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May 6, 2014

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Administration: Section 13.10 Request for Venture Capital Investment Contract Approval and Release of Funding -- Agenda Item XI

REQUEST

On April 8, 2014, the Department of Administration (DOA) provided to the Legislative Audit Bureau (LAB) and the Joint Committee on Finance a complete copy of the proposed contract between the State of Wisconsin and Sun Mountain Kegonsa, LLC for venture capital fund management services. As permitted under the 14-day passive review process specified under 2013 Act 41, the Committee has scheduled a meeting to determine whether the contract conforms to the provisions of Act 41.

On April 14, 2014, DOA submitted a s. 13.10 request for the release of $25 million GPR from the Committee's supplemental appropriation for the capital investment program created under 2013 Act 41.

BACKGROUND

Through the 2013-15 biennial budget deliberations, the Committee removed from the Governor's proposed budget (2013 Assembly Bill 40) a provision which would have provided $25 million GPR in 2013-14 for a capital investment program administered by the Office of Business Development, which is attached to DOA. The bill language specified that, "In consultation with the director of the office of business development, the secretary shall provide $25,000,000 in fiscal year 2013-14 for a capital investment program to make coinvestments in business startups and investment capital projects." The Office of Business Development was created in statute under 2011 Act 32 to provide administrative support to the Small Business Regulatory Review Board and to perform other functions, as determined by the Secretary of DOA. Neither the Executive Budget Book nor budget bill provided information on the organization, structure, design, or implementation of the capital investment program. Further, the bill did not specify that the

coinvestments be made for startup businesses located in, or employing residents of, the state of Wisconsin, nor did it establish the terms of providing the funds, such as the private funding match for the coinvestment, the number of jobs to be created, or a minimum rate of return on the investment. On May 15, 2013, the Committee removed the provision from the budget bill and placed $25 million GPR in the Committee's supplemental appropriation to be used for a capital investment program developed under separate legislation.

Separate legislation (2013 Assembly Bill 181) creating a venture capital investment fund was adopted by the Legislature in June, 2013 (in the Assembly by a 91-2 vote and in the Senate by a 29-3 vote). The Governor signed 2013 Act 41 (AB 181) with a partial veto that deleted the provision of $25 million GPR in 2013-14 to the appropriation s. 20.505(1)(fm) for a fund of funds investment program, which would have been in addition to the $25 million provided to the Committee's supplemental appropriation under the 2013-15 budget bill. The partial veto did not, however, affect s. 16.295(5)(a) of the Statutes, which states that "the department shall pay $25,000,000 from the appropriation under s. 20.505(1)(fm) to the investment manager in fiscal year 2013-14."

The capital investment bill adopted a "fund of funds" model for the establishment of a venture capital investment program within DOA. Under the fund of funds model, the State would commit $25 million of capital to invest in venture capital funds, rather than making investments in businesses directly. The venture capital funds would then make direct investments in businesses. In addition to the State's contribution of $25 million, the investment manager must commit $300,000 of its own capital and raise at least $5 million from sources other than the State. In total, at least $30.3 million would be available for the fund of funds investment program. In addition, the bill contains provisions relating to the following: (a) investment manager compensation; (b) investments in businesses with headquarters in Wisconsin or which employ residents of Wisconsin; (c) investments in small businesses; (d) industries in which investments may be made; (e) diversity of geographic location of investments in businesses within Wisconsin; (f) private fund matching requirements; (g) limits, timing, and number of investments; (h) disclosure and reporting requirements; and (i) profit-sharing between the State and the investment manager.

On January 10, 2014, DOA announced that it had selected an investment manager, Sun Mountain Kegonsa, LLC, through a request for proposal and evaluation process that assigned a score to each proposal based on a firm's: (a) background; (b) investment philosophy, process, and capabilities; (c) venture capital access; and (d) terms and fees. According to DOA, the Sun Mountain Kegonsa proposal received the highest score. In an April 4, 2014, letter DOA reported to the LAB that it had negotiated a proposed contract with Sun Mountain Kegonsa. The Department then submitted to the LAB and the Committee a complete copy of the proposed contract on April 8, 2014.

Under s. 16.295(3) of the Statutes, DOA must select an investment manager for the program and submit to the Legislative Audit Bureau and the Joint Committee on Finance a proposed contract with the investment manager for review by the LAB. Within 14 days after receiving the proposed contract, the LAB must submit to the Committee and DOA a letter of review that evaluates the terms of the contract and offers an opinion concerning the extent to which the contract conforms to the provisions of Act 41. Subsequent to receiving the letter of review from the

LAB, the Committee has 14 working days to notify DOA that a meeting has been scheduled to determine whether the proposed contract with the investment manager conforms to the provisions of Act 41. If the Committee determines that the contract fails to comply with or implement specific provisions of the bill, DOA cannot execute the contract.

In accordance with the Act 41 requirement, the LAB submitted its letter of review to the Committee and DOA on April 21, 2014. In addition, on April 28, 2014, DOA submitted a letter to the Committee and the LAB addressing the questions raised by the LAB in its April 21 letter of review. An objection was raised by the Committee and the review of the proposed contract was placed on the s. 13.10 meeting agenda for consideration by the Committee. Further, the Department requested release of the $25 million in the Committee's appropriation for the venture capital fund. This matter is also before the Committee.

For the Committee's reference, the following documents are attached to this memorandum: (a) the April 4, 2014, letter from DOA to the LAB [Attachment 1]; (b) the April 8, 2014, letter from DOA to the LAB [Attachment 2]; (c) the April 21, 2014, letter from the LAB to the Finance Committee and DOA [Attachment 3]; and (d) the April 28, 2014, letter from DOA to the Committee and the LAB [Attachment 4]. The proposed contract between the State and Sun Mountain Kegonsa is posted on the Joint Finance Committee's website under "Passive Review."

ANALYSIS

The proposed contract establishes a limited partnership, Badger Fund of Funds I, L.P., between Sun Mountain Kegonsa, LLC (the general partner), the State of Wisconsin (a limited partner), and other limited partners to be determined at a later date. The Department indicates that this organizational structure was chosen because a limited partnership agreement is standard for the venture capital fund industry. As a member of the partnership, the State would own a share of the fund's investments proportionate to the State's capital commitment, in relation to the partnership's total capital commitments. Sun Mountain Kegonsa itself is a partnership between Kegonsa Capital Partners, LLC (located in Wisconsin) and Sun Mountain Capital, LLC (located in New Mexico). Included with the proposed contract as "Exhibit B" is a management agreement between Sun Mountain Kegonsa (the general partner) and Sun Mountain Capital (the investment manager).

As required under the bill, the contract includes the following among its provisions: (a) investment manager compensation (paid to the general partner, which would then pay the investment manager); (b) investments in Wisconsin businesses and businesses employing Wisconsin residents; (c) investments in small businesses; (d) industries in which investments may be made; (e) geographic diversity of investments in Wisconsin businesses; (f) venture capital fund matching requirements; (g) limits, timing, and number of investments; (h) disclosure and reporting requirements; (i) profit-sharing; and (j) capital commitment requirements. Accordingly, in its April 21 letter of review, the LAB found from its evaluation of the contract that the terms generally conform to the provisions of 2013 Act 41 [Attachment 3]. Therefore, the Committee could choose to approve the proposed contract as conforming to Act 41, and approve the release of $25 million GPR in 2013-14 from its supplemental appropriation for the fund of funds investment program. [Alternative 1]

The LAB did, however, also raise a number of questions that the Committee may wish to consider in determining whether the contract conforms to the intent of Act 41. Following is a discussion of the questions posed by the LAB in its April 21 letter.

Fees and Expenses. The LAB identifies two issues relating to fees and expenses provisions of the contract: (a) monitoring charges and partnership expenses, separate from management fees; and (b) the payment of management fees in the event of management services agreement termination.

Act 41 requires that the contract "establish the investment manager's compensation, including any management fee. Any management fee may not exceed, annually for no more than 4 years, 1 percent" of the funds provided by the State ($25 million) and the $5 million that the manager raises from other sources. The contract establishes a management fee of 1% annually for the first four years (the maximum permitted under the bill), which is equivalent to $250,000 annually for the State, totaling $1.0 million over four years. Although the contract does not specify the purpose for which the management fee is to be used, the contract requires that the general partner (Sun Mountain Kegonsa) must bear the following costs of the partnership: (a) any office overhead necessary for the partnership's operations; (b) the compensation of the general partner's personnel; and (c) organizational expenses (expenses incurred in organizing the limited partnership and the marketing and offering of interests in the limited partnership, including legal and accounting fees, travel, and filing fees) in excess of 0.5% of the aggregate capital commitments of the partners.

The contract also establishes a "monitoring charge" beginning in the fifth year of the program. The monitoring charge would start at 0.9% in the fifth year ($225,000 payable by the State), and would gradually decrease each year until it reached 0.53% in the tenth year ($132,900 payable by the State). In the event the program were extended beyond 10 years, the monitoring charge payable by the State would be $125,000 annually (0.5% annually). In its April 4 letter to the LAB, DOA indicated that "management fees will be used towards recruiting and establishing investors, directing fund managers, monitoring funds in the investment portfolio, and preparing reports that demonstrate how the funds have been invested." Regarding the monitoring charges, DOA explains that the contract "continues monitoring fees in years 5-10 for preserving Wisconsin's investments and continued quarterly reporting obligations as required under State law." Management and monitoring fees payable by the State are shown in Table 1 provided by the LAB below. Management fees and monitoring charges payable by the State over 10 years would total to $2,054,300 (8.2% of its capital commitment).

