NORTHERN TRUST
2010 INSTITUTIONAL CLIENT CONFERENCE

Reaching for the **New Gold Standard of Investing**

The Realities of Private Equity and Hedge Fund Transparency and Fair Valuation

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Custodial View of the 2009 Audit Process

- Reliance on NAV as the Practical Expedient
  - Inconsistencies in defining what constitutes an alternative asset
  - Inconsistencies in assigning Level 2 when NAV was relied upon
- Audit Confirmations
  - Requests for fund redemption restrictions
  - Requests for descriptions of investment policies & risks for alternative assets
- Revisiting Exclusive Reliance on Custodial Statements: DOL ERISA Advisory Council Hearings
  - Limited Scope audits limit the amount of work the auditor has to do
  - Financial statement preparers still must comply with FASB FV reporting and disclosure requirements

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PCAOB Inspection Report Themes

- **Testing needs to be more rigorous & comprehensive**
  - ***Testing of Pricing Vendors/Specialists***
    - Failed to obtain sufficient understanding of valuation methods
    - Failed to evaluate reasonableness of assumptions
    - Failed to adequately test the models & inputs
  - ***Testing of Issuer's Process***
    - Failed to perform alternative procedures to test ***all*** of issuer's significant estimated FV, when 3rd party pricing information could not be obtained
    - Limited inquires for difficult-to-value securities to issuer personnel
    - Failed to involve a valuation specialist despite risk factors suggesting that it would be prudent to do so
- **Doing the work is not sufficient; it needs to be documented in the audit work papers**

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Northern Trust Conference

The realities of Private Equity and Hedge Fund Transparency and Fair Valuation

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David Larsen is a managing director in the San Francisco office and part of the Portfolio Valuation service line. He has more than 25 years of transaction and accounting experience.

David has advised numerous strategic and private equity acquirers in all areas of mergers, acquisitions, joint ventures and divestitures. David serves as a special advisor to the Institutional Limited Partners Association; board member, project manager and technical advisor to the Private Equity Industry Guidelines Group and was instrumental in developing and drafting the Private Equity Industry Guidelines Group's Valuation and Reporting Guidelines; member of Financial Accounting Standards Board's Valuation Resource Group responsible for providing the Board with input on potential clarifying guidance on issues relating to the application of the principles of FASB Statement No. 157, Fair Value Measurements; board member of the International Private Equity and Venture Capital Valuations Board, which released international Private Equity Guidelines in 2005 and will be updating those guidelines in 2009; and member of the American Institute of Certified Public Accountants (AICPA) Net Asset Value Task Force.

Prior to joining Duff & Phelps, David was a Partner in KPMG LLP's Transaction Services practice, where he was the segment leader of KPMG's U.S. Institutional Investor practice. He served 13 years in KPMG's Seattle, Düsseldorf and Prague audit practices prior to moving full time to deal work.

David received his M.S. in accounting from Brigham Young University's Marriott School, his B.S. in accounting from Brigham Young University. He is a certified public accountant licensed in California and Washington. David is also a member of the AICPA and the California and Washington Society of Certified Public Accountants.

Duff & Phelps Services Overview

A leading provider of global financial advisory and investment banking services, Duff & Phelps delivers trusted advice to clients, principally in the areas of valuation, transactions, financial restructuring, dispute and taxation. The firm's world class capabilities and resources, combined with an agile and responsive delivery, distinguish the Duff & Phelps client experience.

Valuation

Provide objective and independent assessments of value that fulfill the most complex financial reporting and tax requirements.

Transaction Advisory

Support clients through every stage of a transaction, offering services, including due diligence, strategic value advisory and business modeling.

Tax Services

Provide a variety of tax services, including transfer pricing analyses, property tax and business incentives consulting and compliance.

Investment Banking

Advise buy- and sell-side clients on mergers and acquisitions, joint ventures, restructurings and recapitalizations. Investment banking services are provided by Duff & Phelps Securities, LLC.

