

**Creative Investment Research, Inc.**

*William Michael Cunningham*

*Social Investing Adviser*

1411 K Street, NW

Suite 1400

Washington, DC 20005

Voicemail/Fax: 866-867-3795

*Statement of William Michael Cunningham*

*Submitted to the*

**Subcommittee on Select Revenue Measures of the Committee  
on Ways and Means and the Subcommittee on Domestic  
Monetary Policy and Technology of the Financial Services  
Committee of the Financial Services Committee.**

Thursday, June 18, 2009

Chairman Watt, Chairman Neal, Ranking Member Paul, Ranking Member Tiberi,

Thank you for the opportunity to participate in this important hearing. I am testifying with respect to the CDFI Fund and the New Markets Tax Credit (NMTC) program. These documents are presented so that you can fully explore the record the CDFI Fund with respect to our firm, an African American CDE.

NMTC program impact data compiled by the U.S. General Accounting Office<sup>1</sup> shows the program can work better: low-income persons and low income communities have yet to benefit. Another GAO report<sup>2</sup> on the NMTC program noted that:

“..we infer that the most likely effect of the credit is that corporate investors, which make the majority of investments..are shifting investment into low-income communities from higher income communities.”

A third GAO report<sup>3</sup>, the focal point of this hearing, showed that the probability of receiving a NMTC award decreases if the CDE applying for NMTCs is minority owned or controlled. The study proves that, from 2005 through 2008, minority-owned and controlled CDE's had a lower probability of NMTC Program success. We concur with GAO's findings and, in Appendix A, review the statistical techniques used. We believe the study suggests that the NMTC Program can be improved.

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<sup>1</sup> *New Markets Tax Credit. Progress Made in Implementation, but Further Action Needed to Monitor Compliance.* GAO Report Number GAO-04-326. January, 2004.

<sup>2</sup> *New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance.* GAO Report Number GAO-07-296. January, 2007.

<sup>3</sup> *New Markets Tax Credit Program: Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities,* GAO-09-536, Washington, D.C.: April 30, 2009.

## **Experience with the CDFI program<sup>4</sup>**

Creative Investment Research, Inc., has applied for CDFI funding during several rounds:

- In 1998, we applied to the CDFI Fund for financing to create an on-line, internet based facility for financing women and minority owned businesses, [www.minorityfinance.com](http://www.minorityfinance.com). The application was not funded.
- In 1999, we applied for CDFI Fund funding to create a minority mortgage initiative. The application was not funded.

## **Experience with the NMTC program**

Creative Investment Research, Inc. has applied for NMTC funding during several rounds. Our applications have ranged in size from \$2 million to \$200 million:

- In 2002, we applied, in conjunction with the National Monetary Fund (a minority-owned venture capital firm located in Oakland, California) for \$200 million in NMTC funding to create a venture capital fund targeting minority and low income communities. The application was not funded.
- In 2003, we applied for \$2 million in NMTC funding to purchase and renovate a vacant commercial office building located in the Minneapolis Empowerment Zone. The application was not funded.
- In 2004, Creative Investment Research, Inc. partnered with the City of Minneapolis to submit a NMTC application. The application sought \$120 million in community development funding:

Low income community outreach and input efforts were to be managed by the Hennepin County-funded African American Men Project (AAMP). AAMP specifically focuses on underserved area partners lacking access to conventional sources of capital. We planned to use city and county funds to increase the reach and impact of their efforts.

Legal services were to be provided by Halleland Lewis Nilan Sipkins & Johnson, a Minneapolis firm with exceptional legal expertise.

Capital – both debt and equity - was to be provided by Piper Jaffray Public Finance, a world class investment bank headquartered in Minneapolis. Piper

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<sup>4</sup> Appendix B provides general background information on William Michael Cunningham and Creative Investment Research, Inc.

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provided a ***letter of commitment*** for \$120 million. Secondary letters of interest were received from Pax World Funds, a socially responsible mutual fund company, Wells Fargo Bank, and from U.S. Bank, a financial services holding company with \$1.4 billion in tax credit investments.

