

TIS Section 2220, *Long-Term Investments*

Sections 2220.18–.27 are intended to assist reporting entities when implementing the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification*[™] (ASC) 820, *Fair Value Measurements and Disclosures*, to estimate the fair value of their investments in certain entities that calculate net asset value. Sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4 and 5 of FASB ASC 820-10-15.

.18 Applicability of Practical Expedient

Inquiry—Which investments are permitted, as a practical expedient, to be measured at fair value on the basis of the net asset value (NAV)?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification*[™] (ASC) 820-10-35-59 permits reporting entities, as a practical expedient, to estimate the fair value of their investments in certain entities that calculate NAV per share (or its equivalent) by using NAV. Such investments, which are often referred to as *alternative investments*, include interests in hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as some bank common/collective trust funds and other similar funds. Companies in various industries, including investment companies, broker-dealers, banks, insurance companies, employee benefit plans, healthcare organizations, and not-for-profit organizations, often invest in alternative investments.

.19 Unit of Account



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Inquiry—According to the FASB ASC glossary, the *unit of account* is “[t]hat which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated).” How should the unit of account be identified for an interest in an alternative investment?

Reply—For interests in alternative investments, the appropriate unit of account is the interest in the investee fund itself, not the underlying investments within the investee fund; this is because the reporting entity owns an undivided interest in the whole of the investee fund portfolio and typically lacks the ability to dispose of individual assets and liabilities in the investee fund portfolio. However, as discussed in FASB ASC 820-10-35-61, if it is probable at the measurement date that a reporting entity will sell a portion of an investment at an amount different from NAV, and the criteria described in FASB ASC 820-10-35-62 are met, the portion that the reporting entity intends to sell is valued in accordance with other provisions of FASB ASC 820, *Fair Value Measurements and Disclosures*. The remaining portion of the interest that is not probable of being sold may be valued by using NAV as a practical expedient in accordance with FASB ASC 820-10-35-59.

.20 Determining Whether NAV is Calculated Consistent with FASB ASC 946, *Financial Services—Investment Companies*

Inquiry—FASB ASC 820-10-35-59 states:

A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

How does a reporting entity conclude that the NAV, as most recently reported by the manager of the alternative investment (reported NAV), has been calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*?

Reply—A reporting entity’s management is responsible for the valuation assertions in its financial statements. Determining that reported NAV is calculated consistently with FASB ASC 946, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820, requires a reporting entity to independently evaluate the fair value measurement process utilized by the investee fund manager to calculate the NAV. Such an evaluation is a matter of professional judgment and includes determining that the investee fund manager has an effective process and related internal controls in place to

estimate the fair value of its investments that are included in the calculation of NAV. The reporting entity's controls used to evaluate the process of the investee fund manager may include the following:

- *Initial due diligence* (procedures performed before the initial investment)
- *Ongoing monitoring* (procedures performed after the initial investment)
- *Financial reporting controls* (procedures related to the accounting for, and reporting of, the investment) (Refer to Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* [AICPA, *Professional Standards*, vol. 1, AU sec. 9332 par. 02–.04] and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* for examples of these controls.¹⁾)

Before concluding that the reported NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, the reporting entity might evaluate the evidence that is gathered via the initial due diligence and ongoing monitoring of the investee fund. Only after considering all relevant factors can the reporting entity reach a conclusion about whether the reported NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946. For example, the reporting entity might consider the following key factors relating to the valuation received from the investee fund manager:

- The investee fund's fair value estimation processes and control environment, and any changes to those processes or the control environment²
- The investee fund's policies and procedures for estimating fair value of underlying investments, and any changes to those policies or procedures³
- The use of independent third party valuation experts to augment and validate the investee fund's procedures for estimating fair value
- The portion of the underlying securities held by the investee fund that are traded on active markets
- The 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

¹ The AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* is available on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/pract_aid_alt_invest.htm.

² For further guidance, see AU section 332, *Auditing Derivative Instruments* (AICPA, *Professional Standards*, vol. 1), and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations*.

