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The hedge fund industry reached a record $2.35tn in Q1 2013, with net new capital inflows totaling $15bn for the quarter.\(^1\) Hedge fund assets have rebounded nearly 80% since the financial crisis having experienced positive inflows for 15 of the last 16 quarters.\(^2\) Despite record growth in hedge fund assets, investors hold on to the hard-learned lessons from past events such as Madoff, the financial crisis of 2008, and MF Global to name just a few. As institutional allocators become an increasingly more important part of the hedge fund investor community, they bring with them strict rules to safeguard assets over long-term investment periods. Investors expect managers not only to generate positive risk-adjusted returns but to also mitigate risk which ultimately brings a hedge fund’s people, process and technology into focus. Investors have indicated that while a period of poor performance may be forgiven in the short-term, operational failure will never be tolerated.

Against this backdrop, operational due diligence (OODD) continues to be a critical part of the pre-investment and on-going due diligence process. Hedge funds, more than ever, need to invest the time and resources to institutionalize their infrastructure in order to meet investors’ expectations. In this study, the Deutsche Bank Hedge Fund Consulting Group highlights how ODD teams have evolved in terms of their skill-sets and process, outlines what is expected of managers before, during, and after the ODD process, and provides insights as to how managers may prepare for the road ahead.

\(^1\)HFR Report 1Q2013  
\(^2\)HFR Report 1Q2013
Key Highlights

1. **The importance of ODD in the investment decision process is increasing.** Over 70% of ODD teams now have explicit veto authority, which was exercised in almost 10% of the manager reviews conducted by our respondents last year. Furthermore, 63% of investor respondents will not reconsider investing in a fund that their ODD team has previously vetoed.

2. **New and changing regulatory requirements will influence ODD reviews.** 74% of ODD teams ranked a fund’s compliance and regulatory framework as a top focus area for 2013 and 55% of investors expect to review a fund’s Form PF as part of the ODD process.

3. **Investors are placing greater emphasis on the depth and breadth of their ODD team.** Respondents on average conduct 50 manager reviews a year, and almost 80% of respondents have dedicated ODD teams. 64% of those have teams of four or more people. Teams predominantly consist of operations and accounting experts; however, we expect to see allocators increasingly looking for legal and compliance backgrounds in the future as they place the spotlight on a fund’s regulatory framework.

4. **Managers can expect a thorough review of daily operations during the site-visit.** Many investors have indicated a “trust but verify” approach to validating what managers represent in their documentation during the ODD review. Almost 60% of respondents state that they observe daily operations as part of a typical ODD review and we expect this percentage to increase significantly in the coming years.

5. **Start-up managers need to invest in people and process.** Investment in human capital and proper segregation of duties were ranked as the top two operational recommendations for start-up and emerging managers.

6. **Investors are increasingly focused on fund expenses.** The majority of respondents have little or no tolerance for certain expenses being charged to the fund, such as non research-related travel and employee compensation. However, over 40% of respondents feel that it is acceptable to charge regulatory reporting to the fund, provided that it is disclosed appropriately.

7. **Independent governance is expected.** The majority of respondents prefer at least three directors on the board including two independent directors. Furthermore, nearly a quarter of respondents have vetoed an investment due to lack of independent governance.
Methodology & Investor Profile
Earlier this year, we asked our global hedge fund investor network to participate in this survey, and we gathered the data over the subsequent two months.

The context in which investors have been answering the survey is during a time of intense regulatory change in the industry and increased pressure for hedge fund managers to institutionalize their infrastructure. We believe that the profile represented in the survey is consistent with current industry trends including the institutionalization of the hedge fund investor base, consolidation of assets at larger allocators, and allocation activity predominantly based in North America.

Our respondents comprise a wide variety of investor types from around the globe. The respondents represent 68 investor entities from North America, Europe/Middle East/Africa (“EMEA”), and Asia/Australia that collectively manage and/or advise on over $2.13tn of total assets with a hedge fund allocation in excess of $724bn.

**Investor Profile:**

- Institutional investors, which for the purposes of this survey include consultants, endowments, public pensions and sovereign wealth funds, account for 37% of respondents by number, yet manage approximately 79% of total hedge fund assets under management (“HF AUM”) represented in the survey.

- Funds of funds are the largest contributing group by number representing 47% of respondents, yet accounting for only 18% of HF AUM.

