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FIDUCIARY PLAN GOVERNANCE, LLC

Due Diligence for "Hard-to-Value" Investments

Fi360 Annual Conference
April 28, 2013

Edward M. Lynch, Jr., AIFA®, RF™, GFS™, C(k)P™ CEO, Fiduciary Plan Governance, LLC

Charles Humphrey, Esq., Humphrey Benefits Law Group

Dr. Susan Mangiero, AIFA®, CFA, FRM, Fiduciary Leadership, LLC

Michelle A. Sullivan, CPA, FreedMaxick

Trust earned. FreedMaxick™

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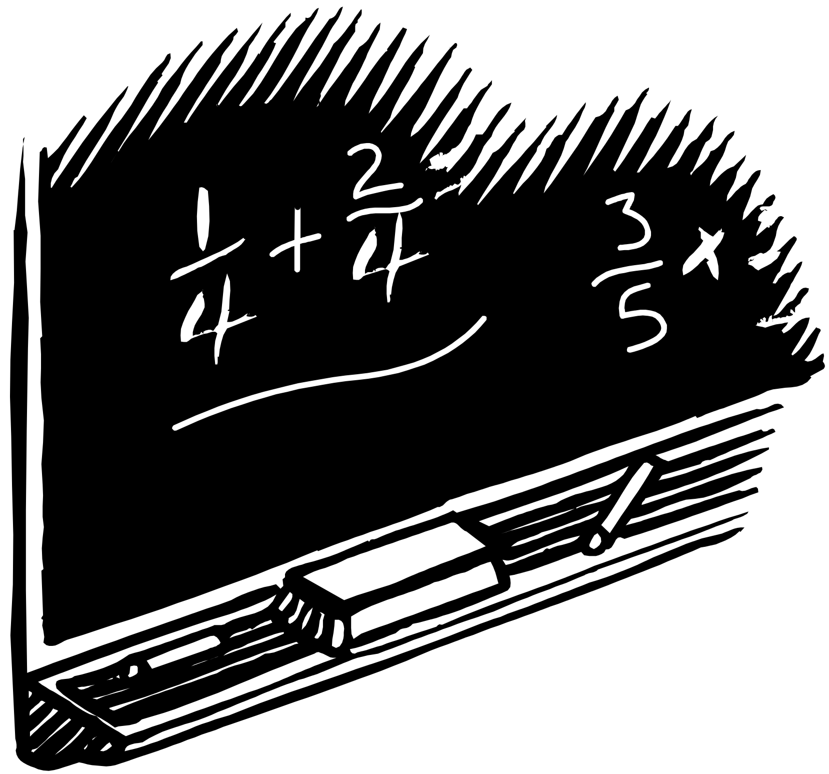
Investment Best Practices | Risk Management | Valuation

SPEAKER BIOS



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Ed Lynch, AIFA®, RF™, GFS™, C(k)P™

Ed is the founder and CEO of FPG and has worked with ERISA-qualified plan sponsors and designated fiduciaries in most aspects of plan development and maintenance since the early 1980s. In 2003, Mr. Lynch became one of the first practitioners in the United States to complete the Accredited Investment Fiduciary Auditor, AIFA®, program of advanced studies at The Center for Fiduciary Studies (Joseph Katz School of Business, University of Pittsburgh).

In September 2008, Mr. Lynch became "[one of] the first Investment Advisors globally" to successfully complete the Centre for Fiduciary Excellence (CEFEX) independent certification process. The CEFEX certification "provides assurance to investors, both institutional and individual, that Mr. Lynch has demonstrated adherence to the industry's best fiduciary practices…indicating [it's] interests are aligned with those of investors."

In 2009, Mr. Lynch was voted by his peers as one of the 40 "Most Influential Retirement Plan Advisors" in the United States in a national survey conducted by the 401(k) Wire, the 401(k) Exchange and The Boston Research Group. Based on over 100,000 votes from the industry, business metrics and input of an editorial board, the top 300 and top 40 were recognized for their business success, and their influence on retirement plans, their fellow advisors and retirement plan providers.

