

ANNUAL REPORT OF THE

OFFICE OF THE CHIEF COMPLIANCE OFFICER

JULY 1, 2006 – JUNE 30, 2007

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 Chapter 8A 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.

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 several venture capital and private equity funds, and the awarding of numerous grants and loans by the SEIC Board. 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 primarily involved in activities related to the hiring of the Credit Suisse Customized Fund Investment Group 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, and activities related to the actual investment of those funds. Throughout the year, the Chief Compliance Officer performed several functions, including advising the Michigan Strategic Fund Board to assure the legality of its actions, analyzing documents to ascertain statutory compliance, and resolving questions related to requirements of Chapter 8A of the Michigan Strategic Fund Act. The Chief Compliance Officer received significant cooperation from legal staff at the Michigan Economic Development Corporation and the Michigan Department of Attorney General, and counsel for Credit Suisse, such that all compliance issues were successfully resolved.

The process to choose a fund manager, which began prior to July 1, 2006, involved the issuance of a request for proposals and the selection of the Credit Suisse Customized Fund Investment Group to identify and recommend opportunistic investments. The Chief Compliance Officer reviewed, and if necessary recommended changes to, various agreements entered into between Credit Suisse and the Michigan Strategic Fund to ensure their compliance with the Michigan Strategic Fund Act. These included:

1. 21st Century Investment Fund Manager Agreement;
2. Michigan 21st Century Investment Fund, L.P. Limited Partnership Agreement;
3. Michigan 21st Century Investment Fund, L.P. Strategic Plan and Timeline; and
4. Request for proposals to solicit interested private equity, venture capital, and mezzanine funds.

Over the course of the year, the Chief Compliance Officer discussed and/or reviewed various agreements to be entered into between the Michigan 21st Century Investment Fund, L.P. and the private equity and venture capital funds selected by the Michigan Strategic Fund Board. The funds selected for investments during the period covered by this report include:

1. Nth Power;
2. Arboretum Ventures;
3. Venture Investors LLC;
4. EDF Ventures;
5. Quad Partners; and
6. Relativity Fund, L.P.

In this regard, the Chief Compliance Officer discussed statutory requirements with legal counsel for Credit Suisse. In all cases, recommendations by the Chief Compliance

Officer were implemented, including those for statutorily-required due diligence and incorporation of the following provisions of the Michigan Strategic Fund Act:

1. A prohibition against using the money for a stadium, arena, or casino;
2. A prohibition against providing money to persons convicted of certain crimes or held liable in certain civil proceedings, and in the other situations described in MCL 125.2088c(4); and
3. A requirement that the fund operate a business development office in Michigan staffed with a full-time equivalent employee, and fulfill the other requirements described in MCL 125.2088e or 125.2088f.

In other areas, the Office of the Chief Compliance Officer was involved as necessary in the development of the Choose Michigan Fund, a loan enhancement program, and in the issuance of the Retention of Pfizer Assets Toward the Advancement of Life Sciences Technologies Request for Proposals, to assure their compliance with the Michigan Strategic Fund Act.

In sum, Credit Suisse was hired to manage investments by the Michigan Strategic Fund Board, and six private equity or venture capital funds were chosen to receive investments. Issues that arose during this process 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:

The Office of the Chief Compliance Officer was primarily involved in activities related to the selection and funding of 78 awardees of grants and loans totaling \$126 million of funds appropriated to the 21st Century Jobs Fund. Throughout the year, the Chief Compliance Officer filled several roles, including giving advice and guidance to the Strategic Economic Investment and Commercialization Board and its members to assure the legality of its and their actions, overseeing and assisting with the performance of due diligence on awardees to make sure they met all statutory requirements to receive an award, and examining documents to ascertain statutory compliance.

The selection process, which began prior to July 1, 2006, initially involved the issuance of a request for proposals and the selection of the American Association for the Advancement of Science to identify and recommend applicants who met thresholds for scientific and technical merit, personnel expertise, commercial merit, and the ability to leverage additional funding. The Chief Compliance Officer's first involvement in the process to choose awardees was advising the SEIC Board and individual members thereof on appropriate procedures and actions to avoid any conflicts of interest during two separate votes on potential awardees. Areas covered included:

1. Advice to the entire Board on how to handle materials provided by AAAS to prevent conflicts of interest from arising;
2. Advice to a Board member to not participate in the interview phase of the process to choose awardees;
3. Advice to a Board member to not participate in the discussion of and vote on an applicant with which a former partner of the Board member was associated; and
4. Advice to a Board member whose organization provided free advice to a number of applicants without condition and without an expectation of profit that it was permissible to vote on those matters.