TABLE 1

Maximum Management Fees and Monitoring Charges the State Would Pay Under the Proposed Contract* April 21, 2014

Year**	Management Fees	Monitoring Charges	Total
First	$250,000	N/A	$250,000
Second	250,000	N/A	250,000
Third	250,000	N/A	250,000
Fourth	250,000	N/A	250,000
Fifth	N/A	$225,000	225,000
Sixth	N/A	202,500	202,500
Seventh	N/A	182,250	182,250
Eighth	N/A	164,025	164,025
Ninth	N/A	147,623	147,623
Tenth	N/A	132,860	132,860
Total	$1,000,000	$1,054,258	$2,054,258

Source: Legislative Audit Bureau

*Based on the first ten years after Sun Mountain Kegonsa had raised at least $5.0 million from other sources. If the proposed contract were extended, the State would pay $125,000 in monitoring charges annually. The proposed contract could be terminated earlier under certain circumstances.

**The State would not be required to make its first payment of the management fees until after Sun Mountain Kegonsa had raised at least $5.0 million from other sources.

As noted by the LAB, in addition to management fees and monitoring charges, the contract requires that limited partners (including the State) pay for certain "partnership expenses" incurred including: (a) fees, costs, and expenses of tax advisors, legal counsel, auditors, consultants, and other professionals; (b) fees, costs, and expenses to develop, negotiate, structure, and dispose of investments in venture capital funds, including but not limited to financing, legal, accounting, advisory, and consulting expenses; (c) brokerage commissions, custodial expenses, and other investment costs incurred in connection with venture capital fund investments; (d) interest, fees, and expenses arising out of any borrowing made by the limited partnership; (e) the costs of litigation, liability, and other insurance, indemnification, and extraordinary expenses or liabilities relating to the limited partnership's affairs; (f) expenses associated with liquidating the limited partnership; (g) taxes, fees, or other governmental charges levied against the limited partnership, expenses of any tax audit, investigation, settlement, or review of the limited partnership; (h) expenses incurred in organizing the limited partnership and the marketing and offering of interests in the limited partnership, including legal and accounting fees, travel, and filing fees (up to 0.5% of the capital commitment, after which the general partner would be responsible for such organizational expenses); (i) expenses of the contractually created Advisory Committee (which

would provide advice and counsel as requested by the general partner); (j) the expense of maintaining an independent registered agent in Wisconsin for service of process in connection with any suit, action, or other proceeding arising out of the proposed contract; and (k) marketing, sponsorship, and advertising expenses to promote the limited partnership.

The State would be responsible for a proportion of the partnership expenses equal to the proportion of capital the State has committed out of total partnership commitments. For example, if the State provides $25 million and other limited partners provided $5 million, the State would be responsible for 83.3% of partnership expenses. Unlike management fees and monitoring charges, partnership expenses are not determined in the contract as a percentage of capital committed to the partnership. However, in an attachment to its April 28 letter [Attachment 4], DOA provided an estimate of some partnership expenses (not including any expenses arising out of borrowing by the partnership or expenses to promote the partnership, such as marketing, sponsorship, or advertising expenses), which would total to 1.4% of total capital commitments over 10 years. If partnership expenses totaled 1.4% of capital commitments, the share payable by the State would equal $350,000. The Department indicates that this represents only a rough estimate of partnership expenses. The actual amount could be higher or lower than the estimate provided.

In a publication titled, "Fund of Funds—A Money for Minnows Strategy to Increase Job Creation in Wisconsin," authored by Kegonsa Capital Partners (one of the two partners forming Sun Mountain Kegonsa), the firm proposed in 2012 that for a $100 million fund, $10 million (or 10%) would be used for management fees and partnership expenses. For the State to expend 10% of its capital commitment over 10 years for management fees, monitoring charges, and partnership expenses, reimbursement of partnership expenses would need to account for 1.8% of the State's capital commitment, or $445,700.

Given that monitoring charges and partnership expenses are similar to management fees in some ways, the charges and expenses could be considered contrary to the Act 41 limit of management fees to 1% annually for four years. However, s. 16.295(4)(a) of the Statutes states that the contract "shall establish the investment manager's compensation, including any management fee." It could be argued that Act 41 does not prohibit other fees or charges, as the use of the word "including" suggests that the bill permits forms of compensation other than a management fee. In addition, partnership expenses are costs incurred in operating the partnership, and could be thought of as cost reimbursements to or for the partnership rather than compensation for the investment manager.

However, since the maximum amount of partnership expenses payable by the State is not determined in the contract, these expenses could exceed the estimate provided by DOA. To the extent that the management fee provision in Act 41 was intended to limit administrative expenses of the program, the Committee could choose to set a maximum amount allowable for these expenses to be charged to the limited partners. If the State were required to pay partnership expenses in the amounts estimated by DOA, management fees (total of 4%), monitoring charges (4.2%), and partnership expenses (1.4%) would total to $2.4 million (9.6% of its capital commitment) over a 10-year period. Total estimated fees, charges, and expenses, therefore, would remain at less than 10% of the State's capital commitment over 10 years. To provide a degree of flexibility in the case of unanticipated partnership expenses, the Committee could choose to limit

the partnership expenses payable by limited partners to a somewhat higher percentage amount, such as: (a) no more than 1.75% (administrative expenses total of 9.95%) of the capital commitment over 10 years [Alternative 3a]; (b) no more than 2.0% (administrative expenses total of 10.2%) of the capital commitment over 10 years [Alternative 3b]; or (c) no more than 2.25% (administrative expenses total of 10.45%) of the capital commitment over 10 years [Alternative 3c]. These partnership expense limit options are summarized in Table 2 below.

TABLE 2

Estimated Administrative Expenses Payable by the State Under Partnership Expense Limits*
May, 2014

	Alternative 3a	Alternative 3b	Alternative 3c
Partnership Expense Limit (%)	1.75%	2.00%	2.25%
Partnership Expenses	$437,500	$500,000	$562,500
Management Fees	1,000,000	1,000,000	1,000,000
Monitoring Charges	1,054,300	1,054,300	1,054,300
Total Administrative Expenses	$2,491,800	$2,554,300	$2,616,800

*Administrative expenses shown are totals over a 10-year period.

The LAB also notes that the management services agreement between Sun Mountain Kegonsa and Sun Mountain Capital (Exhibit B of the proposed contract) requires Sun Mountain Kegonsa to continue paying management fees to Sun Mountain Capital in the event that the management agreement is terminated. In its April 28 letter [Attachment 4], DOA indicated that if the agreement were terminated and a new manager were hired, Sun Mountain Kegonsa "would be solely responsible for paying the new manager's fees. The State would not incur any additional liability, and would not be obligated under the [Limited Partnership Agreement] or the service agreement to pay the management fee twice." Nevertheless, DOA states that it would be willing to request that the service agreement be amended to address this concern. Therefore, the Committee may wish to direct DOA to modify the contract language to clearly state that limited partners would not be obligated to pay the management fee twice if the management agreement were terminated. [Alternative 3d]

Investments. The LAB identifies four questions relating to investments: (a) the portion of the State's capital commitment which will be invested, and the method by which fees and expenses are paid; (b) language relating to the timing of investments in venture capital funds; (c) language relating to the timing of investments in businesses; and (d) a provision allowing alternative investment structures.

The LAB notes that the contract permits fees, charges, and expenses to be paid in several ways. Under the contract, the expenses could be paid from: (a) capital commitments; (b) investment proceeds; (c) funds borrowed by the partnership, which would be repaid by the partners including the State; or (d) the general partner's own funds. The Department indicates that for

management fees, monitoring charges, and partnership expenses, the State would first draw from existing capital commitments to cover these costs. Although s. 16.295(5)(b) of the Statutes requires that the investment manager must invest the capital commitments of $30.3 million specified under Act 41, the section does not provide for an alternative source of funding for investment manager compensation under s. 16.295(4)(a). In addition, investment proceeds may not be immediately available to pay management fees and partnership expenses in the early years of the program. However, under the definition of "Unpaid Capital Commitments," the contract excludes administrative expenses from being considered paid capital commitments. Therefore, if the State's share of such proceeds were equal to or greater than the amounts the State paid for administrative expenses, all $25 million could be invested in venture capital funds through the reinvestment of such proceeds.

The LAB also notes that under Section 3(c)(iv)(B)(y) of the contract the general partner may choose to not invest capital commitments if the general partner deems that it is "necessary or advisable due to a change in law or regulation that is materially adverse" to the partnership, or is "impractical or otherwise unadvisable due to adverse market conditions or other prevailing circumstances" or for any other reason with the consent of the advisory committee. According to DOA, this is a standard provision which is intended to mitigate litigation risk during periods of market uncertainty and can only be activated following formal written consultation with the partnership's legal counsel. The Department also states that Sun Mountain Capital assures the State it has never had to exercise this standard provision as a private equity investment manager.

Under Act 41, the investment manager must commit at least half of capital commitments to investments in venture capital funds within 12 months after the date the contract is executed, and all capital commitments to venture capital funds within 24 months after the contract is executed. Likewise, each venture capital fund that receives these amounts must invest in businesses half of the capital it receives within 24 months after the date it receives the funds, and must invest in businesses all of the capital it receives within 48 months of receiving the funds. Under the proposed contract, the investment manager and each venture capital fund must make "commercially reasonable efforts" to meet these requirements. According to DOA, this language was negotiated in response to the general partner's concern that "if it was actively closing on a contract with a venture capital fund, but would go over a statutory deadline by a week or two in order to conduct proper due diligence, [Sun Mountain Kegonsa] did not want that to be considered a material breach of the agreement." The Department notes that if contract negotiation (or investments in businesses by venture capital funds) were rushed, it could result in a poor investment outcome. Further, DOA states that the general partner and investment manager (and venture capital funds), will still be subject to the statutory requirements under s. 16.295(5)(c)2 (and s. 16.295(5)(d)2), and the State would still be able to pursue a breach of contract claim if it felt the general partner, investment manager, or venture capital funds were not making commercially reasonable efforts to meet the deadlines.

The final question raised in relation to investments is Section 2(h) of the contract which permits "alternative investment structures." The contract states that, "If the General Partner determines in good faith that for legal, tax, regulatory or other reasons it is in the best interests of any or all of the Partners that all or any portion of a Portfolio Investment be made through an alternative investment structure" the general partner may do so. In its April 28 letter, DOA explains

that alternative investment structures are typically used "when a limited partner is a tax-exempt entity and investing in a particular fund directly through the limited partnership would jeopardize that limited partner's tax-exempt status." Act 41 does not explicitly prohibit the use of alternative investment structures. Further, the contract clause provides an exception for the State, in the event that the Secretary of DOA does not consent to making a portfolio investment in an alternative investment vehicle.

