Deutsche Bank
Global Prime Finance

Third Annual
Operational Due Diligence Survey
Summer 2014

Passion to Perform

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Introduction & key highlights

At the end of 2013, industry assets reached a record high of USD $2.6 trillion and hedge funds, typically classed as an "alternative" strategy, made their mark as an important part of the mainstream asset management industry.[1] The incredible growth of the hedge fund industry, and particularly the growth since the financial crisis of 2008, has led not only to the institutionalization of the industry, but also to the increased utilization of hedge funds as part of an investor's broader set of portfolio solutions. As a result, the business model of hedge funds has changed considerably. Investors and regulators expect and require significantly more robust operating infrastructure across all levels of the hedge fund organization, ranging from compliance to technology. As a result, Chief Operating Officers ("COO") at hedge funds, now more than ever, must successfully navigate an exhausting list of challenges ranging from cross-border regulatory reporting and regulatory exams to increased transparency and technology.

Against the backdrop of growth, operational due diligence ("ODD") remains a critical component of the pre-investment and ongoing due diligence process. Hedge funds need to ensure that their resources and infrastructure meet the expectations of both institutional investors and regulators alike. In our third annual ODD study, the Deutsche Bank Hedge Fund Consulting Group highlights how ODD teams approach a review in terms of skill-sets and process, outlines what managers may expect throughout the initial and ongoing ODD review and provides insights as to how managers may prepare for the year ahead.

Earlier this year, we asked our global hedge fund investor network to participate in this survey. We thank our investor network for contributing their valuable time and insight to make this publication possible.

[1] 2014 Deutsche Bank Alternative Investment Survey

Key highlights

1. **Expenses charged to the fund come under more scrutiny.**
64% of respondents will investigate miscellaneous line item expenses and may place limits on certain expenses. Respondents have little tolerance for certain expenses being charged to the fund, such as employee compensation, marketing and non research-related travel.

2. **Unwillingness to provide transparency is the most frequently cited reason for an investor veto, moving to first from seventh place in 2013.**
Investors vetoed investments in 7% of their reviews this past year, and indicated a wide variety of reasons for doing so. The five most frequently cited "red flags" are an unwillingness to provide transparency, inadequate compliance policies and procedures, poor segregation of duties, individuals' lack of experience in critical roles and inappropriate valuation policies.

3. **An overwhelming majority (81%) of ODD teams are willing to provide constructive feedback to managers in order to enable an investment.**
While 65% of responding investors have explicit veto authority, meaning the right to block an investment entirely, surprisingly 81% indicated they are willing to take a consultative approach through the use of a "qualified" veto which allows a manager to remedy a stated deficiency in order to reengage with the investor.

4. **The compliance and regulatory framework of a fund manager continue to be of critical importance to investors.**
73% of responding investors will be increasingly focused on the compliance and regulatory framework of a fund manager in 2015. The industry continues to face new and ongoing regulatory reporting requirements, leaving investors and managers to cope with mounting challenges and deadlines, particularly as regulation becomes more cross-border in nature (e.g., FATCA, AIFMD, EMIR, etc.). Overall, investors seek to understand how the manager will mitigate regulatory risk posed by registration, reporting and exams required by regulators.

5. **Valuation is in sharp focus for 38% of responding investors in 2014.**
Indeed, concerns around valuation were one of the top five reasons investors issued a veto over the past year. 100% of respondents indicated that they will review a fund's valuation policy during the ODD review and 78% stated that they will verify the valuation procedure during the on-site review.

6. **Outsourcing of key functions is a more accepted practice for emerging managers.**
68% of respondents indicated a willingness to invest with emerging managers, defined in this survey as a manager who has a track record of less than three years. Responding investors highlighted some differences when compared to their approach to established managers. They are slightly more likely to veto an emerging versus established manager (9% veto rate versus 6%). Additionally, investors are more accepting of outsourcing key functions at emerging managers. Finally, they will spend more time reviewing daily operations, speaking with more senior management including the CIO and fund directors.

2 Methodology & investor profile

The environment in which investors answered the survey is one of continued regulatory pressure as the alternatives industry adapts to the impact of global regulation. Additionally, the business model of hedge funds is becoming ever more institutional, converging with the their peers in the broader asset management industry. These changes mean hedge funds face greater challenges in handling regulatory, reputational, business and operational risk, in addition to delivering returns for their clients.

Our respondents comprise a wide variety of investor types from around the globe. The respondents represent over 70 investor entities from North America, Europe, and Asia/Australia that collectively manage or advise on over USD $2.72 trillion of total assets with an aggregate hedge fund allocation in excess of USD $730 billion.

Investor profile

— Institutional investors, which for the purpose of this survey include consultants, endowments, public pension funds, government organizations and insurance companies, represent 31% of respondents and account for 73% of the hedge fund assets under management ("HF AUM") represented in the survey.

— Funds of funds are the largest contributing group by number representing 45% of respondents, yet accounting for just 19% of HF AUM.

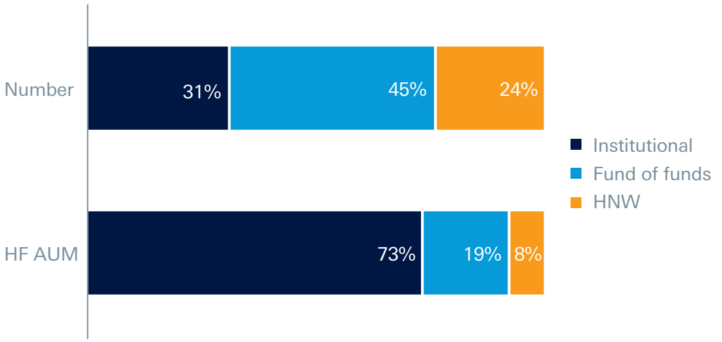
— High net worth ("HNW") investors, which include private banks and family offices, represent 24% of respondents and 8% of HF AUM for all respondents.

— The majority of respondents are based in North America, representing 68% of respondents by number. European investors represented 25% of respondents and Asia/Australia investors accounted for the remaining 7% of respondents.

— Of the hedge fund managers that received ODD reviews from responding investors over the past year, 61% were based in North America, 23% in Europe and 14% in Asia.

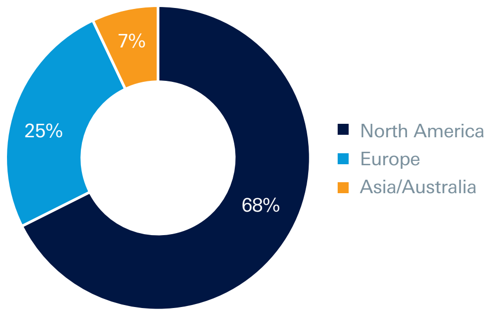
— The average HF AUM of respondents is USD $10 billion. 72% of respondents manage more than USD $1 billion in HF AUM and 15% of respondents manage more than USD $10 billion in HF AUM.

