



**KPMG LLP**  
Suite 200  
30 North Third Street  
PO Box 1190  
Harrisburg, PA 17108-1190

October 16, 2009

Audit Committee  
First State Independence Fund I, LLC  
Dover, Delaware

Ladies and Gentlemen:

We have audited the financial statements of the First State Independence Fund I, LLC (the Fund or FSIF) for the year ended December 31, 2008, and have issued our report thereon dated October 16, 2009. In planning and performing our audit of the financial statements of the Fund, in accordance with auditing standards generally accepted in the United States of America, we considered the Fund's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

During our audit, we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are summarized in Appendix A.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the Fund's organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This communication is intended solely for the information and use of management, the audit committee, State of Delaware, Office of Auditor of Accounts, and others within the Fund and is not intended to be and should not be used by anyone other than these specified parties. The Fund's written response to our comments and recommendations has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Very truly yours,

**KPMG LLP**



**First State Independence Fund I, LLC**

Observation:

The First State Independence Fund I, LLC (FSIF) was formed on June 25, 2008, and commenced operations on July 1, 2008. FSIF is a hedge fund-of-funds of which the Delaware Public Employees' Retirement System (DPERS or the System) is the sole member, and FSIF's operations are governed by the Board of Pension Trustees. Barlow Partners (Barlow) is the investment advisor for FSIF and Barlow has been given the primary responsibility for conducting ongoing monitoring controls over the investments of the FSIF. Ashford Consulting Group, Inc. (Ashford), DPERS' investment advisor, also assists in these ongoing monitoring responsibilities to a lesser extent.

Per discussions with Barlow personnel and review of materials provided by Barlow, we noted that control procedures performed include, but are not limited to: meetings with hedge fund investment managers, calculation of expected investment performance and comparison to actual results, peer group comparisons, review of quarterly SEC 13-F filings, and analysis of total FSIF exposure to long/short positions, regions and sectors. Barlow prepares a performance summary report which is distributed to management and the Investment Committee for review.

The AICPA Practice Aid: *Alternative Investments – Audit Considerations* notes that “*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. This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity’s management. Although the investor entity’s management may look to the fund manager for the mechanics of the valuation, management must have sufficient information to evaluate and independently challenge the fund’s valuation. The underlying investments generally are measured at estimated fair value by the fund manager in accordance with its stated valuation policies for determining net asset value.*”

During preliminary discussions and audit planning meetings held with management, it was indicated to KPMG that management would have visibility into the underlying holdings of the investments of the FSIF. However, it was subsequently determined that neither Barlow, DPERS, or KPMG would be provided with listings of the underlying investments held by the individual fund managers.

As indicated above, management has given Barlow primary responsibility for conducting ongoing monitoring controls over the investments of the FSIF. Management currently does not have adequate review and documentation control procedures in place which would allow management to conclude on the results of procedures performed by Barlow and take responsibility for the valuation of investments. This lack of management oversight was mitigated by the fact that the FSIF's year-end was changed from June 30 to December 31. This change was made to coincide with the availability of audited financial statements for all of the funds held by the FSIF. However, the potential inability to opine on the FSIF financial statements as of June 30 could affect an auditor's ability to issue an unqualified opinion on DPERS' financial statements as a whole as of June 30, if the FSIF were to become more material to the DPERS overall financial position.



Recommendation:

The AICPA Practice Aid: *Alternative Investments – Audit Considerations* notes that “Taking responsibility for the valuation of the alternative investments will necessitate that the management of the investor entity has a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method and significant assumptions used by the fund manager to value the underlying investments. The nature and extent of management’s process for valuing investments, and the related internal controls, are particularly important when the investor entity invests in securities for which readily determinable fair market values do not exist. In these instances, management should have in place a process and internal control over that process to ensure that its alternative investments are recorded at amounts in accordance with its stated accounting policies. Management’s valuation process need not include recalculation of estimated fair values for alternative investments, but it should ensure that the investor entity’s management has a sufficient understanding of the characteristics of the underlying investments and the alternative investment’s valuation process for investments held as of the investor entity’s balance sheet date.”

KPMG recommends that management evaluate the monitoring procedures already being performed by DPERS, as well as those being performed by Barlow and Ashford, and implement additional internal review procedures and documentation standards to be in a position for management to take responsibility for the valuation of the investments held by the FSIF at other than calendar year-end.

Management Response:

DPERS’ staff is undertaking a project to review and develop documentation protocols/ financial controls and compliance oversight of the financial processes, procedures and controls in place to monitor DPERS’ assets and the First State Independence Fund (FSIF). Increased documentation and communication has been requested from DPERS Investment Advisor and the Manager of the FSIF. It is anticipated that, additionally, the FSIF will impose certain standards on managers brought into the FSIF to include that managers use Third Party Administrators, Independent Brokerage Accounts, and are SAS70 compliant. This should provide FSIF greater transparency and independence in the valuation methodology. Additionally, DPERS is mindful of the fluid status of the regulatory markets and is proactively monitoring the markets for potential new regulatory initiatives to further regulate these types of investments.