Management of Investment Proceeds. The LAB identified two questions relating to management of investment proceeds: (a) the use of escrow accounts; and (b) indemnification obligations.

Under. s. 16.295(6)(a) of the Statutes, the investment manager must hold the gross proceeds from investments of the State's capital commitment in an "escrow account" and return to the State the proceeds on at least an annual basis, for deposit into the general fund. Under the proposed contract, distributions would be made "only to persons who, according to the books and records of the Partnership, were the holders of record of Interests in the Partnership on the date determined by the General Partner as of which the Partners are entitled to any such distributions." The contract does not specify that the account which would hold the proceeds prior to being distributed must be an escrow account. Therefore, the Committee could direct DOA to modify the contract to require that the proceeds be held in an escrow account prior to being distributed to the State. [Alternative 3e]

The LAB notes that under Section 10(a)(i) of the proposed contract, separate "capital accounts" would be established for each partner of the limited partnership. According to DOA, in this context, a capital account is an accounting term for a record maintained that represents a partner's share of ownership in the partnership. The entries of a capital account would include records of contributions, distributions, gains, losses, and debits. The net value would show the partner's share in the partnership.

In addition, the LAB highlights the indemnification obligation provisions of the contract, in particular a "claw back" provision which would require partners to return to the partnership proceeds that had been received, up to 50% of capital commitments (which in the case of the State is $12.5 million). The Department explains in its April 28 letter that the indemnity requirements were developed by weighing the risks of including such requirements (potentially resulting in the return by partners of investment proceeds) against the risks of not including such requirements (difficulty attracting investors, who expect such provisions). In addition, under s. 16.295(6)(b) of the Statutes, investment proceeds distributed to the State are deposited into the general fund. Therefore, if the claw back provision of the indemnity requirements is triggered, the claim procedures under s. 16.007 of the Statutes would apply.

Disclosure and Reporting. The LAB identified four questions related to the disclosure and reporting requirements of Act 41: (a) disclosures of interest for intended investments; (b) independent financial audits; (c) internal rate of return reporting; and (d) quarterly reporting of business investments.

Under. s. 16.295(5)(d)6. of the Statutes, each venture capital fund that receives capital

through the program must disclose to the investment manager and DOA any interest that the venture capital fund or an owner, stockholder, partner, officer, director, member, employee, or agent of the venture capital fund holds in a business in which it invests or intends to invest the program funding. The proposed contract language requires such disclosures for actual but not intended investments.

Under s. 16.295(7)(a)1. of the Statutes, the investment manager must submit to DOA on an annual basis a financial audit of the investment manager conducted by an "independent" certified public accountant. The contract language does not require that the certified public accountant or accountants conducting the audit be independent.

Under s. 16.295(7)(a)3.d. of the Statutes, the investment manager must annually submit to DOA a report that includes the average internal rate of return on each venture capital fund's investment of the program funds. The proposed contract language requires the report to include the average internal rate of return on all investments made with the partnership's capital commitment, rather than for each venture capital fund.

Under s. 16.295(7)(c)2. of the Statutes, the investment manager must report to DOA on a quarterly basis certain information regarding each business in which a venture capital fund held investments in the prior quarter, including the amounts of the State's capital commitment invested in each business. The contract language requires that the information be provided for each business in which a venture capital fund held investments at the "end" of the quarter and does not require identification of the State's share of the investments.

The Department indicates that it would be receptive to aligning the contract language more closely to the bill language in the four instances identified by the LAB. Therefore, the Committee may choose to direct DOA to modify the contract to match the bill language relating to disclosure and reporting requirements. [Alternatives 3f, 3g, 3h, and 3i]

Amendments to the Contract. Finally, the letter notes that, once executed, the contract may be amended or supplemented by the written consent of Sun Mountain Kegonsa, LLC, and DOA. Therefore, the Committee may wish to require that any such amendments be submitted to the Committee. [Alternative 3j]

In order to expedite the contract approval process and release of funding, under the alternatives provided in response to the LAB's questions, the Committee could direct DOA to make specific modifications to the contract and then submit the contract with the modifications to the Co-Chairs to review and approve the changes within five working days. The $25 million for the fund of funds investment program would then be released upon approval of the modifications. Approval of the revised contract would be subject to the determination by the Co-Chairs that the changes fulfill the Committee's instructions.

Lastly, as provided under s. 16.295(3)(b)2., the Committee may choose to determine that the contract in its entirety is contrary to 2013 Act 41 and deny the release of $25 million for the program at this time. [Alternative 3] Under this alternative, DOA would need to submit a newly drafted contract to the LAB under the process outlined in Act 41 and the Committee would again

make a determination as to whether the contract conforms with the Act. However, as noted, the LAB's report indicates that the contract generally conforms to the language of Act 41. The LAB raises questions for the Committee's consideration, but does not indicate that the contract does not comply with the provisions of Act 41.

ALTERNATIVES

1. Approve the contract as conforming to the provisions of 2013 Act 41, and release $25.0 million GPR to s. 20.505(1)(fm) for the fund of funds investment program.

2. Deny the contract as not conforming to the provisions of 2013 Act 41. In addition, deny the release of funding for the fund of funds investment program.

3. Direct the Department of Administration to incorporate any of the following modifications to the contract and authorize the release of $25.0 million GPR in 2013-14 from the Committee's supplemental appropriation [s. 20.865(4)(a)] to the fund of funds investment program [s. 20.505(1)(fm)], upon the review and approval of the changes, within five working days, by the Co-Chairs of the Joint Committee on Finance:

Fees and Expenses

a. Limit partnership expenses payable by the State over 10 years to a total of no more than 1.75% of the $25.0 million provided by the State. [Cannot be taken with Alternative 3b or Alternative 3c]

b. Limit partnership expenses payable by the State over 10 years to a total of no more than 2.0% of the $25.0 million provided by the State. [Cannot be taken with Alternative 3a or Alternative 3c]

c. Limit partnership expenses payable by the State over 10 years to a total of no more than 2.25% of the $25.0 million provided by the State. [Cannot be taken with Alternative 3a or Alternative 3b]

d. Clarify that limited partners would not be obligated to pay the management fee twice if the management agreement were terminated.

Management of Investment Proceeds

e. Require the investment manager to hold in an escrow account its gross proceeds from investments of the State's $25 million prior to distributing the proceeds, as specified under s. 16.295(6)(a) of the Statutes.

Disclosure and Reporting

f. Require that each venture capital fund that receives funds from the Limited Partnership to make the same disclosures of interest for intended investments that are required of

actual investments, as specified under s. 16.295(5)(d)6. of the Statutes.

g. Require that annual audits of the investment manager's financial statements be performed by an independent certified public accountant, as specified under s. 16.295(7)(a)1. of the Statutes.

h. Require the investment manager to include in its annual report to DOA the average internal rate of return on each venture capital fund's investment of program funds, as specified under s. 16.295(7)(a)3.d. of the Statutes.

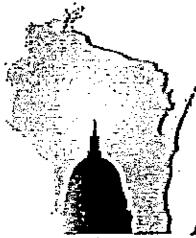
i. Require the investment manager to include in its quarterly report to DOA information regarding each business in which a venture capital fund held investments at any time in the prior quarter, including the amount of investments made with the State's capital commitment in each business, as specified under s. 16.295(7)(c)2. of the Statutes.

Amendments to the Contract

j. Require that any amendments to the contract be submitted to the Joint Committee on Finance.

Prepared by: Rachel Janke
Attachments

ATTACHMENT 1



WISCONSIN DEPARTMENT OF
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April 4, 2014

Senator Alberta Darling, Senate Chair
Joint Committee on Finance
State Capitol
Room 317 East
Madison, WI 53703

Representative John Nygren, Assembly Chair
Joint Committee on Finance
State Capitol
Room 309 East
Madison, WI 53703

Dear Senator Darling and Representative Nygren,

Enclosed is a copy of the proposed contract between the Department of Administration (DOA) and Sun Mountain Kegonsa (SMK) for the venture capital program. DOA will enter into a contract with SMK on behalf of the State of Wisconsin for SMK to provide fund manager services to the State.

As required under Act 41, the Legislative Audit Bureau has 14 days to review the contract and submit a letter to the Joint Finance Committee that evaluates the contract's terms and adherence to Act 41 requirements. As you will see in the enclosed documents, DOA has ensured that all requirements have been included in the contract.

According to Act 41, once the Joint Finance Committee receives the Audit Bureau's evaluation, your committee then has 14 days to verify that the proposed contract adheres to the Act's requirements. We respectfully request that you also release the $25 million approved for the venture capital investment in the biennial budget as those funds are required to be released by the end of this fiscal year.

Thank you in advance for your review and approval of the venture capital investment program fund of funds management contract.

Sincerely,

Mike Huebsch
Secretary

cc: ✓Robert Lang, Legislative Fiscal Bureau Director

WISCONSIN DEPARTMENT OF
ADMINISTRATION

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April 4, 2014

Legislative Audit Bureau
ATTN: Joe Chrisman, State Auditor
22 E. Mifflin Street
Suite 500
Madison, WI 53703

Dear Mr. Chrisman,

As designated in 2013 Wisconsin Act 41, the Secretary of Department of Administration (DOA) formed the required committee to release a Request for Qualifications (RFQ) to select a qualified fund manager for the venture capital investment program. Sun Mountain Kegonsa (SMK) received the highest score from the committee in the RFQ evaluation process based upon: firm background; investment philosophy, process and capabilities; venture capital access; and terms and fees. Therefore, DOA intends to enter into a contract with SMK on behalf of the State of Wisconsin. Enclosed is a copy of the proposed contract for the Legislative Audit Bureau's review and approval.