- High Net Worth (“HNW”) investors, which include private banks and family offices, represent 16% of respondents and 3% of HF AUM.

- The majority of respondents are based in North America, representing 69% of respondents and 81% of HF AUM. EMEA and Asia/Australia collectively represented 19% of HF AUM and 31% of respondents.

- 63% of responding investors manage more than $1bn in HF AUM
Respondents’ Total HF AUM by Size

- Less than $500mn: 22%
- $500mn to $1bn: 15%
- $1bn to $5bn: 38%
- $5bn to $10bn: 12%
- $10bn and over: 13%

Source: 2013 Deutsche Bank ODD Survey

Percentage of Respondents’ HF AUM by Region

- Asia/Australia: 4%
- EMEA: 15%
- North America: 81%

Source: 2013 Deutsche Bank ODD Survey

Breakdown of Respondents by Type

<table>
<thead>
<tr>
<th>Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional</td>
<td>79%</td>
</tr>
<tr>
<td>HNW</td>
<td>3%</td>
</tr>
<tr>
<td>Funds of funds</td>
<td>18%</td>
</tr>
</tbody>
</table>

Source: 2013 Deutsche Bank ODD Survey

Percentage of Respondents by Region

- Asia/Australia: 69%
- EMEA: 19%
- North America: 12%

Source: 2013 Deutsche Bank ODD Survey
Composition of the ODD Team
Almost 80% of investors use a dedicated ODD team to evaluate a manager ahead of making an investment. Endowments, which accounted for the majority of the respondents who do not have a dedicated ODD team, typically integrate the ODD function into their broader investment review and use a combination of investment and non-investment staff.

**Dedicated vs Non-dedicated ODD Team**
Who primarily conducts operational due diligence for your firm?

- 22% Dedicated ODD professional / team
- 78% Non-dedicated team or consultant

Source: 2013 Deutsche Bank ODD Survey

Globally, ODD teams are increasingly larger with 62% of all investors reporting ODD teams of four or more people. This growth may be attributable to the growing number of reviews that ODD teams are now conducting. Survey respondents conduct an average of 50 manager reviews annually. North American allocators complete on average twice as many manager reviews when compared to their to EMEA and Asia/Australia peers. This is largely due to the fact that investment activity has been notably higher in North America, where allocators are more likely to have larger investment teams. Likewise, institutional investors in our survey completed nearly twice as many reviews as responding funds of funds and HNW investors.
Team Size
How many people in your firm are involved in some or all aspects of ODD?

```
<table>
<thead>
<tr>
<th></th>
<th>1-3 people</th>
<th>4+ people</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dedicated ODD</td>
<td>29%</td>
<td>49%</td>
</tr>
<tr>
<td>professional / team</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

```
|                      | 9%         | 13%       |
| Non-dedicated team   |            |           |
| or consultant        |            |           |

Source: 2013 Deutsche Bank ODD Survey

Number of Manager Reviews (by region)
For how many managers have you conducted an ODD review in the past 12 months?

```
<table>
<thead>
<tr>
<th>Region</th>
<th>All investors</th>
<th>North America</th>
<th>EMEA</th>
<th>Asia / Australia</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>50</td>
<td>60</td>
<td>30</td>
<td>25</td>
</tr>
</tbody>
</table>
```

Number of Manager Reviews (by type)
For how many managers have you conducted an ODD review in the past 12 months?

```
<table>
<thead>
<tr>
<th>Type</th>
<th>All investors</th>
<th>Institut.</th>
<th>Funds of Funds</th>
<th>HNW</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>50</td>
<td>68</td>
<td>44</td>
<td>29</td>
</tr>
</tbody>
</table>
```

Source: 2013 Deutsche Bank ODD Survey
ODD teams are comprised of individuals that are well equipped to assess the quality of a fund’s non-investment infrastructure. More than 50% of an average ODD team has specific industry experience in accounting or operations. Given investors’ increased focus on the fund’s compliance and regulatory framework, we expect to see a shift in the profile of the average ODD team, placing greater emphasis on legal and compliance backgrounds.

**Skill-sets of the ODD Team**

Indicate the primary skill-set of each individual within your ODD team.

