
- Enhanced is a subsidiary of Enhanced Capital Partners. In addition to the District's CAPCO program, Enhanced Capital Partners participated in CAPCO programs in 6 other states.
- Wilshire is an affiliate of New York-based NewTek Business Services Inc. (NewTek). Started in 1999, NewTek is a public company whose stock trades on the America Stock Exchange.

D.C. Act 15-254, D.C. Code § 29-1201, and 26 DCMR, Chapter 5600 govern the management of the CAPCO program. D.C. Act 15-254, D.C. Code § 29-1201, and 26 DCMR, Chapter 5600 include the following key requirements:

1. The DISB Commissioner shall conduct an annual review of each Certified Capital Company.
2. Under the CAPCO program, 25% of employees of a Qualified Business are required to be District residents, 75% of employees must be employed in the District, and the business must be headquartered in the District.
3. The DISB Commissioner can waive requirements of a Qualified Business if the Commissioner determines that the proposed investment will further economic development in the District.
4. At its option, a Certified Capital Company may request an opinion from the DISB Commissioner on whether a business meets Qualified Business requirements.
5. A Qualified Business must certify that the business was unable to obtain conventional financing.
6. CAPCOs must provide the DISB Commissioner with annual audited financial statements.
7. The application for CAPCO certification shall include the applicant's overall investment strategy and 3 year business plan.

In addition to objectives set forth on page 1, the Auditor specifically focused on these mandates in conducting the audit.

## **FINDINGS**

### **THE DEPARTMENT OF INSURANCE, SECURITIES AND BANKING FAILED TO VERIFY INFORMATION PRESENTED ON QUALIFIED BUSINESS APPLICATIONS**

D.C. Act 15-254, § 6(e), states: “At its option, a Certified Capital Company, prior to making an investment in a specific business, may request from the Commissioner a written opinion that the business is a Qualified Business. Upon receiving the request, the Commissioner shall have 15 days to determine whether or not the business is a Qualified Business and notify the Certified Capital Company of its determination...”

According to DISB officials, DISB did not verify information about Qualified Business applicants because DISB considered the terms of § 6(e) to be “optional”. Furthermore, officials stated that since DISB planned to review information presented in Qualified Business applications during the annual review of each CAPCO, it was not necessary for DISB to review information when the application was submitted. There are at least two major problems with DISB’s assertions.

First, since the inception of the CAPCO program in 2003 through the audit period, DISB failed to conduct annual reviews of CAPCOs. Since DISB did not conduct any annual reviews, DISB did not review or verify information submitted for its written opinion as to whether the business was a Qualified Business as part of an annual review process.

Second, once a CAPCO exercised the § 6(e) option, it was incumbent upon the DISB Commissioner to review the documentation and make an informed determination that the business met or did not meet the Qualified Business requirements. While it was optional for CAPCOs to request a review, it certainly was not optional for the DISB Commissioner to conduct a thorough review of a business as the basis for a reasoned opinion as to whether or not the business met the Qualified Business requirements. By failing to verify information, DISB failed to comply with D.C. Act 15-254, § 6(e).

#### **Failure To Verify Residence Of Employees**

The Auditor reviewed all of the Qualified Business applications that were submitted since the inception of the District’s CAPCO program through the audit period. The Auditor found questionable statements about the residence of employees that DISB should have verified before issuing an opinion that a business met the Qualified Business requirements.

As previously noted, CAPCOs invest in small businesses. The Act states the requirements for certification of a business to participate in the CAPCO program. One of the requirements is that 25% of employees of a business must reside in the District. The residence requirement was important because the CAPCO program was designed to

increase the number of residents, jobs, taxes on income and the sale of goods and services. Given the potential benefits to the District associated with the residency requirement, it was important that DISB verify that 25% of a Qualified Business's employees were District residents.

Consider the July 11, 2006, Qualified Business application of CreateHope submitted to DISB for review by Advantage. The application stated that 11 of CreateHope's 44 employees were District residents, thereby meeting the 25% requirement.

The Auditor reviewed the list of CreateHope employees included with the application and found three employees with the same address on Woodley Place, NW, D.C. If the three Woodley Place residents did not live in the District, the number of CreateHope employees who were D.C. residents decreased from 11 to 8. With only 8 of a total of 44 CreateHope employees residing in the District, the percentage of employees who were D.C. residents would decrease from 25% to 18% thus not meeting the 25% residency requirement.

To verify the number of CreateHope employees who resided in the District, the Auditor requested Advantage to provide CreateHope's June 2006 payroll reports. The Auditor reviewed CreateHope's payroll reports and found that 2 of the Woodley Place employees paid Virginia state taxes. Since state taxes are based on place of residence, it appears that 2 of the Woodley Place employees lived in Virginia, not D.C.<sup>8</sup>

The Auditor also found a total of 49 employees listed on Create Hope's June 28, 2006 payroll report. The Qualified Business application stated that CreateHope had a total of 44 employees. In addition, according to the June 28, 2006, payroll report, 8 employees paid taxes to the District instead of 11 employees as reported on the application. If CreateHope had a total of 49 employees instead of the reported 44 employees, then with 8 employees residing in the District, only 16% of the total employees were District residents. CreateHope would not satisfy the 25% requirement without misrepresenting its total number of employees and the number of employees actually residing in the District. Table I presents the total number of CreateHope employees and the total number that were District residents.

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<sup>8</sup> The response to the Auditor's request for CreateHope's payroll report included the notation: "Payroll incorrect VA State listing; have affidavit from individual attesting to DC residency."

**Table I**  
**Total Number of CreateHope Employees**  
**and D.C. Residents**

|                                                         | <b>Number of D.C. residents</b> | <b>Percentage of D.C. residents</b> |
|---------------------------------------------------------|---------------------------------|-------------------------------------|
| CreateHope Data<br><i>7/11/06 Advantage application</i> | 11 of 44 employees              | 25%                                 |
| Payroll Data<br><i>6/28/06 CreateHope payroll</i>       | 8 of 49 employees               | 16%                                 |

Without verifying questionable statements about the residence of employees on July 17, 2006, DISB advised Advantage that: "Based on our review of the information you have submitted, we are of the opinion that CreateHope, Inc...meets the requirements to be a "Qualified Business," as defined in the Act." On July 31, 2006, Advantage invested \$1.1 million of CAPCO funds in CreateHope.

One year later, on June 7, 2007, Advantage submitted a Qualified Business application to DISB for a "Follow-On" investment in CreateHope. In the application, Advantage stated "...the company is headquartered in the District and greater than 75% of its employees work in the District, less than 25% of the employees reside in the District (16.67%)." [Auditor's Emphasis]

The June 2007 letter from Advantage stating that 16.67% of CreateHope's employees resided in the District is consistent with the Auditor's finding that in July 2006, only 16% of CreateHope's employees resided in DC.

Subsequently, Advantage and another CAPCO, Enhanced, submitted applications to DISB for additional investments in CreateHope. The Advantage and Enhanced applications for additional investments contained another issue that DISB should have addressed. Specifically, on the Enhanced application one employee<sup>9</sup>, the Coordinator, Client Services<sup>10</sup>, listed Washington, D.C. as the place of residence. The Advantage application stated that the Coordinator, Client Services resided in New York. Since DISB did not verify information presented on either application the discrepancy was not addressed.

Despite inconsistencies regarding the residence of the Coordinator, Client Services, DISB again certified CreateHope as a Qualified Business and approved additional investments totaling \$743,846. Between July 12, 2007, and September 27, 2007, Enhanced invested \$495,897 in CreateHope, and on September 30, 2007, Advantage invested an additional \$247,949 in CreateHope.

<sup>9</sup> Employee with zipcode 10013 and zipcode and 20009.

<sup>10</sup> 2006 CreateHope Organization chart.

In another example of DISB's failure to verify employee residence information, on May 4, 2005, DISB advised Wilshire, a CAPCO, that Community Financial Services met requirements to be a Qualified Business. On the same date, DISB advised Wilshire that Small Business Solutions was a Qualified Business. Both letters from DISB included the proviso that, "the business will be required to comply with the Act's residency and employee location requirements." On May 27, 2005, Wilshire invested \$1.9 million of CAPCO funds in Community Financial Services and \$1.9 million in Small Business Solutions.

The Auditor requested information from DISB on Wilshire's compliance with DISB's requirement to provide employee residence information for Community Financial Services and Small Business Solutions. According to DISB, Wilshire did not provide any employee residence information. DISB stated:

**"As you have seen from your review of the QB (Qualified Business) files, some applications contain information about employees and some do not. I maintain that the CAPCO law does not require the Department to obtain or review residency information in order to approve the QB applications. [Auditor's Emphasis] I say this because the submission of the QB application is optional. The CAPCO's are legally authorized to fund the QB's without the Department's prior review [of] approval of employment information, terms of the funding, or anything else. In other words, the CAPCOs are able to fund QB's based on their belief that the QBs satisfy the definition of a QB as set forth in the law."<sup>11</sup> [Auditor's Emphasis]**

As previously noted in this report, once Wilshire exercised the option to have DISB determine that Community Financial Services and Small Business Solutions met Qualified Business requirements, it was incumbent upon DISB to verify that employees met the residence requirements of the Act. DISB should have obtained credible employee residence information from Wilshire before DISB awarded Qualified Business status to Community Financial Services and Small Business Solutions to participate in the CAPCO program.

## **RECOMMENDATION**

DISB should specify the type of residency information that must be submitted and verify employee residence information presented on Qualified Business applications, before awarding Qualified Business status.

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<sup>11</sup> Email from D. Sheppard dated June 30, 2008.

**THE DEPARTMENT OF INSURANCE, SECURITIES AND BANKING  
AWARDED QUALIFIED BUSINESS STATUS TO BUSINESSES THAT DID  
NOT MEET REQUIREMENTS OF THE ACT**

Under the CAPCO program, CAPCOs can only invest in businesses that meet the requirements of the Act. According to § 2(12)(A) of the Act, there are six requirements that a business must meet to qualify to participate in the CAPCO program. Businesses that meet the following requirements are referred to as Qualified Businesses:

- The business must be headquartered and have its principal operations in the District;
- At least 25 percent of the company's employees must be residents of the District;
- At least 75 percent of the company's employees must work in the District;
- The business must be a "small business concern" as defined by the U.S. Small Business Administration<sup>12</sup>;
- The business must certify that it has attempted and failed to obtain conventional financing; and
- The business cannot be engaged in professional services provided by accountants, lawyers or physicians.