The capital investment program will promote economic growth in Wisconsin by identifying new investors for our state, bringing new capital to Wisconsin businesses, and cultivating Wisconsin's entrepreneurship. In negotiating the contract with SMK, our objectives were to (1) implement Act 41, (2) attract investors to the investment program, and (3) minimize Wisconsin's risk.

The partnership agreement between the State and SMK incorporates all of the requirements of Act 41. The table below sets forth all of the requirements of Act 41 and where those provisions can be found in the partnership agreement.

Requirement	Statutory Reference	Location in Agreement
Investment Manager compensation	Wis. Stat. § 16.295(4)(a)	Section 6(a)-(c); Section 3(f)(i)(2)
Management Fee	Wis. Stat. § 16.295(4)(a)	Section 6(b)
Investment manager disclosure of interest in funds receiving state money	Wis. Stat. § 16.295(4)(b)	Section 4(h)(ii)
State's $25 million contribution	Wis. Stat. § 16.295(5)(a), (b)(1)	Section 3(b)(iv); Exhibit A
Investment Manager's $300 thousand commitment	Wis. Stat. § 16.295(5)(b)(2)	Section (3)(b)(ix); Exhibit A
Third-Party Investor's $5 million commitment	Wis. Stat. § 16.295(5)(b)(3)	Section 3(b)(iv); Exhibit A
Investment manager shall not invest more than $10 million in a single venture capital fund	Wis. Stat. § 16.295(5)(c)(1)	Section 4(a)
Investment Manager shall commit at least ½ of money within 12 months	Wis. Stat. § 16.295(c)(2)	Section 4(a)

Requirement	Statutory Reference	Location in Agreement
Investment Manager shall commit remaining ½ of money within 24 months	Wis. Stat. § 16.295(c)(2)	Section 4(a)
Investment Manager shall invest in at least 4 venture capital funds	Wis. Stat. § 16.295(5)(b)	Section 4(a)
Venture capital funds shall invest money received in businesses headquartered in WI and employ at least 50% of employees in WI	Wis. Stat. § 16.295(5)(d)(1)	Section 1 ("Eligible Business" definition); Section 4(a)(i)
Venture capital funds shall invest at least ½ of moneys received in businesses with fewer than 150 employees	Wis. Stat. § 16.295(5)(d)(1)	Section 1 ("Eligible Small Business" definition); Section 4(a)(i)
Business must return moneys invested if within 3 years it relocates its headquarters outside of WI or fails to employ at least 50% of its employees in WI	Wis. Stat. § 16.295(5)(d)(1)	Section 4(a)(ii)
Venture capital funds must invest at least ½ of moneys received within 24 months of receipt	Wis. Stat. § 16.295(5)(d)(2)	Section 4(a)(iv)
Venture capital funds must invest at remainder of moneys received within 48 months of receipt	Wis. Stat. § 16.295(5)(d)(2)	Section 4(a)(v)
Venture capital funds shall invest all moneys received in certain types of businesses (e.g., agriculture, advanced manufacturing, etc.)	Wis. Stat. § 16.295(5)(d)(3)	Section 1 ("Eligible Business" definition); Section 4(a)(i)-(ii)
Venture capital funds shall attempt to ensure moneys are invested in businesses that are diverse with respect to geographic location within the state	Wis. Stat. § 16.295(5)(d)(3)	Section 4(a)(vi)
Venture capital funds must at least match moneys received and ensure that for every $1 received from investment manager, it invests $2 from other sources	Wis. Stat. § 16.295(5)(d)(4)	Section 4(a)
Venture capital funds must provide investment manager with information necessary to complete reporting requirements	Wis. Stat. § 16.295(5)(d)(5)	Section 4(a)(viii)
Venture capital funds must disclose any interest it has in a business in which it invests	Wis. Stat. § 16.295(5)(d)(6)	Section 4(a)(ix)

Requirement	Statutory Reference	Location in Agreement
Investment manager's profit-sharing agreement with each venture capital fund must be on terms substantially equivalent to terms applicable for other funding sources	Wis. Stat. § 16.295(5)(e)	Section 4(a)
Investment manager shall pay proceeds from investment of State's $25 million to DOA at least annually until the $25 million is repaid	Wis. Stat. § 16.295(6)(b)	Section 3(f)(i)(1)
Once the State has recouped its $25 million investment, the investment manager shall distribute proceeds as follows: 90% to DOA, 10% to the investment manager	Wis. Stat. § 16.295(6)(c)	Section 3(f)(i)(2)
Investment manager annual reporting requirements	Wis. Stat. § 16.295(7)(a)	Section 7(c)(ii)-(iii)
Investment manager quarterly reporting requirements	Wis. Stat. § 16.295(7)(c)	Section 7(c)(i)(3)

The contract is structured as a limited partnership agreement because that is the normal structure for venture capital funds. This structure allows the State to own part of the business, rather than simply distributing the $25 million per the typical type of vendor contract. This limited partnership will be called the *Badger Fund of Funds I*. In turn, Sun Mountain Kegonsa must meet the Act 41 requirements of:

- ☐ Finding private partners to invest $5 million
- ☐ Investing in at least four venture capital funds, which will then invest in Wisconsin start-up businesses to expand Wisconsin's economic development

As typical with a fund of funds venture capital investment program, the limited partnership will be formed under the limited partnership laws of Delaware. When responding to the RFQ, both SMK and Customized Fund Investment Group (Credit Suisse) noted that partnering under Delaware law would be necessary to attract investments. Venture capitalists are familiar with limited partnership operations under Delaware law, which ultimately provides certainty to investors. Delaware has long-established corporate and partnership laws dating back to 1899, and many businesses across the nation form corporations and partnerships under Delaware's law because of its long history and established case law.

It is crucial to note that establishing as a limited partnership under Delaware laws will have no impact on Wisconsin tax collections. All investments will be made in Wisconsin and the State maintains its ability to collect all applicable taxes, such as income, withholding, etc. In addition, any legal disputes would be heard in Wisconsin by Wisconsin courts. Incorporating under Delaware simply provides an additional level of assurance to future investors.

As designated by State law (Wis. Stats. 16.295(4)), the contract limits SMK's annual management fee to 1% of the money designated for investment for four years. Wisconsin has designated $25 million as the total venture capital investment, so SMK's management of funds fee for the first four years will be $250,000 per year from the State. The private partners will also contribute 1% of their venture capital investment per year to SMK's management fees.

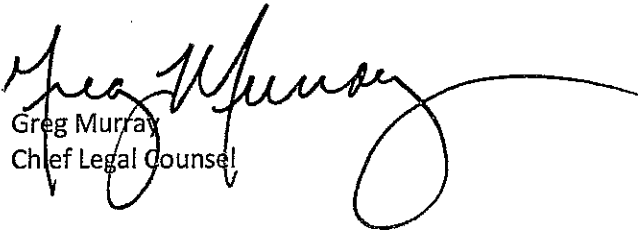
These management fees will be used towards recruiting and establishing investors, directing fund managers, monitoring funds in the investment portfolio, and preparing reports that demonstrate how the funds have been invested. The obligation to pay management fees to SMK does not go into effect until after they have raised the $5 million. The contract continues monitoring fees in years 5-10 for preserving Wisconsin's investments and continued quarterly reporting obligations as required under State law.

As noted, the quarterly progress reports are a requirement of Act 41 to demonstrate how Wisconsin's funds have been invested. These reports will identify each venture capital fund, the businesses in which an investment has been made, and the number of persons employed by these start-up companies.

As venture capital is a long-term economic development strategy, it is expected that the first few progress reports will have limited information because investments will just be underway. In addition, these reports are expected to fluctuate regularly as venture capital markets are more volatile due to their very nature of looking for the next inspired idea, solution or product. While it is expected that not all start-up companies will be successful, we look forward to the opportunity to support new ideas in Wisconsin and ultimately realize economic opportunities for our taxpayers.

Thank you in advance for your review and approval of the venture capital investment program fund of funds management contract.

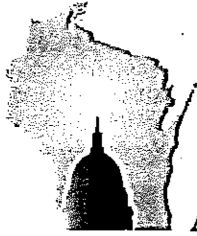
Sincerely,



Greg Murray
Chief Legal Counsel

cc: Senator Alberta Darling, Joint Finance Committee Co-Chair
Representative John Nygren, Joint Finance Committee Co-Chair
Robert Lang, Legislative Fiscal Bureau Director

ATTACHMENT 2



SCOTT WALKER
GOVERNOR
MIKE HUEBSCH
SECRETARY
Office of the Secretary
Post Office Box 7864
Madison, WI 53707-7864
Voice (608) 266-1741
Fax (608) 267-3842

April 8, 2014

(Via Hand-Delivery)

Legislative Audit Bureau
ATTN: Joe Chrisman
22 East Mifflin Street, Suite 500
Madison, Wisconsin 53703

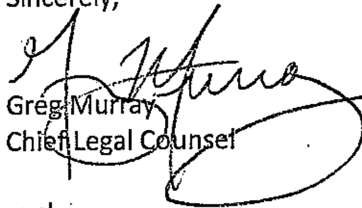
Dear Mr. Chrisman,

Thank you for your letter of April 7, 2014. Attached is a copy of the Services Agreement between Sun Mountain Kegonsa, LLC and Sun Mountain Capital, LLC, referenced as Exhibit B in the proposed contract for venture capital fund management services. I apologize for not including it with the proposed contract I sent you on April 4, 2014.

For your convenience we have reprinted and included another complete copy of the proposed contract we provided on Friday, April 4, 2014.

Please contact me at 267-0202 if you have any questions.