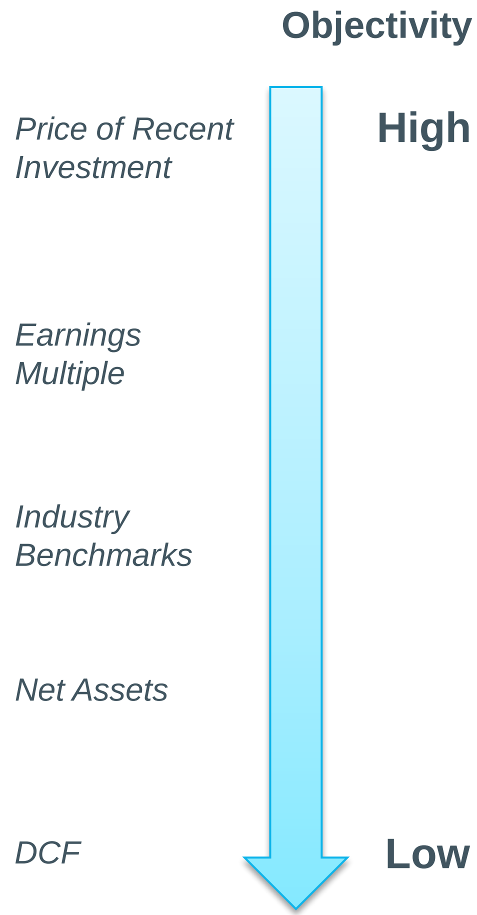
Dispute and Legal Management Consulting

Assist companies with dispute resolution, including strategies for litigation, arbitration or mediation, expert testimony and advisory opinions. Help legal teams maximize performance for all stages of strategy, operations and technology planning and implementation.

Why Fair Value?

- Fair Value is the best basis to make “apples to apples” asset allocation decisions.
- Fair Value allows interim investment (manager selection) decisions on a comparable basis.
- Fair Value is often necessary as a basis to make incentive compensation decisions at the investor level.
- Fair Value provides a comparable basis for monitoring interim performance in the context of exercising the investor’s fiduciary duty.
- Most investors are required by relevant GAAP to report their investments on a Fair Value basis. Therefore, most LP’s require Fair Value.
- Investment Companies (under US GAAP) are exempt from consolidation rules because their investments are carried at Fair Value.
- Limited Partners need consistent, transparent information to exercise their fiduciary duty. Fair Value provides such information. An arbitrary reporting basis such as cost does not allow comparability.

Valuation Hierarchy



Management Responsibilities

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

(AU 328 paragraph 4)

- *Applies to GPs for Fund Financial Statements*
- *Applies to LPs for LP Financial Statements*

Use of NAV: Historical Background

- **Prior to 2007 (before application of SFAS 157):** NAV routinely used by investors to estimate the fair value of an interest in an alternative investment fund.
- **July 2007:** FASB's Valuation Resource Group discusses the question as to whether or not NAV is considered Fair Value in the context of SFAS 157 Fair Value Measurements. FASB Staff responds "Not necessarily" but provides no further guidance
- **2008 – January 2009:** The AICPA formed a taskforce to address the question of NAV and Fair value. A draft issues paper *FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments,* was released for comment in early 2009.
- **February 2009:** FASB's VRG again discusses the NAV / Fair Value Question.
- **June 2009:** FASB issued its proposed FSP FAS 157-g, *"Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide, Investment Companies".*
- **Summer 2009-September 2009:** FASB issued its exposure draft on using NAV to value interests in alternative investments, culminating with the issuance of ASU 2009-12 *"Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)"* in September 2009.
- **September 2009:** IPEV issues updated guidelines including a new section focused on valuing LP interests.
- **December 2009:** The AICPA released TIS (*Technical Information Service)* Section 2220 *Long-Term Investments,* to assist reporting entities in implementing the provisions outlined in FASB ASC 820, *Fair Value Measurements and Disclosures.* More specifically, the TPA *(Technical Practice Aid)* aims to assist those reporting entities attempting to estimate fair value of their investments by utilizing NAV.
- The Technical Practice Aid answers 10 questions related to estimating and disclosing the fair value if interests in alternative assets. The TPA can be accessed at the following link: TIS Section 2220- Long-Term Investments