³ See footnote 2.

system, but as a general risk factor in evaluating the integrity of the data obtained from the investee fund manager)

- Qualifications, if any, of the auditor’s report on the investee fund’s financial statements
- Whether there is a history of significant adjustments to the NAV reported by the investee fund manager as a result of the annual financial statement audit or otherwise
- Findings in the investee fund’s advisor or administrator’s SAS 70⁴ report, if any
- Whether NAV has been appropriately adjusted for items such as carried interest and clawbacks (more fully described in paragraph .29 of Technical Question and Answer [TIS] section 6910, “Investment Companies” [AICPA, *Technical Practice Aids*])
- Comparison of historical realizations to last reported fair value

If the last reported NAV is not as of the reporting entity’s measurement date, refer to section 2220.22 for further considerations.

In cases when the reporting entity invests in a *fund of funds* (the investee fund invests in other funds that do not have readily determinable fair values), the reporting entity might conclude that the NAV reported by the fund of funds manager is calculated in a manner consistent with FASB ASC 946 by assessing whether the fund of funds manager has a process that considers the previously listed items in the calculation of the NAV reported by the fund of funds, and that the fund of funds manager has obtained or estimated NAV from underlying fund managers in a manner consistent with paragraphs 59–62 of FASB ASC 820-10-35 as of the measurement date. The reporting entity is not required to look through the fund of funds interest to underlying fund investments if the reporting entity has concluded that the fund of funds manager reports NAV consistent with FASB ASC 946 for the fund of funds interest.

.21 Determining Whether an Adjustment to NAV is Necessary

Inquiry—FASB ASC 820-10-35-60 allows the reporting entity, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 4 and 5 of FASB ASC 820-10-15 using the NAV as reported by the investee when the reporting entity has satisfied itself that (a) the investee has calculated NAV consistent with FASB ASC 946 (see section 2220.20), and (b) the NAV has been calculated as of the reporting entity’s financial reporting (measurement) date.

⁴ Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), was issued by the AICPA Auditing Standards Board (ASB) in 1992. In November 2008, the ASB issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on Controls at a Service Organization*, which would supersede the guidance for service auditors in SAS No. 70 as well as an exposure draft of a proposed SAS, *Audit Considerations Relating to an Entity Using a Service Organization*, which would supersede the guidance for user auditors in SAS No. 70. The final statements are expected to be issued in the first quarter of 2010. Readers should be alert for the issuance of final statements.

FASB ASC 820-10-35-60 further states:

If the net asset value per share of the investment obtained from the investee is not as of the reporting entity's measurement date or is not calculated in a manner consistent with the measurement principles of Topic 946, the reporting entity shall consider whether an adjustment to the most recent net asset value per share is necessary. The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.

How does a reporting entity determine whether an adjustment to the last reported NAV is necessary?

Reply—Examples of when an adjustment to the last reported NAV may be necessary include, but are not limited to:

- NAV is not as of the reporting entity's measurement date; or
- NAV is not calculated in a manner consistent with the measurement principles of FASB ASC 946 (which requires, among other things, measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820);
- Or both.

The existence of either of these factors may lead the reporting entity to conclude that an adjustment to the last reported NAV may be necessary. Practically, it is difficult to assess whether an adjustment is necessary unless an estimate of the adjustment is calculated.

.22 Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date

Inquiry—If the reporting entity concludes that the reported NAV is calculated consistently with FASB ASC 946, but an adjustment is necessary because the NAV is not as of the reporting entity's measurement date, how should the reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—FASB ASC 820-10-35-60 states that “The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.” If the last reported NAV is calculated consistently with FASB ASC 946 but is not as of the reporting entity's measurement date, the reporting entity may either request the investee fund manager to provide a supplemental NAV calculation consistent with the measurement principles of FASB

ASC 946 as of the reporting entity's measurement date, or it may be necessary to adjust or roll forward (or roll back)⁵ the reported NAV for factors that might cause it to differ from the NAV at the measurement date. For example, the following factors might necessitate an adjustment to the reported NAV when it is not calculated as of the reporting entity's measurement date:

- The reporting entity has made an additional investment(s) (capital contributions) since the calculation date of the reported NAV and prior to the reporting entity's measurement date;
- The reporting entity has received a distribution(s) or partial redemption since the calculation date of the reported NAV;
- The reporting entity has become aware (through inquiry of the investment manager or communication by the investment manager to the reporting entity) of changes in the value of underlying investments since the calculation date of the reported NAV;
- Market changes or other economic conditions have changed to affect (favorably or unfavorably) the value of the investee's portfolio after the calculation date of the reported NAV;
- Changes have occurred in the composition of the underlying investment portfolio of the investee fund after the NAV calculation date.

