

GOVERNMENT OF THE DISTRICT OF COLUMBIA

DEPARTMENT OF INSURANCE, SECURITIES AND BANKING



ANNUAL REVIEW OF

ENHANCED CAPITAL DISTRICT FUND,
LLC

FOR THE PERIOD

JANUARY 1, 2011 THROUGH DECEMBER 31, 2011

SALUTATION

Washington, DC
March 4, 2013

The Honorable William P. White
Commissioner, District of Columbia
Department of Insurance, Securities and Banking
810 1st Street, NE, Suite 701
Washington, DC 20002

Commissioner White:

Pursuant to your instructions and in accordance with D.C. Official Code § 31-5237(a) a review of Enhanced Capital District Fund, LLC (“the CAPCO”) has been performed to assess CAPCO compliance with the requirements for Certified Capital Companies contained in D.C. Official Code § 31-5231 et seq.

FORWARD

This report format sets forth reportable observations of both a positive and negative nature and notes material adverse findings. This is a report by exception. As discussed in more detail in paragraphs 22 and 23, one of the CAPCO’s Qualified Businesses failed to provide all of the documentation demonstrating economic benefit to the District required in D.C. Official Code §31-5237(9)(c)(1) and D.C. Official Code §31-5237(9)(c)(2) for loans or investments made on or after April 7, 2010. No other negative observations or material adverse findings were identified.

SCOPE OF REVIEW

This review covers the period from January 1, 2011 through December 31, 2011, including any material transactions or events occurring during the fieldwork and noted during the review. In reviewing material for this report, the Reviewer relied on records and materials maintained by the CAPCO and provided to the Reviewer in response to requests for information initiated by the Department of Insurance, Securities and Banking (“DISB”) and the Reviewer.

The review included consideration of the CAPCO’s compliance concerning operational and funding requirements contained in D.C. Official Code § 31-5231 et seq., including:

- Certification requirements
- Satisfaction of requirements for “Qualified Businesses”

- Aggregate limitations on premium tax credits
- Qualification for premium tax credits
- Requirements for continuance of certification

The review also includes new requirements provided by the “Certified Capital Companies Improvement Amendment Act of 2010.”

METHODOLOGY

The review process involved a review of D.C. Official Code § 31-5231 et seq. to identify the various standards and requirements applicable to CAPCOs operating in the District of Columbia that would be considered during the review and information provided by the CAPCO to determine compliance with each of the standards and requirements. Following the completion of a work plan, an initial request for documentation and submission to the CAPCO was prepared. Supplemental requests for information were made as needed. Documents and other materials in response to the information request were provided by the CAPCO in hard copy and electronic format. The information was examined to determine whether the CAPCO satisfied the various tests and standards set forth in D.C. Official Code § 31-5231 et seq. Findings pertaining to the Reviewer’s findings were noted and were used in the preparation of the report.

Presentation of the Reviewer’s findings track D.C. Official Code § 31-5231 et seq., i.e., requirements and legal standards applicable to the operation of the CAPCOs, and separate requirements applicable to Qualified Businesses. Substantive findings in the report contain: (i) an initial statement of the specific requirement or legal standard contained in D.C. Official Code § 31-5231 et seq; (ii) a brief summary of the information reviewed; and (iii) the Reviewer’s findings relative to that requirement or legal standard.

FINDINGS

REVIEW OF CAPCO

1. *D.C. Official Code §31-5232(d) requires the CAPCO to maintain its principal office in the District of Columbia.*

According to the CAPCO’s business plan and other records the CAPCO has been located within the District of Columbia since 2004. On January 12, 2010 the CAPCO’s relocated its offices to 2445 M St., NW, Washington, DC.

2. *D.C. Official Code §31-5232(e) requires that at least two of the CAPCO’s principals or two employees engaged to manage the funds for the CAPCO have three or more years of experience in the venture capital industry.*

The CAPCO identified two employees and three principals who were responsible for making investment decisions in 2011. According to information provided by the CAPCO, John D. Tyson served as Director and Mark L. Slusar as Managing Director. Both claim more than three years' experience in the venture capital industry. The CAPCO also identified three Principals who serve as members of an Investment Committee: Founder and Board Chairman Andrew M. Paul, Michael A.G. Korengold, and Barry A. Osherow. All three of these individuals claim more than ten years' venture capital experience. No exceptions to this requirement were noted.