He is a graduate, *summa cum laude,* of Gordon College in Wenham, Massachusetts, is a member of a number of professional and employee benefits organizations, a columnist as well as a frequent speaker on ERISA-plan topics.

Chuck Humphrey, J.D.

Chuck is a principal of the Law Offices of Charles G. Humphrey in Andover, MA and Buffalo, New York. He has concentrated his practice in the area of ERISA and employee benefits law for over 35 years, assisting corporate, governmental, tax exempt employers, and their advisers with their benefit plan issues, with a primary area of focus on ERISA fiduciary responsibility compliance. Lately he has provided counsel to his clients on the vexing issues related to compliance with the Labor Department service provider and participant fee and expense disclosure requirements.

Chuck maintains an interest in seeing that the government agencies develop reasonable rules in their administration of the federal benefits laws. He is a member of the IRS Northeast Pension Liaison Committee and the American Bar Association Employee Benefits Committee and its Fiduciary Resp0nsibility/ Plan Investments, Multiple Employers, Professional Employer Organizations (PEOs) and Controlled Groups, Executive Compensation and Fringe Benefits Sub Committees. He is also a member of the New England Benefits Council, where he has been on the on the planning committees for the NEEBC's two major annual events, The Benefits Fair and Trade Show and Washington Update. Mr. Humphrey lectures and writes frequently on employee benefit plan topics. He holds an undergraduate degree in history from the University of Michigan and a law degree from the University of Buffalo Law School. He is admitted to practice in New York and Washington, D.C.

Chuck is also a consultant to Fiduciary Plan Governance, LLC where he has helped develop processes for the management of fiduciary responsibility by its employer and adviser clients.

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Michelle A. Sullivan CPA, Director

Michelle A. Sullivan, CPA is a Director in Freed Maxick's Auditing and Accounting Practice. Michelle also co-manages the Firm's Employee Benefit Plan group. She has 18 years of public accounting experience which includes audits of employee benefit plans, including 11-K filings and non-profit organizations.

Michelle specializes in employee benefit plan audits including defined contribution, defined benefit, and health and welfare plans for both private and public companies. Her experience includes auditing of alterative and other hard to value investments and expert witness testimony regarding ERISA litigation.

She is responsible for the technical review of the employee benefit plan audits in accordance with both the Department of Labor (DOL) and Public Company Accounting Oversight Board (PCAOB). Michelle is responsible for the overall planning, organization, supervision, and completion of the Firm's 100 employee benefit plan audits. She is also involved with the Firm's staff training programs and has conducted training in the employee benefits area.

Michelle's other responsibilities include overseeing compliance testing with the plan document, IRS and DOL regulations, and examination of the plan's operations including recommendations for improvement. She has assisted clients in ERISA and IRS reviews and has consulted on employee benefit plan administration issues, including plan mergers, plan terminations, and corrective implementation for employee benefit plans. Michelle has also assisted numerous entities in preparing and reviewing Forms 5500 and 5330.

Trust earned.

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Dr. Susan Mangiero, AIFA, CFA, FRM

- Dr. Susan Mangiero is a managing director with Fiduciary Leadership, LLC. Dr. Mangiero is a CFA charterholder, certified Financial Risk Manager and Accredited Investment Fiduciary Analyst™. She has provided testimony before the ERISA Advisory Council, the OECD and the International Organization of Pension Supervisors as well as offering expert testimony and behind-the-scenes forensic analysis, calculation of damages and rebuttal report commentary for various investment governance, investment performance, fiduciary breach, prudence, risk and valuation matters. She has over twenty years of experience in capital markets, global treasury, asset-liability management, portfolio management, economic and investment analysis, derivatives, financial risk control and valuation. This includes work on trading desks for several global banks, in the areas of fixed income, foreign exchange, interest rate and currency swaps, futures and options.