The Auditor found that two businesses, NuAmerica Bank and CreateHope, certified by DISB did not meet § 2(12)(A) Qualified Business requirements.

**NuAmerica Bank**

Advantage submitted a Qualified Business application to DISB for NuAmerica Bank on December 20, 2006. The application stated: "Because Advantage Capital plans to invest prior to the actual start of the Bank, there are currently no employees at this time, however the anticipated number of employees and their residential makeup are outlined..." The letter further noted, "...technically today, the Bank does not exist because it is awaiting regulatory approval."

On February 13, 2007, DISB advised Advantage that, "NuAmerica Bank meets the requirements to be a "Qualified Business," as defined in § 2(12)(A) of the Act." On April 17, 2007, Advantage invested \$1 million of CAPCO funds in NuAmerica Bank, which did not exist at that time or thereafter.

Despite certification by DISB of NuAmerica Bank as a Qualified Business, NuAmerica Bank did not meet the Qualified Business requirements set forth in Section 2(12)(A). NuAmerica Bank did not have any employees and its headquarters technically did not exist and thus were not in the District. Despite these deficiencies and the statement from Advantage that NuAmerica Bank did not exist, DISB declared

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<sup>12</sup> The Small Business Administration definition of a small business is called a "size standard." Generally, the size standard is stated either as the number of employees or average annual receipts of a business concern.

NuAmerica Bank a Qualified Business that met requirements of Section 2(12)(A) of the Act. Table II presents requirements of the Act and qualifications of NuAmerica Bank.

**Table II**  
**NuAmerica Bank Business Qualifications**

| <b>Qualified Business Requirements</b>      | <b>NuAmerica Bank Qualifications</b> |
|---------------------------------------------|--------------------------------------|
| Headquarters and Principal Operations in DC | No Headquarters                      |
| 25% employees reside in DC                  | No Employees                         |
| 75% employees work in DC                    | No Employees                         |

While it was improper for DISB to find that NuAmerica Bank met requirements of § 2(12) (A) of the Act, DISB could have waived Qualified Business requirements using § 2(12) (C) of the Act. Section 2(12)(C) states : “A business that does not meet all of the qualifications set forth in subparagraph (A) of this paragraph may be deemed a Qualified Business...if the Commissioner determines that the proposed investment will further economic development in the District and certifies the business as a Qualified Business for purposes of the investment.” The economic development waiver may have been a more appropriate way to address the deficiencies of the NuAmerica Bank Qualified Business application. The incorrect interpretation and implementation of provisions of the Act by the DISB Commissioner were recurring problems with DISB’s management of the CAPCO program.

Advantage advised DISB that the reason NuAmerica Bank did not have employees was because the bank was awaiting regulatory approval by the Federal Deposit Insurance Corporation. On June 10, 2008, when organizers of NuAmerica Bank abandoned the project, NuAmerica Bank still had not obtained regulatory approval. Furthermore, NuAmerica Bank still did not have employees or headquarters in the District. NuAmerica Bank still did not exist.

### **CreateHope**

The initial investment that Enhanced made in CreateHope was in September 2005. In a letter to DISB dated May 31, 2005, Enhanced stated, “CreateHope is currently headquartered in Bethesda, Maryland and its principal business operations are also currently located in Bethesda, Maryland. However, upon the closing of this investment, CreateHope will relocate its headquarters and its principal business operations to the District of Columbia within ninety days of such closing.”

DISB, in a letter dated June 3, 2005, to Enhanced stated:

“Based on our review of the information you have submitted, we are of the opinion that CreateHope, Inc. meets the minimum requirements to be a “Qualified Business,” as defined in the Act, with the exceptions noted in

your letter. As you are aware, the business will be required to comply with all or is the all (sic) of the Act's requirements and we are not waiving those requirements by providing you with this opinion. Please provide the Department with an affidavit indicating the company is in compliance with all of the provisions in the Act no later than 120 days after the company receives funding from Enhanced." [Auditor's Emphasis]

Section 2(12)(A) of the Act states: "Qualified Business means a business, except as provided in subparagraphs (B) and (C) of this paragraph, that meets the following qualifications **as of the time of a Certified Capital Company's initial investment in the business**" [Auditor's Emphasis] According to the Act, a Qualified Business had to be headquartered and have its principal operations in the District at the time of the investment. Despite the statutory mandate, DISB granted CreateHope 120 days, after receipt of CAPCO funds to comply with Qualified Business requirements.

Enhanced advised DISB in a letter dated September 2, 2005, that CreateHope moved its headquarters to the District. On September 16, 2005, Enhanced invested \$2 million of CAPCO funds in CreateHope. Despite the fact that CreateHope met the requirements of the Act at the time of the Enhanced investment, the decision by DISB incorrectly applied provisions of the Act by granting CreateHope up to 120 days after receipt of CAPCO funds to meet Qualified Business requirements.

### **RECOMMENDATION**

DISB should consistently apply the Qualified Business requirements of the Act and only certify a business as a Qualified Business if it meets all of the Qualified Business requirements.

### **THE COMMISSIONER OF DISB DID NOT CONDUCT ANNUAL REVIEWS OF CAPCOS, AS REQUIRED BY D.C. ACT 15-254 § 8(a)**

D.C. Act 15-254 §8(a) states: "The Commissioner shall conduct an annual review of each Certified Capital Company to determine if the Certified Capital Company is complying with the requirements of certification, to advise the Certified Capital Company as to the eligibility status of its Qualified Investments, and to ensure that no investment has been made in violation of this act."

The first investment under the District's CAPCO program was made by Wilshire on May 27, 2005. Since that time, the District's CAPCOs have invested more than \$22 million in 15 businesses. The Auditor found that since the inception of the CAPCO program through the audit period, DISB had not conducted any annual reviews of CAPCOs. According to the Commissioner of DISB, "The Department is currently preparing procedures to be used to conduct a review of the CAPCO program."<sup>13</sup>

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<sup>13</sup> Letter dated May 14, 2008, from Commissioner Hampton to the D.C. Auditor RE: Request for Documents for the Audit of District of Columbia Certified Capital Companies Program.

The Auditor is concerned that almost half of the \$50 million of CAPCO funds have been invested without DISB conducting the required annual reviews of CAPCOs to determine whether investments were made in violation of the Act. For DISB to effectively manage and achieve the mission of the CAPCO program, it is essential for DISB to conduct annual reviews of all CAPCOs.

### **RECOMMENDATION**

The Commissioner of DISB should promptly conduct annual reviews of all CAPCOs, as required by D.C. Act 15-254 § 8(a).

### **ANNUAL AUDITED FINANCIAL STATEMENTS WERE BASED ON FALSE ASSUMPTIONS**

D.C. Act 15-254 § 6(3) required CAPCOs to provide the DISB Commissioner with annual audited financial statements. The Auditor found that CAPCOs complied with the annual audited financial statement requirement; however, audits were based on unreliable or incorrect assumptions. The Procedures Performed and Results of Testing of the Independent Accountant submitted by the independent accountant for Advantage states the procedure to verify that 25% of employees of Qualified Businesses resided in the District was to obtain residence information from 1099 payroll accounts. However, the independent accountant did not comply with this procedure because the independent accountant incorrectly assumed that the issuance of a Qualified Business certificate by DISB meant that DISB verified that, in fact, 25% of employees resided in the District. Similarly, the report from the independent accountant for Enhanced stated that the management of the CAPCO program was responsible for the accuracy of statements on the percentage of employees that resided in the District.<sup>14</sup>

As previously noted, DISB awarded Qualified Business status without verifying information on the application. Inaccurate audited CAPCO financial statements are a consequence of the persistent failure of DISB to manage the CAPCO program in a manner consistent with the Act and effective management practices and principles.

DISB was aware that independent accountants assumed that DISB verified Qualified Business application information when in fact it did not. In an email dated April 4, 2006, from DISB to Advantage, DISB stated:

“...I note that PWC (*PricewaterhouseCoopers*) is relying on the Department’s letter opining on (sic) that GridPoint, Inc. met the requirements as a “Qualified Business” under the statute. The Department, **in lieu of doing its own examination of the CAPCOs, intended to rely on the auditor to verify this information.** [Auditor’s Emphasis] I see no

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<sup>14</sup> Enhanced Capital District Fund, LLC, letter dated April 29, 2008, from Director of Finance to DISB, Report of Independent Auditors, Ernst & Young, Applying Agreed-Upon Procedures, page 1.

reason to do anything about this for 2005. Please confirm that PWC can do an independent audit of the qualified businesses next year.”

The Auditor found that DISB management did not request CAPCOs to advise accountants that DISB certified Qualified Businesses without verifying information. Further, in subsequent audits, accountants for CAPCOs did not verify Qualified Business information.

### **RECOMMENDATION**

DISB should request CAPCOs to inform their accountants that DISB has not verified information presented in Qualified Business applications.

### **A CAPCO QUALIFIED BUSINESS OBTAINED \$9 MILLION IN EQUITY FINANCING FROM INVESTORS YET CLAIMED IN ITS APPLICATION THAT IT COULD NOT OBTAIN CONVENTIONAL FINANCING**

Section 12(A) (v) of the Act requires Qualified Businesses to certify: “...in an affidavit that the business is unable to obtain conventional financing, which means that the business has failed in an attempt to obtain funding for a loan from a bank or other commercial lender or that the business cannot reasonably be expected to qualify for financing under the standards of commercial lending.”

On September 22, 2005, Advantage filed a Qualified Business application for GridPoint. GridPoint made energy management appliances. The application included the requisite affidavit, dated September 21, 2005, stating that GridPoint was unable to obtain conventional financing. DISB advised Advantage on September 29, 2005, that GridPoint met requirements of a Qualified Business. On September 30, 2005, Advantage invested \$600,000 of CAPCO funds in GridPoint.