The roll forward NAV might be calculated as follows:

i. Last Reported NAV (calculated consistently with FASB ASC 946)	\$	X,XXX
ii. Add capital contributions/subscriptions		C,CCC
iii. Subtract distributions/redemptions/withdrawals		(D,DDD)
iv. Adjust for changes in valuations ^(a)		<u>V,VVV</u>
Roll forward NAV (as of the reporting entity's measurement date)		
	\$	<u>R,RRR</u>

(a) *Market changes* refer to market fluctuations between the date of the reported NAV and the reporting entity's measurement date. Examples of other economic conditions for which it may be necessary to adjust a reported NAV include, but are not limited to, a portfolio company being acquired, going public, or declaring bankruptcy between the date of the reported NAV and the reporting entity's measurement date, or changes in

⁵ When the reporting entity's measurement date is prior to the net asset value (NAV) calculation date, it may be more appropriate to use that NAV and perform a roll back rather than using a reported NAV calculated prior to the entity's measurement date.

the value of underlying investments caused by company performance or market conditions, or both.

.23 Adjusting NAV When It Is Not Calculated Consistent with FASB ASC 946

Inquiry—If the reporting entity concludes that an adjustment is necessary because a reported NAV is not calculated consistently with the measurement principles of FASB ASC 946, how does a reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—Although it is not possible to state all the reasons why a reported NAV may not be consistent with the measurement principles of FASB ASC 946 (that is, it is not fair value based), the reporting entity would need to consider and understand the following:

- The reasons why NAV has not been based upon fair value. In some cases investees may appear to function similarly to investment companies, but do not meet the definition of an *investment company* provided in FASB ASC 946-10-15-2 and it is not industry practice for the investee to issue financial statements using the measurement principles in FASB ASC 946. (In those cases, the practical expedient is unavailable and the entity should be valued using the general measurement principles of FASB ASC 820.)
- Whether a fair value based NAV can be obtained from the investee manager.
- Whether the specific data needed to adjust the reported NAV can be obtained and properly utilized to estimate a fair value based NAV.

Examples of circumstances in which the reporting entity may be able to obtain data to estimate an adjustment include, but are not be limited to:

- Reported NAV is on a cash basis. The reporting entity could estimate the fair value of each underlying investment as of the measurement date by obtaining additional information from the investee manager,
- Reported NAV utilizes blockage discounts taken on securities valued using level 1 inputs, which is not consistent with FASB ASC 820. The reporting entity could estimate the adjustment to reported NAV required to remove the blockage discount based on additional information from the financial statements or from the investee manager.
- Reported NAV has not been adjusted for the impact of unrealized carried interest or incentive fees. The reporting entity could estimate the impact of carried interest or incentive fees and adjust reported NAV.

If the reporting entity finds that it is not practicable to calculate an adjusted NAV (for example, because sufficient information is not available or it is not in a position to reasonably evaluate the

information available and estimate values consistent with FASB ASC 946), then the practical expedient is not available. The reporting entity may also elect not to utilize the practical expedient. In those instances, the reporting entity should apply the general measurement principles of FASB ASC 820 instead (see section 2220.27).

.24 Disclosures—Ability to Redeem Versus Actual Redemption Request

Inquiry—FASB ASC 820-10-35-58(c) states:

If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized as a Level 2 or a Level 3 fair value measurement. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.

In most cases, redemptions from alternative investment funds that redeem at NAV are only permitted with advance notice, ranging from 30 to 120 days. In order to classify the investment as level 2, must the investor have submitted a previous redemption request effective as of the measurement date or is it sufficient for an investor to have had the ability to redeem on the measurement date, even though it may not have exercised this ability?

Reply—Determining the appropriate level within the fair value hierarchy is a matter of professional judgment. Even though a redemption notice may not have been submitted effective on the measurement date, so long as the reporting entity has the ability to redeem at NAV in the near term (for example, it has the contractual and practical ability to redeem) at the measurement date, then consistent with 820-10-35-58(a), the investment may be classified as level 2.

.25 Impact of “Near Term” on Classification Within Fair Value Hierarchy

Inquiry—What is considered “near term” for purposes of determining whether the investment would be classified as level 2 or level 3? (Refer to the inquiry in section 2220.24 for applicable FASB literature.)

