

**ANNUAL REPORT OF THE**

**OFFICE OF THE CHIEF COMPLIANCE OFFICER**

**JULY 1, 2008 – JUNE 30, 2009**

## **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 21<sup>st</sup> 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.

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 21<sup>st</sup> Century Jobs Fund Programs, including investments by the MSF Board with venture capital and mezzanine financing funds; the completion of the second competition for competitive edge technologies by the SEIC Board; and the continuation of the program to help retain Pfizer Corporation employees and assets affected by the 2007 downsizing of Pfizer in the State of Michigan. New programs were also created, including the Centers of Energy Excellence and the Michigan Supplier Diversification Fund programs. 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 the creation and implementation of 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 to for-profit companies for any of the following purposes:

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

Initial work on this program included review of the Michigan Strategic Fund Act and recommendations to Michigan Economic Development Corporation personnel concerning statutorily-required steps to take to establish the program, including appropriate measures to ensure that any members of the review committee appointed by the Michigan Strategic Fund Board did not have any conflicts of interest with any potential applicants. The MSF Board thereafter established the COEE program.

Over the course of the year, the Chief Compliance Officer reviewed the submissions of eight 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 \$43 million to the following six companies:

1. A123 Systems, Inc. (\$10 million for lithium-ion battery production);
2. American Process Inc. (\$4 million for a biorefinery);
3. Mascoma Corporation (\$20 million for a cellulosic ethanol facility);
4. Sakti3, Inc. (\$3 million for advanced battery technologies and processes);
5. Swedish Biogas International, LLC (\$4 million for a waste to bio-methane production plant); and
6. Working Bugs, LLC (\$2 million for a biorefinery).

Adaptive Materials, Inc. received a conditional award due to the fact that the money appropriated for the COEE program was previously committed to the other six projects.

Additional work by the Chief Compliance Officer on the COEE program included review and approval of the grant agreements for the awardees, a determination that Mascoma's engineering firm needed to establish an office in the State of Michigan to meet the requirements of the MSF Act, and a determination that there was no basis to an allegation by the eighth applicant of a potential conflict of interest with respect to the review of its application, which was not approved for an award.

One of the 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 the loan documents for A123 Systems. An opinion was also rendered at the request of Michigan Economic Development Corporation legal counsel to the effect that the loan documents were required by statute to contain language clearly enumerating the terms and conditions related to job creation for the loan to be forgivable. In this instance, A123 Systems has committed to create 350 jobs.

The Office of the Chief Compliance Officer was also involved in the creation of 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 the review, amendment, and approval of a variety of documents related to these programs, including program guidelines and contractual agreements with involved parties.

With respect to previously-established programs, the Office of the Chief Compliance Officer was involved in activities related to 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 21<sup>st</sup> Century Jobs Fund.

The Chief Compliance Officer reviewed and approved the limited partnership agreement and the side letter agreement into which Credit-Suisse entered with Maranon Mezzanine Fund, the second mezzanine financing firm with which the MSF Board authorized an investment. 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 potential investments brought to the MSF Board by Credit-Suisse. In June, 2009, the following funds were selected for investments in the following amounts:

1. Arsenal Venture Partners II, L.P., a venture capital fund, up to \$5.0 million;
2. Early Stage Partners II, L.P., a venture capital fund, up to \$6.0 million;
3. Peninsula Fund V, L.P., a mezzanine fund, up to \$14.5 million; and
4. Triathlon Medical Ventures Fund II, L.P., a venture capital fund, up to \$10 million.

Credit-Suisse also has certain reporting requirements contained in the agreements into which it has entered with the Michigan Strategic Fund, those being the 21<sup>st</sup> Century

Investment Fund Manager Agreement and the Michigan 21<sup>st</sup> Century Investment Fund, L.P. Limited Partnership Agreement. This year the Chief Compliance Officer again undertook a review of the materials submitted by Credit-Suisse to assure that it was in compliance with its reporting requirements for the 2008 calendar year and to make any necessary recommendations. The materials which Credit-Suisse is required to provide include monthly reports, quarterly reports, and an annual report. Results of the review were discussed with Credit-Suisse and MEDC personnel and showed that Credit-Suisse is in compliance with its reporting requirements. Recommendations related to the reporting process were provided to the MEDC and have been implemented.

