REVIEW OF MANAGEMENT PRACTICES AT THE TREASURY DEPARTMENT'S COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND

A Majority Staff Report

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I. Executive Summary

- The Community Development Financial Institutions Fund ("CDFI Fund" or "the Fund") was created by an act of Congress in August 1994 "to promote economic revitalization and community development through investment in and assistance to community development financial institutions, including enhancing the liquidity of community development financial institutions." Originally established as a separate government-owned corporation, the CDFI Fund was transferred permanently to the control of the Department of the Treasury ("the Department" or "Treasury") in a 1995 appropriations act. The CDFI Fund administers two separate programs: the CDFI program, which makes financial awards to "community development financial institutions" based upon proposed development activities, and the Bank Enterprise Award program ("BEA program"), which makes awards to any type of financial institution that has demonstrated a commitment to community development lending. In late 1995, Kirsten Moy was appointed Director of the CDFI Fund and Steve Rohde was appointed Deputy Director.

- In July 1996, the CDFI Fund awarded $37.2 million to 31 CDFIs (out of 268 applicants) under the CDFI program, and more than $13.1 million to 38 financial institutions participating in the BEA program. In September 1997, the CDFI Fund awarded $38.3 million to 48 institutions under the CDFI program and $16.25 million to 54 institutions under the BEA program. The Fund announced a third round of funding on March 20, 1998. As of May 1998, the Fund had approximately $115 million in unobligated funds and expected to obligate $94.5 million in fiscal year 1998, including expenditures of $20 million for training and technical assistance programs.

- In March 1997, as a result of complaints about the selection process utilized in the first round of grants announced in July 1996, Rep. Spencer Bachus, Chairman of the General Oversight and Investigations Subcommittee of the

House Committee on Banking and Financial Services ("the Subcommittee"), requested information about management practices at the CDFI Fund from the Department. Its response indicated that the Fund had failed to employ an objective scoring system in selecting award winners, and that the Director and Deputy Director of the Fund had participated in making awards to firms with which they had been previously associated. Troubled by these disclosures, Chairman Bachus requested that Subcommittee staff be permitted to review application files and other documents.

- The preliminary Subcommittee staff review, initiated on April 18, 1997, revealed an absence of documentation that would explain why winning applicants were selected over others; extensive correspondence between applicants and CDFI Fund personnel after the application deadline; evidence that a group of applicants connected to Chicago-based Shorebank Corporation received almost $11 million of the $37 million awarded in the first round; and the presence in the files of certain undated evaluation memoranda for the Shorebank-related institutions purporting to justify their awards.

- On May 9, 1997, Chairman Bachus requested additional information from the Department, including an explanation of the undated memoranda. In a May 27, 1997 response, the Department indicated that it had referred the matter to its Office of Inspector General. A Report of Investigation completed in July 1997, by the Inspector General disclosed the following:

    - At the time Chairman Bachus initiated the Subcommittee review of the program in March 1997, evaluation memoranda justifying almost $11 million in awards to the Shorebank-related entities granted in July 1996 did not exist;

- On the eve of the Subcommittee staff's initial visit to review documents on April 18, 1997, the CDFI Fund's Director called the Deputy Director from Paris and instructed him to make every effort to complete the "evaluation memoranda" prior to the Congressional staff review, and asked that he consider the possibility of leaving the memoranda undated;

- The Deputy Director worked throughout the evening of April 17th and early morning hours of April 18th preparing undated evaluation memoranda (which were not worded in the past tense, thus creating an impression that they had been drafted before the awards were finalized) and instructed that they be inserted in the files prior to the arrival of Subcommittee staff.

- Members of the House Banking and Financial Services Committee registered their strong concern about these events in a July 15, 1997, letter to Secretary Rubin. On August 6, 1997, the Treasury Department announced the resignations of the Director and the Deputy Director.

- In the wake of the disclosures that senior CDFI Fund officials had sought to mislead Subcommittee investigators, Chairman Bachus requested a streamlined review of the first round of CDFI Fund awards, including the factors used in selecting winning applicants, the safeguards utilized to protect against abuse, and the Fund's failure to adopt an objective scoring system to evaluate applications. Subcommittee staff reviewed documents provided by Treasury and interviewed certain key CDFI Fund employees. Former Director Moy declined to make herself available for an interview in person. The Subcommittee staff review disclosed the following:

- A Treasury Department transition team, in conjunction with an interagency task force, developed draft procedures for the CDFI Fund during the summer of 1995. These draft procedures incorporated a scoring system in which applications would be graded and provided a numerical score, a procedure similar to that used by other federal grant programs to ensure objectivity in the review process and protect against abuse. The draft regulations also incorporated other standards designed to enhance objectivity and reduce arbitrariness in the selection process. In September 1995, senior Treasury Department officials rejected these proposals in order to "maximize the Fund's flexibility and discretion . . .." In so doing, the Fund failed to follow the recommendations of its own Office of Inspector General, which recommended use of a scoring system.

- The CDFI Fund adopted what the Deputy Director termed an "unorthodox" approach to selecting winning applicants during its first round that was characterized by "due diligence," in which reviewers were encouraged to gather information on an informal basis from industry participants and other sources. CDFI Fund officials could not identify any other federal agency that utilizes such an approach, and Subcommittee staff is aware of none.

- The documentation generated in the CDFI Fund's first round is wholly inadequate in demonstrating why certain applicants were chosen over others. So-called "first stage" evaluation memoranda appear to have been drafted in a "slanted" fashion to justify funding decisions and do not reveal the extent to which information was obtained from third party industry sources. Examples include instances where undocumented positive references from third parties were used to support the selection of particular applicants, and one instance where

an allegation of sexual harassment against an official of an applicant that was disclosed in a conversation with a third party was a factor in rejecting the applicant. The undated evaluation memoranda prepared by the Deputy Director on the Shorebank-related applicants do not appear to reflect the discussion that apparently occurred among CDFI Fund personnel reviewing the applications. The draft "second stage" memoranda fail to reveal how the review panel resolved concerns about management track records for particular institutions, and do not disclose, for instance, that the second stage review panel apparently chose to consider "ethnic diversity" factors in selecting certain applicants.

- In making first round award decisions, the CDFI Fund appears never to have developed a systematic approach to comparing start-up organizations to established institutions. Moreover, certain applicants were rejected on the grounds of poor management track records or weak financial standing, while others with similar records were selected for funding. As a general matter, the Fund sought to determine if management changes were pending at institutions seeking funding, and rejected applications on this basis; however, in the case of one applicant, the CDFI Fund claims to have been unaware of a pending management change that resulted in a new CEO being appointed within weeks of being awarded a grant.

- The Fund's conflict of interest policy was inadequate, and an unreasonable interpretation by Fund officials of the ethical regulation governing "appearance" problems rendered it meaningless. Despite implicit recognition of an appearance problem, the Deputy Director did not follow ethics regulations requiring him to confer with the agency's

designated ethics officer before participating in the review of an application from his former employer.

- The CDFI Fund awarded almost $11 million to one self-styled “system” – the Shorebank system – that was characterized by interlocking management and profit-sharing arrangements. In construing a statutory provision limiting CDFI awards to $5 million to any one institution and its affiliates, the Department relied upon Federal Reserve “presumptions” that an institution is not affiliated with another unless it owns stock in that entity.

- The CDFI Fund awarded over $769,500 in “technical assistance” grants to particular awardees without utilizing a competitive selection process. In one instance, Shorebank Advisory Services, which had prepared an institution’s CDFI application (and had a profit-sharing arrangement with the applicant) made a direct plea for a technical assistance grant to cover its own consulting relationship with the applicant. The CDFI Fund earmarked a total of $489,500 to Shorebank Advisory Services during the 1996 funding round.

- The Department and the Deputy Director claim that political factors did not influence grant decisions. However, internal documents indicate that the Director and the Deputy Director discussed tentative first round winners in terms of the applicants’ connections to prominent political figures in a conversation purportedly relating to the announcement of awards. In addition, the Department stated that a letter from President Clinton commending an applicant that was later awarded funding despite being labeled a “risky” “start-up” by a reviewer, was not shown to members of the review panel that selected the winning applicants. A sworn statement by a CDFI Fund employee

indicates that the letter was in fact shown to the Director of the Fund, who participated in the award process, prior to the selection of the applicant for a grant. The Deputy Director stated that the Fund did not respond to White House inquiries concerning particular applicants; however, the Deputy Director acknowledges that the Fund received pressure from the White House to announce the first round awards according to a timetable that he considered unrealistic. The Deputy Director attributes the inadequacy of documentation relating to the award process to pressure from the White House, the Treasury Department, and the industry to expedite announcement of the awards, and to his being enlisted in the extensive public relations effort conducted by the Department in conjunction with the announcement of the awards in July 1996.

- Rather than hiring key personnel, the CDFI Fund relied upon highly paid outside consultants to conduct the grant process and provide management services. One consultant was paid over $228,000 for part-time work over an 18-month period, including over $31,000 to reimburse her for weekly travel to Washington from New York City; another was paid over $180,000 for part-time work over a 20-month period. The Fund's arrangements with outside consultants evaded the dictates of 5 U.S.C. sec. 3109, which limits both amounts paid to outside contractors and the duration of their tenure.

- The Fund engaged in a wholesale evasion of the Federal Acquisition Regulations, which require that competitive procedures be followed in selecting contractors. The Department utilized section 8(a) set-aside contracts (designed to promote minority and disadvantaged firms) as mere "pass-through" vehicles for the purpose of using subcontractors pre-selected by CDFI Fund officials. (Subcontractors were generally

selected by word-of-mouth and on an informal basis; the former Director has acknowledged knowing at least 18 of the contractors selected for the 8(a) firms.) These hand-picked subcontractors provided well over 50 percent of the services -- and on many task orders, more than 90 percent of the services -- provided by the 8(a) firms.

  - The CDFI Fund paid Ernst & Young, LLP, an outside consulting firm, over $800,000 to provide advice on new grant procedures. Ernst & Young was selected on a de facto "sole source" basis, even though Ernst & Young personnel advising the Fund had no prior experience devising federal grant programs.

- Subcommittee staff did not conduct a substantive review of the second round of grants, in which the Department utilized a modified scoring system, placed greater emphasis on documentation, and subjected potential conflicts of interest to increased scrutiny. Notwithstanding these improved procedures, the Fund did not resolve the continuing programmatic ambiguity regarding the extent to which the Fund's resources should be targeted at start-ups. The scoring system utilized in the second round did not rigorously track the selection factors established in the regulations, and required a significant exercise of discretion by application reviewers. Furthermore, the scoring system did not assign greater weight to those factors that were concededly the most important, and scores granted to particular applicants by first stage reviewers were ignored by the second stage panel that made final recommendations to the Director.

- Fund officials reportedly concluded that there had been a significant decline in the quality of applicants during the second round, even in comparison to what was seen as a relatively weak applicant pool in the first round. The Fund

expects to spend approximately $20 million in 1998 on training and technical assistance.

- The CDFI Fund's 1997 Annual Report identified continuing deficiencies in the administration of the program, most of which were not resolved as of March 1998. These include lack of a formal Federal Managers Financial Integrity Act program; failure to establish Chief Financial Officer and Controller positions and functions; failure to establish Awards administration and monitoring positions and functions; failure to establish and implement post-award monitoring procedures; no formal review of monthly financial statements and accounting records or completion of supporting reconciliations; inadequate delineation of organizational responsibilities; and failure to complete program award files. An outside auditing firm found similar deficiencies. In addition, an evaluation completed by the Treasury Office of Inspector General determined that the Department failed to provide a consistent team to oversee implementation of the CDFI Fund program, resulting in confusion concerning the placement of the agency within the Department, the failure to perform a comprehensive written needs assessment, and the failure to provide critical accounting and procurement services.

II. The Community Development Financial Institutions Fund

A. Origins of the CDFI Fund

As Governor of Arkansas, Bill Clinton supported the concept of community development banking modeled on the Grameen Bank in Bangladesh and the South Shore Bank in Chicago. Governor and Mrs. Clinton spearheaded the effort to import this approach to development lending into Arkansas.[1] As part of his 1992 presidential

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[1] Jan Piercy, a former college roommate of Mrs. Clinton's, was a Senior Vice President at Shorebank Corp. ("Shorebank"). Shorebank, referred to as "Clinton's Favorite Bank" in a 1993 *ABA*

campaign, candidate Bill Clinton pledged to provide $1 billion over five years to fund 100 new community development banks that would operate in distressed urban and rural areas.

After the election, President Clinton submitted a modified proposal to Congress under which government funds would be distributed to a variety of qualified institutions -- including established banks as well as start-ups -- rather than initiating the development of 100 new community development banks.[2] Legislation creating a Community Development Financial Institutions ("CDFI") Fund was enacted in August 1994 as part of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994 (P.L. 103-

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Banking Journal article, is the parent company of South Shore Bank. Ms. Piercy, who would later serve on the Clinton Administration's transition team and as the U.S. Executive Director to the World Bank, had reportedly discussed the community development lending concept with the Clintons during a visit to Little Rock in the mid-1980's; the Clintons were intrigued and worked with several Shorebank officers to establish Southern Development Bancorporation ("Southern Development") in Arkadelphia, Arkansas in 1988. Mrs. Clinton, one of the company's original shareholders, served on its board of directors until her departure for Washington following the 1992 election. Also serving on the Board were Ronald Grzywinski, a cofounder of Shorebank, and George Surgeon, a board member at Shorebank who was chosen to serve as the first President of Southern Development. Another of Mrs. Clinton's fellow Southern Development shareholders and board members was Mack McLarty, who would later serve as White House chief of staff. Mrs. Clinton's law firm, the Rose firm, handled the company's legal work, collecting fees totaling between $100,000 and $200,000 for its services. Southern Development received assistance from the Winthrop Rockefeller Foundation to purchase Elk Horn Bank in 1988, which became the principal subsidiary of Southern Development. Governor Clinton reportedly used his influence to help obtain capital for Southern Development. Mr. Surgeon has been quoted as saying Governor Clinton "twisted a lot of arms" to get Southern Development funded. A quasi-state agency established by Governor Clinton, Arkansas Capital Corp., contributed $300,000 to start up the bank. *See* generally, Charles R. Babcock and Sharon LaFraniere, "The Clintons' Finances: A Reflection of Their State's Power Structure," *The Washington Post*, July 21, 1992, at A7; Tom Leander, "In Arkansas, They're Banking on the Poor," *American Banker*, December 2, 1991; Glenn R. Simpson, "U.S. Loans to Firms with Clinton Ties Are Questioned," *The Wall Street Journal*, May 15, 1997, at A24; "Three Chicago Banks Invest in Clinton's Favorite Bank (South Shore Bank, Chicago)," *ABA Banking Journal*, May 1, 1993, at 9; Lorin Mitchell, "Former Chicagoan Is On Track to World Bank Post," *Chicago Tribune,* May 19, 1994, at 7; "Banking System Changes are Key to Clinton's Economic Plan," *Business Management*, Vol. 68, No. 10., October 1, 1992, at 36.

[2] Proponents of the plan argued that there was little reason to establish new banks when existing banks were already providing similar services. George Surgeon, President of Southern Development, one of four banks awarded a CDFI grant in 1996 during the first round, said in 1993, "Whatever the final proposal, we're hoping they won't forget those of us who have been toiling in the vineyard and gotten little support for the past 12 years." David R. Sands, "Budget slashed for Clinton banking pet," *The Washington Times,* April 14, 1993, at C1. As discussed below, the issue of whether the CDFI Fund should be targeted to develop start-ups as opposed to funding existing institutions has yet to be resolved on a programmatic level by the Treasury Department.

325). President Clinton continues to state publicly that his goal is to make the CDFI Fund a billion dollar program over five years.[3]

Under the legislation, Title I established the CDFI Fund as a separate government-owned corporation, temporarily lodged within the control of the Treasury Department. The stated purpose of the legislation was "to promote economic revitalization and community development through investment in and assistance to community development financial institutions, including enhancing the liquidity of community development financial institutions."[4] The statute detailed the eligibility requirements of a CDFI,[5] the application requirements, selection criteria for awardees, and the types of assistance the Fund can provide under the CDFI program. In 1995, P.L. 104-19, an emergency supplemental appropriations and rescissions act, placed the CDFI Fund permanently within the Treasury Department.[6]

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[3] "Clinton Wants to Triple Credit to U.S. Microenterprises," *Agence France Presse,* January 31, 1997.

[4] P.L. 103-325, Sec. 102.

[5] The regulatory definition of a CDFI is highly technical yet subject to interpretation by Fund officials. CDFI regulations state that the Fund will determine "in its sole discretion" whether an applicant fulfills the requirements for eligibility based upon six factors: primary mission of promoting community development; a targeted population or investment area; a primary function of lending money; provision of development services in conjunction with the grants; community accountability through representation on a governing board; and independence from any agency of any U.S. government. 12 CFR Chapter XVIII, *et. al*, "Community Development Financial Institutions Program, Bank Enterprise Award Program, Environmental Quality; Interim Final Rule and Notice of Funding Availability," October 19, 1995, Sec. 1805.200, at 54117. In addition, a holding company may qualify as a CDFI if its affiliates "collectively satisfy" all the listed requirements. It is unclear how many CDFIs currently exist. The CDFI Fund received 268 applications for funding in 1996 and 162 applications in 1997; recently, the General Accounting Office ("GAO") sent surveys to over 900 institutions it preliminarily identified as potential CDFIs.

[6] P.L. 104-19 provides: "Notwithstanding any other provision of law, for purposes of administering the Community Development Financial Institutions Fund, the Secretary of the Treasury shall have all powers and rights of the Administrator of the CDFI Act and the Fund shall be within the Department of the Treasury." P.L. 104-19 also limited the CDFI Fund to ten full-time equivalent employees, a limitation that ended on September 30, 1996.

Additionally, the parallel BEA program, functioning under different criteria, was placed under the supervision of the CDFI Fund.[7] The BEA program differs from the CDFI program in that all financial institutions are eligible, and are selected for awards based upon their investment in CDFIs, lending activities in distressed communities, and provision of certain services and assistance. One third of the appropriated funding for the CDFI Fund is set aside for the BEA program.[8]

A 15-member advisory board, comprised of nine private citizens appointed by the President, five Cabinet Secretaries, and the Administrator of the Small Business Administration, was established to advise the Fund.[9]

B. Administration of the Fund

During 1994 and 1995, a Treasury Department transition team, in consultation with an interagency task force, developed a proposed regulatory structure for the CDFI Fund. On October 19, 1995, the Treasury Department issued a Notice of Funds Availability ("NOFA"), in conjunction with Proposed Regulations, for the CDFI Fund's "first round" of funding.[10]

Also in October, Kirsten Moy commenced duties as Director of the Fund, responsible for supervising the efforts of the Deputy Director in implementing the program, serving as a member of the panel established to make grant decisions ("the final

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[7] P.L. 103-325, Sec. 114.

[8] P.L. 103-325, Sec. 121. Appropriation authority for the Fund provided for $60 million in FY95 and totaled $392 million spread over four years, of which $5.55 million was designated for administrative expenses annually. The House Appropriations Subcommittee on Veterans Affairs, Housing and Urban Development and Independent Agencies has jurisdiction over the Fund.

[9] Pauline Smale, "Community Development Financial Institutions (CDFI) Fund," CRS Report 97-819 E, November 19, 1997, at 2.

[10] 12 CFR Chapter XVIII, et. al., "Community Development Financial Institutions Program, Bank Enterprise Award Program, Environmental Quality; Interim Final Rule and Notice of Funding Availability," October 19, 1995, at 54110-54139.

review panel" or the "second stage panel"), and approving the selections of that panel.[11] Before joining the CDFI Fund, Ms. Moy had served as a vice president of Equitable Real Estate Investment Management and other Equitable Company subsidiaries, and had also been an uncompensated member of an advisory panel to the New York-based Low Income Housing Fund, a successful applicant for funding during the first round.

In December 1995, Steve Rohde was appointed Deputy Director of the CDFI Fund. Prior to joining the agency, Mr. Rohde had been employed in the Washington, D.C. office of the Local Initiatives Support Corporation, another successful first round applicant. Mr. Rohde's duties at the CDFI Fund were to manage the grant process, review applications, recruit and supervise other reviewers, assign reviewer tasks, and ensure overall consistency in the review process.[12]

C. First Round of Awards in 1996

The first round NOFA dictated the contents of the applications, which were required to include a funding request; a mission statement; a service area designation; statements on accountability, ownership, community impact and need; identification of funding sources and match dollars; potential risks; partners; and conflicts of interest. The proposed regulations also specified the selection criteria and established a three-tier review process, detailed below.

In response to the NOFA, the Fund received 268 applications in 1996 for assistance from applicants representing 48 states and one U.S. territory; the BEA Fund

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[11] *See* Letter from Linda L. Robertson, Treasury Assistant Secretary for Legislative Affairs and Public Liaison, to Chairman Spencer Bachus, March 26, 1997. In testimony before the House VA, HUD and Independent Agencies Subcommittee on March 12, 1997, Secretary Rubin described the process that led to Ms. Moy's hiring: "[W]e knew who we wanted. Then the question was, how do we get her? We finally got the President to call and the President persuaded Kirsten to join us."