However, a report appearing in the September 6, 2005, edition of Investor’s Business Daily stated: “50 investors recently put \$9 million into GridPoint raising its total funding to \$10.8 million.” A November 29, 2005, report from VentureWire stated that the \$9 million was the, “first tranche of a \$15 million Series B round targeted to close by the end of the year.”

It is problematic that a few weeks after receiving \$9 million in equity financing, GridPoint signed an affidavit stating that the business was unable to obtain conventional financing. In response to the Auditor’s request for additional information regarding GridPoint’s finances, Advantage provided the following statement:

“...regarding the source of GridPoint’s initial funding, the company raised its initial operating capital in the form of equity investments or shareholder loans from investors which were converted to equity in GridPoint. Bank of America also issued the company a standby line of credit in the amount of \$700,000, which required guarantees collateralized

by the personal assets of the Chairman of the Board and the CEO of GridPoint. This standby credit fell far short of the millions of dollars that were needed to operate the start up business during this period. At this stage the company was unable to obtain conventional financing needed to fund operations...”

Advantage noted that after receiving the Bank of America line of credit GridPoint was unable to obtain additional financing, however, the Bank of America line of credit was issued on November 6, 2003. While GridPoint was unable to obtain conventional financing in 2003, GridPoint apparently was able to obtain financing two years later when the CAPCO Qualified Business affidavit was signed.

Several factors support the conclusion that GridPoint could have obtained financing in 2005. For example, GridPoint had grown since 2003 and energy awareness was increasing. In addition, the federal Energy Policy Act of 2005 encouraged consumers to take advantage of GridPoint’s technology and federal agencies were using GridPoint’s products to comply with the Energy Policy Act.<sup>15</sup>

In light of the importance of Qualified Business requirements, an affidavit was insufficient evidence that a business was unable to obtain conventional financing. Businesses seeking CAPCO funding should be required to provide DISB with documentation from a bank or commercial lender stating that the business was unable to obtain conventional financing. In addition, there should be a time limit on the period between denial of financing and submission of the Qualified Business application. As in the case of GridPoint, a two year period between denial of financing and submission of the Qualified Business application was too long. Finally, if a business is able to obtain financing regardless of the source, that business should not be considered a Qualified Business to participate in the CAPCO program.

## **RECOMMENDATIONS**

1. The Council of the District of Columbia should amend D.C. Act 15-254 to require Qualified Business applicants to provide DISB with documentation from a bank or commercial lender, stating that the applicant was denied funding for a loan not more than sixty days prior to the submission of the Qualified Business application.
2. The Council of the District of Columbia should amend D.C. Act 15-254 to state that Qualified Business applicants were unable to obtain financing, instead of the current requirement that Qualified Business applicants were unable to obtain conventional financing.

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<sup>15</sup> GridPoint website, Press Releases 2005, August 30, 2005: GridPoint helps Consumers Reap Tax Credits and Other Benefits of New Energy Law with Intelligent Energy Management Products; August 30, 2005 : GridPoint helps Federal Agencies comply with Mandates for Implementation Technologies supporting Renewable Energy.

**CAPCOs INVESTED OVER \$13 MILLION IN COMPANIES THAT DID NOT CONSISTENTLY COMPLY WITH CAPCO's INVESTMENT STRATEGIES AND BUSINESS PLANS**

CAPCOs submitted applications to DISB to participate in the District's CAPCO program. As part of the application process, CAPCOs presented their investment strategies. Title 26 DCMR, Chapter 5600, Section 5602.1(j) states: "The Application for Certification shall contain the following: The applicant's overall investment strategy and the applicant's three (3) year business plan including an organizational chart."

The June 27, 2003, report on the Act by the Council of the District of Columbia's Committee on Consumer and Regulatory Affairs stated that CAPCOs:

"...would provide long-term equity capital for new or expanding small businesses, stimulate the creation of high-wage jobs, create and foster a local venture capital infrastructure within the District, and produce an incentive to bring out-of-state companies to the District by providing an insurance premium tax credit for insurance companies making qualified investments in certified capital companies."

**Advantage**

Advantage's application for certification as a CAPCO<sup>16</sup> stated: "A wide variety of opportunities will be considered, assuming they meet return and diversification objectives. **However, it is expected that the Applicant's investment focus will be on companies that develop or apply innovative technologies to products, systems and services in the following industries:** [Auditor's Emphasis]

**Information Technology ("IT")**

Healthcare IT

Defense IT

Financial Services IT

Communications IT

IT Services and Products

**Companies in Sectors with Potential for Rapid Growth and High Profitability**

Biotech

Defense-Related/Homeland Security

Government-Related Information Services and Technologies

Business Services"

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<sup>16</sup> Advantage Capital D.C. Partners I, L.L.C. Certified Capital Company Application, Submitted to the Government of the District of Columbia, Department of Insurance, Securities and Banking, September 8, 2004, page 11.

Advantage invested \$1.9 million of CAPCO funds in businesses that did not develop or apply “innovative technologies” such as AV Smoot, a construction company, Inside Higher-Ed, a media company, and NuAmerica Bank. However, Advantage invested \$3 million in technology firms such as CreateHope, ARC Solutions and GridPoint. Tables III and IV present amounts Advantage invested in various technology and non-technology businesses.

**Table III**  
**Technology Investments made by Advantage**

| <b>Name of Business</b> | <b>Description</b> | <b>Total Investment</b> |
|-------------------------|--------------------|-------------------------|
| CreateHope              | Software           | \$1,397,949             |
| ARC Solutions           | Software           | \$1,100,000             |
| GridPoint               | Energy Management  | \$ 600,000              |
| <b>Total</b>            |                    | <b>\$3,097,949</b>      |

**Table IV**  
**Non-Technology Investments made by Advantage**

| <b>Name of Business</b> | <b>Description</b> | <b>Total Investment</b> |
|-------------------------|--------------------|-------------------------|
| Inside Higher Ed        | Media              | \$250,000               |
| NuAmerica Bank          | Bank               | \$1,000,000             |
| AV Smoot                | Construction       | \$700,000               |
| <b>Total</b>            |                    | <b>\$1,950,000</b>      |

### **Wilshire**

Wilshire’s application for certification as a CAPCO stated: “The Company intends to take a leadership role in initiating, structuring, negotiating transactions and **actively working with the management of qualified technology businesses in the District of Columbia.** [Auditor’s Emphasis]”<sup>17</sup> Wilshire invested \$6.4 million of CAPCO funds in Home Slice, a pizza business, Rumba Tivoli, a restaurant, I.C.M. Productions, a theatre company, Newtek Insurance Agency, and Community Financial Services. Wilshire did not invest in any technology businesses. It is important to note that Newtek Insurance Agency and Community Financial Services are affiliated with Newtek Business, the holding company for Wilshire. Table V presents amounts that Wilshire invested in various businesses.

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<sup>17</sup> Wilshire DC Partners, L.L.C., Plan of Operations, August 9, 2004, page 2.

**Table V**  
**Non-Technology Investments made by Wilshire**

| <b>Name of Business</b>   | <b>Description</b>        | <b>Total Investment</b> |
|---------------------------|---------------------------|-------------------------|
| Community Federal Savings | Business Support Services | \$1,900,000             |
| Newtek Insurance Agency   | Insurance                 | \$1,900,000             |
| I.C.M. Productions        | Theatre Company           | \$1,900,000             |
| Rumba Tivoli              | Restaurant                | \$ 450,000              |
| Home Slice                | Pizzeria                  | \$ 280,000              |
| <b>Total</b>              |                           | <b>\$6,430,000</b>      |

**Enhanced**

Enhanced's application for certification as a CAPCO stated: "The Company will consider investments in a wide variety of industries...the Company is biased toward the following industries:<sup>18</sup>

1. Healthcare
2. Information Technology
3. Communications
4. Distribution
5. Environmental Services/ Technology"

Enhanced invested \$4.7 million in the following non-technology companies: \$500,000 in Inside Higher Ed, media company, \$2.1 million in Virillion, internet news publisher, \$1.5 million in JLC New Hope, construction, \$120,000 in Session Title Service, \$50,000 in AV Smoot, construction, and \$350,000 in D.H. Lloyd & Associates, commercial insurance. However, Enhanced invested \$5.8 million in CreateHope and ARC Solutions, technology firms. Tables VI and VII present amounts that Enhanced invested in various industries.

**Table VI**  
**Technology Investments made by Enhanced**

| <b>Name of Business</b> | <b>Description</b> | <b>Total Investment</b> |
|-------------------------|--------------------|-------------------------|
| CreateHope              | Software           | \$3,595,897             |
| ARC Solutions           | Software           | \$2,200,000             |
| <b>Total</b>            |                    | <b>\$5,795,897</b>      |

<sup>18</sup> Enhanced Capital District Fund, L.L.C., Investment Strategy and Business Plan, July 20, 2004, page 18.

**Table VII**  
**Non-Technology Investments made by Enhanced**

| <b>Name of Business</b> | <b>Description</b>   | <b>Total Investment</b> |
|-------------------------|----------------------|-------------------------|
| Verillion               | Internet Publishing  | \$2,150,000             |
| JLC New Hope            | Construction         | \$1,500,000             |
| Inside Higher Ed        | Media                | \$ 500,000              |
| D.H. Lloyd              | Commercial Insurance | \$ 350,000              |
| Session Title Services  | Real Estate Services | \$ 120,000              |
| AV Smoot                | Construction         | \$ 50,000               |
| <b>Total</b>            |                      | <b>\$4,670,000</b>      |

The District sacrificed insurance premium tax revenues for anticipated economic growth through income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues. According to the CAPCO's investment strategies, in general CAPCOs planned to invest in high-tech start ups. If CAPCOs followed their investment strategies, one outcome of the CAPCO program may have been District-based high-tech companies. However, CAPCOs did not follow their investment strategies. The Auditor did not find any documents in which DISB objected to CAPCO investments in businesses that were inconsistent with their stated investment strategies.