Sincerely,



Greg Murray
Chief Legal Counsel

encl.
cc: Senator Alberta Darling, Joint Finance Committee Co-Chair
Representative John Nygren, Joint Finance Committee Co-Chair
Robert Lang, Legislative Fiscal Bureau Director

ATTACHMENT 3

STATE OF WISCONSIN
Legislative Audit Bureau

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www.legis.wisconsin.gov/lab

Toll-free hotline: 1-877-FRAUD-17

Joe Chrisman
State Auditor

April 21, 2014

Senator Alberta Darling and
Representative John Nygren, Co-chairpersons
Joint Committee on Finance
State Capitol
Madison, Wisconsin 53702

Mr. Michael Huebsch, Secretary
Department of Administration
101 East Wilson Street
Madison, Wisconsin 53703

Dear Senator Darling, Representative Nygren, and Secretary Huebsch:

2013 Wisconsin Act 41 created a venture capital investment program, which is intended to support venture capital funds that invest in Wisconsin businesses. As required by Act 41, we have reviewed the Department of Administration's (DOA's) proposed contract with an investment manager for the State's venture capital investment program. Act 41 requires us to evaluate the terms of the proposed contract and opine on the extent to which the proposed contract conforms with s. 16.295, Wis. Stats., and implements the provisions in ss. 16.295(4) through (7), Wis. Stats. Our review was required to be completed and submitted to the Joint Committee on Finance and DOA within 14 days of our receipt of the proposed contract. Attachment 1 contains 2013 Wisconsin Act 41.

On April 8, 2014, DOA provided us with a complete version of its proposed contract with Sun Mountain Kegonsa, LLC, as required by s. 16.295(3), Wis. Stats. Attachment 2 contains the proposed contract. The proposed contract would create Badger Fund of Funds I, L.P., as a limited partnership between Sun Mountain Kegonsa (the general partner), the State (a limited partner), and other unspecified entities that would invest funds as limited partners. The investment manager (Sun Mountain Kegonsa) is statutorily required to invest in venture capital funds $25.0 million of general purpose revenue (GPR), at least $300,000 of its own funds, and at least $5.0 million that the investment manager raises from other sources.

Under the proposed contract, the limited partnership would last for ten years after the contract's execution, but it could be extended for additional years or terminated earlier under certain circumstances. The proposed contract also indicates that Sun Mountain Kegonsa and the limited partnership would enter into a separate "services agreement" with Sun Mountain Capital LLC, which would provide management and administrative services.

We have evaluated the terms of the proposed contract and found them to generally conform to ss. 16.295(4) through (7), Wis. Stats. Under passive review, Act 41 requires the Joint Committee on Finance to determine whether the contract, in whole or in part, is contrary to the provisions of Act 41 or fails to implement an applicable provision of ss. 16.295(4) through (7), Wis. Stats. To assist the Committee, we have identified questions that it may wish to consider to determine whether the terms of the proposed contract conform to the intent of Act 41. These include questions about the types of payments that the State would make, the investments, the management of investment proceeds, and disclosure and reporting.

Types of Payments that the State Would Make

The proposed contract includes three types of payments that would be made by the State. These are:

- management fees;
- monitoring charges; and
- partnership expenses.

Section 16.295(4)(a), Wis. Stats., requires the contract to establish the investment manager's compensation, including any management fee, which may not exceed, annually for no more than four years, 1.0 percent of the sum of the State's $25.0 million and the funds that the investment manager raises from other sources. The State's share of management fees under the proposed contract would be up to $250,000 annually for four years. The State would not be required to make its first payment of management fees until after Sun Mountain Kegonsa had raised at least $5.0 million from other sources.

We have identified two questions for consideration regarding the types of payments that the State would make under the terms of the proposed contract.

Are required payments under the proposed contract consistent with the intent of Act 41?

The proposed contract would require the State and other limited partners to pay amounts in addition to the management fees. Beginning with the fifth year after Sun Mountain Kegonsa had raised at least $5.0 million from other sources and continuing through the final year of the proposed contract, the State and other limited partners would be required to pay a "monitoring charge." The State's share of the monitoring charges would be up to $225,000 in the fifth year and would decrease in future years.

As shown in Table 1, the State would pay up to $2.1 million in management fees and monitoring charges during the first ten years after Sun Mountain Kegonsa had raised at least $5.0 million from other sources. If the proposed contract were extended for additional years, the State would pay $125,000 in monitoring charges annually.

Table 1

Maximum Management Fees and Monitoring Charges the State Would Pay Under the Proposed Contract[1]

Year[2]	Management Fees	Monitoring Charges	Total
First	$ 250,000	n/a	$ 250,000
Second	250,000	n/a	250,000
Third	250,000	n/a	250,000
Fourth	250,000	n/a	250,000
Fifth	n/a	$ 225,000	225,000
Sixth	n/a	202,500	202,500
Seventh	n/a	182,250	182,250
Eighth	n/a	164,025	164,025
Ninth	n/a	147,623	147,623
Tenth	n/a	132,860	132,860
Total	**$1,000,000**	**$1,054,258**	**$2,054,258**

[1] Based on the first ten years after Sun Mountain Kegonsa had raised at least $5.0 million from other sources. If the proposed contract were extended, the State would pay $125,000 in monitoring charges annually. The proposed contract could be terminated earlier under certain circumstances.

[2] The State would not be required to make its first payment of the management fees until after Sun Mountain Kegonsa had raised at least $5.0 million from other sources.

The proposed contract would also require the State to pay a portion of certain "partnership expenses." Because partnership expenses would be incurred after the proposed contract is executed, their amount is unknown. However, the amount that the State would be contractually obligated to pay for a given

partnership expense could vary based, in part, on the State's $25.0 million as a proportion of all amounts provided by the limited partners. For example, if other limited partners provided $5.0 million, the State's $25.0 million could make it contractually responsible for approximately 80.0 percent of partnership expenses, which include:

- the fees, costs, and expenses of tax advisors, legal counsel, auditors, consultants, and other professionals;
- all fees, costs, and expenses to develop, negotiate, structure, and dispose of investments in venture capital funds, including but not limited to financing, legal, accounting, advisory, and consulting expenses;
- brokerage commissions, custodial expenses, and other investment costs actually incurred in connection with actual venture capital fund investments;
- interest, fees, and expenses arising out of any borrowing made by the limited partnership;
- the costs of litigation, liability and other insurance, indemnification, and extraordinary expenses or liabilities relating to the limited partnership's affairs;
- expenses associated with liquidating the limited partnership;
- any taxes, fees, or other governmental charges levied against the limited partnership, and all expenses of any tax audit, investigation, settlement, or review of the limited partnership;
- all expenses incurred in organizing the limited partnership and the marketing and offering of interests in the limited partnership, including legal and accounting fees, travel, and filing fees, up to 0.5 percent of the amounts provided by the State, other limited partners, and Sun Mountain Kegonsa;
- the expenses of the contractually created Advisory Committee, which would include up to five members, including the DOA secretary or designee, and would conduct contractually specified duties, such as providing advice and counsel as requested by Sun Mountain Kegonsa;
- the expense of maintaining an independent registered agent in Wisconsin for service of process in connection with any suit, action, or other proceeding arising out of the proposed contract; and
- marketing, sponsorship, and advertising expenses to promote the limited partnership.

As noted, the monitoring charges and partnership expenses included in the proposed contract are in addition to the management fee specified as compensation in Act 41. Given that neither statutes nor the proposed contract specify the services that the management fees or monitoring charges would cover, the Committee may wish to obtain clarification from DOA about the distinction among the management fees, monitoring charges, and partnership expenses.

Should Sun Mountain Capital continue to receive "management fees" after termination of the separate services agreement?

The separate services agreement authorizes Sun Mountain Capital to act on behalf of the limited partnership as it deems necessary in order to provide management and administrative services. It indicates that Sun Mountain Capital would continue to receive "management fees" even if the services agreement were terminated. The Committee may wish to ascertain from DOA the reasons why management fees would be paid to Sun Mountain Capital after the termination of the services agreement.

Investments

We have identified four questions for consideration regarding investments under the terms of the proposed contract.

What portion of the State's $25.0 million would be devoted to investment in venture capital funds?

The proposed contract would allow the management fees, monitoring charges, and partnership expenses to be paid in several ways, including:

- from the $25.0 million provided by the State and the amounts provided by the other limited partners;
- from the investment proceeds of the State and the investment proceeds of the other limited partners; and
- from funds borrowed by the limited partnership, which would be repaid by the State and the other limited partners.

In addition, the proposed contract would allow Sun Mountain Kegonsa to use its own funds to pay for some or all of the partnership expenses, if it chose to do so.

Section 16.295(5)(b), Wis. Stats., requires the investment manager to invest the State's $25.0 million in at least four venture capital funds. If the management fees, monitoring charges, and partnership expenses were paid from the State's $25.0 million, the amount that would be invested in venture capital funds would be reduced. In addition, we note that the proposed contract would allow Sun Mountain Kegonsa not to invest all $25.0 million under certain circumstances, such as adverse market conditions.

Is the commitment of funds by the investment manager under the proposed contract sufficient to meet the intent of Act 41?

Section 16.295(5)(c)2, Wis. Stats., states that the investment manager "shall commit" at least half of the program funds to investments in venture capital funds within 12 months after the contract's execution, and that the investment manager "shall commit" all program funds to such investments within 24 months after the contract's execution. The proposed contract would require Sun Mountain Kegonsa to make "commercially reasonable efforts to cause the Partnership to commit" at least half of the limited partnership's funds—less a reasonable reserve for management fees, monitoring charges, partnership expenses, and similar fees and expenses—to investments in venture capital funds within 12 months after the proposed contract's execution and all of the limited partnership's funds—less a reasonable reserve for management fees, monitoring charges, partnership expenses, and similar fees and expenses—to investments in venture capital funds within 24 months after the proposed contract's execution.

Is the commitment of funds by a venture capital fund under the proposed contract sufficient to meet the intent of Act 41?

Section 16.295(5)(d)2, Wis. Stats., states that each contract between the investment manager and a venture capital fund receiving program funds must require the venture capital fund to "commit" at least half of the funds to investments in businesses within 24 months after the venture capital fund receives the funds and to "commit" all of the funds within 48 months after the venture capital fund receives the funds. The proposed contract would require each venture capital fund to agree to make "commercially reasonable efforts to commit" the funds to investments in businesses within the statutorily specified time periods.