[12] *Ibid.*

received 49 applications.[13] Applications were initially reviewed by CDFI Fund staff to verify that required application components were included and eligibility requirements were met. During this stage, applications were evaluated and judged for their viability for further consideration. These reviews were conducted by CDFI Fund senior management and eight outside reviewers selected by the Director and the Deputy Director. No formal "scoring" or numeric grading system was utilized in this process. Fifty-nine applicants passed this evaluation procedure and became "finalists." The finalists then moved to the final review conducted by a panel composed of the Director, the Deputy Director, one other CDFI Fund employee, and two outside consultants. This review panel conducted interviews of finalists in May 1996. The review panel met in June and July to select the winning applicants. From these discussions, 31 winners were chosen to receive $37.2 million in awards.[14] The winners were announced on July 31, 1996.[15]

The BEA Fund's first round of funding was held simultaneously with the CDFI Fund awards. The BEA Fund, however, was "undersubscribed" during its first round -- it did not receive a sufficient number of applications to exhaust all of its funds. As a result, all eligible applicants received BEA awards and left-over funds were transferred to the CDFI Fund.

Although the CDFI Fund announced its awards in July 1996, disbursement of award monies was contingent upon the consummation of a formal assistance agreement between the applicant and the CDFI Fund. The assistance agreements, as stated in the October 19, 1995 NOFA, required awardees to certify their compliance with the CDFI program's performance goals and conditions of assistance. At the time that the CDFI

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[13] *See* Exhibit 1 (list of first round applicants to the CDFI and BEA programs). Four first round applicants withdrew their applications.

[14] The form of the award -- grant, loan, or equity investment -- depended upon the nature of the applicant's matching funds.

[15] *See* Exhibit 2 (list of first round CDFI and BEA program applicants receiving awards).

Fund noticed its second round of funding on April 4, 1997, only $14 million (or 37.6 percent) of the first round awards had been disbursed.

D. The Second Round in 1997

After the first round winners were announced, the CDFI Fund modified its procedures. In its second NOFA, published in the Federal Register on April 4, 1997, the Fund allowed CDFIs to apply as either an "intermediary component" or as a "core component" applicant.[16] This permitted "intermediary CDFIs" to win awards in order to provide specialized and financial technical assistance to smaller community development funds across the country. Using modified procedures that included an objective scoring system, increased emphasis on formal documentation, and greater attention to conflicts of interest,[17] on September 30, 1997, the Fund announced 48 winners of CDFI awards, totaling $38.3 million, and 54 winners of BEA awards, totaling $16.25 million.

E. The Third Round in 1998

On March 20, 1998, the CDFI Fund issued a NOFA for its third round of funding. In conjunction with this round of funding, the CDFI Fund expects to spend $20 million on training and technical assistance programs.

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[16] 12 CFR Part 1805, "Community Development Financial Institutions Program, Revised Interim Rule with Request for Comment," April 4, 1997, pp. 16444-16459.

[17] *See* Section VII below.

III. Initiation of Oversight Activities

A. Complaints about First Round Procedures

Shortly after Treasury announced the recipients of its first round of CDFI Fund awards in July 1996, the process by which those grants had been awarded came under criticism. Several unsuccessful applicants complained in press accounts that the awards had gone "overwhelmingly to established players" at the expense of newly-formed community development lenders that many in the industry believed the 1994 legislation had been intended to benefit.[18] The Subcommittee also heard complaints from other industry participants.[19] As a result of concerns that the Department had deviated significantly from congressional intent in awarding some $37 million in federal funds, Chairman Bachus initiated a preliminary inquiry into the circumstances surrounding the CDFI Fund's first round of awards.

B. March 11, 1997 Request for Information by Chairman Bachus

On March 11, 1997, Chairman Bachus wrote to Treasury Secretary Robert Rubin requesting general information concerning administration of the CDFI and BEA programs, including a detailed description of "the review process, evaluation criteria, [and] scoring system used to select CDFI award recipients."[20]

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[18] Barbara F. Bronstien, "Losers Hit Treasury on Community Lending Grants," *American Banker*, August 7, 1996, at 6.

[19] In fact, it appears that a member of the Fund's advisory board raised questions concerning the lack of a scoring system in the board's January 1997 meeting. See Exhibit 3 (excerpt from advisory board meeting transcript).

[20] Copies of all correspondence related to this investigation are collected in an Appendix to this Report.

The Treasury Department's response to Chairman Bachus' request disclosed several troubling aspects of the 1996 grant process:

1. In selecting grant recipients, the CDFI Fund had failed to devise and implement an objective scoring system of the kind typically utilized in federal grant programs to prevent political favoritism and provide a record of deliberations;

2. Almost eight months after announcing the award of some $37 million in federal funding to 31 different recipients, the CDFI Fund had succeeded in disbursing a mere $4.8 million to three grantees; and

3. The Director of the CDFI Fund, Ms. Moy, had served as an advisor to one of the award recipients prior to assuming her governmental responsibilities, while the Deputy Director, Mr. Rohde, had been employed by another winning applicant, creating an appearance of a conflict of interest in the selection process.

These revelations prompted Chairman Bachus to request immediate access to the CDFI Fund's records relating to the first round of awards, including individual applicant files.[21] Prior to commencing its review of these materials, the Subcommittee agreed as an accommodation to the Treasury Department – and in recognition of the legitimate privacy interests of CDFI Fund applicants – to preserve the confidentiality of any proprietary or confidential business information contained in the files made available for staff's inspection.[22]

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[21] *See* Letter from Chairman Spencer Bachus to Treasury Secretary Robert Rubin, April 14, 1997.

[22] *See* Letter from Chairman Spencer Bachus to Treasury Secretary Robert Rubin, April 17, 1997. The Subcommittee resisted the Treasury Department's attempts to impose further limitations on its use of the information contained in the CDFI Fund's files, however, on the ground that such restrictions were antithetical to Congress' Constitutionally-grounded authority to exercise oversight of the executive branch.

C. Initial Staff Review of Applicant Files

Subcommittee staff began its preliminary review of applicant files[23] at the CDFI Fund on April 18, 1997. This preliminary review revealed certain deficiencies in the procedures used by the CDFI Fund to award federal grant money.

1. Lack of documentation indicating the reasons successful applicants were selected

The Subcommittee staff review disclosed a lack of documentation in the files reflecting that a meaningful deliberative process had been undertaken in making grant decisions, *i.e.*, documents that would indicate why the Fund chose one entity for funding over another. As noted above, of the 268 applications processed by the CDFI Fund during the 1996 round of funding, 59 were selected as “finalists” by the review panel of CDFI Fund personnel and outside contractors. For each of the 59 “finalists,” a CDFI Fund reviewer was to prepare an “evaluation memo,” the purpose of which was to summarize the relative strengths and weaknesses of the application, and to analyze whether funding the applicant would promote economic development and capital formation in economically distressed communities. At best, this document described strengths and weaknesses of the particular applicant, but did not reveal why particular institutions were more deserving of funding than others.

There was essentially no record of the deliberations of the second stage review panel that chose the 31 winning applicants from the ranks of the 59 finalists. The Subcommittee staff’s review revealed two memos prepared by Valerie Piper, an assistant to the Deputy Director, purporting to reflect discussions of the second stage review panel. These memoranda were marked “draft” and consisted of “bullet point” information that

[23] Subcommittee staff reviewed the files of all 31 winners and a sample of other applicants.

provided no basis upon which to assess the relative strengths and weaknesses of particular applicants.

2. Undated evaluation memos for Shorebank-related entities

Subcommittee staff's preliminary document review at the CDFI Fund disclosed that evaluation memos prepared on the applications of four of the 31 winning applicants – Shorebank, Southern Development, Douglass Bancorp, Inc. ("Douglass"), and Louisville Development Bancorp, Inc. ("Louisville Development") – had been left undated. These finalists received almost $11 million of the $37 million awarded by the Fund. Of the 268 applications processed by the Fund, these applications were four of the five that the Deputy Director chose to review personally.

3. No record of whether the Fund addressed conflicts of interest on the part of reviewers

In addition to the concerns raised previously by Chairman Bachus regarding the involvement of Director Moy and Deputy Director Rohde in making awards to entities with which they had been associated prior to joining the CDFI Fund, the Subcommittee staff's review revealed that certain of the reviewers retained by the Fund had existing or prior relationships with certain of the applicants. There was no record of how such conflicts of interest (either actual or perceived) were addressed, if at all, in the grant process.

4. Correspondence on behalf of applicants received after the application deadline

The Subcommittee review revealed extensive correspondence and material in the applicant files that appeared to have been received after the application deadline of January 22, 1996. For example, the application file of successful applicant Enterprise

Corporation of the Delta ("Enterprise Corporation") contained a May 2, 1996 letter from President Clinton to former Governor William Winter of Mississippi, copied to Treasury Secretary Rubin, reflecting President and Mrs. Clinton's long-standing interest in and support for Enterprise Corporation's parent organization. Other application files contained correspondence with extensive information about applicants that was received after January 29, 1996. This practice, ostensibly part of the Fund's effort to conduct "due diligence," raised the possibility that the CDFI Fund had permitted certain applicants to "strengthen" or clarify their applications after the deadline, giving them an advantage over applicants who had strictly adhered to the deadline.

5. $11 million in awards to a "Shorebank system" despite a statutory cap on awards to one institution

The CDFI Fund statute and regulations limit grants to any one awardee and its "affiliates" to $5 million over a three year period.[24] Shorebank was awarded $4.5 million by the CDFI Fund in the first round. Subcommittee staff's preliminary review of the files indicated that three other institutions with strong ties to Shorebank received an additional $5.75 million in first round equity and grants. The files indicated that a subsidiary of Shorebank prepared the applications for two of these institutions, and represented them in dealings with the Fund concerning their funding requests. An additional $489,500 in technical assistance was earmarked by the Fund for this subsidiary. Correspondence from the Shorebank subsidiary indicated that Shorebank itself referred to a "Shorebank system" that included two of these three institutions.

[24] 12 CFR Chapter XVIII, Community Development Financial Institutions Fund, Section 1805.502, Federal Register, Vol. 60, No. 202, October 19, 1995, at 54119. Additional amounts are allowed if the awardee intends to use the money to serve an investment area or targeted population outside of its current service areas. This additional sum can total up to $3.75 million in the same period.

D. May 9, 1997 Request for Explanation of Undated Memoranda and Other Irregularities

Based upon the preliminary staff review, Chairman Bachus wrote to Secretary Rubin on May 9, 1997, summarizing his concerns about procedural irregularities in the CDFI Fund's first round of awards, including the presence of the undated evaluation memoranda. Chairman Bachus noted that "it would be a truly serious matter if documents are being prepared and inserted in the file for the purpose of misleading Congressional investigators." Chairman Bachus requested additional information concerning the Fund, including an explanation of the presence of the undated memoranda.[25] The Chairman's letter also requested information concerning whether the letter from President Clinton concerning Enterprise Corporation had been shown to reviewers of the application; documentation produced by an outside consulting firm that had originally been requested on April 14, 1997; and a limited set of documentation regarding analysis of first round winners and procedures that were adopted.[26]

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[25] The request in the May 9, 1997 letter was as follows: "As noted above, Subcommittee staff discovered several undated memoranda in the files. Please indicate (a) when these undated memoranda were prepared; (b) how this can be verified; (c) why the memoranda were undated and who decided that they would be undated; and (d) when it was decided to insert them in the files."

[26] Chairman Bachus requested the following documents: (a) complete, unredacted copies of all documents flagged for copying by Subcommittee staff during its preliminary review of applicant files; (b) complete, unredacted copies of all documents contained in the applicant files of Shorebank; Southern Development; Douglass; Louisville Development; and Enterprise; (c) complete, unredacted copies of all documents contained in the file labeled "Master File;" (d) complete, unredacted copies of all documents prepared by CDFI Fund employees or contractors relating to any application received during the first round of CDFI Fund awards; (e) complete, unredacted copies of all documents reflecting any communication between the CDFI Fund and officials or representatives of any other executive branch agencies, including but not limited to the Department and the White House, relating to any CDFI Fund award recipient that were not contained in an original application; and (f) complete, unredacted copies of all documents, either produced by Treasury Department employees or others, that reflect deliberations, analysis, suggestions or discussion regarding review procedures for CDFI Fund applications. (Pursuant to this request the Treasury Department provided 44,760 pages of documents; its production was not completed until July 31, 1997.)

IV. Inspector General Investigation Requested by Treasury Department in Response to May 9, 1997 Subcommittee Letter

The Treasury Department addressed the undated evaluation memos and the other issues raised by Chairman Bachus in a May 27, 1997, letter signed by Under Secretary Hawke.[27] While defending the CDFI Fund's grant process as fair and its selection of awardees as based on merit, the Treasury Department acknowledged that the agency's "infrastructure and quality control systems needed to be more formally developed and many aspects needed improvement."[28] On the issue of the undated "evaluation memos," the Treasury Department declined to supply answers to any of Chairman Bachus' specific questions regarding the circumstances surrounding the memos' creation, choosing instead to refer the entire matter to the Treasury's Office of Inspector General (OIG) for further review.[29]

A. The Inspector General's Findings

Following a six-week investigation, the OIG reported its findings on July 11, 1997. The OIG's Report of Investigation validated the concerns expressed by Chairman Bachus in his May 9, 1997 letter that the undated evaluation memoranda had been created as part of a calculated scheme to mislead the Subcommittee's investigators. The pertinent findings in the OIG's Report – as summarized in a July 15, 1997 letter to Secretary Rubin signed by Chairman Leach, Chairman Bachus, and five other members of the Banking Committee – were as follows:

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[27] Treasury sought two extensions of time before responding to Chairman Bachus' May 9, 1997, letter. The Subcommittee later learned that intensive internal deliberations were held among Treasury and CDFI Fund officials over how to respond to certain of the questions posed by the Chairman. When it was finally submitted to the Subcommittee, Treasury's response was accompanied by an unusual disclaimer across the top of its first page: "Departmental Responses (based upon information provided by the CDFI Fund) to Questions Submitted by Chairman Bachus in May 9, 1997 letter."

[28] *See* Letter from Treasury Under Secretary for Domestic Finance John D. Hawke, Jr. to Chairman Spencer Bachus, May 27, 1997.

[29] *Ibid.*

- As of the time that the Subcommittee initiated its investigation in March 1997, “evaluation memos” had been prepared by CDFI Fund personnel and outside contractors on all but four of the 32 entities awarded funding in July 1996: Shorebank Corporation; Southern Development; Louisville Development Bancorp; and Douglass Bancorp.

- On April 17, 1997, the General Counsel of the CDFI Fund informed the agency’s Director, Kirsten Moy, that on the following day, Congressional staff would commence a review of files relating to the CDFI Fund’s first round of awards.

- After learning of the impending Congressional visit, Ms. Moy called the CDFI Fund’s Deputy Director, Steve Rohde, from Paris, where she was attending a conference, and instructed him to make every effort to complete “evaluation memos” on the Shorebank, Southern Development, Louisville, and Douglass applications in time to have them inserted in the files prior to the arrival of Congressional investigators the following morning.

- Later that day, at the instance of Director Moy, Mr. Rohde approached the CDFI Fund’s General Counsel and broached the possibility of leaving undated the memos that he had been instructed to prepare. The General Counsel rejected Mr. Rohde’s suggestion, and advised him to place current dates on any documents created pursuant to Director. Moy’s instructions.

- Throughout the evening of April 17 and the early morning hours of April 18, Mr. Rohde remained at the CDFI Fund offices preparing “evaluation memos” on the four applications for which such memos had not been previously prepared. Contrary to the advice of CDFI Fund counsel, he left the memos undated.

- At 7 a.m. on April 18, Mr. Rohde was joined by his secretary, who typed the handwritten notes generated during the course of his all-night drafting session. Shortly before 10 a.m., Mr. Rohde’s file memos were delivered to an agency file clerk, with instructions that they be immediately placed in the files to be reviewed by Congressional staff. Two hours later, Subcommittee investigators arrived at the CDFI Fund to commence that review.

In their letter to Secretary Rubin, the Banking Committee members underscored the troubling implications of the activities outlined in the OIG’s report:

> Reduced to their essence, the OIG's findings suggest that the top management at CDFI Fund agreed between themselves to mislead Congressional investigators, by creating in April 1997 "evaluation memos" purporting to memorialize an April 1996 analysis of four successful applications for funding. There appears to be no plausible explanation for the decision to leave the documents undated other than the desire to foster a false impression that they had been prepared contemporaneous with the grant decisions. Likewise, the decision to leave the documents undated appears to have been designed to conceal the fact that the CDFI Fund's decision a year earlier to award some $11 million in taxpayer funds to Shorebank, Southern Development, Louisville and Douglass had been made in the absence of credible documentation reflecting the kind of deliberative process to which all other applicants for funding were subjected.

Appended to the OIG's Report were memoranda summarizing investigators' interviews with various CDFI Fund and Treasury Department personnel. In their statements to the OIG, Director Moy and Deputy Director Rohde attempted to explain the creation of the facially misleading documentation. For his part, Mr. Rohde justified the insertion of the undated memos in the CDFI Fund's files just prior to the Subcommittee's visit on two grounds: (1) if ever asked about the documents' true provenance, he and other CDFI Fund officials intended to "tell the truth" about the timing of their preparation; and (2) as drafted, the documents indicated that they memorialized an earlier analysis, and therefore could not fairly be read as seeking to create the impression that they were prepared at the time that the relevant applications for funding were under consideration. Chairman Leach and the other signatories to the July 15 letter to Secretary Rubin found neither of these arguments persuasive:

> First, we are confident that the Department of the Treasury does not consider it an acceptable or honorable practice for senior Treasury Department employees in positions of leadership to engage in conduct that has no other purpose than to mislead Congressional investigators, so long as they intend to "tell the truth" if ever caught. It is hard to conclude anything other than that senior CDFI Fund officials view Congressional oversight as a kind of "cat and mouse" game, in which executive branch officials pursue a strategy of concealment and obfuscation, and the truth is only revealed – and public officials held accountable – if Congressional investigators ask precisely the right questions in precisely the right way. At

a minimum, this conduct reflects bad faith on the part of the Department and undermines the Constitutionally-mandated system of Congressional oversight of the executive branch. . . .

Second, the Deputy Director's claim that his undated April 18, 1997 memos are not misleading because they purport at the outset to memorialize his "evaluation and recommendation . . . made in April 1996" is disingenuous. As an initial matter, other memoranda that were presumably prepared contemporaneously with the award decisions also utilize the term "memorialize" regarding earlier analysis; as a result, use of the term by the Deputy Director does not distinguish his undated memoranda from those that were prepared and dated correctly. More significantly, the plain language of the Deputy Director's memoranda creates the impression that they were written during the CDFI Fund's review of the relevant applications, and **prior to the selection of the award recipients in July 1996.** Although the OIG chose not to detail them, the following excerpts from the undated memoranda are illustrative:

- "I recommend that the applicant be given further consideration for funding."

- "[T]he applicant is potentially competitive. The interview team will need to review the application in depth to determine whether or not the application is in actuality competitive, and if it is competitive, how much funding to provide, in what form, and for which initiatives."

- "Since a CDFI investment could be a key in enabling the applicant to become operational, the upside community development impact as a return on a CDFI Fund investment is potentially quite high."

- "If the interview team determines that the application is competitive, it will need to consider the risks and returns associated with investing in each initiative, to determine how most effectively to utilize Fund resources."

The above-quoted passages in which the present-tense is used are affirmatively misleading: they clearly convey that the memoranda were drafted, as were the memoranda produced by other CDFI Fund reviewers, during the period in mid-1996 when the CDFI Fund was deciding which applicants to fund, not, as we now know, almost one year later, long after those decisions had already been made.

B. Treasury Department's Mischaracterization of Inspector General's Findings

Presented with incontrovertible evidence of wrongdoing by the CDFI Fund's two highest ranking officials, the Treasury Department's initial reaction appeared to be an ill-fated effort at political damage control. While assuring the Subcommittee that the OIG's Report of Investigation would "be given the most serious consideration by senior officials of the Treasury Department," the Department also claimed that the OIG's findings actually **vindicated** the process used by the CDFI Fund to award grants during its 1996 round of funding. In a July 14, 1997 letter to Chairman Bachus, Under Secretary Hawke asserted that "the Inspector General found no basis for concluding that the CDFI Fund improperly selected which applicants would receive funds," thereby "confirm[ing] [Mr. Hawke's] strong conviction that the CDFI Fund's decisions with respect to awards were made solely on the merits."

Within hours of being notified of Mr. Hawke's characterizations, the OIG issued a statement categorically rejecting them. In a memorandum to Mr. Hawke,[30] Treasury Inspector General Valerie Lau reminded him that the OIG's inquiry had been limited in scope to "the issues related to the failure to date several specific evaluation memoranda," and had not reached the question of "whether the CDFI Fund properly or improperly selected which applicants would receive funds." Thus, wrote Ms. Lau, the OIG's findings had been "too broadly construed" in Mr. Hawke's letter to Chairman Bachus.

C. Resignations of Director Moy and Deputy Director Rohde

In their July 15, 1997 letter, Committee members asked the Secretary to identify "what administrative or disciplinary actions the Department might contemplate to

[30] *See* Exhibit 4 (memorandum from Treasury Inspector General Valerie Lau to Under Secretary Hawke, July 14, 1997).

demonstrate . . . that it will not tolerate deceptive actions on the part of its senior officials."