3. *D.C. Official Code §31-5232(h) prohibits an insurance company, either directly or through an affiliate, from owning more than 15% of the voting equity interests or other voting ownership interests in the CAPCO.*

The CAPCO is wholly owned by Enhanced Capital Partners, Inc. ("ECP, Inc"). ECP, Inc. is wholly owned by Enhanced Capital Partners Stock Ownership Trust, the trustee of which is Reliance Trust Company. The beneficial owners are the employees of ECP. No exceptions to this requirement were noted.

4. *D.C. Official Code 31-5231(13) requires that the CAPCO's debt instruments be issued at par or at a premium, with an original maturity date at least 5 years from the date of issuance and a repayment schedule which is no faster than a level principal amortization over 5 years, which does not permit the Certified Investor to receive prepayment of interest, and which contains no interest, distribution, or payment features which are related to the profitability of the CAPCO or the performance of its investment portfolio.*

In response to a request for information from the reviewed the CAPCO provided a statement that no changes had been made to existing debt instruments in 2011, and further, no new debt instruments were executed on or after January 1, 2011. No exceptions to this requirement were noted.

5. *D.C. Official Code §31-5236(a) permits the payment of Qualified Distributions at any time.*

D.C. Official Code §31-5231(14) defines "Qualified Distributions," i.e., payments of a CAPCO in connection with the following:

(A) Reasonable costs and expenses that can be paid in connection with the CAPCO's formation or syndication, or related costs;

(B) Reasonable management costs, and management fees not to exceed 2.5% of Certified Capital.

(C) Projected increases in federal or state taxes of direct or indirect equity holders of the CAPCO resulting from the earnings or other tax liability of the CAPCO to the extent the increase is related to the investment in the ownership of a CAPCO.

The CAPCO's total Certified Capital as of the Allocation Date was \$25,919,405. The CAPCO provided financial records reflecting approximately \$50,000 in professional expenses. These payments do not appear to be unreasonable in relation to the types of services that were provided.

Other financial records supplied by the CAPCO reflect payment of accrued management fees during the period under review in the amount of \$175,000. The combined payments for professional and management fees is within the 2.5% limitation. No exceptions to this requirement were noted.

6. *D.C. Official Code §31-5235(a) mandates minimum Qualified Investments of its Certified Capital by each CAPCO according to the following schedule: (1) 20% within 30 months after the CAPCO'S Allocation Date; (2) 40% within 4 years after the CAPCO's Allocation Date; and (3) 50% within 5 years after the CAPCO's Allocation Date. In 2010 the Act was amended to modify the calculation in situations where the CAPCO seeks to utilize the investment credit enhancement that is available in situations where the num*

As of the CAPCO's Allocation Date of November 12, 2004, its Certified Capital was \$25,919,405. Records provided by the CAPCO reflecting the history and pattern of investments indicate that the CAPCO met or exceeded each of the minimum investment requirements at the 30 month, 48 month and 60 month mark. By the time of the CAPCO's 5 year anniversary in 2009, the CAPCO had invested \$13,734,910, or approximately 53% of its Certified Capital. In 2011 the CAPCO invested an additional \$105,000 in two Qualified Businesses. No exceptions were noted in regard to the CAPCO's meeting each of the investment thresholds.

7. *D.C. Official Code §31-5235(d) prohibits any single investment in a Qualified Business from exceeding 15% of its total Certified Capital.*

The Qualified Business Applications as well as records of funding approvals from the DISB indicate that the CAPCO has not exceeded the 15% cap on investments in any one Qualified Business.

8. *D.C. Official Code §31-5235(f) places restrictions on investments a CAPCO is permitted to make in investments other than Qualified Businesses, e.g., a prohibition against investing any more than 5% of Certified Capital in a security issued by a Certified Investor or its affiliate unless the investment is guaranteed or otherwise secured in favor of the Certified Investors.*

The CAPCO provided financial documentation of its investments. According to the information that was provided the CAPCO'S investments were limited to Qualified Businesses and money market accounts in financial institutions. No exceptions were noted.

9. *D.C. Official Code §31-5235(g)(2) requires each CAPCO to report annually to the DISB on the following: (1) the amount of Certified Capital at the end of the prior year; (2) whether the CAPCO has invested more than 15% of its total certified capital in any one business; and (3) all Qualified Investments made in the prior year.*

On January 30, 2012 the CAPCO provided the DISB with its 2011 DC Annual CAPCO Report. No exceptions to this requirement were noted.

10. *§ D.C. Official Code 31-5235(g)(3) requires each CAPCO to provide an annual, audited financial statement, as well as an agreed-upon procedures report conducted by the independent auditor to assess compliance with the requirements in Chapter 52-A.*

The CAPCO provided copies of audited financial statements and agreed upon procedures reports to the Reviewer. No exceptions were noted.