- Some of her recent engagements include: (a) analysis of DB plan funding status for a private equity buyer of a closely-held company (b) analysis of an investment manager's actions by a group of union plans (c) review of annuity terms for DB and DC plans (d) review of investment policy statement language in the aftermath of bank downgrades (e) assessment of damages by an asset manager that did not properly hedge positions (f) review of benefit distributions by a plan sponsor that is being investigated and (g) analysis of fees paid by a large trust. Dr. Mangiero has provided insights about asset allocation, fiduciary duties, risk management, modeling, hedge effectiveness, hedge funds, private equity funds, ERISA, valuation and industry best practices for consulting clients and employers that include the General Electric Company, Prudential Retirement, PricewaterhouseCoopers, Mesirow Financial, Bankers Trust, Bank of America, Chilean pension regulator, World Bank, Pension Benefit Guaranty Corporation, RiskMetrics, U.S. Department of Labor, Northern Trust Company and the U.S. Securities and Exchange Commission. Dr. Mangiero is the author of *Risk Management for Pensions, Endowments and Foundations* (John Wiley & Sons, 2005), a primer on risk and valuation issues, with an emphasis on fiduciary responsibility and best practices. Dr. Mangiero has written chapters for several books, including the *Litigation Services Handbook* and *The Handbook of Interest Rate Risk Management*.

- She is a frequently invited speaker and has keynoted or led workshops for organizations such as the Stable Value Investment Association, Harvard Law School, Florida Public Pension Trustees Association, New York State Department of Insurance, Association of Public Pension Auditors, AICPA - Employee Benefits Section, National Association of Corporate Directors and Financial Executives International. She is a member of the 401(k) vendor RFP best practices committee for the Association of Financial Professionals. Susan can be reached at susanm@fiduciaryleadership.com or 203-261-5519.

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"The First Rule for Fiduciaries Is to Put Their Interests Last."

Michelle A. Sullivan, CPA

Director in the firm's Accounting and Audit Department and is responsible for leading the firm's Employee Benefit Plan Audit Group. Her area of specialty includes the audits of defined contribution, defined benefit and health and welfare plans for both private and public companies. Ms. Sullivan is responsible for the technical review of the employee benefit plan audits in accordance with both the Department Of Labor (DOL) and Public Company Accounting Oversight Board (PCAOB). She is responsible for the overall planning, organization, supervision, and completion of over 75 pension plan audits the firm performs.
Ms. Sullivan's responsibilities include: overseeing compliance testing with the plan document, IRS and DOL regulations, and examination of the plan's operations including recommendations for improvement.

Ms. Sullivan has assisted clients in ERISA and IRS reviews and has consulted on employee benefit plan administration issues, including plan mergers, plan terminations, and corrective implementation for employee benefit plans. She has also assisted numerous entities in preparing and reviewing Forms 5500, 5330 and 990.

During her professional career, she has also obtained experience in the construction, manufacturing, not-for-profit, retail and general service industries. Ms. Sullivan is also involved with the firm's staff training programs and has conducted training in the employee benefits area. Ms. Sullivan is a member of the AICPA and the Buffalo Chapter of the New York State Society of Certified Public Accountants. She graduated from University of Buffalo with a Bachelor of Science in business administration. She joined Freed Maxick (formerly Freed Maxick Sachs & Murphy, P.C.), in 1995 after having worked for a local CPA firm.

OVERVIEW

Program Description

Plan sponsor fiduciaries have additional responsibilities when portfolios include an allocation of money to alternatives such as hedge funds, private equity, venture capital and/or read estate. Due diligence by a financial advisor on behalf of his or her ERISA or public pension plan client must take into account economic, legal and operational attributes such as (1) lock-ups (2) redemption rights (2) leverage (3) access to capital in case an alternative fund needs to borrow money quickly (4) key person risk and compensation incentives and (5) valuation. An advisor's responsibility is to educate his or her clients about unique return and risk issues.

This session will focus both on the legal issues and the internal control compliance issues that cannot be ignored by anyone with a fiduciary responsibility to prudently select and monitor. Talking points include session the (1) changing allocations to alternatives (2) various regulatory guidelines about alternative investing and (4) suggested industry best practices.