The Act delegated CAPCO investment decisions to CAPCOs on the assumption that they were better equipped to identify promising companies.<sup>19</sup> While the Act did not authorize DISB to make investment recommendations to CAPCOs, DISB could have expressed concern that CAPCOs were not investing in businesses that were consistent with the CAPCO's stated investment strategies. The DISB Qualified Business certification process would have been an opportune time for DISB to note that a proposed investment was inconsistent with the CAPCO's investment strategy.

In addition to the Qualified Business certification process, DISB could have expressed concern about the types of businesses that received CAPCO funds during DISB's annual review of CAPCOs. However, as previously noted DISB did not conduct any annual reviews of CAPCOs and thus missed a valuable opportunity to emphasize the importance of economic development and advise CAPCOs to make investments that were consistent with their investment strategies. Although DISB had numerous opportunities to raise the issue of investments in businesses that were inconsistent with CAPCO's stated investment plans DISB persistently failed or refused to do so.

Regarding state sponsored venture capital programs, the National Association of Seed and Venture Funds (NASVF) states: "Tax credits...work best when awarded with discretion, where a person or board accountable to the state picks from among competing

<sup>19</sup> The Examiner, June 23, 2006, D.C.'s \$50M venture fund on track to meet target, Katie Wilmeth.

projects and ensures that the credits are used for the highest and best purpose.”<sup>20</sup> [Auditor’s Emphasis] DISB should have implemented the best practice recommendation of NAVSF and encouraged CAPCOs to follow their investment strategies to ensure that tax credits were used for their highest and best purpose.

## **RECOMMENDATIONS**

1. DISB’s annual review of CAPCOs should include an analysis of CAPCO investments in Qualified Businesses to determine consistency with the CAPCO’s stated Investment Strategy and Business Plan.
2. DISB should not certify a business as a Qualified Business if the business differs from the CAPCO’s stated Investment Strategy and Business Plan.

## **DISB COMMISSIONER DID NOT DEVELOP CRITERIA BY WHICH TO DETERMINE WHETHER INVESTMENT IN A QUALIFIED BUSINESS WOULD FURTHER ECONOMIC DEVELOPMENT IN THE DISTRICT**

D.C. Act 15-254 §2(12)(C) states: “A business that does not meet all of the qualifications set forth in subparagraph (A) of this paragraph may be deemed a Qualified Business for purposes of allowing an investment in the business by a Certified Capital Company if the Commissioner determines that the proposed investment will further economic development in the District and certifies the business as a Qualified Business for purposes of the investments.”

The Act permits the Commissioner to waive Qualified Business requirements upon a determination that the proposed investment will further economic development in the District. The Act fails to define the term economic development. Furthermore, during a meeting with the Auditor, the Commissioner stated that DISB did not establish any criteria to determine whether a proposed investment would further economic development. Thus, any determination that a proposed CAPCO investment would further economic development was based on the inconsistent, subjective views of the DISB Commissioner.

It was important for DISB to define economic development because numerous methodologies could have been used to measure the impact an investment would have on economic development. For example, DISB could have measured economic development impact based on the growth and expansion of businesses,<sup>21</sup> gross receipts,<sup>22</sup> attraction of additional investors<sup>23</sup>, cost-benefit analysis of direct investments,<sup>24</sup> or the

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<sup>20</sup> The National Association of Seed and Venture Funds, Seed and Venture Capital, State Experiences and Option, May 2006, page 17.

<sup>21</sup> The National Association of Seed and Venture Funds page 21.

<sup>22</sup> The National Association of Seed and Venture Funds page D-8.

<sup>23</sup> The National Association of Seed and Venture Funds page 1.

<sup>24</sup> Office of Missouri State Auditor, Performance Audit, Review of State Tax Credits Administered by the Department of Economic Development, page 12.

creation of new jobs and increased employment of bona fide District residents. Since DISB did not establish standards or criteria to measure economic development impact, DISB could not effectively document, measure and substantiate the impact of CAPCO program investments on the District's economic development goals. In the absence of the establishment of standards and criteria to measure economic development, DISB could not make an informed determination that a proposed investment would further economic development in the District or that the CAPCO program was achieving its important mission.

The Auditor found that in 2005 Advantage, Enhanced and Wilshire commissioned Professor Stephen Fuller, Director of George Mason University's Center for Regional Analysis, to analyze the economic impact of the CAPCO program on the District's economy. In an email dated April 24, 2008, Professor Fuller stated:

"...due to the lack of no (sic) cooperation from the participants (the CAPCOs) I was unable to collect the data necessary to complete it or draw any conclusions. No additional work has been conducted on this study since 2005. As far as I know, no other studies have been initiated. I am sorry to report that I failed to succeed in monitoring and evaluation (sic) of what had been expected to be an important source of business development in the District. That is not to say that the CAPCO program has not achieved benefits, but rather that I have no facts by which these could be measured."<sup>25</sup>

The Auditor further found that, in the absence of establishing standards and benchmarks by which to measure economic development impact resulting from CAPCO program investments, DISB waived Qualified Business requirements based on determinations that were unsupported and unjustified.

For example, on June 12, 2007, in response to Enhanced's proposed \$750,000 investment in CreateHope, DISB wrote:

"Your letter states that CreateHope, Inc. meets all of the requirements of the Act, with the exception of the residency requirement. Your letter requests a waiver of that requirement based on the anticipated positive impact CreateHope, Inc. will have on the District's economy. I hereby waive the residency requirement pursuant to the authority found in Section 2(12)(C) of the Act..."

Similarly, in a response dated June 12, 2007, to Advantage regarding a \$250,000 investment in CreateHope, DISB again used Section 2(12)(C) of the Act to waive the residency requirement. In both instances, DISB granted an economic development waiver without providing a credible, written explanation of the basis for its determination that investments in CreateHope would further economic development in the District. Based

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<sup>25</sup> Email from D. Sheppard to Professor Stephen Fuller, April 24, 2008.

on the record, it is impossible to conclude whether DISB granted waivers based on payroll, number of employees, or other objective measures of economic development impact. Without established criteria or a credible written explanation of the basis for economic development waiver, DISB's determinations were arbitrary and unsubstantiated.

In the absence of DISB establishing economic development impact standards, CAPCOs attempted to create their own economic development standards. For example, in requests to DISB for waivers of the residency requirement, Advantage and Enhanced offered their own economic development impact measures. The use of different standards by Advantage and Enhanced emphasizes the importance of DISB establishing uniform standards to measure economic development impact in the District. For example, Enhanced stated: "CreateHope currently employs 38 in the District and will generate revenue of over \$4 million in 2007." Advantage stated: "Payroll for 2005 and 2006 was \$2,516,371 and \$3,215,555 respectively." Advantage used payroll to demonstrate economic development while Enhanced relied on number of employees and neither factor was concretely tied to a positive impact on economic development in the District of Columbia.

According to a report on indicators of success for state-sponsored or state-facilitated venture capital programs by the NASVF<sup>26</sup>: "The best programs establish outcome measures from the beginning, keep track of program results, and evolve according to changes in conditions." DISB took none of these actions and the District's CAPCO program failed to evolve.

Since the District established the CAPCO program to stimulate local growth and given the District's loss of future tax revenue due to insurance premium tax credits, it was imperative that DISB's economic development waivers were based on clearly articulated, established guidelines. DISB failed to monitor CAPCOs to ensure that CAPCOs invested in businesses that increased economic development in the District. In addition, DISB did not review businesses that received CAPCO funds to determine if the businesses had the desired economic impact of increasing the number of residents, jobs, taxes on income and sales of goods and services. As a result of DISB's failure to accurately interpret and implement the provisions of the Act, the District is unable to effectively measure the economic impact of the CAPCO program.

## **RECOMMENDATIONS**

1. The Commissioner of DISB should establish objective, outcome oriented standards to measure economic development impact and use these standards to make determinations of whether or not to grant waivers of compliance with the Qualified Business requirements of D.C. Act 15-254 §2(12)(C).

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<sup>26</sup> The National Association of Seed and Venture Funds, page 1.

2. The Council of the District of Columbia should require the Commissioner of DISB to develop and implement objective, outcome oriented standards by which to measure economic development impact.

### **CAPCO SET-UP COSTS EXCEEDED CAPCO INVESTMENTS**

The District implemented the CAPCO program to increase economic development. The expectation was that tax revenue the District lost due to insurance premium tax credits would be offset by taxes paid on incomes and profits generated by CAPCO investments, as well as funds the District would not pay for welfare and unemployment benefits, Medicaid, and other costs of supporting employed and under employed residents. The ultimate success of the CAPCO program was whether jobs and revenue that flowed from the program would offset the foregone tax revenues.<sup>27</sup> This expectation has not materialized.

The National Venture Capital Association (NVCA) published a report in 1998 to document the impact of venture capital on economic development.<sup>28</sup> The CAPCO program is a venture capital program. According to the NVCA report, after 5 years a typical venture backed company met the following metrics:

- Produced new jobs at the rate of 40% per year;
- Created high-quality skilled positions at four times the rate of the general economy; and
- Sales increased by 66.5% per year

Since the District's CAPCO program was established to promote economic development, the Auditor reviewed the investments of each CAPCO to determine the economic impact of businesses that received CAPCO funds. To measure economic impact, the Auditor focused on costs associated with the formation of the District's CAPCOs, the number of new jobs created by CAPCOs, and the number of new District residents employed by CAPCOs.

### **Wilshire D.C. Partners**

Wilshire D.C. Partners, LLC is an affiliate of New York-based NewTek Business Services Inc. (NewTek). NewTek's/Wilshire's business strategy states:

"We have determined that features of the capco (sic) programs facilitate our use of the capco funds in the support of our development as a holding company for a network of small business service providers...we have

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<sup>27</sup> The Colorado CAPCO Program, page 14.

