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An Audit Report on

The Emerging Technology Fund

April 2011

Report No. 11-029

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Overall Conclusion

The Emerging Technology Fund (ETF) should make significant improvements to promote greater transparency and accountability.

Issues in a number of areas impair the ability to administer the ETF in the best interests of the State. It is important to hold recipients of funds accountable. Auditors identified the following weaknesses:

- Decision making related to the ETF and recipients of funds is not open to the public.
- The ETF conducts limited monitoring of recipients' performance and expenditures of funds.
- The Office of the Governor does not report the value of the State's investments through the ETF on its financial statements.
- The ETF does not administer its contracts with the seven Regional Centers for Innovation and Commercialization (RCICs) and the Texas Life Science Center for Innovation and Commercialization (Texas Life Science Center) in a consistent manner. Both the RCICs and the Texas Life Science Center evaluate and make recommendations to the ETF's Advisory Committee regarding applications for funds. The Advisory Committee then makes its recommendations to the ETF's trustees. Trustees make the final approvals on ETF grants and awards.

The Office of the Governor, which administers the ETF, was cooperative and provided all of the information the State Auditor's Office requested during this audit.

Background Information

The Legislature established the Emerging Technology Fund (ETF) in 2005 and initially funded it with:

- \$100 million from the General Revenue Fund.
- \$100 million from the Economic Stabilization Fund (Rainy Day Fund).

As of August 31, 2010, a total of 153 grants and awards totaling \$342,336,567 had been awarded to recipients.

Recipients can receive funds in three ways:

- **Commercialization awards** are investments that help companies take ideas from concept to the marketplace.
- **Research matching grants** create public-private partnerships with higher education institutions, federal government grant programs, and industry.
- **Research superiority grants** are awarded to higher education institutions to recruit research talent.

The Governor, Lieutenant Governor, and Speaker of the House of Representatives are the trustees for the ETF. After receiving recommendations from an Advisory Committee, the trustees make the final decision about which applicants will receive funds.

Key Points

The RCICs and the Texas Life Science Center do not have consistent processes, and their board members were not required to sign conflict of interest disclosure statements until 2010.

The RCICs and the Texas Life Science Center do not consistently record board meeting minutes, votes, and recusals.

Board members for RCICs and the Texas Life Science Center were not required to sign conflict of interest disclosure statements until 2010. Members of application review committees are not required to sign conflict of interest disclosure statements; those members are the first individuals to review a commercialization award application to determine its viability.

Advisory Committee meetings, subcommittee application review meetings, and teleconferences are not open to the public.

Meetings of the ETF's Advisory Committee are not open to the public. Although the ETF is required to follow the Texas Public Information Act, under Texas Government Code, Section 490.057, ETF application information is treated as confidential while an application is considered for an award or a grant. Ten other states with similar programs that auditors surveyed allowed significantly more public access to meetings and documents related to the award of public funds.

Advisory Committee

The Governor appoints the members of the Advisory Committee, which comprises up to 17 individuals who are industry leaders in Texas or nationally recognized researchers from higher education institutions.

The Advisory Committee reviews applications for commercialization awards, research matching grants, and research superiority grants and makes recommendations to ETF trustees.

The Advisory Committee does not record meeting minutes, member votes on applications, members' recusals, or milestones that applicants must achieve.

Because the Advisory Committee does not maintain minutes of its meetings, it is not possible to evaluate how the Advisory Committee addresses disclosures of conflicts of interest. For example, one Advisory Committee member had consulting contracts with two recipients of ETF awards at the time that those recipients received additional disbursements of funds approved by the Advisory Committee. It is unclear whether the Advisory Committee member who had the consulting contracts voted to approve those additional disbursements of funds because the Advisory Committee does not maintain meeting minutes or record member votes.

The Advisory Committee does not follow consistent processes for accepting, evaluating, and recommending applications to receive funds from the ETF.

The Advisory Committee has been inconsistent in terms of which applications it will accept for review. The Advisory Committee recommended that the ETF trustees provide a commercialization award for an application that had been rejected twice by an RCIC and once by the Texas Life Science Center.

The code of ethics policy for the Advisory Committee should be strengthened.

The code of ethics policy for the Advisory Committee does not prohibit Advisory Committee members from accepting compensation from or investing in ETF recipients.

The ETF should improve its documentation related to research matching grants and research superiority grants.

The grant agreement for the \$50 million research matching grant provided to Texas A&M University for the National Institute for Therapeutics Manufacturing specified that \$2 million in matching funds would be required. However, the application for that grant specified that \$125 million in matching funds would be required. There is no documentation of the amount of matching funds included in the information provided to the ETF trustees. In addition, the commitment letters that the trustees send to recipients do not specify the total matching funds required.

The ETF did not ensure that ETF recipients consistently submitted required annual reports.

ETF recipients did not submit the majority of the annual reports required in calendar years 2007 through 2009. For a sample of 31 of those recipients, the ETF had no evidence indicating that it followed up with the recipients regarding the annual reports they did not submit in calendar years 2008 and 2009.

Although the sample of 31 recipients submitted annual reports in calendar year 2010, they submitted 81 percent of those reports after the due date.

The Office of the Governor did not report the value of all investments held by the ETF on its annual financial report or on its annual report to the Legislature; the only investment it reported was from the one award from which the ETF has profited.

From fiscal year 2006 through fiscal year 2010, the Office of the Governor disbursed \$135,652,349 in funds from the ETF for commercialization awards. However, the Office of the Governor reported \$1,712,728 in ETF investments on its fiscal year 2010 annual financial report.

The \$1,712,728 amount was from the one award from which the ETF has profited. In this case, ETF provided a \$1,350,000 commercialization award to a company,

and that company was later purchased by a publicly traded company. According to the ETF's January 2011 report to the Legislature, the ETF received \$2,277,792 in cash compensation and 77,499 shares of stock in the publicly traded company; as of August 31, 2010, that stock was valued at \$1,712,728.

Summary of Management's Response

The Office of the Governor did not agree with certain conclusions and recommendations in this report, and its detailed management's response is presented in Chapter 6 beginning on page 40. The State Auditor's Office reviewed the information in management's response but did not modify the conclusions or recommendations in this report as a result of that review.

Summary of Objectives, Scope, and Methodology

The objectives of this audit were to:

- Determine whether the Office of the Governor disburses funds from the ETF in accordance with Texas Government Code, Chapter 490.
- Determine whether the Office of the Governor monitors ETF recipients to ensure they comply with the terms of the grants and Texas Government Code, Chapter 490.
- Determine whether the Office of the Governor and ETF recipients have controls to ensure accountability for the use of funds from the ETF.

The scope of this audit covered June 14, 2005, through April 7, 2011.

The audit methodology included collecting information and documentation; conducting interviews with ETF staff; analyzing and evaluating the results of testing; observing processes; and reviewing policies, procedures, and statutes. This audit did not include a review of information technology systems.

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Detailed Results

Chapter 1

The Legislature and the ETF Should Improve Transparency and Accountability at All Levels of the ETF Grant and Award Processes

Improving transparency and accountability at all levels of the Emerging Technology Fund's (ETF) grant and award processes will help to ensure that funds can be awarded in an impartial manner to applicants that have demonstrated they meet all requirements.

Auditors identified specific issues that limit transparency and accountability at the following levels:

- The seven Regional Centers for Innovation and Commercialization (RCICs), which contract with the ETF to evaluate applications for commercialization awards and forward their recommendations to the statewide Advisory Committee.
- The statewide Texas Life Science Center for Innovation and Commercialization (Texas Life Science Center), which contracts with the ETF to evaluate applications for commercialization awards in a variety of technical areas, such as medicine, biotechnology, and pharmaceuticals and forwards its recommendations to the statewide Advisory Committee.
- The Advisory Committee, which evaluates applications forwarded by the RCICs and the Texas Life Science Center and makes funding recommendations to the Governor, Lieutenant Governor, and Speaker of the House of Representatives, who are the trustees for the ETF.
- The ETF Office, which provides support to the Advisory Committee; negotiates contracts with recipients; and performs other functions, such as verifying information associated with applications for funds, providing information to the trustees, and announcing awards.

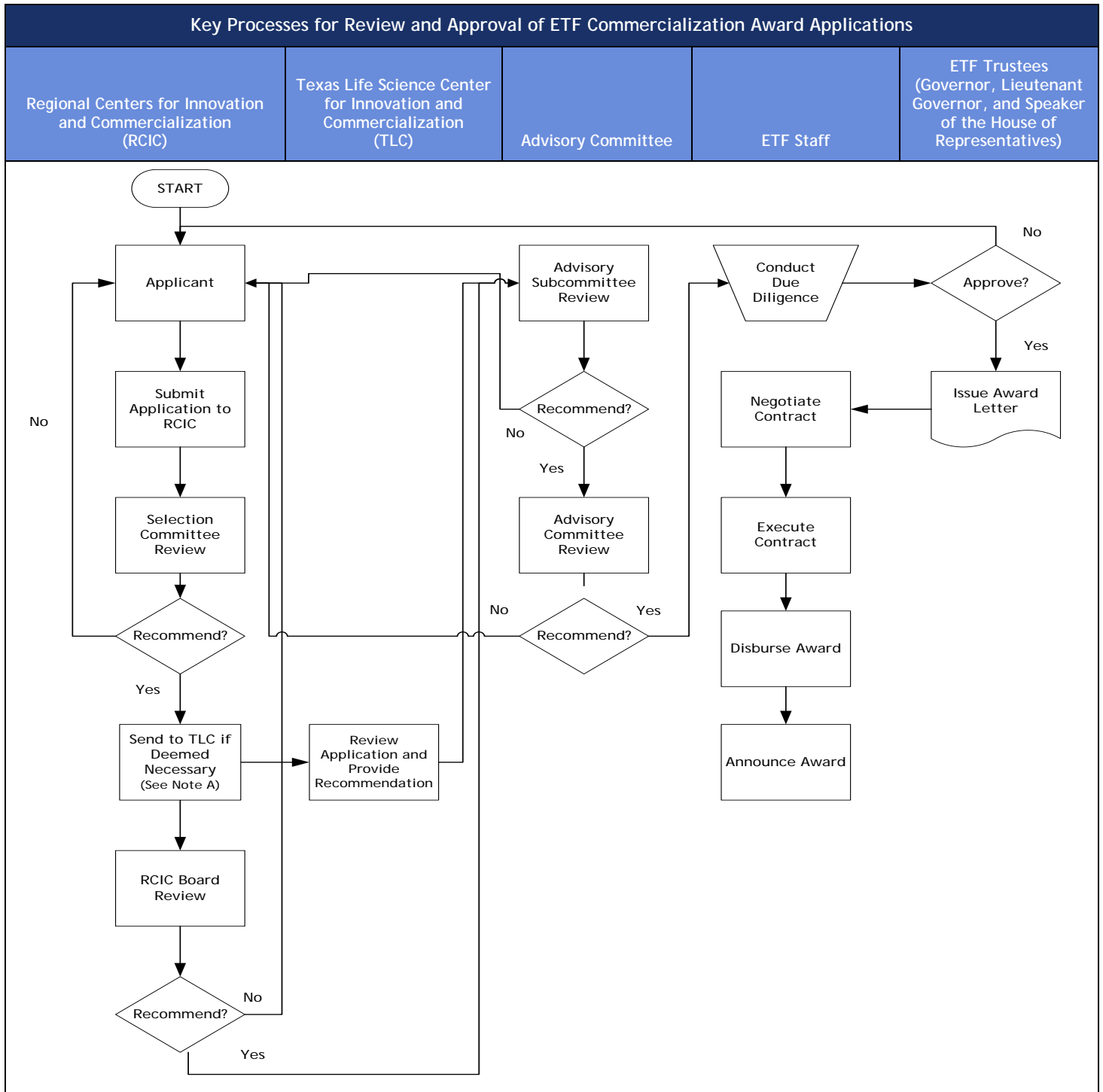
The issues auditors identified primarily involve:

- Meeting minutes that are either not kept or are not available to the public.
- A failure to record votes, recusals, and conflicts of interest.
- Inconsistencies in the processes for evaluating and approving applications.

This chapter makes recommendations to both the Legislature and the ETF to address those issues.

Figure 1 shows the key processes for review and approval of ETF commercialization award applications.

Figure 1



Note A: An RCIC can send an application to the TLC if the application involves a variety of technical areas, such as medicine, biotechnology, and pharmaceuticals. If an RCIC sends an application to the TLC, the Advisory Committee can receive information from both the RCIC and the TLC.

Source: Prepared by auditors based on information from the ETF.

The ETF Should Improve Consistency, Transparency, and Accountability at the RCICs and the Texas Life Science Center

The RCICs and the Texas Life Science Center do not always perform processes consistently. For example, the RCICs and the Texas Life Science Center do not consistently record board meeting minutes, votes, and recusals. By improving consistency, the ETF can improve transparency and accountability for the ETF.

The ETF also did not require board members for the RCICs and the Texas Life Science Center to sign conflict of interest disclosure statements until 2010. The ETF does not require the members of application review committees that perform initial reviews of the applications for the RCICs to sign conflict of interest disclosure statements. Those members are the first individuals to review an application to determine its viability. In addition, the ETF does not require staff at the RCICs and staff other than the executive director at the Texas Life Science Center to sign conflict of interest disclosure statements.

The ETF also has not developed substantive criteria for the RCICs and the Texas Life Science Center to use when receiving and evaluating applications.

RCICs and the Texas Life Science Center do not consistently record board meeting minutes, board members' votes on applications, or board members' recusals.

Without consistent documentation of board members' votes and recusals, it cannot be determined whether board members appropriately addressed conflicts of interest. Five of the seven RCICs and the Texas Life Science Center maintain board meeting minutes. Six of the seven RCICs and the Texas Life Science Center do not record individual board members' votes on applications for funds. In addition, five of the seven RCICs and the Texas Life Science Center reported that they document board members' recusals from voting on applications when a member has a conflict of interest with the application.

Because they are not public entities, six of the seven RCICs and the Texas Life Science Center are not required to make their meeting minutes available to the public. The exception is the West Texas RCIC, which considers itself a public entity because of its affiliation with Texas Tech University.

The ETF did not require the RCICs and the Texas Life Science Center to comply with a conflict of interest disclosure policy until 2010. However, the Texas Life Science Center and four of the seven RCICs had their own internal conflict of interest policies in fiscal years 2008 and 2009.

In fiscal year 2010, the ETF added a conflict of interest disclosure policy to its contracts with the RCICs and the Texas Life Science Center (see Appendix 3 for the policy). The policy:

- Required board members for the RCICs and the Texas Life Science Center to sign conflict of interest disclosure statements. (Auditors confirmed that all board members signed the required statements.)
- Restricted board members for the RCICs and the Texas Life Science Center from investing in or receiving compensation from ETF recipients. Specifically, board members cannot make investments in or receive compensation from ETF recipients until the earlier of (1) the 90th day after the public announcement of an ETF award, (2) the closing of an ETF recipient's initial public offering, or (3) the closing of a qualifying liquidation event.¹

The conflict of interest disclosure policy applies to conflicts involving ETF applicants, recipients, and "affected organizations," which were defined as organizations that either compete directly with or whose business would be materially affected by the success or failure of an ETF applicant or recipient.

The conflict of interest disclosure policy also established guidelines for financial relationships between board members and ETF applicants and recipients. Specifically, it required disclosure:

- If a board member has an equity or debt investment in an ETF applicant or recipient.
- If a board member has at least a 2 percent equity or debt investment in an affected organization.
- If a board member has a direct financial interest or material indirect financial interest in an ETF applicant, recipient, or affected organization.
- If a board member's spouse or any other immediate family member has any of the above-described relationships with an ETF applicant, recipient, or affected organization.

By signing the conflict of interest disclosure statement, a board member agrees to (1) disclose situations listed above in writing to the RCIC board or the Texas Life Science Center board and (2) abide by the decision of the RCIC board or the Texas Life Science Center board regarding the board member's recusal from participation in the consideration of a grant or award or any other action.

¹ According to the contract template for ETF commercialization awards, a qualifying liquidation event occurs when substantially all of an ETF recipient's assets are sold to external parties or when more than 50 percent of the voting power for the recipient is transferred to external parties due to the sale of equity or merger with another entity.

Neither the conflict of interest disclosure policy nor the RCICs' and Texas Life Science Center's contracts with the ETF requires the board members to submit information to the ETF regarding how conflicts were resolved. In addition, the conflict of interest disclosure policy does not require board members to report any investments they make in or compensation they receive from ETF recipients after the conflict of interest disclosure policy allows them to make such investments or receive such compensation.

It is important for the ETF to monitor conflict of interest disclosure statements from the RCICs and the Texas Life Science Center to ensure consistent implementation of the conflict of interest disclosure policy. For example, several members of the Texas Life Science Center had financial relationships with ETF recipients prior to the implementation of the conflict of interest disclosure policy in 2010. Those conflicts were never reported to the ETF. The executive director of the Texas Life Science Center asserted that the conflict of interest disclosure policy applied to relationships between board members and new ETF applicants after the conflict of interest disclosure policy was implemented in 2010.

The application review committee members, RCIC staff, and Texas Life Science Center staff are not required to sign conflict of interest disclosure statements. Only RCIC and Texas Life Science Center board members are required to sign those statements. Six of the seven RCICs have volunteer application review committees that perform a key initial evaluation of applications. Four of those six RCICs do not require volunteer application review committee members to sign conflict of interest disclosure statements. Volunteer application review committee members at two RCICs sign the RCICs' internal conflict of interest disclosure statements. The volunteer application review committees play a significant role in the RCIC boards' evaluation of applications.

Although it is not a requirement, staff members for six of the seven RCICs signed the ETF's conflict of interest disclosure statements; however, staff at one RCIC did not. The Texas Life Science Center executive director complied with a requirement to sign a conflict of interest disclosure statement (see Chapter 4 for additional details).