Are the alternative investment structures that could be created by the proposed contract consistent with the intent of Act 41?

Although alternative investment structures were not specifically identified in Act 41, the proposed contract would allow Sun Mountain Kegonsa to invest funds of the limited partnership through alternative investment structures, which are not contractually defined but may be created for legal, tax, regulatory, or other reasons that are in the best interests of Sun Mountain Kegonsa or any

of the limited partners. Such investments would be made outside the limited partnership through other organizational structures that would invest "on a parallel basis with or in lieu of" the limited partnership and would be made on terms "substantially identical in all material respects to those of the Partnership, to the maximum extent allowable consistent with the reasons for utilization" of the alternative investment structure. The State would not be required to invest through any alternative investment structure without the consent of the DOA secretary. The Committee may wish to ascertain from DOA the likelihood that such alternative investment structures would be created and how such structures would affect investments made with the State's $25.0 million.

Management of Investment Proceeds

We have identified two questions for consideration regarding management of investment proceeds under the terms of the proposed contract.

Is the use of a separate "capital account" sufficient to meet the intent of Act 41?

Section 16.295(6)(a), Wis. Stats., requires the investment manager to hold the gross proceeds from investments of the State's $25.0 million in an "escrow account." The proposed contract would require Sun Mountain Kegonsa to establish for each limited partner a separate "capital account" for the funds provided by that limited partner and the profits allocated to that limited partner.

Are the State's indemnification obligations under the proposed contract consistent with the intent of Act 41?

Although indemnification provisions were not specifically identified in Act 41, the proposed contract contains provisions stating that for up to three years after its termination, or until resolution of any legal action, suit, or proceeding pending before any court, arbitrator, governmental body, or other agency, the State and the other limited partners would be required to return to the limited partnership the "distributions" they had previously received in order to cover the limited partnership's indemnification obligations. The amount of distributions that the State and the limited partners would be required to return would be limited under the proposed contract. As a result, the State's maximum liability would be $12.5 million after the contract's termination, presuming it had received that amount in distributions.

Disclosure and Reporting

We have identified four questions for consideration regarding disclosure and reporting under the terms of the proposed contract.

Are the disclosures required by each venture capital fund under the proposed contract sufficient to meet the intent of Act 41?

Section 16.295(5)(d)6, Wis. Stats., requires each venture capital fund that receives program funds to disclose to the investment manager and DOA any interest that the venture capital fund or an owner, stockholder, partner, officer, director, member, employee, or agent of the venture capital fund holds in a business in which the venture capital fund invests or "intends to invest" program funds. The proposed contract would require each venture capital fund that receives the limited partnership's funds to make such disclosures for actual investments but not for intended investments.

Are the audit requirements under the proposed contract sufficient to meet the intent of Act 41?

Section 16.295(7)(a)1, Wis. Stats., requires the investment manager to annually submit to DOA an audit of the investment manager's financial statements performed by an "independent" certified public accountant. The proposed contract would require Sun Mountain Kegonsa to annually provide an opinion of a firm of certified public accountants based on its audit of the financial statements of the limited partnership, rather than of Sun Mountain Kegonsa. The proposed contract would not require the certified public accountants to be independent.

Is reporting on the average internal rate of return on investments made with the limited partnership's funds sufficient to meet the intent of Act 41?

Section 16.295(7)(a)3.d, Wis. Stats., requires the investment manager to annually submit to DOA a report that includes certain information, including the average internal rate of return on each "venture capital fund's" investments of program funds. The proposed contract would require Sun Mountain Kegonsa to report on the average internal rate of return on investments made with "funds attributable to the Partnership," rather than on each venture capital fund's investments of program funds.

Is the information specified under the proposed contract for inclusion in the quarterly report to DOA sufficient to meet the intent of Act 41?

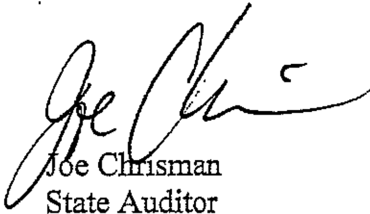
Section 16.295(7)(c)2, Wis. Stats., requires the investment manager to report quarterly to DOA on certain information regarding each business in which a venture capital fund held investments "in the prior quarter," including the amount of the State's funds invested in each business. The proposed contract would require Sun Mountain Kegonsa to provide the specified information for the businesses in which a venture capital fund held investments at the "end" of the prior fiscal quarter. In addition, the proposed contract would require Sun Mountain Kegonsa to identify the amount of limited partnership funds invested in each business, but not the amount of the State's funds invested in each business.

Amendments and Changes to the Contract

Our review and the questions we identified for the Committee's consideration are based on the proposed contract contained in Attachment 2. The proposed contract may be executed and then amended or supplemented, within certain specified limits, by the written consent of Sun Mountain Kegonsa and DOA.

I hope you find this information helpful. Please let me know if you have any questions.

Sincerely,



Joe Chrisman
State Auditor

JC/DS/sw

Attachments

cc: Members, Joint Committee on Finance
Members, Joint Legislative Audit Committee

Bob Lang, Director
Legislative Fiscal Bureau

ATTACHMENT 4

WISCONSIN DEPARTMENT OF
ADMINISTRATION

SCOTT WALKER
GOVERNOR
MIKE HUEBSCH
SECRETARY
Office of the Secretary
Post Office Box 7864
Madison, WI 53707-7864
Voice (608) 266-1741
Fax (608) 267-3842

April 28, 2014

Senator Alberta Darling and
Representative John Nygren, Co-chairpersons
Joint Committee on Finance
State Capitol
Madison, Wisconsin 53702

Joe Chrisman
State Auditor
Legislative Audit Bureau
22 East Mifflin Street, Suite 500
Madison, Wisconsin 53703

Dear Senator Darling, Representative Nygren, and Mr. Chrisman,

The Department of Administration (DOA) is pleased that the Legislative Audit Bureau (LAB) has concluded that the terms of the proposed contract with Sun Mountain Kegonsa, LLC (SMK), to serve as investment manager for the State's venture capital program under 2013 Wisconsin Act 41 (Act 41) conforms to the requirements of the Act.

The purpose of this letter is to share DOA's responses to the additional clarification questions raised by LAB in its April 21, 2014 letter, which is attached. We look forward to discussing any further questions the Joint Committee on Finance (JCF) may have after reviewing our responses to LAB's letter.

Below is an outline of the questions posed by LAB, along with DOA's responses.

TYPES OF PAYMENTS THAT THE STATE WOULD MAKE

1) Are required payments under the proposed contract consistent with the intent of Act 41?

Answer: YES

The proposed contract with SMK takes the form of a limited partnership agreement (LPA). This will create a new business entity called the Badger Fund of Funds I, L.P., which is a limited partnership (partnership or LP). Under the LPA, SMK, acting as general partner (GP), would be entitled to two primary types and potentially a third type of payment from the partnership. These payments identified by LAB

include the following: 1) management fees; 2) monitoring charges; and 3) partnership expenses. To cover these fees, charges and expenses, each limited partner must make contributory payments based on their pro rata contributions of capital to the partnership.

A. Management Fees
The purpose of the management fee is threefold. First, it compensates SMK for bringing capital into the State by finding investors for the venture capital program. Second, it compensates SMK for cultivating venture capital in the State by finding appropriate venture capital funds in which to invest that capital. Finally, it compensates SMK for performing management services for the State's investments such as compensation of the GP's personnel, costs and overhead of providing offices, certain GP organizational expenses, etc.

The statutory authority for the State's contributory payments of management fees is Section 16.295(4)(a) of the Wisconsin Statutes, which states that "[T]he department shall contract with the investment manager. The contract shall establish the investment manager's compensation, including any management fee. Any management fee may not exceed, annually for no more than four years, 1 percent of the total moneys designated under sub. (5) (b) 1 and raised under sub. (5) (b) 3."

Consistent with the authority and limitations of Section 16.295(4)(a), Sections 6(b)(i)&(ii) of the LPA require each limited partner to pay a management fee to SMK limited to 0.25% of their respective capital commitment each quarter, for four years. For the State, this means paying $250,000 per year, for four years, in management fees to SMK.

B. Monitoring Charges
The purpose of the monitoring charge is to compensate SMK for performing investment monitoring services after the initial four years of the limited partnership's existence, in order to: a) ensure the investments are preserved and are not being mismanaged by the venture capital funds; and b) comply with the continued quarterly reporting requirements of Act 41.

The statutory authority for the State's contributory payments of monitoring charges is also in Section 16.295(4)(a) of the Wisconsin Statutes, which specifies that "[t]he department shall contract with the investment manager," and that "[t]he contract shall establish the investment manager's compensation." The only limitation placed on DOA with respect to negotiating the investment manager's compensation under Act 41 is that to the extent the contract allows for a management fee, such fee cannot exceed $250,000 per year, for four years. Given the specific language of the statute, it appears the legislature contemplated that the contract would provide for payment of a variety of expenses and compensation usual and customary within the field, but that any management fee would be capped.

Consistent with the authority and limitations of Section 16.295(4)(a), Section 6(b)(iv) of the LPA requires each limited partner to pay a monitoring charge to SMK, commencing in the fifth year of the limited partnership. The monitoring charges

gradually reduce over time in recognition of the fact that as time passes, the need for active monitoring of the partnership's investments declines.

C. Partnership Expenses
When considering the purpose of these expenses, it is important to note that the Badger Funds of Funds, I, like any business will need to incur traditional business operations expenses. For example, the partnership itself, as a business and distinct from SMK will have to engage auditors, CPAs, consultants and other professionals; it will have to incur certain closing costs and transaction expenses in making investments and cover other actual out of pocket expenses. These "partnership expenses" are distinct from monies actually paid directly to the SMK. Once it gets up and running, the partnership itself will pay these third parties and other expenses directly as part of business operations. However, as pointed out by LAB it is contractually possible for SMK to "front" some of these expenses to the partnership; in such case SMK would be reimbursed for them.