<sup>28</sup> Understanding CAPCOs, page 1.

simultaneously been able to use this funding source as a means to facilitate the growth of our businesses..."<sup>29</sup>

Instead of promoting emerging small businesses, Newtek/Wilshire used CAPCO funds to invest in its own businesses. Regarding Newtek/Wilshire's CAPCO business strategy the Director of the Colorado Office of Economic Development stated: "The investments are legal, but they violate the legislative intent."<sup>30</sup>

In addition, Newtek/Wilshire relies on management fees to cover operating expenses. NewTek states: "We rely on the annual management fees of 2.5% of certified (initial) capital, as fixed by the capco statutes, as our principal source of cash to cover our operating expenses."<sup>31</sup> While Newtek/Wilshire relies on management fees to cover operating expenses, management fees are not the primary source of income for CAPCOs. Most CAPCOs receive a share of profits when a successful investment pays off through the sale of a business or the issuance of stock.<sup>32</sup>

Through the CAPCO program Wilshire invested \$6 million in five businesses; Community Financial Services, Small Business Solutions LLC (now Newtek Insurance Agency, LLC) Rumba Tivoli, Home Slice, and Mumin Productions. Community Financial Services went out of business and the operations of Mumin Productions ceased with the production of one play in 2006.

As previously noted, under the CAPCO program the insurance company earns a premium tax credit equal to the amount of its total debt and equity investment in the CAPCO. The insurance company applies the premium tax credits against the District's Premium Tax Liability. Regarding tax credits, NewTek stated: "These credits are unaffected by the returns or lack of returns on investments made by the capcos."<sup>33</sup> In the case of Wilshire's investment in the business that failed, Community Financial, it appears that insurance companies will earn their premium tax credit despite the failure of the business.

The cost of formation, operation, management, insurance financing, and repayments for Wilshire was approximately \$23 million. Table IIX presents start up costs, management fees, insurance financing and repayments for Wilshire.

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<sup>29</sup> Securities Exchange Commission, 10-K Filing, filed by NewTek Business Services Inc on March 30, 2004, Chapter 6, page 19.

<sup>30</sup> Bob Lee, Director of the Colorado Office of Economic Development, quoted in article by David Milstead, Rocky Mountain News, July 30, 2003, "[State doles out new round of venture money to capco funds](#)".

<sup>31</sup> Securities Exchange Commission, 10-K Filing, filed by NewTek, Chapter 5, page 14.

<sup>32</sup> The Colorado CAPCO Program, page 17.

<sup>33</sup> Securities Exchange Commission, 10-K Filing, filed by NewTek, Chapter 5, page 19.

**Table IIX**  
**Wilshire Costs**

|                                                          |                     |
|----------------------------------------------------------|---------------------|
| Formation and Operation                                  | \$ 1,047,037        |
| Management Fees                                          | \$ 1,021,552        |
| Guaranteed Repayments to Insurance Companies*            | \$13,106,416        |
| Financing and Insuring Repayments to Insurance Companies | \$ 7,969,713        |
| <b>TOTAL</b>                                             | <b>\$23,144,718</b> |

*\*Insurance companies loan CAPCOs 99% to 100% of their total capitalization. These loans are usually fully guaranteed. The guarantees extend to repayments of principal and interest for the life of the loan.*

Regarding the number of new jobs created, before businesses received Wilshire CAPCO funds the five businesses had a total of 44 employees. After receiving CAPCO funds, the businesses had a total of 59 employees. Wilshire's investments in CAPCO businesses yielded 15 new jobs.

With respect to the number of new District residents, before businesses received Wilshire CAPCO funds, 40 employees resided in DC. After businesses received Wilshire CAPCO funds the number of employees who resided in DC and worked at businesses that received Wilshire CAPCO funds decreased to 39 District residents. Table IX presents number of jobs and DC residents attributed to Wilshire Qualified Businesses.

**Table IX**  
**CAPCO Funding, Jobs, and DC Residents Attributable to Wilshire**

| Qualified Business                                                         | Amount of CAPCO funding | Employees before CAPCO funding | Employees after CAPCO funding | DC Residents before CAPCO funding | DC Residents after CAPCO funding |
|----------------------------------------------------------------------------|-------------------------|--------------------------------|-------------------------------|-----------------------------------|----------------------------------|
| Community Financial                                                        | \$1,900,000             | 1                              | 0<br>Business Failed          | 1                                 | 0<br>Business Failed             |
| Home Slice                                                                 | \$ 280,800              | 4                              | 30                            | 4                                 | 20                               |
| Mumin Productions                                                          | \$1,900,000             | 2                              | 2*                            | 2                                 | 2                                |
| NewTek Insurance                                                           | \$1,900,000             | 2                              | 9                             | 1                                 | 3                                |
| Rumba Tivoli                                                               | \$ 450,000              | 35                             | 18                            | 32                                | 14                               |
| <b>TOTAL</b>                                                               | <b>\$6,430,800</b>      | <b>44</b>                      | <b>59</b>                     | <b>40</b>                         | <b>39</b>                        |
| <i>*27 employees during production of play, "Where Eagles Fly" in 2006</i> |                         |                                |                               |                                   |                                  |

### **Advantage D.C. Partners**

Advantage was founded in 1992. The firm has offices in Missouri, Louisiana, New York, Texas, Florida, Mississippi and Washington, D.C. with affiliated offices in Alabama, Colorado, and Wisconsin.

Through the CAPCO program Advantage invested \$5 million in six businesses; ARC Solutions, AV Smoot, CreateHope, GridPoint, Inside HigherED and NuAmerica Bank. GridPoint moved to Arlington, Virginia and organizers of NuAmerica Bank, "abandoned the project."<sup>34</sup> The cost of formation, operation, management, insurance financing and repayments for Advantage was approximately \$13.8 million. Table X presents start-up costs, management fees, insurance financing, and repayments for Advantage.

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<sup>34</sup> Julio Lopez-Brio, NuAmerica Bank, letter to NuAmerica Subscribers, June 10, 2008.

**Table X**  
**Advantage Costs**

|                                                          |                     |
|----------------------------------------------------------|---------------------|
| Formation and Operation                                  | \$ 520,870          |
| Management Fees                                          | \$ 278,767          |
| Guaranteed Repayments to Insurance Companies             | \$ 6,803,426        |
| Financing and Insuring Repayments to Insurance Companies | \$ 6,150,701        |
| <b>TOTAL</b>                                             | <b>\$13,753,764</b> |

With respect to the number of new jobs created, before businesses received Advantage CAPCO funds the six businesses had a total of 77 employees. After receiving CAPCO funds, the businesses had a total of 91 employees. Advantage's investments in CAPCO businesses yielded 14 new jobs. While at the time of the move to Arlington GridPoint had 82 employees, those employees are not included in the Auditor's economic impact analysis since the District will not receive tax revenue from GridPoint.

Regarding the number of new District residents, before businesses received Advantage CAPCO funds, 26 employees resided in DC. After businesses received Advantage CAPCO funds, the number of employees who resided in DC and worked at CAPCO funded businesses decreased to 25 District residents. Table XI presents number of jobs and DC residents attributed to Advantage Qualified Businesses.

**Table XI**  
**CAPCO Finding, Jobs, and DC Residents Attributable to Advantage**

| Qualified Business | Amount of CAPCO funding | Employees before CAPCO funding | Employees after CAPCO funding                  | DC Residents before CAPCO funding | DC Residents after CAPCO funding |
|--------------------|-------------------------|--------------------------------|------------------------------------------------|-----------------------------------|----------------------------------|
| ARC Solutions      | \$1,110,000             | 6                              | 18                                             | 2                                 | 4                                |
| AV Smoot           | \$ 700,000              | 10                             | 25                                             | 3                                 | 6                                |
| CreateHope         | \$1,397,949             | 22                             | 32                                             | 5                                 | 8                                |
| GridPoint          | \$ 600,000              | 26                             | 82<br><i>Before move to VA</i>                 | 9                                 | 0<br><i>After move to VA</i>     |
| InsideHigher ED    | \$ 250,000              | 13                             | 16                                             | 7                                 | 7                                |
| NuAmerica Bank     | \$1,000,000             | 0                              | 0                                              | 0                                 | 0                                |
| <b>TOTAL</b>       | <b>\$5,047,949</b>      | <b>77</b>                      | <b>91</b><br><i>Does not include GridPoint</i> | <b>26</b>                         | <b>25</b>                        |

### **Enhanced Capital District Fund, L.L.C.**

Enhanced Capital District Fund is a subsidiary of Enhanced Capital Partners. In addition to the District's CAPCO program, Enhanced Capital Partners participated in CAPCO programs in 6 other states.

Through the CAPCO program Enhanced invested \$10.4 million in eight Qualified Businesses; ARC Solutions, AV Smoot, CreateHope, InsideHigher ED, JLC New Hope, DH Lloyd, Session Title, and Virilion. The cost of formation, operation, management, insurance financing, and repayments for Enhanced was approximately \$16.2 million. Table XII presents start up costs, management fees, insurance financing, and repayments for Enhanced.

**Table XII**  
**Enhanced Costs**

|                                                          |                      |
|----------------------------------------------------------|----------------------|
| Formation and Operation                                  | \$ 984,377           |
| Management Fees                                          | \$ 1,729,614         |
| Guaranteed Repayments to Insurance Companies             | \$12,453,348         |
| Financing and Insuring Repayments to Insurance Companies | \$ 1,166,373         |
| <b>GRAND TOTAL</b>                                       | <b>\$16, 288,712</b> |

With respect to the number of new jobs created, the eight businesses that received Enhanced CAPCO funds had a total of 135 employees. After receiving Enhanced CAPCO funds the businesses had a total of 177 employees. Enhanced's investments in CAPCO businesses yielded 42 new jobs.

Regarding the number of new District residents, before businesses received Enhanced CAPCO funds, 49 employees resided in DC. After Enhanced Qualified Businesses received CAPCO funds, the number of employees who resided in DC increased to 57. Table XIII presents number of jobs and DC residents attributed to Enhanced businesses.