RCICs and the Texas Life Science Center do not follow consistent processes for evaluating and receiving applications. For example, the RCICs and the Texas Life Science Center do not have a scoring system for board members to use when evaluating applications for commercialization awards. However, four RCICs have developed guidance for the qualitative review process that their volunteer application review committees follow. The processes that the RCICs follow vary widely in areas such as the questions to ask an applicant, grading an applicant, documenting why an applicant was recommended for an award, and documenting an applicant's perceived weaknesses.

In addition, the ETF has an informal process through which an applicant can apply to RCICs outside the applicant's home region, including applicants

whose applications were not approved in their home regions (see Appendix 2 for a map showing the RCIC locations). However, when auditors asked RCICs if they understood that an applicant could apply at another RCIC, three RCICs responded yes, two RCICs responded no, and two RCICs responded that they would not inform an applicant that it could apply outside the region.

On October 28, 2010, the ETF instituted a conflict of interest escalation and resolution policy that advises ETF applicants of their options if they perceive a conflict of interest related to an RCIC's or the Texas Life Science Center's review of its application. However, the ETF did not publicly disseminate that policy and does not provide that policy to applicants when they apply for funds.

Recommendations

The ETF should:

- Establish a contractual requirement that the RCICs and the Texas Life Science Center:
 - ♦ Maintain minutes from board meetings. At a minimum, the minutes should document which applicants were recommended to the Advisory Committee for funding. In addition, the minutes should be published on the RCICs' and Texas Life Science Center's Web sites and submitted to the ETF.
 - ♦ Maintain records that document how individual board members and application review committee members vote on each application, including their recusals and the reasons for the recusals.
- Clarify with RCICs and the Texas Life Science Center that the contractually required conflict of interest disclosure policy applies to both ETF applicants and recipients.
- Contractually require RCIC board members and Texas Life Science Center board members to report any investments they make in or compensation they receive from ETF recipients after the conflict of interest disclosure policy allows them to make such investments or receive such compensation.
- Contractually require RCIC staff, Texas Life Science Center staff, and RCIC application review committee members to sign conflict of interest disclosure statements.
- Contractually require the RCICs and the Texas Life Science Center to immediately report in writing to the ETF any disclosed conflicts of interest and how those conflicts were resolved.

- Make its conflict of interest escalation and resolution policy available to applicants on the RCICs' Web sites, the Texas Life Science Center's Web site, and the ETF's Web site.
- Develop substantive criteria for all RCICs and the Texas Life Science Center to follow when evaluating applications and make those criteria available to the public.

Chapter 1-B

The Legislature and the ETF Should Improve Transparency and Accountability for the Advisory Committee

Meetings of the Advisory Committee for the ETF are not open to the public,

and the Advisory Committee does not formally document its decisions in meeting minutes. Although the ETF is required to follow the Texas Public Information Act, under Texas Government Code, Section 490.057, ETF application information is treated as confidential while an application is considered for an award or a grant. Ten other states with similar programs that auditors surveyed allowed significantly more public access to meetings and documents related to the award of public funds (see Chapter 5 for additional information on other states' programs).

Because the Advisory Committee does not maintain minutes of its meetings or record how Advisory Committee members vote on applications, it is not possible to evaluate how the Advisory Committee addresses potential conflicts of interest. In addition, the Advisory Committee has been inconsistent in terms of which applications it will accept for review.

Advisory Committee

The Governor appoints the members of the Advisory Committee, which comprises up to 17 individuals who are industry leaders in Texas or nationally recognized researchers from higher education institutions.

The Advisory Committee reviews applications for commercialization awards, research matching grants, and research superiority grants and makes recommendations to ETF trustees. The trustees are the Governor, the Lieutenant Governor, and the Speaker of the House of Representatives.

ETF awards and grants have been approved through various funding rounds, which take place approximately every three months. As of February 2011, the Advisory Committee had met for 20 funding rounds to consider applications.

Prior to funding round 17 held on October 29-30, 2009, the Advisory Committee also did not formally communicate to the ETF trustees which applications it recommended for funding (see text box for additional information about the Advisory Committee's funding rounds).

In addition, the selection of Advisory Committee members does not ensure adequate legislative representation on the Advisory Committee.

Advisory Committee meetings, subcommittee application review meetings, and teleconferences are not open to the public. In contrast, the meetings of similar boards in 10 other states that auditors surveyed are open to the public. In some cases, the other states surveyed allow their boards to go into executive session for discussion of items such as proprietary information, trade secrets, and company financial information. In addition, each of the 10 states that auditors surveyed makes its program information available to the public, with some exceptions. See Chapter 5 for additional details.

The Advisory Committee does not record meeting minutes, member votes on applications, members' recusals, or milestones that applicants must achieve. The Advisory Committee does not formally document its decisions, the decisions of its subcommittees, and teleconferences in meeting minutes. Therefore, there is no documentation of how members voted, members' recusals, and members' disclosures and resolutions of conflicts of interest.

Without this documentation, it cannot be determined whether Advisory Committee members who had conflicts of interest voted on applications or recused themselves from voting on applications. For example, auditors identified one Advisory Committee member who had consulting contracts with two ETF recipients. The Advisory Committee member was not on the Advisory Committee when it initially recommended the recipients for an award. Both recipients signed contracts to receive ETF awards in June 2009, approximately three months before the individual joined the Advisory Committee. The Advisory Committee member signed a consulting agreement with one recipient in July 2009 and signed a consulting agreement with the other recipient in January 2010. The Advisory Committee member was on the Advisory Committee when these two recipients were approved for subsequent disbursements of ETF funds. Milestones in the two recipients' contracts with the ETF required them to hire a regulatory consultant as a condition for receiving a second disbursement of funds. The recipients' consulting agreements with the Advisory Committee member satisfied that milestone.

The Advisory Committee member discussed above disclosed the relationship with one recipient through an email, but the committee member did not disclose the consulting agreement with the other recipient. Auditors identified the consulting agreements by reviewing the compliance reports the two recipients submitted to the ETF. (See Chapter 2 for additional details on the ETF's review of compliance reports.) Additionally, auditors could not determine whether the Advisory Committee member discussed above abstained from deliberations and voting on the subsequent disbursements of funds to those two recipients because there is no documentation of whether the Advisory Committee member recused himself. However, ETF staff assert that the Advisory Committee member abstained from voting on subsequent disbursements to both of those recipients. The Advisory Committee member never signed a statement of compliance with the code of ethics, which was implemented in October 2010, (the code of ethics is discussed in more detail below) and resigned from the Advisory Committee in February 2011.

The 10 other states that auditors surveyed maintain board meeting minutes that record board member attendance, motions considered, votes, and recusals. Those states also require that meeting minutes be open to the public, with exceptions allowed for proprietary information, trade secrets, and company financial information. Five of those 10 states require that board meeting minutes be posted on fund Web sites; the remainder make the minutes available only through open records requests.

In addition, because the Advisory Committee does not record its meeting minutes, there is no formal documentation of the milestones the Advisory Committee stipulates are conditions for approval of an application.

The Advisory Committee does not follow consistent processes for accepting, evaluating, and recommending applications to receive funds from the ETF. The Advisory Committee has no written policies and procedures for how it receives, reviews, and recommends applications for funding. As a result, there is a lack of consistency in the consideration of applications, which could create the perception that the Advisory Committee is not impartial when choosing applications to review. For example, the Advisory Committee recommended a commercialization award for an application that had not been approved by an RCIC, and it did not formally vote on a research matching grant application that was later approved by the trustees. Specifically:

- The former ETF director intervened to forward an application for a commercialization award to the Advisory Committee after an RCIC had rejected that application twice and the Texas Life Science Center had not approved the application. The Advisory Committee approved the application to receive a \$4.5 million commercialization award.
- The Advisory Committee did not vote on a \$50 million research matching grant that the trustees approved for Texas A&M University (see Chapter 1-C for additional information on that grant).

In addition, Texas Government Code, Chapter 490, specifies that the Advisory Committee will recommend proposals eligible for funding to the ETF trustees. However, prior to funding round 17 held on October 29-30, 2009, the Advisory Committee did not provide written documentation to the trustees regarding which applications the Advisory Committee recommended for funding. Prior to funding round 17, the Advisory Committee relied on ETF staff to communicate to the trustees which proposals the Advisory Committee recommended for funding.

The absence of a formal notification from the Advisory Committee to the trustees created the risk that (1) the trustees could approve funding for an application that was not recommended or (2) an application that was recommended for funding would not be considered by the trustees. In September 2010, the Chair of the Advisory Committee began sending a letter to the trustees listing the applications that the Advisory Committee had recommended for funding.

In October 2010, the director of the ETF also began sending a letter to the trustees to confirm the applications that the Advisory Committee had approved for funding.

The code of ethics policy for the Advisory Committee should be strengthened. In October 2010, the ETF implemented a written code of ethics policy that

requires Advisory Committee members to disclose conflicts of interest involving an applicant (see Appendix 4 for that policy). There was no written code of ethics policy for the Advisory Committee prior to that date. The code of ethics policy addresses conflicts of interest and creates a conflict of interest group to review potential conflicts of interest. However, the code of ethics policy does not clearly prohibit activities such as Advisory Committee members investing in or accepting compensation from ETF applicants or recipients.

Auditors compared the Advisory Committee code of ethics policy to the policies of the University of Texas Investment Management Company (UTIMCO) and the Teacher Retirement System (TRS) and identified several areas in which the code of ethics policy should be strengthened. Specifically:

- Accepting Compensation from ETF Applicants and Recipients. The code of ethics policy requires Advisory Committee members to disclose employment with ETF applicants and recipients to the chairman of the Advisory Committee, but it does not specifically prohibit such employment. One Advisory Committee member was offered a position as a compensated advisor to an ETF applicant. In February 2011, the conflict of interest group determined that this Advisory Committee member would need to recuse himself from all actions regarding the applicant, but that he could accept the position. In contrast, the UTIMCO and TRS policies prohibit board members and trustees from accepting employment or compensation from companies in which their entities have invested. For example, TRS prohibits a trustee or a trustee's spouse from being employed by an entity receiving funds from TRS.
- Investments. The code of ethics policy does not explicitly prohibit Advisory Committee members from making investments in ETF recipients. It specifies only that, in certain circumstances, an Advisory Committee member must disclose such an investment to the conflict of interest group. An Advisory Committee member submitted a statement of compliance with the code of ethics policy that disclosed investments in two ETF recipients that the Advisory Committee member had made prior to the implementation of the code of ethics policy.² The UTIMCO and TRS policies prohibit board members and trustees from investing in companies in which their respective entity has an ownership interest. For example, UTIMCO prohibits its board members from entering into an agreement with a private entity in which UTIMCO has an ownership interest, or is in the process of acquiring, as a private investment.

² According to the Advisory Committee member's statement of compliance with the code of ethics policy, both investments were made before the Advisory Committee member joined the Advisory Committee. In addition, the Advisory Committee member joined the board of directors of one of the ETF recipients after receiving approval from the ETF Office and the chairman of the Advisory Committee. The Advisory Committee member asserted that he had recused himself from all deliberations and votes pertaining to that ETF recipient

- Written Disclosure of Conflicts of Interest. The code of ethics policy requires Advisory Committee members to disclose potential conflicts of interest to the chairman of the Advisory Committee, but it does not require them to disclose potential conflicts of interest in writing and it does not require that those disclosures be documented in meeting minutes. The UTIMCO and TRS policies require that such disclosures be made in writing to the general counsel (for UTIMCO) or the executive director (for TRS) or in board meeting minutes. Additionally, at UTIMCO, when a conflict is discussed at a board meeting, the minutes describe the nature of the conflict.
- Financial Disclosure. The conflict of interest policy does not require members of the Advisory Committee to file annual financial disclosure statements. The UTIMCO and TRS policies require board members and trustees to file annual financial disclosures with the compliance officer (for UTIMCO) or the executive director (for TRS).
- Disclosure of Financial Interest in Applicants Prior to Voting on Applications. The conflict of interest policy does not require Advisory Committee members to disclose whether they have a financial interest in an applicant prior to voting on an application. UTIMCO's policy requires that, before UTIMCO makes an investment in an entity, board members must certify that they do not have a pecuniary interest in that entity.
- Required Training. The code of ethics policy does not outline specific training requirements for the Advisory Committee members. TRS's policy requires trustees to obtain training on the Texas Government Code before voting, obtain open government training within 90 days of appointment, and obtain annual ethics training.

The code of ethics policy requires Advisory Committee members to sign a statement of compliance with the code of ethics policy within 10 days of appointment and on an annual basis thereafter. However, there was no requirement to sign a compliance statement when the code of ethics policy was first adopted. As a result, as of January 20, 2011, 6 of the 16 Advisory Committee members had not signed a compliance statement.

The process to appoint members to the Advisory Committee does not ensure adequate legislative representation. Although the Speaker of the House of Representatives and Lieutenant Governor are ETF trustees and approve applications for funding, they have comparatively little input on the composition of the Advisory Committee. The Texas Government Code permits the Lieutenant Governor and the Speaker of the House of Representatives to nominate individuals for the Advisory Committee. However, the Governor makes final determinations regarding all appointments to the Advisory Committee. There are no positions on the

Advisory Committee specifically reserved for the individuals nominated by the Lieutenant Governor and the Speaker of the House of Representatives.

As of March 2011, one member of the Advisory Committee was nominated by the Speaker of the House of Representatives. A member of the Advisory Committee who had been appointed by the Lieutenant Governor resigned in January 2011. Four of the 10 other states that auditors surveyed require their governors to appoint members with the consent of the Senate.

Recommendations

The Legislature should consider amending Texas Government Code, Section 490, to:

- Require the Advisory Committee to follow the Open Meetings Act or selected provisions of the Open Meetings Act, such as posting agendas and notices of meetings and recording meeting minutes.
- Require the Advisory Committee and its subcommittees to document and retain a record of each member's votes, recusals, and the specific nature of any disclosed conflicts of interest and the resolution to those conflicts of interest.
- Change the composition of the Advisory Committee to include two senators and two representatives appointed by the Lieutenant Governor and the Speaker of the House of Representatives, respectively.
- Require Advisory Committee members to file annual financial disclosure statements with the ETF.

The ETF should:

- Work with the Advisory Committee to develop written policies and procedures for accepting, evaluating, and recommending applications for the ETF. The policies and procedures should ensure that the Advisory Committee votes on all applications before applications are sent to the trustees for consideration for funding.
- Revise the Advisory Committee code of ethics policy to:
 - ♦ Prohibit Advisory Committee members from investing in or receiving compensation from ETF recipients.
 - ♦ Require that all Advisory Committee members sign required conflict of interest statements prior to participating in Advisory Committee deliberations and voting on applications.

- ♦ Require Advisory Committee members to disclose conflicts of interest in writing, and require the Advisory Committee to record any disclosures and associated resolutions in the meeting minutes.
- ♦ Require Advisory Committee members to disclose whether they have a financial interest in an applicant prior to voting on an application.
- ♦ Require Advisory Committee members to receive training on conflicts of interest, open meetings requirements, and open records requirements.

Chapter 1-C

Accountability Should Be Improved Within the ETF Office

The ETF Office has not developed comprehensive, documented policies and procedures for the ETF (see text box for additional information about the ETF Office). For example, there are no policies for the ETF application process. This had led to uncertainty in areas such as the amount of matching funds that the ETF trustees should require recipients to provide.

The ETF Office

The six full-time staff in the ETF Office:

- Coordinate with the RCICs and the Texas Life Science Center.
- Provide support to the ETF Advisory Committee and trustees.
- Conduct due diligence on ETF applications.

The ETF Office provides the trustees with a brief description of the applicants that the Advisory Committee has recommended should receive an ETF grant or award.

The ETF Office also oversees the contract writing and compliance functions with the help of other staff within the Office of the Governor.

Other issues involving the ETF Office underscore the need to strengthen that unit's processes. Specifically:

- The ETF Office's due diligence reviews do not include a credit check or criminal history background check on commercialization award applicants' officers and investors.
- The ETF Office has announced 90 commercialization awards an average of 55 days after contracts were executed.

- ETF Office staff do not consistently sign statements of compliance with the required ethics and fraud policy or complete outside employment forms.

Auditors confirmed that amounts in 71 ETF contracts tested did not exceed the amounts on the commitment letters that the trustees sent to ETF recipients.

The ETF Office has not developed comprehensive and documented policies and procedures.

The ETF Office does not have a complete set of policies and procedures for the ETF. The policies and procedures that have been developed are not all signed and do not have effective dates. For example, neither the conflict of interest escalation and resolution policy (which was not signed) nor the qualified financial transaction extension request policy (which was signed by the director of the ETF) has effective dates. In addition, there are no

documented policies and procedures that outline the ETF application process from the initial submission of an application to an RCIC, to approval by the Advisory Committee and the trustees, and through the final contracting process.

Having documented, approved policies and procedures helps to ensure that all processes are performed in a consistent manner.

The ETF Office should improve the documentation and approval of research matching and research superiority grants. For two of the four research matching grants auditors tested, there was no documentation of what information the ETF Office sent to the trustees for their decision making. In addition, as discussed in Chapter 1-B, because the Advisory Committee does not maintain meeting minutes, there is a lack of documentation regarding which applications the Advisory Committee recommended to the trustees.

The commitment letters the trustees send to recipients also do not specify the total matching funds required. As a result:

- The grant agreement for the \$50 million research matching grant provided to Texas A&M University for the National Institute for Therapeutics Manufacturing specified that \$2 million in matching funds would be required from another source. However, the application, which was included as an exhibit in the grant agreement, specified that \$125 million in matching funds would be required. Including conflicting matching requirements in a grant agreement makes it difficult to require a recipient to provide a specific amount of matching funds. As of December 31, 2010, Texas A&M University reported to the ETF that it had received \$3 million in matching funds.
- For 5 (25 percent) of 20 research superiority grants, the amounts of matching funds included in the final contracts were less than the matching fund amounts in the information that the ETF Office provided to the trustees. The difference between the amount of matching funds specified in the five final contracts and the amount of matching funds in the information provided to the trustees ranged from \$500,000 to \$42 million per contract. The trustees do not specify a matching requirement in the commitment letters sent to recipients.

