

ANNUAL REPORT OF THE

OFFICE OF THE CHIEF COMPLIANCE OFFICER

JULY 1, 2009 – JUNE 30, 2010

INTRODUCTION:

The Office of the Chief Compliance Officer was created by 2005 Public Act 225. Its mission is to assist the Michigan Strategic Fund board of directors, the Strategic Economic Investment and Commercialization Board, and their employees and agents in carrying out the duties specified in Chapters 8A and 8B of the Michigan Strategic Fund Act. Those duties include awarding grants, loans, and contracts and making investments for economic development as part of the 21st Century Jobs Fund Programs.

The Office of the Chief Compliance Officer has certain responsibilities established by statute, which primarily involve recommending policies and procedures to the MSF board of directors and the SEIC Board and ensuring that those policies and procedures and related laws are followed by the boards and their agents and employees. In carrying out those responsibilities, the Chief Compliance Officer works closely with staff of the Michigan Economic Development Corporation, the Michigan Department of Attorney General, and the Credit Suisse Customized Fund Investment Group, which was hired by the MSF Board to carry out certain investment activities. Additional responsibilities of the Office of the Chief Compliance Officer added since it was first created include working with the Michigan Film Office and the MSF Board in the event funds are sought by production companies or film and digital media private equity funds under the MSF Board's loan enhancement program; and providing guidance in the area of conflicts of interest during the awarding of contracts for the Michigan tourism promotion program. And, pursuant to Executive Directive No. 2010-2, effective April 30, 2010, the Office of the Chief Compliance Officer now has similar responsibilities concerning the Michigan Economic Growth Authority and its board of directors and staff.

This annual report is prepared pursuant to the Michigan Strategic Fund Act and its requirement that the Chief Compliance Officer “[p]repare a written annual report that evaluates compliance with internal policies and procedures and with applicable state and federal law, explains any compliance matters that arose during the previous year, and suggests revisions to agency policies and procedures.”

A great deal of activity took place during the past year with respect to the 21st Century Jobs Fund Programs, including investments by the MSF Board with venture capital and mezzanine financing funds; and the continuation of previously established programs including the Centers of Energy Excellence; the Michigan Supplier Diversification Fund; and the Company Formation and Growth Fund. The existence of the Office of the Chief Compliance Officer proved highly useful during the course of these activities, and the willingness of all involved parties to accept the advice and incorporate the recommendations of the Chief Compliance Officer ensured that all applicable laws, policies, and procedures were followed. The activities of the Office are discussed in more detail below.

ACTIVITIES OF THE OFFICE OF THE CHIEF COMPLIANCE OFFICER RELATED TO THE MICHIGAN STRATEGIC FUND:

The Office of the Chief Compliance Officer was involved in continued work on the Centers of Energy Excellence program, the purpose of which is to promote the development, acceleration, and sustainability of energy excellence sectors in the state through collaboration between the private sector, academia, and government. This program awards grants only to for-profit companies for all of the following purposes:

1. Providing up to a 1-for-1 match for federal funding;
2. Supplementing in-kind contributions provided by a person or entity;
3. Accelerating the commercialization of an innovative energy technology or process; and
4. Activities of the center of energy excellence.

Over the course of the year, the Chief Compliance Officer reviewed the submissions of three companies to ensure that they complied with the application process established by the MSF Board. Upon receiving recommendations from the review committee, the MSF Board awarded \$14.5 million to the following companies:

1. The Dow Chemical Company (\$5 million to focus on low-cost carbon fiber materials for industrial applications, such as wind turbine blades);
2. Energetx Composites, LLC (\$3.5 million for wind turbine blade design); and
3. Astraeus Wind Energy, Inc. (\$6 million for wind turbine blade manufacturing).

Adaptive Materials, Inc. also received \$3 million in funding of a previously-conditional award due to the fact that the money was not available in the year in which the award was granted.