**Table XIII**  
**CAPCO Funding, Jobs, and DC Residents Attributable to Enhanced**

| Qualified Business | Amount of CAPCO funding | Employees before CAPCO funding | Employees after CAPCO funding | DC Residents before CAPCO funding | DC Residents after CAPCO funding |
|--------------------|-------------------------|--------------------------------|-------------------------------|-----------------------------------|----------------------------------|
| ARC Solutions      | \$2,200,000             | 6                              | 18                            | 2                                 | 4                                |
| AV Smoot           | \$ 50,000               | 10                             | 25                            | 3                                 | 6                                |
| CreateHope         | \$3,595,897             | 22                             | 32                            | 5                                 | 8                                |
| InsideHigher ED    | \$ 500,000              | 13                             | 16                            | 7                                 | 7                                |
| JLC New Hope       | \$1,500,000             | 17                             | 14                            | 12                                | 12                               |
| DH Lloyd           | \$ 350,000              | 10                             | 11                            | 3                                 | 3                                |
| Session Title      | \$ 120,000              | 4                              | 3                             | 3                                 | 3                                |
| Virilion           | \$2,150,000             | 53                             | 58                            | 14                                | 14                               |
| <b>TOTAL</b>       | <b>\$10,465,897</b>     | <b>135</b>                     | <b>177</b>                    | <b>49</b>                         | <b>57</b>                        |

## **AUDITOR'S ASSESSMENT OF THE EFFECTIVENESS OF THE DISTRICT'S CAPCO PROGRAM**

The District's CAPCO program was enacted in March 2004 and the first CAPCO investment was made in May 2005. A best practice for evaluating CAPCO programs is for policymakers to take a long-term perspective. In addition, legislators are advised to, "expect no measurable impact for at least five years and do nothing to compromise the integrity of the investment process."<sup>35</sup> Even though at the time of the audit, the District's CAPCO program existed for only four years instead of the recommended five years, it is clear that the District's CAPCO program has not had the desired economic impact.

CAPCOs invested \$22 million in businesses through the District's CAPCO program. A total of 205 individuals were employed by businesses that received CAPCO funding. After receiving CAPCO funding, the number of individuals employed by these businesses increased by 31 to a total of 236. The number of employees of businesses that received CAPCO funding and resided in the District decreased from 98 residents to 96 residents. Table XIV presents the total amount of CAPCO funding and the total number of jobs and D.C. residents.

**Table XIV**  
**Total CAPCO Funding, Jobs, and DC Residents**

| <b>Total Number Qualified Businesses</b> | <b>Total amount of CAPCO funding</b> | <b>Total Employees before CAPCO funding</b>                                                                           | <b>Total Employees after CAPCO funding</b>                                                                            | <b>Total DC Residents before CAPCO funding</b>                                                                        | <b>Total DC Residents after CAPCO funding</b>                                                                         |
|------------------------------------------|--------------------------------------|-----------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|
| 15                                       | \$21,944,646                         | 205*                                                                                                                  | 236*                                                                                                                  | 98*                                                                                                                   | 96*                                                                                                                   |
|                                          |                                      | <i>*Adjusted for 51 employees of Qualified Businesses that received certified capital from Advantage and Enhanced</i> | <i>*Adjusted for 91 employees of Qualified Businesses that received certified capital from Advantage and Enhanced</i> | <i>*Adjusted for 17 employees of Qualified Businesses that received certified capital from Advantage and Enhanced</i> | <i>*Adjusted for 25 employees of Qualified Businesses that received certified capital from Advantage and Enhanced</i> |

The District's CAPCO program cost \$76 million, \$54 million in set-up costs and \$22 million in investments. For \$76 million, 31 new jobs were created. The number of District residents employed by businesses that received CAPCO funds decreased by 2. Table XV presents total costs to set-up each CAPCO and the total amount of CAPCO funding.

<sup>35</sup> Growing New Businesses with Seed and Venture Capital: State Experiences and Options, Robert Heard and John Sibert, Phd., page 17.

**Table XV**  
**Total Costs to Set-Up and Fund CAPCOs**

|              | <b>Total Cost to Set-Up<br/>CAPCO *</b> | <b>Total Amount of<br/>CAPCO funding</b> | <b>Total CAPCO funding<br/>and Set-Up Cost</b> |
|--------------|-----------------------------------------|------------------------------------------|------------------------------------------------|
| Advantage    | \$13,753,764                            | \$ 5,047,949                             | \$18,801,713                                   |
| Enhanced     | \$16,288,712                            | \$10,465,897                             | \$27,532,191                                   |
| Wilshire     | \$23,144,718                            | \$ 6,430,800                             | \$29,575,518                                   |
| <b>Total</b> | <b>\$53,187,194</b>                     | <b>\$21,944,646</b>                      | <b>\$75,909,422</b>                            |

*\*Set-up Costs includes formation, operation, management, insurance financing, and repayments to insurance companies of loans and interest.*

The District's CAPCO program was designed to stimulate local business development through job creation, increased income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues. The 31 jobs created by the CAPCO program is not the return that the District expected from the \$76 million investment. Thirty-one (31) jobs will not yield the District sufficient tax revenue to offset insurance premium tax credits. In addition, the CAPCO program failed to meet the goal of stimulating the creation of high-wage jobs and fostering a local venture capital infrastructure within the District<sup>36</sup>.

The District's CAPCO program was not the only program that experienced low job creation. Florida lost more than 150 jobs after the initial \$150 million investment in their CAPCO program. According to a February 9, 2004, Denver Post article, the New York CAPCO program lost 88 jobs and cost \$280 million.<sup>37</sup> The Missouri Auditor found that the Missouri CAPCO program did not produce enough state revenue to offset costs of premium tax credits. Legislators in Wisconsin and Florida decided not to provide additional funding for CAPCO programs in their states.

Numerous reports state that the CAPCO program is not the most effective vehicle to increase economic development. An assessment of the Colorado CAPCO program found: "the principal problem with the CAPCO program is the large share of funds (40-60 percent) raised that are not available for investing in qualified businesses because they are held in government securities to guarantee the insurance company's initial investments." Based on an economic impact analysis, the Missouri State Auditor reported that the Missouri Certified Capital Company Tax program was, "an inefficient and ineffective tax credit program."<sup>38</sup>

<sup>36</sup> The June 27, 2003, report on the Act by the Council of the District of Columbia's Committee on Consumer and Regulatory Affairs.

<sup>37</sup> SSTI Weekly Digest, March 12, 2004.

<sup>38</sup> Review of State Tax Credits Administered by the Department of Economic Development, Missouri State Auditor's Office, July 2, 2004, page 2.

Despite the failure of the District's CAPCO program to increase economic development, insurance companies will receive guaranteed returns on their investments in CAPCOs. In addition, insurance companies will receive the full insurance premium tax credit regardless of the success of businesses that received CAPCO funds.<sup>39</sup> Further, CAPCOs could profit from a share of profits when a CAPCO's investment in a business pays off through the sale of the business or the issuance of stock. The Act does not provide similar financial rewards for the District.

A report by Robert Heard and Dr. John Sibert titled Growing New Businesses with Seed and Venture Capital: State Experiences and Options stated: "The best programs treat the state as a valued financial partner, not as a chump. When states commit capital, support programs with tax incentives, or bear risk in any way, they should be compensated with an opportunity for a financial return commensurate with the risk they take."<sup>40</sup>

## **CONCLUSION**

The purpose of the Certified Capital Companies Act of 2003 (Act) was to stimulate the growth of small and start-up businesses in the District of Columbia. The District sacrificed insurance premium tax revenues in exchange for anticipated economic growth through income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues.

The CAPCO program has fallen short of achieving the desired impact on economic development in the District of Columbia. The District's CAPCO program cost \$76 million, \$54 million in set-up costs and \$22 million in investments. For \$76 million, 31 new jobs were created. The number of District residents employed by businesses that received CAPCO funds decreased by 2.

The CAPCO program was poorly managed by the Department of Insurance, Securities and Banking (DISB). DISB misinterpreted key provisions of the Act and failed to consistently comply with statutory mandates. In addition, DISB did not administer the CAPCO program in a manner that maximized economic development in the District of Columbia.

Many states found CAPCO programs to be inefficient and expensive. In light of disappointing results from CAPCO programs in Colorado, Missouri, Wisconsin, and Florida, DISB should have meticulously managed the District's CAPCO program to avoid similar results. Instead DISB:

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<sup>39</sup>State Science & Technology Institute (SSTI) Weekly Digest, March 12, 2004.

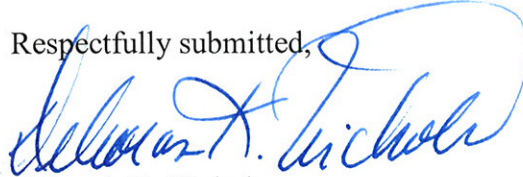
<sup>40</sup> Growing New Businesses with Seed and Venture Capital: State Experiences and Options by Robert G. Heard and John Sibert, PhD., page 18.

- Failed to verify information presented in Qualified Business applications.
- Failed to conduct mandated annual reviews of CAPCOs.
- Certified businesses to participate in the program that did not meet CAPCO requirements.
- Failed to encourage CAPCOs to invest in businesses that complied with CAPCO's investment strategies.
- Failed to establish a standard to measure the economic impact of the CAPCO program.

In conclusion, DISB did not effectively manage the CAPCO program. As a consequence, the CAPCO program failed to achieve the goal of stimulating local business development through job creation, increasing income tax revenues from salaries paid to District residents who were employees of CAPCO businesses, sales tax revenues from the purchase of goods and services from these businesses, and business tax revenues. The CAPCO program will not produce enough tax revenue to offset insurance premium tax credits. The CAPCO program has had a negligible impact on economic development in the District of Columbia. Clearly, the costs of the CAPCO program outweigh the benefits.

The Council of the District of Columbia should terminate the CAPCO program.