The ETF Office should improve its due diligence reviews. The ETF Office maintained complete due diligence documentation for all but 1 of the 21 commercialization award applications tested (see text box for additional

Due Diligence Process

The ETF Office's due diligence process includes:

- Review of the application.
- Preparation of the assessment by the Advisory Committee.
- Review of a technology and industry assessment.
- Preparation of a company and management assessment.
- Review of intellectual property and collaboration with higher education institutions.
- Review of financial sources and use of funds.
- Review of agreement terms.
- Review of the business strategy and milestone analysis.
- Preparation of an investment synopsis.

information on the due diligence process). For the one commercialization award with incomplete due diligence documentation, the assessment by the Advisory Committee was not documented.

Auditors were unable to determine from the documentation available for the 21 applications tested whether the ETF Office performed due diligence steps and independently verified the information provided by the applicant, such as intellectual property or financial information. One way to document the verification would be to use a checklist to document that it performed due diligence, who performed the due diligence, and the date the due diligence was performed. Conducting due diligence helps to ensure that the information that applicants submit is complete and accurate.

In addition, the ETF Office's due diligence process does not include requiring a criminal history background check or conducting a credit check for the officers of or investors in applicants for commercialization awards. The due diligence process also does not include (1) obtaining photo identification for commercialization award applicants' officers and investors or (2) research into any U. S. Securities and Exchange Commission penalties levied against commercialization award applicants, their officers, and their investors.

The ETF Office does not publically announce commercialization awards when contracts are signed. On average, for the 90 commercialization awards auditors tested, the ETF Office announced the awards 55 calendar days after contracts were executed. The ETF disbursed a total of \$39,973,000 to commercialization award recipients before the awards were announced. Announcing the awards when contracts are signed is important to inform the public and the Legislature of how public funds will be utilized. The announcement date is also important because the conflict of interest policy allows RCIC and Texas Life Science Center board members to invest in or receive compensation from ETF recipients on the 90th day after the awards have been publicly announced.

ETF Office staff should consistently maintain current, signed ethics and fraud policy statements and outside employment forms. Two ETF staff did not sign an ethics and fraud policy statement within the past three years. The current ETF director did not sign an ethics and fraud policy statement for fiscal year 2010 or fiscal year 2011 but did sign a statement for a prior year. Another staff member signed an ethics and fraud policy statement for fiscal year 2011 but not for fiscal year 2010. Employees are required to sign an ethics and fraud policy statement annually.

In addition, the former ETF director did not submit an outside employment form. However, the former director received stock as compensation from an Advisory Committee member for work the former director performed related to a company that did not receive funds from the ETF.

It is important to ensure that all employees sign and submit ethics and fraud policy statements and outside employment forms when required to ensure that the employees have read, understand, and agree to follow ethics and outside employment policies.

Commitment letters were sent consistently, and contract amounts did not exceed amounts in those letters. Auditors confirmed that the contracts for 71 commercialization awards, research matching grants, and research and superiority grants tested had a corresponding commitment letter from the trustees approving the grant or award and the amount. The amounts on the contracts also did not exceed the amounts in the commitment letters. However, as discussed above, for the research matching grants and research superiority grants, the required amounts of matching funds were not documented in the commitment letters.

Recommendations

The ETF should:

- Develop written policies and procedures for the ETF.
- Provide consistent and complete documentation to the trustees, including the amount of matching funds recipients must provide.
- Clarify the amount of matching funds recipients must provide in both (1) trustee commitment letters and (2) contracts for research matching grants and research superiority grants.
- Ensure that all ETF staff sign a statement of compliance with the ethics and fraud policy and complete outside employment forms when required.
- Prior to submitting applications to the ETF trustees:
 - ♦ Require applicants to obtain federal and state criminal history background checks on their officers and investors and send the results of those checks to the ETF Office.
 - ♦ Conduct credit checks on applicants' officers and investors.
 - ♦ Obtain photo identification for commercialization award applicants' officers and investors, and research any U. S. Securities and Exchange Commission penalties levied against commercialization award applicants, their officers, and their investors.

- Send a list of commercialization award applicants' officers and investors to the ETF trustees.
- Announce all ETF grants and awards in a timely manner.

The ETF Should Improve Its Reviews of ETF Recipients, RCICs, and the Texas Life Science Center to Ensure That They Comply with Requirements and Spend Funds Appropriately

The ETF has not ensured that ETF recipients comply with requirements to submit reports. Contracts for commercialization awards, research matching grants, and research superiority grants require the recipients to submit annual compliance verification reports (annual reports). In addition, the contracts for commercialization awards require recipients to submit interim reports when they request additional funds.

ETF recipients did not submit the majority of the annual reports required in calendar years 2007 through 2009. For a sample of 31 of those recipients, the ETF had no evidence indicating that it followed up with the recipients regarding the annual reports they did not submit in calendar years 2008 and 2009. Although the sample of 31 recipients submitted annual reports in calendar year 2010, they submitted 81 percent of those reports after the due date.

Three commercialization award recipients that either declared bankruptcy or ceased operations in 2010 did not submit at least one annual report required prior to 2010; a fourth commercialization award recipient ceased operations before an annual report was due.

In addition, as of March 17, 2011, the ETF had not reviewed 25 (81 percent) of a sample of 31 recipients' annual reports that auditors tested. It also did not consistently verify that recipients met required milestones before it disbursed additional funds to recipients. Further, the ETF did not ensure that the RCICs and the Texas Life Science Center submitted required reports.

The ETF did not ensure that recipients consistently submitted required annual reports, and it did not review reports in a timely manner.

Recipients did not always submit annual reports, and they submitted some annual reports late. Auditors reviewed whether recipients submitted annual reports due in calendar years 2007 through 2009 for all commercialization awards, research matching grants, and research superiority grants and identified the following:

- Recipients did not submit 9 (60 percent) of the 15 annual reports due in calendar year 2007.
- Recipients did not submit 31 (67 percent) of the 46 annual reports due in calendar year 2008.
- Recipients did not submit 47 (59 percent) of the 80 annual reports due in calendar year 2009.

Auditors reviewed the contract files for a sample of 31 commercialization awards, research matching grants, and research superiority grants. The contract files contained no documentation indicating that the ETF contacted the recipients of those grants and awards to inquire about the annual reports they did not submit in calendar years 2008 and 2009.

The 31 recipients in the sample submitted all of the required annual reports for calendar year 2010, but they submitted 25 (81 percent) of those 31 reports after the due date. The improvement in recipients' compliance with annual report submission requirements in calendar year 2010 was due to improved communication and correspondence between the ETF and the recipients.

Commercialization awards recipients submitted 86 percent of the required interim reports. Contracts for commercialization awards also require recipients to submit an interim report on the earlier of (1) six months after the contract effective date or (2) the date on which a recipient requests additional funds. Recipients submitted 97 (86 percent) of the 113 reports required under those contract terms in calendar years 2007 through 2010.

The ETF does not always review recipients' annual reports in a timely manner. Only one individual conducts all monitoring activities for the ETF.

As of March 9, 2011, the ETF had not completed reviewing all of the annual reports that recipients of commercialization awards, research matching grants, and research superiority grants had submitted. For example:

- The ETF had not completed its review of 19 (83 percent) of a sample of 23 annual reports that recipients of commercialization awards submitted for calendar year 2010. For the four reports the ETF did review, one of the recipients did not submit supporting documentation showing that it achieved the required milestones in its contract.
- The ETF had not completed its review of 2 (50 percent) of a sample of 4 annual reports that recipients of research matching grants submitted in calendar year 2010.
- The ETF had not completed its review of any of the 4 sampled annual reports that recipients of research superiority grants submitted in calendar year 2010.

In addition, the ETF does not have a standard format for the annual reports that recipients must submit. As a result, it does not receive all information necessary to ensure that recipients comply with requirements, which could delay its review process. Commercialization award recipients are inconsistent in the type and amount of information they submit in annual reports. For example:

- Some recipients provided only a general report specifying whether they had achieved required milestones, but they did not provide supporting documentation as evidence that they had achieved those milestones.
- Some recipients provided financial information such as invoices or financial statements as evidence of their financial status and use of state funds.
- Some recipients provided pictures and diagrams of their products as evidence that they had achieved required milestones.

Although ETF contracts with recipients allows the ETF to access recipients' financial information, the ETF does not require recipients to submit (1) financial information in their annual reports or (2) supporting documentation for expenditures of funds. Therefore, it cannot consistently verify whether recipients make expenditures only for authorized purposes. The ETF also does not routinely conduct on-site visits at recipients.

The ETF does not consistently verify that recipients meet required milestones before it disburses funds. Recipients must achieve certain milestones before they can receive their subsequent disbursements of funds from the ETF. However, auditors were unable to verify that 4 (17 percent) of 23 commercialization award recipients tested met required milestones before receiving their subsequent disbursement of funds because information was insufficient or incomplete. In addition, for 1 (25 percent) of those 4 commercialization award recipients, the ETF did not complete its compliance verification worksheet—which it uses to verify a recipient's achievement of required milestones—before it disbursed funds to the recipient. The ETF approved and made the subsequent disbursements to the 23 commercialization award recipients tested.

Auditors verified that all six recipients of research matching grants and research superiority grants tested submitted the required reports before the ETF disbursed additional funds to them. However, the ETF did not review one of those six reports before approving the additional disbursement. The ETF maintained internal routing and approval documentation for all of those six disbursements.

Auditors' review of a judgmental sample of four commercialization award recipients that either went bankrupt or ceased operations identified weaknesses in ETF monitoring. ETF recipients StarVision Technologies, Inc.

and ThromboVision, Inc. were awarded contracts in 2007 and went bankrupt in 2010. Neither recipient submitted required annual reports for calendar years 2008 through 2010. The ETF provided second disbursements of funds to StarVision Technologies, Inc. in June 2008 and to ThromboVision, Inc. in February 2008. The ETF had no documentation indicating that it followed up with those recipients until March 2010. The ETF was unaware of ThromboVision, Inc.'s bankruptcy until after the bankruptcy had been reported in a newspaper.

Ensuring that these two recipients had submitted their required annual reports, or following up with those recipients when they did not submit their required annual reports, could have enabled the ETF to recognize early warning signs that these recipients were in financial distress. Table 1 summarizes events involving those two recipients.

Table 1

| Summary of Compliance with Reporting Requirements For Two ETF Recipients That Went Bankrupt | | | | | | | |
|--|-----------------------|-------------------------|---|---|---|-------------------------------------|---|
| Recipient | Total Amount of Award | Contract Effective Date | Annual Report Required for Calendar Year 2008 | Annual Report Required for Calendar Year 2009 | Annual Report Required for Calendar Year 2010 | Date Recipient Filed for Bankruptcy | Date Recipient Notified ETF of Its Bankruptcy |
| StarVision Technologies, Inc. | \$750,000 | October 30, 2007 | Not Submitted | Not Submitted | Not Submitted | October 4, 2010 | November 4, 2010 |
| ThromboVision, Inc. | \$1, 500,000 | July 5, 2007 | Not Submitted | Not Submitted | Not Submitted | September 2, 2010 | October 5, 2010 |

Source: Prepared by auditors from documentation from the ETF.

ETF recipients Bauhaus Software, Inc. and Nanocoolers, Inc. ceased operations after they were awarded contracts. Specifically:

- Bauhaus Software, Inc. (which changed its name to MyToons Holding, Inc. in July 2008) received funds in 2006; it submitted annual reports for 2007 and 2008, but not for 2009 and 2010. The ETF provided a second disbursement of funds to Bauhaus Software, Inc. in December 2006. The ETF had no documentation indicating that it followed up with this recipient until March 2010.
- Nanocoolers, Inc. received funds in March 2007; because it ceased operations nine months later in December 2007, it was not required to submit an annual report. The ETF provided a second disbursement of funds to Nanocoolers, Inc. in July 2007.

Table 2 summarizes events involving those two recipients.

Table 2

| Summary of Compliance with Reporting Requirements For Two Recipients That Ceased Operations | | | | | | | |
|---|-----------------------|-------------------------|---|---|---|---|---|
| Recipient | Total Amount of Award | Contract Effective Date | Annual Report Required for Calendar Year 2007 | Annual Report Required for Calendar Year 2008 | Annual Report Required for Calendar Year 2009 | Annual Report Required for Calendar Year 2010 | Date Recipient Notified ETF That It Ceased Operations |
| Bauhaus Software, Inc. | \$500,000 | July 5, 2006 | Submitted | Submitted | Not Submitted | Not Submitted | September 2, 2010 |
| Nanocoolers, Inc. | \$3,000,000 | March 5, 2007 | No Report Due | No Report Due | No Report Due | No Report Due | December 10, 2007 |

Source: Prepared by auditors from documentation from the ETF.

Although three of the four recipients discussed above did not submit all of the required annual reports, all four recipients submitted other reports required in order to receive funds after the first disbursement. However, auditors were unable to verify from three of the four other reports whether the recipients had met the milestones required for receiving these disbursements because the information in those reports was incomplete or unavailable. The ETF asserted it had verified that those recipients met the milestones.

The ETF did not ensure that RCICs and the Texas Life Science Center consistently submitted required reports.

RCICs and the Texas Life Science Center did not submit all reports required by their ETF contracts. Specifically:

- In fiscal year 2008, the RCICs and the Texas Life Science Center were required to submit four reports each, but none of the RCICs submitted all four reports. One RCIC submitted its report for fiscal year 2008 more than one year after the contract expiration date.
- In fiscal year 2009, the RCICs and the Texas Life Science Center were not required to submit any reports, but each entity submitted a report.
- In fiscal year 2010, the RCICs were required to submit two reports each. RCICs submitted all of the 14 reports required. However, they submitted 10 of those 14 reports after the due date.

Ensuring that RCICs and the Texas Life Science Center comply with contract requirements is complicated by the fact that requirements in their contracts differ (see Chapter 4 for additional details on the differing contract requirements).

The ETF also did not review the majority of the reports that the RCICs and the Texas Life Science Center submitted for fiscal years 2008 and 2009. Specifically, it reviewed only the reports they submitted prior to the ETF making the second disbursement of funds to the RCICs and the Texas Life Science Center. The ETF did not review within 30 days of receipt 11 (79 percent) of the 14 biannual reports that the RCICs had submitted for fiscal year 2010.

Auditors verified that the RCICs and the Texas Life Science Center met the fund matching requirements before the ETF made the second disbursement of funds to the RCICs and the Texas Life Science Center. In addition, the ETF paid less than the contracted amount to one RCIC for the time period from March 30, 2010, to August 31, 2010, because that RCIC did not have a full-time executive director as required.

Recommendations

The ETF should:

- Ensure that recipients submit all required reports in a timely manner.
- Review recipients' reports in a timely manner.
- Track when recipients' reports are due and received so that it can promptly follow up on reports not submitted and review in a timely manner the reports that are submitted.
- Evaluate the resources it needs to review recipients' reports.
- Conduct on-site visits at recipients.
- Include in recipients' contracts a standard format for reports that recipients must submit. At a minimum, the contracts should specify the detailed supporting documentation that recipients must submit to (1) demonstrate that they achieved required milestones, (2) report their financial status, and (3) support their expenditures of state funds.
- Retain the documentation it uses to verify recipients' achievement of milestones before making second disbursements of funds to recipients.
- Ensure that RCICs and the Texas Life Science Center submit reports required by their contracts in a timely manner.

- Review in a timely manner the reports that the RCICs and the Texas Life Science Center submit.

The Office of the Governor Should Ensure That It Correctly Accounts for and Reports Financial Information Related to the ETF

The Office of the Governor did not report the value of ETF investments on its annual *Report to the Texas State Legislature on the Texas Emerging Technology Fund* dated January 2011. It also did not accurately report the value of those investments on its annual financial report for fiscal year 2010. In addition, the Office of the Governor understated encumbrances by at least \$6 million on its annual financial report for fiscal year 2010, and it did not transfer appropriated funds into a dedicated account for the ETF as required by statute and the General Appropriations Act.

The Office of the Governor did not report the value of investments held by the ETF in its report to the Legislature. In its January 2011 report to the Legislature, the Office of the Governor reported that it had awarded \$170,047,349 in ETF

Commercialization Awards and Investments

In the ETF contracts with companies that receive commercialization awards, the ETF has historically received the rights to purchase stock in those companies. Those rights allow the ETF to purchase stock issued by the companies in an amount that is proportionate to the amount of the commercialization award and at a time and price specified in the contract.

In recent years, the ETF also has included in commercialization award contracts a promissory note (a written promise to pay a specified sum of money to a designated party) that is equal to the amount of the award and that is payable by the company under certain conditions defined in the contract.

commercialization awards, as of August 31, 2010. Although the Office of the Governor listed the shares of stock for which it had taken ownership, with one exception discussed in more detail below, the Office of the Governor did not list the value of investments associated with commercialization awards in its report to the Legislature. (As discussed below, the Office of the Governor used a similar accounting practice in its annual financial report for fiscal year 2010.) It is important for the Legislature to be aware of the value of those investments so that it can readily view the value of the State's investments (see text box for additional information about investments related to commercialization awards).

If it does not determine the value of its investments, the Office of the Governor lacks a basis for measuring the performance of the ETF.

The Office of the Governor did not comply with applicable accounting guidance when reporting the value of investments held by the ETF on its annual financial report. From fiscal year 2006 through fiscal year 2010, the Office of the Governor disbursed \$135,652,349 in funds from the ETF for commercialization awards. However, the Office of the Governor reported \$1,712,728 in ETF investments on its fiscal year 2010 annual financial report. That amount was from the one award from which the ETF has profited. In this case, ETF provided a \$1,350,000 commercialization award to a company, and that company was later purchased by a publicly traded company. According to the ETF's January 2011 report to the Legislature, the ETF received \$2,277,792 in cash compensation and 77,499 shares of stock in the publicly traded company; as of August 31, 2010, that stock was valued at \$1,712,728.