Reply—What is viewed as near term is a matter of professional judgment and depends on the specific facts and circumstances. A redemption period of 90 days or less generally would be

considered near term, because any potential discount relative to the time value of money to the next redemption date would be unlikely to be considered a significant unobservable input in accordance with FASB ASC 820. However, other factors (for example, likelihood or actual imposition of gates) may influence the determination of whether the investment will be redeemable in the near term.

.26 Categorization of Investments for Disclosure Purposes

Inquiry—The sample disclosure provided in FASB ASC 820-10-55-64A appears to apply to an institutional investor with a diversified portfolio of hedge, private equity, and real estate funds. Certain entities, however, specialize in one particular investment category or have a significant investment in one such category, such as private equity or venture capital. Should these reporting entities use a different categorization than that appearing in the sample disclosure?

Reply—Yes. FASB ASC 820-10-55-64A indicates that “the major categories presented are provided as examples only and are not intended to be treated as a template. The major categories disclosed should be tailored to the nature and risks of the reporting entity’s investments.”

Accordingly, the disclosure should be tailored to address the concentrations of risk that are specifically attributable to the investments. For example, a private equity fund of funds should not simply categorize its investments as “private equity” as this categorization is not specific enough to address the nature and risks of the investee funds. In this example, more specific categorization, perhaps relating to industry, geography, vintage year, or the strategy of the investees (venture, buyout, mezzanine, and so on), may be more appropriate and more useful to the reader. Such categorization is a matter of judgment and should only be made after careful consideration of the specific risks and attributes of the portfolio investments has been made.

.27 Determining Fair Value of Investments When the Practical Expedient is not Used or is not Available

Inquiry—For entities that do not elect to use NAV as a practical expedient to estimate fair value or are unable to adjust the most recently reported NAV to estimate a NAV that is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity’s measurement date, what inputs or investment features should be considered in estimating fair value?

Reply—Section 2220.27 distinguishes between redeemable and nonredeemable types of alternative investments, which are defined as follows:

- **Investments with redeemable interests.** Typically consist of hedge funds (based both in the United States and offshore) and some bank common/collective trust funds. These

investment funds permit holders periodic opportunities to subscribe for or redeem interests at frequencies that can run from daily to annually. Certain funds may impose lock-up periods after an initial investment, under which an investor agrees that it may not redeem its investment for a specified period of time (in some cases, an early redemption may be permitted upon payment of an early redemption fee).

- **Investments with nonredeemable interests.** Typically consist of private equity, venture capital, and real estate funds. Generally, these investments have an initial subscription period, under which each investor makes a commitment to contribute a specified amount of capital as called for by the investment manager, typically as investments are identified and money is needed to acquire them. Due to the inherent illiquidity of the underlying investments, redemptions are not permitted during the fund's life; however, typically, as investments are sold or experience another liquidity event (for example, an initial public offering), the proceeds of the sale, less any incentives due to the fund sponsor, are often distributed back to the investors in the fund immediately following the sale or liquidity event.

Investment Inputs

A reporting entity might first consider the other market participants to whom it could sell the asset. In accordance with FASB ASC 820-10-35-9, “[t]he fair value of the asset ... shall be determined based on the assumptions that market participants would use in pricing the asset...” Based on guidance in FASB ASC 820-10-35-53, in the absence of relevant observable inputs, a reporting entity uses “unobservable inputs [that] shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).” In accordance with FASB ASC 820-10-35-55, “[i]n developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort.” When doing so, the reporting entity is reminded that the FASB ASC glossary defines *market participants* as “knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.” Thus, it can be presumed that a market participant would be aware of, and may be willing to accept, limitations on conversion to cash inherent to alternative investments. However, in some cases, those types of limitations may also affect the fair value measurement (see “Investment

Features”).⁶ It also can be presumed that market participants may consider other factors such as the investment manager’s track record and potentially limited access to desirable investment opportunities. Finally, it should be acknowledged that market participant assumptions normally result in a range of values. According to FASB ASC 820-10-35-24, “[a] fair value measurement is the point within that range that is most representative of fair value in the circumstances.” See FASB ASC 820-10-35-9 for further guidance. The reporting entity should also consider the guidance in paragraphs 51A–51H of FASB ASC 820-10-35.