11. *D.C. Official Code §31-5235(g)(4) requires payment of an annual \$10,000 certification fee to the DISB.*

Documentation and other information provided by the CAPCO in response to the Reviewer's request indicated that the required payments were made to the DISB. No exceptions were noted.

12. *D.C. Official Code §31-5236 prohibits a CAPCO from making any distribution other than a Qualified Distribution before 100% of its Certified Capital has been distributed in Qualified Investments.*

The CAPCO provided financial records (Cash Logs) reflecting payments made during the review period. These records do not evidence any distributions other than a Qualified Distribution or a Qualified Investment.

REVIEW OF QUALIFIED BUSINESSES

Overview: The law restricts investments by the CAPCO to "Qualified Businesses" as defined in §31-5231(12) of the law. During the period under review the CAPCO invested \$175,000 in 2 businesses purporting to satisfy the definition of a "Qualified Business." Though the end of 2011 the CAPCO had invested approximately 54% of its Certified Capital.

The CAPCO made the following follow-on investment on September 9, 2011:

- Rep Equity: \$75,000

The CAPCO made the following initial investment on October 12, 2011:

- Finance Flows: \$30,000

The 2010 amendments to the CAPCO law were effective April 7, 2010 and added new designations of Qualified Businesses as either “Tier One,” “Tier Two,” or Tier Three,” based upon the nature of the business, its location within the District, and other criteria. Among other things, the “Tier” designation determines the credit the CAPCO will receive for its investment in the business.

Because Rep Equity received investments prior to the enactment of the 2010 changes to the law, the CAPCO will receive a dollar for dollar credit for its investment in that business.

13. *D.C. Official Code §31-5235(b)(2)(F) provides that a Qualified Business that receives an Initial Investment or a Follow-on Investment and that fails to maintain satisfaction of the eligibility criteria to receive an Initial or a Follow-on Investment, as applicable, for 6 consecutive months after the date of the Initial or Follow-On Investment shall be deemed to have invested \$0 for every dollar invested.*

The CAPCO provided payroll records for each Qualified Business through year-end 2011, indicating that as of that date each remained a going concern and maintain their principal place of business in the District. The CAPCO provided payroll records for each Qualified Business evidencing payments made to employees in the fourth quarter. The CAPCO also provided payroll records for each business sufficient to establish that those businesses satisfied the 25% District residency requirement on a continuous basis from the date of funding and for 6 consecutive months thereafter.

14. *D.C. Official Code §31-5231(12)(A)(i) establishes physical and operational contact requirements with the District of Columbia. Each Qualified Businesses must: (i) be headquartered in the District; (ii) have their principal place of operations located in the District; and (iii) use the Qualified Investments it receives to support business operations in the District.*

With respect to each investment made during 2011 the CAPCO provided documentation indicating that at the time of each initial investment each of the Qualified Businesses was headquartered in and maintained its principal place of operations in the District.

The information provided by the CAPCO gave no indication that any of the Qualified Businesses were using invested funds to support business operations outside the District. Consideration of compliance with this particular requirement, however, was limited to information in the possession of and provided by the CAPCO. A definitive determination of compliance with this requirement would require an examination of each Qualified Business’ financial

and other business records. Such an examination falls outside the scope of the review.

15. *D.C. Official Code §31-5231(12)(A)(ii) requires that at the time of initial funding a minimum of 25% of employees of a Qualified Business reside in the District.*

The application procedures established by DISB for initial and follow-on investments Qualified Businesses require a certification from the CAPCOs that the Qualified Business satisfied the District residency requirement. The information provided by the CAPCO to the Reviewer indicates that the required statement of compliance was included with each funding request. Further, the DISB now requires CAPCOs to submit independent evidence establishing that Qualified Business applicants comply with the 25% District residency requirement. This evidence can include drivers' licenses, utility bills, or other documentation that a particular employee is a District resident. In addition to this information, the Reviewer was also provided with payroll and other additional documentation of compliance with the residency requirement.

Specific findings in regard to each of these Qualified Businesses include:

- *Finance Flows, Inc.* Documentary evidence was provided demonstrating that the business' sole employee was a D.C. resident at the time of initial funding.
- *Rep Equity, Inc.* Documentary evidence was provided demonstrating that 7 of its 20 full-time employees, or 35%, were D.C. residents at the time of initial funding.

No exceptions to this requirement were noted.

16. *D.C. Official Code §31-5231(12)(A)(iii) requires that at the time of initial funding a minimum of 75% of employees of a Qualified Business be employed at a location within the District.*

- *Finance Flows, Inc.* Documentary evidence was provided demonstrating that the business' sole employee was employed at the business' D.C. location.
- *Rep Equity, Inc.* Documentary evidence was provided demonstrating that 15 of its 20 employees, or 75%, were employed at the business' D.C. location.