Breakdown of respondents by type



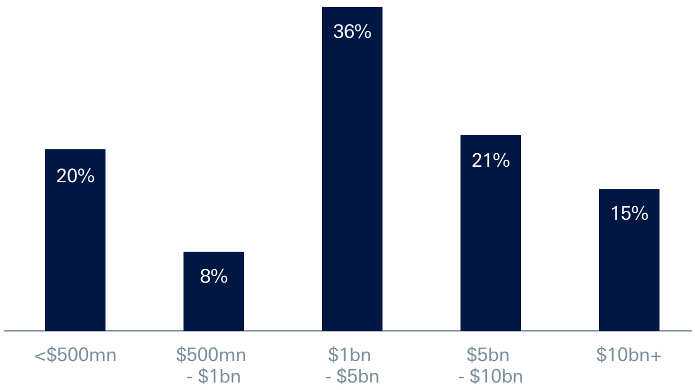
Source: 2014 Deutsche Bank ODD Survey

Percentage of respondents by investor region



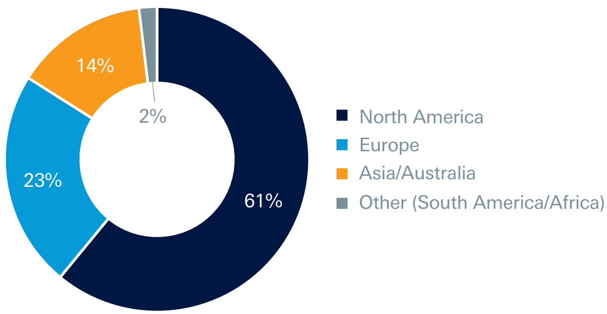
Source: 2014 Deutsche Bank ODD Survey

Respondents' total HF AUM by size



Source: 2014 Deutsche Bank ODD Survey

Percentage of ODD reviews by manager region



Source: 2014 Deutsche Bank ODD Survey

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Emerging vs. established managers

In this year's survey we delved further into the differences between an ODD team's processes for reviewing emerging managers versus established managers.

For the purpose of this survey, we defined an "emerging manager" as a manager with a track record of less than three years. Throughout the survey, we asked respondents to distinguish their answers between emerging versus established managers on specific areas of the ODD review process.

In this section, we summarize respondents' appetite for investing in emerging managers and compare key similarities and differences in investors' procedures for performing operational due diligence on emerging and established managers. A more in-depth analysis for each point is explored throughout the rest of the survey.

"Looking forward to 2014, investors are bullish on the new launch landscape. 43% of investors feel that the opportunity set for new launches in the US is more attractive in 2014 as compared to 12 months ago, whereas 39% feel the same for Europe."

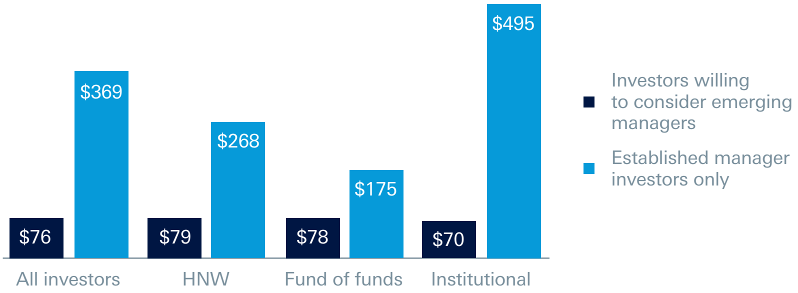
2014 Deutsche Bank Alternative Investment Survey

Key highlights

Investors demonstrate a willingness to invest in emerging managers.
68% of respondents indicated a willingness to invest with an emerging manager. These investors have significantly lower thresholds for both AUM and business maturity of the prospective manager (USD $76mn AUM and 5 months on average) when compared to investors who only invest in established managers (USD $369mn AUM and over 3 years on average).

Minimum AUM requirements for an investment (average)

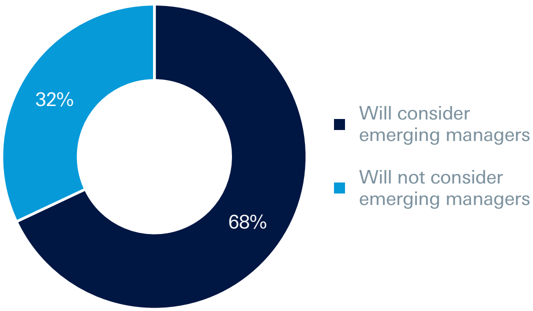
What is the minimum AUM that a manager must have before you will consider an investment? (USD $mn)



Source: 2014 Deutsche Bank ODD Survey

Emerging manager investment activity

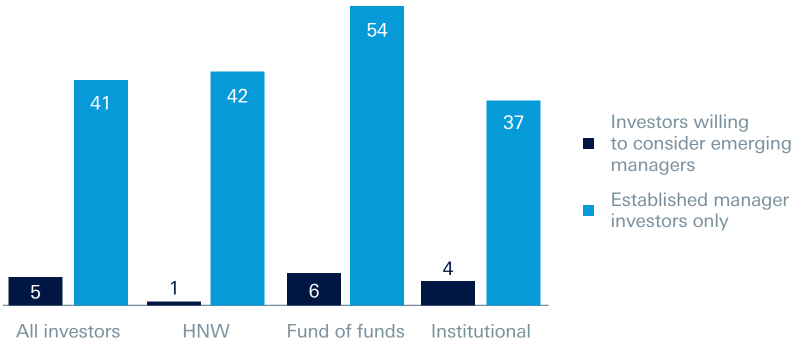
Percentage of investors willing to consider an investment with an emerging manager (less than three year track record).



Source: 2014 Deutsche Bank ODD Survey

Minimum business longevity for an investment (average)

What is the minimum period of time that a manager must have been in business before you will consider an investment (months)?



Source: 2014 Deutsche Bank ODD Survey

Emerging managers are more likely to receive an ODD veto.

Emerging managers are more likely to receive an ODD veto than their established manager counterparts. Overall, however, emerging managers received an ODD veto in 9% of reviews conducted whereas established managers received a veto 6% of the time (see page 37, “Percentage of ODD Vetoes issued”). Investors noted that emerging managers are often more flexible and willing to work toward a solution in order to make an investment work.

Investors are more accepting of outsourcing key functions at emerging firms.