On August 6, 1997, Secretary Rubin notified Chairman Leach and Chairman Bachus that he had accepted the resignations of CDFI Fund Director Moy and Deputy Director Rohde.[31] Secretary Rubin acknowledged that the placement of the undated evaluation memos in the CDFI Fund's files just prior to congressional review "was a serious error of judgment and inconsistent with the standards that should govern our relationship with Congress."[32] The Secretary offered his "personal assurance that the Department will make it clear that such actions will not be tolerated."[33] However, the Department chose to permit both Director Moy and Deputy Director Rohde to remain in their positions until completion of the second round of awards in October.

V. Subcommittee Review of First Round Procedures

In the wake of the disclosures that senior Treasury officials had sought to mislead his investigators, Chairman Bachus requested a streamlined Subcommittee staff review of the first round, including the factors utilized in selecting applicants for CDFI Fund awards; the CDFI Fund's safeguards against abuse during the first round; and the explanation for the Fund's failure to adopt an objective scoring system to evaluate applications. The BEA program was not reviewed since it was not required to engage in a competitive process in the first round.

As part of this review, Subcommittee staff reviewed documents produced by the Treasury Department and by Ernst & Young, the accounting and consulting firm hired to institute total quality management ("TQM") techniques at the Fund. In addition,

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[31] *See* Letter from Treasury Secretary Robert E. Rubin to Chairman James A. Leach, August 6, 1997; Letter from Treasury Secretary Robert E. Rubin to Chairman Spencer Bachus, August 6, 1997.

[32] *Ibid.*

[33] *Ibid.*

Subcommittee staff interviewed Ron Lobel of Ernst & Young; Bruce Morgan, Fred Cooper, Jeannine Jacokes, Steve Rohde, and Maurice Jones of the CDFI Fund; Don Bard, an outside contractor retained to assist in the grant process; Carolyn Smith of Treasury's Procurement Office; and Michael Barr of the Treasury Department.[34] Former Director Kirsten Moy declined to be interviewed in person, although she did answer a set of written questions propounded to her through her attorney.[35]

A. The Treasury Department Rejected Accepted Federal Grant Procedures

At several junctures, the Department had the opportunity to adopt structured, standardized procedures for the first round of awards. However, it was not until the summer of 1997, after Congressional scrutiny began to be applied to the CDFI Fund, that the Department accepted standardized procedures. As a result, over $37 million in taxpayer dollars was handed out in 1996 with inadequate documentation and under procedures that raise questions about fairness and protection against abuse.

1. "Unorthodox" procedures were used in first round

The CDFI Fund utilized what Deputy Director Rohde characterized as a "venture capital" model drawn from the private sector in making its first round of awards. Mr. Rohde acknowledged that this was an "unorthodox process" from the standpoint of

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[34] The interviews were not transcribed nor were they under oath. All witnesses were given an opportunity to review their statements for accuracy. The Subcommittee minority, which received copies of all correspondence and documents produced by the Department in response to Subcommittee document requests, was notified and invited to participate in all scheduled interviews.

[35] *See* March 25, 1998 letter from John Nields, Esq. (attorney for former Director Moy) to Chairman Spencer Bachus. Mr. Nields indicated that Director Moy would possibly be amenable to a phone interview; Chairman Bachus determined that this was not an acceptable substitute for an in-person session.

federal grant programs. Mr. Rohde viewed the CDFI Fund as similar to a venture capital firm, in that the Fund sought to make long-term investments in specific financial institutions. This venture capital model required "complex judgments" and the exercise of "third party due diligence" techniques that in turn required the Fund to retain the "best people" in the industry who had prior familiarity with industry participants. These experts were expected to obtain information outside of that contained in the written applications -- from applicants, unrelated third parties, or the reviewer's own experience with industry participants -- in order to make informed judgments concerning particular applicants.[36]

Mr. Rohde believes that outside consultants were used efficiently in the first round. He noted in interviews with Subcommittee staff that the venture capital model requires partners in a firm to reach "consensus." Accordingly, the Fund sought to have the five person final review team reach a consensus based upon their personal expertise. From Mr. Rohde's perspective, it was impossible to "score" applications because of the complexity of the factors involved in the review process for CDFIs -- the track record, the business plan and, most importantly, the management team.[37]

Neither Director Moy nor Deputy Director Rohde had any formal experience running a federal grant program. Furthermore, Mr. Rohde conceded that he was aware of

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[36] As noted previously, this unstructured methodology raises questions as to whether particular applicants were permitted to revise or otherwise supplement their applications after the January 1996 deadline. For instance, the President of Douglass Bank sent a letter to the Deputy Director on April 22, 1996, that included a 1996 budget memo from the Board of Directors; monthly board meeting summaries; March and April (actual and estimated) loan closure rates; and resumes of employees who had begun employment with the bank after the application deadline. The material was relevant to the issue of financial standing and strength of management team (the CDFI Fund considered strength of management to be one of the highest priority elements of the review process). (Letter from Ronald Wiley to Steve Rohde with attachments, April 22, 1996.) Handwritten notes also indicate that Fund officials discussed a "revised" business plan submitted by Louisville Development during consideration of its application.

[37] It was Mr. Rohde's view that in any event scoring systems are often "rigged" to reach the pre-determined results a particular agency prefers. Mr. Rohde provided the reviewers in the first round a document that summarized key factors to be considered in evaluating the applications. *See* Exhibit 5.

no other federal agency that utilized this "due diligence" and "consensus" approach in exercising grant-making authority.[38]

2. The Treasury Department rejected the recommendations of Treasury staff and an interagency task force

In implementing the "venture capital" approach at the CDFI Fund, the Director and the Deputy Director chose to ignore the regulatory framework developed for the program during 1995 by Treasury Department staff working in conjunction with an interagency task force.

Shortly after creation of the CDFI Fund in late 1994, Treasury Department staff began developing proposed regulations and procedures for the new program. Ms. Jeannine Jacokes[39] was a principal drafter of the proposed regulations and notices. Ms. Jacokes indicated that during 1995, a "transition team" held a series of meetings to discuss possible approaches to rules and regulations. An interagency task force, made up of representatives from various agencies, including the Department of Agriculture, the Department of Housing and Urban Development ("HUD"), the Small Business Administration ("SBA"), the Office of Management and Budget ("OMB"), and banking regulatory agencies, also provided input. The Treasury Department General Counsel's office provided support and reviewed the proposed regulations. During this period, Ms.

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[38] Based upon informal inquiries, Subcommittee staff determined that this approach is contrary to procedures used at the Department of Education, the Department of Transportation, the National Endowment for the Arts, and the Department of Housing and Urban Development. Subcommittee staff has not come across any other federal agency utilizing a "venture capital" model in awarding federal funds. Mr. Rohde argued that the process adopted by the Fund was similar in some respects to certain state-level programs with which he had been involved.

[39] Ms. Jacokes indicated she played a significant role in drafting the CDFI Fund legislation while employed at the Senate Banking Committee in 1994. In late 1994, she came to the Treasury Department and participated in drafting the interim regulations for the CDFI Fund and helped set up the application process for both the CDFI and BEA programs. She administered the BEA side of the CDFI Fund and participated in eligibility and certification determinations on CDFI program applicants during the first round.

Jacokes indicated that she reported to Ms. Fe Morales Marks, Deputy Assistant Secretary for Financial Institutions Policy at the Treasury Department.

As a result of this collaborative effort, draft interim regulations were prepared. These interim regulations outlined a three-tiered review procedure. The proposed third tier utilized a scoring system: applicants who passed the first two tiers were awarded up to 100 points based on three criteria -- organizational and financial capacity, external resources, and community impact. Five bonus points could be awarded to applicants that facilitated geographic diversity in serving underrepresented groups, and additional points could be awarded to applicants with all matching funds firmly committed at the time of application. The draft interim regulations also sought to inject greater objectivity in other aspects of the program by incorporating a "financial institutions" test to determine whether an applicant's primary operating activity would be to provide development investments and loans, and a "primary mission" and "target market" test to demonstrate how the financial institution's activities would be dedicated to community development in targeted markets.

These draft guidelines and regulations were presented to Under Secretary Hawke in late summer 1995. In interviews with Subcommittee staff, Ms. Jacokes conceded that if the proposals were prepared for Under Secretary Hawke, it is reasonable to assume that they reflected the "best thinking" of the Treasury transition team and the interagency task force that developed the proposed interim regulations.

A September 5, 1995, memorandum prepared by Ms. Jacokes references an August 25, 1995 meeting attended by soon-to-be Director Moy and Under Secretary Hawke at which the Department decided to reject a structured approach to disbursing taxpayer funds in favor of "maximiz[ing] the Fund's flexibility and discretion . . .." Although Ms. Jacokes did not participate in the meeting, at Ms. Moy's request, she

prepared a memorandum to Under Secretary Hawke noting that the interim regulations had been "changed to reflect [Under Secretary Hawke's] comments."[40]

Under a heading titled "Maximizing Flexibility," the memo states, "In response to your desire to maximize the Fund's flexibility and discretion, the following modifications have been made [in waiver authority, eligibility requirements, and rating and selection]." Ms. Jacokes stated that the proposed regulations were redrafted to reflect these changes. As a result, the CDFI Fund's regulations did not mandate that Fund officials utilize a scoring system or other objective standards typically adhered to in federal grant-making programs.

3. The Treasury Department also rejected recommendations of its own Inspector General

On February 20, 1996, the Treasury Office of Inspector General submitted to the CDFI Fund its recommendations concerning awards application procedures. Among its recommendations were the following:

> A numeric scoring system has certain advantages when processing a large number of applications with similar characteristics. This type of system involves scoring/ranking each proposal reviewed and can ensure that adequate documentation exists to successfully defend funding decisions. Each clearly defined criteria category is assigned a relative point value based on predetermined weights.
>
> Significant disparities between panelists' scores for particular applicants are discussed among the panelists. If a disparity cannot be resolved through discussion within a reasonable amount of time,

[40] *See* Exhibit 6 (memorandum to Undersecretary John D. Hawke from Jeannine Jacokes, September 5, 1995). Ms. Jacokes indicated that she did not have any direct communication with Mr. Hawke but was told that these views reflected the decisions made in the meeting. Director Moy presumably considered the memo an accurate reflection of the preferences expressed by Undersecretary Hawke in the meeting as she apparently participated in editing drafts of the memorandum. (Draft memo transmitted from Kirsten Moy to Fe Morales Marks, August 20, 1995).

> an equitable decision will be made by the panel chairperson after consulting with each panelist.[41]

The CDFI Fund did not adopt this recommendation.

B. Documentation Fails to Reflect Accurately the Factors Used in Selecting Applicants

As noted, the preliminary Subcommittee staff review of CDFI Fund files revealed that no accurate record of the decision making process existed for the first round. This lack of documentation was exacerbated by the Fund's failure to utilize an objective scoring system or other systematic approach to selecting award recipients. This raises questions as to whether the award process was vulnerable to politicization and abuse. Mr. Rohde rejected any suggestion that "politics" played a role in the CDFI Fund's first round of awards. However, the Subcommittee review establishes that many factors that were critical to the first round selection process were never documented, making it impossible to verify Mr. Rohde's assurances.

Mr. Rohde acknowledged that the documentation for the first round was inadequate. He attributed this in part to the time pressures placed upon the CDFI Fund by the White House, the Treasury Department, and members of the industry. Mr. Rohde pointed out that some documentation existed, including the (1) first stage evaluation memoranda; (2) draft memoranda prepared by his assistant, Valerie Piper, summarizing conclusions of the final review panel; (3) notes of discussions held by the second stage review panel; and (4) a memorandum Mr. Rohde began to prepare after the first round was completed that he never finished. The inadequacies of these documents are discussed below.

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[41] "Community Development Financial Institutions Fund Award Applications Procedure, OIG-96-006," Evaluations Staff, Office of Inspector General, U.S. Department of the Treasury, February 1996, at 6-7. In the event a scoring system was rejected, an alternative was to produce "narrative justifications" that "should be well documented to establish a trail of consistent and logical conclusions by the

1. The first stage evaluation memoranda do not reflect the actual process used in selecting candidates for second stage review

The first stage of the review process entailed reviewers analyzing particular applications and drafting evaluation review memos that recommended either that the application be carried forward for further review by the final review panel or rejected. With the exception of the memoranda prepared by the Deputy Director on the eve of the Subcommittee staff's first visit to the CDFI Fund, it appears that drafts of all evaluation memoranda were provided to the second stage review panel prior to interviews of the finalists. These memoranda were not "finalized," however, until May or June 1996. This prompted the Fund's counsel to recommend that the memoranda indicate that they were "memorializations" of the earlier drafts provided to the second stage panel.[42]

As a general matter, these memoranda only purport to indicate whether a particular application met a certain threshold and do not reflect the decisions made by the second stage review panel in selecting the winning applications. Mr. Rohde acknowledged that the "crucial" decisions occurred at the second stage.

In response to negative publicity generated by the Inspector General's July 1997 report,[43] the Treasury Department reportedly argued that the evaluation memos placed in

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reviewers." As discussed below, the Fund never produced a true narrative of the first round selection process.

[42] Each of the cover memoranda provided by individual reviewers when submitting the final versions of their respective evaluation memoranda contains a reference to the fact that the memoranda were a "memorialization" of earlier versions. As discussed previously, the inclusion of this term in Mr. Rohde's undated memos on the Shorebank-related applicants does not serve to distinguish his work product from that prepared contemporaneously with the review process.

[43] Glenn Simpson, "Treasury Aides Trumped Up Papers To Defend Awards as Probe Drew Near," *The Wall Street Journal*, July 16, 1997 at A4; Ann Marriott, "Funding for loan program in jeopardy," *The Washington Times*, July 16, 1997, at B7; William Gruber & Nancy Millman, "Firings Urged in Treasury Program; Fund Execs 'Warped Rules,' Critics Say," *The Chicago Tribune*, July 18, 1997, at 1; Paula Dwyer, "Banking on Clinton Connections? There's suspicion that's just what some community banks did," *Business Week*, July 28, 1997, at 35.

the agency's files just prior to congressional inspection "were far less crucial to the award process than the Banking Committee would have them seem."[44] However, due to the failure of the Fund to complete any other formal documentation, these preliminary memoranda appear to have become by default the crucial documentation for the first round. As reported by the OIG, the Fund's counsel, Maurice Jones, maintained that awards could not be made to individual grantees until evaluation memos on those entities had been completed. In interviews with Subcommittee staff, Mr. Jones described this as general advice that no awards should be disbursed unless all relevant documentation was completed. In point of fact, however, it appears that the evaluation memos were the **only** documents specifically identified as being essential before funds could actually be disbursed.[45]

Regardless of their significance, questions exist as to whether the evaluation memos reliably describe the factors that contributed to decisions made in the first stage.

a. Evaluation Memoranda do not reveal crucial role of the Deputy Director

As an initial matter, the first stage evaluation memoranda do not reflect discussions that occurred between Mr. Rohde and the individual reviewers, nor the fact that the conclusions stated in the evaluation memoranda concerning applicants were the product of a consensus that emerged from extensive deliberations between Mr. Rohde and the

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[44] Nancy Millman, "Cronyism Charges Unfair, Development Banker Says," *The Chicago Tribune*, July 27, 1997, at 1. The Subcommittee became aware of Treasury's contention regarding the purported insignificance of the "evaluation memos" by reading press accounts quoting unnamed Department sources. The claim was never articulated in any of the Department's lengthy written submissions to the Subcommittee defending the integrity of the CDFI Fund's selection process.

[45] Furthermore, it is at the very least counterintuitive that the CDFI Fund's two highest-ranking officials would have taken the extraordinary actions described by the OIG to complete the memoranda on the four Shorebank-related entities if, as the Treasury Department later claimed, the documents that were the subject of their efforts were of relatively little importance. Put another way, if the merits of the CDFI Fund's decisions to fund certain applications could be defended in the absence of the evaluation memos, then one must ask why Mr. Rohde's all-night drafting session was viewed as necessary in the first place.

individual reviewers. Mr. Rohde indicated he was "responsible" for the "first stage" and made periodic status reports to Ms. Moy; Mr. Rohde saw his role as to supervise the specialized reviewers and promote internal consistencies. Mr. Rohde stated that he worked very closely with individual reviewers in analyzing each of the particular applicants; he held detailed discussions with reviewers and made suggestions regarding applicants. Due to his extensive industry contacts, Mr. Rohde often suggested consultations with outside parties. Mr. Rohde contended in Subcommittee interviews that he sought to ensure that individual reviewers conducted a thorough review and "pushed" them to make sure they had done the work.

Mr. Rohde conceded that in regard to some applicants, his participation "changed the direction" of reviewers, on some occasions as a result of information Mr. Rohde obtained from third parties or his sources in the industry. However, he felt that he reached a "consensus" with each reviewer regarding particular applicants, and wanted each individual reviewer to "take ownership" of their reviews. He wanted all the reviewers to get "on the same wavelength" and develop clear justifications for why applicants were rejected. The first stage evaluation memoranda do not reflect Mr. Rohde's apparently extensive role in guiding the individual reviewers.

b. Memoranda describe applicant strengths and weaknesses in a slanted fashion

The format and content of the evaluation memoranda do not allow for meaningful comparisons between competing applications. Ms. Jacokes stated that early in the first round selection process, she attended a briefing for the evaluation reviewers conducted by Mr. Rohde. Ms. Jacokes recalls Mr. Rohde instructing reviewers that in drafting the evaluation memoranda, they should stress "positive" information in applications being recommended for further consideration and "negative" information for those not being passed forward. This practice raises questions as to whether the memoranda provide a balanced picture of strengths and weaknesses, or were instead tailored to justify pre-

ordained outcomes. Ms. Jacokes stated that one reviewer told her that he wanted to do "debriefings" (in which reviewers explained to unsuccessful applicants the reasons they were rejected) only on those applications that he had reviewed and for which he had prepared evaluation memos; he was concerned that if someone else not familiar with the applications did the debriefings, the evaluation memoranda would present an unduly negative picture of the respective applicants.

Mr. Rohde confirmed the accuracy of Ms. Jacokes' account, but insisted that his intent was simply to encourage reviewers to make clear in their respective evaluation memoranda why a particular recommendation was made. He noted that it was difficult when reading some draft evaluation memos to determine the reviewer's basis for a recommendation. He stressed, however, that he never said "only write positive or negative." He noted that several of the evaluation memoranda on applicants that reached the second round did identify potential weaknesses. As an example, Mr. Rohde stated that the application for Enterprise Corporation was characterized as "risky" by the first stage reviewer; this was to signal to the review panel that the application should be scrutinized particularly closely.

c. Memoranda do not reveal extent of reviewer reliance upon supplemental information provided by applicant and information obtained from third parties

Consistent with the so-called "due diligence" approach adopted by the CDFI Fund, Deputy Director Rohde encouraged reviewers to rely upon information obtained from sources other than the application itself, including supplemental information requested from or supplied by the applicants, and information obtained via "third party due diligence" -- the process of gathering information on particular applicants from other industry participants.[46]

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[46] Consistent with this approach, Mr. Rohde selected reviewers in part based upon their independent knowledge of particular applicants. For instance, Mr. Rohde acknowledged that he possessed

The evaluation memoranda do not indicate whether in specific instances, reviewers relied upon their independent knowledge or conducted follow-up with third parties prior to drafting recommendations. For example, Mr. Rohde noted that as to one applicant he considered "borderline," he contacted an industry acquaintance who was familiar with the applicant. As a result of this inquiry, the Fund became aware of allegations of sexual harassment against one of the applicant's principals. The Fund made an independent determination that these allegations were credible and that there was potential management instability at the institution. (Mr. Rohde clarified that this was one of a number of factors that contributed to the decision not to fund the applicant). Upon the advice of counsel, neither the nature of this information nor its source was detailed in the evaluation memoranda or apparently in any other formal CDFI program documentation.

d. The undated after-the-fact memoranda prepared by the Deputy Director are unreliable

As discussed previously, Mr. Rohde prepared evaluation memoranda for Southern Development, Shorebank, and two other applications prepared by Shorebank Advisory Services some nine months after the fact. As a result, their accuracy is open to serious challenge.

i. The Deputy Director's memoranda do not reflect full discussion concerning applicants

Mr. Rohde maintained in an interview with the OIG that he had in fact conducted a thorough review of Shorebank and the three other Shorebank-related applications prior to

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"extensive knowledge" about Shorebank based upon his previous experience in development lending. (In fact, Mr. Rohde stated that Shorebank was "worried" about him being at the Fund because in his previous experience with the company as director of a Michigan community development lending program, Mr. Rohde had "put them through hell." Shorebank's concern appears to have been unwarranted, since the Shorebank "system" received almost $11 million in the first round.)

awards being made, but simply had not had time to draft the evaluation memoranda. In place of preparing a memorandum, he stated that he made an oral presentation to other review team members -- an "oral memorandum" as he characterized it -- that provided the same information as would have been contained in written memoranda had he prepared them.[47] The Inspector General's investigation concluded that contemporaneous notes (prepared by Mr. Rohde, his assistant Ms. Piper, and others) exist that were prepared during the review process, and that the oral presentation made by the Deputy Director was consistent with the memoranda he later wrote. However, the Inspector General's office also noted that the Deputy Director's handwritten jottings were "almost illegible, and comparison of notes to memoranda was very difficult. The other set of notes were easier to decipher but still sketchy."