Conditions Required to use NAV as an LP's estimate of Fair Value

- Applicable for investments required or permitted to be recorded or disclosed at fair value including interests in Fund-of-Funds, Hedge Funds, Real Estate Funds, Private Equity Funds (Buyout, Venture Capital, Mezzanine Debt) etc., which are not actively traded if the following conditions are met:
  - The fund *meets* the definition of an investment company as contained in the Investment Companies Guide (*AICPA Audit and Accounting Guide, Investment Companies*) (Topic 946).
  - Net Asset Value ("NAV") has been calculated in accordance with Topic 946 (e.g., NAV is derived based on valuing underlying investments at fair value consistent with Topic 820 (FAS 157)).
  - NAV is as of the same date as the investors measurement date (e.g., no reporting lag).
- No IFRS Guidance
- NAV not necessarily an IFRS concept
- IPEV Guidelines consistent with ASU 2009-12

How do LPs Determine that NAV is Usable?

- **Considerations for qualifying Fund Managers' reported NAV include:**
  1. ***Initial due diligence (procedures performed before the initial investment).***
  2. Ongoing monitoring (procedures performed after the initial investment).
  3. Financial reporting controls (procedures related to the accounting for, and reporting of, the investment).

- **Additionally, consideration should be given to:**
  - ***The fund's fair value estimation processes and control environment, and any periodic changes***
  - ***The fund's policies and procedures for estimating fair value***
  - Use of independent third party valuation experts to augment and validate the investee fund's procedures for estimating fair value
  - Portion of the underlying securities that are actively traded
  - Professional reputation and standing of the investee fund's auditor (this is not intended to suggest that the auditor is an element of the investee fund's internal control system, but may reflect a general risk factor in evaluating the integrity of data obtained from the fund)
  - Qualifications, if any, of the auditor's report in the fund's financial statements
  - Whether there is a history of significant adjustments to the NAV reported by the fund manager as a result of the annual financial statement audit or otherwise
  - Findings in the investee fund's advisor or administrator's SAS 70 report, if any

IPEV Guidelines Provide Consistency

Section I.2

Changes to Topic 820 which may impact Alternative Asset Investors

Why did FASB issue the Proposed ASU?

Convergence

- FASB & the IASB have a plan to jointly develop high quality accounting standards
- There is currently no IFRS equivalent to FASB ASC Topic 820
- The IASB released a Fair Value Measurement Exposure Draft in 2009
- The IASB due process consideration of responses to their initial exposure draft and results from roundtables pushed towards a common US GAAP / IFRS Fair Value Standard
- Joint deliberations by FASB/IASB resulted in the need to modify ASC Topic 820 to achieve a converged standard.
- The IASB issued a companion Exposure Draft to the Proposed FASB ASU focused on Fair Value Disclosures

Common Definition of Fair Value

- *Fair value is the price that would be received to sell an asset or paid to transfer a liability in an* ***orderly transaction*** *between* ***market participants*** *at the measurement date.*

How vs. When

- Topic 820 explains how to measure fair value. It does not dictate when fair value is used. Other accounting standards dictate when fair value is used.
- Topic 946 for US GAAP requires Investment Companies to record assets at fair value.
- Under IFRS IAS 39 requires investments to be recorded at fair value
- IFRS problematic for Alternative Assets—Requires Control Investments be consolidated (Exposure draft expected in 2010 to correct the problem)

What are the key proposed changes to Topic 820?