- **Accounting**: 29%
- **Operations**: 24%
- **Investments**: 15%
- **Legal**: 10%
- **Compliance / Regulatory**: 7%
- **Risk**: 6%
- **Internal audit**: 4%
- **Information technology**: 3%
- **Human resources**: 1%
- **Marketing**: 0%

Source: 2013 Deutsche Bank ODD Survey

*Refers to chart “ODD Focus Areas for 2013” on page 44*
Duration and Frequency of Reviews
The ODD process requires a considerable amount of time for both managers and investors. Almost half of respondents in our survey spend 4-8 weeks on ODD and will likely repeat the ODD process annually. The duration of the ODD process varies considerably among institutional investors. Endowments, who conduct integrated investment and operational due diligence, tend to complete the operational portion in less than 2 weeks, whereas consultants and pensions with dedicated ODD teams are more likely to take between 8 and 12 weeks.

**Duration of ODD Review**
Prior to investing, on average, what is the duration of a typical ODD review?

**Duration of ODD Review (by type)**
Prior to investing, on average, what is the duration of a typical ODD review?

Source: 2013 Deutsche Bank ODD Survey
In the absence of a trigger-event, defined as a major change to the fund or management company, investors typically conduct ODD reviews on a prescriptive basis. 63% of responding investors perform annual reviews.

**Frequency of ODD Reviews**

In the absence of a major change to the fund, how often do you typically conduct ODD reviews post-investment?

- 63% Annually
- 9% Semi-annually
- 9% Quarterly
- 12% Every 2-3 years
- 7% Solely based on risk factors or trigger-events

*Source: 2013 Deutsche Bank ODD Survey*
49% of respondents cited regulatory investigations as the most common trigger for an out-of-cycle review. Hedge funds are now subject to multiple regulatory inquiries globally. For US managers, SEC inquiries have become more prevalent in recent months with the introduction of “presence exams” for newly registered funds which focus on five “higher-risk” areas: marketing, portfolio management, conflicts of interest, safety of client assets and valuation. For UK managers, both SEC and FSA inquiries have become more common, especially with respect to market abuse and insider dealing offenses.

**Out-of-Cycle Review Factors (Top Choice)**

Indicate and rank the following factors that would trigger an out-of-cycle review (Top choice)

- Regulatory investigations: 49%
- Key person or principal’s departure: 22%
- NAV re-statement: 13%
- Senior back-office staff changes: 12%
- Change of administrators: 3%
- Redemption of founders’ shares: 1%
- Changes of other key service providers (legal, accountant, etc): 0%

Source: 2013 Deutsche Bank ODD Survey
The ODD Review
The Due Diligence Questionnaire (DDQ)

Preparation begins with a comprehensive DDQ. Results from the survey suggest that investors are largely indifferent towards DDQ templates with nearly half of investors saying that they had no preference as to which template managers use. Concurrently, there is a slight preference for the Alternative Investment Management Association (AIMA) template over internally constructed documentation, with 31% citing the former and 23% citing the latter. In practice, many managers will prepare both AIMA and internal templates, with their own internal document summarizing answers to investor questions not included in the AIMA DDQ. Most will also include a marketing presentation to tell the story of the firm and provide an introductory overview.

Documentation Requirements

The ODD review requires that the manager supply or make available dozens of documents, which the ODD team will subsequently spend several weeks reviewing. The chart “Documentation Time Frame” on the next page shows the specific documentation that responding investors require before, during, or after a site visit.

Respondents are fairly divided on how they plan to review and utilize newly reported regulatory information, such as Form PF. 55% of investors expect to review a fund’s Form PF either prior to or during a site visit. Investors are in a better position to ask for the document if the fund, rather than the management company, has paid for its preparation.
### Documentation Time Frame