The notes are in fact sketchy and illegible. Assuming the notes represent a contemporaneous record, they suggest that Mr. Rohde chose to include certain matters in his evaluation memoranda that the notes do not confirm were presented to the second stage review panel. For instance, the after-the-fact evaluation memorandum on Louisville Development's application places particular emphasis on the quality of its management team and business plan, while acknowledging as "negatives" the applicant's status as a start-up with no record of community development. However, the notes taken by Valerie Piper during Rohde's "oral memorandum" do not reflect that such an extensive discussion occurred.[48] The Piper notes regarding Louisville Development begin with the statement "probably one of our best startups" and then merely lists some questions related to the

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[47] Mr. Rohde stated that he made the "oral memoranda" before the interviews were scheduled for the respective Shorebank-related applicants in May 1996. The Inspector General's report notes that the five-member review team typically reviewed the evaluation memorandum prepared for a finalist before the interview. It seems likely that failing to have memoranda summarizing the applications impacted the ability of the review team to understand fully the applications of the Shorebank-related entities, forcing them as a result to rely more heavily upon the Deputy Director's judgment.

[48] *See* handwritten notes of "oral memoranda" written by Valerie Piper, OIG Report of Investigation exhibit 28g.

status of the management team: 1) "how good are Kim and Kelly;" 2) "What are their team dynamics;" 3) "K and K now revising BP - What's the status now?"[49]

Similarly, the Piper notes on the Douglass[50] application do not reflect the detailed information contained in the section of the Douglass undated memo prepared by Mr. Rohde entitled "Track Record, Financial Strength and Current Operations." While Ms. Piper notes cryptically (23 total lines of notes), "Past stage of going under," and "Still have a capital raise issue," there is no mention of a previous Cease and Desist order against Douglass, when it was lifted, and the general financial status of the bank, as was detailed in the undated memo.

As a result, the memoranda do not appear to track the information shared by Mr. Rohde with the review team, at least as reflected in the contemporaneous notes, to prepare them for the interviews of the Shorebank-related applicants.

ii. CDFI Fund senior management was concerned about "political" impact of discovery that memos had never been prepared on Shorebank and related entities

Director Moy told the Inspector General that in asking the Deputy Director to prepare the undated evaluation memos just prior to the visit by Subcommittee staff, it was not her intent to mislead Congress. Director Moy said that she thought the notes should be there "because it was important for Congress to know how CDFI made the award decision."

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[49] As a general matter, it appears that the information contained in the undated memos more closely tracks the discussion that occurred at the time of the applicant interview, rather than the information presented by Mr. Rohde to prepare the review team for the interview.

[50] *See* handwritten notes of "oral memoranda" written by Valerie Piper, OIG Report of Investigation exhibit 29b.

Interview notes from the Inspector General's inquiry and Subcommittee interviews with Mr. Rohde indicate, however, that Director Moy was particularly sensitive to the political dimension of the CDFI Fund's operations, and these concerns may have informed her suggestion that Mr. Rohde leave the memoranda undated. Ms. Moy's concerns certainly included the potential impact upon the program if the Subcommittee discovered that no evaluation memos on the Shorebank-related entities had been prepared contemporaneously with the award selection in July 1996.[51]

It appears that Director Moy may have been concerned about possible political fall-out for the Clinton Administration arising out of the President and Mrs. Clinton's ties to the Shorebank grantees. Interview notes from the Inspector General's report indicate that Mr. Rohde made a statement to an OIG investigator to the following effect:

> She (Moy) directed me to write the memo, spec[ulated] that insider feeding stuff to Bachus, she was concerned that Clinton could be embarrassed.[52]

In interviews with Subcommittee staff, Mr. Rohde stated: "As we sit here today, I don't have a memory of saying [to the Office of Inspector General] Clinton would be embarrassed. It is possible I would have said that but I don't think I would put it that way. She [Ms. Moy] was afraid there would be a political attack and we would be embarrassed." Mr. Rohde said that his conversation with Ms. Moy lasted about 20 to 30

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[51] Other circumstances also raise questions as to whether preparation of the memoranda was motivated solely by a desire to inform Congress as opposed to concern that the awards to applicants with White House ties would be questioned if there was no documentation. In addition to reviewing the four Shorebank-related entities that received awards, Mr. Rohde had also reviewed the application of a fifth applicant with no known ties to Shorebank -- Albina -- but never bothered to prepare a memorandum on it. Furthermore, an interview memorandum prepared by Ernst & Young personnel, indicates that Mr. Rohde inquired as to whether he should back-date the Shorebank-related memoranda as early as December 1996.

[52] *See* Exhibit 7 (excerpt of the Inspector General's interview with Deputy Director Steve Rohde, June 23, 1997).

minutes, but included other business. Mr. Rohde described Ms. Moy as not "a particularly political person."

Mr. Rohde stated that he did not view leaving the memos undated as an intentionally deceptive practice; he indicated that he was aware of the seriousness of misleading Congress. "My name was on the memo and I take responsibility. It was bad judgment. In my mind at 8 a.m. on April 18th after being up all night, I believed there was no intent to mislead Congress and Counsel said, 'Let's go with that,' which I took to be concurrence.[53] But I realize that it was bad judgment."

2. No adequate record of second stage decision-making exists

After 59 applicants were selected for "further consideration," a five person review panel chose the 31 award winners. According to the Deputy Director, the crucial decision-making occurred at this second stage, which involved review of the evaluation memoranda; interviews of the finalists (primarily during May 1996); and discussion of particular strengths and weaknesses. The panel then met on June 17-18th and tentatively selected a group of winners. The panel met again on July 11th and formally selected the 30 institutions that would receive $37.2 million in grants (an additional institution was added later when it was realized that the undersubscription of the BEA program had freed up additional funds).

No formal transcripts or minutes exist to reflect the deliberations that led to the selection of winners. Contained within the more than 40,000 pages of documents produced by Treasury were many pages of notes taken at various meetings by various individuals. As a general matter, these notes are highly cryptic, more often than not illegible, and virtually impossible to decipher. As such, they provide no reliable basis for

[53] Mr. Rohde contends that Maurice Jones, the CDFI Fund counsel, had vaguely concurred with his decision to leave the memoranda undated. Mr. Jones denies this.

determining the critical factors that went into the decision making of the final review panel.

Two sets of documents do summarize in a general fashion the second stage deliberations. First, in July 1996, Valerie Piper purportedly prepared two draft memoranda – one detailing the 31 winners and one detailing the applicants considered but rejected during second stage discussions held by the review panel in June 1996. Mr. Rohde stated that he intended to review, revise and finalize these documents but never did so. In fact, Mr. Jones, the Fund's counsel, stated that he does not recall seeing the documents prior to the Subcommittee staff's review of them, and believes a copy of each of the Piper memos was inserted in the applicant files in anticipation of the Subcommittee staff's first visit to the CDFI Fund on April 18, 1997. Moreover, these memoranda do not provide an accurate picture of the second stage deliberations. In addition to the Piper memoranda, Mr. Rohde began drafting a memorandum to describe in greater detail the factors that went into the Fund's decision-making shortly before the completion of the first round but never finalized it.

a. The Piper memoranda do not reflect a comparative selection process

As a general matter, Ms. Piper's memoranda simply list strengths and weaknesses of particular applicants in bullet form, but do not reflect the comparative analysis that presumably occurred when the second stage panel selected the winning applications in mid-June. Furthermore, Ms. Piper's memoranda do not appear to reflect the discussions held in mid-May 1996 in conjunction with interviews of prospective award recipients. However, Mr. Rohde stated that many issues were resolved and some tentative decisions were made during the interviews conducted in May.

Subcommittee staff noted several examples in which critical decision making was not described in the Piper memos. For instance, the first stage reviewer for Enterprise Corporation noted in the evaluation memo that "due to the tremendous challenge being

undertaken, this is the most aggressive and risky application" of the ones being recommended for further consideration by the reviewer.[54] Mr. Rohde stated that the second stage review panel discussed the concerns identified in the evaluation memo but felt positively about the applicant after their interview in May. Mr. Rohde stated that he personally harbored concerns about the Enterprise Corporation application based upon his previous experience in the industry, but that his concerns were allayed when the Fund received a very good reference from a third party. In interviews with Subcommittee staff, Mr. Rohde stated that the decision by the second-stage review panel concerning whether to fund Enterprise Corporation "came down to feeling very good about the management team." Ms. Piper's memorandum does not reflect the extent of this discussion -- the impact of the interview, the role of the third-party reference, or how the second stage panel resolved, if in fact it did, the specific concerns identified in the evaluation memorandum.

In another example, Southern Development of Arkadelphia, Arkansas, previously had operated Southern Ventures, a Small Business Investment Corporation chartered by the Small Business Administration. Southern Development lost the SBA charter, however, due to mismanagement and other operational irregularities.[55] The Piper memo only notes in cryptic fashion: "track record mixed among the affiliates, in challenging operating environment." Mr. Rohde stated that the Southern Ventures debacle was discussed, but the review panel decided to fund Southern Development because it felt that the bank had "learned" from the experience. Mr. Rohde stated that the Southern Ventures issue was probably discussed and resolved during the May interview, rather than during the final review panel discussions held in June.

Likewise, the second stage panel apparently considered certain ethnic "diversity" factors in making grants that were never documented in the CDFI program files. Mr.

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[54] The memo also notes: "Although a virtual start-up, the applicant is off to an excellent start."

[55] Glenn R. Simpson, "U.S. Loans to Firms With Clinton Ties Are Questioned," *The Wall Street Journal*, May 15, 1997, at A24.

Rohde reportedly stated in interviews conducted by Ernst & Young personnel that diversity of institution type as well as ethnic diversity of target populations played a role in the selection process. In interviews with Subcommittee staff, Mr. Rohde stated that it was "conceivable this [ethnic diversity] would have had an impact" in the evaluations of certain institutions, although neither the CDFI organic statute nor its regulations authorized consideration of these factors. The Piper memoranda do not reveal the relative weight accorded these diversity factors, or why certain institutions received this preference while others serving traditional minority groups did not.

b. Mr. Rohde began drafting a memorandum that provided a partial picture of the review process but it was never completed

While reviewing documents produced by the Treasury Department, Subcommittee staff discovered a draft memorandum produced from Mr. Rohde's office that provides somewhat greater detail concerning the comparative analysis conducted by the review panel and comes closest to providing a true "narrative" of the decision-making process. The document was prepared after-the-fact, discusses <u>only</u> those applicants that were rejected, and was never finalized. Furthermore, it was not widely circulated within the CDFI Fund; the Fund's counsel stated that he had not seen the document prior to it being shown to him by Subcommittee staff in January 1998.

C. It is Difficult to Find Consistency in the Evaluation Process

Mr. Rohde supervised the first stage evaluation to ensure consistency. Mr. Rohde stated that he believed that a consistent set of standards was applied to all applicants. Furthermore, the second stage relied upon the "consensus" of the five member review team, which in Mr. Rohde's view, guaranteed consistency. Due to the failure of the Fund to utilize an objective system of scoring applications, it would be difficult as a general

matter to ascertain whether a consistent evaluation of applications was conducted by the Fund. Due to the absence of reliable documentation, this undertaking is practically impossible.

In early 1997, the CDFI Fund retained Don Bard, an outside consultant, to provide advice concerning a grants management system and procedures to be followed in the second round in 1997. In interviews with Subcommittee staff, Mr. Bard stated that he has more than 25 years of experience in the area of federal grant programs at the Department of Transportation and the National Endowment for the Arts. Mr. Bard conducted a review of the first round evaluation memoranda and found there was little consistency in format; that the memoranda did not track the statutory factors or the factors stressed in the applications themselves; and that there was no evidence that the second stage review team had resolved concerns noted by the first stage reviewers.[56]

1. The CDFI Fund addressed start-up organizations on an ad hoc basis

The CDFI Fund did not resolve how much of its mission should be dedicated to encouraging the creation of start-up institutions. This ambiguity had programmatic effects during the first round that led to the CDFI Fund addressing start-ups on an ad hoc basis, thus further increasing the discretionary nature of the first round decision making.

Mr. Rohde stated that an applicant's ability to demonstrate a strong management track record was a critical factor in the CDFI Fund's selection process. However, the CDFI Fund chose to fund certain start-up organizations which by definition did not have a track record at the time they were awarded funding. Mr. Rohde stated that in evaluating start-ups with no track record, the CDFI Fund put more emphasis on management and the business plan. Mr. Rohde did not provide greater detail other than to state that the review

[56] *See* Exhibit 8 (memorandum by consultant Don Bard regarding evaluation process).

team had to determine whether it was “comfortable” with the management teams of particular start-ups. Such descriptions provide little substantive explanation of why certain start-ups were selected over others or how some start-ups could compete successfully against established institutions while others could not.

2. Certain applicants with poor management track records were selected for funding

Mr. Rohde stated that management ability was probably the most important factor in selecting applicants, and it appears that many applicants were rejected on the grounds that their management teams were considered weak. For example, one applicant was rejected in part because the review panel “identified a CEO who is a good banker but who did not present a compelling community development focus,” and “[d]emonstrated capacity to run an operating organization but not necessarily a start-up.” In another instance, Ms. Piper wrote: “Applicant has a bright, charismatic Executive Director upon whom the success of the business plan almost wholly depends.” Fund documents do not explain why these applicants were rejected while others with demonstrably poor management records – Southern Development for example – received awards.

3. Some applicants with poor financial standing were selected while others were rejected on this basis

Mr. Rohde indicated that certain applicants were rejected due to poor financial results. However, this factor does not seem to have disqualified other applicants from receiving funding.

For instance, Mr. Rohde stated that the review panel had significant concerns about one applicant, Finca International, Inc. (“Finca”), because of “financial difficulties” experienced by the institution and lack of financial and management information systems. In its application, Finca proposed to create a separate non-profit CDFI in the U.S. that

would receive the CDFI Fund award and be controlled by the international parent. Mr. Rohde noted that Finca had experienced financial problems but its recent U.S. operations (termed "essentially a start-up" by the first stage reviewer) were considered by the Fund to be more successful. Rather than rejecting the application due to Finca's questionable track record, the CDFI Fund chose to award it a $450,000 grant, subject to a requirement that it establish a separate corporate structure for the entity that would receive funding and impose other safeguards to shield it from the parent. The Deputy Director distinguished this decision from an instance where an applicant was rejected because of the "recent poor financial track record of its parent and sponsoring organization" on the ground that the financial strength of the parent in that instance was more "crucial" than in the Finca circumstance.

4. Consistency of due diligence: the CDFI Fund was not aware that Southern Development planned to change its CEO

The hallmark of the "venture capital" approach was thorough due diligence of applicants, with particular emphasis on management capability. For instance, uncertainty created by the impending departure of its Chief Executive Officer led to one applicant being initially rejected.[57]

Questions arise, however, as to whether this due diligence approach was consistently applied. Southern Development was awarded CDFI funding on July 31, 1996, and within weeks announced a change in its CEO. Documents in the CDFI Fund files, reportedly obtained by the Fund after the announcement of the award, indicate that Southern Development had contemplated a management change for some time. Mr. Rohde contends, however, that this was not known by the CDFI Fund at the time of its award to Southern Development.

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[57] Neighborhoods, Inc., a CDFI finalist, was originally rejected because it lacked a CEO. After a new CEO was selected, Neighborhoods, Inc.'s application was reconsidered and approved for funding.

Mr. Rohde stated that he was "not pleased" when he learned about the change in management at Southern Development, but it was his understanding that the September 1996 decision happened faster than Southern Development had anticipated. Mr. Rohde stated that it was well known in industry circles that George Surgeon, CEO of Southern Development at the time of the application, wished to return to Shorebank. Mr. Rohde was told that the agreement to hire William Brandon as Surgeon's replacement was negotiated after the CDFI award decision was announced (after July but presumably before October 1996, when Mr. Brandon was announced as the new CEO). When asked whether it was reasonable to assume that Southern Development was not contemplating a change of CEO during the pendency of its application for CDFI funding (as indicated by Fund documents), Mr. Rohde acknowledged that Southern Development was "not as up front" as he would have "ideally liked."

Mr. Rohde stated that the CDFI Fund was "prepared" to walk away from its commitment to fund Southern Development because George Surgeon's departure could have been considered a "material change" in circumstances. In retrospect, however, Mr. Rohde decided that the management change was positive. Mr. Rohde stated that the "implication" of the Southern Development business plan was to expand its operations in eastern Arkansas, possibly through acquisition of a suitable bank. Mr. Brandon, the President and CEO of First Delta Corporation in Phillips County, Arkansas, was made CEO as part of Southern Development's decision to acquire his bank.[58] Mr. Rohde noted that Mr. Brandon was former President of the American Bankers Association and an experienced Arkansas banker, and, as a result, Mr. Rohde viewed this as a "fortuitous" development for Southern Development. As to concerns that CDFI Fund monies were being used simply to fund a profitable acquisition -- a purpose arguably outside the scope of the Fund's statutory mission -- Mr. Rohde acknowledged that Mr. Brandon was a stockholder in First Delta Corp., but noted that "Brandon thinks it may have been a bad

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[58] Recent press reports indicate that Southern Development expects to close the First Delta acquisition in July 1998. *See* Don Chaney, "Bank Set to Buy First Delta," *Arkansas Democrat-Gazette*, March 31, 1998.

deal" for him personally. Mr. Rohde stated that the CDFI award was only a portion of the money needed to acquire Mr. Brandon's bank.

D. Conflicts of Interest Policy was Inadequate during First Round

1. Director Moy and Deputy Director Rohde were involved in making awards to institutions with which they were previously associated

As revealed in the Treasury Department's March 26, 1997 letter to Chairman Bachus, immediately before joining the CDFI Fund, Ms. Moy served as an unpaid member of an advisory board for the Low Income Housing Fund ("LIHF"), and Mr. Rohde was employed in the Washington office of the Local Initiatives Support Corporation ("LISC"). Both of these entities were given awards during the first round. Neither the Director nor the Deputy Director formally recused themselves from consideration of these applicants, and indeed both actively participated in the decisions to award them federal funds.

The Ethics Regulations governing Treasury Department employees state:

> (a) Consideration of appearances by the employee. Where an employee knows that a particular matter involving specific parties is likely to have a direct and predictable effect on the financial interest of a member of his household, or knows that a person with whom he has a covered relationship is or represents a party to such matter, and where the employee determines that the circumstances would cause a reasonable person with knowledge of the relevant facts to question his impartiality in the matter, the employee should not participate in the matter unless he has informed the agency designee

> of the appearance problem and received authorization from the agency designee in accordance with paragraph (d) of this section.[59]

Examples of situations in which federal officials should recuse themselves include the following:

> An engineer has just resigned from her position as vice president of an electronics company in order to accept employment with the Federal Aviation Administration in a position involving procurement responsibilities. Although the employee did not receive an extraordinary payment in connection with her resignation and has severed all financial ties with the firm, under the circumstances she would be correct in concluding that her former service as an officer of the company would be likely to cause a reasonable person to question her impartiality if she were to participate in the administration of a DOT contract for which the firm is a first-tier subcontractor.[60]

Due to Director Moy's decision not to make herself available for an interview, the Subcommittee did not receive a full explanation for her participation in selecting LIHF. As to his prior relationship with LISC, Mr. Rohde stated to Subcommittee staff that he and Ms. Moy discussed the subject, and neither thought there was a conflict of interest. Mr. Rohde said he did not feel he would be biased in favor of LISC, and in fact had a low opinion of the abilities of certain management personnel at LISC based upon his tenure at the company. Mr. Rohde noted that his prior relationship was arguably problematic, conceding "I could see how that could raise some eyebrows in hindsight now."

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[59] 5 CFR Sec. 2635.502(a).

[60] *Ibid.*, Example 4.

In fact, it appears from Mr. Rohde's conduct at the time that he recognized the ethical complications arising out of his prior association with LISC, and chose to partially recuse himself from consideration of its application. Mr. Rohde stated that he did not involve himself as directly in the initial review of LISC's application as he did in other cases, and assigned it to a reviewer in whom he had confidence. Mr. Rohde stated, "In part, because I was aware that somebody could raise a question on the LISC application, . . . is one of the reasons why the assignments were divided into national organizations and I assigned it to Nancy [Andrews], who had the most expertise and credibility. When I gave the assignment to Nancy, I said, 'I am going to take a more passive role on this application and rely on you.'" Mr. Rohde stated that he tried to "bend over backwards" to make sure that Ms. Andrews was equipped to evaluate the applicant.

Mr. Rohde conceded that he participated in the second stage review panel's consideration of the LISC application: "I did participate in the interview. Because I knew them so well, I was able to ask the tough questions. When it came to the discussions [on whether to fund LISC], I purposely held back. Maybe it would have been a wiser decision to just find another way to deal with them." Mr. Rohde admitted that he was responsible for the evaluation of whether LISC should be certified as a CDFI. Mr. Rohde stated that he considered the decision whether to certify LISC a "slam dunk." However, Mr. Jones, the Fund's counsel, stated that an exercise of discretion and judgment was involved in determining CDFI certification.