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 five 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 45 background checks were completed. Five loan agreements were thereafter reviewed and approved for the awardees under this program.

With respect to this program, the Office of the Chief Compliance Officer was also involved in a review of the files related to the 29 awardees of loans. The purpose of the review was to assure that the awardees are in compliance with the semi-annual and annual reporting requirements of their loan agreements and to make any necessary recommendations. Results of the review were discussed with MEDC personnel and showed that the awardees are generally in compliance with their reporting requirements. Recommendations related to the monitoring process were provided to the MEDC and are being implemented.

In sum, the Office of the Chief Compliance Officer reviewed 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 firms, 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. The Office of the Chief Compliance Officer also 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.

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

The Office of the Chief Compliance Officer was involved in activities related to the 2008 commercialization competition held by the Strategic Economic Investment and Commercialization Board. This \$30 million competition sought to find companies with products close to commercialization, rather than companies and organizations involved in applied or basic research. Throughout the year, the Chief Compliance Officer filled several roles, including giving advice and guidance to the SEIC Board and its members and to the peer review agency to assure the legality of its and their actions, and examining documents to ascertain statutory compliance.

Prior to the SEIC Board voting on any applications, activities of the Office of the Chief Compliance Officer included review and approval of the contract to be entered into with Business Engines, the peer review expert that had been chosen to review those applications for which the National Center for Manufacturing Sciences had a conflict; direction to NCMS that its recommendations had to be based on the objective results of the peer review process rather than subjective beliefs concerning the viability of any particular project; and review and approval of a process to standardize the written evaluation of applications between NCMS and Business Engines. The Chief Compliance Officer also reviewed and determined in 35 situations whether conflicts of interest existed for SEIC Board members, and in one case for a peer review panelist; the existence of any potential conflicts of interest had been requested from board members, applicants, and the peer review experts in accordance with the process adopted for the 2008 competition. All of this work culminated in the SEIC Board awarding 17 applicants a total of almost \$30 million in October, 2008.

Subsequent to the awards, the Chief Compliance Officer reviewed and approved the convertible loan agreement and the warrant agreement to be used to contract with the awardees. The Chief Compliance Officer also reviewed and determined in two situations whether conflicts of interest precluded staff of the Michigan Economic Development Corporation from working with awardees. No conflict was found where the MEDC had made a prior investment in an awardee; a conflict was found where a portfolio manager assigned to an awardee had a previous business arrangement with one of its executives.

The Office of the Chief Compliance Officer also undertook to run background checks on the awardees. Ultimately, 367 criminal and civil background checks were run on 21 awardees to assure that the awardees met the requirements of the Michigan Strategic Fund Act; four of the original 17 awardees either withdrew or could not reach acceptable terms for a loan, and thus had been replaced with four additional awardees. Due diligence uncovered three awardees with significant due diligence issues, which were successfully resolved after research and review of related records and discussions with

counsel. Loan agreements for all awardees that successfully completed the due diligence process during the year were reviewed and approved.

This year the Chief Compliance Officer again undertook a review of the files and online information related to the 78 awardees of the 2006 SEIC Board competition; 75 were actually reviewed as 3 awardees for various reasons did not proceed with their proposed activities. 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 2008 calendar year and to make any necessary recommendations. Results of the review were discussed with MEDC personnel and showed good compliance with the reporting requirements. Recommendations related to the reporting process were provided to the MEDC and have been implemented.

Finally, it should be noted that five 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.

In sum, the Strategic Economic Investment and Commercialization Board completed its second competition which focused exclusively on commercialization projects, and which awarded grants or loans to 17 awardees totaling approximately \$30 million. Issues that arose during this process involved conflict of interest questions and the requirements of the Michigan Strategic Fund Act. 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 neither received, nor is aware of, any complaints concerning compliance with the requirements of the Michigan Strategic Fund Act by any of these entities. To the extent that 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, the Strategic Economic Investment and Commercialization 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.

Respectfully submitted,

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