**Codification of Statement of Auditing Standards
AU Section 328.04**

"Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurement are in accordance with GAAP [generally accepted accounting principles]."

Source: American Institute of Certified Public Accountants.

Auditing standards specify that an investor's management is responsible for making the value measurements and disclosures that are to be included in the financial statements (see text box for additional details). The Office of the Governor is not reporting the value of the ETF investments as assets, and it is not reporting the net increase or decrease in the value of these investments on its annual financial reports. The Office of the Governor also has not disclosed the existence of those investments in the notes to its annual financial reports.

Not reporting the value of investments as assets on its annual financial reports results in an understatement of the total assets that the Office of the Governor holds through the ETF. In addition, not reporting any applicable net increase

or decrease in the value of those investments in a given year could result in an understatement or overstatement of the Office of the Governor's revenues for the reporting period.

Auditors surveyed 10 other states with similar programs to determine whether they value their programs' investments. Three states have internal staff or venture capital investors who value their investments. Information was unavailable for five states. The remaining two states do not have investments (see Chapter 5 for more information on other states' programs).

Requirements in the Office of the Comptroller of Public Accounts' Accounting Policy Statement 018

State agencies and institutions of higher education must report binding encumbrances and payables for the current appropriation year within 30 days following each of the first three quarters of the fiscal year.

Annually, binding encumbrances and payables must be reported to the Office of the Comptroller of Public Accounts, the State Auditor's Office, and the Legislative Budget Board by October 30 for all appropriation years. On November 1 of each fiscal year, the Office of the Comptroller of Public Accounts lapses all unencumbered appropriation balances based on the binding encumbrances and payables reported. Certifications are required when binding encumbrances and payables are reported.

An encumbrance is for actual contracts awarded, not anticipated contracts or contracts under negotiation.

Source: Texas Comptroller of Public Accounts, Accounting Policy Statement 018 at <https://fmx.cpa.state.tx.us/fm/pubs/aps/18/ind ex.php>.

The Office of the Governor understated the amount encumbered for the ETF on its fiscal year 2010 annual financial report by at least \$6 million. This occurred because the Office of the Governor did not encumber funds for one ETF contract. In this case, the trustees' commitment letter for that contract, which communicates to the applicant that it has been awarded funds, was dated July 1, 2009. The contract was signed on July 12, 2010.

The Office of the Governor does not consistently encumber funds. The Office of the Governor informed auditors that it encumbers funds when the trustees' commitment letter is sent to an ETF recipient, which is before contracts are negotiated and signed. This process does not comply with the Office of the Comptroller of Public Accounts' Accounting Policy Statement 018 (APS 018, see text box).

However, information in the Office of the Governor's internal accounting system indicated that funds were not encumbered on the date of the commitment letter or on the contract execution date. In one instance, the Office of the Governor encumbered funds more than 2.5 years before

signing a contract. Encumbering funds appropriately and consistently is important in ensuring that obligations do not exceed budgeted amounts.

The Office of the Governor's internal accounting system indicated that, as of January 31, 2011, the total amount encumbered for the ETF was \$76,033,238. As of that same date, the ETF had unobligated balances totaling \$82,457,258 in the ETF and in the General Revenue Fund.

The Office of the Governor has not complied with requirements to transfer funds for the ETF into a dedicated account. Texas Government Code, Section 490.101, and Rider 15, page I-55, the General Appropriations Act (81st Legislature), required the Office of the Governor to transfer any funds appropriated by the Legislature for the ETF into a dedicated account in the General Revenue Fund. The ETF was appropriated \$24,000,000 for appropriation year 2010. However, the Office of the Governor did not transfer those funds from the General Revenue Fund into the ETF dedicated account. In addition, it disbursed \$4,675,000 for commercialization awards from General Revenue for appropriation year 2010. Complying with the requirement to transfer funds into a dedicated account is important because it would help enable the Legislature to determine that funds were spent as intended and it would make fund balances more easily identifiable.

Recommendations

The Office of the Governor should:

- Determine the appropriate value calculation methodology for the investments held by the ETF and report those investments correctly on its reports to the Legislature and on its annual financial reports.
- Record encumbrances in a consistent manner in its internal accounting system by following the Office of the Comptroller of Public Accounts' APS 018 and accounting standards.
- Comply with statutory and General Appropriations Act requirements to transfer ETF appropriations into a dedicated account.

The ETF Should Improve Its Administration of Contracts with RCICs, the Texas Life Science Center, and ETF Recipients

Auditors identified significant omissions and inconsistencies in the ETF's contracts with the RCICs and the Texas Life Science Center. The ETF also did not consistently enforce the requirements in its contracts with the RCICs and the Texas Life Science Center. In addition, auditors identified weaknesses in the ETF's administration of its contracts with ETF recipients.

Auditors identified significant omissions and inconsistencies in the ETF's contracts with the RCICs and the Texas Life Science Center. Specifically:

- The ETF did not have contracts with the RCICs prior to fiscal year 2008. In addition, the ETF did not have contracts with 6 of the 7 RCICs for various time periods during fiscal years 2008, 2009, and 2010; the time periods during which there were no contracts ranged from 3 weeks to almost 13 months. The ETF paid the Texas Life Science Center \$110,000 for expenditures that organization incurred during a time period when it did not have a contract with the ETF. In addition, the ETF paid one RCIC \$47,000 for expenditures that the RCIC may have incurred during a time period when it did not have a contract with the ETF.
- Requirements in the contracts between the ETF and the RCICs and the Texas Life Science Center were not consistent. For example, the contracts for fiscal year 2009 required the RCICs to conduct some type of monitoring of recipients and submit quarterly reports to the ETF "to the extent that information is available" to the RCICs. The contracts with the RCICs for fiscal year 2010 did not include that requirement; however, the contract with the Texas Life Science Center included that requirement. In addition, the fiscal year 2010 contract with the Texas Life Science Center required that organization's executive director to sign a conflict of interest statement, but the fiscal year 2010 contracts with the RCICs did not include a similar requirement for RCIC executive directors.
- The contracts between the ETF and the RCICs prohibit the use of contract funds for the repayment of debt, but they do not contain any other restrictions on RCICs' expenditures of funds. One RCIC reported to the ETF that it spent \$59,731 on "Meals and Entertainment" in fiscal year 2010. In addition, the contracts with the RCICs do not require the RCICs to segregate funds received from the ETF in a separate account, which makes it difficult to determine how RCICs spend funds they receive from the ETF.

The ETF did not consistently enforce the requirements in its contracts with the RCICs and the Texas Life Science Center. For example, two RCICs and the Texas Life Science Center follow internal record retention policies that conflict with the

record retention requirements in their contracts with the ETF. Specifically, those two RCICs and the Texas Life Science Center did not retain certain documentation for seven years as required by their contracts. In 2008, the former ETF director approved one RCIC's record retention policy when that policy conflicted with the contract requirements. As a result, auditors were unable to view past applications for commercialization awards that this RCIC did not approve.

The ETF also did not enforce contract requirements that (1) RCICs must submit a request for the first disbursement of funds within three months of the effective date of the contract and (2) RCICs must submit a request for the second disbursement of funds within nine months of the effective date of the contract. If it had enforced those contract requirements, this could have resulted in the cancellation of an RCIC contract and no disbursement of funds to an RCIC. Enforcing those contract requirements also could have reduced the amount disbursed to an RCIC to only the amount of the first disbursement.

Auditors identified weaknesses in the ETF's administration of its contracts with ETF recipients. Specifically, the ETF has signed contracts with ETF recipients after the contract effective date. Auditors identified 62 instances in which contracts were signed after the effective date specified in the contract:

- Contracts for 53 (54 percent) of 98 commercialization awards tested were signed after the contract effective date. The number of calendar days between effective dates and signature dates ranged from 1 to 50 days.
- Contracts for 4 (31 percent) of 13 research matching grants tested were signed after the contract effective date. The number of calendar days between effective dates and signature dates ranged from 3 to 63 days.
- Contracts for 5 (25 percent) of 20 research superiority awards tested were signed after the contract effective date. The number of calendar days between effective dates and signature dates ranged from 49 to 192 days.

By signing contracts after the effective date, the ETF cannot ensure that contract requirements are in effect throughout the entire time frame of the contract.

Recommendations

The ETF should:

- Obtain signatures on its contracts with RCICs and Texas Life Science Center in a timely manner.
- Pay RCICs and the Texas Life Science Center only for expenditures they incur during the contract period.

- Re-evaluate the responsibilities specified in its contracts with RCICs and the Texas Life Science Center.
- Clarify and enforce the record retention requirements in its contracts with RCICs and the Texas Life Science Center.
- Clearly define allowable expenditures in its contracts with RCICs and the Texas Life Science Center.
- Require RCICs and the Texas Life Science Center to have separate accounts for expenditures related to the ETF.
- Sign contracts with ETF recipients on or before the contract effective date.

Information Regarding Similar Programs in 10 Other States

Auditors researched how 10 other states have established and manage programs that are similar to the ETF in Texas. Those 10 states and their programs included:

- Florida – The Florida Opportunity Fund.
- Indiana – The Indiana 21st Century Research and Technology Fund.
- Kansas – The Bioscience Program.
- Maine – The Maine Technology Institute.
- Michigan – The Michigan 21st Century Jobs Fund.
- New York – The New York State Foundation for Science, Technology and Innovation.
- Oklahoma – The Oklahoma Center for the Advancement of Science and Technology.
- Ohio – The Third Frontier Project.
- Pennsylvania – The Ben Franklin Technology Partners.
- Washington – The Life Sciences Discovery Fund.

Tables 3 through 5 on the following pages compare the establishment and management of the ETF in Texas with programs in the other 10 states.

Table 3 presents information on program governance, appointments, conflicts of interest, and disclosure.

Table 3

| Comparison of the ETF with Similar Programs in Other States Governance, Appointments, Conflicts of Interest, and Disclosure | | | | | | |
|--|--|--|---|---|---|--|
| State | Entity Responsible for Program | Program Governance and Oversight Structure | Who Appoints Advisory Committee or Board Members? | Is There a Conflict of Interest Policy for the Advisory Committee or Board? | Are Advisory Committee Members or Board Members Required to Disclose Conflicts of Interest? | Are Advisory Committee Members or Board Members Required to File Personal Financial Disclosure Statements? |
| Texas | State agency | Trustees, advisory committee, and regional centers | Governor | Yes | Yes | No |
| Florida | Public-private partnership | Board of directors | Governor and House with consent of the Senate; Senate leaders also make appointments | No ^a | Yes | Yes |
| Indiana | State agency operating as a public-private partnership | Board of directors | Governor | Yes | Yes | No |
| Kansas | Independent instrumentality of the state | Board of directors | Governor; Senate, and House leaders and Kansas Technology Enterprise Corporation also make appointments; Board of Regents appoints two non-voting members; voting members are confirmed by the Senate | Yes | Yes | No |
| Maine | Publicly funded non-profit corporation | Board of directors | Governor (board of directors also includes heads of certain state agencies) | Yes | Yes | No |
| Michigan | Public-private partnership | Board of directors | Governor | No, but board members must recuse themselves if there is a conflict | Yes | No |
| New York | Public authority | Board of directors | Governor with consent of the Senate; Senate and State Assembly leaders also make appointments | Yes | Yes | Yes |

**Comparison of the ETF with Similar Programs in Other States
Governance, Appointments, Conflicts of Interest, and Disclosure**

| State | Entity Responsible for Program | Program Governance and Oversight Structure | Who Appoints Advisory Committee or Board Members? | Is There a Conflict of Interest Policy for the Advisory Committee or Board? | Are Advisory Committee Members or Board Members Required to Disclose Conflicts of Interest? | Are Advisory Committee Members or Board Members Required to File Personal Financial Disclosure Statements? |
|--------------|---|--|--|---|---|--|
| Oklahoma | State agency | Board of directors | Governor, House, and Senate make appointments | Yes | Yes | Yes |
| Ohio | State agency | Commission and advisory board | Governor with consent of the Senate; Senate and House leaders also make appointments | Yes | Yes | Yes |
| Pennsylvania | State agency | Board of directors | Governor; four members are appointed by legislative members; several cabinet members are appointed through statute | Information not available | Information not available | Yes |
| Washington | Independent instrumentality and agency of the state | Board of trustees | Governor with consent of the Senate; Senate and House leaders also make appointments | Yes | Yes | Yes |

^a Members are required by statute to file a financial interest disclosure.

Sources: Information from the ETF and auditors' survey of other states.

Responsible Entity. The ETF Office within the Office of the Governor, a state agency, is the entity responsible for the ETF. For the 10 other states surveyed:

- Three states' responsible entities are state agencies.
- Two states' responsible entities are independent instrumentalities of the state.
- Three states' responsible entities are public-private partnerships.
- One state is a publicly funded non-profit corporation.
- One state's responsible entity operates as a public authority.

Governance and Oversight. The ETF is governed by three trustees, and the Governor appoints a 17-member Advisory Committee. Programs in the 10

other states surveyed are governed by a board of directors, a board of trustees, or a commission.

Board or Advisory Committee Appointments. The Governor appoints the members of the ETF Advisory Committee. For the other 10 states surveyed:

- Three states' programs have boards appointed by the governor.
- Four states' programs have boards that are appointed by the governor with the advice and consent of the Senate. The Senate president and Speaker of the House also appoint members.
- Three states' programs have boards that are appointed by the governor and include other members who are appointed by state legislatures or other members who are the heads of certain state agencies or higher education institutions.

Conflict of Interest Policies. As of October 1, 2010, the members of the ETF Advisory Committee were required to sign a statement of compliance with the code of ethics policy, which includes information on conflicts of interest. For the other 10 states surveyed:

- Seven states' programs require board members to sign conflict of interest statements.
- Two states' programs do not require board members to sign conflict of interest statements. One of those state's program requires board members to recuse themselves if they have conflicts; the other state's program requires board members to file financial interest disclosures.
- Information was not available for one state.

Disclosure of Conflicts of Interest. The code of ethics policy requires members of the ETF Advisory Committee to disclose conflicts of interest. For the other 10 states surveyed:

- Nine states' programs require board members to disclose conflicts of interest prior to a vote.
- Information was not available for one state.

Personal Financial Disclosure Statements. ETF Advisory Committee members are not required to file personal financial disclosure statements. For the other 10 states surveyed:

- Six states' programs require board members to file personal financial disclosure statements.

- Four states' programs do not require board members to file personal financial disclosure statements.

Table 4 presents information on open meetings and open records requirements.

Table 4

| Comparison of the ETF with Similar Programs in Other States Requirements for Open Meetings and Open Records | | | | |
|---|---|---|--|--|
| State | Are Advisory Committee Meeting Minutes or Board of Directors Meeting Minutes Made Open to the Public? | Do Advisory Committee Meeting Minutes or Board of Directors Meeting Minutes Record Attendance, Motions Considered, Votes, and Recusals? | Are Advisory Committee Meetings or Board of Directors Meetings Open to the Public? | Is Program Required to Follow Open Records Laws? |
| Texas | Not applicable ^a | Not applicable ^a | No | Yes, with exceptions |
| Florida | Yes, upon request | Yes | Yes, with exceptions | Yes, with exceptions |
| Indiana | Yes, upon request | Yes | Yes, with exceptions | Yes, with exceptions |
| Kansas | Yes, online | Yes | Yes, with exceptions | Yes, with exceptions |
| Maine | Yes, upon request | Yes | Yes, with exceptions | Yes, with exceptions |
| Michigan | Yes, online | Yes | Yes, with exceptions | Yes, with exceptions |
| New York | Yes, online | Yes | Yes, with exceptions | Yes, with exceptions |
| Oklahoma | Yes, upon request | Yes | Yes, with exceptions | Yes, with exceptions |
| Ohio | Yes, upon request | Yes | Yes, with exceptions | Yes, with exceptions |
| Pennsylvania | Yes, online | Yes | Yes, with exceptions | Yes, with exceptions |
| Washington | Yes, online | Yes | Yes, with exceptions | Yes, with exceptions |

^a Not applicable because the Advisory Committee does not record meeting minutes.

Sources: Information from the ETF and auditors' survey of other states.

Public Availability of Advisory Committee or Board Meeting Minutes. The ETF Advisory Committee does not keep minutes of its meetings; therefore, minutes are not available to the public. For the other 10 states surveyed:

- Five states' programs make board meeting minutes available to the public and publish the minutes on the program Web site.
- Five states' programs make board meeting minutes available only through open records requests.

Contents of Advisory Committee or Board Meeting Minutes. The ETF Advisory Committee is not required to maintain meeting minutes; therefore, attendance, motions considered, votes, and recusals are not recorded. For the other 10 states surveyed:

- All 10 states' programs have board meeting minutes that contain records of attendance, motions considered, votes, and recusals.
- The five states whose programs post minutes on a Web site record votes as follows:
 - ♦ Three states' programs record whether the vote was unanimous, as well as recusals and absences.
 - ♦ One state's program listed the vote counts for ayes, nays, recusals, and absences (one set of minutes listed the members' names, but that was not recorded consistently).
 - ♦ One state's program documented in the minutes how each board member voted, as well as which members were absent or did not vote.

Public Access to Advisory Committee or Board Meetings. ETF Advisory Committee meetings are not open to the public. Meetings for the boards in the 10 other states surveyed are open to the public. However, some of the boards are allowed to go into executive session for discussion of items such as proprietary information, trade secrets, and company financial information.

Public Availability of Program Information. The ETF is required to follow open records laws, with certain exceptions. Texas Government Code, Section 490.057, specifies that certain information related to an ETF applicant is confidential.