**When do you typically receive each document?**

<table>
<thead>
<tr>
<th>Document Type</th>
<th>Prior to Site Visit</th>
<th>During Site Visit</th>
<th>Never</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Organizational Documents</td>
<td>99%</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Director Information / Bios</td>
<td>96%</td>
<td>4%</td>
<td>1%</td>
</tr>
<tr>
<td>Marketing Materials / Presentation</td>
<td>96%</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>Due Diligence Questionnaire</td>
<td>96%</td>
<td>4%</td>
<td>1%</td>
</tr>
<tr>
<td>Financial Statements</td>
<td>93%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>Form ADV I &amp; II</td>
<td>90%</td>
<td>1%</td>
<td>9%</td>
</tr>
<tr>
<td>Valuation Policy</td>
<td>87%</td>
<td>10%</td>
<td>3%</td>
</tr>
<tr>
<td>Trade Flow Diagram</td>
<td>78%</td>
<td>16%</td>
<td>6%</td>
</tr>
<tr>
<td>Partnership / Shareholder Agreement</td>
<td>78%</td>
<td>7%</td>
<td>15%</td>
</tr>
<tr>
<td>Staff Turnover Metrics</td>
<td>73%</td>
<td>16%</td>
<td>11%</td>
</tr>
<tr>
<td>Risk Summary Report Sample</td>
<td>67%</td>
<td>16%</td>
<td>17%</td>
</tr>
<tr>
<td>BCP / DR Plan and Written Test Results</td>
<td>61%</td>
<td>28%</td>
<td>11%</td>
</tr>
<tr>
<td>Compliance Manual</td>
<td>57%</td>
<td>37%</td>
<td>6%</td>
</tr>
<tr>
<td>Fund Administration Agreement</td>
<td>54%</td>
<td>22%</td>
<td>24%</td>
</tr>
<tr>
<td>Counterparty Exposure Reports</td>
<td>51%</td>
<td>34%</td>
<td>15%</td>
</tr>
<tr>
<td>Authorized Trading Signatories</td>
<td>49%</td>
<td>33%</td>
<td>18%</td>
</tr>
<tr>
<td>Prime Broker Agreements / Trading Agreements</td>
<td>43%</td>
<td>23%</td>
<td>34%</td>
</tr>
<tr>
<td>Results of Regulatory Exams (i.e. SEC Deficiency Letter)</td>
<td>34%</td>
<td>51%</td>
<td>34%</td>
</tr>
<tr>
<td>Monthly NAV Reporting Package</td>
<td>33%</td>
<td>55%</td>
<td>12%</td>
</tr>
<tr>
<td>Form PF</td>
<td>33%</td>
<td>45%</td>
<td>15%</td>
</tr>
<tr>
<td>Agenda / Minutes from Most Recent Board Meeting(s)</td>
<td>33%</td>
<td>22%</td>
<td>45%</td>
</tr>
<tr>
<td>Sample Daily Reconciliation Reports</td>
<td>12%</td>
<td>73%</td>
<td>15%</td>
</tr>
</tbody>
</table>

*Source: 2013 Deutsche Bank ODD Survey*
The Site Visit

52% of institutional investors “sometimes” observe daily operations, while 48% “always” conduct this type of review. Many investors have indicated a “trust but verify” approach to validate documented processes, and as such, we expect that over time the majority of investors will observe daily operations as part of their standard review.

Initial On-Site Review of Daily Operations
During an initial on-site review, do you observe daily operations?

Source: 2013 Deutsche Bank ODD Survey

Initial On-Site Review of Daily Operations (by type)
During an initial on-site review, do you observe daily operations?

Source: 2013 Deutsche Bank ODD Survey
Almost 60% of responding investors review daily operations including daily reconciliations (trades, positions, and cash), trade booking, and cash controls and wire management during the initial on-site review. Investors also noted compliance monitoring, IT infrastructure, and physical security as areas of focus during a visit.

**Functions Observed During Initial On-Site Review**

*What functions do you observe during an initial on-site review?*

- **Daily reconciliations (trades, positions, cash)**: 91%
- **Trade booking**: 81%
- **Cash controls and wire management**: 81%
- **Other**: 21%

Source: 2013 Deutsche Bank ODD Survey
Service Provider Reviews

Almost 100% of investors say that they will contact the fund’s administrator.

When contacting fund administrators, investors will inquire about the ownership structure and operations of the fund administrator, including assets under administration, staff experience and office locations. A thorough review of the processes for daily reconciliations, trading flows, NAV calculation, AML/KYC, pricing and valuation is also a standard procedure.

78% will contact the fund’s prime brokers.

Investors will also contact prime brokers to verify the relationship with the fund as well as the date that the relationship was established. In addition, investors will ask for net equity and/or AUM as of a specific date in time and may review this figure on a regular basis. Finally, investors will also often request an authorized signatory list.

66% will contact the fund’s accountants.