100% of respondents who invest in emerging managers find it acceptable for these managers to either fully or partially outsource IT support. 98% are comfortable with emerging managers outsourcing some or all aspects of middle office and 94% would find it acceptable to outsource some or all aspects of fund accounting (see page 26, “Outsourcing”). These results are consistent with our observation of typical operational models for start-up managers.

The duration and frequency of ODD reviews are largely the same for emerging and established managers.

Two-thirds of respondents indicated that the typical duration of an initial ODD review would be the same regardless of the maturity of the business. The remaining respondents will typically spend more time reviewing an emerging manager (eight or more weeks) than an established manager (four to eight weeks) (see page 17, “Duration of ODD reviews”). The vast majority (79%) of investors conduct follow-up reviews post-investment with the same degree of frequency for emerging and established managers (see page 17, “Frequency of ODD reviews”).

During the ODD review, emerging managers can expect a strong focus on operations, senior management and fund directors.

Emerging managers tend to be more open to investors during active capital raising and growth. Respondents indicated that they are more likely to elect to observe daily operations during an initial on-site review for emerging managers (59%) when compared to their procedures for established managers (50%) (see page 22 “Initial on-site review of daily operations”). During an on-site review for an emerging manager, investors will generally meet more senior personnel who perform multiple roles such as the CEO/President and COO/CFO. Almost 40% of respondents also indicated that they request a meeting with the Chief Investment Officer (“CIO”) and trading team of an emerging manager (see page 23, “Key personnel met during on-site review”). Finally, respondents indicated that they are more likely to contact the fund directors of an emerging manager to verify that the director has an appropriate skill-set and requisite time (see page 24, “Service provider reviews”).

> “It [the minimum number of years required] will vary depending on the strategy, opportunity set, manager/team provenance, etc. Of overriding importance is the existence of an operational infrastructure which is adequate to the strategy.”
>
> Government organization respondent, North America

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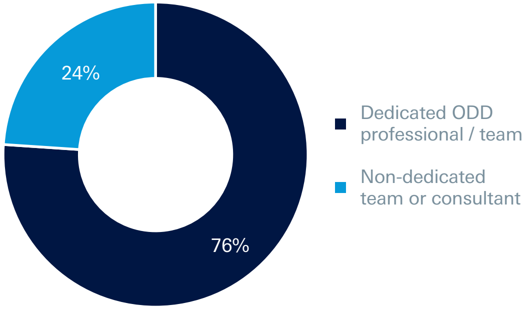
Composition of the ODD team & manager review activity

76% of investors continue to use a dedicated ODD team, rather than assigning responsibility to the investment team or an external consultant. This team will both evaluate a manager during initial due diligence and perform ongoing monitoring for the duration of the investment. Investors using non-dedicated teams to conduct ODD noted varying degrees of integration with the investment due diligence team ranging from completely integrated to merely augmenting the investment team or conducting a deeper analysis after an initial review by the investment team. Consistent with our 2013 survey results, the typical ODD team has more than four members as cited by 59% of respondents.

Operations, accounting and investment backgrounds continue to be the top three primary skill-sets of ODD professionals, although most individuals approach the task with a variety of skills developed through diverse career experiences.

Dedicated vs. non-dedicated ODD team

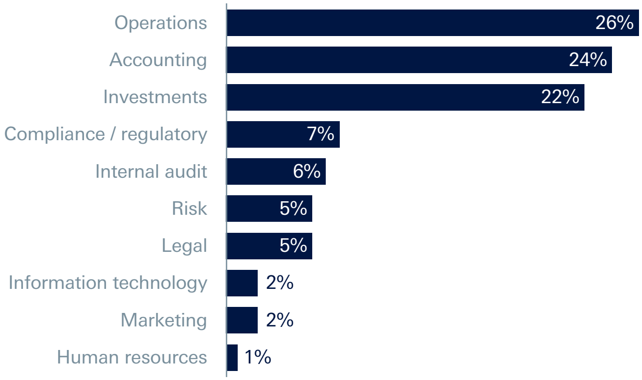
Who primarily conducts operational due diligence for your firm?



Source: 2014 Deutsche Bank ODD Survey

Skill-sets of the ODD team

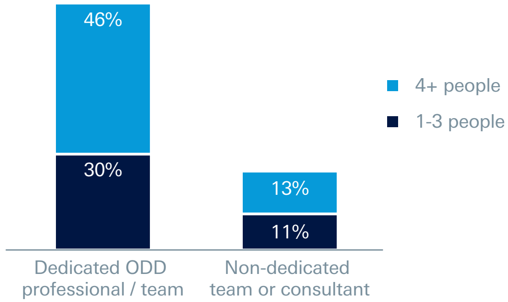
Indicate the primary skill-set of each individual within your ODD team.



Source: 2014 Deutsche Bank ODD Survey

Team size

How many people in your firm are involved in some or all aspects of ODD?



Source: 2014 Deutsche Bank ODD Survey

Initial ODD review activity

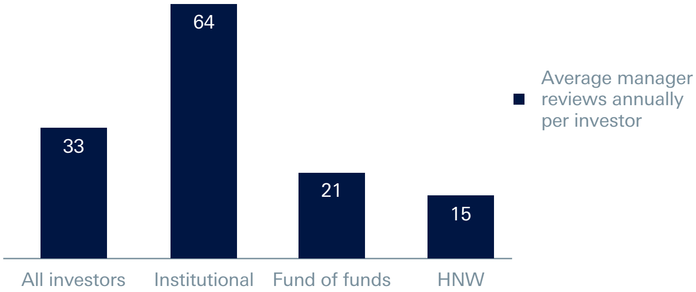
Survey respondents conducted an average of 33 reviews for new investments over the past 12 months with institutional investors conducting on average three times as many manager reviews when compared to funds of funds and HNW investors. Institutional investors typically have larger ODD teams with an average of ten individuals per ODD team when compared with an average of five team members for fund of funds and four team members for HNW investors.

Investment activity remains highest in North America with investors indicating that 61% of managers reviewed over the past 12 months were located in North America, followed by 23% in Europe and 14% in Asia. Other regions where managers received initial operational due diligence included South America and Africa.

Of the investors who consider allocations with emerging managers, respondents cited that over a third of their initial ODD reviews for new investment were conducted for emerging managers. Additionally, investors were asked to indicate the AUM of the managers that received initial due diligence over the past 12 months. 40% of managers reviewed by survey respondents had AUM greater than USD $1 billion. Funds of funds accounted for almost 70% of reviews conducted for managers with less than USD $100 million at the time of the investor's review.