This is a very broad topic. Our session is intended to update the audience and invite listeners to learn more about investing in alternatives thereafter.

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Session Talking Points

- **Pension Plan Allocations to Alternatives**
- **Concept of "Hard to Value" Investing**
- **Risk and Return Attributes**
- **Regulatory Guidance**
- **Due Diligence Considerations**
- **Disclosure**
- **Lessons Learned**

What’s an Alternative Investment?

- **Not always what you think**
- **What it is not *(stock, bond, cash)***
- **Chief Characteristics**
- **Examples (*hedge funds, managed futures, real estate, commodities and derivatives contracts)***

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Why do we care?

- **Fiduciary Obligations**
- **Plan Reporting**
- **Payment of Plan Benefits**

TRENDS IN ALTERNATIVES INVESTING

Alternatives in Headlines

- **“Pensions Find Riskier Funds Fail to Pay Off” by Julie Creswell, *New York Times*, April 1, 2012**
- **“Cash-strapped US pension funds ditch stocks for alternatives” by Sam Forgione, *Reuters*, August 16, 2012**
- **“Alternatives continue to win pension assets” by Emma Boyde, *Financial Times*, July 7, 2012**
- **“More Pensions Turn to ‘Alternative’ Investments” by SHRM Online Staff, SHRM Website, September 1, 2011**
- **“Enforcement Priorities in the Alternative Space” by Bruce Karpati, Chief, SEC Enforcement Division’s Asset Management Unit, U.S. Securities and Exchange Commission, December 18, 2012**

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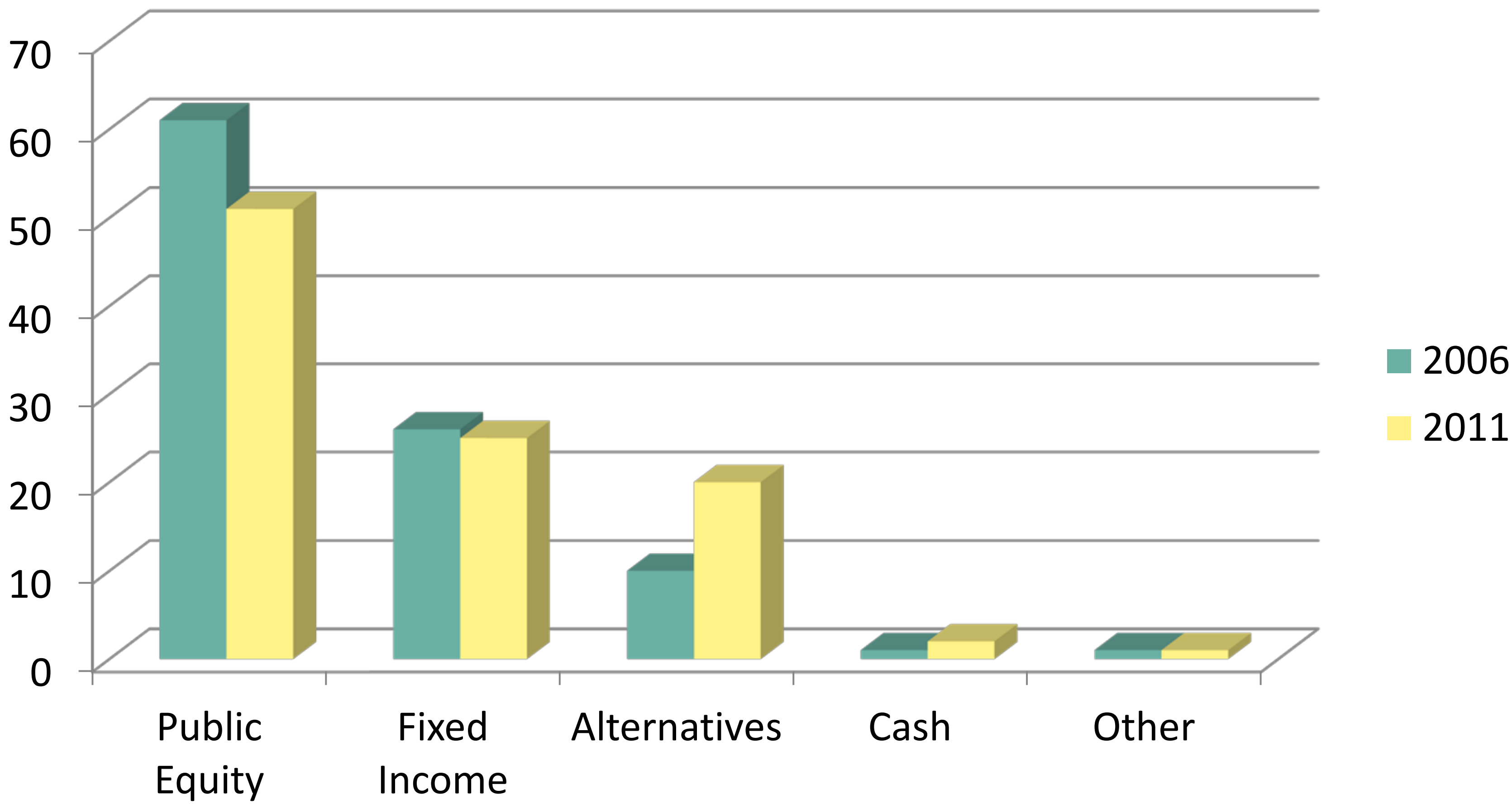
Public Pension Plan Allocations