In September 2006 and October 2006, the SEIC Board awarded \$137 million to 85 awardees. The Chief Compliance Officer thereafter oversaw and in many cases undertook the performance of due diligence on 84 of these awardees. This due diligence included running background checks on individual awardees and, in cases where the awardee was a business entity, on affiliates, subsidiaries, officers, directors, managerial employees, and any person who, directly or indirectly, held a pecuniary interest in the business entity of 20% or more.

The background checks were run for the purpose of ensuring that money expended was not used for:

1. Grants or loans to a person who was convicted of a criminal offense incident to the application for or performance of a state contract or subcontract; and
2. Grants or loans to a person who was convicted of a criminal offense, or held liable in a civil proceeding, that negatively reflected on the person's business integrity, based upon a finding of embezzlement, theft, forgery, bribery, falsification or destruction of records, receiving stolen property, or violation of state or federal antitrust statutes.

The number of background checks required for any particular awardee ranged from one to fifty-one; see the note at the end of this section for additional discussion of this topic. A total of 536 background checks were completed. These were done using the Westlaw Locator database. At the request of the SEIC Board subcommittee on due diligence, checks were also run for outstanding tax liens.

It was routine to have to determine whether criminal convictions, liens and judgments appearing in the database pertained to applicants or related persons with common names. When an outstanding lien or judgment was discovered, steps were taken to determine the basis for the lien or judgment and whether it was still outstanding, including speaking with the debtor, searching court records, and obtaining proof of payment or copies of releases.

While the due diligence process was underway, the Chief Compliance Officer reviewed the templates for the grant and loan agreements to be entered into between the SEIC Board and the awardees to assure compliance with applicable laws and the incorporation of the following provisions of the Michigan Strategic Fund Act:

1. A prohibition against using the money for a stadium, arena, or casino; and
2. A prohibition against providing money to persons convicted of certain crimes or held liable in certain civil proceedings, and in the other situations described in MCL 125.2088k(6).

Upon completion of the due diligence process for an awardee, the Chief Compliance Officer reviewed and approved the grant or loan agreement as being in compliance with the law. During the course of this entire process, seven of the 85 awardees withdrew for a variety of reasons; e.g., one company was unable to obtain access to necessary intellectual property from a third party, key personnel left another company, and others were precluded by their financial conditions from accepting a loan.

In other areas, the Chief Compliance Officer drafted a conflict of interest policy, which was adopted by Strategic Economic Investment and Commercialization Board in March 2007. An investment policy was then drafted and approved by a Board subcommittee; it awaits approval by the entire Board when it next meets.

In sum, the Strategic Economic Investment and Commercialization Board awarded grants or loans to 78 awardees totaling approximately \$126 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.

Note: One concern that arose during the due diligence background checks relates to the provision in the Michigan Strategic Fund Act—MCL 125.2088k(6)—that the SEIC Board establish requirements to ensure that money expended will not be used for grants or loans to persons convicted of various crimes or held liable in certain civil proceedings. In the case of business entities, “person” is defined to include directors. However, some non-profit awardees had boards of directors that were very large, resulting in background checks being run on up to fifty-one persons for one awardee.

In all of these cases, most members of the board of directors had no direct involvement in the running of the organization. Nor were they involved in the organization’s day-to-day affairs. Under these circumstances, the question is whether this provision of the legislation was meant to apply to these organizations. While none were precluded from receiving their awards, substantial effort was expended to ascertain their compliance with the statute.

It is recommended that consideration be given to amending the statute so that it does not apply to members of boards of directors of non-profit organizations who do not have direct involvement in running the organization.

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, as witnessed by the results of the performance audit of the 21st Century Jobs Trust Fund Programs by the Michigan Auditor General, which found no reportable conditions. In particular, the audit report contained the following comments by the Auditor General:

“We concluded that MSF’s processes for awarding grants, loans, and contracts and making investments for economic development were effective.” And,

“We concluded that the SEIC Board’s processes for awarding grants, loans, and contracts to encourage the development of competitive edge technologies to create jobs in the State were effective.”

Consequently, no substantive changes are recommended to existing policies and procedures. However, now that the Boards have made various investments and awards, the Office of the Chief Compliance Officer will 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.

Respectfully submitted,

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