Proposed Changes

Most proposed changes are not intended to modify existing application of Topic 820

Some proposed changes clarify the Boards intent about existing guidance:

- Highest & best use and the valuation premise are only applicable to non-financial assets
- Measuring the fair value of an instrument classified in shareholders equity
- Measuring the fair value of financial instruments managed within a portfolio
- Prohibiting the use of blockage factors for level 2 & 3 inputs
- Specifying that premiums and discounts may be appropriate for level 2 & 3 inputs
- Additional disclosures about fair value measurements
  - Measurement Uncertainty for level 3 inputs; impact on fair value of using other reasonable unobservable inputs.
  - Use of an asset in a way that differs for its highest and best use.
  - Categorization by level for items not reported at fair value, but disclosed at fair value.

Effective Date

To be determined

Impact of the Proposed Update on Alternative Assets

Potential impact on Alternative Asset Valuations

- Highest & best use and the valuation premise are only applicable to non-financial assets
  - Some interpret the change to prohibit financial assets from being measured as part of a group
  - Impacts Funds that invest in control equity and debt of the same portfolio company
    - » In such situations, current practice results in the fair value of debt equaling the par value of debt given the call feature by the control equity.
    - » In the future, debt would be "fair valued" on a standalone basis and would not necessarily equal par value.
- Prohibiting the use of blockage factors for level 2 & 3 inputs
- Specifying that premiums and discounts may be appropriate for level 2 & 3 inputs
  - Questions: Is the Unit of account a single share, or the combined interest in a non-traded portfolio company? Does Topic 946 specify the Unit of Account?
- Additional disclosures about fair value measurements
  - Measurement Uncertainty for level 3 inputs; impact on fair value of using other reasonable unobservable inputs.
  - However, the board has indicated that the proposed Financial Instruments project would not require such disclosure for unquoted equity instruments. Yet, the example at **820-10-55-80** has implications that could reverse this exception.

Excerpt from Measurement Uncertainty Analysis 820-10-55-80

		Difference in Fair Value from Using Different Unobservable Inputs That Could Have Reasonably Been Used		
	Fair Value at 12/31/X9	Increase in Fair Value	Decrease in Fair Value	Significant Unobservable Inputs
Private Equity Investments	$ 25	$ 4	$ (3)	Net asset value provided by the investee
Venture capital investments	10	3	(2)	Net asset value provided by the investee

Example Implication: LPs must disclose Measurement Uncertainty impact. Logically, the LP will ask the GP for the information to support the disclosure. Therefore, while the GP may not be required to disclose measurement uncertainty, they may still need to provide such data to their LPs who would be required to perform a measurement uncertainty analysis and provide related disclosures.

Open Questions to be resolved

- Does the proposed amended wording prohibit control equity and debt investments in the same portfolio company to be valued jointly?
  - If yes, how should enterprise value be allocated?
    - » Debt at fair value?
    - » Equity value equal to Enterprise value less debt at par or debt at fair value?
  - If no, clarification of the proposed ASU language is likely required.
- Does the “unit of account” language effectively prohibit the use of premiums, if applicable, even though they are expressly allowed?
- If the topic 820 amendments are effective before the Financial Instrument standard is effective, will GPs be required to provide measurement uncertainty analysis for equity investments?
- Are LPs required to provide a measurement uncertainty analysis as is implied by the proposed example?
  - If yes, where do LPs obtain the data for such an analysis if they are using NAV as their estimate of Fair Value?
  - Will GPs need to provide measurement uncertainty disclosures as part of the financial statements or outside the financial statements to support LPs in determining their disclosures.
- Does the substantial rewrite and reordering of Topic 820 allow other inconsistencies to be resolved:
  - Restrictions—attribute of the holder or attribute of the security?
  - Contingent Assets—recorded at fair value?
  - Undue Cost & Effort?