Respectfully submitted,



Deborah K. Nichols  
District of Columbia Auditor

# **AGENCY COMMENTS**

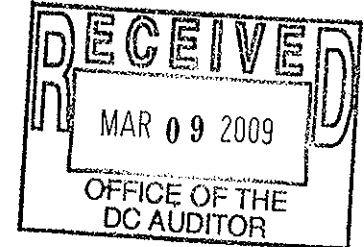
## **AGENCY COMMENTS**

On February 25, 2009, the Office of the District of Columbia Auditor submitted a report in draft for review and comment to the Department of Insurance, Securities and Banking. The Auditor received written comments from the Department of Insurance, Securities and Banking on March 6, 2009. The written comments from the Department of Insurance, Securities and Banking along with the Auditor's response to the comments are included in their entirety with this report.

**Government of the District of Columbia**  
**Department of Insurance, Securities and Banking**



**Thomas E. Hampton**  
**Commissioner**



March 3, 2009

Ms. Deborah K. Nichols  
District of Columbia Auditor  
Office of the District of Columbia Auditor  
717 14<sup>th</sup> Street, NW, Suite 900  
Washington, DC 20005

Re: Agency Comments on Draft Report of the Audit of the Certified Capital  
Companies Program

Dear Ms. Nichols:

The Department of Insurance, Securities and Banking (the "Department", "Agency" or "We"). We have received and reviewed your draft report entitled, "Certified Capital Companies Program" and we are providing you with our comments on the draft report. I would like first to thank you and your staff for conducting a thorough audit of the Certified Capital Companies ("CAPCO") program. Your findings and recommendations will assist us in our efforts to amend the CAPCO law, as well as our oversight of the program. In fact, we have already incorporated many of your comments and recommendations into the proposed legislative amendments that we believe will greatly enhance the benefits of the program, and improve our ability to regulate the CAPCOs and the businesses that receive CAPCO funding. The Department does, however, take exception to some of your findings and recommendations, as more fully set forth below.

In the Background Section of the report you write, "The loss of revenue, due to insurance premium tax credits, will occur in each succeeding fiscal year between fiscal years 2009 and 2012 until the maximum \$50 million in tax credits are claimed." The statement is incorrect and misleading in that it suggests that the Certified Investors (insurance companies) will claim the entire \$50 million in premium tax credits during the aforementioned years. It is incorrect and misleading because it is not possible to compute at this time the value of the tax credits that will be claimed by the insurance companies in fiscal year 2009 and beyond. The statement is misleading because it omits the fact that the three CAPCOs have invested approximately \$22 million dollars in District-based businesses to date, and no premium tax credits have been claimed by the Certified Investors to date. This is an important aspect of the CAPCO program that should not be omitted from the background section.

Letter to Deborah Nichols, DC Auditor  
Re: Agency Comments on Draft Report of the Audit  
of the Certified Capital Companies Program  
March 3, 2009  
Page 2 of 6

We also take exception to your characterization of the “key” requirements of the CAPCO laws and regulations, also in the background section. There are several key parts of the CAPCO law and regulations, such as the investment milestones that must be adhered to in order for the CAPCOs to avoid decertification, the fifteen percent (15%) investment limitation in a single qualified business, the entire section regarding decertification, and the allocation and transfer of premium tax credits, all of which are essential provisions of the CAPCO law because of the potential fiscal impact to the District, and the economic development impact of the CAPCO program on the District’s economy. We think the key provisions are unfairly prejudicial because the audit report’s characterization of the “key” provisions of the CAPCO law and regulations happen to correspond to those aspects of the CAPCO program that your office concluded needed improvement.

The discussion of the first finding, “The Department of Insurance, Securities and Banking Failed to Verify Information Presented on Qualified Business Applications” is incorrect, incomplete and misleading. First and foremost it is incorrect to say that the Department failed to review the information provided in the qualified business applications. The audit report focuses on the payroll reports of Create Hope, Inc., and concludes that, because the June 28, 2006 payroll report showed that two employees who supposedly lived on Woodley Place in the District paid taxes in Virginia, Create Hope did not have the minimum number of District resident employees at the time it received its CAPCO investment to satisfy the qualified business provision. The conclusion in this regard relies on a faulty assumption. The fact that persons who claimed to be residents of the District, but paid Virginia taxes does not necessarily support a conclusion that such persons were not residents of the District. It is equally plausible that such persons were in fact District residents, but did not file their income tax returns in the appropriate jurisdiction. To illustrate this point, the Department sought documents from employees of one qualified business to verify that that were in fact District residents at the time of funding. We requested a government-issued identification and one other proof of residency such as telephone or utility bill, car title or other similar document that would establish proof of residency in the District. The Department was provided with copies of passports from several employees claiming to be District residents. The Department questioned why none of these employees provided copies of their drivers’ licenses. Upon further inquiry, we determined that these employees were living in the District, but had failed to obtain a drivers’ license from DDOT. The fact that these employees had failed to obtain a District drivers’ license did not mean they had failed to establish residency in the District. Rather, it established that those persons had failed to comply with the motor vehicle laws of the District. Furthermore, the Auditor does not mention that the residency and other requirements must be satisfied “as of the time of the Certified Capital Company’s initial investment in the business.” See § 2(12)(A). The Auditor’s review of a payroll report would not disclose whether one or more employees temporarily established residency in the District so the business would qualify for CAPCO funding. The Department has no statutory authority to request information from qualified businesses, and the Auditor does not mention that the CAPCO law fails to provide the Department statutory authority to require the

Letter to Deborah Nichols, DC Auditor  
Re: Agency Comments on Draft Report of the Audit  
of the Certified Capital Companies Program  
March 3, 2009  
Page 3 of 6

qualified businesses to file of information or submit to examinations or audits by the Department. In conclusion, the Auditor and her staff spent nine months reviewing the residency information in connection with approximately forty-nine (49) investments, and found only a few problems in this area. The Department, on the other hand, is forced by statute to verify information within 15 days of receipt of the qualified business application and supporting documents, and must do so without any statutory authority to verify the information or ability to prohibit the CAPCOs from going forward with proposed investments without the Department's prior approval. It is worth noting that the Auditor failed to recommend a statutory change that would strengthen the Department's oversight in this regard. This, in the Department's opinion, reflects the Auditor's failure to fully understand and appreciate the operation of the CAPCO program and the limitations the Department must operate under. As a result of these shortcomings in the CAPCO law, the Department has prepared legislative amendments that will strengthen the Department's oversight of both the certified capital companies and the qualified businesses that receive CAPCO funding.

The discussion of the Auditor's second finding, "The Department of Insurance, Securities and Banking Failed Awarded Qualified Business Status to Businesses That Did Not Meet the Requirements of the Act" is incorrect and an inappropriate criticism of the Department for exercising appropriate discretion in its administration of the CAPCO program.

### **NuAmerica Bank**

The Auditor is correct when she indicates that the Department provided Advantage Capital DC Partners, LLC with a letter stating that NuAmerica Bank was a qualified business when it was still in the formation stage, and had no employees. The Auditor is also correct when she states that the Department could have waived one or more of the qualified business requirements, including the residency and number of employees employed in the District. It is, however, inappropriate to draw a conclusion that the Department failed to follow the law in granting qualified business status to NuAmerica Bank. The Department's Banking Bureau worked closely with NuAmerica officials over an extended period during NuAmerica's effort to obtain a bank charter in the District. NuAmerica planned to open a bank in the Adams Morgan community. The Department consciously granted the qualified business status to NuAmerica Bank to ensure that NuAmerica would have to comply with all of the residency and employee requirements when it commenced operations. We believe strongly that this was a much better approach than waiving one or more of the residency and employee requirements. To do so would have relieved NuAmerica of any obligation to employ District residents.

### **CreateHope**

In the matter of CreateHope, the Auditor raises a compliance issues that does not exist. The Auditor concludes that the Department failed to follow the law by providing Enhanced Capital

Letter to Deborah Nichols, DC Auditor  
Re: Agency Comments on Draft Report of the Audit  
of the Certified Capital Companies Program  
March 3, 2009  
Page 4 of 6

with a qualified business letter for CreateHope at a time when CreateHope was still located in Bethesda, Maryland. The purpose of the CAPCO program is to increase and enhance economic activity in the District. The Department strenuously objects to the Auditor's conclusion that it acted improperly by providing Enhanced Capital with a letter opining that CreateHope, a then Maryland-based business, would be a qualified business if it were headquartered in the District, and giving the business a reasonable time to relocate to the District. The Department's letter clearly indicated that it was not waiving the requirement that the business be headquartered in the District, or any of the other qualified business requirements. And, after receiving the Department's letter, CreateHope relocated to the District, and received CAPCO funding after it had relocated to the District. This is precisely the outcome the Department wanted to achieve, and it did so without violating the law. Moreover, the Auditor ignores a very important provision in the very law, i.e., the qualified business letter is optional. That is, a CAPCO is not required to seek the Department's determination that a business is a qualified business prior to funding the business. The CAPCO could have simply waited for CreateHope to relocate to the District and then make its investment. However, CreateHope reasonably did not want to incur the cost and inconvenience of relocating its offices and employees to the District, only to be told after the fact that it would not be considered a qualified business. The Auditor focuses on the date the Department issued the letter, and in doing so, construes the law incorrectly and too rigidly in light of the purpose of the law, the Department's reasonable discretion in administering the program, and in light of prudent business practices. In doing so, the Auditor improperly concludes the Department violated this provision of the law when in fact it did not.

The discussion of the Auditor's third finding, "The Commissioner of DISB did not Conduct Annual Reviews of CAPCOs, as Required by D.C. Act 15-254§ 8(a)" is correct, but fails to put this issue in context and does not address the Department's limited authority to collect the necessary information. As stated previously, the CAPCOs have the full authority under the CAPCO law to invest in businesses without obtaining the Department's prior approval, or even notifying the Department of their investments before or after the fact. The only purpose of conducting the annual review is to determine whether the businesses that have received CAPCO funding are "qualified businesses" as defined by the CAPCO Act. Department and the three CAPCOs agreed that no businesses would be funded unless the CAPCOs first filed a request with the Department seeking a letter indicating whether a business was a qualified business for purposes of the Act. At the time, it was thought that this arrangement would eliminate the need to conduct the annual review because the Department would be reviewing the same information it had already been provided and approved. The Department has since reconsidered its obligations under this provision, and is currently performing annual reviews of the three CAPCOs. In addition, the Department has proposed legislative amendments that would, among other things, give the Department the necessary authority to obtain information that will be helpful in determining whether the qualified businesses are in compliance with the CAPCO Act.