When investors reach out directly to accounting/tax firms, they will verify the exact service level engagement the firm has with the fund in question, and request bios of the entire service team (including tax). Investors will want to thoroughly understand the firm’s approach to valuation and their overall role in the process. Finally, they will request to see the indicative annual fee structure for their services and will ask for details of any liability caps. At a minimum, accounting/tax firms will confirm their level of engagement with the fund.
Acceptable Outsourced Functions

Outsourcing certain functions has become increasingly acceptable to investors. Outsourcing enables the manager to scale the business more efficiently and provide access to expertise in either deep technical or rapidly changing topical areas. However, there is a disparity among investors as to which functions are appropriate to be outsourced. 96% of investors agree outsourcing IT support is acceptable, whereas only 46% and 41% feel that outsourcing risk reporting and middle office, respectively, is appropriate. Outsourcing the CFO is unacceptable for the overwhelming majority of respondents.

66% of investors will allow for outsourced compliance. Utilizing an outsourced compliance consultant has become more common over the past few years as investors have become increasingly comfortable with these specialist consultancy firms. Additionally, we have observed over the last few years an increase in the quality of service provider offerings which is a trend that is expected to continue. Outsourced compliance firms do not eliminate the need for a Chief Compliance Officer, who still remains responsible for this area to regulators, but they will supplement the compliance monitoring and reporting functions. This can be a substantial benefit for smaller funds with COO’s who also act as the CCO.

Outsourcing
What do you consider acceptable for managers to outsource?

- IT support: 96%
- Marketing (Third-party marketer): 79%
- Compliance: 66%
- Risk reporting: 46%
- Middle office: 41%
- Trading: 13%
- CFO function: 7%

Source: 2013 Deutsche Bank ODD Survey
Suggestions for Start-Up and Emerging Managers

Investors need to have confidence in the people, processes and technology necessary to safeguard their investment. When start-up and emerging managers determine their organizational structure, consideration of the segregation of duties is as important as determining the appropriate number of employees.

In terms of segregation, investors will focus on checks and balances in order to help prevent against fraud and misappropriation. At the highest level this means separating the approvals and instructions (e.g. trading and cash movements) from accounting, reconciliation, and custody. Investors recognize the difficulty that smaller firms face with fewer employees; however, they expect reasonable efforts to be made including compensating controls or reporting and reconciliation via a third-party such as a fund administrator or custodian.

Our respondents ranked building a skilled, capable and experienced team and ensuring segregation of duties as the most important considerations for start-up and emerging managers.

Suggestions for Start-Up and Emerging Managers
Rank your suggestions for start-up managers in order of importance. (Top three rankings)

- Ensure segregation of duties: 26%
- Invest in human capital: 25%
- Ensure fund terms are commensurate with fund strategy: 14%
- Ensure sufficient written policies and procedures: 11%
- Demonstrate procedure for reconciling to your administrator: 10%
- Invest in technology: 9%
- Demonstrate process for evaluating service providers: 3%
- Demonstrate level of expertise negotiating counterparty agreements (e.g. PB, ISDA): 2%

Source: 2013 Deutsche Bank ODD Survey
External Certifications
While gaining an external third-party certification can be a helpful exercise on behalf of the manager, especially in terms of optimizing the fund’s processes and controls, 87% of respondents will conduct the same level of ODD regardless of any type of external certification.

External Certifications
Will you reduce the level of ODD procedures you undertake for a manager that has an external certification?

- **Same level of review regardless**: 87%
- **Reduced level of review with certification**: 13%

Source: 2013 Deutsche Bank ODD Survey
The Veto Right
While the ODD process occurs in tandem with the investment due diligence process, ODD typically starts after a significant amount of work has already been done by the investment team. Regardless of how much effort has been expended on the investment due diligence process, the results from our survey show that over 70% of ODD teams have an explicit right to veto an investment and have exercised their veto authority in almost 10% of reviews conducted by respondents last year.\(^4\)

**Explicit Veto Right**
Does your ODD team have an explicit veto right?

![Pie chart showing 71% 'Yes' and 29% 'No']

Source: 2013 Deutsche Bank ODD Survey

\(^4\)10% veto rate calculated based on number of vetoes reported by respondents divided by total number of manager reviews conducted by respondents
While 91% of funds of funds have an explicit veto right, only 44% of institutional investors hold the same authority. This can be explained based on the fact that the institutional category in this survey consists largely of endowments that typically do not have an explicit ODD veto right.

**Explicit Veto Right (by type)**

ODD teams with an explicit veto right

Source: 2013 Deutsche Bank ODD Survey
Top Factors Contributing to an ODD Veto

Our respondents cited several factors that played a critical role in their ODD team’s decision to veto an investment last year. The most frequently cited factors include:

**Insufficient operational/technology infrastructure:**

In recent years, investors have become increasingly focused on ensuring managers implement a “strategy-appropriate” infrastructure. The infrastructure for a global structured credit fund could look very different from a typical long/short equity fund, for example.