Alternative investments may lend themselves to valuation techniques consistent with the income or market approaches. If both of these approaches are used to measure fair value, the results should be evaluated and weighted as discussed in FASB ASC 820-10-35-24. When NAV is not used as a practical expedient, examples of factors that might be used when estimating fair value (depending on the valuation technique(s) and facts and circumstances) are as follows:

- NAV (as one valuation factor)
- Transactions in principal-to-principal or brokered markets (external markets) and overall market conditions
- Features of the alternative investment
- Expected future cash flows appropriately discounted (detailed description is beyond the scope of this document; however, for many funds with nonredeemable interests, expected future cash flows from the interests might typically coincide with the expected future cash flows from the underlying investments)
- Factors used to determine whether there has been a significant decrease in the volume and level of activity for the asset when compared with normal market activity for the asset (FASB ASC 820-10-35-51A)

The preceding examples are not listed in any order of importance. Rather, the reporting entity might determine the relative weighting and importance of these inputs based on its view of what market participants might consider in estimating fair value.

Investment Features⁷

⁶ FASB ASC 820-10-35-15 states that “the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be considered by market participants in pricing the asset.”

⁷ The “Investment Features” section contains important information related to features of alternative investments that a reporting entity may consider in determining fair value when the option to utilize the practical expedient is unavailable or not elected. The list of features highlighted in this section is intended to provide some examples to better explain the types of scenarios that could impact fair values. Because individual investments may have additional terms and features, the examples included in the “Investment Features” section should not be viewed as an all-inclusive “checklist.” Professional judgment should be applied in evaluating the assumptions appropriate to any individual investment. The actual computation of fair value requires management’s professional judgment and is beyond the scope of this Technical Questions and Answers section.

A valuation technique used to measure the fair value of an asset or a liability should reflect assumptions a market participant might use to price the asset or liability, including assumptions about liquidity and risk, based on the best information available. The following discussion provides a detailed description of features of alternative investments that normally might be expected to be considered by market participants in the estimation of the fair value of an alternative investment. When considering the potential impact of the features of an alternative investment on its fair value, it is important that all relevant features be considered in the aggregate because that is how a market participant might be likely to evaluate them in determining how much it might be willing to pay for an alternative investment.

Other factors that may be considered include observed subscriptions and redemptions in redeemable interests; external market transactions in nonredeemable interests; expected future cash flows; and features of the alternative investment. Additionally, a market participant might normally be expected to compare the performance of the alternative investment to publicly available data (for example, benchmarks, indexes, expected returns, and returns of comparable vehicles), and the cash returns of the investment to NAVs reported by the alternative investment during the year. A conclusion may ultimately be reached that the reported NAV is equivalent to fair value, either because no conditions exist to suggest an adjustment is necessary or because factors indicating a discount to the reported NAV may be offset by other factors that might justify a premium. In other cases, however, the investment may be valued at a discount or premium to the reported NAV because factors indicate that the fair value of the investment is less than, or more than, the reported NAV. Regardless of whether or not NAV is determined to be equivalent to fair value, the reporting entity needs to evaluate the relevant individual factors and their potential impact on fair value, and consider the level of documentation in its evaluation.

Among the factors that market participants might be expected to consider are the various terms and features of the alternative investment. Such features generally fall into one of two categories: initial due diligence features or ongoing monitoring features. The magnitude of any adjustment resulting from consideration of ongoing monitoring features is a matter of judgment and should be evaluated based on the facts and circumstances specific to each investee fund.

Initial Due Diligence Features. Generally, *initial due diligence features* are inherent characteristics that may have been considered by the reporting entity as part of its due diligence when making its initial investment in the particular investee fund. The following provides examples of initial due diligence features of an alternative investment. Not every feature may be relevant to every alternative investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation.

Lock-up periods and redemption fees. (Typically applies only to redeemable interests)

Lock-up period refers to the initial amount of time a reporting entity is contractually required to invest before having the ability to redeem. Typically, when the lock-up period

expires, the reporting entity may redeem its interests on any scheduled liquidity date, subject to the other liquidity terms described in the investee fund's governing documents. The length of the lock-up period often depends on the quality and reputation of the fund manager as well as the expected liquidity of the underlying investment portfolio. In some instances, alternative investments may offer reduced fees if an investor agrees to a longer lock-up period. Also, some funds may permit investors to redeem during a lock-up period upon payment of a redemption fee. Such fees are typically imposed on the amount to be redeemed and generally range from 1 percent to 3 percent of the gross redemption amount.