Commercial real estate development and management tasks were to be carried out by the Ryan Companies, a Minneapolis based commercial real estate development and construction firm with over 65 years of experience, serving customers in more than 150 cities.

Loan administration and servicing were to be provided by Franklin Bank, an urban community development bank in Minneapolis.

NMTC compliance and auditing services were to be provided by Novogradic and Company, LLP, a national certified public accounting and consulting firm with eight offices nationwide.

Input from a wide variety of community based entities and groups would have been made part of our process. Some of these groups are listed below:

- 1) The Minneapolis Lifesciences Corridor
- 2) The West Broadway Business Association
- 3) Women Venture - national leader in technical assistance for women owned companies.
- 4) The Minneapolis Urban League
- 5) Project for Pride in Living
- 6) The Minneapolis Chapter of the NAACP
- 7) Neighborhood Development Center, Inc.
- 8) The Elliot Park, Ventura Village, Phillips West, and Midtown Phillips Neighborhood Associations
- 9) The Minneapolis Farmers Market Annex
- 10) Roosevelt High School
- 11) The University of St. Thomas
- 12) Hennepin County Medical Center
- 13) and others.

All projects in the application were high social impact real estate properties located in or near the Minneapolis Empowerment Zone. The application was not funded.

- In 2008, we applied for NMTC funding to invest in minority and community development banks. The application sought \$50 million in community development funding:

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We partnered with The Williams Group, to create a limited partnership, MBF, LP, whose mission is to make investments in minority-owned banks. MBF's three person management team is comprised of:

Elrick Williams is Founder, Chairman & CEO of Allston Trading LLC, a firm specializing in algorithmic electronic trading of stocks, Treasury bonds, currencies, futures and options, generating revenues of \$150 million annually. From 1981-1991 and from 1999 to the present, Mr. Williams was/is a member of the Chicago Mercantile Exchange. He graduated from the Harvard Business School, with a concentration in Finance. He holds a BA Chemistry from Williams College.

Mr. Glenn Harvey, formerly, President and Chief Operating Officer of Broadway Federal Bank. Prior to joining Broadway Federal in 2006, Mr. Harvey was a senior vice president with Comerica Bank-California, Entertainment Group Division. Mr. Harvey received an undergraduate degree from UC Berkeley and a Masters in Business Administration and Juris Doctor from UCLA.

William Michael Cunningham. Mr. Cunningham holds a Masters degree in Economics and an MBA in Finance, both from the University of Chicago. He holds an undergraduate degree in Economics from Howard University. In July, 2004, he completed the Community Development Lending School Program and Course, sponsored by the Federal Reserve Bank of San Francisco. He is a member of the CFA Institute, formerly the Association for Investment Management and Research (AIMR) and of the Twin Cities Society of Security Analysts.

The application was not funded.

- In 2009, we applied for \$50 million in NMTC funding to invest in minority and community development banks. As of the date of this hearing, the application has not been reviewed.

We believe that low income persons and areas designated for NMTC assistance can be helped by the program's efforts and funding. According to a report on the NMTC program issued on January 30, 2004 by the General Accounting Office,

*"Although Congress authorized the NMTC program to provide credit against federal taxes for billions of dollars starting in 2001 to spur investments in community development projects, CDFI Fund officials said that it is unlikely that many projects had started by the end of 2003 and that they will not know the status of projects for all Community Development Entities (CDEs) until early 2005."*

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In fact, much of the program's monetary assistance has gone to a few favored applicants, a few investment banks (including Bear Stearns and Goldman Sachs), and a few professional service firms (real estate developers, accountants, lawyers, and consulting firms).