The DISB requires CAPCOs to certify that Qualified Businesses meet the 75% threshold at the time of initial funding. Information received from the CAPCO and reviewed supports a conclusion that at the time of initial funding the Qualified Business met this requirement.

17. *D.C. Official Code §31-5231(12)(A)(iv) requires that Qualified Businesses meet the definition of a Small Business Concern as defined in 21 CFR § 121.201.*

21 CFR § 121.201 establishes standards for businesses that qualify as "Small Business Concerns" based on either the entity's gross revenue or number of

employees. Signed certifications were provided for both businesses stating that each met the requirements for a small business concern. No exceptions to this requirement were noted.

18. *D.C. Official Code §31-5231(12)(A)(v) requires certification in an affidavit that the Qualified Business was unable to obtain conventional funding, i.e., that the business tried and failed to obtain conventional financing, or that the business cannot be “reasonably expected” to qualify for conventional financing.*

The application materials completed by each Qualified Business contained the required certification of compliance. The affidavits were completed and signed on behalf of each of the applicants and contained a statement that the applicant was unable to obtain conventional financing. The CAPCO also provided copies of declination letters from commercial lenders evidencing the applicants’ inability to obtain conventional financing. No exceptions to this requirement were noted.

19. *D.C. Official Code §31-5231(12)(B)(i) through (iv) excludes from the definition of Qualified Business any business that is a regional or national franchise, is primarily engaged in real estate development or leasing projects, is primarily engaged in the business of insurance, or is engaged in providing professional services provided by lawyers, accountants, or physicians.*

The CAPCO submitted for review the business plans that were submitted by each applicant for a Qualified Investment. Those business plans contained information about the nature of the business, including the services that the business intended to provide. None of these business plans evidenced an intention to provide any of the proscribed professional services. Independent verification was also made where possible through checking the Qualified Business’ website and the description of the business’ services. No exceptions were noted.

20. *For loans or investments in Qualified Businesses made on or after April 7, 2010, D.C. Official Code §31-5231(12)(A)(vi) requires certification that the business was not organized by a Certified Capital Company or an affiliate of a Certified Capital Company.*

The CAPCO provided a signed certification both Qualified Business stating that it was not organized by the CAPCO or an affiliate. No exceptions to this requirement were noted.

21. *For loans or investments in Qualified Businesses made on or after April 7, 2010, D.C. Official Code §31-5231(12)(A)(vii) requires certification that the business does not have an ownership interest, investment interest, compensation arrangement, or similar financial arrangement with a Certified Capital Company or any affiliate thereof prior to the date of the initial investment.*

The CAPCO provided a signed certification from each Qualified Business stating that it did not have a prior ownership, business or investment relationship with the CAPCO. No exceptions to this requirement were noted.

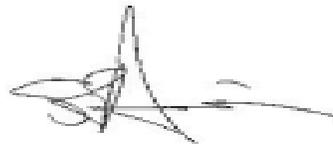
22. *For loans or investments in Qualified Businesses made on or after April 7, 2010, D.C. Official Code §31-5238.02(c)(1) requires each Qualified Business to annually report to the CAPCO the number of jobs that it created and retained in the District, salaries paid to each employee, taxes paid to the District, money spent with local businesses or persons, and whether such businesses are located in the District or elsewhere, and to provide documentation to the CAPCO in support of the information provided in the report.*

In addition to payroll records for each Qualified Business through year-end 2011, the CAPCO provided documentation evidencing diligent efforts to obtain the information required by this section of the law from each Qualified Business that received initial funding on or after April 7, 2010. Because the Qualified Businesses did not provide the CAPCO with all of the information requested, as set forth in the Statute, the CAPCO was unable to provide this information to DISB.

23. *For loans or investments in Qualified Businesses made on or after April 7, 2010, D.C. Official Code §31-5238.02(c)(2)) requires each Qualified Business to provide the CAPCO with documentation in support of its report, including copies of tax returns, invoices leases, payroll reports, employment records and contracts.*

In addition to payroll records for each Qualified Business through year-end 2011, the CAPCO provided documentation evidencing diligent efforts to obtain the information required by this section of the law from each Qualified Business that received initial funding on or after April 7, 2010. Because the Qualified Businesses did not provide the CAPCO with all of the information requested, as set forth in the Statute, the CAPCO was unable to establish compliance with this section of the law, as it was unable to provide this information to DISB.

Respectfully Submitted,



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