Fair Value Summary

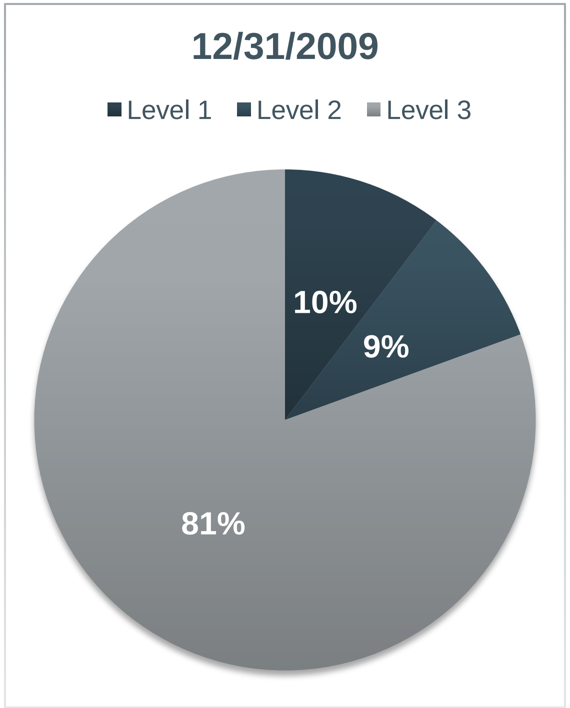
A View from Private Informant

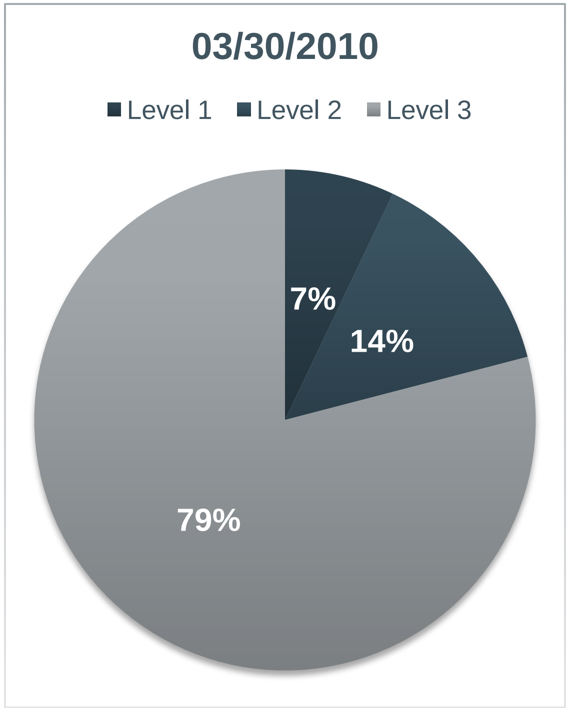
James C. Bachman IV, CAIA
The Burgiss Group

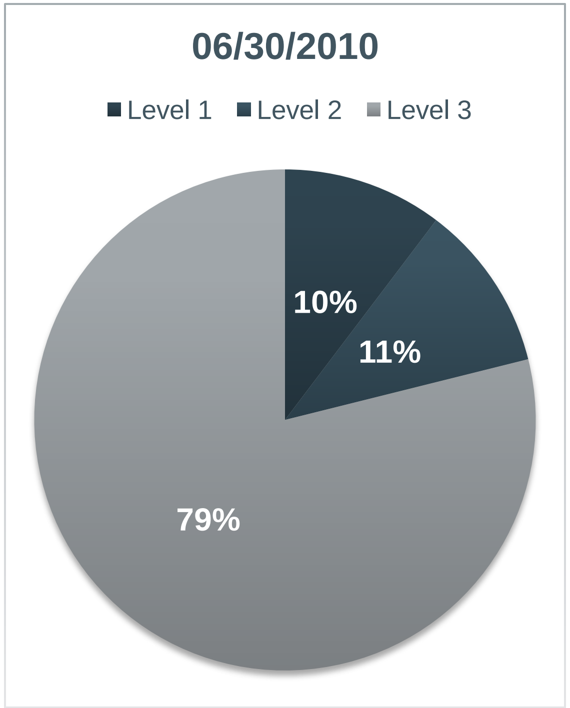
- Long-term partnership with Northern Trust
- Solutions provider to Limited Partners:
  - **Portfolio management software**
  - **Portfolio holdings information service**
  - **Decision support tools and benchmarks**
- 300 clients, $1 trillion in commitments

Private Informant

Fair Value Summary







*Underlying data is sourced from annual and quarterly reports furnished to Limited Partners by General Partners

Biographies

David Larsen is Managing Director in the San Francisco office and part of the Portfolio Valuation service line. He has more than 25 years of transaction and accounting experience.