We suggest the Committee request details concerning all NMTC transactions. This would include reviewing pricing for NMTC transactions. We further suggest you review commission amounts paid to intermediaries, including brokers, lawyers, accountants and consultants. As the 2007 GAO Report noted,

*"A complete evaluation of the (NMTC's) program's effectiveness also requires determining the costs of the program.."*<sup>5</sup>

According to the New Markets Tax Credit Coalition<sup>6</sup>, "Most of the projects (funded by the NMTC program) are for real estate." The program as currently structured allowed real estate developers to develop projects on far more favorable terms than would otherwise be the case. Also according to the Coalition, there has been "little activity in small business lending and venture capital." We contend that this is contrary to low income community needs. In summary, the New Markets Tax Credit program may be operating in a discriminatory and unfair manner.

Even when the program operates in an administratively fair manner, the bulk of the societal and monetary benefits derived from the program are being captured by real estate developers, accountants, lawyers, and consulting firms, not low income community residents.

The program was designed to spur small business lending and venture capital investments in low income communities. It has not done so.

In the alternative, we believe the NMTC program could be modified to operate in a more consistent manner, in keeping with what we believe to be Congressional intent. We suggest that the NMTC program tax credit vary according to the following:

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<sup>5</sup> *New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance.* GAO Report Number GAO-07-296. January, 2007.

<sup>6</sup> *NMTC Reauthorization Working Session.* PowerPoint Presentation. NMTC Coalition Policy Conference. May 12, 2005. Washington Court Hotel.

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1. Ownership of the qualified active low income community business (QALICB) receiving an investment supported by the credits. For smaller, minority or women-owned QALICB's, the tax credit should be higher;
2. Location of the QALICB receiving the investment (income in census tract where firm is located). For QALICB's located in very low income areas, the tax credit should be higher;
3. Nature (debt or equity) of the QALICB investment supported by the credits. The tax credit should be higher for equity investments in QALICBs.

We believe these modifications will make it more likely that low-income persons and low income communities will benefit from the program. Below, in Appendix C, is a table explaining these proposed modifications. Thank you.

<http://www.creativeinvest.com>

<http://www.minorityfinance.com>

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info@creativeinvest.com

**Appendix A: Review of statistical techniques used in *New Markets Tax Credit Program: Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities*, GAO-09-536 (Washington, D.C.: April 30, 2009).**

Hsiu-Jui (Sherry) Chang<sup>7</sup>, and Jui-Kai Li<sup>8</sup>, Interns, Creative Investment Research, Inc. Edited by William Michael Cunningham, Social Investing Adviser, Creative Investment Research, Inc.

Through New Market Tax Credit (NMTC) Program, investors claim a tax credit of 39% in exchange for investing in Community Development Entities (CDEs). CDEs reinvest in low income communities. A GAO study reviewed NMTC program participation by minority-owned or controlled CDEs. The report identifies how many, from 2005 to 2008, minority-owned or controlled and non-minority-owned or controlled CDEs applied for and received NMTCs. Further, the report described the NMTC application process and reviewed scoring for minority and non-minority-owned or controlled CDEs. Finally, the report describes challenges that minority-owned or controlled and non-minority-owned or controlled CDEs have faced. We have a number of concerns with the GAO study, and suggest the following items be addressed.

**1. Model Estimation and Sampling Errors**

The GAO report reviewed NMTC Program award data from the 2005 to 2008 NMTC allocation rounds. The study estimated a model of the probability of NMTC award receipt, based on several factors. The probability of receiving a NMTC Award ( $Pr^{NMTC \text{ Award}}$ ) was calculated as a function of the following factors:

$$Pr^{NMTC \text{ Award}} = [.0026 * \text{CDE Asset Size}] + [-.1520 * \text{CDE minority owned or controlled}] + [.1900 * \text{CDE is a certified CDFI}] + [.0044 * \text{CDE conducts activities in a severely distressed area}] + [.0011 * \text{CDE conducts activities in an urban area}]$$

Thus, statistically speaking, the probability of receiving a NMTC award increases with CDE Asset size, CDE CDFI certification, CDE activities in a severely distressed area, and CDE activities in an urban area. The probability of receiving a NMTC award decreases if the CDE is minority owned or controlled.