**Poor segregation of duties and insufficient personnel:**

According to respondents, a weak or inexperienced team with undefined front and back-office responsibilities will inevitably lead to poor segregation of duties. This ranked as the second most common reason for an ODD veto (42%).

**Insufficient compliance policies and procedures:**

This category tied for the second most common reason for an ODD veto (42%). Compliance policies and procedures become even more important given that investors indicated they plan to increase focus on the compliance and regulatory framework of a fund.5

Many of the ODD veto factors listed on the next page are correlated to the respondents’ top suggestions for start-up and emerging managers.6 Again, respondents have demonstrated that they place particular emphasis on segregation of duties and human capital.

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5Refers to chart “ODD Focus Areas for 2013” on page 44
6Refers to chart “Suggestions for Start-Up and Emerging Managers” on page 26
Factors Contributing to an ODD Veto

For those managers who received an ODD veto in the past year, indicate which factors contributed to the veto.

Source: 2013 Deutsche Bank ODD Survey
63% of investors reported that they would not reconsider investing in a fund that initially received an ODD veto. Of those respondents that will consider investing after an initial veto, funds of funds comprise almost half (45%) and institutional investors account for only 18%.

Interestingly, European investors are more likely to reconsider an investment after an initial ODD veto. European investors responding to the survey mentioned that they often will outline specific areas the respective manager needs to improve or change prior to their investment, and some even work with the manager to guide them as they implement these changes.

Reinvestment After an ODD Veto
Have you ever invested in a fund initially given a veto?

Source: 2013 Deutsche Bank ODD Survey

Reinvestment After an ODD Veto (by region)
Percentage of investors that have invested in a fund initially given a veto

Source: 2013 Deutsche Bank ODD Survey

Reinvestment After an ODD Veto (by type)
Percentage of investors that have invested in a fund initially given a veto

Source: 2013 Deutsche Bank ODD Survey
Current Areas of Focus for Investors
There are certain business considerations, including compensation and retention structures, fund expenses, corporate governance, and personal trading policies that investors place particular emphasis on during the ODD process. It is important for managers to understand these key areas, as well as investor expectations for them, in order to ensure that policies and documentation meet investor requirements.

**Fund Expenses:** Results from the survey affirm that investors are placing greater scrutiny on fund expenses. Over half of investors find it unacceptable for any of the expenses in the chart “Expenses Charged to the Fund” to be charged to the fund even if disclosed in the prospectus or offering memorandum. The majority of respondents have little or no tolerance for certain expenses, such as non research-related travel and employee compensation, to be charged to the fund. That said, over 30% consider it acceptable to charge regulatory reporting to the fund provided that it is properly disclosed. The Deutsche Bank Hedge Fund Consulting Group takes the view that this will be an area to watch in the year ahead when the use of various regulatory reports is expected to be determined.

**Expenses Charged to the Fund**
Which of the following expenses would you accept as a fund expense if disclosed in the Prospectus / Offering Memorandum?

![Bar chart showing percentages of expenses accepted by investors](chart.png)

Source: 2013 Deutsche Bank ODD Survey
**Transparency on Compensation and Retention Structures:** Investors typically focus on compensation and retention with a view to align their interests with those of the respective hedge fund manager. Investors have historically focused on the level of fund investment by key principals, but they are now requesting further transparency on the compensation structure for all employees. Over 66% of investors request such information, including equity ownership of the management company, revenue share, deferrals, discretionary bonus and base salaries. 87% of those investors requesting increased transparency specifically request the equity ownership breakdown of the management company.

**Requested Information on Compensation**

If you require transparency on compensation and retention structures, indicate which of the following you request?

- **Equity ownership of management company:** 87%
- **Revenue share:** 74%
- **Deferrals:** 61%
- **Discretionary bonus:** 54%
- **Base salaries:** 48%

Source: 2013 Deutsche Bank ODD Survey
Corporate Governance: The institutionalization of the hedge fund industry has brought corporate governance into focus, and today it ranks fourth among the most important areas to watch for 2013. The growing institutional capital base has meant higher governance standards and requirements for managers. For example, the majority of investors prefer a fund to have at least three directors, two of whom are independent. There is also a strong preference for a minimum of four board meetings per year, with at least one in-person meeting.