Number of manager reviews (by investor type)

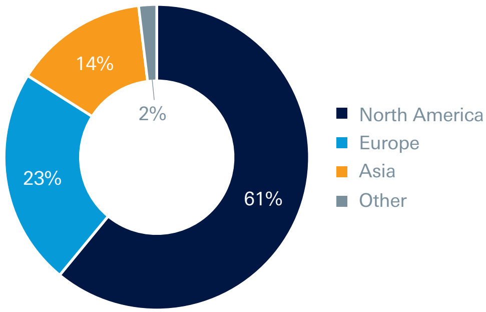
Please indicate the number of managers for whom you conducted an initial ODD review for a new investment over the past 12 months.



Source: 2014 Deutsche Bank ODD Survey

Percentage ODD reviews (by manager region)

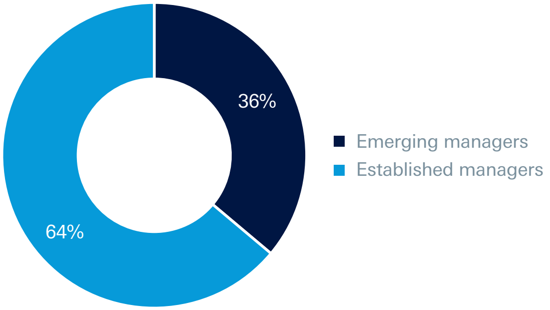
Please indicate the number of managers per region for whom you conducted an initial ODD review for a new investment over the past 12 months.



Source: 2014 Deutsche Bank ODD Survey

Manager review activity (by manager type)

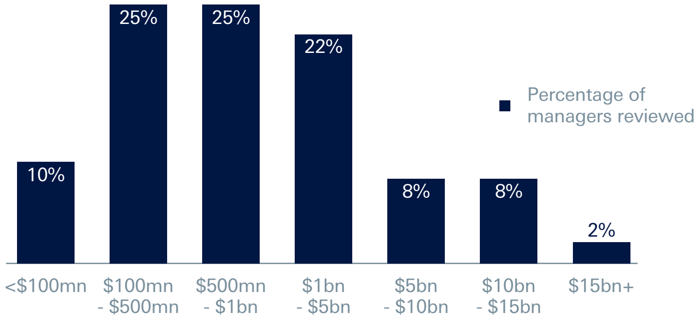
Please indicate the number of managers for whom you conducted an initial ODD review for a new investment over the past 12 months.



Source: 2014 Deutsche Bank ODD Survey

Manager review activity (by manager AUM)

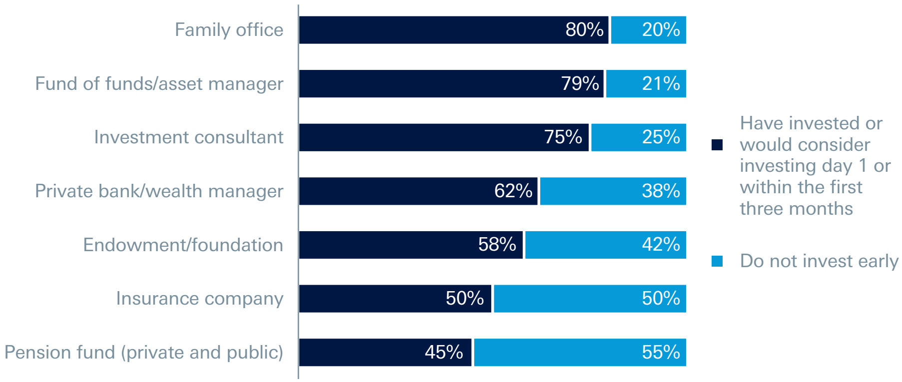
Given that your firm conducted initial ODD reviews over the past 12 months, please indicate the breakdown of managers by AUM range.



Source: 2014 Deutsche Bank ODD Survey

According to the 2014 Deutsche Bank Alternative Investment Survey, funds of funds remain some of the most active early stage investors with 79% indicating that they have invested or would consider investing within the first three months.

Do you/your clients invest early?



Source: 2014 Deutsche Bank Alternative Investment Survey

Duration and frequency of reviews

Prior to an investment, the initial ODD review provides the investor transparency into all aspects of a hedge fund's operating model. A majority of respondents indicated that their analysis may take between two and eight weeks. Institutional investors show the most variation in the duration of their ODD process. Endowments are likely to conduct integrated investment and operational due diligence and complete the operational portion of the review in less than two weeks. Pensions and consultants with dedicated ODD teams, on the other hand, are more likely to take more than eight weeks. As mentioned previously, institutional investors also tend to have larger ODD teams that may help them in completing their ODD reviews in a more efficient manner.

While two-thirds of investors have the same review duration for both emerging and established managers, 30% would typically spend more than eight weeks reviewing an emerging manager compared with only 15% of investors who would spend more than eight weeks in their review of an established manager. Funds of funds and HNW investors, known for early investing and even taking on a consultative role during the initial stages of the fund's launch, indicated a longer review duration for emerging managers.

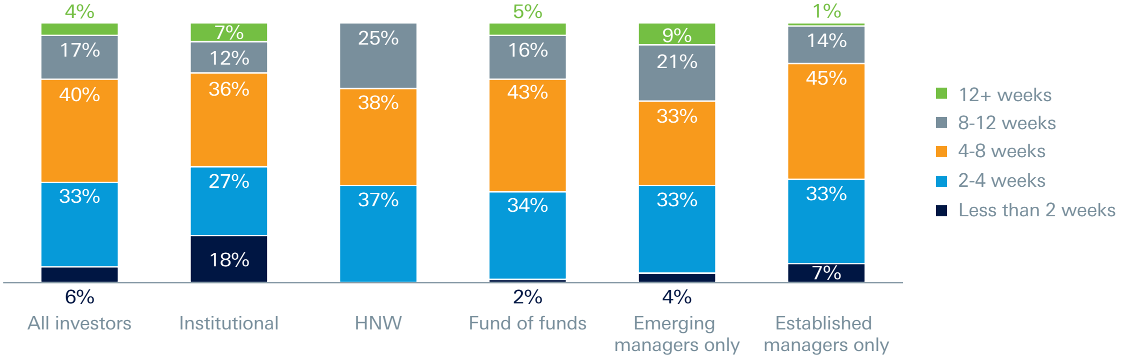
The majority of respondents have a consistent policy for the frequency of ODD reviews post-investment with 70% conducting annual reviews. 10% of respondents will review an established manager every two to three years, while no respondent would allow this review frequency for an emerging manager. Endowments, who tend to use the investment team to conduct ODD, represent the majority of investors who stated they may follow-up with managers solely based on risk factors. These investors may cover operational topics during their routine investment-related reviews.

"The review process doesn't ever start or end. Once we invest we are in frequent contact with the manager and evaluating regularly."