When asked why he did not follow the formal recusal process, Mr. Rohde noted that the Treasury Department concluded that he was not actually in violation of the ethics code. He acknowledged that at the time of the first round, he was not aware of the requirement that a Treasury Department employee consult with the designated agency ethics officer in any situation involving the appearance of a conflict of interest. Mr. Rohde said that he did not recall any conversations concerning recusal with any Treasury Department officials outside the CDFI Fund. He stated that he believes that Mr. Jones

and the Fund's predecessor counsel were aware of the LISC relationship and yet did not raise any concerns about it with him.

The Treasury Department has maintained in correspondence with the Subcommittee that the ethics regulations were not violated by Ms. Moy and Mr. Rohde.[61] However, Mr. Jones indicated to Subcommittee staff that he does not recall being made aware that Mr. Rohde's immediate former employer was LISC until it was brought to his attention by the Subcommittee (he does not know whether the attorney who was counsel to the CDFI Fund before Mr. Jones commenced his duties in April 1996 considered the applicability of the regulation).[62] Mr. Jones stated that he also was not aware of Director Moy's prior relationship with LIHF.

Mr. Jones noted that the ethics regulation places the burden on the employee to make a judgment call on recusal based on two factors: whether the employee feels he or she can be impartial, and whether a reasonable person with knowledge of the facts could question the official's impartiality. Mr. Jones argued that Ms. Moy was uncompensated and volunteered her time to LIHF, and therefore was not obligated to seek guidance from the Department's designated ethics officer (*i.e.*, a reasonable person would not question her involvement in the application). Mr. Jones acknowledged that it was a "tougher call" regarding Mr. Rohde, because he came to the CDFI Fund from a paid position at LISC.

Mr. Jones stated that for the CDFI Fund's second round, it adopted a conflict of interest policy that barred outside contractors from participating in the review process if they had relationships with applicants similar to those involving Ms. Moy and the Deputy

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61 *See* Letter from Linda L. Robertson, Treasury Assistant Secretary for Legislative Affairs and Political Liaison, to Chairman Spencer Bachus, May 8, 1997.

62 The ability of the Department (and the public) to uncover the existence of this prior relationship was hampered by the fact that the Deputy Director failed to file his statutorily-required personal financial disclosure statement until July 1997, over a year after it was due in May 1996. The Deputy Director stated that he was too busy with the first round evaluation process to file the form, and decided simply to pay the fine and file the form late.

Director in the first round. However, this policy only applied to outside contractors and not to CDFI Fund employees.

2. Individual reviewers with relationships to applicants were permitted to review applications from competitors

As stated, during the first round, the CDFI Fund considered prior, independent knowledge concerning the operations of an applicant to be a positive factor in assigning reviewers to specific applications. As a result, the CDFI Fund did not consider it necessary to shield particular reviewers from applications with which they had independent familiarity.

Mr. Rohde stated that he barred certain reviewers from reviewing applications in which they had a direct interest. However, reviewers with interests in applications were permitted to review competing applications -- including applications from entities in the same industry and geographic grouping -- and in fact rejected applications from competitors. For instance, one reviewer who served on the advisory board of one applicant reviewed applications from other entities in the same industry grouping. Likewise, another reviewer who had participated in preparing application materials for an applicant was allowed to review applications of competitors.

Mr. Jones, the Fund's counsel, stated that the policy adopted by the Fund for the second round (after questions were raised by the Subcommittee) addressed this situation by barring individuals from reviewing applications of a member of an industry grouping if they had a current or previous relationship with an applicant in that same grouping.

E. The Fund granted almost $11 million in awards to the self-styled "Shorebank system"

1. Documents contained in CDFI Fund application files indicate that Shorebank had financial interests in and exercised substantial control over Southern Development, Douglass, and Louisville Development

The single largest beneficiary of first round CDFI funding was Shorebank, the institution touted by many as the leading practitioner of community development banking in inner-city communities. Shorebank itself received a $4.5 million award, by far the largest award made during the first round.

Shorebank had strong financial interests in three other successful CDFI Fund applicants – Southern Development, Douglass, and Louisville Development, the same institutions for which contemporaneous evaluation memoranda were not prepared. Shorebank, acting through its for-profit subsidiary, Shorebank Advisory Services, prepared applications for Douglass and Louisville Development. In correspondence with the CDFI Fund on behalf of Douglass, a Shorebank executive referred to a "Shorebank system" that included Southern Development and Douglass.[63] Among them, Shorebank, Southern Development, Douglass, and Louisville Development received grants totaling $10,739,500, prompting concern that the awards in the aggregate violated the $5 million statutory limit.[64]

The indicia of Shorebank's substantial control over Southern Development, Douglass and Louisville Development were readily apparent from the materials contained in the applicant files for these institutions. The documents reviewed by Subcommittee

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63 *See* Letter from Lisa Richter, Shorebank Advisory Services, to Steve Rohde, May 3, 1996.

64 *See* Letter from Chairman Spencer Bachus to Treasury Secretary Robert Rubin, May 9, 1997.

staff at the CDFI Fund disclosed the existence of a close and ongoing relationship between Shorebank and Southern Development, which received a $2 million CDFI Fund award. Principally responsible for setting up Southern Development in 1986,[65] Shorebank continued to play a central role in the company's operations. For example, Southern Development's president for much of its corporate existence, George Surgeon, was formerly a senior executive at Shorebank;[66] the chairman of its board of directors, Ronald A. Grzywinski, was also chairman of Shorebank's board; and another Southern Development board member, Mary Houghton, was President of Shorebank. Surgeon, Grzywinski, and Houghton all owned shares in Southern Development as well, and served on the board of directors of Elk Horn Bank & Trust Company in Arkadelphia, which Southern Development purchased in 1988. Though a subsidiary of Southern Development, Elk Horn Bank & Trust is listed in materials submitted to the CDFI Fund as a member of the Shorebank "system." Furthermore, documents contained in the Southern Development application indicated that Shorebank was contemplating a formal purchase of Southern Development.

Douglass of Kansas City, Missouri received a grant of $1.75 million. Shorebank Advisory Services prepared the CDFI Fund application for Douglass. Furthermore, material contained in Douglass' application file suggests it was subject to extensive control by Shorebank.[67] It appears that at the time of the application, two members of

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[65] *See* footnote 1.

[66] In interviews, Mr. Rohde indicated that Mr. Surgeon was in fact still an employee of Shorebank, for purposes of retaining health insurance benefits, while serving at Southern Development.

[67] The following information appears in the Douglass application:

- Pg. 6: "As part of the reorganization of Douglass in 1991, the Bank retained Shorebank Corporation, the holding company of the South Shore Bank of Chicago, for a five-year performance-based advisory contract covering a range of bank management issues." The application also notes that a new contract was being negotiated.
- Pg. 8: "Under its contract with Douglass, Shorebank established and [chaired or advised?] a Loan Committee with minimal participation from the Board or other non-lender staff. (brackets in original.) Shorebank prepared a valuation of the loan portfolio leading to the reclassification of loans as pass, substandard, doubtful, and loss."

Shorebank's senior management team sat on Douglass' board of directors; Shorebank "provided valuable advisory services on an ongoing and regular basis to the bank;" and Douglass officials were essentially treated as Shorebank employees. The extent of Shorebank's interest in Douglass was highlighted by its management agreement with Douglass, under which Shorebank was compensated according to a formula that provided it 40 percent of Douglass' annual earnings in excess of a base amount. Shorebank referred to Douglass as part of the "Shorebank system."

In addition to seeking an equity investment, Douglass' application requested a separate grant to cover the costs of "technical assistance" to be provided Douglass by Shorebank Advisory Services. The CDFI Fund accommodated this request, supplementing Douglass' $1.75 million award with $153,000 earmarked specifically for Shorebank Advisory Services.

Shorebank Advisory Services also played a central role in the successful application submitted by Louisville Development, which received a $2 million grant from the CDFI Fund. Shorebank Advisory Services was initially retained in 1993 by a group of Louisville civic and community leaders to formulate a business plan for a development bank patterned after the Shorebank model. Once Louisville Development was incorporated, Shorebank Advisory Services took primary responsibility for recruiting the company's chief executive officer and other senior management. Louisville Development's CDFI Fund application, prepared by Shorebank Advisory Services, highlighted the Shorebank connection:

- Pg. 9: During 1991 and 1992, a Shorebank Senior vice-president spent extended periods on-site at Douglass, resulting in a reorganization and reduction-in-force.
- Pg. 11: "Mr. Fletcher [Shorebank board member] is integrally involved in the operations of Douglass. In addition to attending board meetings, he generally spends time in Kansas City each month with the officers in strategic planning and is always available on an as-needed basis."
- Application notes that Shorebank assists with staff training and development.

> We have worked with Shorebank Advisory Services for nearly four years, building a relationship that we intend to sustain through the formation, launch, and ongoing operation of Louisville Bank. . . . Once the institution becomes operational, a representative of Shorebank senior management will be likely to sit on its Board and develop a one-to-one relationship with the CEO to regularly review the development and financial performance of the institution.[68]

In addition to the requested $2 million in equity funding, Louisville Development sought $673,000 from the CDFI Fund to subsidize its technical assistance contract with Shorebank Advisory Services. Half that amount, or $336,500, was ultimately awarded.

2. The Deputy Director conducted a review of the affiliations issue but the final review panel apparently was not made aware of it

Pursuant to statute, CDFI Fund grantees and their "subsidiaries and affiliates" are limited to no more than $5 million in assistance during any three-year period.[69] Regulations promulgated by the Treasury Department define an "affiliate" for purposes of this provision as "any company that controls, is controlled by, or is under common control with another company."[70] Moreover, the Fund appears to have the discretion to limit funding. For instance, the formal awards decision memorandum for the second round of funding completed in 1997 notes that the Director made a policy decision to limit all first-time awardees selected in the second round to $2.5 million.[71] It is not clear why such a decision to limit funding was not made during the first round.

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[68] Louisville Development application file.

[69] 12 U.S.C. Sec. 4707(d)(1).

[70] 12 C.F.R. Sec. 1805.104(b).

[71] Awards decision memorandum from Kirsten Moy regarding the Second Round, September 4, 1997.

Deputy Director Rohde made the determination that the Fund did not violate the statutory cap in awarding almost $11 million to the Shorebank-related entities. Mr. Rohde, who performed the first stage evaluations of the four relevant institutions, told Subcommittee staff that he personally considered the affiliation issue during the first stage review process,[72] with particular reference to the possible acquisition of Southern Development by Shorebank.[73]

It appears that the Deputy Director was the only person who addressed the affiliation issue prior to the selection of the first round winners. (The Fund's counsel stated that he did not conduct an analysis until after the issue was raised by Chairman Bachus.) As to Douglass' profit-sharing relationship with Shorebank, Mr. Rohde said the affiliation issue did not come up in the review panel's deliberations concerning Douglas' application. (Mr. Rohde's memorandum on Douglass did not provide a detailed discussion of the bank's close relationship with Shorebank.) He also was unsure whether the correspondence that detailed the Shorebank-Douglass relationship had been shown to the final review panel.

The Deputy Director's decision to address the affiliation question himself, apparently without consulting other Fund personnel, raises questions as to whether the Fund adequately considered the implications of directing almost one-third of the Fund's awards to one "system" during the first round. Mr. Rohde acknowledged that legitimate

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[72] As to the "due diligence" he conducted, Mr. Rohde stated that he (1) reviewed the representations of the four applicants; (2) held conversations with the applicants; (3) read applications; and (4) held a brief conversation with a Federal Reserve official (probably no more than 10 seconds on the subject during the course of another conversation), who indicated that the Federal Reserve had no concerns about the close relationship between Shorebank and Douglass.

[73] Mr. Rohde acknowledged that Shorebank had discussed purchasing Southern Development. However, Mr. Rohde stated that it was his understanding that this transaction was not going to be consummated. Mr. Rohde remembers that while he was employed at LISC in July 1995, he spoke with someone who had a close relationship with Shorebank, who told Mr. Rohde that the discussions about a possible acquisition of Southern Development were not going well. Based on this and another conversation with a Shorebank official in early 1996, Mr. Rohde did not think the purchase was going forward. He conceded, however, that the "purchase proposal" was still on the table at the time that Shorebank and Southern Development were being considered for CDFI funding, but does not remember the issue being discussed by the review panel.

policy issues existed as to whether the CDFI Fund should fund so many entities related to Shorebank. According to Rohde, the review panel decided to go on the "merits" and didn't want to see a "relationship" to Shorebank adversely affect an applicant. Mr. Rohde noted that Shorebank advises many community development lending institutions, and he felt that the transfer of expertise from Shorebank to others in the field should be encouraged.

3. Treasury Department rejected concerns over statutory violation

In correspondence with the Subcommittee, the Treasury Department denied that the statutory limits had been exceeded, based upon the following line of reasoning:

> (1) The statute provides that the term "affiliate" has the same meaning as in Section 2(k) of the Bank Holding Company Act of 1956;
>
> (2) Section 2(a)(3) of the Bank Holding Company Act creates a "presumption" that any company that does not own, control or have the power to vote at least 5% of any class of another company's securities does not control the other company;
>
> (3) Section 2(a)(3) of the Bank Holding Act provides that one company controls another if either directly or indirectly, or acting through one or more other persons, it owns, controls or holds the power to vote 25% or more of any class of the company's voting securities; it controls the election of a majority of the directors or trustees of the other company; or the Federal Reserve has made a determination that it exercises a controlling influence over the management or policies of the other company;
>
> (4) Because Shorebank does not own, control, or vote any of the securities of Southern Development, Douglass, or Louisville Development, does not control the election of a majority of their directors or trustees, and has never been determined by the Federal Reserve to exercise control over their management, those entities do not qualify as Shorebank's "affiliates."[74]

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[74] *See* Letter from Treasury Under Secretary for Domestic Finance John D. Hawke, Jr. to Chairman Spencer Bachus, May 27, 1997.

In response, Chairman Bachus pointed out that the "presumptions" upon which the Treasury's argument rested were not dispositive in the context of a government grant program:

> [T]he many competing policy concerns that inform the presumptions derived from the Bank Holding Company Act are not the appropriate policies to inform the presumptions derived from the act creating the CDFI Fund. . . . [I]t is obvious that the $5 million cap contained in the CDFI Fund Act was designed to ensure that taxpayer funds are not overly concentrated under the control of any one institution. I do not think the Department would dispute that the documents maintained by the CDFI Fund indicate that Shorebank exercises significant management control over the institutions for which it prepared CDFI Fund applications. Furthermore, these documents indicate that Shorebank has strong and direct financial interests in these institutions. As such, by having almost a third of the funds redound to the benefit of one institution, the Department has clearly violated the spirit of the Act if not its letter.[75]

F. Technical Assistance Contracts were Awarded with Little Scrutiny

During the first round of grants, the CDFI Fund funded eight requests for technical assistance in a total amount of $769,500. Of this amount, more than half was earmarked for Shorebank Advisory Services on behalf of Douglass ($153,000) and Louisville ($336,500). Shorebank Advisory Services prepared the applications of both of these institutions.

Mr. Rohde stated that the CDFI Fund did not consider alternative sources of technical assistance, but simply agreed to the requested provider if the application was reasonable. In correspondence with the CDFI Fund, Shorebank officials made a direct pitch for assistance from the CDFI Fund for technical assistance. A May 3, 1996 letter from a Shorebank official to Mr. Rohde stated in part:

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[75] *See* Letter from Chairman Spencer Bachus to Treasury Secretary Robert Rubin, May 28, 1997.

> As the CDFI Fund considers Douglass' request for a $2 million equity investment, we trust that you will also consider a grant to cover the costs of this technical assistance as a means to enhance the value of the equity investment.

Mr. Rohde appeared to recognize that this represented a conflict of interest on the part of Shorebank Advisory Services. He indicated that he resolved his concerns by consulting directly with employees of Douglass and Louisville to determine if they in fact desired the technical assistance grant.

Mr. Rohde stated that Shorebank was considered the model for the industry and no one else had replicated the Shorebank model. In Mr. Rohde's view, it was an "advantage" for an applicant to have Shorebank participate in its management, though he stressed that the Fund still reviewed the fitness of the institution's own management team before awarding grant money.

G. Contractors were Hand-picked by Fund Officials

Deputy Director Rohde believed that protections against abuse were built into the review process by the use of outside experts to conduct the first stage review, coupled with the "consensus" required of the five person final review panel. As detailed below, the CDFI Fund selected all of its outside contractors without observing competitive bidding procedures and without complying with the federal statute governing outside consultants. Several of these contractors benefited from particularly lucrative financial arrangements that extended beyond the first round review process, thus raising questions as to whether these lucrative arrangements created undue deference to Fund officials or otherwise influenced the judgment of the consultants.

H. The Fund Determined CDFI Status of Certain Applicants After The Applicants Had Been Chosen for Funding

Under the regulations in place during the first round, the CDFI Fund was required to engage in a three tier process: Tier I required weeding out ineligible or otherwise incomplete applications; Tier II reviewed whether an applicant possessed the organizational and financial capacity to be a successful CDFI; and Tier III involved selection of the most competitive applications. The Fund's counsel indicated that the determination of whether an institution qualified as a CDFI required an exercise of discretion and judgment in assessing the applicant's ability to maximize community impact, operate soundly and achieve the public policy goals of the Fund.

It appears that the Fund actually awarded grants to some institutions before making the basic determination whether they qualified as eligible CDFIs or had demonstrated they could become one within three years. The Deputy Director indicated that due to time constraints, the first two tiers were collapsed and conducted not sequentially, as contemplated by the regulations, but concurrently. For instance, during the first round, the Fund chose to make awards to Finca and Tlingit-Haida, before undertaking a formal evaluation of their CDFI status and resolving key questions concerning their eligibility.

I. Political Considerations may have Influenced Award Process

The Treasury Department has denied that political factors played a role in the selection of awardees during the first round. In interviews with Subcommittee staff, Mr. Rohde said he repeatedly cautioned reviewers against considering political factors, and pointed to the requirement that the five member review panel reach consensus as a safeguard against political favoritism. Mr. Rohde emphasized that he viewed all first round award recipients as eligible and highly deserving.

Mr. Rohde stated that he personally was unaware of the involvement of the President and Mrs. Clinton in the establishment of the corporate parent of Enterprise

Corporation (see discussion below of letter from President Clinton concerning his and Mrs. Clinton's association with the institution). Mr. Rohde stated that he was aware of Mrs. Clinton's strong connection to Southern Development and Shorebank's involvement in setting up Southern Development, as well as former Clinton Administration official Jan Piercy's involvement in Shorebank. Mr. Rohde stressed, however, that none of this was discussed during the review process. During the course of the Subcommittee's investigation, however, certain facts and documents emerged that raise questions about the extent to which CDFI Fund activities were insulated from political considerations.

1. Notes of July 1, 1996 meeting with Treasury official Michael Barr suggest various political factors were discussed concerning the announcement of the awards

As discussed, the second stage review panel selected a tentative group of award winners on June 17-18, 1996, and met again on July 11 to finalize its decisions. On July 1, 1996, Deputy Director Rohde and Director Moy discussed the tentative winners with Michael Barr, Special Assistant to Secretary Rubin. Interviewed by Subcommittee staff, Mr. Barr stated that the purpose of the meeting was to determine how to "roll out" announcement of the winners of the first round. The Department hoped to place the announcement ceremony on the President's schedule. Mr. Rohde confirmed that this was the purpose of the meeting. The Treasury Department did take extensive steps to publicize the announcement of the first round of awards, including requesting taped radio actualities by President Clinton.

Notes prepared by Mr. Barr and produced to the Subcommittee[76] reference a variety of political connections between specific tentative winners and various political figures, including Mrs. Clinton (identified by her Secret Service acronym "FLOTUS"), various prominent members of Congress, including Rep. Louis Stokes of Ohio, Senator

[76] *See* Exhibit 9 (notes of July 1, 1996 meeting between Michael Barr, Kirsten Moy, and Steve Rohde).

Kit Bond of Missouri, Senator Carl Levin of Michigan, and Mayor Jerry Abramson of Louisville, Kentucky.

Although he recalled the meeting, Mr. Rohde had only a vague recollection of the specifics. For instance, he did not recall the discussion relating to Mrs. Clinton or to Senator Levin, but he did recall Senator Bond's name coming up and possibly that of Rep. Stokes, and conceded he probably mentioned to Mr. Barr Mayor Abramson's involvement in Louisville Development.

Mr. Barr stated in Subcommittee interviews that he was generally unfamiliar with the first round applicants prior to the July 1, 1996 meeting, although he had a general familiarity with Shorebank. He stated that he was not aware of the connections between the First Lady and Southern Development prior to the meeting (and was still generally unaware at the time of the Subcommittee interview), nor did he have a recollection of knowing what was meant by a reference in the notes to a "local group with Stokes ties."