Number of Board Meetings Annually
How many total board meetings should a fund have each year?

- Minimum number of board meetings
- Number of in-person board meetings

Source: 2013 Deutsche Bank ODD Survey

Refer to chart “ODD Focus Areas for 2013” on page 44
Shadow Accounting: In an industry where investors expect a fund’s books and records to be created and maintained by a third-party fund administrator, there is an active debate as to whether the management company, at its own expense, should replicate the third-party administrator’s books and records (i.e. trial balance, general ledger) for the fund. While less than a third of respondents require shadow books and records for the fund, nearly 70% of investors prefer it; however only 8% of respondents vetoed an investment due to lack of shadow accounting.\(^8\)

**Shadow Accounting Preference**

Assuming adequate controls are in place, is shadow accounting required, preferred, or not necessary?

![Chart showing the preference for shadow accounting across different investor categories.](image)

Source: 2013 Deutsche Bank ODD Survey

\(^8\)Refer to chart “Factors Contributing to an ODD Veto” on page 33
Personal Trading Policy: Establishing a policy for employee trading that is consistent with investors’ expectations, and demonstrating compliance with that policy during a review are important requirements for managers. 65% of responding investors prefer that there is no personal trading in either securities held by the fund or in asset classes traded by the fund.

Personal Trading Policy Preference

<table>
<thead>
<tr>
<th>Policy Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No personal trading in asset classes traded by the fund</td>
<td>34%</td>
</tr>
<tr>
<td>No personal trading in securities held by the fund</td>
<td>31%</td>
</tr>
<tr>
<td>No personal trading in individual securities or indices</td>
<td>18%</td>
</tr>
<tr>
<td>No personal trading</td>
<td>17%</td>
</tr>
</tbody>
</table>

Source: 2013 Deutsche Bank ODD Survey
Insurance: During the ODD review, investors expect transparency from the manager regarding type and level of insurance. Interestingly, while most investors will inquire about insurance levels as part of the ODD process, less than 50% indicated Directors & Officers (D&O) and Errors & Omissions (E&O) insurance as mandatory and a vast majority, over 80%, consider key person life and employment practice coverage to be optional.

**Insurance Preference**
Is coverage of the following insurance mandatory or optional?

Source: 2013 Deutsche Bank ODD Survey
A Look Ahead: 2013 and Beyond
ODD Focus Areas for 2013
For which issues will you increase your focus in 2013?

- Compliance / regulatory framework: 74%
- Valuation: 46%
- Counterparty risk: 40%
- Corporate governance: 34%
- Reputational risk / background checks: 25%
- Risk management: 21%
- Outsourcing: 12%
- Treasury management: 12%
- Technology: 9%
- Legal documentation: 9%
- Business continuity / Disaster recovery: 6%
- Succession planning: 4%

Source: 2013 Deutsche Bank ODD Survey
74% of respondents plan to increase their focus on the compliance and regulatory framework of a fund in 2013.

This is indicative of the many global regulatory changes (mandatory SEC registration, central clearing for OTC instruments, AIFMD, and Form PF to name a few) that have come into focus this past year. As regulators seek to bring increased transparency to the industry, managers and investors alike must also educate themselves on these regulations and determine how new regulatory requirements will impact operational and investment decisions. Many of these new requirements oblige funds to increase investment in their back-office resources as well as the systems that help them to aggregate the required data. As a result, we have observed growing interest among managers in evaluating and installing data aggregation products and services.

46% of respondents will increase focus on proper valuation policies and procedures for hard-to-value assets.

The emphasis on ensuring multiple broker quotes and independent third-party valuation continues to grow. Firms that trade illiquid and hard-to-value assets will often create a formal valuation committee comprised of senior principals on both the investment and non-investment side of the business. 97% of respondents in this survey want to review and discuss the fund’s valuation policy and 100% will contact the fund’s administrator. 9/10

40% of respondents will be more focused on counterparty risk

Post-2008, there was a spike in interest for establishing multi-prime broker and custodial bank relationships to manage counterparty risk. Recent regulatory changes such as mandatory OTC clearing and AIFMD will place further emphasis on the fund’s counterparty relationships. As investors adapt to these requirements, hedge fund managers should expect more in-depth conversations regarding their choice of counterparties and the commercial and risk terms negotiated with each firm.

9Refer to chart “Documentation Time Frame” on page 21
10Refer to “Service Provider Reviews” text on page 24
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