Fund of funds respondent, North America

Duration of ODD reviews

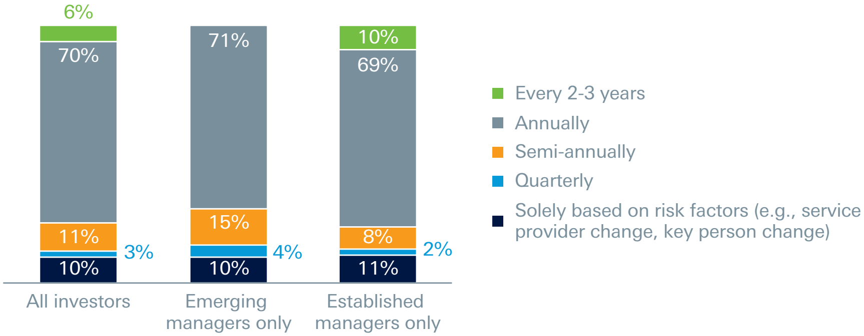
Prior to investing, on average, what is the elapsed time of a typical ODD review?



Source: 2014 Deutsche Bank ODD Survey

Frequency of ODD reviews

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



Source: 2014 Deutsche Bank ODD Survey

5
The ODD review

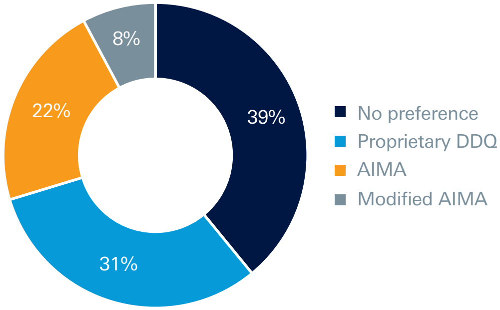
The due diligence questionnaire

Results from the survey suggest that investors are indifferent toward which template is used for a due diligence questionnaire ("DDQ") with 39% indicating "no preference." Of the remaining respondents, 30% prefer to receive a manager DDQ based on the Alternative Investment Management Association's ("AIMA") format or a modified version. An almost equal number prefer managers to use their proprietary DDQ. Regardless of the template used, the most important factor for a manager in completing a DDQ is to ensure that it clearly and thoroughly details the entire operational infrastructure of the fund.

In practice, the DDQ often serves as an introduction to the fund's operational processes and infrastructure. Investors will likely have many more questions to ask throughout the duration of the ODD review. 70% of respondents stated that they prefer not to ask additional questions in the form of a supplementary written questionnaire. Instead, they may cover additional topics in on-site visits or conference calls with the relevant staff at the hedge fund.

DDQ template preference

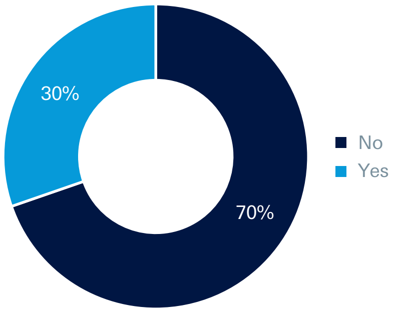
What template, if any, do you prefer managers use for DDQ purposes?



Source: 2014 Deutsche Bank ODD Survey

Additional DDQ requirement

Regardless of whether you receive a DDQ from a manager, do you still require that your own DDQ template is completed by the manager?



Source: 2014 Deutsche Bank ODD Survey

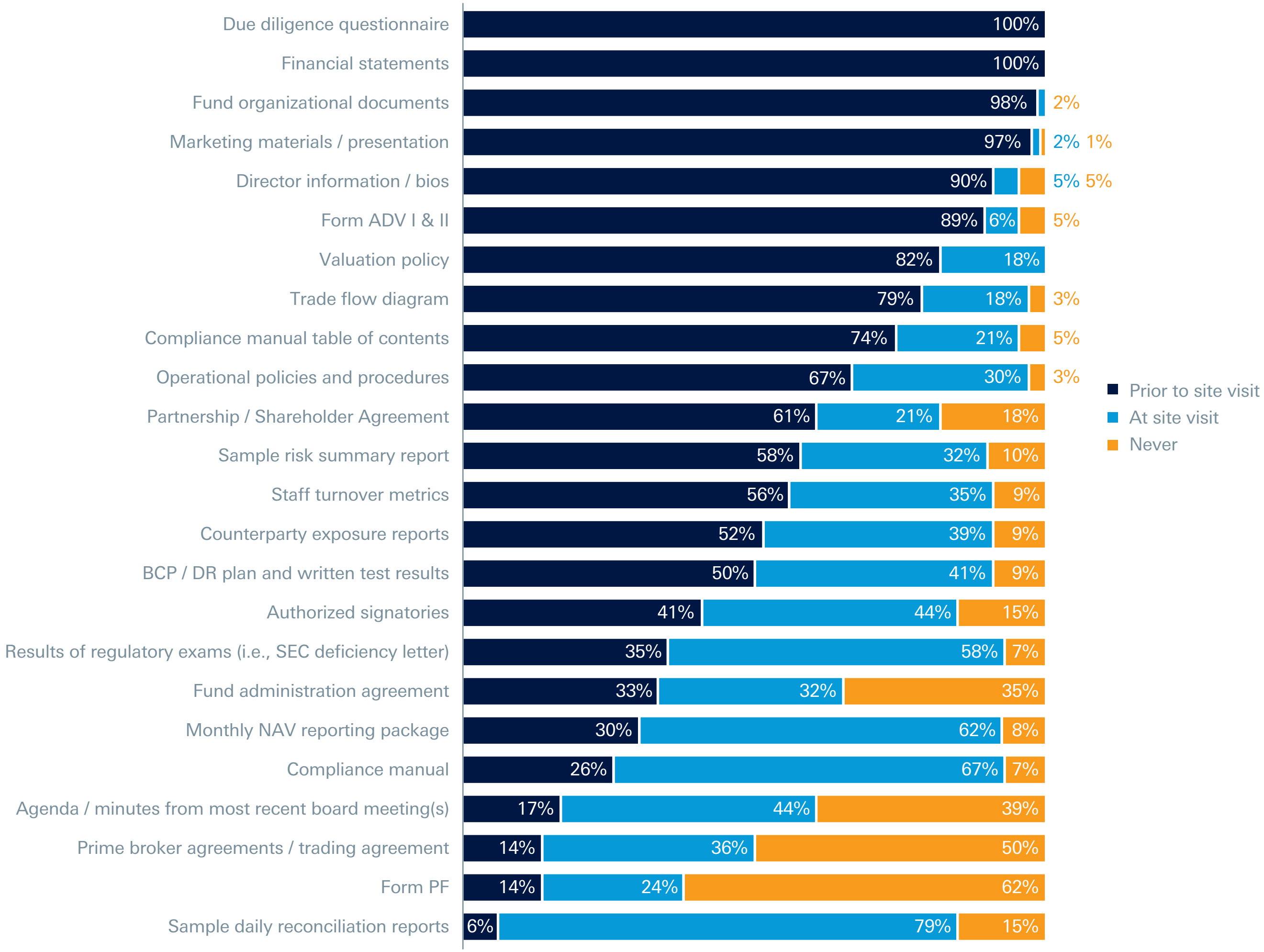
Documentation requirements

Prior to the on-site visit, the documentation review is typically the first step in the ODD process. Certain documents such as the DDQ, financial statements and the fund's organizational documents will almost always be reviewed prior to the site visit. More sensitive information, such as the monthly NAV reporting package, compliance manual and daily reconciliation reports, may be reviewed during the site visit. The graph "Documentation time frame" contains a list of typical documents that investors may ask to review and the likelihood that each will be requested before or during a site visit.