2. A sworn statement contradicts the Treasury Department's contention that a letter from President Clinton praising Enterprise Corporation was not shown to the review panel

Enterprise Corporation, headquartered in Jackson, Mississippi, received a $2 million award from the CDFI Fund. Southern Development's president, George Surgeon, served on Enterprise's Board of Directors. The board of directors of Enterprise's parent corporation, Foundation of the Mid South, included among its members Mrs. Clinton and a host of other prominent Arkansas businessmen and government officials.[77] Enterprise's

[77] The Chairman of the Board of Foundation of the Mid South, Donald Munro, was a strong supporter of President Clinton during his career as Arkansas governor, and later contributed the maximum amount permitted to President and Mrs. Clinton's legal expense trust. Other board members included long-time Arkansas state banking commissioner Marlin Jackson; former director of the Arkansas Development Finance Authority (ADFA) Bob Nash, who serves the Clinton White House as director of presidential personnel; former Director of the Arkansas Department of Finance and Administration Mahlon Martin (now deceased), who was also a member of the Shorebank and Southern Development boards; S. Robson Walton, Chairman of Wal-Mart Stores in Bentonville, Arkansas, and another long-time

CDFI Fund application was comprised in part of materials prepared by Shorebank Advisory Services, Inc.[78]

On May 13, 1996, the CDFI Fund received a copy of a letter from President Clinton to former Mississippi Governor William Winter, responding to Governor Winter's request for a letter of commendation for the application of Enterprise Corporation. The President's letter stated:

> Thank you for your letter advising me of the subsidiary corporation created by Foundation for the Mid South to aid in economic development in the Delta area. Because of our interest and early involvement with the Foundation, both Hillary and are *(sic)* gratified by the continued successes *(sic)* stories from your efforts.
>
> I have forwarded a copy of your letter to Secretary Rubin at the Department of the Treasury to let him know of your personal recommendation regarding the Enterprise Corporation's application to the Community Development Financial Institution's Fund for a $3 million grant.[79]

In his May 9, 1997, letter to the Department, Chairman Bachus asked whether any persons involved in reviewing Enterprise's application were shown a copy of the President's letter.

In its May 27 response, the Treasury Department stated:

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contributor to President Clinton's political campaigns; and Richard Herget, a Little Rock businessman whose financial support of President Clinton dates back to his first campaign for statewide office in 1976.

78 *See* Letter from Treasury Under Secretary for Domestic Finance John D. Hawke, Jr. to Chairman Spencer Bachus, August 29, 1997.

79 *See* Exhibit 10 (letter from President Clinton to Former Mississippi Governor William Winter, May 2, 1996).

> As to the President's letter, to the best of our knowledge it was not provided either to the initial reviewer of the Enterprise Corporation of the Delta . . . or to the subsequent review panel.

There is reason to question the accuracy of this response. The Inspector General took a sworn statement from Mr. Bill Leucht, Public Affairs Specialist at the CDFI Fund, who made the following assertion:

> Typically, correspondence that requires no reply would just be filed, but since the correspondence was forwarded from the White House, I have a recollection that I had shown Kirsten Moy, Director of the CDFI Fund, my copy of the correspondence in passing.[80]

Director Moy, of course, was a member of the "subsequent review panel" that interviewed Enterprise Corporation's management on May 9, 1996. According to Mr. Leucht's sworn statement, Ms. Moy was shown the letter around May 13, 1996, when it arrived at the CDFI offices, prior to the meeting of the second stage review panel on June 17th and 18th in which Enterprise was selected for funding.[81] Furthermore, the evaluation memorandum for Enterprise Corporation was not finalized until July 11, 1996. Due to Director Moy's failure to make herself available for an interview, the Subcommittee was not able to obtain a full explanation, if any, for these inconsistencies.

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[80] Affidavit, William B. Leucht, Jr., June 19, 1997. Later, Mr. Leucht clarified to OIG investigators that he did not believe any of the other panelists received a copy of the letter because one was not placed in the master file until after the file had been copied and sent to each reviewer. He reiterated, however, that he showed a copy of the correspondence to Ms. Moy as a courtesy.

[81] Although the letter was in the applicant file, Deputy Director Rohde denied seeing the letter from President Clinton prior to the Subcommittee's inquiry. In support of this contention, Mr. Rohde recalled in an interview by the Inspector General that when he called Enterprise Corporation Executive Director William Bynum to notify him of the company's grant in late July 1996, Mr. Bynum jokingly told Mr. Rohde "that the correspondence from [the President] must have done it [helped Enterprise obtain an award]." Mr. Rohde claims that he did not know what Mr. Bynum was talking about because Mr. Rohde was unaware of the letter. Furthermore, Mr. Rohde contends that the decision to fund Enterprise Corporation was a result of discussion by the five person review panel shortly after its interview of Enterprise; as a result, the meeting in mid-June was something of a formality. Due to the lack of an adequate record of the decision-making process, Mr. Rohde's account cannot be documented.

3. The CDFI Fund received "pressure" from the White House and Treasury Department concerning the timing of the first round awards

In response to an inquiry from the Subcommittee, White House Counsel Charles Ruff acknowledged extensive contacts between Clinton Administration officials and the CDFI Fund about a wide variety of issues, including two conversations concerning particular applicants and the announcement of awards.[82] Mr. Barr recalled speaking with Gene Sperling of the National Economic Council -- both before and after the announcement of the awards -- concerning the reasons one institution supported by Mr. Sperling did not receive an award, and another conversation with another White House official, Paul Weinstein, concerning an institution that did not receive an award during the first round (Mr. Barr could not recall the name of the institution that was the subject of the Weinstein inquiry).

According to Mr. Rohde, Ms. Moy indicated to him that there was "pressure" from the White House and Treasury to get the selection process completed. Mr. Rohde added that he was informed that the White House had reportedly asked sometime in late 1995 if the CDFI Fund could finish making its awards in time for the State of the Union address in January 1996; later, after this "deadline" for making the awards passed, the White House inquired as to whether the CDFI Fund could finish the selection process by February 1996. Ms. Moy also told Mr. Rohde that the White House wanted it done by February or March, but Mr. Rohde told her it would take a minimum of four months. Mr. Rohde stated that in his view, the Fund "did feel pressure from the White House," and that the White House was "disappointed" when the awards were not announced earlier. He stressed that the Fund also felt strong pressure from industry members who were anxious to learn whether they were to receive awards.

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[82] *See* Letter from White House Counsel Charles Ruff to Chairman Spencer Bachus, December 17, 1997.

Deputy Director Rohde stated that in late June 1996, he attended a meeting at "Main" Treasury with approximately a half dozen officials from various Treasury offices. According to Mr. Rohde, Treasury hoped to plan a "Presidential event" for the announcement of the CDFI Fund awards. During this meeting, Mr. Rohde said a woman (whose name he cannot recall) pressured him to give a date certain on which the announcement could be made. Mr. Rohde stated that he refused because more work was required. Mr. Rohde characterized this meeting as "contentious" and felt that he made some "enemies" as a result of his refusal to cooperate with the attempt to establish a definite deadline for "rolling out" the awards. Indeed, Mr. Rohde recalls that when someone demanded that he provide a date on which the Secretary would be present to announce awards, Mr. Rohde responded that he would resign if forced to do so.[83] He emphasized, however, that Department officials did not lobby the Fund on behalf of particular applicants.

Mr. Rohde said a tentative date for announcing the awards was provided to Treasury shortly after the June 1996 meeting, when he knew the "substance" of the selection process was completed but documentation was still lacking (the Shorebank evaluation memoranda, for instance). He noted that the CDFI Fund review team met on July 11 to conduct a final review of the winning applications and to make some revisions in the awards.

Mr. Rohde stated that due to time constraints, he was unable to finalize certain documentation prior to announcement of the grants. He noted that had he had just three or four more days, he would have been able to prepare a formal "narrative" memorandum explaining in detail the reasons particular applicants were selected over others, a detailed cover memorandum for Ms. Moy, and the evaluation memoranda for the Shorebank-related applicants. Mr. Rohde stated that his plans to complete the documentation prior to

[83] Mr. Rohde stated in a subsequent conversation with Subcommittee staff that he now "regrets" making this resignation threat.

the awards ceremony were also disrupted by his being pulled into the extensive public relations effort that went into the awards announcement.[84]

4. The Fund took steps at the request of the Department to expedite the disbursement of the award to Louisville Development

Mr. Barr recalled making an inquiry to the CDFI Fund concerning the slow disbursement of Louisville Development's award. He noted that he had a general concern about the slow disbursement of all awards, but conceded that his specific inquiry relative to Louisville Development was prompted by a complaint Treasury received from an assistant to Mayor Abramson of Louisville.

Apparently as a result of this inquiry to the Treasury Department, the CDFI Fund requested that a check for Louisville Development be cut on December 31, 1996. The Fund was forced to return the check to the Department after Fund officials determined that Louisville Development had failed to meet the conditions required for disbursement. The Fund did not disburse the award to Louisville Development until January 1998.

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[84] The Treasury Department mounted a fairly substantial public relations effort to publicize the awards. President Clinton recorded radio actualities to be aired in 17 cities in which local CDFIs were awarded funds. A formal event was held in Washington following the announcement and attended by representatives from the winning CDFIs, the Director of the Fund, and Secretary Rubin. *See* Exhibit 11 (copies of the radio actuality list and related planning documents).

VI. Use of Outside Contractors

A. The CDFI Fund Adopted a Strategy of Reliance Upon Outside Contractors

After reviewing information from the Treasury Department suggesting extensive use of outside consultants, Chairman Bachus pressed for specific information concerning the use of these contractors.[85] Treasury's response indicated that the CDFI Fund had chosen to use non-employees to perform evaluations of applications. Although the amounts paid and the duration of the engagements were somewhat excessive, they did not appear to depart radically from the practice followed in other federal grant programs of utilizing outside reviewers for initial evaluation of applications. However, the Treasury response also revealed that the CDFI Fund utilized contractors over extensive periods of time and at extraordinary rates for the purpose of providing general "management" services.

Under restrictions contained in appropriations legislation (P.L. 104-19), the CDFI Fund was limited to 10 full-time employees until September 30, 1996. It appears the Fund adopted a deliberate strategy of relying upon outside consultants that continued well after this restriction had been lifted. Examples include the CDFI Fund's decision to use outside consultants to provide management services (rather than hiring a permanent Chief Financial Officer) and to devise grant procedures (rather than hiring an awards administrator). As a consequence, a permanent CFO was not hired until November 1997, after the first two rounds of awards had already been completed; an awards administrator was not hired until January 1998.

From the beginning of Director Moy's tenure in October 1995 until her departure in October 1997, the CDFI Fund authorized the expenditure of over $2.4 million on

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[85] *See* Letter from Chairman Spencer Bachus to Secretary of the Treasury Robert Rubin, July 30, 1997.

outside consultants and contractors. Of this amount, over $1.4 million went to general management consultants. These management consulting services were provided over extended periods of time by five individual consultants (retained via three Small Business Administration Section 8 firms under contract with the Fund) and by the accounting and consulting firm of Ernst & Young, LLP, which received $843,000 of the total amount.[86]

The Treasury Department is authorized under 31 U.S.C. sec. 332 to "contract for the temporary or intermittent services of experts or consultants as authorized by section 3109 of title 5, United States Code, at rates not to exceed the per diem equivalent to the rate of GS-18."[87] Section 3109 of Title 5, in turn, limits retention of consultants and contractors to one year, and authorizes the Office of Personnel Management to issue regulations that govern the terms of retention of outside experts and consultants.[88] None of the outside consultants or contractors that provided management consulting services to the CDFI Fund was retained under the statutory authority of 5 U.S.C. 3109. Rather the funds to pay their fees were expended on a *de facto* sole source basis through small purchase contracts and via a questionable use of the Small Business Administration's 8(a) program. By operating in this manner, the Treasury Department engaged in a wholesale avoidance of the Federal Acquisition Regulations. As a result, certain individual management consultants were retained for periods in excess of one year and at rates higher than what could be paid under 5 U.S.C. 3109.

One consultant, Nancy Andrews, provided services to the CDFI Fund from April 1996 until January 1998. The CDFI Fund paid her a total of $228,065.91 during this

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[86] *See* Letter from Treasury Under Secretary John D. Hawke, Jr., to Chairman Bachus, March 25, 1998.

[87] The CDFI statute does not reference a separate authority to retain outside consultants or experts under 5 U.S.C. Sec. 3109, but as the CDFI Fund was placed within the Treasury Department, it presumably has derivative authority under 31 U.S.C. Sec. 332.

[88] 5 USC Sec. 3109(b) states that "[w]hen authorized by an appropriation or other statute, the head of an agency may procure by contract the temporary (not in excess of 1 year) or intermittent services of experts or consultants or an organization thereof, including stenographic reporting services."

period, at rates ranging from $125 to $133 per hour.[89] (At $133 per hour, a full time equivalent employee would be paid $276,640 per year.) Another consultant, Joyce Klein, was paid over $183,000 for work over a 20-month period, and another was paid over $100,000 primarily for work done during a six-month period. These consultants were provided free office space by the CDFI Fund.

It appears that the Director and the Deputy Director were personally acquainted with a substantial percentage of the outside reviewers selected by the CDFI Fund. Director Moy stated in response to written questions propounded by the Subcommittee that she knew personally 18 of the consultants retained by the CDFI Fund, which she attributed to the small size of the community development industry.[90] Mr. Rohde stated that he knew contractors Paul Pryde and Jim Paquet fairly well (Mr. Paquet was retained under an intergovernmental exchange program). Mr. Rohde said that he met Ms. Andrews through Ms. Moy shortly before he officially joined the Fund; at that time, Ms. Moy suggested Ms. Andrews would be a good candidate for a consultant. He presumed that Ms. Moy had worked with Ms. Andrews previously and described them as having a "working friendship."

After the first round of grants was completed in July 1996, the CDFI Fund continued to utilize Ms. Andrews and Ms. Klein for well over a year to provide undefined "management consulting" services. Mr. Rohde stated that there was discussion of hiring Ms. Andrews for a permanent position, possibly as Chief Financial Officer, but it was his understanding that it was not feasible to bring her in at the level of Senior Executive Service, the only level in which she was interested. As a result, the Fund continued to retain her services as an outside contractor.

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89 *See* Exhibit 12 (list of contract reviewers and management consultants).

90 *See* Letter from John Nields, Esq. (Ms. Moy's attorney), to Chairman Spencer Bachus, March 25, 1998.

It appears that Ms. Andrews, who also provided services to the Department of Housing and Urban Development,[91] traveled on a weekly basis to Washington from New York City to provide services to the Fund. The CDFI Fund paid her travel and lodging expenses during this period, such as airfare and lodging at various Washington, D.C. hotels, including frequent stays at the Mayflower. All told, the Department paid over $31,000 in travel expenses for Ms. Andrews alone during this time. In fact, her frequent trips prompted the Director to initiate a request in May 1997 that the Treasury procurement office lease an apartment for Ms. Andrews rather than pay for extended hotel stays.[92] (Ms. Carolyn Smith, the Supervising Contract Specialist in the Treasury Procurement Services Division,[93] was the Contracting Officer who oversaw the Fund's Section 8(a) contracts. She stated that she rejected Director Moy's request that the Department provide an apartment for Ms. Andrews on the grounds that it was unusual, was of questionable business judgment, and out of concern that the precedent would create complications for the procurement office.)

In September 1997, Chairman Bachus expressed his concern to the Treasury Department about what appeared to be exorbitant rates paid to outside consultants over lengthy time periods.[94] Chairman Bachus shared his concerns with the House VA, HUD, and Independent Agencies Appropriations Subcommittee, which chose to add language to the FY98 appropriation bill in an apparent attempt to limit the compensation being paid to contractors and consultants by the CDFI Fund. The language, however, targeted

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[91] Ms. Andrews was paid $182,510 during FY96 and part of FY97 by HUD. *See* Letter from Hal C. DeCell, III, HUD Assistant Secretary for Congressional and Intergovernmental Affairs, to Chairman Spencer Bachus, September 19, 1997.

[92] *See* Exhibit 13 (miscellaneous procurement documents including e-mail from Wes French, May 30, 1997, referencing request for reimbursement for apartment for Ms. Andrews).

[93] The Procurement Services Division provides procurement services to the "Departmental Offices," which include the Secretary's office, and roughly correspond to what is generally referred to as "Main Treasury." The office reportedly manages about $50 million in procurements annually, with over 90 percent being done through small business concerns and over 60 percent of this amount being through Small Business Administration 8(a) firms.

[94] *See* letter from Chairman Spencer Bachus to Treasury Secretary Robert Rubin, September 8, 1997.

consultants retained under 5 U.S.C. 3109, rendering it meaningless because, as noted above, none of the consultants was retained under this statute.

Despite these expressions of Congressional concern, Director Moy apparently was not dissuaded from extensive use of the outside consultants. Bruce Morgan, the Contracting Officer Technical Representative for the second round,[95] stated that shortly before the end of her service with the CDFI Fund, Ms. Moy indicated that she wanted to renew contracts with Ms. Andrews and Ms. Klein. This was reflected in a handwritten note Ms. Moy sent to Mr. Morgan on September 17, 1997, stating that she wished to discuss "renewal of contracts" because of her concern that "if we don't renew now, all work will stop on September 30th."[96] She underscored her request by noting that "Jerry Hawke has indicated I should proceed with business as usual."[97]

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[95] Mr. Morgan did not play the role of technical representative during the first round, as the authority was not delegated to him until December 1996; however, during the first round he acted as an advisor to the contracting officer. He stated that contracting authority at the CDFI Fund was delegated to Ms. Moy, unlike other agencies where the authorities are delegated to lower level staff.

[96] *See* Exhibit 14 (handwritten note from Director Moy to Bruce Morgan, September 17, 1997).

[97] Mr. Morgan stated that Ms. Moy was unable to reach him during her last week at the Fund because he was out of the office attending a training seminar and on sick leave. Ms. Moy became upset with him and wrote him a memorandum that was copied to his personnel file accusing him of not returning her phone calls, which Mr. Morgan denies, and failing to extend contracts with outside consultants. She noted that the failure to extend the contracts had been reported to Under Secretary Hawke. See Exhibit 15 (memo from Director Moy to October 25, 1997). Mr. Morgan also claims that as a result of the perception that he failed to extend the contracts on a prompt basis, Ms. Moy took action to place a pending promotion which she had earlier approved on indefinite hold. Mr. Morgan noted that Ms. Moy had earlier called him into her office to interrogate him about statements he gave to the Treasury Inspector General, statements he felt had been made in confidence. Subcommittee staff did not review these complaints.

B. SBA 8(a) Firms were Utilized by the Department as "Pass-throughs" to Retain Pre-selected Subcontractors

1. SBA 8(a) firms were selected on a sole-source basis to provide undefined "management" services

Ms. Smith, the Contracting Officer, indicated that Treasury Procurement initially retained outside contractors selected by the CDFI Fund through small purchase contracts that were limited at the time to $25,000. Ms. Smith stated that the CDFI Fund contacted her in late 1995 or early 1996 about retaining certain outside contractors to review grant applications. Ms. Smith stated that the Director of Procurement suggested to her that "small purchase contracts" should be utilized to address the Fund's "urgent need."[98] The CDFI Fund provided a list of three names for each position to the contracting officer and noted their first choice, who was then selected.

When the Fund realized that it would exceed the $25,000 cap in the case of several of the outside consultants, Treasury Procurement chose to utilize a succession of 8(a) firms to provide the services. (As discussed below, these firms utilized subcontractors selected by CDFI Fund officials to provide the overwhelming majority of the services requested by the Fund.) According to Ms. Smith, the CDFI Fund indicated in early 1996 that it needed general management assistance. She stated that 8(a) firms were used because the services could be obtained more quickly through the streamlined procedures -- 8(a) firms can be selected on a sole-source basis.[99] Metrica, Inc. ("Metrica") was utilized

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[98] Ms. Smith noted that small purchase contracts involve more streamlined procurement processes than those entailed by larger purchases, but were limited at the time to a maximum of $25,000. These procurements are subject to a requirement that the contracts be advertised by being "posted" on a bulletin board located in the Treasury Department. As a result of this process, Ms. Smith stated that the outside contractors were considered "procurements" and not "consultants" subject to the limitations of 5 U.S.C. 3109; by virtue of this distinction, the only limitation on the amounts paid to the contractors was that they be "fair and reasonable."

[99] The contracts permitted the firms to provide services not only to the CDFI Fund but to all "Departmental Offices." Ms. Smith stated that this was done in order to permit flexibility so that the 8(a) firms would be available to meet other "needs" within the Departmental offices.

first, and then Kevric Company, Inc. ("Kevric"), a firm recommended by Metrica. Native American Management Services ("NAMS") was later retained for the second round. Metrica had an existing contract with the Department; Kevric executed a new contract with the Department via the Small Business Administration[100] in June 1996; NAMS entered into a similar contract in March 1997.[101]

The contracts with Kevric and NAMS were similar. Both required the firms to perform "management services" on an indefinite delivery, indefinite quantity, delivery order basis. Neither contract indicated that a primary service rendered by the firms would be application reviews for the CDFI Fund.[102] Ms. Smith noted to Subcommittee staff that task orders were utilized to spell out the specific requests for work under the general contracts with the 8(a) firms. The task orders were requested by the CDFI Fund. Mr. Morgan indicated that typically Ms. Moy would instruct him to request a particular task from the 8(a) firm.

Procurement documents indicate that NAMS received more than an 18 percent markup on all work provided by its subcontractors; Kevric received more than a 5 percent markup; and Metrica received almost a 10 percent markup.

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[100] As a technical matter, under 8(a) program contracts, the "prime" contractor with the Treasury Department is the SBA, with the particular 8(a) firms acting as subcontractors of the SBA. However, because the SBA does not involve itself in administration of the contract, the term "subcontractor" herein refers to subcontractors under the contract between the 8(a) firm and the Treasury Department.