The US Department of the Treasury CDFI Fund, administrators and managers of the NMTC Program, did not collect data on the ethnic ownership of CDEs before 2005. The first NMTC awards were issued in 2002. The GAO analysis does not explain how

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<sup>7</sup> Master of Business Administration candidate, August, 2009, Carey Business School, Johns Hopkins University.

<sup>8</sup> Master of Science in Finance candidate, May, 2010, George Washington University.

<http://www.creativeinvest.com>

<http://www.minorityfinance.com>

<http://www.minoritybank.com>

info@creativeinvest.com

sampling error may distort the interpretation of the data. Sampling error occurs when observations are omitted. This limitation may also give rise to a specification error, whereby variables are omitted, or the relationships between the explanatory variables is misspecified.

We reviewed the model selection process, and conclude that a Fixed<sup>9</sup> or Random<sup>10</sup> Effects model and using the Hausman test<sup>11</sup> is appropriate. The test results show there is sufficient evidence to conclude that model estimates are not biased. Small standard errors (the standard deviation of the residuals) implies better prediction of the dependent variable (probability of receiving a NMTC Award) by the independent variables (asset size, minority status, certification as a CDFI, activities in severely distressed and urban areas).

Note that even if the model is reasonable and the small standard errors suggest that this analysis includes all possible variables, sampling error may cause statistical bias.

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<sup>9</sup> The Fixed Effects Model: If we are only interested in generalizing study results, the factors (or variables) GAO included may be appropriate. But we are not trying to generalize to other factors that might have included. In a non-experimental setting, a variable may have a small number of levels. For example, suppose that we selected 10 cities at random and did a survey using cluster sampling. Normally, "city" could be thought of as a factor in the study design, with 10 levels. If we did not want to generalize our results to all of the cities that might have been selected (the 10 cities included could be regarded as a sample drawn from a larger population of cities) -- but only wanted to generalize to the 10 cities included in the survey, then "city" could be treated as a "fixed" effect.

<sup>10</sup> In the case of a fixed factor, we are usually interested in comparing the scores on the dependent variable among the levels of the factor: our interest is in differences between means. In the case of a random factor, we are not really interested in the specific differences from one mean level of a factor to another -- we are interested in the extent to which the random factor accounts for variance in the dependent variable. Rather than being interested in the individual mean levels across the levels of the fixed factor, we are interested in the variance of means across the levels of a random factor.

<sup>11</sup> Given a model and data where fixed effects estimation would be appropriate, a Hausman test determines if a random effects estimation would be as good. In a fixed-effects case, the Hausman test is a test of H0: that random effects would be consistent and efficient, versus H1: that random effects would be inconsistent. (Note that fixed effects would be consistent.) The result of the test is a vector of dimension k (dim(b)) which will be distributed chi-square(k). If the Hausman test statistic is large, one must use a fixed effects model. If the statistic is small, one may use a random effects estimation technique.

See: <http://economics.about.com/>

## 2. **Qualitative factors not considered**

*Page 13: “NMTC applications are first reviewed and scored by a group of external reviewers selected by the CDFI Fund who have demonstrated experience in business, real estate, or community development finance.”*

*Page 25: “Our analysis indicates that these differences are not explained by the size of the CDE—that is, they are not problems shared by other small, non-minority CDEs that applied for NMTC allocations. However, these differences could be associated with some other feature that minority CDEs share with non-minority CDEs for which we do not have data to include in our analysis.”*

The GAO survey focused on quantitative and statistical analysis. We suggest a review of qualitative factors (such as the definitions of the categories analyzed and the scoring process used by “external reviewers”). If a problem exists with these definitions and standards, if they were biased when established, statistical analysis of the evaluation process and the results of that evaluation process is useless. For example, page 24 of the GAO study states that minority CDEs scored 25% lower than non-minority CDEs with respect to capitalization strategy. No information is provided on how reviewers compared the capitalization strategies of minority CDEs versus non-minority CDEs and no clear explanation of the large difference in capitalization strategy scoring was given.