While respondents to last year's survey were fairly divided on how they planned to review and utilize newly reported regulatory information, such as Form PF, 62% of respondents this year have opted not to review Form PF. The results of regulatory exams, however, are more likely to be reviewed by investors now than in the recent past. This is likely due to the fact that regulatory bodies, such as the SEC and FCA, have increased the focus and frequency of manager examinations.

Documentation time frame

When do you typically receive each document?



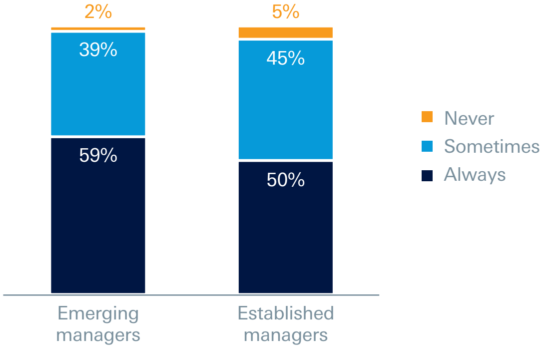
Source: 2014 Deutsche Bank ODD Survey

The site visit

Investors are more likely to observe daily operations during an initial on-site review for emerging managers (59%) when compared to their policy for established managers (50%). When asked which functions and technology are observed during an ODD review, respondents commented that they will likely have an in-depth discussion on each of the items listed in graph "Functions and technology observed during initial on-site review" and then corroborate the information received by observing the function first-hand. For example, an investor may ask to observe the "life of a trade" and request staff to perform a trade walk-through following a trade from inception on the trade blotter through to the confirmation process with the prime broker statement. 78% of investors will also verify the valuation procedure by reviewing the NAV and valuation reports.

Initial on-site review of daily operations

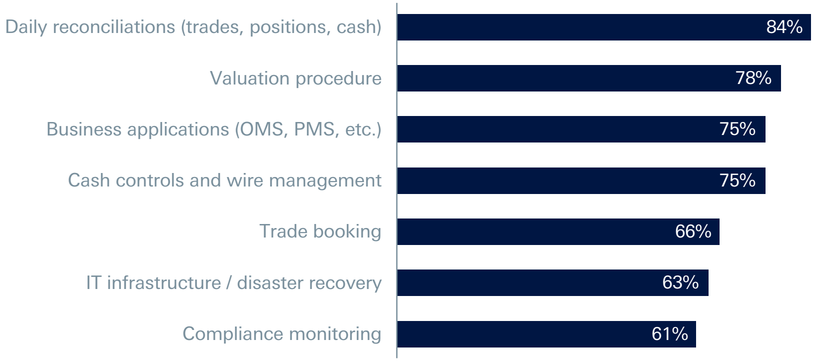
During an initial on-site review,
do you observe daily operations?



Source: 2014 Deutsche Bank ODD Survey

Functions and technology observed during initial on-site review

During an initial on-site review, which functions and technology do you observe? (Select all that apply)



Source: 2014 Deutsche Bank ODD Survey

During a review, investor ODD teams will typically focus on meeting non-investment personnel. Over 85% of respondents will meet with the COO, Chief Financial Officer ("CFO"), Head of Operations and the Chief Compliance Officer ("CCO"). There were some minor differences when comparing an emerging manager review to an established manager review. For emerging managers, investors will generally meet more senior personnel, such as the CEO/President and COO/CFO, due to the fact that in the early stages of the business these individuals perform multiple roles. As established managers likely already have a general counsel and large technology team, investors will likely request to meet these individuals.

In addition to the non-investment personnel, ODD teams often request to meet the CIO and trading team. This is more likely with emerging managers where almost 40% of investors expect to meet the CIO, versus 26% for established managers.

Key personnel met during on-site review

While on-site, which functional areas do you require to meet with if the position exists? (Select all that apply)

"It is important for us to get past investor relations and speak to the individuals who actually perform relevant operational functions."

Government organization respondent, North America

Source: 2014 Deutsche Bank ODD Survey

Service provider reviews

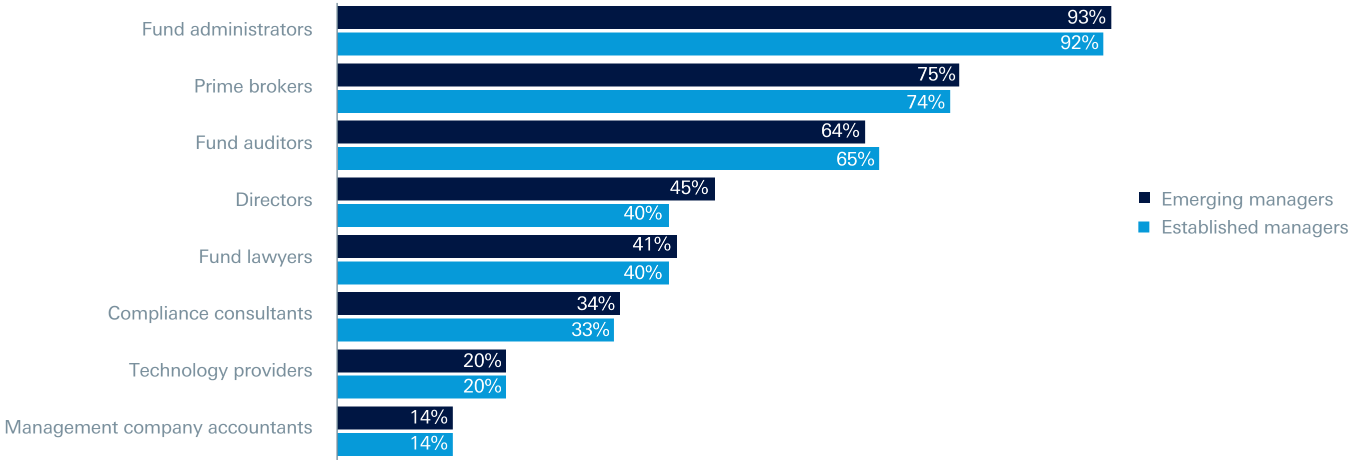
In addition to a thorough desk review and a comprehensive on-site visit, investors will frequently verify the fund's relationship with certain contracted service providers. In the post-Madoff world, the vast majority (92%) of investors regard the fund administrator as the most important external service provider to contact during an ODD review. Administrators have indicated that they are seeing more requests for on-site reviews of their post-trade processes, as well as requests to review their pricing matrices and client fund administration agreement. This is a strong focus area due to the central role of the administrator in both reconciling a fund's trades, positions and cash with its counterparties and custodians as well as liaising with a fund's auditor. Additionally, a majority of investors will also contact a fund's prime broker to verify a number of key items, including the existence and structure of accounts, balances maintained in the account and the quality of the prime broker's processes relating to protecting customer assets. Finally, a significant number of investors contact a fund's auditors which is consistent with the "trust but verify" approach in the post-Madoff environment.