Source: "Trends in State Pension Asset Allocation & Performance," Cliffwater LLC, June 26, 2012

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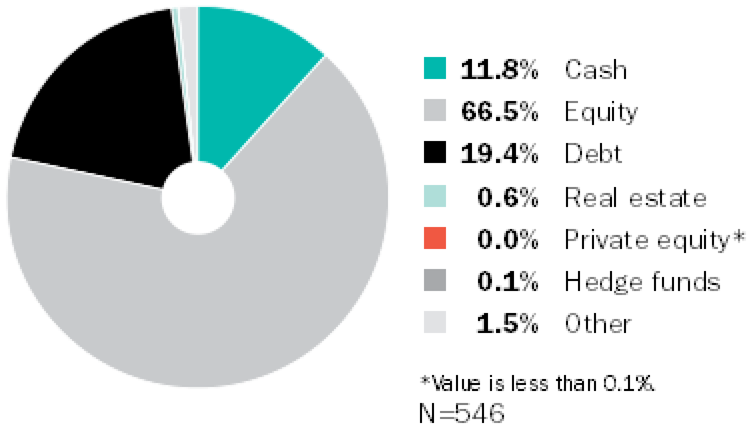
Corporate Pension Plan Allocations

Level 1



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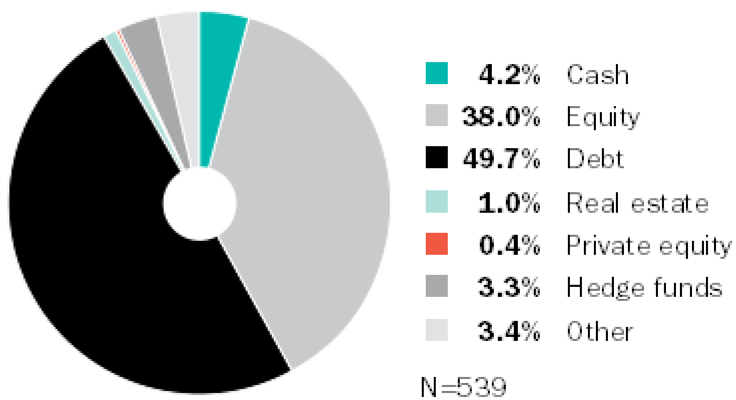
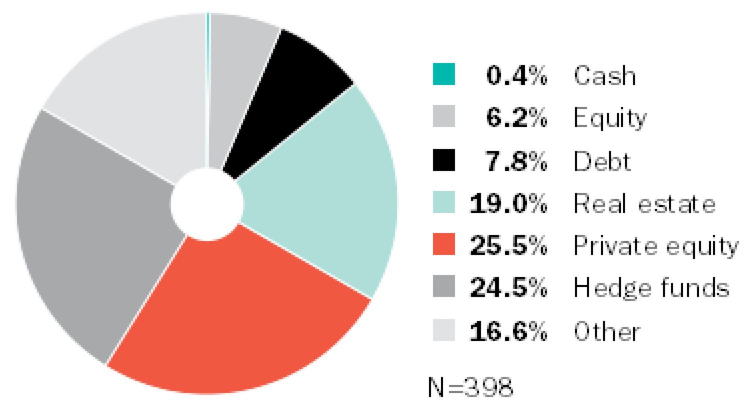