Related to the concept of lock-up periods is the general frequency in which an investor is allowed to redeem or withdraw from a fund. In the absence of a lock-up period, investors with redeemable interests typically may only redeem at prescribed liquidity dates (generally monthly, quarterly, or annually).

Notice periods. (Typically applies only to redeemable interests)

Following the expiration of any applicable lock-up period, a reporting entity may, upon specified prior written notice (generally 45–120 days) to the general partner or manager (redemption notice), elect to redeem all or a portion of its interest as of the last day of a calendar month, quarter, or year (redemption date).

Holdbacks. (Typically applies only to redeemable interests)

When the general partner or investment manager receives a redemption notice, the fund will redeem the interests of an investor as specified in the redemption notice, at the redemption price (as discussed subsequently) as of the applicable redemption date. The fund will distribute all or a substantial portion (for example, 90 percent) of the redemption price with respect to the interests being redeemed within a specified number of business days (for example, 30 days) following the applicable redemption date. Any balance (for example, the remaining 10 percent) is distributed within a specific time frame, often following the release of the fund's audited financial statements for the year in which the redemption date falls. Holdback amounts protect the general partner or investment manager from adjustments reducing the NAV of the fund during an audit of the financial statements.

Suspension of redemptions (“gates”). (Typically applies only to redeemable interests)

Pursuant to the fund's governing documents, the general partner or investment manager can suspend or restrict the right of any investor to redeem his or her interests (whether in whole or in part). The general partner or investment manager can implement this restriction for certain reasons, including the aggregate amount of redemption requests, certain adverse regulatory or tax consequences, reduced liquidity of portfolio holdings,

and other reasons that may render the manager unable to promptly and accurately calculate the fund's NAV. The most common example is the use of a "gate," whereby certain redemption requests are deferred, in whole or in part, because the aggregate amount of redemption requests as of a particular redemption date exceeds a specified level, generally ranging from 15 percent to 25 percent of the fund's net assets. The mere presence of a provision allowing the imposition of a gate might not normally be expected to have an effect on fair value, in the absence of any evidence suggesting that the provision actually may be exercised (see "Ongoing Monitoring Features," which follows).

Lack of redemption option. (Nonredeemable interests and instances where all or a portion of otherwise redeemable interests have been declared nonredeemable)

As discussed earlier, funds investing in private equity, venture capital, or real estate investments generally do not permit withdrawals or redemptions, primarily to match the liquidity provisions of the fund with the liquidity of the investment portfolio. When the fund sells any of its portfolio holdings, it often distributes the proceeds received on the sale to the investors in the fund.

Fund sponsor approval to transfer. (Redeemable and nonredeemable interests)

As discussed earlier, in virtually all cases, transfers of interests in alternative investments are not permitted under the governing documents of the fund without the written consent of the fund sponsor or general partner, for regulatory or tax reasons or both, and thus, are inherent to the category of investments. Past experiences, as well as the current operating environment, are both considerations in assessing the likelihood of such approval being granted.

In some private equity, venture capital and real estate funds that require investors to make commitments to invest over time and periodically call on the commitments as needed, the fund sponsor or general partner may allow an investor to withdraw or redeem from the fund and, thus, be absolved of future commitments, but the investor may forfeit its existing interest if no other investors (including the fund sponsor or general partner) are willing to assume the withdrawn partner's interest, including future commitments. If forfeiture occurs (which, in practice, is rare), the investor's interest is generally reallocated to the remaining investors in the fund. (The balance of the withdrawing partner's commitment may also be reallocated to the other investors, or the total size of the fund may be reduced).