One of the previous awardees under the Centers of Energy Excellence program—A123 Systems, Inc.—also became the first company to receive a forgivable loan under the Choose Michigan loan program. In this regard, the Chief Compliance Officer reviewed and approved revised loan documents for A123 Systems. Additionally, 46 criminal and civil background checks were run to assure that A123 Systems met the requirements of the Michigan Strategic Fund Act. An additional awardee of a straight loan under the Choose Michigan loan program was Great Lakes Towers, LLC, now known as VenTower Industries. Twenty-four criminal and civil background checks were run with respect to this company, and the loan documents concerning its loan were reviewed and approved.

The Office of the Chief Compliance Officer was also involved in continued work on the Michigan Supplier Diversification Fund program, which was developed to provide assistance to businesses having difficulty raising capital due to the currently-constricted capital markets and which consists of two parts. The first of these is the Michigan

Collateral Support Program, which allows the Michigan Strategic Fund to deposit funds with a lender to supplement the collateral pledged by a qualifying company. The second is the Michigan Loan Participation Program, which allows the MSF to purchase a less than 50 percent interest in a bank loan to a qualifying company. Work by the Chief Compliance Officer included running a total of 177 background checks on 13 awardees to assure that they met the requirements of the Michigan Strategic Fund Act. Two awardees each had a significant due diligence issue, which was successfully resolved after review of related records and discussions with the awardee. The bank deposit agreements for nine awardees that successfully completed the due diligence review process were reviewed and approved.

During the year, the Office of the Chief Compliance Officer also worked with Credit Suisse Customized Fund Investment Group, which has been hired to find prominent private equity, venture capital, and mezzanine funds in which to invest \$114 million of funds appropriated to the 21st Century Jobs Fund. In this regard, the Chief Compliance Officer reviewed and approved the limited partnership agreement and the side letter agreement into which Credit-Suisse entered with each of Early Stage Partners II, L.P., a venture capital fund, and Peninsula Fund V, L.P., a mezzanine fund, with which the MSF Board authorized investments of \$6.0 million and \$14.5 million, respectively; the latter investment was later rescinded. Credit-Suisse agreed with all recommendations of the Chief Compliance Officer and took all steps necessary to assure that those recommendations were implemented.

The Chief Compliance Officer also reviewed materials related to one potential investment brought to the MSF Board by Credit-Suisse. In February, 2010, Pegasus Partners V, L.P., a private equity fund, was selected for an investment of up to \$10.0 million.

Another existing program with which the Office of the Chief Compliance Officer was involved is the Company Formation and Growth Fund. This program established an eight million dollar fund to lend money to companies either formed by ex-Pfizer employees or which hire ex-Pfizer employees who lost their jobs due to the 2007 downsizing of Pfizer Corporation in the State of Michigan. Permissible uses of the funds include hiring ex-Pfizer employees, purchasing Pfizer equipment, or leasing space in former Pfizer facilities.

The Chief Compliance Officer undertook due diligence on eight companies and their personnel during the year. As required by the MSF Act, background checks were run for the purpose of ensuring that money expended was not used for loans to persons convicted of certain criminal offenses or held liable in certain civil proceedings described in the Act. A total of 84 background checks were completed. Five loan agreements were thereafter reviewed and approved for the awardees under this program.

In sum, the Office of the Chief Compliance Officer was involved in the implementation of the Centers of Energy Excellence and the Michigan Supplier Diversification Fund programs, both of which are designed to create jobs and diversify the economy in

Michigan. This Office also reviewed potential investments in venture capital and mezzanine financing firms, and companies seeking to make use of Pfizer assets. Issues that arose during these processes generally involved questions of what the Michigan Strategic Fund Act requires and how that needs to be implemented. In all cases, recommendations by the Chief Compliance Officer were followed, and hence all parties involved were in compliance with all applicable laws, policies, and procedures during the period covered by this report.

ACTIVITIES OF THE OFFICE OF THE CHIEF COMPLIANCE OFFICER RELATED TO THE MICHIGAN STRATEGIC ECONOMIC INVESTMENT AND COMMERCIALIZATION BOARD:

Due to budgetary constraints this year, the Strategic Economic Investment and Commercialization Board did not hold a competition related to competitive-edge technologies as it did in 2006 and 2008. Instead, the Board approved a plan to hold a competition to choose two or more accelerator funds to fund companies at the earliest stages of growth.