The statutory authority for the State's contributory payments to cover partnership expenses is likewise Section 16.295(4)(a) of the Wisconsin Statutes.

Consistent with the authority and limitations of Section 16.295(4)(a), Section 6(c) of the LPA requires each limited partner to make contributory payments to cover the expenses of the limited partnership. LAB's letter outlines the various expenses for which the limited partners will reimburse SMK. These expenses are also set forth in Section 6(c)(i) of the LPA. For administrative convenience, some of these expenses may be paid for by SMK and then SMK would be reimbursed by the Badger Fund of Funds as set forth in Section 6(c)(i) of the LPA. The expenses are borne by each investor, both private investors and the State, in proportion to their respective capital commitment to the Badger Fund of Funds.

It should be noted that Section 3(a) and (f) of the LPA specifies how investment proceeds are to be distributed to the limited partners. Consistent with Act 41, the State is to receive 100% of its pro rata share of all investment proceeds until it fully recoups its $25 million investment. Thereafter, the State and SMK split the State's investment proceeds 90%/10%. Thus, even though a small fraction of the State's $25 million will go to SMK as management fees, monitoring charges, and potentially partnership expenses, SMK will not get a share of any investment proceeds until the State has recouped its full contribution towards such fees and expenses. In other words, if the venture capital program is successful, the fees and expenses will pay for themselves.

2) Should Sun Mountain Capital continue to receive "management fees" after termination of the separate services agreement?

The State's obligation to pay management fees to SMK is not impacted by the separate services agreement.

Under LPA Section 6(b)(viii), SMK, as general manager of the limited partnership, will enter into a services agreement with Sun Mountain Capital, LLC, (SMC). Under

that agreement SMK assigns certain rights to SMC, including the right to receive the management fee and monitoring charges, and further delegates certain of its duties under the LPA to SMC.

While the LPA references the services agreement between SMK and SMC, neither the State nor Badger Fund of Funds, L.P. is a party to that contract. Consistent with Act 41, the LPA requires the State and the other limited partners to pay SMK management fees. However, it is important to understand that if SMK were to terminate the agreement with SMC and hire another manager, SMK would be *solely* responsible for paying the new manager's fees. The State would not incur any additional liability, and would not be obligated under the LPA or the service agreement to pay the management fee twice.

It should also be noted that SMK itself is a limited liability corporation with two shareholders: SMC and Kegonsa. Therefore the likelihood that SMK would terminate one of its only two partners is remote.

Notwithstanding the above, if the JCF desires, we can request that this provision of the service agreement be amended.

INVESTMENTS

1) What portion of the State's $25.0 million would be devoted to investment in venture capital funds?

One hundred percent of the State's $25 million will be invested into the LP. Although a small portion of the $25 million will go towards fees and expenses, this is no different than what happens if an individual were to invest $25 million in mutual funds with a broker, such as Vanguard or Fidelity Investments. Each mutual fund carries fees and expenses, which are typically considered part of the "investment."

Moreover, as investment proceeds are distributed back to the limited partners the LPA contains provisions that instruct SMK to redirect a portion of those proceeds equal to the amount each limited partner contributed to management fees, monitoring charges, and partnership expenses, back into venture capital fund investments. Thus, based on this structure, if the program is successful $25 million will in fact be invested over time in at least 4 venture capital funds as expressly required by the act.

While it is difficult to determine with exact precision all total costs associated with operating a business enterprise over a potentially 10 year period, SMK has nonetheless provided DOA with rough estimates, which are attached as Exhibit A. These estimates are not intended to serve as benchmarks, but instead are provided to give you a very rough sense of the order of magnitude for partnership expenses.

Additionally, while the legislature specifically directed DOA to provide for compensation in Act 41, the legislature did not provide any separate appropriation

for the investment manager's compensation, fees or expenses. Therefore, it appears that the legislature intended that the compensation, fees and expenses under Wis. Stat. 16.295(4)(a) would be paid initially out of the original $25M appropriation.

Finally, LAB cites to section 3(c)(iv)(B)(y) of the contract to suggest that the GP could broadly avoid its obligation to invest all $25M under adverse market conditions. We would note that this is a standard provision in these kinds of contracts to mitigate litigation risk by LPs against the partnership during times of significant market fluctuation; moreover, such provision can only be triggered following formal written consultation with the partnership's legal counsel affirming the existence of the specific unique triggering market conditions. Moreover, SMC has advised us that in all of their years serving as a private equities investment manager, it has never had to exercise this standard provision. Finally, we note that the LPs are protected from an abuse of this authority because the LPA allows the GP to be removed without cause.

2) Is the commitment (or investment) of total LP funds into the specific venture capital funds by the investment manager under the proposed contract sufficient to meet the timing intent of Act 41?

Answer: YES

Section 16.295(5)(c)2 of the Wisconsin Statutes requires the investment manager to commit at least half of the venture capital program funds to investments in venture capital funds within 12 months after the contract's execution, and all remaining funds within 24 months. LAB's letter raises questions about two aspects of the LPA that address this aspect of Act 41.

First, the letter notes that the LPA requires SMK to make "commercially reasonable efforts to cause the Partnership to commit" funds within the time parameters of Act 41. The inclusion of this "commercially reasonable efforts" language in the LPA came about as a result of extensive negotiations with SMK. SMK's reasonable concern was that if it was actively closing on a contract with a venture capital fund, but would go over a statutory deadline by a week or two in order to conduct proper due diligence, SMK did not want that to be considered a material breach of the agreement. Significantly, the alternative would be a rushed decision, without proper due diligence, which could result in a bad investment.

It should be noted that Section 16.295(5)(c)2 requires the investment manager to meet the statutory deadlines, regardless of what is in the LPA. Thus, if SMK were to miss an investment deadline the State could still choose to pursue a statutory claim against SMK. It would also still be able to pursue a breach of contract claim if it felt that SMK was not making commercially reasonable efforts to meet the statutory deadlines.

Second, the letter notes that the LPA allows SMK to withhold a reasonable reserve for fees and expenses. As discussed above, because fees and expenses are

considered part of the State's investment, this provision is consistent with the requirements of Act 41.

3) Is the commitment (or investment) of funds by a venture capital fund into specific businesses under the proposed contract sufficient to meet the timing intent of Act 41?

Answer: YES

This question raises a similar issue as the previous question. Specifically, Section 16.295(5)(d)2 requires that each contract between SMK and the venture capital funds receiving program funds must require the venture capital funds to invest those funds in Wisconsin businesses within certain deadlines. Our response to the previous question addresses this issue.

4) Are the alternative investment structures that could be created by the proposed contract consistent with the intent of Act 41?

Answer: YES

SMK's ability under the LPA to utilize alternative investment structures (AIS) should not have any effect on investments made with the State's $25 million.

AISs are not exotic investments. An AIS is essentially a separate legal business entity created to allow investments outside of the partnership, using partnership funds. Typically AISs are used when a limited partner is a tax-exempt entity and investing in a particular fund directly through the limited partnership would jeopardize that limited partner's tax-exempt status.

When a general partner sets up an AIS the organizational documents for that structure mirror those found in the LPA, modified only to reflect the structure itself and for changes necessary for the purpose for which the structure was created (e.g., to include provisions protecting a limited partner's tax exempt status).

Section 2(h) of the LPA allows SMK to make investments in AISs. However, the State is not legally obligated to invest, and the LPA contains strong protections for the State to ensure that the investments of its funds are consistent with the requirements of Act 41. Section 2(h) of the LPA specifies that investments in AISs shall be on terms "substantially identical in all material respects to those of the Partnership, to the maximum extent allowable consistent with the reasons for utilization of the alternative investment structure." Thus, if SMK decides to create an AIS to protect the tax-exempt status of limited partner, the organizational documents would be virtually identical to the LPA, with changes to protect the tax-exempt status of the limited partner, which are unlikely to affect the investment's compliance with the requirements of Act 41. Moreover, because SMK would be investing venture capital program funds into the AIS, all of Act 41's requirements would apply to those investments as well. The money would go to venture capital funds, which in turn could only invest in qualified Wisconsin businesses.

Finally, the LPA allows the State to opt out of any investment in an alternative investment structure. Thus, DOA will be given the opportunity to review the organizational documents of the alternative investment structure and decide whether it complies with the requirements of Act 41 before agreeing to invest in it.

Because SMK has not yet signed up additional outside investors as limited partners it is impossible to speculate how frequently it would need to consider investments via an AIS. If none of the outside investors are tax-exempt entities it is likely that SMK will never have to utilize an AIS.

MANAGEMENT OF INVESTMENT PROCEEDS

1) Is the use of a separate "capital account" sufficient to meet the intent of Act 41?

Answer: YES

Section 16.295(6)(a) of the Wisconsin Statutes requires the investment manager to "hold in an escrow account its gross proceeds" from the investments of the State's $25 million and make distributions from that account at least annually.

Escrow accounts and capital accounts serve two distinct functions. An escrow account is effectively a bank account where investment proceeds are deposited until they are distributed. The Badger Fund of Funds, LP, will have a bank account into which its investment proceeds from its investments in venture capital funds will be deposited. A capital account is an accounting mechanism, akin to a ledger in a checkbook, used to keep track of debits and credits. There is nothing inconsistent with using a separate capital account for each limited partner, including the State, to track their debits and credits, and using a bank account to hold the partnership's investment proceeds before they are distributed to each individual partner. As contemplated by Act 41 money in this Badger Fund of Funds bank account does not flow directly to SMK, and further money cannot be released from this account without all applicable fiduciary, contractual and legal obligations being fulfilled.

As discussed previously above, the State will recoup its full $25 million investment, before the investment manager is entitled to any share of the proceeds returned on the State's investment. Therefore, the LPA does not allow SMK individually to hold any of the State's investment proceeds at all until the State is repaid. We believe this structure is consistent with Legislature's express intent to prohibit the investment manager from taking proceeds until the State is repaid its entire initial investment.

2) Are the State's indemnification obligations under the proposed contract consistent with the intent of Act 41?