Level 3



Source: "Asset Allocations of Corporate Pension Plans as of Year-End 2010," Towers Watson, October 2011

RISK & RETURN CONSIDERATIONS

Concept of "Hard to Value"

- "Hard to Value" Concept Can Apply to Traditional Investments Such as Mutual Funds
- Some Hedge Funds Invest in Actively Traded Stocks and Bonds and Are Not Considered "Hard to Value" Funds
- With FAS 157 and Other Accounting Rules, "Hard to Value" Typically Relates to Absence of Active Trading Market and Need For Use of Pricing Model to Determine Value
- "Hard to Value" Assets May be Included in Portfolios of Hedge Funds, Private Equity Funds, Complex Derivative Funds, Venture Capital Funds, Infrastructure Funds, Real Estate Funds, Commodity Pools and/or Mutual Funds

Source: Testimony of Dr. Susan Mangiero Before ERISA Advisory Council on "Hard to Value" Assets, September 11, 2008

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Cited Benefits of Alternatives

- **Diversification**
- **Yield Enhancing**
- **Flexibility**
- **Absolute Return Potential**
- **Add-On to Immunization Strategy**
- **Leverage**

Some Risk Factors to Consider

- Rights, Responsibilities & Liabilities of Manager(s) & Investors, Respectively
- Liquidity of Asset Portfolio
- Diversification of Client Base
- Rights to Redeem
- Cash Versus In-Kind Redemption, if Allowed
- Key Person Risk
- Valuation Procedures
- Independence of Board Members
- Fees and Expenses
- Transparency of Policies & Performance
- Access to Credit
- Use of Prime Broker
- Distribution Channels
- Rogue Trading Controls
- Reputable Auditor
- Anti-Money Laundering Policies
- Safeguards Against Insider Trading

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REGULATORS ARE PAYING ATTENTION

SEC Exam Priorities for 2013

"Alternative" Investment Companies. The IA-IC Program is focusing on the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds ("ETFs"), and variable annuity structures. More specifically, the staff will assess whether: (i) leverage, liquidity and valuation policies and practices comply with regulations; (ii) boards, compliance personnel, and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.

Source: "Examination Priorities for 2013," Office of Compliance Inspections & Examinations, U.S. Securities & Exchange Commission, February 21, 2013

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DOL Enforcement

- Has been an area enforced since the early 1990’s
- Individual investigators have discretion to open cases with alternative investments
- Some training sessions in various regions on this issue

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ERISA Section 404(a)(1)

- 404(a)(1) A Exclusive benefit
- 404 (a)(1) B Prudence
- 404(a)(1) C Diversification
- 404(a)(1) D In accordance with the plan documents(s)

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Prior DOL Guidance

- Assess Investment Funds for Particular ERISA Plan Portfolio
- Consider ERISA Plan's Potential for Losses and Market, Credit, Legal and Operational Risks
- Understand Role of Derivatives in Pooled Investment Fund

Source: Letter to Honorable Eugene A. Ludwig With Office of the Comptroller of the Currency From Olena Berg With U.S. Department of Labor, PWBA, March 21, 1996

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PPA of 2006 & Plan Asset Limit