Respondents indicated a higher likelihood of contacting the directors of an emerging manager rather than an established manager. This is likely due to the fact that investors want to be assured that the selected directors of an emerging manager have the appropriate skill-set and adequate time to perform their duties.

Investors noted that in addition to the service providers listed on the graph "Service provider reviews," they may also reach out to any external valuation consultants as a testament to the importance of independent pricing for hard-to-value assets.

Service provider reviews

Which service providers will you contact during your ODD process? (Select all that apply)



Source: 2014 Deutsche Bank ODD Survey

Outsourcing

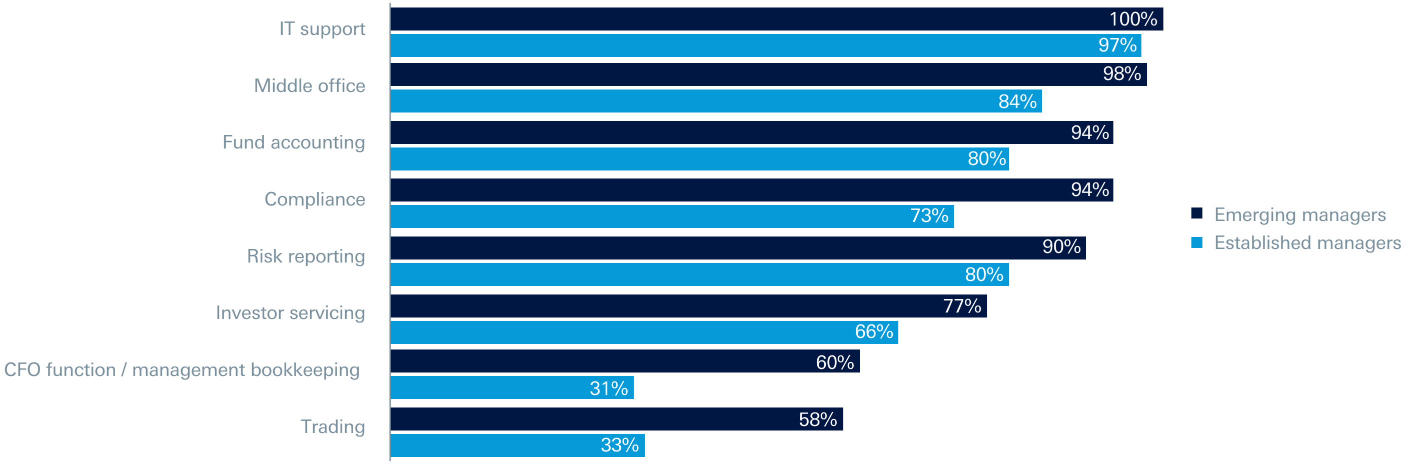
Either fully or partially outsourcing functions of the business continues to be more acceptable to investors with the understanding that the responsibility remains with the manager and that the functions are adequately controlled and supervised.

Over 84% of investors indicated that they are comfortable with managers outsourcing some or all aspects of the middle office. Broadly, middle office services may include a combination of trade matching and confirmation, a daily P&L, daily reconciliations with their counterparties and custodians, trade break resolution, and wire and collateral management. Many fund administrators have extended their middle office offering to managers and it is now common for emerging managers to utilize the proven operational infrastructure and technology of the fund administrator at a reasonable cost. Since the manager is still responsible for ultimate delivery, it is crucial that the outsourcing is effectively supervised and controlled and that the middle office provider has the appropriate skills to handle the products traded. Though the model does not work for everyone, it has proven to be a logical extension of the business for many firms.

Outsourcing non-investment functions is common for the hedge fund industry generally, but even more so for emerging managers as they grow their business. Respondents indicated they are more comfortable with emerging managers outsourcing each function listed in the graph "Outsourcing" than their established peers. Notably, 100% of respondents would find it acceptable for an emerging manager to outsource some or all aspects of IT support. Additionally, 98% of investors would find it acceptable for emerging managers to outsource all or some aspects of middle office. Finally, 94% of respondents would find it acceptable to fully or partially outsource fund accounting.

Outsourcing

Which functions do you consider acceptable for managers to fully or partially outsource assuming overall responsibility for the function remains with the management company?



Source: 2014 Deutsche Bank ODD Survey

Out-of-cycle review factors

Outside of routine monitoring, an investor would typically only reengage with a manager if the fund or the manager experienced a material event. The two most cited individual factors leading to an out-of-cycle review included regulatory investigations (94%) and the departure of a key person or principal (75%). These two factors have consistently remained top ranked by investors over the past two years.

Out-of-cycle review factors

Theme	Yes (% respondents)	Individual factors	Yes (% respondents)
Headline risk	75%	Regulatory investigations	94%
		Adverse press	56%
Key personnel	61%	Key person or principal's departure	75%
		Senior back-office staff changes (e.g., Head of Operations, etc)	48%
Accounting & operations	60%	NAV re-statement	65%
		Major revision from estimated to final NAV	56%
Fund management & investor servicing	44%	Style drift from strategy in the PPM	66%
		Investor redemptions	38%
		Change of leverage	28%
Key service providers	23%	Change of administrator	38%
		Change of other key service providers (legal, accountant, etc)	18%
		Change in board of directors	17%
		Change in auditor	17%

Source: 2014 Deutsche Bank ODD Survey

Based on the list of specific factors that investors indicated may initiate an out-of-cycle review, five basic themes emerge that encapsulate these triggers:

1. **Headline risk (75%):**
   With the SEC and other regulators outside the US conducting prescriptive examinations, it is expected that any regulatory investigation may trigger a due diligence review. In 2013, the SEC filed 686 enforcement actions, with 140 (approximately 20%) filed against investment advisers, an increase of 85% since 2009.[2] In its 2014/15 Business Plan, the FCA also warned that it will increase its thematic supervision across the investment management sector, highlighting a new review of market abuse controls for asset managers.[3]

2. **Key personnel (61%):**
   75% of respondents cited "key person or principal's departure" as a trigger reason for an out-of-cycle review, which clearly indicates that investors want to understand the reason for the change in management with a focus on determining whether the departure was caused by a fundamental problem within the firm or if the departure was more idiosyncratic.