Work by the Office of the Chief Compliance Officer for this project included reviewing and approving a request for proposals, which was issued by the SEIC Board. Additional work involved the selection of an independent peer review expert. The Office of the Chief Compliance Officer also answered questions concerning whether Board members had conflicts of interest in discussing and voting on particular applicants for an award; two Board members recused themselves in accordance with the opinion of the Chief Compliance Officer.

This year the Chief Compliance Officer again undertook a review of the online information related to the 78 awardees of the 2006 SEIC Board competition; 74 were actually reviewed as three awardees for various reasons did not proceed with their proposed activities and one awardee paid back its loan. The purpose of the review was to assure that the awardees were in compliance with the semi-annual and annual reporting requirements of their grant and loan agreements for the 2009 calendar year and to make any necessary recommendations. Compliance with the reporting requirements improved over previous calendar years and exceeded 90 percent compliance in the three categories reviewed (progress reports, site visits, and financial reports). Recommendations related to the reporting process were provided to the MEDC and have been implemented.

The Chief Compliance Officer also undertook a review of the online information related to the 18 awardees of the 2008 SEIC Board competition. This was done for the same purpose as for the 2006 awardees. Compliance with the reporting requirements approached 100 percent in this first review of reporting requirements for these awardees.

Finally, it should be noted that 10 awardees of the 2006 SEIC Board competition received their final disbursements because they successfully completed the projects they had outlined which led to their winning an award, bringing the total number of successful projects to fifteen.

In sum, the Strategic Economic Investment and Commercialization Board began work related to a competition for accelerator funds. Issues that arose during this process involved conflict of interest questions and the requirements of the Michigan Strategic Fund Act. Additionally, the Office of the Chief Compliance Officer took steps to monitor previously-existing programs for compliance issues. In all cases,

recommendations by the Chief Compliance Officer were followed, and hence all parties involved were in compliance with all applicable laws, policies, and procedures during the period covered by this report.

EFFECTIVENESS OF POLICIES AND PROCEDURES:

The policies and procedures employed by the Michigan Strategic Fund Board, the Strategic Economic Investment and Commercialization Board, and the Michigan Economic Development Corporation, and monitored by the Office of the Chief Compliance Officer, worked extremely well during the past year.

The Office of the Chief Compliance Officer received one inquiry concerning compliance with the requirements of the Michigan Strategic Fund Act by the Strategic Economic Investment and Commercialization Board. This potential compliance issue related to the fact that in 2009 the SEIC Board did not hold a \$25 million competition to award grants and make loans for competitive edge technologies. Such a competition was called for in the first iteration of the 21st Century Jobs Fund legislation, to be funded from an anticipated appropriation of \$75 million. A review of the facts revealed that subsequent changes to the law requiring additional programs and two reductions in the 2009 appropriation rendered it impossible to fund a \$25 million competition. Research of opinions of the Attorney General showed that such reductions are legal and that the statutory language at issue merely stated an intent to appropriate a certain sum for a certain purpose and thus was not binding. Based upon the facts and law, the Chief Compliance Officer concluded that no violation of the Michigan Strategic Fund Act occurred.

To the extent that any other issues arose during the course of the year, these were addressed and resolved in accordance with the guidance and recommendations of the Office of the Chief Compliance Officer.

Consequently, no substantive changes are recommended to existing policies and procedures. The Office of the Chief Compliance Officer will continue to monitor the policies and procedures employed by the Michigan Strategic Fund Board and the Michigan Economic Development Corporation to assure continued compliance with the law by all parties, both for new and existing programs and investments; it is noted that the Strategic Economic Investment and Commercialization Board has been abolished pursuant to Executive Order No. 2010-8, effective October 18, 2010.

Respectfully submitted,

John D. Walter
Chief Compliance Officer
Office of the Chief Compliance Officer

ADDENDUM:

While there are no reporting requirements associated with the additional responsibilities assigned to the Office of the Chief Compliance Officer concerning the Michigan Economic Growth Authority, it is noted that the Office undertook 354 civil and criminal background checks, reviewed and approved 14 MEGA credit agreements, and reviewed the files associated with eight tax credit certificates during the period covered by this annual report.