David has advised numerous strategic and private equity acquirers in all areas of mergers, acquisitions, joint ventures and divestitures. David serves as a special advisor to the Institutional Limited Partners Association; board member, project manager and technical advisor to the Private Equity Industry Guidelines Group's and was instrumental in developing and drafting the Private Equity Industry Guidelines Group's Valuation and Reporting Guidelines; member of Financial Accounting Standards Board's Valuation Resource Group responsible for providing the Board with input on potential clarifying guidance on issues relating to the application of the principles of FASB Statement No. 157, Fair Value Measurements; board member of the International Private Equity and Venture Capital Valuations Board.

David received his M.S. in accounting from Brigham Young University's Marriott School, his B.S. in accounting from Brigham Young University. He is a certified public accountant licensed in California and Washington. David is also a member of the AICPA and the California and Washington Society of Certified Public Accountants.

James Bachman, IV, CAIA is the Head of Research at the Burgiss Group, LLC, the global leader in private equity software solutions and data services for investors. In this role he is principally responsible for research-related initiatives as well as expanding the technology platform's portfolio management capabilities. Prior to the Burgiss Group, James worked at the Bridgeton Companies, an alternative assets investment boutique.

James obtained his BA in Economics and Business Administration as an Omicron Delta Epsilon graduate from Muhlenburg College, and received his MBA from Texas A&M University at Commerce. Additionally, he holds the Chartered Alternative Investment Analyst designation. James is a member of the CFA Institute's Global Investment Performance Standards (GIPS) Private Equity Working Group. James co-authored the Wiley Finance book, “Inside Private Equity” which was published in 2009.

Biographies

Peggy Bradley has spent her 30-year banking career supporting the custody, trust and investment needs of institutional clients. As a member of the bank's Industry Update & Evaluation Committee, she collaborates on the development and implementation of solutions to address emerging accounting, audit and regulatory issues. In this capacity, Peggy led the FAS 157 Implementation Project for the Bank's internal and external clients. Prior to stepping into her current role, she served as Senior Relationship Manager for Northern Trust's Fortune 500 plan sponsor and insurance company clients. She has also managed the custody, fund accounting, and regulatory reporting functions for common and collective trust fund sponsors for JP Morgan Chase (formerly First National Bank of Chicago). She began her banking career at the Federal Reserve Bank of Chicago, where she served as Product Manager for Treasury Investments and Safekeeping Services.

Peggy has had the opportunity to represent the custodial services perspective at various industry conferences over the last several years, including those sponsored by the AICPA, Illinois CPA Society, and NIPA. She earned her Bachelor of Arts degree in Urban Studies in 1978 from Marietta College, in Marietta, Ohio, and currently resides in Chicago, Illinois.

Paul Finlayson is a Senior Vice President at The Northern Trust Company, Chicago. He is a Product Manager in the Strategic Product Strategy group of Corporate & Institutional Services. His current focus is on developing reporting and analyses addressing the unique needs of alternative assets portfolios.

Paul's 30 years of experience includes investment policy development, portfolio modeling, as well as investment performance and risk analysis. Paul has also consulted to the Northern Trust Benefits Investments Plans, including policy development and analysis.

Finlayson received a B.A. degree from DePaul University. Prior to joining Northern Trust as a Second Vice President in April, 1994, he was associated with SEI Corporation. He was named a Senior Vice President in February, 2009.

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