- Plan Asset or Not, that is the question….
- < 25% of equity interest of every class in a hedge fund/private equity fund held by benefit plan investors, then not plan assets and investment manager is not ERISA fiduciary
- Most fund managers try to stay below this 25% threshold.
- Is private equity fund a venture capital company?
- Changes made by PPA

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Prohibited Transaction Question

- Examine How Fund Manager is Compensated
- See Department Of Labor Advisory Opinions:

  1986- BDN Management Company and Batterymarch Management Company; and 1998-Alliance Capital and 1999-Mount Lucas Management Company

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Sophisticated Investor Concepts

- Hedge funds/private equity funds do not have to register under section 3(c)(1) or 3(c)(7) of the "1940 Act" by restricting the type of investor

- ERISA Pension Plan with > $5 million in Total Assets, an ERISA Plan with < $ 5 Million if Decision Made by ERISA Plan Fiduciary that is Either a Bank, Savings & Loan Association, Insurance Company or RIA and a Participant-Directed ERISA Plan Where Participants are "Accredited Investors"

- "Qualified Purchaser" Includes Any Person, Acting for Own Account or Accounts of Other Qualified Purchasers, Who in Aggregate Owns & Invests on a Discretionary Basis > $25 Million in Investments

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ERISA Advisory Council Guidance

- Identify Type of Due Diligence Needed to Make Investment
- Understand Plan Liquidity Needs
- Diversify Plan Assets
- Apply "Prudent Investor Rule"
- Consider Long-Term Investment Goals of Plan
- Understand Fee Structure
- Evaluate Expertise of Investment Manager
- Consider What is Needed to Value Investment

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GETTING STARTED

Some Suggestions

- Identify Strategies to Assess Fit With ERISA Plan Needs, Objectives and Constraints
- Conduct Research About Different Investment Strategies
- Assess Whether to Invest Directly or Indirectly Via Fund of Funds
- Meet with Fund Managers to Review Answers to RFI and/or Due Diligence Questionnaire

Source:"Hedge Funds and Private Equity Investments," ERISA Advisory 2011 Council Report

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Performance Reporting

- Evaluate Annualized Return and Risk of Strategy Over 7 to 10 Year Period
- Compare Alternatives Fund Metrics to Broader Market-Based Index
- Compare Alternatives Fund Metrics to HFRI Composite Index or Sub-Set Index as Appropriate for Alternative Fund Strategy
- Review Manager's Use of Leverage or Derivatives
- Evaluate Track Record of Private Equity Fund General Partners
- Adjust Performance Numbers for Survivorship Bias and Other Factors That Could Influence Reported Results

Source:"Hedge Funds and Private Equity Investments," ERISA Advisory 2011 Council Report

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Risk Management

- Ask About How Portfolio Risk is Controlled
- Query About Operational Due Diligence Procedures
- Ask About Personnel Background Checks
- Inquire About Technology Systems
- Ask About Whether Stress Tests Are Conducted and How Often

Source:"Hedge Funds and Private Equity Investments," ERISA Advisory 2011 Council Report

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LESSONS LEARNED

Lessons Learned

- Excessive Leverage
- Undue Concentration in High-Risk Strategy and/or Securities
- Poor Reference Checks on Staff
- Failure to Oversee Key Traders and Back Office Staff
- Short Track Record
- Style Drift
- Inadequate Risk Management Systems
- No Independent Valuation Reviews
- Absence of Knowledgeable and Reputable Auditor
- Perverse Compensation That Rewards Too Much Risk-Taking
- No Diversification in Client Base
- Insufficient Access to Capital

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Fiduciary Plan Governance | Fiduciary Success

"The first rule for fiduciaries is to put their interests last."

FPG is not an investment advisor and does not provide any investment-related services. We are an expert resource actively engaged in advising, training and supporting broker/dealers, registered representatives, registered investment advisors, trustees and other fiduciaries in effectively meeting their responsibilities.

Please contact us for further information on how we can strengthen and broaden your professional services. Our team is looking forward to working with you.

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