Programs in all 10 states surveyed are required to follow open records laws, with exceptions or restrictions for items such as proprietary information, trade secrets, and company financial information. However, portions of an application are kept confidential unless an applicant consents to disclosure of the information. For the 10 states surveyed:

- Four states' programs never make the application publicly available because it is exempt from public records or the program is allowed to withhold the application on the grounds that it contains proprietary information.
- Five states' programs publish parts of the application, but not all application information is publicly available. Generally, those states' programs post the abstract and a title page but keep other information confidential.
- Information was not available for one state.

Table 5 presents information on grant and award approvals, financial requirements, and annual reporting.

Table 5

| Comparison of the ETF with Similar Programs in Other States Grant and Award Approvals, Financial Requirements, and Annual Reporting | | | | | | |
|--|--|--|--|--|---|--|
| State | Position or Group Responsible for Approval of Grant Agreement or Contract | Position or Group Responsible for Approval of Awards of Funds | Is Recipient Required to Provide Matching Funds? | Does the Program Determine Value of Investments Held by the Program? | Does the Program Require Recipients to Repay Funds? | Does the Program Prepare an Annual Report? |
| Texas | Chief of staff at the Office of the Governor | Governor with prior approval from the Lieutenant Governor and the Speaker of the House | Yes ^a | No | Contract specifies default terms | Yes |
| Florida | Board of directors | Board of directors | Yes | Information not available | No | Yes |
| Indiana | Chief executive officer of the Indiana Economic Development Corporation and secretary of state | Indiana State Budget Committee | Yes | Information not available | If company relocates | Yes |
| Kansas | Board of directors | Board of directors | Yes | Yes | If company relocates | Yes |
| Maine | Approved by board of directors and signed by president of the Maine Technology Institute | Board of directors | Yes | Information not available | Yes | Yes |
| Michigan | Board of directors | Board of directors | Yes | Information not available | Yes | Yes |
| New York | Board of directors | Board of directors | Yes | Yes | No | Yes |
| Oklahoma | Executive director | Chief financial officer and director of administration | Yes | Information not available | Yes | Yes |
| Ohio | Commission | State's controlling board | Yes | Not applicable | Contract specifies default terms | Yes |
| Pennsylvania | Information not available | Board of directors | Yes | Yes | Contract specifies default terms | Yes |
| Washington | Executive director | Board of trustees | No | Not applicable | No | Not after the program's first two years |

^a The two types of ETF grants require matching funds. The ETF commercialization awards do not require matching funds.

Sources: Information from the ETF and auditors' survey of other states.

Approval of contracts or grant agreement. The chief of staff for the Office of the Governor signs the final contracts and grant agreements for the ETF. For the other 10 states surveyed:

- Six states' programs require a board or commission quorum to approve the contracts or grant agreements.
- Three states' programs require the chief executive officer and the secretary of state to approve or require the executive director to approve contracts or grant agreements.
- Information was not available for one state.

Approval of the Award of Funds. With prior approval from the Lieutenant Governor and the Speaker of the House of Representatives, the Governor approves awards from the ETF. For the other 10 states surveyed:

- Seven states' programs authorize their boards to approve the award of funds.
- Two states' programs require some type of legislative body or a state budget committee to approve the award of funds.
- One state's program requires the chief financial officer and the director of administration to approve the award of funds.

Matching Requirements. The ETF requires recipients to provide matching funds for research matching grants and research superiority grants; the ETF does not require recipients to provide matching funds for commercialization awards. For the other 10 states surveyed:

- Nine states' programs require matching funds for at least one program.
- One state's program does not require matching funds.

Valuation of Program Investments. The ETF determines the value of investments only in public companies and has done this for only one investment. For the other 10 states surveyed:

- Three states' programs determine the value of investments:
 - ♦ Two states determine the value of the investments internally.
 - ♦ One state relies on venture capital investors to determine the value of the investments.
- Five states have not responded.
- Two states do not have investments.

Recipient Repayment. The ETF has repayment requirements for certain default events defined in the contract. For the other 10 states surveyed:

- Five states' programs include repayment terms or default terms in their agreements and contracts.
- Two states' programs require repayment if the recipient moves out of the state within a certain time frame.
- Three states' programs have no repayment requirements.

Annual Report Requirements. The ETF is required to prepare an annual report. For the other 10 states surveyed:

- Nine states' programs are required to prepare annual reports.
- One state's program is not required to prepare an annual report. A report was required only for the first two years of that state's program.

**Office of the Governor of Texas
Management's Response to State Auditor's
Audit Report on the Emerging Technology Fund**

Summary of OOG Management's Response

The Office of the Governor of Texas (OOG) appreciates the State Auditor's Office's (SAO's) review of the Texas Emerging Technology Fund (TETF). The members of the SAO's audit team were consistently courteous, professional, and supportive of the OOG's audit response team. In this report, the SAO has made several valuable recommendations for improving the TETF program, and the OOG is pleased to implement them as described further below.

In particular, the OOG generally agrees with the SAO's identification of opportunities to improve the OOG's monitoring and enforcement of TETF recipients' compliance with their contractual obligations. To that end, the OOG has recently completed an internal review of grants and grant monitoring across the board, the results of which have led to the creation of a Compliance and Oversight Division (COD) within the OOG. The COD will substantially improve the compliance process within the TETF and other OOG funded programs, by combining and leveraging existing resources within the OOG. This new COD employs professional auditors and contract compliance staff who, individually and collectively, have extensive monitoring and auditing experience. The OOG has allocated additional resources to the review of compliance reports, and will soon be implementing new and additional procedures to improve this process.

The OOG disagrees, however, with some of the SAO's conclusions and recommendations. We believe there are at least two primary reasons why these disagreements remain despite our mutually cooperative relationship with the SAO's audit team.

First, we believe the disagreements result from the SAO's selective focus on certain aspects of the TETF program to the exclusion of others. For example, the SAO focused extensively on how the program addresses potential conflicts of interest, presumably because that issue has received extensive media attention over the past several months. This is certainly an appropriate area on which to focus an audit such as this. The SAO report, however, never addresses the question of "whether the Office of the Governor disburses funds from the ETF in accordance with Texas Government Code, Chapter 490," which was the SAO's first stated objective of the audit. Presumably, if the SAO had found that the OOG has disbursed funds in violation of Chapter 490, it would have said so in its report. Its focus on other issues appears to have distracted it from confirming that the OOG *has* acted in accordance with the statute.

Second, we believe that the disagreements result in large part from the SAO's misunderstanding of the nature and role of the entities and individuals involved in the TETF program and, at least in some respects, the very purposes of the program itself. For this reason, it is worth quoting directly from the statute that describes and defines those purposes:

PURPOSES. The [TETF] is established under this chapter to *develop and diversify the economy of this state* by:

- (1) *expediting* innovation and commercialization of research;
- (2) *attracting, creating, or expanding* private sector entities that will promote a substantial increase in high-quality jobs; and
- (3) *increasing* higher education applied technology research capabilities.

TEX. GOVT. CODE § 490.002 (emphases added).

At a minimum, we believe that the OOG and SAO have a fundamental disagreement over the best ways to accomplish these purposes while balancing the various competing interests that must be considered. The OOG absolutely agrees, for example, that consistency, transparency, and accountability are valuable at all levels of the TETF process. But effectively protecting and promoting those values in light of the legislatively-defined purposes of the program requires an accurate and proper understanding of the nature and roles of each of the entities and individuals involved.

The OOG's responses in the following chapters will explain in detail why the OOG disagrees with many of the SAO's conclusions and recommendations. Our disagreements, however, do not lessen our appreciation for the SAO's efforts, and for the professionalism and courtesy of its audit team members. The OOG looks forward to continuing these discussions on how to improve the effectiveness of this very important program.

Chapter 1-A: "The ETF Should Improve Consistency, Transparency, and Accountability at the RCICs and the Texas Life Science Center."

Chapter 1-A of the SAO's report overlooks the importance of the fact that each organization that serves as a Regional Center for Innovation and Commercialization (RCIC)¹ is a separate non-profit entity that is independently governed and operates within its own local geographical area. The Austin Chamber of Commerce, for example, serves as the Central Texas RCIC, the Houston Technology Center serves as the Gulf Coast RCIC; the Alliance for Higher Education operates the North Texas RCIC, and the Northwest Texas Small Business Development Center operates the West Texas RCIC. The OOG did not originally fund these independent entities, and currently provides them only with matching funds to support the TETF aspects of their broader operations.

¹ For reasons unrelated to the audit, the OOG previously decided not to renew the Life Science Center for Innovation and Commercialization, but to instead distribute the expertise of that entity around the state through the RCICs. In light of this, the OOG's responses will refer to all of the Centers collectively as RCICs.

By design, each RCIC serves unique populations and geographical areas. Their ability to tailor their processes to their unique customers and to adapt their models to their local business climate is a key asset for successful economic development throughout the State. For this reason, each RCIC operates independently, under the leadership of its own board of directors, and is governed by its own organizational documents and by-laws. In light of this, the SAO's call for complete "consistency" in the RCIC's practices would be impractical and, we believe, counter-productive.

The SAO also fails to appreciate both the uniqueness of and the limitations on the statutorily-created role that the RCICs play in the TETF process. As defined by the Legislature, the RCICs engage in research and development, provide commercialization for the results, serve as incubators for new business opportunities, and provide workforce training for the resulting endeavors. TEX. GOVT. CODE § 490.152(c). At quarterly Application Presentation Days, they discuss the merits of each TETF applicant with the Advisory Committee, thus combining local input with statewide guidance in accordance with the ideal model for economic development in the state of Texas. But they only make funding *recommendations* to the Advisory Committee. The Advisory Committee, in turn, makes *recommendations* to the Governor, Lieutenant Governor, and Speaker of the House of Representatives (the TETF Trustees), who are the only ones with legal authority to make the funding decisions. The RCICs do not make any decisions to determine which entities will receive funds or how much any grant will be.

The SAO also misstates TETF processes when it states that TETF has "an informal process through which an applicant can apply to RCICs outside the applicant's home region." The TETF does have a "Conflict of Interest Escalation and Resolution Policy," which permits an applicant "to reapply to any other RCIC," but only when there is a "perceived conflict of interest" between the applicant and its local RCIC. And, while the SAO is correct that the TETF "does not provide that policy to applicants when they apply for funds," this is because the applicants apply to the RCICs, not to the TETF. The TETF, which is typically not aware of the applications at that point, has provided the policy to the RCICs, which actually receive the applications and thus can advise the applicants of this policy.

Finally, the SAO discounts the legitimate need for confidentiality for some of the information that the RCICs receive and review, which is a standard business practice considering the competitive and delicate nature of the emerging technology industry. This is an example of when the need for transparency must be balanced against the statutory purposes of the TETF program. The Legislature has expressly recognized this, and has expressly provided that information regarding the "identity, background, finance, marketing plans, trade secrets, or other commercially or academically sensitive information of an individual or entity being considered for an award" is confidential by law. TEX. GOVT. CODE § 490.057. To protect and promote the economic interests that the TETF is designed to encourage, the SAO's call for greater transparency must take into account this statutory confidentiality.

Nevertheless, as the TETF program has developed and matured, the OOG has recognized the value of encouraging consistent practices and implementing uniform policies and procedures

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whenever doing so would improve the program without undermining the value of the RCICs' independence and role in the process. For example, the OOG provides a standard format for all applications and presentations to be provided by the RCICs to the Advisory Committee and the OOG. And, in 2010, the OOG began to contractually require all RCIC board members to sign a conflict of interest disclosure statement even though, as the SAO acknowledges, five of the RCICs already had their own internal conflict of interest policies. The OOG has not required that all RCIC staff members and review committee members sign such a statement (although, as the SAO has acknowledged, most do), because the staff members have no vote in the application review process.

Based on these comments and considerations, the OOG responds to the SAO's Chapter 1-A recommendations as follows:

SAO Recommendation 1-A (1): Establish a contractual requirement that the RCICs and the Texas Life Science Center

- **maintain minutes from board meetings, which, at a minimum, should document which applicants were recommended to the Advisory Committee for funding, and publish such minutes on the RCIC's web sites; and**
- **document how individual board members' and application review committee members vote on each application, including their recusals and reasons for their recusals.**

The OOG agrees in part with this recommendation. The OOG agrees to contractually require each RCIC to maintain board meeting minutes that document which applicants the RCIC decides to recommend to the Advisory Committee for funding, the individual board members' votes on those decisions, and any board member recusals, and to require the RCICs to submit these minutes to the TETF. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

The OOG does not agree to contractually require the RCICs to maintain minutes that identify the applicants that the RCICs decide *not* to recommend for funding, because the public identification of these applicants serves little, if any, legitimate public purpose, and publication of the fact of their rejection by the RCIC would likely jeopardize the future success of these small Texas businesses. This would be the equivalent of publicizing the identities of small Texas businesses that failed to qualify for loans, or of families who were rejected for a mortgage loan. Such publication would unnecessarily harm reputations and undermine opportunities for future financing.

The OOG does not agree to require documentation of how application review committee members vote on each application, because these review committees merely provide guidance to the RCIC board members (which in turn, make recommendations to the Advisory Committee, which, in turn, merely makes

recommendations to the TETF Trustees who, again, are the only ones who can make the funding decisions).

The OOG does not agree to contractually require the RCICs to post their minutes on their web sites, because the applicants that the RCICs decide to recommend for funding are not guaranteed to receive funding, as they must still obtain the Advisory Committee's recommendation, and then the TETF Trustees must make the funding decision. More than 92% of the companies that apply to an RCIC for a commercialization award *never* receive any funds from the TETF. Publicizing the identities of these rejected applicants serves little, if any, legitimate public purpose, and would jeopardize the future of these business endeavors. Moreover, a requirement to publish minutes on a web site would have to be limited to protect confidential information under section 490.057.

SAO Recommendation 1-A (2): Clarify with the RCICs that the contractually required conflict of interest disclosure policy applies to both ETF applicants and recipients.

The SAO's report does not adequately identify any past problems that would require such a change. Nevertheless, the OOG agrees to provide such clarification. The TETF division will be responsible for implementing this recommendation, and will do so within 30 days after the publication of this report.

SAO Recommendation 1-A (3): Contractually require RCIC board members to report any investments they make in or compensation they receive from TETF recipients after the conflict of interest disclosure policy allows them to make such investments or receive such compensation.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (4): Contractually require RCIC staff and application review committee members to sign conflict of interest disclosure statements.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (5): Contractually require the RCICs to immediately report in writing to the TETF any disclosed conflicts of interest and how those conflicts of interest were resolved.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (6): Make the TETF's Conflict of Interest Escalation and Resolution Policy available to applicants on the RCIC's and TETF's web sites.

The OOG agrees with this recommendation. The TETF and IT divisions will be responsible for posting the policy on the TETF web site, and will implement this change within 30 days after the publication of this report. The OOG's General Counsel and TETF divisions will be responsible for contractually requiring the RCICs to post the policy on their web sites, and will implement this change beginning with the next RCIC contract.

SAO Recommendation 1-A (7): Develop substantive criteria for the RCICs to follow when evaluating applications and make those criteria available to the public.

The OOG agrees in part with this recommendation because, in fact, the TETF has already developed appropriate criteria, which are already published on the TETF and RCIC web sites. As discussed above, however, the OOG does not agree that RCICs should be required to utilize detailed standardized criteria, because the RCICs' ability to tailor their processes to their unique customers and to adapt their models to their *local* business climate is a key asset for successful economic development throughout Texas.

Chapter 1-B: "The Legislature and the ETF Should Improve Transparency and Accountability for the Advisory Committee."

The SAO's review of the Advisory Committee, like its review of the RCICs, fails to recognize the limited role that the Advisory Committee plays in the TETF process. The Advisory Committee consists of volunteers who are able to provide valuable expertise because they are "industry leaders in this state or . . . are nationally recognized leaders from public or private institutions of higher education in this state." TEX. GOVT. CODE § 490.052(b). Because of the knowledge, experience, and successes of its individual members, the Advisory Committee is able to professionally evaluate the applicants that the RCICs recommend for funding, and then decide which of those applicants it will recommend to the TETF Trustees. But it is then the Trustees, and not the Committee members, who decide which applicants will receive the funds. The Advisory Committee has no power or authority to encumber or appropriate state funds.

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For this reason (among others), the programs of the 10 other states to which the SAO's report refers (and to which all of Chapter 5 of the SAO's report is dedicated) are, in fact, not at all "similar" to the TETF. Those states' programs are governed by a board or a commission that has direct authority to make funding decisions for their state. For the same reasons, the SAO's comparison of the Advisory Committee to the boards of the University of Texas Investment Management Company and the Texas Teachers Retirement System is not valid because the Advisory Committee has no governing authority and does not award funds or make the funding decisions. Comparing these entities with the TETF Advisory Board is both misleading and inaccurate.

The SAO's suggestions for increased transparency of the Advisory Committee's activities are appropriate, but must be balanced against the goal of encouraging the formation and participation of successful ventures and the need to protect those companies' ability to succeed in the competitive emerging technology industry. At a minimum, the confidentiality requirements that the Legislature has expressly imposed in Section 490.057 must be preserved. Moreover, most of the applicants that the Advisory Committee considers and discusses do not ultimately receive TETF funds, and the public identification of the identities of those companies and of the Committee's evaluation of them would be of little, if any, legitimate public interest, and would likely jeopardize their future business and job creation success.

For these reasons, the SAO's suggestion that the Advisory Committee should conduct open meetings and should maintain and publicize meeting minutes must be viewed with caution. The Committee does record and report the total vote count on each of its recommendations, on any member's recusal from that vote, and on the Committee's recommended milestones for each company. Pursuant to the Committee's code of ethics, members are required to "promptly" disclose all potential conflicts of interest. The letter that the TETF director sends to the TETF Trustees to confirm the Advisory Committee's funding recommendations specifically lists the vote counts, as well as any recusals.