Letter to Deborah Nichols, DC Auditor  
Re: Agency Comments on Draft Report of the Audit  
of the Certified Capital Companies Program  
March 3, 2009  
Page 5 of 6

The Department disagrees with the Auditor's fourth finding that the "Annual Audited Financial Statements Were Based on False Assumptions." The Auditor indicates that the CAPCOs' independent auditors relied on the assumption that the Department had reviewed the qualified businesses, which was incorrect because the Department did not verify information on the qualified business applications. The Department acknowledges that it could do more to verify employment information submitted in connection with the qualified business applications, but disagrees that it did not do any verification of the information provided in the qualified business applications. As stated previously, the Department does review the information provided in the qualified business applications. The real issue here is how much review should be undertaken, which the Auditor appropriately raises. The Department believes the proposed amendments will provide additional authority to address the Auditor's concerns. As a result, the changes will provide the CAPCOs' auditors with more reliable data upon which to reach their opinions.

The Department disagrees with the Auditor's fifth finding that the "A CAPCO Qualified Business Obtained \$9 Million in Equity Financing From Investors Yet Claimed in its Application that it Could not Obtain Conventional Financing." The Auditor's discussion on this purported violation highlights a problem with the law, which the Department agrees should be amended. The Department, however, denies that it failed to properly administer the law in this area. Section 2(12)(A)(v) of the CAPCO law states that a qualified business is one that, among other things, certifies that it was unable to obtain conventional financing. GridPoint so certified its inability to obtain conventional financing. The Auditor draws an erroneous conclusion from the fact that GridPoint had grown since 2003 and energy awareness was increasing, and the fact that the federal Energy Policy Act of 2005 encouraged consumers to take advantage of GridPoint's technology, and federal agencies were using GridPoint's products to comply with the Energy Policy Act. The Department respectfully counters that none of the facts the Auditor uses supports the conclusion she has drawn. First and most importantly, GridPoint satisfied the requirements of the law. In addition, subsequent to the CAPCO's investment, GridPoint raised \$80 million in venture funding. The Department doubts GridPoint would have opted for funding from venture capitalists if qualified for conventional bank financing. The Department agrees with the Auditor that the section of the CAPCO law requiring a qualified business to certify its inability to obtain conventional financing should be amended to clarify and strengthen this important provision.

The Department disagrees with the Auditor's sixth finding that "CAPCOs Invested Over \$13 Million in Companies That Did Not Consistently Comply with CAPCO's [sic] Investment Strategies and Business Plans." The Department agrees that the CAPCOs have made investments in businesses that were not in the industries set forth in their business plans, but the Department believes it is an overstatement to use the word "consistently." For example, the Auditor suggests that Advantage has invested in businesses that are engaged in business that are inconsistent with those described in its investment strategy and business plan. We believe that one category of companies described in Advantage's application, "Business Services," is broad

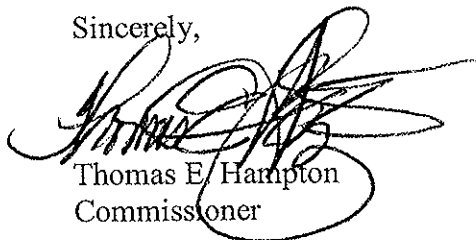
Letter to Deborah Nichols, DC Auditor  
Re: Agency Comments on Draft Report of the Audit  
of the Certified Capital Companies Program  
March 3, 2009  
Page 6 of 6

enough to include Inside Higher Ed, Nu America Bank and AV Smoot because media, banking and construction, respectively, can easily be found to be consistent with the broad category of "business services." It is also worth repeating that the CAPCOs have the statutory authority to invest in any business that satisfies the definition of a qualified business. CAPCOs are statutorily authorized to invest in any business, except businesses engaged in professional services provided by accountants, lawyers, and physicians, notwithstanding any statements in their business plans. Section 2(12)(B). The Department has proposed legislative amendments that will promote the funding of businesses in particular industries consistent with the Mayor's economic development plans for the District.

In conclusion, I thank you again for the opportunity to review and comment on the draft report. You and your staff have worked diligently to identify problems with the CAPCO program, and make recommendations to improve the program's benefits to the District. In this regard, the audit report will be very useful. The primary shortcoming of the audit report is that in most respects it overstates the nature of the problems by failing to mention that the vast majority of investments undertaken by the certified capital companies were made in compliance with the CAPCO law and regulations. For example, the report mentions that two businesses certified by the Department failed to meet the qualified business requirements, but it does not mention that there were approximately forty businesses that received funding that did meet those requirements. As a result, a reader of the report may conclude that the Department has completely failed in its oversight of the CAPCO program when that is simply not the case. The audit report could be vastly improved if it provided a more balanced assessment of the CAPCO program, which would provide District policymakers with a better understanding of those areas that work as well as those areas that need improvement.

If you have any questions, please contact me.

Sincerely,



Thomas E. Hampton  
Commissioner

TEH/DS/cws

## **AUDITOR'S RESPONSE TO DISB'S COMMENTS**

The Auditor appreciates comments on the draft of this report that were provided by the Department of Insurance, Securities and Banking (DISB). The Auditor made revisions to the final report as appropriate, based on the comments. Also, the Auditor offers the following response to certain DISB comments.

1. **DISB Comment:** DISB disagreed with the statement that, "The loss of revenue, due to insurance premium tax credits, will occur in each succeeding fiscal year between fiscal years 2009 and 2012 until the maximum \$50 million in tax credits are claimed." According to DISB, this statement is misleading because, "it omits the fact that the three CAPCOs have invested approximately \$22 million dollars in District-based businesses to date, and no premium tax credits have been claimed by the Certified Investors to date."

**Auditor's Response:** The Auditor notes that Certified Investors have not claimed the premium tax credit to date because under the Act Fiscal Year 2009 is the first time that the insurance premium tax credit is available. The Auditor stands by the Chief Financial Officer's statement that the revenue impact of the CAPCO program will begin in Fiscal Year 2009 with a loss of \$12.5 million in tax revenue resulting from the use of insurance premium tax credits. The loss of revenue due to insurance premium tax credits will occur in each succeeding fiscal year between fiscal years 2009 and 2012 until the maximum \$50 million in tax credits are claimed.

2. **DISB Comment:** DISB objected to the Auditor's characterization of the "key" requirements of the CAPCO laws. DISB noted that the "key provisions of the CAPCO law and regulations happen to correspond to those aspects of the CAPCO program that your office concluded needed improvement."

**Auditor's Response:** The Auditor agrees with DISB's comment and notes that the report states, "In addition to objectives set forth on page 1, the Auditor specifically focused" on the key requirements in conducting the audit.

3. **DISB Comment:** DISB objects to the Auditor's finding that DISB failed "to review the information provided in the qualified business applications." DISB notes that the Act does not provide "the Department statutory authority to require the qualified businesses to file of [sic] information or submit to examination or audits by the Department."

**Auditor's Response:** The Auditor stands by the finding that DISB failed to verify information presented on Qualified Business applications. While DISB notes that additional statutory authority, such as reducing the 15-day time limit would make it easier for DISB to verify information, the fact remains that DISB did not verify information presented on Qualified Business applications.

4. **DISB Comment:** DISB disagreed with the finding that NuAmerica Bank was awarded Qualified Business status despite the fact that NuAmerica Bank failed to meet the requirements of the Act. DISB asserts that "The Department consciously granted the qualified business status to NuAmerica Bank to ensure that NuAmerica would have to comply with all of the residency and employee requirements when it commenced operations."

**Auditor's Response:** The Auditor is not persuaded by DISB's circular reasoning and stands by the finding that NuAmerica Bank did not meet the requirements of the Act and DISB improperly awarded Qualified Business status to NuAmerica Bank.

5. **DISB Comment:** DISB disagreed with the finding that CreateHope was awarded Qualified Business status despite the fact that CreateHope did not have headquarters in the District. DISB states, "The Department strenuously objects to the Auditor's conclusion that it acted improperly by providing Enhanced Capital with a letter opining that CreateHope, a then Maryland-based business, would be a qualified business if it were headquartered in the District..."

**Auditor's Response:** The Auditor stands by the finding that CreateHope was not a Qualified Business because the business was not headquartered in the District. As DISB notes, "if it were headquartered in the District", CreateHope may have met the requirements to be properly certified as a Qualified Business. The fact of the matter is CreateHope was not headquartered in the District, as required by the Act to be certified as a Qualified Business.

6. **DISB Comment:** DISB objects to the Auditor's finding that the Commissioner of DISB did not conduct annual reviews of CAPCOs. DISB states that they reached an agreement with the CAPCOs not to conduct annual reviews. DISB further notes that they reconsidered this arrangement and currently DISB is performing annual reviews of the CAPCOs.

**Auditor's Response:** The Auditor maintains that since the inception of the CAPCO program until the time of the audit, DISB failed to comply with the requirement of D.C. Act 15-254 § 8 (a) to conduct annual reviews of CAPCOs.

7. **DISB Comment:** DISB disagrees with the finding that annual audited financial statements were based on false assumptions. DISB contends, "The real issue here is how much review should be undertaken..."

**Auditor's Response:** Regarding the verification of information presented in Qualified Business applications, the issue is not the extent of the review. The issue is that DISB failed to verify information presented in Qualified Business applications. As a result of this failure, CAPCO accountants based their financial statements on the incorrect assumption that DISB verified information presented in Qualified Business applications. The Auditor stands by the finding that annual audited financial statements were based on false assumptions.

8. **DISB Comment:** DISB states, "The primary shortcoming of the audit report is that in most respects it overstates the nature of the problems by failing to mention that the vast majority of investments undertaken by the certified capital companies were made in compliance with the CAPCO law and regulations." In support of this claim DISB states that 40 businesses received CAPCO funding.

**Auditor's Response:** DISB's statement that 40 businesses received CAPCO funding is inaccurate. Only 15 businesses received CAPCO funding.