Use of "side pockets." (Typically applies only to redeemable interests)

As noted earlier, certain funds issuing redeemable interests may be allowed to invest a portion of their assets in illiquid securities. In such cases, a common mechanism used is a

“side pocket,” whereby, at the time of an investment in an illiquid security, a proportionate share of an investor’s capital account, relative to the entire interest of the fund, is assigned to a separate memorandum capital account or *designated account*. Typically, the investor loses its redemption rights to the designated account, and even a full redemption request is fulfilled only with that capital ascribed to his or her *basic capital account* (that is, the nondesignated capital account), while the investor continues to hold its proportionate interest in the designated account. Only when the security is sold (or otherwise deemed liquid) by the fund is the amount moved back to each applicable investor’s basic capital account (and otherwise withdrawn investors can redeem the designated account balance). This designated account generally does not pay a performance fee⁸ (although one may be levied) until the illiquid investment is sold or otherwise deemed liquid. Designated accounts are often referred to as “side pocket accounts” or as “special investment accounts.” Similar to “gates,” the mere existence of contractual provisions permitting the use of side pockets typically does not have a material effect on estimating the fair value unless those provisions are actually exercised and access to a portion of the investment is actually limited (see “Ongoing Monitoring Features,” which follows).

As previously noted, these examples of initial due diligence features are common characteristics of alternative investment funds and, as such, are generally considered and accepted by investors when making investment decisions in these investments. Accordingly, a market participant may or may not require an adjustment to the reported NAV in a transfer of an investment interest in an alternative investment solely due to the existence of these items. However, it is necessary to consider these features in conjunction with other inputs available to the reporting entity. For example, if the reporting entity is valuing redeemable interests and observes that other investors are subscribing for interests at the reported NAV under the same terms as the reporting entity’s agreement, that fact may provide evidence that no adjustment to the reported NAV is necessary. However, if other investors are subscribing to the fund at the reported NAV under terms that, in aggregate, are less favorable than those in the reporting entity’s agreement (for example, higher fees, greater restrictions on redemption), that fact may provide evidence that the reporting entity’s holdings may trade at a premium to the reported NAV. Similarly, if other investors are receiving more favorable terms in aggregate than those in the reporting entity’s agreement (for example, lower fees, fewer restrictions on redemption), that fact may provide evidence that the reporting entity’s holding may trade at a discount to the reported NAV. An investor may also typically consider whether the fund’s terms are more or less restrictive than those prevailing in

⁸ Consistent with the definition in the AICPA Audit and Accounting Guide *Investment Companies*, a *performance fee* (also referred to as an *incentive fee*) is a fee paid to an investment adviser based upon the fund’s performance for the period. It may be an absolute share of the fund’s performance or a share of the performance in excess of a specified benchmark.

the current market. For example, terms that are more restrictive may suggest a discount. Alternatively, the quality of the investment manager may command a premium.

In short, if market participants would be expected to place a discount or premium on the reported NAV because of features, risk, or other factors relating to the interest, then the fair value measurement of the interest would need to be adjusted for that risk or opportunity.⁹ However, if market participants might accept the same features, risk, and other factors relating to the interest and might transact at the reported NAV without a premium or discount, that fact may suggest that no adjustment is needed for the factors discussed previously to estimate fair value.

Ongoing Monitoring Features. *Ongoing monitoring features* are characteristics related to activity in an investee fund subsequent to a reporting entity's initial investment. Because ongoing monitoring features often include specific events relating to the investee fund, the fund sponsor, the industry or the asset class, they are more likely to result in consideration of a discount or premium to the reported NAV than initial due diligence features. The following provides some examples of ongoing monitoring features for an alternative investment.

As with initial due diligence features, not every feature may be relevant to a particular investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation. Also, changes in market conditions may affect the investor's assumptions relating to the significance of any particular feature.

Imposition of a gate. (Typically applies only to redeemable interests)

Though an investee fund manager's mere ability to impose a gate on redemption requests is a common initial due diligence feature (as noted previously), the actual imposition of a gate by an investee fund manager may warrant further consideration of whether a discount should be applied to the reported NAV. The act of imposing the gate generally implies that the investee fund manager is experiencing liquidity concerns, either related to specific investments or its portfolio as a whole, which the reporting entity and a market participant normally would be expected to consider in estimating fair value of the interest in the investee fund. Further, the imposition of a gate increases the uncertainty of the ultimate timing of receipt of cash upon redemption, sometimes significantly, and, thus, may impose an additional risk premium on the investment.

Redemptions from an investee fund. (Typically applies only to redeemable interests)

⁹ This is consistent with FASB ASC 820-10-35-54, which states, "A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability."

Even in the absence of the actual imposition of a gate, when an investee fund experiences material redemption requests this may suggest comparable liquidity issues that could result in a discount from the reported NAV, particularly in situations when the investee fund is leveraged.