The OOG disagrees with the SAO's conclusion that "it is not possible to evaluate how the Advisory Committee addresses disclosures of conflicts of interest." The code of ethics specifically describes how the Committee addresses such disclosures, and additional documents provided to the SAO demonstrate how it has in fact done so. Moreover, the SAO's conclusion that, in reference to a specific past situation, "it is unclear whether the Advisory Committee member who had the consulting contracts voted to approve those additional disbursements of funds," is simply incorrect because it ignores the documents that show how that individual followed the code of ethics requirements, fully disclosed his interests, and was either not yet on the Advisory Committee during the initial voting or recused himself from future votes on additional disbursements.

When the SAO's report states that an "Advisory Committee member was on the Advisory Committee when ... two recipients were approved for *subsequent* disbursements of ETF funds," it omits the fact that the Advisory Committee member was *not* on the Advisory Committee when the Committee originally made the decision to recommend that the award be

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made, and therefore he had no possibility of a conflict of interest at that time. It further omits the fact that, after he became a member of the Committee, he recused himself and did not participate in any votes when the Committee considered whether to recommend subsequent disbursements to these recipients.

In concluding that the Advisory Committee “does not follow consistent processes,” the SAO’s report ignores the written criteria and processes, sample contracts, and process graphs that have been posted on the TETF’s and the RCIC’s web sites since 2007. (See, e.g., “Subchapter D, Commercialization Funding Criteria (PDF)”, “The Subchapter D, Commercialization Application Process (PDF)”, “Subchapters E and F Application Process(PDF)”, and “Standard Due Diligence by the Office of the Governor (PDF).”) The TETF has continually developed and improved these processes over the life of the fund, and will continue to do so.

When the SAO’s report states that “the Advisory Committee recommended a commercialization award for an application that had not been approved by an RCIC,” and that “the former ETF director intervened to forward an application,” the report fails to note that, in that situation, the RCIC itself sought such relief due to a possible conflict of interest and requested that the Advisory Committee consider the application. No law or policy prohibited that reasonable approach to resolving the possible conflict, and the TETF then adopted the Conflict of Interest Escalation and Resolution Policy to formally approve that alternative approach if that situation ever arises again.

Based on these comments and considerations, the OOG responds to the SAO’s Chapter 1-B recommendations as follows:

SAO Recommendation 1-B (1): The Legislature should require the Advisory Committee to follow the Open Meetings Act or selected provisions of the Open Meetings Act, such as posting agendas and notices of meetings and recording meeting minutes.

The OOG disagrees with this recommendation because it ignores the nature and the statutory role of the Advisory Committee. The Advisory Committee is not a governmental body, and it does not receive, encumber, appropriate, or distribute state funds, or decide how state funds should be appropriated or distributed. It serves only in an advisory capacity. In doing so, it receives, evaluates, and discusses detailed information regarding small Texas businesses, most of which never receive state funds. Publicly disclosing this detailed information regarding the companies that are *not* recommended to receive public funds would serve little, if any, legitimate public purpose. Doing so would disclose not only the detailed business information that is protected under section 490.057, but also the fact that the Advisory Committee decided not to recommend the company for funding. This would likely jeopardize the future success of these companies. Moreover, disclosing detailed information regarding the entities that the TETF

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Trustees *do* ultimately decide to fund would place the taxpayer's investment in those entities at an extreme competitive disadvantage, and would undermine the TETF's statutory purpose to "expedit[e] innovation and commercialization of research." TEX. GOVT. CODE § 490.002.

SAO Recommendation 1-B (2): The Legislature should require the Advisory Committee and its subcommittees to document and retain a record of each member's votes, recusals, and the specific nature of any disclosed conflicts of interest and the resolution to those conflicts of interest.

The OOG agrees that the Advisory Committee should document and retain a record of each member's vote when deciding whether to recommend that the TETF Trustees fund an applicant. The OOG does not agree that subcommittees should be required to do the same, unless the subcommittee is acting on behalf of the Committee such that the subcommittee will be submitting its recommendation directly to the TETF Trustees. The OOG already requires the Advisory Committee to maintain a record of any member's recusal, the specific nature of any disclosed conflicts of interest, and how those conflicts were resolved.

SAO Recommendation 1-B (3): The Legislature should change the composition of the Advisory Committee to include two senators and two representatives appointed by the Lieutenant Governor and the Speaker of the House of Representatives, respectively.

The OOG has no objection to these recommendations, so long as all Committee members are "[emerging technology] industry leaders in this state or . . . are nationally recognized leaders from public or private institutions of higher education in this state," as required by section 490.052(b).

SAO Recommendation 1-B (4): The Legislature should require Advisory Committee members to file annual financial disclosure statements with the ETF.

The OOG disagrees with this recommendation because it is unnecessary and it would undermine the valuable role that the Advisory Committee plays. The Committee has no authority to allocate state funds. Its members are completely uncompensated volunteers who are extensively involved in their own, unrelated, successful business endeavors. The code of ethics already requires Committee members to disclose those financial interests that create a potential conflict of interest.

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SAO Recommendation 1-B (5): The TETF should work with the Advisory Committee to develop written policies and procedures for accepting, evaluating, and recommending applications for the ETF, which policies should ensure that the Advisory Committee votes on all applications before applications are sent to the Trustees for consideration for funding.

The OOG agrees with this recommendation, and has been doing this since the TETF was formed.

SAO Recommendation 1-B (6): The TETF should revise the Advisory Committee code of ethics policy to prohibit Advisory Committee members from investing in or receiving compensation from ETF recipients.

The OOG agrees that the code of ethics should prohibit Advisory Committee members from investing in or receiving compensation from a TETF recipient if the member previously participated in Committee discussions or votes related to that recipient. The General Counsel and TETF divisions will be responsible for implementing this revision to the code of ethics prior to the signing period in July/August 2011.

For other situations in which a member may have dual interests, such as when a company in which a member has a pre-existing financial interest appears as an applicant before the Committee, the code of ethics already requires the Advisory Committee member to promptly disclose the interest; requires, at a minimum, that the member recuse himself or herself from any discussions or votes regarding that applicant; and prohibits the Advisory Committee member from using his or her position on the Committee "to seek or obtain personal gain or benefit beyond any properly authorized compensation or expense reimbursement." Prohibiting Committee members from having a financial interest in any and all businesses that apply would both prevent promising companies from applying and discourage experienced entrepreneurs from volunteering their services and thus deprive the TETF Trustees of their valuable advice.

SAO Recommendation 1-B (7): The TETF should revise the Advisory Committee code of ethics policy to require that all Advisory Committee members sign required conflict of interest statements prior to participating in Advisory Committee deliberations and voting on applications.

The OOG agrees with this recommendation, but would note that the code of ethics already requires each Advisory Committee member to sign the required statement at the time of their initial appointment to the Committee and then annually in July or August thereafter. The only members who have not signed and submitted the statement are those who were appointed and already serving before the written code of ethics was adopted in October 2010, but they too will be required to sign

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and submit the statements in July/August 2011. In the meantime, the code of ethics expressly provides that, “[b]y serving or continuing to serve as a Committee Member, as applicable, each Committee Member accepts this Code and agrees to comply with its provisions.” These Committee members are therefore bound by the code of ethics even though they have not signed the form.

SAO Recommendation 1-B (8): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to disclose conflicts of interest in writing, and require the Advisory Committee to record any disclosures and associated resolutions in the meeting minutes.

The OOG agrees with this recommendation. Whenever Committee members have a potential conflict of interest, the code of ethics requires them to disclose that fact and recuse themselves while other Committee members discuss the disclosure and decide upon the proper resolution. We agree that the Committee should be required to document the disclosure in writing, if the disclosing member has not already done so, and the Committee should also document the process followed and the chosen resolution. The General Counsel and TETF divisions will be responsible for implementing any revisions to the code of ethics that are necessary to clarify and confirm these requirements, and will do so prior to the next annual signature period in July/August 2011.

SAO Recommendation 1-B (9): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to disclose whether they have a financial interest in an applicant prior to voting on an application.

The OOG agrees with this recommendation. The code of ethics already requires Advisory Committee members to “make a full and fair disclosure of all matters that could diminish his or her independence and objectivity or conflict with his or her duties as a Committee Member,” and to do so “promptly.” Although we believe that “promptly” means “prior to voting on an application” in which the member has a financial interest, we will revise the code of ethics to make this more explicit. The General Counsel and TETF divisions will be responsible for implementing this revision, and will do so prior to the next annual signing period in July/August 2011.

SAO Recommendation 1-B (10): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to receive training in conflicts of interest, open meetings, requirements, and open records requirements.

The OOG agrees in part with this recommendation. The General Counsel and TETF divisions will be responsible for revising the code of ethics policy to require Advisory Committee members to receive training in conflicts of interest, and will do so prior to the next annual signature period in July/August 2011. The

OOG does not agree that the Committee members should be required to receive training in open meetings and open records requirements, because the Texas Open Meetings Act and the Texas Public Information Act do not apply to the Advisory Committee.

Chapter 1-C: “Accountability Should Be Improved Within the ETF Office.”

The OOG agrees that increased accountability within the TETF is valuable, but it does not agree with several of the conclusions on which the SAO bases this recommendation. The TETF, for example, has adopted policies, criteria, procedures to govern the application process, sample contracts, and process graphs that have been posted on the TETF’s and RCIC’s web sites since 2007. (See, e.g., “Subchapter D, Commercialization Funding Criteria (PDF)”, “The Subchapter D, Commercialization Application Process (PDF)”, “Subchapters E and F Application Process(PDF)”, and “Standard Due Diligence by the Office of the Governor (PDF).”). The OOG also provided the SAO a series of charts and graphs that detail each decision point for the funding applications, along with several other policy and procedure documents. The SAO refers to and makes recommendations regarding these policies and procedures throughout its report. Its real concern, then, cannot be that “there are no policies for the ETF application process,” but is apparently that the policies and procedures “are not all signed and do not have effective dates.”

Without regard to the bases for the SAO’s conclusions, the OOG does agree that increasing accountability can be beneficial to the program, its participants, and the taxpayers who fund it. Based on these comments and considerations, the OOG responds to the SAO’s Chapter 1-C recommendations as follows:

SAO Recommendation 1-C (1): The ETF should develop written policies and procedures for the ETF.

The OOG agrees in part with this recommendation. The TETF has already developed written policies and procedures, but has not adopted the format or organization (including a formal numbering, dating, and signature system) that the SAO prefers. The TETF division will be responsible for exploring the implementation of such a system as it continues to develop its policies, and will continue to make the policies publicly available through its web site.

SAO Recommendation 1-C (2): The ETF should provide consistent and complete documentation to the trustees, including the amount of matching funds recipients must provide.

The OOG agrees to continue providing consistent and complete documentation to the TETF Trustees, and to include the amount of matching funds that the Advisory Committee recommends the recipient must provide. The TETF will be responsible for implementing this recommendation, and will do so upon

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publication of this report. Pursuant to Texas law, the TETF Trustees will continue to decide the amount of the required matching funds.

SAO Recommendation 1-C (3): The ETF should clarify the amount of matching funds recipients must provide in both (1) trustee commitment letters and (2) contracts for research matching grants and research superiority grants.

The OOG agrees to recommend to the TETF Trustees that they include specific matching funds amounts in commitment letters, and to include such amounts in contracts for research matching grants and research superiority grants. The TETF and General Counsel divisions will be responsible for implementing these recommendations, and will do so upon publication of this report.

SAO Recommendation 1-C (4): The ETF should ensure that all ETF staff sign a statement of compliance with the ethics policy and complete outside employment forms when required.

The OOG agrees to ensure that all ETF staff sign a statement of compliance with the ethics policy and complete outside employment forms when required. The TETF and HR divisions will be responsible for implementing this recommendation, and will do so upon publication of this report.

SAO Recommendation 1-C (5): Prior to submitting applications to the ETF Trustees, the ETF should:

- **require applicants to obtain federal and state criminal history background checks on their officers and investors and send the results of those checks to the ETF office;**
- **conduct credit checks on applicants' officers and investors; and**
- **obtain photo identification for commercialization award applicants' officers and investors, and research any U.S. Securities and Exchange Commission penalties levied against commercialization award applicants, their officers, and their investors.**

The OOG agrees with these recommendations. The COD and the TETF division will be responsible for implementing these recommendations, and will do so within 60 days after publication of this report.

SAO Recommendation 1-C (6): The ETF should send a list of commercialization award applicants' officers and investors to the ETF Trustees.

The OOG agrees with this recommendation. The COD and TETF division will be responsible for implementing this recommendation, and will do so within 60 days after publication of this report.

SAO Recommendation 1-C (7): The ETF should announce all ETF grants and awards in a timely manner.

The OOG agrees with this recommendation, but would note that the events that concern the SAO have involved announcements made *after*, not *before*, execution of the contract. This often occurs because the TETF and the companies agree to delay the announcement until plans for a public event have been made, or for other reasons that increase the company's competitive advantage. The OOG believes that the "timeliness" of the announcement must take these objectives into account. The SAO report contends that TETF should announce awards when it executes a contract with the awardee "because the conflict of interest policy allows RCIC and TLSCIC board members to invest in or receive compensation from ETF recipients on the 90th day after the awards have been publicly announced." But the delay of the announcement only serves to extend (not shorten) this period, and thus only increases the protection that this aspect of the conflict policy provides.

Chapter 2: "The ETF Should Improve Its Review of ETF Recipients, RCICs, and the Texas Life Science Center to Ensure That They Comply with Requirements and Spend Funds Appropriately."

The OOG agrees that the TETF program will benefit from increased review and monitoring to ensure the recipients' and the RCICs' compliance with program requirements.

However, because the SAO's report focuses exclusively on the TETF's review of annual and interim reports, it incorrectly implies that these are the only ways in which the TETF monitors fund recipients. In fact, the TETF continuously monitors recipients through ongoing telephone calls, email communications, and in-person conversations. In addition, the RCICs are in regular contact with recipients, and report their findings to the TETF staff. Moreover, the TETF requests and receives additional reports, such as a survey that 118 (99%) of commercialization award recipients responded to in 2010.

Nevertheless, the OOG agrees that there is room for improvement in these areas, and has continually been engaged in efforts to implement those improvements. To continue strengthening the compliance review process, the OOG proactively conducted an internal review to assess the compliance needs of TETF program. As a result of this review, the OOG confirmed that the greatest challenges have resulted from the limited compliance resources dedicated to the TETF program, in light of the additional demands on those resources. For example, the SAO's report notes that, as of March 2011, TETF had not yet reviewed most of the 2010 compliance reports. But the report fails to acknowledge that, since December 2010, the TETF has been dedicating an inordinate amount of its time responding to the SAO's audit inquiries.

Having identified these issues through its own internal review, the OOG has recently created a Compliance and Oversight Division ("COD"), which will substantially improve the

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compliance process within the TETF and other OOG granting divisions, by combining and leveraging existing resources within the OOG. This new COD employs professional auditors and contract compliance staff who individually and collectively have extensive monitoring and auditing experiences. The OOG has allocated additional resources to the review of compliance reports, and will soon be implementing new and additional procedures to improve this process.

Based on these comments and considerations, the OOG responds to the SAO Chapter 2 recommendations as follows:

SAO Recommendation 2 (1): The ETF should ensure that recipients submit all required reports in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to track and follow up with recipients to ensure that they submit all required reports in a timely manner, and are doing so as of the publication of this report.

SAO Recommendation 2 (2): The ETF should review recipients' reports in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to ensure that recipients' reports are reviewed in a timely manner, and is doing so as of the publication of this report.

SAO Recommendation 2 (3): The ETF should track when recipients' reports are due and received so that it can promptly follow up on reports not submitted and review in a timely manner the reports that are submitted.

The OOG agrees with this recommendation and, in fact, already tracks when recipients' reports are due and received. The COD is in the process of implementing a new database that will enhance the tracking and the generation of reminder notices that will be sent to recipients 60 and 30 calendar days before the due date of the compliance verification report, along with a notice that will be sent when the report is not received by close of business of the due date. The COD is responsible for implementing these processes and will complete implementation within 30 days after publication of this report. The TETF and General Counsel divisions will assist with follow up as necessary.

SAO Recommendation 2 (4): The ETF should evaluate the resources it needs to review recipients' reports.

The OOG agrees with this recommendation and has already conducted such an evaluation, which resulted in part in the creation of the new COD.

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SAO Recommendation 2 (5): The ETF should conduct on-site visits at recipients.

The OOG agrees with this recommendation and, in fact, already conducts on-site recipient visits. In addition, the OOG contractually requires RCICs to visit each recipient at least annually and report back to the OOG. The TETF and General Counsel divisions will be responsible for continuing this practice, and the COD will also begin selecting recipients for onsite visits using a risk-based approach.

SAO Recommendation 2 (6): The ETF should include in recipients' contracts a standard format for reports that recipients must submit. At a minimum, the contracts should specify the detailed supporting documentation that recipients must submit to (1) demonstrate that they achieved required milestones, (2) report their financial status, and (3) support their expenditure of state funds.

The OOG agrees in part with this recommendation. Several RCICs have issued guidelines and recommended formats for such reporting. But because recipients are in highly diverse industries, requiring a completely standardized format for all reporting requirements would undermine the need to evaluate the types of information that may be specific and unique to each recipient. The OOG does agree that template reports should address the minimum three items listed, and the TETF division will be responsible for ensuring that such templates are made available within 60 days after publication of this report.

SAO Recommendation 2 (7): The ETF should retain the documentation it uses to verify recipients' achievement of milestones before making second disbursements of funds to recipients.

The OOG agrees with this recommendation, but it already retains such documents. The SAO has noted that, despite this requirement, it could not locate a few documents in older files. The COD will be responsible for ensuring that such documents are retained in accordance with the applicable document retention schedules, beginning upon publication of this report.