### **Summary**

- The GAO study proves that, from 2005 through 2008, minority-owned and controlled CDE’s had a lower probability of NMTC Program success.
- The statistical evaluation process appears reasonable, but all available data, from 2002 to 2008, should be used.
- Using statistical tools to allocate NTMCs might be insufficient for minority owned or controlled CDEs, given the errors these tools generate. Qualitative factors should be considered.
- We suggest the CDFI Fund review successful minority business development programs. We caution, however, against relying on data from two sources: the US SBA 8(a) Program and minority banking trade associations. The 8(a) Program excludes financial institutions. While the “express mission of minority banks is to promote underbanked, underprivileged communities,” we suggest the CDFI Fund seek independent opinions concerning the effectiveness of minority banks.

<http://www.creativeinvest.com>

<http://www.minorityfinance.com>

<http://www.minoritybank.com>

info@creativeinvest.com

## **Appendix B: Background on William Michael Cunningham and Creative Investment Research, Inc.**

William Michael Cunningham registered with the U.S. Securities and Exchange Commission as an Investment Advisor on February 2, 1990. Mr. Cunningham manages an investment advisory and research firm, Creative Investment Research, Inc. The firm researches and creates socially responsible investments and provides socially responsible investment advisory services.

Mr. Cunningham's understanding of capital markets is based on first hand knowledge obtained in a number of positions at a diverse set of major financial institutions. He served as Senior Investment Analyst for an insurance company. Mr. Cunningham was an Institutional Sales Representative in the Fixed Income and Futures and Options Group for a leading Wall Street firm. Mr. Cunningham also served as Director of Investor Relations for a New York Stock Exchange-traded firm. On November 16, 1995, his firm launched one of the first investment advisor websites. The Community Development Financial Institution Fund of the US Department of the Treasury certified the firm as a Community Development Entity on August 29, 2003. SBA certified our firm as an 8(a) program participant on October 19, 2005. We withdrew from the 8(a) program in December, 2008, having found it completely ineffective.

In a speech given in San Francisco, California before the Greenlining Coalition's First Annual Minority Economic Development Conference on March 5, 1994, Mr. Cunningham called for the creation of tax advantaged community development programs to provide equity capital to women and minority-owned businesses located in low income census tracts.

The firm and Mr. Cunningham have long been concerned with the ability of financial markets to meet the needs of the country:

- On July 9, 1993, Mr. Cunningham wrote an SEC Commissioner to notify the Commission about a certain specific investing "scam." A timely warning was not issued to the investing public.
- On June 18, 1998, Creative Investment Research opposed the application, approved by the Federal Reserve Board on September 23, 1998 and endorsed by the SEC, of Travelers Group Inc. to become a bank holding company by acquiring Citicorp. One Travelers subsidiary, Salomon Smith Barney Inc., (created when Salomon, Inc. merged with Smith Barney) had a history of defrauding investors and operating schemes in restraint of trade. This single fact

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<http://www.minoritybank.com>

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should have rendered the proposed merger potentially injurious to the public welfare and, therefore, prohibited. *It did not.* On April 28, 2003, the merged firm, Citigroup Global Markets Inc., paid fines totaling \$400 million. The firm was found, again, to be defrauding investors and operating schemes in restraint of trade.