[101] The Contracting Officer indicated that Metrica "graduated" from the 8(a) program and was no longer eligible for the program. Kevric was a "mismatch" with the CDFI Fund and, as a result, the Fund requested NAMS be retained, which was done under a contract to provide similar "management services on an indefinite delivery, indefinite quantity, delivery order basis" to the CDFI Fund and other "Departmental offices."

[102] The statements of work in the two contracts define the services to be provided in similar language: "The required services shall include but not be limited to project management, supervision, manpower, and administrative support required to furnish the required various management services and other data as may be specified on individual task orders." The contracts also provide that the 8(a) firms will provide: "Economic research analysis, financial analysis, data base management services, and reviews of various financial loan arrangements" (Kevric) or "Economic research analysis, financial analysis, data base management services, administrative and logistical support and analysis of financial arrangements" (NAMS).

2. Small Business Administration regulations call for 8(a) firm employees to provide at least 50 percent of the services

Pursuant to Section 8(a) of the Small Business Act, the SBA administers a program designed to benefit presumptively disadvantaged minority groups. Under the program, federal agencies submit proposals to the SBA for which a particular 8(a) firm is appropriate. The SBA has issued regulations governing the 8(a) program, including a requirement that:

> In the case of an 8(a) contract for professional and/or non-professional services (except construction), at least 50 percent of the cost of contract performance incurred for labor must be expended for employees of the 8(a) concern.[103]

The contracts with NAMS and Kevric were indefinite quantity contracts. In this regard, SBA regulations provide:

> Indefinite quantity contracts. (1) In order to ensure that the required percentage of an indefinite quantity 8(a) award is performed by the Program Participant, at any point in time the Program Participant must have performed the required percentage of the total value of the contract to that date. For a service or supply contract, this does not mean that the Program participant must perform 50 percent of each task order with its own force. But, rather, the Participant is required to perform 50 percent of the combined total of all task orders to date. The Regional Administrator or his/her designee may waive this requirement where a large amount of subcontracting is essential in the early stages of performance before the work to be done by the Participant can be performed, provided that there are written assurances from both the Participant and the procuring agency that the contract will ultimately comply with the requirements of this section.[104]

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[103] 13 CFR sec. 124.314(a)(1).

[104] 13 CFR Sec. 124.314(d)(1).

As discussed below, this regulation is designed, presumably, to ensure that the 8(a) firm develops necessary infrastructure and expertise, and to prevent 8(a) firms from being mere "pass-throughs" for an agency seeking to retain services without having to comply with federal procurement regulations.

Based upon interviews conducted by Subcommittee staff, it appears that Treasury procurement does not monitor the subcontracting percentage by the 8(a) firms it utilizes, and in fact relies upon the particular 8(a) contractor and the SBA to ensure compliance with contractual and regulatory provision. Furthermore, in the case of the CDFI Fund, the SBA was never notified that either Kevric or NAMS was utilizing subcontractors, despite provisions in the contracts requiring the 8(a) firms to notify SBA of use of the subcontractors.[105]

3. The Department relies upon a questionable open-ended interpretation of 8(a) regulations to permit subcontractors to provide over 50 percent of the work performed by 8(a) firms

a. The Department implicitly concedes subcontractors were hand-picked by CDFI Fund officials

On February 20, 1998, the Subcommittee requested that the Department indicate what percentage of the work provided to the CDFI Fund was performed by the 8(a) firm employees. In a response received from the Department on May 7, 1998, Linda Robertson, Treasury Assistant Secretary for Legislative Affairs and Public Liaison, revealed that subcontractors provided well over half of the actual work provided by the 8(a) firms: "[U]nder the Kevric contract, 30 percent of the work, measured by invoice

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[105] Contract administration documents provided by the SBA suggest that SBA officials approved the contract with NAMS without obtaining the required agreement from the 8(a) firm to provide the required percentage of work. *See* Exhibit 16 (SBA 8(a) Contract Legal Review for NAMS contract, March 14, 1997).

amounts, was performed by the contractor and 70 percent by subcontractors. Under the NAMS contract, the corresponding percentages were 27 percent and 73 percent."[106]

In its response, the Department argued that it is permissible for subcontractors to the 8(a) firms to provide 70 percent of the work for the CDFI Fund under the SBA's 50 percent rule, citing a definition of "subcontracting" contained in the SBA regulations that it asserts excludes from the 50 percent rule any services provided by "government-directed" subcontractors.:

> SBA advises that under its regulations, the cost of Government-directed sources (including consultants) is excluded in applying the limitations relating to the percentage of work that may be performed by subcontractors. *See* 13 CFR sec. 1125.6(b)(7). Applying the prescribed SBA methodology, [the Department] has determined that the percentages of personnel costs paid to employees of NAMS and Kevric were 63 percent and 88 percent, respectively. Accordingly, the allocation of work under these contracts was in compliance with SBA regulations.[107]

The SBA regulations cited by the Department (13 CFR sec. 1125.6(b)(7) defines the term "subcontracting" for purposes of the SBA 8(a) program:

> That portion of the contract performed by a firm, other than the concern awarded the contract, under a second contract, purchase order, or agreement for any parts, supplies, components, or subassemblies which are not available off-the-shelf, and which are manufactured in accordance with drawings, specifications, or designs furnished by the contractor, or by the government as a portion of a solicitation. Raw castings, forgings, and moldings are considered as materials, not as subcontracting costs. <u>Where the prime contractor has been directed by the Government to use any specific source for</u> parts, supplies, components subassemblies or <u>services</u>, the costs associated with those purchases will be

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[106] *See* Letter from Linda Robertson, Treasury Assistant Secretary for Legislative Affairs and Public Liaison, to Chairman Spencer Bachus, May 4, 1998.

[107] *Ibid.*

> considered as part of the cost of materials, not subcontracting costs.[108]

The open-ended interpretation of this definition advanced by the Department (reportedly after consultation with the SBA) makes it possible for 8(a) firms to evade the 50 percent subcontracting limitation whenever the Department (or any Federal agency, for that matter) chooses. This interpretation would render the 50 percent rule completely void and essentially transforms the 8(a) program into a mechanism by which the Department can retain highly-paid contractors without regard to the Federal Acquisition Regulations or the purposes and goals of the 8(a) program itself.

It is unclear whether there is legal support for the position that inclusion of the word "services" in the SBA's definition of "subcontracting" was intended, as the Department apparently contends, to essentially abrogate the 50 percent limitation that is otherwise prevalent in the SBA regulations. The context of the definition speaks in terms of "parts, supplies, components . . . which are not available off-the-shelf," thus suggesting that the term "services" was included in the definition in order to address circumstances where expertise from a particular source is needed to service such non-off-the-shelf supplies. The definition does not explicitly suggest that it is permissible for the government to "direct" that particular service providers be used under a services-only contract. The Congressional Research Service was unable to provide any material (in the form of background explanation published in conjunction with the regulations, legislative history, caselaw, or otherwise) that would explain the purpose of this "subcontracting" definition or how it interacts with the 50 percent limitation generally.

However, the purpose of the 50 percent rule is clear, and the Department's open-ended interpretation is difficult to reconcile with the Congressional intent in enacting it, as construed in at least one administrative decision. *Sonicraft, Inc. v. Defense Information*

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[108] 13 CFR 125.6(b)(7) (emphasis added).

Systems, a 1992 GSA Board of Contract Appeals decision, offers the following analysis of the statutory purpose behind the SBA 50 percent rule:

> During the course of the legislative deliberation on this law, as it relates to the 50% Rule, Congress was concerned with the "SBA's failure to require that the prime contractor, under a set-aside contract, perform a specific proportion of the work in-house, with its own personnel." See H.R. Rep. No. 99-718, 99th Cong., 2d Sess. 257 (1986). As this legislative history clearly indicates, the 50% level of effort was created "to resolve the question of excessive subcontracting and analysis of whether a joint venture exists." Id. Congress recognized that the participation of legitimate small businesses in federal procurements "is thwarted when set-aside awardees are permitted to function effectively as brokers by disbursing substantial portions of work – in clear excess of normal industry practices – to a host of subcontractors." Id.[109]

The case also notes that a 1987 conference report addressing the 50 percent limitation advanced the following purpose for the rule: "[T]he limitation was imposed to prevent the mere 'brokering' of set-aside contracts with actual performance being undertaken by 'other than small firms,' and to assure that set-aside contracts will afford effective opportunities to sharpen the business management skills of the awardees through actual performance."[110]

Despite taking over 11 weeks to submit its response to the Subcommittee's request for the subcontracting percentage, the Department failed to offer any explanation for the decision to direct that specific subcontractors be used. For instance, Ms. Robertson advanced no business justification for:

(1) the Department's decision to "direct" the 8(a) firms to retain specific subcontractors (at least 18 of whom were friends or acquaintances of the Director)

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109 *Sonicraft, Inc. v. Defense Information Systems*, GSBCA No. 11750-P (May 15, 1992) at 73.

110 *Id*. at 76, citing H.R. Conf. Rep. No. 100-446, 100th Cong., 1st Sess. 662 (1987).

to provide application review services for the first and second rounds of CDFI Fund awards;

(2) the Department's decision to direct the 8(a) firms to use pre-selected "management" consultants for extended periods of time and at exorbitant rates; or

(3) the Department's use of the 8(a) program in the first instance, one consequence of which was to require the Department to pay as much as an 18 percent markup on work overwhelmingly performed by subcontractors selected and supervised by CDFI Fund officials.

Moreover, Ms. Robertson's response evinces no concern on the Department's part concerning these questionable contracting practices, other than to note that the Department will review the matter once the Treasury Inspector General completes an audit.

b. The Department's admission that it pre-selected 8(a) subcontractors is confirmed by Fund employees

By relying upon the artificial percentages calculated above to bring its contracting practices into compliance with SBA regulations, Treasury has implicitly conceded that it "directed" the 8(a) firm to use subcontractors pre-selected by CDFI Fund officials to perform the overwhelming majority of the work. The Department's admission that it hand-picked subcontractors on a *de facto* sole source basis is confirmed by Fund and Department officials.

In interviews with Subcommittee staff, Mr. Rohde described the selection of contractors for the first round. Beginning in December 1995, he said, the CDFI Fund sought to identify persons with particular expertise on financial institutions who did not have conflicts of interest vis-à-vis potential applicants for funding. Mr. Rohde stated that

the contractor reviewer candidates were selected through “word of mouth”; there was no time to advertise. Mr. Rohde noted that Ms. Andrews recommended candidates as well. Mr. Rohde stated that he and Director Moy conducted detailed interviews of the candidates. Through these conversations, he and Ms. Moy selected reviewers who agreed to take the “private sector approach.” The CDFI Fund referred the candidates to the Treasury procurement office to work out contracts. Mr. Rohde stated that he considered conflict of interest issues and only disqualified candidates if the person had a “current portfolio” with an applicant. Through this process, seven reviewers were retained.

A similar process was used for the second round of funding in 1997. Mr. Rohde stated that for the second round, a “core” group of reviewers were selected to help identify other reviewers for the first stage of the second round. The core group consisted of Ms. Moy, Mr. Rohde, and three consultants, Ms. Andrews, Ms. Klein, and Christine Ricco. Short phone interviews were held with other reviewers, and Ms. Moy made the final selections with input from members of the core group. The 8(a) contractor being utilized for the second round, NAMS, also recommended some additional reviewers, but Mr. Rohde did not think any of these were selected. The reviewers became subcontractors of NAMS.

Mr. Rohde stated that he was told that the use of 8(a) firms was “the way to do it.” Mr. Rohde stated that the “whole purpose” for using the 8(a) firms was to “hold over” the same reviewers hired to assist with the first round of grants. Mr. Rohde acknowledged that the 8(a) firms were “adding cost without adding anything” to the process. He stated that Ms. Moy wanted to continue to use Ms. Andrews for administrative services beyond the completion of the first round.

Mr. Morgan confirmed this account of the CDFI Fund’s practices. He stated that for the second round, NAMS conducted a nation-wide search for reviewers. He noted, however, that Ms. Moy asked staff and consultants to come up with a list of names that he was then instructed to submit to NAMS. He was unaware of the arrangements between

NAMS and the subcontractors, but stated that in the second round of funding, CDFI Fund consultants Nancy Andrews and Joyce Klein coordinated the activities of the outside consultants retained to conduct the first stage evaluation. He also stated that it was safe to say that the reviewers for the second round were not on staff at NAMS.

Ms. Smith, the Contracting Officer, stated that she was not involved in selecting subcontractors retained by NAMS, although she does remember that Nancy Andrews and Joyce Klein were carried over from the Kevric contract to the subsequent NAMS contract.

4. Both the percentage of work performed by 8(a) firm employees and the structure of the contracts indicates that the 8(a) firms functioned as mere "pass-throughs" for the purpose of retaining pre-selected consultants

a. By using undefined contracts, the Department received maximum flexibility in use of 8(a) firms

The failure of 8(a) firm employees to provide 50 percent of the services under the underlying contracts with the Department is not the only indication that the 8(a) firms were being utilized to avoid acquisition regulations. As discussed previously, the "base" contract with the 8(a) firms called for the performance of undefined "management" services, thus imposing few restrictions upon the Department's use of the firms. This is demonstrated by Ms. Smith's acknowledgment that she did not know that the CDFI Fund expected to obtain application review services from Kevric at the time the Department entered into the base contract. When asked how the Department could judge the capability of a particular 8(a) firm such as Kevric to provide specific services such as application evaluation services, Ms. Smith stated only that general discussions were held, and that under Treasury procurement practice, the program office (in this case, the CDFI Fund) is permitted to review a specific proposal and determine if it is acceptable.

The fact that these contracts were "cost plus fixed fee" arrangements provided additional flexibility to the Department. However, an official with extensive procurement experience who was informally consulted by Subcommittee staff noted that such arrangements create significant procurement risk and are therefore usually discouraged. It is unclear why the circumstances facing the CDFI Fund justified subjecting the taxpayer funds within its control to this risk.

b. Under specific task orders, subcontractors provided far more than 70 percent of the work

As noted, the Treasury Department acknowledges that Kevric employees provided only 30 percent of the services; a similar amount was provided by NAMS employees under all its task orders. An overall percentage was not requested for Metrica, but under its task order for CDFI review services, Metrica employees performed only 11.9 percent of the tasks.

Since the base contracts with the 8(a) firms speak only in terms of undefined management services and appear to function simply as a general umbrella arrangement between the Department and the firms, particular task orders were generated by the CDFI Fund (and other Departmental offices) to specify the work to be completed. Thus, a more accurate picture of the use of subcontractors is provided by examining the task orders.

Although the 8(a) firm employees performed approximately 30 percent of the overall services provided to the Department, the majority of this work came on task orders that were unrelated to the bulk of the work for the CDFI Fund. As a result, most task orders show an overwhelming amount of the work being performed by subcontractors.

For instance, it appears that the bulk of the work performed by Kevric employees for the Department occurred under a single task order in which Kevric billed the

Department over $110,000 for a "Report on the Future of the Financial Services Industry" that was completed in February 1997 (and presumably did not relate to the CDFI Fund). No subcontractors participated in this delivery order. However, under most other CDFI Fund task orders, subcontractors provided well over 90 percent of the services. These include task orders for the following CDFI Fund projects: second round Microenterprise Evaluations (Employees: $551; Subs: $66,200); Microenterprise Evaluation (Employees: $6,982; Subs: $56,220); second round CDFI evaluations (Employees: $186,805; Subs: $301,582); BEA Financial Analysis Services (Employees: $0; Subs: $2,990); Application Evaluation (BEA) (Employees: $0; Subs: $17,765.63); Financial Analysis Services (BEA) (Employees: $4,078; Subs: $37,567.50). Kevric received a 5 percent markup on work performed by subcontractors.

A similar pattern emerges for CDFI task orders with NAMS. Under one task order for "Conference Management Support," NAMS billed the Department $126,317 for services provided exclusively by NAMS employees. However, the balance of the task orders concerning evaluation and management services for the Fund reflect an almost exclusive reliance upon subcontractors: 1997 Organization and Management Task Orders (CDFI related) (Employees: $13,353; Subs: $155,917.09); Review of CDFI Program for FY97 (Employees: $77,935.77; Subs: $188,215); Evaluation of Applications (Employee: $164,054.43; Subs: $412,336); BEA services (Employees: $3068; Subs: $60,412); Database Programming (Employee: $5,089; Subs: $17,559; Consultants: $75,835). NAMS received an 18 percent markup on work performed by subcontractors (on one task order alone, this amounted to over $116,000).

This pattern also appears to have held true with Metrica, the initial 8(a) firm utilized by the Fund. For CDFI evaluations, Metrica employees provided $1,240.98 in services, while consultants billed $83,615. Metrica received over a 9 percent markup.

c. The salary scale reflects the predominant role of subcontractors

The predominant role of the subcontractors -- and the "pass-through" nature of the 8(a) firms' participation -- are revealed in other ways. First, due to the fact that the Fund essentially pre-selected the subcontractors for retention by the 8(a) firms, it is not surprising that many of the same subcontractors were used regardless of the 8(a) firm utilized. For instance, Ms. Andrews was retained under a series of arrangements with Metrica, Kevric and NAMS.

Second, the subcontractors were often paid at far higher rates than senior staff at the 8(a) firm itself, suggesting that the key work was to be provided by the subcontractors. In one notable example, the NAMS program director (who in theory supervised the subcontractors) was paid at a rate of $45.50 per hour while Ms. Andrews's hourly rate was $125.

Finally, the subcontractors themselves appear to have played a role in selection of the 8(a) firms. Ms. Smith told Subcommittee staff that the CDFI Fund switched from Kevric to NAMS because of disenchantment by the subcontractors with Kevric over purportedly delinquent fee payments.

C. Pervasive Use of Outside Consultants Raises Questions concerning Contractor Performance of Inherently Governmental Functions

Office of Personnel Management rules prohibit outside consultants from performing inherently governmental functions, which are described as activities that require either the exercise of discretion in applying Governmental authority, or the making of value judgments in performing services for the Government.[111] The CDFI Fund's excessive use of contractors raises questions as to whether this regulatory proscription was violated.

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[111] 48 CFR 7 sec. 501.

Documented evidence indicates that outside consultants played prominent roles in administration of the CDFI Fund. Ernst & Young documents indicate that Ms. Andrews was involved in "emergency" meetings to discuss responses to congressional inquiries; Ms. Andrews also appears to have been a primary point of contact for outside consultants, and to have participated in selecting other contractors (see discussion below).

The extensive reliance upon outside consultants may have created internal morale problems as well. Mr. Bard, an outside consultant retained under a small purchase contract, stated that one CDFI Fund official informally asked for his advice after being ordered by an outside consultant to perform menial tasks. Mr. Bard viewed it as highly inappropriate for a consultant to give orders to a federal official. This episode and others prompted Mr. Bard to author a memorandum to Mr. Morgan about the CDFI Fund's extensive use of outside consultants to do substantive policy work.[112] In interviews with Subcommittee staff, Mr. Bard indicated that his concern focused upon the role of outside consultants in developing policy manuals; he considered it inappropriate for temporary consultants to set policy. Mr. Bard also stated that he observed Director Moy relying more heavily upon outside consultants, particularly Ms. Andrews and Ernst & Young, than agency staff, whom he considered highly qualified. He noted that he had never seen this level of involvement in decision making by outside consultants in his 28-plus years of government experience.

The management consultants provided many of the services that would otherwise have been performed by a CFO and an awards administrator. The CDFI Fund did not retain a permanent CFO until November, 1997. It was not until January 1998 that the CDFI Fund retained a permanent awards administrator, who is reportedly conducting a ground-up review of the existing awards procedures.

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[112] *See* Exhibit 17 (memorandum from Don Bard to Bruce Morgan, August 14, 1997).

D. Ernst & Young Was Selected on a De Facto Sole Source Basis

1. Ernst & Young appears to have been retained without a meaningful consideration of its experience with federal grant programs

In the fall of 1996, the CDFI Fund retained Ernst & Young to provide business consulting services to the agency. Ernst & Young conducted an extensive review of the first round for the purpose of determining what procedures had been utilized. After consulting with other agencies, Ernst & Young made recommendations concerning new grant procedures. In addition, it developed a draft "modified" numeric scoring system and made other recommendations.[113]

The Ernst & Young contract was administered directly by the CDFI Fund under a schedule contract that had previously been negotiated between the General Services Administration ("GSA") and Ernst & Young. The schedule contract between GSA and Ernst & Young lists over 130 contractors eligible to provide expertise concerning "quality management theory and practice." The GSA schedule indicates that agencies using firms retained under the schedule "need NOT worry about seeking further competition, synopsizing requirements, making determinations of fair and reasonable pricing, or considering small business set asides." GSA officials informed Subcommittee staff that under the schedule, the CDFI Fund was responsible for selecting the particular contractor and determining if the contractor was appropriate for the task. The CDFI Fund paid Ernst & Young out of Treasury Department funds. As a result of Ernst & Young's inclusion on the GSA schedule, the CDFI Fund retained the firm on a *de facto* "sole source" basis.[114]

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113 *See* Exhibit 18 (Ernst & Young Observations and Recommendations for CDFI Program Financial and Management Internal Control Assistance Project, March 14, 1997).