SAO Recommendation 2 (8): The ETF should ensure that RCICs and the Texas Life Science Center submit reports required by their contracts in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to track and follow up with RCICs to ensure that they submit all required reports in a timely manner, and are doing so as of the publication of this report.

SAO Recommendation 2 (9): The ETF should review in a timely manner the reports that the RCICs and the Texas Life Science Center submit.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to ensure that recipients' reports are reviewed in a timely manner, and are doing so as of the publication of this report.

Chapter 3: "The Office of the Governor Should Ensure That it Correctly Accounts for and Reports Financial Information Related to the ETF."

The OOG disagrees with most of the conclusions, implications, and recommendations in Chapter 3 of the SAO's report.

The SAO is correct that the OOG's *annual report to the Legislature* did not include "the value of ETF investments," but did report "that it had awarded \$170,047,349 in commercialization awards." This report completely complied with the Legislature's instructions in section 490.005 of the Texas Government Code, which requires that the report include "the total number and amount of awards made" and "the number and amount of awards made under Subchapters D, E, and F." The OOG report provided this information, as required by the Legislature. The statute also requires that the report include "a brief description of the equity position that the ... state ... may take in companies receiving awards and the names of the companies in which the state has taken an equity position," and the OOG report included that information. The statute also requires that the report include "the aggregate total of private sector investment," and the OOG report included these amounts. The statute does not, however, require that the report include the "value" of the state's investments in the TETF award recipients.

The SAO's conclusions regarding the OOG's *annual financial reports* are even more misleading. In its "Overall Conclusion" on the first page (page i) of its report, the SAO asserts that the OOG "does not report the value of the State's investments through the ETF on its financial statements." Yet in the body of its report (pages iii and 25), the SAO acknowledges that the OOG did report the value of its investment in one company. It then erroneously suggests that the OOG reported the value of this investment because it was the only one "from which the ETF has profited." In fact, as the SAO later acknowledges, the OOG reported the value only of that one investment because it was the only investment in a *publicly-traded* company, and thus the only investment that had a reasonably determinable value. Although the OOG reported the *amount* of each investment in a *privately-held* company on the TETF web site and in the annual report to the Legislature, it did not report a *value* of those investments in its annual financial report because the value of those investments is not reasonably determinable. As the SAO report acknowledges, of the 10 other states with "similar" programs that the SAO reviewed, only three of them even attempt to determine the value of their privately-held investments. The OOG carefully considered its options, but concluded that estimating a value that, in actuality, is not reasonably determinable would be more misleading than reporting only the amount of the actual investment.

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The OOG follows an account reconciliation process, and in doing so discovered that \$6 million had not been encumbered in the fourth quarter of fiscal year 2010. Upon discovering this, the OOG encumbered this amount in the next reporting period for the first quarter of fiscal year 2011. The OOG agrees that, due to this one omission, the TETF encumbrances in the fiscal year 2010 annual financial report were understated by \$6 million (7%).

The OOG does not agree, however, that it “does not consistently encumber funds.” Under Section 490.101 of the Texas Government Code, the Governor, with the express written approval of the Lieutenant Governor and the Speaker of the House of Representatives, may award TETF funds. These TETF Trustees confirm their agreement and approval of an award by executing a letter and delivering it to the TETF division. Although section 490.101 requires that the Governor enter into a written contract with the recipient “before making an award,” it is the Trustees’ letter, and not the written contract, that legally authorizes the obligation of the state’s funds. The Comptroller’s Accounting Policy Statement 018 (APS 018), to which the SAO report refers, defines an “outstanding encumbrance” as “a contract, agreement, or other action that *legally obligates* state funds” (emphases added). After careful consideration, the OOG has concluded that, in full compliance with APS 018, the appropriate practice is to encumber the funds at the time of the TETF Trustees’ letter, which is the “other legal action” that authorizes the obligation, even though it is subject to and later memorialized through a written contract.

The OOG does not agree that “one contract was encumbered 2.5 years before the contract was signed.” The award to which this statement apparently refers was encumbered in May 2010, upon receipt of the Trustees’ letter, but was entered with an incorrect appropriation year of 2008. The OOG discovered this error during its routine reconciliation of May 2010, and corrected it in June 2010 to reflect the correct appropriation year.

Based on these comments and considerations, the OOG responds to the SAO Chapter 3 recommendations as follows:

SAO Recommendation 3 (1): The OOG should determine the appropriate value calculation methodology for the investments held by the ETF and report those investments correctly on its reports to the Legislature and on its annual financial reports.

The OOG disagrees with this recommendation based on its conclusion that the value of the state’s investments in the privately-held recipients is not realistically determinable, and thus reporting an estimated value would be misleading. However, the OOG agrees to confer with the SAO and the Office of the Comptroller to further explore this issue. The OOG’s Financial Services division will be responsible for doing this, and will begin the process within 30 days after publication of this report.

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SAO Recommendation 3 (2): The OOG should record encumbrances in a consistent manner in its internal accounting system by following the Office of the Comptroller of Public Accounts' APS 018 and accounting standards.

The OOG agrees with this recommendation but believes that it already records encumbrances as required by APS 018. The OOG does not agree that APS 018 requires that the OOG encumber the funds only when a contract is signed, because the Trustees' letter constitutes an "other legal action," which occurs before the contract is signed and authorizes the legal obligation.

SAO Recommendation 3 (3): The OOG should comply with statutory and General Appropriations Act requirements to transfer ETF appropriations into a dedicated account.

The OOG agrees with this recommendation. The Financial Services division has been and remains responsible for ensuring the OOG's compliance with the legal requirements to transfer appropriations into a dedicated account, and it will continue to do so.

Chapter 4: "The ETF Should Improve Its Administration of Contracts with RCICs, the TLSCIC, and ETF Recipients.

The OOG agrees that, generally speaking, it appears beneficial to have consistency among the RCIC contracts, both as between the different RCICs and from year to year. But speaking specifically, it is neither practical nor advisable to do so. Because each RCIC is a separate independent entity that services a unique geographical area, it is often necessary to include terms in one contract that would not be necessary or advisable in another. Moreover, as the TETF program matures, the OOG continually evaluates the contracts and revises them when necessary to provide greater clarity or assurance.

The OOG must take a similarly-flexible approach when dealing with an entity's non-compliance with a contractual term. The purpose of the TETF is "to develop and diversify the economy of this state by: (1) expediting innovation and commercialization of research; (2) attracting, creating, or expanding private sector entities that will promote a substantial increase in high-quality jobs; and (3) increasing higher education applied technology research capabilities." TEX. GOVT. CODE § 490.002. It is not the purpose of the fund to avoid making disbursements whenever possible, or to force the entities to fail by terminating a contract any time the entity comes up short. The state is an investor in these entities. It is therefore in the state's best interest to help the recipients succeed, not to cause them to fail. The OOG has declared companies to be in default, and has refused to provide subsequent disbursements, when it had become apparent that the company could (or would) not comply with its obligations or was unlikely to succeed. But when agreeing to extend a contractual deadline has appeared to be in the best interest of the state, the OOG has appropriately chosen to do so.

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The OOG does not agree with the SAO's conclusion that the practice of signing contracts after their stated effective date constitutes a "weakness." The parties to a contract may agree to make it effective on any particular date, which may be at any time prior to or after the date on which they sign the written document that memorializes their agreement. The parole evidence rule requires that certain contracts must be in writing and signed by the parties, but does not require that the signatures occur on or before the effective date. A contract may provide that it is effective, for example, on a specific date, or on the date last signed by the parties. If the contract specifies an effective date and is signed by the parties on a different date, the specified effective date will be the effective date.² In light of the numerous approvals that are required before the state can execute a contract, and in light of the benefits of having them become effective on a particular date, it is sometimes the better practice to agree to an effective date that pre-dates the date of execution. But before signing the contracts, the OOG reviews them to ensure that the parties can comply and have complied since the stated effective date, and that the requirements are thus in effect throughout the entire timeframe of the contract.

Based on these comments and considerations, the OOG responds to the SAO Chapter 4 recommendations as follows:

SAO Recommendation 4 (1): The ETF should obtain signatures on its contracts with RCICs and Texas Life Science in a timely manner.

The OOG agrees with this recommendation. The General Counsel division will be responsible for implementing it as of the publication of this report.

SAO Recommendation 4 (2): The ETF should pay RCICs and the Texas Life Science Center only for expenditures they incur during the contract period.

The OOG agrees in part with this recommendation. The TETF does not pay RCICs for expenditures, but instead contractually authorizes RCICs to use TETF funds only for certain described purposes. As a general rule, we agree that those purposes should relate to activities during the contract period, but we do not agree that there should never be exceptions to this general rule. The General Counsel and COD divisions will be responsible for implementing this recommendation following the publication of this report.

² See, e.g., *Langhoff Properties v. BP Productions NA*, 519 F.3d 256, 261 (5th Cir. 2008) ("All know that it is the specified effective date that controls, not the date that the document happens to be signed."); *Willson v. Superior Oil*, 274 S.W.2d 947, 951 (Tex. Civ. App. - Texarkana 1955, writ ref'd n.r.e.) ("We think it is clear that the parties intended the effective date . . . to be the date that it bore on its face, to wit, February 2, 1953, and we attach no significance to the fact that the instrument was not signed by [a party] until March 30, 1953 . . .").

SAO Recommendation 4 (3): The ETF should re-evaluate the responsibilities specified in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The TETF and General Counsel divisions have been and will remain responsible for conducting these re-evaluations on an ongoing basis.

SAO Recommendation 4 (4): The ETF should clarify and enforce the record retention requirements in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The COD and General Counsel divisions will be responsible for implementing it upon publication of this report.

SAO Recommendation 4 (5): The ETF should clearly define allowable expenditures in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The TETF and General Counsel divisions have been and will remain responsible for conducting these re-evaluations on an ongoing basis.

SAO Recommendation 4 (6): The ETF should require RCICs and the Texas Life Science Center to have separate accounts for expenditures related to the ETF.

The OOG agrees with this recommendation. The General Counsel division will be responsible for implementing it in future contracts following publication of this report.

SAO Recommendation 4 (7): The ETF should sign contracts with ETF recipients on or before the contract effective date.

The OOG agrees that signing the contracts on or before the effective date is often the preferred practice. It does not agree that it should be a requirement, or that there should never be exceptions to this practice.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to:

- Determine whether the Office of the Governor disburses funds from the Emerging Technology Fund (ETF) in accordance with Texas Government Code, Chapter 490.
- Determine whether the Office of the Governor monitors ETF recipients to ensure they comply with the terms of the grants and Texas Government Code, Chapter 490.
- Determine whether the Office of the Governor and ETF recipients have controls to ensure accountability for the use of funds from the ETF.

Scope

The scope of this audit covered June 14, 2005, through April 7, 2011.

Methodology

The audit methodology included collecting information and documentation; conducting interviews with ETF staff; analyzing and evaluating the results of testing; observing processes; and reviewing policies, procedures, and statutes. This audit did not include a review of information technology systems.

Information collected and reviewed included the following:

- Contracts between the ETF and the Regional Centers for Innovation and Commercialization (RCICs) and the Texas Life Science Center for Innovation and Commercialization (Texas Life Science Center).
- Contracts between the ETF and recipients of ETF commercialization awards, research matching grants, and research superiority grants.
- Expenditures, appropriations, and encumbrances related to the ETF.
- Annual financial reports.
- Policies and procedures related to the ETF.
- Compliance reports and other information the RCICs, the Texas Life Science Center, and recipients prepared.

- Advisory Committee code of ethics policy and signed statements.
- Signed conflict of interest statements for the RCICs and the Texas Life Science Center for fiscal year 2010.
- RCIC and Texas Life Science Center conflict of interest policies for fiscal years 2008 and 2009.
- Conflict of interest statements and outside employment forms signed by ETF staff.
- ETF due diligence documents.
- Application scoring and evaluation documents from the RCICs, the Texas Life Science Center, and the Advisory Committee.
- ETF Advisory Committee conflict of interest group meeting memo.
- RCIC and Texas Life Science Center selected board minutes.
- Code of ethics policies from the University of Texas Investment Management Company and the Teacher Retirement System.

Procedures and tests conducted included the following:

- Interviewed ETF staff.
- Interviewed RCIC and Texas Life Science Center staff.
- Interviewed ETF Advisory Committee members.
- Reviewed Advisory Committee, Texas Life Science Center, and RCIC application scoring documents.
- Reviewed ETF, Advisory Committee, Texas Life Science Center, and RCIC conflict of interest statements and code of ethics policies.
- Reviewed ETF due diligence policies and procedures.
- Reviewed Advisory Committee and trustee award approval documentation.
- Reviewed RCICs', the Texas Life Science Center's, and recipients' grant and award amounts contained in commitment letters and contracts.
- Compared ETF contracts to the *State of Texas Contract Management Guide*.
- Compared the dates on which the ETF announced grants and awards to contract execution dates and fund disbursement dates.

- Reviewed amounts allocated for commercialization awards, research matching grants, and research superiority grants with requirements in Texas Government Code, Chapter 490.
- Reviewed ETF contracts with the RCICs and the Texas Life Science Center.
- Reviewed the RCICs' and the Texas Life Science Center's compliance with contractual record retention periods.
- Reviewed the RCICs' and the Texas Life Science Center's contracts for requirements related to reviews of applicants' intellectual property.
- Reviewed compliance reports that the RCICs, the Texas Life Science Center, and recipients prepared.
- Reviewed the valuation of ETF investments.
- Reviewed ETF total appropriations and total awards amounts.
- Reviewed ETF job descriptions and staff qualifications.
- Reviewed ETF encumbrances.
- Surveyed 10 states with programs similar to the ETF.

Criteria used included the following:

- Texas Government Code, Chapter 490.
- The Office of the Governor's contracts with the RCICs and the Texas Life Science Center.
- The Office of the Governor's contracts with ETF recipients.
- Results from a survey of 10 states with programs similar to the ETF.
- Teacher Retirement System's and the University of Texas Investment Management Company's code of ethics policies.
- General Appropriations Acts (79th, 80th, and 81st Legislatures).
- *State of Texas Contract Management Guide.*

Project Information

Audit fieldwork was conducted from February 2011 through April 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a

reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

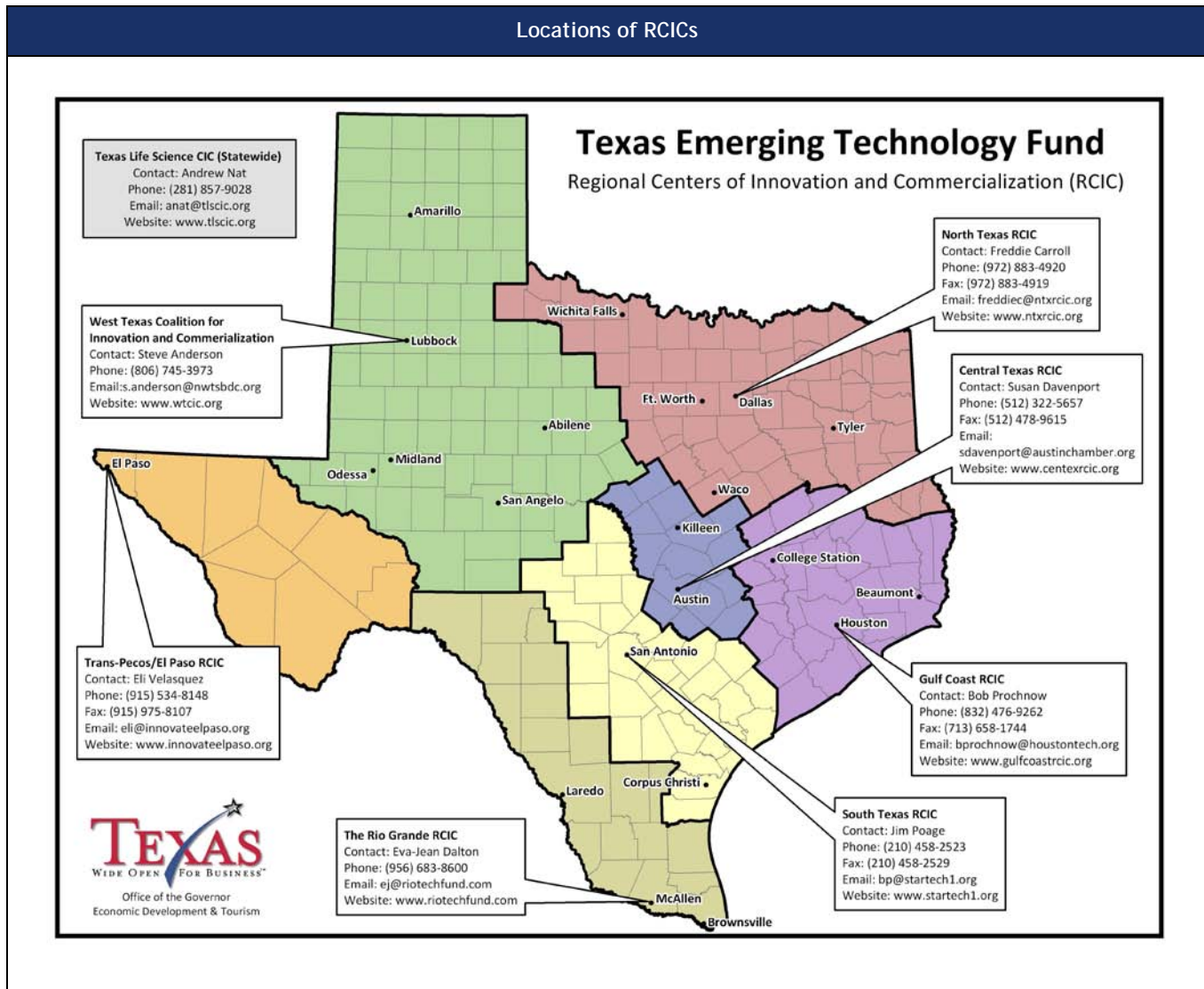
The following members of the State Auditor's staff performed the audit:

- Cesar Saldivar, CGAP, CICA (Project Manager)
- Ann E. Karnes, CPA (Assistant Project Manager)
- Robert H. (Rob) Bollinger, CPA, CFE
- John Boyd, CIDA
- Jennifer D. Brantley, CPA
- Robert Burg, CPA
- Matt Byrnes, CIDA
- Ben Carter
- Michael O. Clayton, CPA, CISA, CIDA, CFE
- Lisa R. Collier, CPA
- Scott Ela, CPA, CIA
- Jennifer R. Logston
- Kimberly Teague, MS
- Kenneth F. Wade, CIA, CGAP
- Charles Wilson, MPAFF
- Mary Ann Wise, CPA, CFE
- Michael C. Apperley, CPA (Quality Control Reviewer)
- John Young, MPAff (Audit Manager)

Location of Emerging Technology Fund RCICs

Figure 2 shows the locations of the Regional Centers for Innovation and Commercialization (RCICs) for the Emerging Technology Fund.