- In an October 1998 petition to the United States Court of Appeals, Mr. Cunningham cited evidence that growing financial market malfeasance greatly exacerbated risks in financial markets, reducing the safety and soundness of large financial institutions. He went on to note that:

*"The nature of financial market activities is such that significant dislocations can and do occur quickly, with great force. These dislocations strike across institutional lines. That is, they affect both banks and securities firms. The financial institution regulatory structure is not in place to effectively evaluate these risks, however. Given this, public safety is at risk."*

- On June 15, 2000, Mr. Cunningham testified before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (GSE's) of the US Congress. He suggested that the GSE's (Fannie Mae and Freddie Mac) be subject to a through "Social Audit." A Social Audit is an examination of the performance of an enterprise relative to certain social objectives. It also includes a review of ethical practices at the firm. Had they been subject to this audit, certain flaws in their operation, including ethical shortcomings, may have been revealed earlier and in a better market in which to make corrections.
- On December 22, 2003, statistical models we created using the Fully Adjusted Return® Methodology signaled the probability of system-wide economic and market failure. See page 6:  
<http://www.sec.gov/rules/proposed/s71903/wmccir122203.pdf>
- In 2004 and 2005, we filed FOIA requests with the CDFDI Fund seeking information on the minority identity of CDEs.
- On Monday, April 11, 2005, Mr. Cunningham testified before Judge William H. Pauley III in the U.S. District Court for the Southern District of New York on behalf of investors at a fairness hearing regarding the \$1.4 billion dollar Global Research Analyst Settlement. No other investment advisor testified at the hearing.

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<http://www.minoritybank.com>

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- In 2005, Mr. Cunningham served as an expert witness for homeowners in a case against PMI Group, Credit Suisse First Boston, Moody's, Standard and Poor's, Fairbanks Capital Corporation, Select Portfolio Servicing, US Bank National Association, as Trustee of CSFB ABS Series 2002-HEI, et. al., in the New Jersey Superior Court Law Division - Monmouth County. Our testimony sought to hold corporate parties responsible for facilitating predatory lending practices.
- On February 6, 2006, statistical models we created using the Fully Adjusted Return® Methodology confirmed that system-wide economic and market failure was a growing possibility. See page 2:  
<http://www.sec.gov/rules/proposed/s71005/wcunningham5867.pdf>
- We participated in a Fannie Mae and Federal Reserve seminar on measuring the social impact of banking activities, August 3, 2006:  
<http://www.knowledgeplex.org/showdoc.html?id=188307>
- Also see: <http://www.usnews.com/articles/business/economy/2008/01/28/the-first-bank-failure-of-2008>
- On Sunday, September 28, 2008, we wrote to US Senator Richard Shelby to comment on the financial rescue plan currently under consideration by the US House and the US Senate. In the appendix to that letter, we provided a four step plan for dealing with the crisis. See: <http://www.ethicalmarkets.com/wp-content/uploads/2008/12/financialbailoutcomment1.pdf>

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<http://www.minoritybank.com>

info@creativeinvest.com

**Appendix C:** Proposed New Markets Tax Credit (NMTC) Restructuring

<b>Type of business (QALICB) receiving NMTCs</b>	<b>Location of business (QALICB) receiving NMTC funding</b>	<b>Type of QALICB investment</b>	<b>NMTC (total tax credit to investors)</b>
Minority or women owned firm	Census tract with income levels that are at or lower than 70% of the area median income	Debt	25%
Non-minority owned firm	Census tract with income levels that are at or lower than 70% of the area median income	Debt	15 %
Minority or women owned firm	Census tract with income levels that are at or higher than 70% of the area median income and at or lower than 80% of the area median income	Debt	20 %
Non-minority owned firm	Census tract with income levels that are at or higher than 70% of the area median income and at or lower than 80% of the area median income	Debt	10 %
Minority or women owned firm	Census tract with income levels that are at or lower than 70% of the area median income	Equity	60 %
Non-minority owned firm	Census tract with income levels that are at or lower than 70% of the area median income	Equity	30 %
Minority or women owned firm	Census tract with income levels that are at or higher than 70% of the area median income and at or lower than 80% of the area median income	Equity	50 %
Non-minority owned firm	Census tract with income levels that are at or higher than 70% of the area median income and at or lower than 80% of the area median income	Equity	25 %

*Note: Type of business (QALICB) refers to the qualified active low income community business receiving financing. NMTC refers to total tax credit amounts received by investors over a seven year period.*

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<http://www.minoritybank.com>

info@creativeinvest.com