114 *See* Exhibit 19 (handwritten note referring to "sole source" opportunity at CDFI Fund).

Bruce Morgan helped administer the Ernst & Young contract.[115] When asked who recommended Ernst & Young, Mr. Morgan recalled a meeting in which the Fund's need for accounting services was discussed. Ms. Andrews, who was in the meeting and had worked with Ernst & Young at HUD, recommended to Ms. Moy that Ernst & Young be retained. Ms. Moy instructed Mr. Morgan to retain Ernst & Young; he stated that to his knowledge no other provider was considered. The CDFI Fund later expanded the scope of Ernst & Young's assignment to encompass grant procedures.

When asked whether Ernst & Young had previous experience with federal grant programs, Mr. Morgan stated that he did not think so because it became apparent to him during the course of its work at the CDFI Fund that Ernst & Young was learning "on the job." Mr. Morgan stated that during conversations with representatives of other federal agencies, he was informed that Ernst & Young was contacting them concerning proper grant procedures.

Mr. Lobel confirmed that as part of its "best practices" inquiry, Ernst & Young contacted other federal agencies to obtain information relating to grant procedures. Mr. Lobel acknowledged that he had no federal grant program experience prior to the work on the CDFI Fund engagement, although he concurrently began work on a Center for Disease Control grant program. He pointed out that Ernst & Young as a firm has extensive expertise in many areas, including grants, and noted that Rachel Lahrim, an Ernst & Young employee working on the CDFI Fund matter, may have done previous work on grants subject to OMB A-133 guidelines.

Ernst & Young coordinated its work with Don Bard, a consultant with over 25 years experience working on federal grant programs. When asked for his personal

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[115] Mr. Morgan stated that he was initially responsible for processing invoices from Ernst & Young. However, he indicated that as time wore on, the Director began to discuss projects directly with Ernst & Young, sometimes from outside the office. Mr. Morgan stated that when he began to receive invoices for work that he had not played a role in authorizing, he became uncomfortable and began to limit his role in the administration of the contract. In interviews with Subcommittee staff, Ron Lobel, the Ernst & Young

assessment of Ernst & Young's competence, Mr. Bard stated that the Ernst & Young personnel appeared to be trying to do a good job but seemed to be hampered by a lack of experience with federal grant programs. Mr. Bard stated that he provided names of friends and associates at other federal agencies for Ernst & Young personnel to contact to gain information on proper federal grant procedure. He stopped making these referrals after getting complaints from former associates about phone calls from Ernst & Young.

2. Certain documents raise questions as to whether Ernst & Young involved itself in political matters

Documents obtained by the Subcommittee raise questions about whether Ernst & Young became embroiled in efforts to perform "damage control" relating to the CDFI Fund's first round of awards.

One example is a March 25, 1997 memo to Nancy Andrews from Mr. Lobel, to which Mr. Lobel attached a Department of Commerce Inspector General Report critical of a Commerce Department program that had failed to document adequately its activities.[116] Mr. Lobel warned Ms. Andrews that "[t]his is the kind of report we want to avoid at CDFI with respect to the first round awards." When asked why Ernst & Young would need to "avoid" anything concerning the first round awards since the firm was retained to advise on second round procedures, Mr. Lobel stated that he felt that it was his responsibility to stress to Director Moy that documentation be completed as a matter of good practice, and this could be an "area of exposure" that the Treasury Inspector General could criticize.

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principal who headed up the firm's CDFI Fund project, indicated that Ernst & Young's primary contact varied over time among various CDFI officials and contractors.

[116] *See* Exhibit 20 (first and last page from Ernst & Young interview memorandum concerning Steve Rohde, December 13, 1996).

In a draft memorandum memorializing an interview of Mr. Rohde,[117] Ernst & Young referenced certain deficiencies in the first round, including the failure to complete evaluation memoranda for the Shorebank-related award winners. The memo reflects that Mr. Rohde asked Ernst & Young personnel whether these evaluation memoranda should be "back dated" (Ernst & Young's answer to this question, if any, is unrecorded), and Mr. Rohde is quoted as denigrating the notion of a scoring system: "Would be a lot of baloney if they put a scoring system in place. They would probably manipulate it to make end result whoever they want to receive awards." In a handwritten note, Mr. Lobel wrote: "Nicole – I would like to 'tone' down a bit, mark draft and have Steve and Valerie look at to confirm our understanding – Ron." When asked why there was any need to tone down the internal memorandum, Mr. Lobel stated that he probably meant to omit colloquial and imprecise terms, and felt that words like "baloney" need not be included in the internal memo, which was not intended to be a verbatim transcript.

Internal Ernst & Young documents also indicate that firm personnel were involved in helping Fund officials prepare for Congressional inquiries. One document reflects notes from an "emergency phone call"[118] on April 16, 1997, in which Mr. Lobel, two Ernst & Young employees, Ms. Jacokes and outside consultant Nancy Andrews discussed how to prepare for the impending Subcommittee staff review of CDFI documents. Mr. Lobel could recall only that Ms. Jacokes was responsible for the response to Congress, and that because she was not heavily involved in administering the CDFI Fund grant process, Ernst & Young was consulted.

Ernst & Young services were also tapped in the Fund's frantic effort to prepare documentation for the Subcommittee staff visit on April 18, 1997. On April 17, 1997, the eve of the Subcommittee's initial review of the files, Ernst & Young updated an earlier version of a file matrix that revealed that the evaluation memoranda for the Shorebank-

[117] *See* Exhibit 21 (memorandum from Ron Lobel to Nancy Andrews, March 25, 1997).

[118] *See* Exhibit 22 (handwritten notes regarding "emergency phone call," April 16, 1997).

related entities were not in the files. This matrix was dated April 17th but not faxed until the 18th.[119]

Mr. Lobel stated that he was told that Ms. Jacokes called Nicole Tassinari of Ernst & Young and told her that the Fund was trying to complete its files and wanted Ernst & Young to update the matrix (to reflect that evaluation memos on the Shorebank-related entities had been prepared and added to the master file). Ms. Tassinari faxed an updated matrix on the evening of the 17th; another was faxed on the morning of the 18th. Mr. Lobel stated that Ms. Tassinari apparently inadvertently failed to change the date from the 17th to the 18th on the version faxed on the 18th. Later, a third version of the matrix was transmitted on the 18th. Mr. Lobel stated that no one from Ernst & Young reviewed the documents in the files at that time to confirm the accuracy of the information in the revised matrix, although an Ernst & Young representative did check the files several weeks later. An attorney for Ernst & Young stressed that the matrix was prepared at the request of the CDFI Fund (Ernst & Young is not listed on the matrix), and thus does not represent an assertion or attestation by Ernst & Young concerning the contents of the files.

VII. Subcommittee Review of Second Round

A. The Treasury Department Took Certain Corrective Actions to Remedy First Round Deficiencies

[119] *See* Exhibit 23 (matrices faxed from Nicole Tassinari, Ernst & Young, to Steve Rohde, April 18, 1997).

In their July 15, 1997, letter to Secretary Rubin, Chairman Leach and his fellow Banking Committee members sought assurances that the Treasury Department would act expeditiously to address the irregularities detailed in the Inspector General's Report of Investigation: "Because the OIG's findings on the subject of the undated documents call into question both the truthfulness of the CDFI Fund's prior representations to the Subcommittee and the fundamental integrity with which the Fund appears to be operated, it is critical that the Treasury Department detail the steps it intends to take to restore confidence in the CDFI Fund's grant-making process." Secretary Rubin's August 6, 1997 reply announcing the resignations of Director Moy and Deputy Director Rohde was accompanied by a detailed outline of procedural and organizational reforms to be implemented by the CDFI Fund in its 1997 funding round. These measures included:

- CDFI Program Reviewer Selection Criteria to assess and select among candidates applying to serve as reviewers;
- A Conflict of Interest Policy for CDFI Fund reviewers, a Conflict of Interest Certification, and a formal recusal letter for actual or apparent conflicts of interest;
- A two-day training curriculum for reviewers and team leaders to familiarize them with the process, their roles and the selection criteria;
- An Initial Review Form to provide the reviewer with evaluation tools;
- A Numeric Worksheet to assist the reviewer in capturing the results of analysis in quantitative terms;
- An interview guide for CDFI program reviewers to provide direction and set standards for consistency;
- A group of review team leaders to ensure consistency;
- Summarized versions of financial statements to accompany applications with financial ratio calculations to assist the reviewers;
- A CDFI Core Component Intake, Review and Award Process for 1997 Funding round policy guide; and

- A CDFI Intermediary Component Intake, Review and Award Process for the 1997 funding round policy guide.[120]

B. Staff Observations of Second Round Procedures

The CDFI Fund received 160 applications for the second round. On September 30, 1997, the CDFI Fund announced that it had awarded 48 CDFIs a total of $38.3 million in financial and technical assistance.

Subcommittee staff conducted only a cursory review of second round procedures, and did not examine the process for consistency in selection factors. In general, the second round involved two stages: a first stage evaluation in which a modified scoring system was utilized, and a second stage in which a review team made preliminary recommendations to the Director. The first stage review was conducted by a single reviewer utilizing a modified objective scoring system. The second stage review was conducted by a three member review team, which was not forced to rely upon the scores generated in the first stage. The Director selected the winning applicants based upon the recommendations of the three-person review team. Based upon a review of documents provided by Fund staff, Subcommittee staff concluded that the Fund appeared to make great strides in documenting the grant process.

The following are miscellaneous observations concerning the second round.

1. Second round evaluation memoranda do not reflect a comprehensive commitment to an objective scoring system

120 *See* Letter from Secretary Robert Rubin to Chairman Spencer Bachus, August 6, 1997.

a. The scoring system does not provide greater weight to the most important factors and first stage scores were ignored

Notwithstanding the adoption of a modified objective scoring system, it does not appear that the Fund made a comprehensive commitment to an objective approach to evaluating the applications. One indication of this is the failure of the scoring system to accord greater weight to the most important criteria. For instance, management strength is, according to Mr. Rohde and others, the most significant factor in selecting applicants, yet the scoring system does not give it greater weight than other measures such as track record and community development impact. The lack of commitment to a comprehensive scoring system is further demonstrated by the fact that the numeric results produced in the first stage were ignored by the second stage review panel; thus, those applicants with the top scores during the first stage review were not necessarily selected for funding nor was a justification provided when the second stage panel departed from the numeric results of the first stage.

b. Second round scoring system does not address distinction between start-ups and established firms

A possible consequence of the Fund's failure to make a comprehensive commitment to objective factors is the continued failure of the CDFI Fund to resolve on a practical programmatic basis the extent to which it is targeted to facilitate start-up firms. This is demonstrated by the scoring sheets used during the first stage. Start-ups apparently received equal eligibility for awards as established firms, despite the fact that under the scoring system start-ups received no score for track record.[121] Subjective judgments were thus required to compare the two categories of institutions.

[121] *See* Exhibit 24 (sample scoring sheet).

c. Scoring system does not track contents of the applications

Furthermore, the evaluation sheets note that the applications were evaluated on the basis of five categories that involved: I. Track Record, Financial Strength, etc.; II. Management Team; III. Quality of Business Plan; IV. Community Development Impact; and V. Matching Funds. However, the NOFA for the second round required applicants to provide at least a dozen different types of substantive information in addition to extensive eligibility information. This information includes, among other categories, data concerning financial track record, management capacity, market analysis, coordination strategy, community impact, risk analysis, and community support. Although the analysis of these factors may be subsumed within the five general headings of the scoring system, the evaluation sheets do not indicate that the analysis tracked with any precision the information required in the NOFA.

For instance, Sec. 1805.701 of the NOFA lists management capacity, market analysis, and financial performance as subsections of the comprehensive business plan. The NOFA also contemplates applicants providing information on the background and expertise of their management teams and the names of key personnel. The scoring sheet adopted for the second round, however, lists each of the subsections as independent considerations of equal weight. The management team scoring sheet asks the reviewers to judge the dynamic relationship of management team members, vision, personal commitment and problem-solving abilities.

The failure to track the NOFA raises a concern as to whether firms possessing better information concerning the actual review process could craft an application that more closely corresponded with the review process, thereby achieving an advantage over firms that merely followed the NOFA.

2. Conflict of interest policy was incomplete

The CDFI Fund initiated a much stronger conflict of interest policy for the second round, as reflected in a certification required of outside contractors.[122] The Fund's counsel, Mr. Jones, stated that this new certification prevents outside contractors from reviewing applications if they have within one year served on an advisory board for an applicant (as Ms. Moy had during the first round) or been employed by an applicant (as Mr. Rohde had during the first round). However, Mr. Jones stated that the Fund does not believe that it has the authority to impose a conflicts standard upon federal employees beyond that imposed by regulation; as a result, the certification requirement imposed upon outside consultants was not extended to Fund employees.

3. Decline in quality of applications suggests industry saturation

An interview memorandum prepared by Ernst & Young revealed that Mr. Rohde considered the first round applicant pool to be limited in quality. In his opinion, of the more than 250 applicants reviewed during the first round, the only ones deserving of federal funding were the 31 selected. Mr. Rohde, who was involved in supervising the second round (although to a lesser degree than the first round), stated in Subcommittee interviews that the second round revealed a significant decline in the quality of the applications. He stated that this view was shared by other Fund officials and contractors, including former Director Moy, who had previously expressed concern about the ability of the industry to absorb more funds to the Office of Management and Budget.

Mr. Rohde's observation appears to be borne out by the decision memorandum prepared by Ms. Moy concerning the selection of second round applicants for funding. According to the memorandum, the three-person review panel submitted for consideration by the Director all applicants that received a recommendation from at least one of the three members of the review panel. The Director selected for funding 34 applicants that

[122] *See* Exhibit 25 (Interim Conflict of Interest Policy for CDFI Fund Reviewers, June 20, 1997).

received positive votes from each panelist. Because these 34 awards did not exhaust the available funding, the Director selected eight applicants who had received only one vote, *indicating that a majority of the second stage panel had voted against funding for these institutions*. Even after dipping this far into the applicant pool, the Director still had money remaining and selected, based on geographic diversity, four applicants that received no positive votes from the review panel but had the highest scores of the remaining applicants and had most of their match funding committed. In all, 46 of the 159 institutions that applied were selected for funding.[123]

The CDFI Fund will reportedly spend $20 million on "training and technical assistance" in 1998 to help address management deficiencies in the industry.

C. 1997 Annual Report Identifies Continuing Deficiencies That Were Presumably Present During The Second Round

1. CDFI Fund's FMFIA Report identified significant procedural deficiencies present during FY97

The CDFI Fund published an annual report for 1997 on February 28, 1998. The Report reveals continued deficiencies that were presumably present during the second round, which concluded in September 1997.[124] The following are excerpts from the Fund's own assessment of its procedural deficiencies as required under the Federal Manager's Financial Integrity Act ("FMFIA"). Following each excerpt is a brief description of the corrective action that the Fund proposes to undertake, as described in a March 25, 1998, interview of Maurice Jones, CDFI Fund counsel, and Paul Gentille, CDFI Fund Chief Financial Officer, by Subcommittee staff.

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[123] Awards decision memorandum from Kirsten Moy regarding the Second Round, September 4, 1997.

[124] *See* Exhibit 26 (CDFI Fund Fiscal Year 1997 Annual Report, Exhibit II, February 28, 1998).

1. No formal FMFIA Program in place.

CDFI did not have a formal FMFIA program in place during FY 1997 to evaluate, continuously monitor and improve the effectiveness of management controls associated with CDFI's programs. Therefore, all of the Fund's internal control processes lacked adequate individual program and operating level self-assessment.

According to Messrs. Jones and Gentille, a decision was made late in FY 1997 by senior Treasury Department officials to require the CDFI Fund to implement an independent FMFIA program. In previous years, it was felt that the Fund did not need a separate FMFIA program because it was assumed that it was part of the Departmental Offices. Mr. Jones and Mr. Gentille stated that as of March 1998, uncertainty still exists as to the formal status of the CDFI Fund – whether it is simply part of Departmental Offices, a separate bureau, or a type of hybrid organization. The distinction has important implications beyond the FMFIA requirements. For instance, until mid-FY 1997, the Fund was able to obtain accounting services from within the Departmental offices; at that time, it was determined that the Fund was not entitled to these services and it was ordered to obtain them independently.

2. CFO and Controller positions and functions not established.

Mr. Gentille was appointed as Deputy Director for Management/Chief Financial Officer in November 1997. A staff accountant was hired in January 1998. However, as of March 25, 1998, the Controller position has still not been filled; an interview process had been commenced, however.

3. Awards Administration and Monitoring Positions and functions not established.

The duties of an awards officer normally include serving as the principal procedural authority, advisor and implementer of awards management policies. Key to such a function is the development and coordination of the Fund's awards management program,

> *including the dissemination of procedural and technical advice, guidance and interpretation on CDFI award management activities and requirements, maintenance of award files, as well as sufficient monitoring of the pre- and post-award operations of the Fund. The lack of an awards manager impairs the Fund's ability to carry out the above activities and to monitor CDFI's program performance and compliance activities.*

Mr. Gentille stated that the Fund appointed an Awards officer in January 1998. As of March 25, 1998, the Awards officer was conducting a "ground up" review of the awards program and was in the process of developing a manual that will establish procedures for award selection. The scoring system utilized in the second round will probably be modified, although Mr. Jones and Mr. Gentille were uncertain in what fashion.

> *4. Post Award Monitoring Procedures not established and implemented.*
>
> *The CDFI Fund lacked formalized, documented post-award monitoring procedures and responsibilities during FY 1997. Monitoring procedures provide a means to assess the award recipient's compliance with their assistance agreements and to determine whether corrective actions are necessary or accomplished in an efficient and timely manner, and a methodology to aid the CDFI Fund in meeting its goals and objectives. Performance award monitoring procedures normally include, among other things, ensuring periodic financial and performance reports required to be submitted by the awardee are received by the Fund, reviewed, and acted upon accordingly. Monitoring procedures can also include site visits, and ensuring performance objectives are being achieved and the awardee's reporting requirements are being met.*

Mr. Gentille stated that, as of March 25, 1998, the new awards officer was in the process of designing an "integrated" system to monitor awards.

> *5. No formal review of monthly financial statements and accounting records or completion of supporting reconciliations.*
>
> *6. Inadequate Delineation of Organizational Responsibilities.*

During FY 1997 there was insufficient delineation of organization responsibilities within the Fund. In general, position descriptions were not adequately adhered to and/or do not adequately define the responsibilities of specific positions. The Fund has been understaffed since its inception in a number of key positions. In addition, there are no established procedures for periodically evaluating employee's performance against established performance criteria and goals. This combination of conditions resulted in instances of incompatible duties, lack of accountability, and ambiguous job responsibilities.

Mr. Gentille stated that as of March 25, 1998, he was still reviewing the organizational structure.

7. Program Award Files not completed.

During FY 1997, the CDFI Fund award files lacked a structured file order format and were not reviewed for completeness. A consistent and structured format is critical in order to have strong controls over the award process and overall monitoring of awards.

Mr. Gentille stated that the new awards officer was in the process of developing a system that will create a structured format for maintaining application files and other materials. This system had not been implemented as of March 25, 1998, however.

2. Outside auditors found similar deficiencies

As reported in the 1997 Annual Report, an outside auditing firm, KPMG Peat Marwick, found similar deficiencies, including the following:

- Absence of a formal Federal Managers' Financial Integrity Act (FMFIA) program to identify and design corrective actions for material weaknesses;
- Lack of a structured system of documentation for award files;

- Vacant positions for oversight of awards programs;
- Lack of formal post-awards monitoring procedures;
- No formal review of monthly financial statements, accounting records, budgetary reports, and supporting reconciliations;
- Vacant positions for Chief Financial Officer and Controller;
- Inadequate delineation of organizational responsibilities within the CDFI Fund; and a
- General lack of documented policies and procedures.

Peat Marwick's report noted that it had tested controls over financial reporting and satisfied itself that for FY97, "amounts reported in financial statements were materially correct." Peat Marwick provided the following note of caution:

> However, we believe immediate and continual attention must be placed on corrective action necessary to eliminate the material weaknesses noted above. Failure to do so, along with the expected increase in financial activity of the CDFI Fund over the next several years, could result in material misstatements in the financial statements and/or material noncompliance with laws and regulations that could have a direct and material effect on the financial statements.

D. Second Round also Characterized by Slow Disbursement of Awards

As with the first round, there appears to be a significant time gap between the announcement of awards and the actual disbursement of those awards to communities. As of May 6, 1998, the CDFI Fund had disbursed only $3.35 million, or 8.8 percent, of the $38.3 million awarded in September 1997.

E. Inspector General's Office Of Evaluations Noted Lack Of Support For CDFI Fund By Treasury Department

The Treasury Department has also been criticized by its Office of Inspector General for failure to provide adequate support to the CDFI Fund.[125] In a January 1998 report by its Office of Evaluations, the Inspector General determined that the Treasury Department failed to provide a consistent team to oversee implementation of the CDFI Fund program, resulting in confusion concerning placement of the agency within the Department, the failure to perform a comprehensive written needs assessment, and the failure to provide critical accounting and procurement services.

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125 *See* Exhibit 27 (CDFI Fund excerpts from Report of Office of Evaluations, Treasury Office of Inspector General concerning Treasury support for High-priority Projects and Special Endeavors, January 1998).