Figure 2



Source: Office of the Governor Web site at http://www.governor.state.tx.us/files/ecodev/etf_regional_map.pdf.

Conflict of Interest Policy for RCICs and the Texas Life Science Center

Below is the conflict of interest policy added to the Emerging Technology Fund (ETF) contracts with the Regional Centers for Innovation and Commercialization (RCICs) and the Texas Life Science Center for Innovation and Commercialization in fiscal year 2010.

Exhibit B

CONFLICT OF INTEREST POLICY

To maintain the credibility of the application process and ongoing administration of the Emerging Technology Fund, and to assure fairness and impartiality therein, I, _____, agree to the following:

For purposes of this policy, a "conflict of interest" arises when I have any of the following relationships with (i) an applicant company being considered for ETF funds or a company that is a recipient of ETF funds (in either case, an "ETF Company") or (ii) any company that either competes directly with an ETF Company or whose business would be materially affected by the success or failure of the ETF Company (an "Affected Organization"):

1. I have an equity or debt investment (or any option or other right to obtain such investment) in an ETF Company or an Affected Organization (excluding debt or equity interests of less than 2% of the relevant outstanding securities of a publicly traded Affected Organization);
2. I have another form of direct financial interest or material indirect interest in an ETF Company or an Affected Organization; or
3. My spouse or any other immediate family member has any of the above-described relationships with an ETF Company or an Affected Organization.

If such a conflict of interest exists with an ETF Company at any time, I agree to disclose promptly the potential conflict of interest in writing to the RCIC and will abide by the decision of the RCIC on my recusal from participation in the consideration of an Award for, or any other action regarding, such ETF Company.

I further agree that neither my spouse or other immediate family member nor I will enter into any relationship described in items 1-3 above with any ETF Company or Affected Organization as long as I am a member of the RCIC Regional Board, provided that such restrictions shall in any case lapse earlier (as the case may be) with respect to a specific ETF Company on the (i) 90th day after an ETF Company award has been publicly announced (ii) closing of its initial public offering, and (iii) closing of a Qualifying Liquidation Event.

Signature Date

Printed Name

Texas Emerging Technology Fund Award Agreement

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Advisory Committee Code of Ethics Policy

Below is the code of ethics policy that the Office of the Governor developed for the Emerging Technology Fund Advisory Committee in October 2010.

TEXAS EMERGING TECHNOLOGY FUND
ADVISORY COMMITTEE
CODE OF ETHICS



TEXAS EMERGING TECHNOLOGY FUND
ADVISORY COMMITTEE
CODE OF ETHICS

Preamble

The nature of Texas Emerging Technology Fund functions requires that the process be independent, fair and impartial. High ethical standards are essential to maintain the public's trust. This Code of Ethics anticipates that many Texas Emerging Technology Advisory Committee members will be active investors, either individually or on behalf of others. Without seeking to disqualify those members from service, except to the extent necessary or appropriate to conform to applicable law and ethical standards, this Code of Ethics holds all members of the Texas Emerging Technology Advisory Committee to high standards of conduct consistent with their special relationship of trust, confidence, and responsibility.

I. Definitions

In this Code:

- (a) "Code" means this Texas Emerging Technology Fund Advisory Committee Code of Ethics.
- (b) "Committee" means the Texas Emerging Technology Advisory Committee.
- (c) "Committee Member" means a member of the Committee.
- (d) "Confidential Information" means any and all confidential or proprietary information obtained by a Committee Member or the Committee by reason of the association with TETF, including, without limitation, confidential or proprietary information of TETF applicants and/or recipients, such as, but not limited to, financial information, know-how, technology, data, product information, specifications, marketing plans, and strategic plans. For an individual Committee Member, or former Committee Member, as applicable, Confidential Information does not include information that: (1) was in such Committee Member's possession before receipt in connection with TETF and without a duty of confidentiality, as evidenced by written record predating such disclosure; (2) is or becomes a matter of public knowledge through no wrongdoing of such Committee Member or the Committee; (3) is rightfully received by such Committee Member from a third party without a duty of confidentiality; (4) is disclosed by the owner of the information to a third party without imposing a duty of confidentiality on the third party; or (5) is independently developed by such Committee Member as evidenced by written record.
- (e) "Default Value" means the default value set in the Investment Unit (defined below) in the event there is no QFT (defined below) on or before the expiration of time for a QFT as set out in the applicable TETF Agreement (defined below).
- (f) "Investment Unit" means the investment unit issued by the applicable entity in connection with that entity's TETF Agreement (defined below).
- (g) "Office of the Governor" means the Office of the Governor of the State of Texas.

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(h) "QFT" means a closed and consummated First Qualifying Financing Transaction as defined in the applicable Investment Unit.

(i) "Relative" means a Committee Member's spouse, child, or other relative within the third degree by consanguinity or the second degree by affinity, determined in accordance with Sections 573.021 - 573.025, *Government Code*.

(j) "TETF" means the Texas Emerging Technology Fund.

(k) "TETF Agreement" means the Texas Emerging Technology Fund Award and Security Agreement or the Commercialization Grant Agreement (or similarly titled agreement), in each case between an entity and the State of Texas, acting by and through the Office of the Governor Economic Development and Tourism, pursuant to which such entity received an award of TETF funding.

(l) "TETF Employee" means a person working for the State of Texas in an employer-employee relationship and assigned to the TETF division of the Office of the Governor.

II. Responsibilities

(a) Each Committee Member (1) shall base his or her recommendations and all other TETF duties on competence, financial merit, and benefit to TETF and the State of Texas, and (2) shall use reasonable care and exercise independent professional judgment and professional integrity when engaging in activities concerning TETF; and (3) shall be guided by the basic principles of integrity, competence, duty of loyalty, prudence, honesty, and fairness.

(b) Each Committee Member shall fully comply with the applicable policies of the Office of the Governor, all applicable laws, and this Code. By way of example and not limitation, each Committee Member shall observe accounting and operating controls of the Office of the Governor and restrictions and prohibitions on the use of state property for personal or other purposes not related to TETF business.

(c) Committee Members shall avoid the appearance of impropriety, as well as any impropriety.

(d) Committee Members who are members of professional organizations shall also comply with any standards of conduct adopted by the organizations of which they are members.

III. Prohibited Conduct

A Committee Member shall not:

(a) solicit, accept or agree to accept any gift, favor, benefit, or service that might influence the Committee Member in the discharge of his or her duties for TETF or that the Committee Member knows or should know is being offered with the intent to influence the Committee Member's actions on behalf of TETF;

(b) solicit, accept, or agree to accept any compensation or benefit for having exercised the Committee Member's authority or performed the Committee Member's duties at TETF in favor of another;

(c) use his or her relationship or position with TETF to seek or obtain personal gain or benefit beyond any properly authorized compensation or expense reimbursement;

(d) solicit, accept or agree to accept a gift that the Committee Member knows or should know is being offered or given because of the Committee Member's position with TETF. This prohibition applies to gifts solicited or accepted for the personal benefit of the Committee Member, as well as to gifts to third parties. The foregoing restriction in this Section III(d) does not apply to the following gifts if acceptance does not violate any law: (1) gifts from the Committee Member's relatives that are based solely on a personal family relationship between the Committee Member and his or her relative; (2) business meals and receptions when the donor or a representative of the donor is present; (3) ground transportation in connection with business meetings, meals, or receptions; (4) fees for seminars or conferences that relate to the Committee Member's TETF duties; and (5) items of nominal intrinsic value, but in no event more than \$50.00, such as modest items of food and refreshment on infrequent occasions, gifts on special occasions, and unsolicited advertising or promotional material such as plaques, trophies, paperweights, note pads, calendars, pens and pencils. Notwithstanding the foregoing, a Committee Member shall not solicit, accept or agree to accept a gift of any of the following, regardless of the value or amount, if the Committee Member knows or should know it is being offered or given because of the Committee Member's position with TETF: cash, negotiable instruments, stocks, convertibles, preferreds, options, warrants, rights, debt instruments, or any other form of investment or contribution; and

(e) notwithstanding anything contained in this Code, use Confidential Information, including, without limitation, a TETF applicant's Confidential Information or advance knowledge of a TETF decision, for the Committee Member's or a Relative's personal gain, including, without limitation, investing in any such entity.

IV. Conflicts of Interest

(a) A conflict of interest exists for a Committee Member when the Committee Member or a Relative has a personal or private commercial or business relationship that could reasonably be expected to diminish the Committee Member's independence of judgment or objectivity in the performance of the Committee Member's TETF duties, including, without limitation, an equity, debt, or other investment in a TETF-funded entity or applicant. Committee Members shall avoid personal, employment, and/or business relationships that are likely to create a conflict of interest.

(b) Each Committee Member must make a full and fair disclosure of all matters that could diminish his or her independence and objectivity or conflict with his or her duties as a Committee Member. Each Committee Member must make such disclosures promptly, but in no event more than ten (10) days following becoming aware that such matters have arisen, and must deliver such relevant information in plain language and effectively to the Chairman of the Committee ("Chairman"), provided the Chairman is not the Committee Member with the conflict of interest or potential conflict of interest. The Chairman will establish procedures for addressing conflicts of interest and potential conflicts of interest. Such procedures shall include the establishment of a committee to resolve conflict of interest issues ("COI Group"). The COI Group shall be comprised of the Chairman, one (1) additional Committee Member, and one (1) employee of the Office of the Governor. In the event the Chairman has a conflict of interest or potential conflict of interest, the Chief of Staff of the Office of the Governor, or his or her designee, shall step into the place of the Chairman with respect to such conflict of interest or potential conflict of interest issues. In such case, the Chairman shall make the required disclosure to the Chief of Staff of the Office of the Governor and shall not

participate in decisions made by the COI Group regarding such conflict of interest or potential conflict of interest.

(c) Circumstances that could diminish a Committee Member's independence and objectivity or conflict with his or her duties as a Committee Member will vary. Following are some examples of circumstances in which disclosure would be required and which the COI Group would make a determination:

- (1) in the event a Committee Member wishes to invest in or serve as a director, officer, employee, or investment consultant or manager of any for profit entity which, prior to the Committee Member's tenure on the Committee, (i) received its final TETF disbursement, or (ii) invested in a for profit entity that received its final TETF disbursement;
- (2) invest in or serve as a director, officer, employee, or investment consultant or manager of any for profit entity which has applied for TETF funding but such funding decision has not yet been made and Confidential Information about such entity was obtained by the Committee Member or the Committee;
- (3) in the event a Committee Member or former Committee Member wishes to invest in or serve as a director, officer, employee, or investment consultant or manager of any for profit entity which, during the Committee Member's tenure on the Committee, received TETF funding, or invested in a for profit entity that received TETF funding, in each case if such investment or service would occur before (i) a QFT or Default Value becomes effective, (ii) the state's final financial investment in the entity has been made, or (iii) one (1) year following termination of the Committee Member's membership on the Committee; or
- (4) in the event a Committee Member or former Committee Member wishes to invest in or serve as a director, officer, employee, or investment consultant or manager of a for profit entity for which Confidential Information was obtained by the Committee Member or the Committee and which, during the Committee Member's tenure on the Committee (i) was turned down for TETF funding, or (ii) invested in a for profit entity that was turned down for TETF funding, in each case if such investment or service would occur before one (1) year following the final determination by TETF not to invest in a for profit entity.

(d) A Committee Member has an affirmative duty to promptly cure any conflict of interest. A Committee Member who becomes aware, or reasonably should have become aware, of a conflict of interest shall cure the conflict by promptly eliminating it in accordance with Section IV(e) below, unless such conflict cannot be cured or except as otherwise provided by Section IV(f) below.

(e) Provided the COI Group does not determine that a conflict of interest or potential conflict of interest requires additional action, a Committee Member may cure a conflict of interest or potential conflict of interest by prudently withdrawing from all action on a particular matter if:

- (1) the Committee Member may be and is effectively separated from relevant deliberations, voting and otherwise influencing the action taken;
- (2) the action may be properly taken by others;
- (3) the nature of the conflict is not such that the Committee Member must regularly withdraw from decisions that are normally the Committee Member's responsibility with respect to TETF; and

(4) the conflict is not resulting from a Committee Member or his or her Relative having a pecuniary interest in the entity in question.

(f) In the event the requirements of Section IV(e) are not met, or the COI Group determines that the conflict of interest or potential conflict of interest requires additional action, the COI Group shall then determine what action is required.

(1) Prior to a final determination by the COI Group, the Committee Member must be absent from any relevant deliberations, must refrain from voting on the matter, and must not attempt to influence any Committee Member in connection with any matters relating to such conflict of interest or potential conflict of interest.

(2) The Committee Member shall immediately comply with the decision of the COI Group. In the event the Committee Member does not agree to immediately comply with the decision of the COI Group, the Committee Member shall, upon the request of the COI Group, immediately give written notice of resignation from the Committee, effective immediately, to the Chairman. If the Chairman resigns, the Chairman will give such notice to the Chief of Staff and General Counsel of the Office of the Governor.

(g) Committee Members shall accept and abide by the decisions of the COI Group and shall fully and promptly comply with all associated required actions.

V. Diligence

Committee Members must exercise diligence, independence, and thoroughness in analyzing investments, making recommendations, and taking investment actions.

VI. Duty to Report

A Committee Member who has knowledge of a violation or suspects a violation of (a) applicable law, this Code, or other applicable ethical obligations by any other Committee Member, or (b) a legal or ethical obligation by any TETF Employee, shall report the violation or suspected violation to the Deputy Chief of Staff and the General Counsel of the Office of the Governor. Such report shall be made promptly but in no event more than ten (10) days after the Committee Member becomes aware of such violation or suspected violation.

VII. Confidential Information

(a) A Committee Member will protect Confidential Information by using reasonable care to prevent the unauthorized use, dissemination or publication of Confidential Information. A Committee Member will not disclose Confidential Information to any third party (except to the extent authorized while conducting due diligence on behalf of the Committee) and will limit disclosure to authorized employees of the Office of the Governor, the Office of the Lieutenant Governor, and the Office of the Speaker of the Texas House of Representatives, as permitted in order to fulfill the Committee Member's TETF duties, unless prior approval is received from the Office of the Governor. Notwithstanding the foregoing, a Committee Member may disclose Confidential Information to the extent required by law or court of competent jurisdiction, provided that prior to any such disclosure, such Committee Member gives at least ten (10) days notice of intent to disclose to the General Counsel of the Office of the Governor or, if such notice is not possible under the circumstances, such notice as is reasonably possible.

(b) A Committee Member shall use Confidential Information for TETF purposes only and not for personal gain or benefit or for the gain or benefit of (1) Relatives; (2) any employee of the Office of the Governor; or (3) any third party.

(c) A Committee Member shall not copy or keep Confidential Information for any reason except as required to fulfill his or her duties for TETF. Each Committee Member must return to the Office of the Governor all Confidential Information in his or her possession immediately upon request by the Office of the Governor or immediately upon the termination of such Committee Member's membership on the Committee, whichever comes first.

VIII. Former Committee Members

(a) For one (1) year after a Committee Member ceases to be a Committee Member, he or she may not appear before or communicate with a then current Committee Member or employee of the Office of the Governor if the communication is made with the intent to influence the current Committee Member or employee of the Office of the Governor on behalf of any person or business entity in connection with TETF.

(b) A former Committee Member may not seek or obtain personal gain or benefit from Confidential Information received or accessed while serving on the Committee.

(c) A former Committee Member may not disclose Confidential Information without the written consent of the Office of the Governor or except as required by law or court of competent jurisdiction.

(d) A former Committee Member shall comply with the applicable provisions of this Code and decisions of the COI Group that extend beyond the Committee Member's service on the Committee.

IX. Code Compliance and Ethics Compliance Statements

(a) Each Committee Member's service on the Committee requires acceptance of and compliance with this Code. By serving or continuing to serve as a Committee Member, as applicable, each Committee Member accepts this Code and agrees to comply with its provisions. Repercussions from a violation of this Code by a Committee Member may include a requirement that the Committee Member immediately resign from the Committee.

(b) With ten (10) days following his or her appointment to the Committee, and; thereafter, annually between July 1st and August 31st of each year and/or such other time as requested by the Office of the Governor, each Committee Member shall execute and deliver to the General Counsel of the Office of the Governor a completed ethics compliance statement in the form and containing the content required by the Office of the Governor; and (b) if a change in circumstances occurs that requires reporting under the Code, promptly, but in no event more than ten (10) days following such change in circumstances, report such information to the Deputy Chief of Staff and General Counsel of the Office of the Governor.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair

The Honorable Joe Straus III, Speaker of the House, Joint Chair

The Honorable Steve Ogden, Senate Finance Committee

The Honorable Thomas “Tommy” Williams, Member, Texas Senate

The Honorable Jim Pitts, House Appropriations Committee

The Honorable Harvey Hilderbran, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor



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