Notification of redemption triggers the assessment of redemption fee. (Typically applies only to redeemable interests)

Though, as noted previously, an investee fund manager may have the ability to charge redeeming investors a redemption fee, the mere existence of this feature is generally considered to be an initial due diligence feature which, in many instances, may not cause the reported NAV to exceed the fair value of the investment interest. However, if a reporting entity irrevocably agrees to redeem some or all of its interest, the redemption fee normally would be expected to cause the reported NAV to exceed the fair value of the investment interest.

Significant changes in key terms of the investee fund. (Redeemable and nonredeemable interests)

The initial due diligence features, as previously noted, represent standard or common characteristics of an alternative investment. They are generally known and accepted by the reporting entity at the time of making an initial investment at the reported NAV. As such, a market participant with full knowledge of these features may also likely transact at the reported NAV, so long as the terms remain within the range prevailing in the market.

If, however, the investee fund makes significant changes to the terms (for example, fees, lock-up periods, notification periods, gates) subsequent to the initial investment, the reporting entity normally would be expected to consider these changes when evaluating whether the reported NAV should be adjusted to arrive at fair value. In some cases, changes may be deemed to have little impact on the investment decisions of a market participant, whereas in other cases, changes to key terms may create a distinct difference between the existing interest and other interests (either in the specific alternative investment or comparable investments), which may result in either a discount or premium to the reported NAV.

Closure of fund to new subscriptions. (Redeemable interests)

Some funds may cease accepting subscriptions from new investors because doing so might cause them to exceed the maximum number of investors they can accept without requiring public filings of financial information under securities laws. In other cases, funds may voluntarily suspend the acceptance of subscriptions from new investors, and even in some cases additional subscriptions from existing investors, because of the

adviser's view that opportunities to make further investments under the fund's investment strategy may be limited given the size of the markets involved or that they might not bring acceptable returns, or both. Such an event may suggest that existing interests in the fund could trade at a premium because prospective investors may have no other means of investing in the fund. Further, a large number of investors or the intent not to "dilute" the fund's returns by accepting additional investment funds, or both, may provide evidence that the fund may trade at a premium to the reported NAV.

Ability of fund to identify and make acceptable investments. (Nonredeemable interests)

Venture capital, private equity, and real estate funds typically offer interests on the basis of committed capital, which is only called from investors as investments are identified. Investors agree to commit capital under implicit or explicit understandings that committed capital will be called during an initial investment period, often from one to five years. Depending on the market environment, managers may find that they are unable to identify sufficient investments to utilize committed capital on a timely basis. Such funds often are smaller and less diversified than expected at the time of inception of the fund, which may negatively influence fair value. Further, certain *vintages* (that is, years when funds were organized) may be identified over time as having represented exceptionally good or poor investment opportunities for the particular investment style, and interests in funds organized in those years may be more likely to incur premiums or discounts, respectively. The fund's potential inability to identify and make acceptable investments will often result in unfunded capital commitments, which may need to be considered when estimating the fair value of an investment interest in the fund.

Allegations of fraud against the investee fund manager. (Redeemable and nonredeemable interests)

If the reporting entity is aware of allegations of fraud, illegal acts, or other improprieties against the investee fund manager or its affiliates, the reporting entity should consider the potential impact of these allegations on the value of its interest in the investee fund. In many cases, such allegations may result in the unexpected inability to obtain any cash proceeds from the investee fund pending the resolution of the investigation or from a general lack of liquidity resulting from historical misrepresentation of the net assets of the fund. In other cases, the ongoing ability of the investee fund manager to manage the fund may be brought into question.

Change in financial strength or key personnel of investment manager. (Redeemable and nonredeemable interests)

In some cases, a key consideration for investment in certain funds is the reputation, and prior investment record, of the investment manager, or specific individuals expected to

manage the investee fund's portfolio. In some situations, the desirability of the investment manager or individuals, or both, may influence the nature of the fee, lock-up, and similar terms investors are willing to accept in making an initial investment. If those key personnel no longer provide services to the alternative investment, investors may not be willing to continue to accept those terms. Further, if the advisory organization experiences financial deterioration, it may be less able to retain key personnel or, for certain private equity, venture capital, or real estate funds, to repay previously-received incentive fees to the fund under contractual clawback provisions (if the fund experiences subsequent losses). Those uncertainties may increase the risk of the investment.