Answer: YES

Act 41 does not guarantee that the State will see a full return of its $25 million investment. Investing has inherent risks, including litigious claims. The risks associated with the inclusion of indemnity requirements of the LPA (potential limited return of investment proceeds) were carefully weighed against the risks associated with not having such requirements (potential difficulty attracting investors, who will expect that limited partners will assist in the partnership in defending against claims). The negotiated terms of the LPA were crafted to balance these two risks.

It should be noted that LAB's letter sets out the worst-case scenario, under which the State would be required to return $12.5 million after the termination of the LPA. While this scenario does exist, it is highly unlikely. For that to happen 1) the State would need to have fully recouped its $25 million investment, 2) the State would need to have recouped at least half of that return within the last three years of the partnership, and 3) a third party would have had to successfully litigate a claim against the partnership.

As LAB indicates in its letter, Act 41 does not address whether the contract between DOA and the investment manager can or should contain such claw back provisions. Instead, it gives DOA broad authority to contract with the investment manager, subject to review by LAB and JCF to ensure compliance with the requirements of Act 41.

The LPA gives SMK limited authority to claw back certain investment proceed distributions from limited partners to the partnership if necessary for the partnership itself to address certain indemnity obligations. The claw back has several limitations. First, in the aggregate, it cannot exceed fifty percent of a limited partner's total capital contributions. Second, the general partner cannot claw back any distributions older than three years, unless there is an actively pending claim against the partnership. Finally, claw backs are treated the same as capital contributions, which means for purposes of determining whether the investment manager's right to a 90%/10% split of investment proceed distributions has been triggered, any indemnification claw back must be taken into account.

The State has an additional protection. Investment proceeds distributed to the State go into the general fund per Section 16.295(6)(b) of the Wisconsin Statutes. Moreover, the State has not waived sovereign immunity in this contract. Therefore, in order for SMK to claw back funds from the State for indemnification it would have to follow the normal claim procedures under Wis. Stat. 16.007. This means SMK is treated no differently under the LPA than any other person or entity with whom the State contracts.

DISCLOSURE AND REPORTING

1) Are the disclosures required by each venture capital fund under the proposed contract sufficient to meet the intent of Act 41?

Answer: YES

Section 16.295(5)(d)6 of the Wisconsin Statutes requires the investment manager to contract with each venture capital fund that receives money under the venture capital program, and further specifies that each contract must require the venture capital fund to disclose any interest it holds in a business in which the fund invests or intends to invest moneys received under the venture capital program.

Section 4(a)(ix) of the LPA contains the same requirement, absent the language underlined above. Nonetheless, the investment manager's actions are governed by both the LPA and Act 41. Thus, the investment manager must still comply with the requirement in Act 41 that its contracts with venture capital funds contain a provision requiring the funds to disclose any interest they hold in business in which they invest or intend to invest moneys received under the venture capital program.

While we believe the LPA as written complies with the requirements of Act 41, we are happy to amend it to include the "or intends to invest" language if JCF feels it is an appropriate or necessary clarification.

2) Are the audit requirements under the proposed contract sufficient to meet the intent of Act 41?

Answer: YES

Section 16.295(7)(a)1 of the Wisconsin Statutes requires the investment manager to submit an annual report to DOA that includes, among other things, an audit of its financial statements performed by an independent certified public accountant. Section 7(c)(iv) of the LPA requires SMK to submit an annual report to each limited partner that includes, among other things, *"an opinion of a firm of certified public accountants based upon their audit of the financial statements of the partnership for the previous fiscal year prepared in accordance with the United States generally accepted accounting principles."* LAB's letter raises two issues: 1) the absence in the LPA of the requirement under Act 41 that the certified public accountant be "independent"; and 2) that the LPA calls for an audit of the partnership's financial statements, and not that of the investment manager.

First, the intent of the quoted language is to require a "quote" independent audit. Thus, we are happy to amend the language if JCF feels it is an appropriate or necessary clarification.

Second, as stated above, the investment manager's actions are governed by both the LPA and Act 41. Thus, in addition to the audit requirements contained in the LPA, SMK must also comply with the requirement in Act 41 that it submit an annual audit of its financial statements performed by an independent certified public accountant to DOA. Again, while we believe the LPA as written complies with the requirements of Act 41, we are happy to amend it, if JCF feels it is necessary, to include the following language: "Annually, within 120 days after the end of the

General Partner's fiscal year, the General Partner shall submit a report to the Wisconsin Department of Administration for that fiscal year that includes an audit of the General Partner's financial statements performed by an independent certified public accountant."

3) Is the reporting on the average internal rate of return on investments made with the limited partnership's funds sufficient to meet the intent of Act 41?

Answer: YES

Section 16.295(7)(a)3.d of the Wisconsin Statutes requires the investment manager to submit an annual report that includes, among other things, for each venture capital fund that contracts with the investment manager the venture capital fund's average internal rate of return on its investments of the moneys it receives under Wis. Stat. 16.295(5)(b). Section 7(c)(ii)(4) requires the general partner to submit an annual report that includes, among other things, "the average internal rate of return on investments made with funds attributable to the Partnership." LAB's letter questions whether the language in the LPA only requires SMK to report on the average internal rate of return on investments with venture capital funds in the aggregate, rather than on each separate venture capital fund's investment of program funds.

Read in isolation, the requirement to submit an annual report containing "the average internal rate of return on investments made with funds attributable to the Partnership" could possibly be interpreted only to require SMK to report on the average internal rate of return on investments with venture capital funds in the aggregate. However, the language must be read in context. Section 7(c)(ii), in its entirety, reads as follows:

> ii. Within 120 days (subject to reasonable delays in the event of the late receipt of any necessary financial information from any Portfolio Company) after the end of each Fiscal Year of the Partnership, the General Partner will send to each Person who was a Partner during such period a schedule of:
>
> (1) the name and address of each Portfolio Company;
>
> (2) the amounts invested by the Partnership in each Portfolio Company;
>
> (3) an accounting of any fee paid by the Portfolio Company to itself, its general partner, manager or the like;
>
> (4) the average internal rate of return on investments made with funds attributable to the Partnership; and
>
> (5) the Partnership's internal rate of return on its Portfolio Investments.

The phrase in question is preceded by three other requirements that are specific to each Portfolio Company (the term "Portfolio Company" is used in the LPA to mean the venture

capital funds contemplated by Act 41.). The placement of the requirement in question after these other three requirements means that it also applies to each specific Portfolio Company. This conclusion is further supported by the next reporting requirement, which explicitly applies to the partnership, and not the individual venture capital funds. The fifth reporting requirement clearly indicates a line of demarcation between reporting requirements that apply with respect to each individual venture capital fund and requirements that apply to the partnership.

We believe these reporting requirements are consistent with the requirements of Act 41. Nonetheless, we are happy to amend the language, if JCF feels it is necessary, to state as follows: "for each Portfolio Company, the average internal rate of return on investments made with funds attributable to the Partnership."

4) Is the information specified under the proposed contract for inclusion in the quarterly report to DOA sufficient to meet the intent of Act 41?

Answer: YES

Section 16.295(7)(c)2 of the Wisconsin Statutes requires the investment manager to report quarterly to DOA on certain information, including the following: 1) an identification of each business receiving funds under Act 41 in the previous quarter; and 2) a separate statement indicating how much of the funds received by that business are attributable to the State. Section 7(c)(2) of the LPA requires the general partner to submit quarterly reports on certain information, including the following: 1) an identification of each business owned by a Portfolio Company at the end of such fiscal quarter; and 2) the investment in such business attributable to the partnership.

LAB raises two questions in its letter: 1) whether there is an inconsistency between requiring an identification of each business receiving funds under Act 41 in the previous quarter, and requiring an identification of each business owned by a Portfolio Company at the end of the fiscal quarter; and 2) whether there is an inconsistency between a separate statement indicating how much of the funds received by a business are attributable to the State and a statement indicating how much of the funds received by a business are attributable to the partnership.

As stated above, the investment manager's actions are governed by both the LPA and Act 41. Thus, in addition to the reporting requirements contained in the LPA, SMK must also comply with the reporting requirements in Act 41.

While we believe the LPA as written complies with the requirements of Act 41 and specifically requires the information set forth in LAB's question, we are happy to amend it, if JCF feels it is necessary, to include the following reporting requirement: "An identification of each Eligible Business in which a Portfolio Company invested funds attributable to the Partnership and a statement of the amount of the investment in each Eligible Business that separately specifies the amount of the State's Capital Contribution that was contributed to the investment."

AMENDMENTS

Finally, LAB noted that the LPA could in fact be amended by the parties. This concept is a very standard and is included in all State contracts. Contract amendment is not addressed in Act 41 and was not the subject of any substantive discussion among the parties. If JCF has questions about this provision, we are happy to address them.

I hope you find this information helpful. Please let me know if you have any other questions.

Sincerely,

Gregory D. Murray
Chief Legal Counsel

Attachment

cc: Mike Huebsch, Secretary, Department of Administration
Bob Lang, Legislative Fiscal Bureau Director

Badger Fund of Funds 10 Year Projected Fund Expenses

Draft Materials

Fund size	$30,000,000									
Management fee	1%									
Year	1	2	3	4	5	6	7	8	9	10
Management fee	300,000	300,000	300,000	300,000	0	0	0	0	0	0
Monitoring Costs	0	0	0	0	270,000	243,000	218,700	196,830	177,147	159,432
Organization costs	60,000	0	0	0	0	0	0	0	0	0
Other costs *	50,000	60,000	40,000	35,000	35,000	30,000	30,000	30,000	25,000	25,000
Total expenses	410,000	360,000	340,000	335,000	305,000	273,000	248,700	226,830	202,147	184,432

*Other costs
- Accounting/auditing/reporting
- Tax preparation and consulting
- E & O insurance
- Legal fees
- Investment due diligence
- Taxes and licenses

Note: for years 5-10, Other Costs represent audit and accounting fees, tax preparation costs, legal expenses, and insurance