   Implementing retention and compensation structures has become critical to both emerging and established managers. Typically, managers with more than USD $1 billion in AUM will implement a more sophisticated deferred compensation program. These programs will often have a base compensation level for senior employees and hold back 10% to 50% of performance-based compensation which is held over the course of three years. Managers with less than USD $1 billion in AUM face more pressure to invest deferrals back into the fund. Smaller and emerging managers are also more likely to offer equity ownership interests in the management company (in addition to any profits interest) to ensure retention of key personnel.

   Alternatively, larger and established hedge funds find themselves assessing succession plans for equity holders and senior personnel. Investors may ask how the manager plans to handle leadership transitions and how the treatment of the founders' economic interest in the firm will be addressed.

2 http://www.sec.gov/news/newsroom/images/enfstats.pdf
3 http://www.fca.org.uk/static/documents/corporate/business-plan-2014-2015-interactive.pdf

3. **Accounting & operations (60%):**
A restatement of NAV is a major red flag and would likely generate an out-of-cycle review of the fund manager. NAV restatements rarely occur, but when they do it is because of a material change in valuation of core positions or from missing/erroneous trade bookings. Materiality is defined by the fund administration industry as a 50bps impact on NAV.

   When a top five fund administrator was asked about the frequency of NAV restatements, the percentage given was very low. For example, if the administrator cuts 5,000 NAVs per month and 60,000 per year, only one to two NAV restatements could ever be expected for the entire year.

4. **Fund management & investor servicing (44%):**
Respondents highlighted that the investment due diligence team would initially address a fund management issue such as style drift or change in leverage. Style drift from the Private Placement Memorandum ("PPM") could be considered a violation of the investment contract and cause for redemption at par value. Style drift from what was represented in marketing efforts and other non-contractual materials is also a serious issue that is monitored by both the investment and operational due diligence teams. Finally, investor redemptions are monitored by the ODD team in order to enable them to understand how this may affect a fund's ability to effectively manage its capital needs.

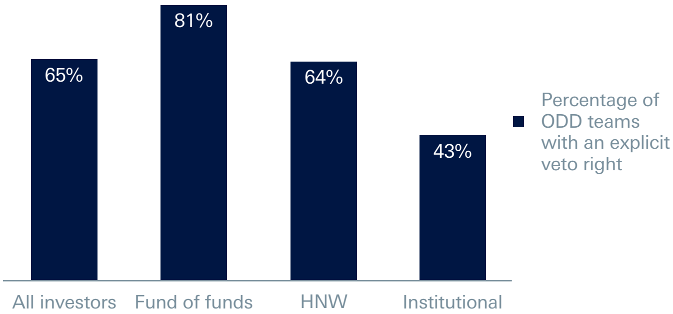
5. **Key service providers (23%):**
Whether or not an investor is concerned by a change in key service providers to the fund would depend on whether the change was expected and announced in advance. Additionally, investors noted that any one service provider issue in isolation may not prompt the investor to act, however several issues within a small time frame is more likely to trigger a review.

6 The veto right

Survey results this year once again confirm that nearly two-thirds of responding investor entities provide their ODD team with a veto right, defined as the authority to block an investment if the ODD team finds that one or more areas of a fund are deficient. While more than two-thirds of ODD teams at funds of funds and HNW firms have an explicit veto right, less than half of institutional investors have the same, largely due to the population of endowment respondents who conduct integrated investment and operational due diligence. As a benchmark, respondents exercised their veto right in 7% of reviews conducted last year, comprised of both explicit vetoes (5%) and qualified vetoes (2%).[4] We note that this number may be understated as respondents indicated that some reviews are abandoned if it becomes obvious it will not pass.

Explicit veto right (by investor type)

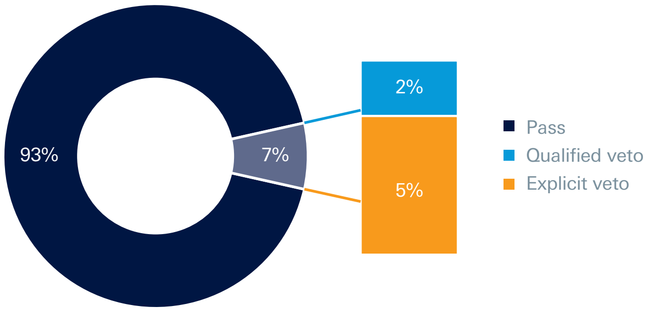
Does your team have an explicit veto right?



Source: 2014 Deutsche Bank ODD Survey

Percentage of vetoes issued

How many of the managers you reviewed in the past 12 months received each type of ODD veto?



Source: 2014 Deutsche Bank ODD Survey

[4] Veto rate calculated based on number of vetoes reported (explicit and qualified) by respondents divided by total number of manager reviews conducted by respondents

Yellow flags: top reasons an ODD veto may be reconsidered later

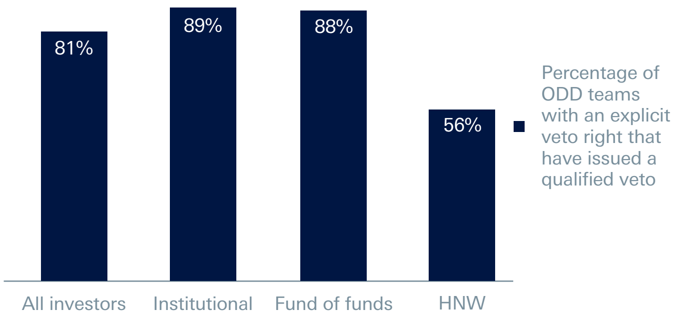
If an operational deficiency can be remedied or set to the standard expected by the investor, they may allow the manager time to remedy the issue with the aim of reengaging later to complete a satisfactory review. We defined this consultative approach as a "qualified veto," meaning a decision to veto an investment in a fund with a willingness to proceed with the investment if an area of concern is remedied to the satisfaction of the investor. 81% of investors who indicated that their ODD team has an explicit veto right responded they have indeed issued a qualified veto. Furthermore, 28% of vetoes issued by respondents last year were of a qualified nature. Based on these results, investors show a significant amount of willingness to engage in a dialogue with a fund in order to remedy deficient areas before an ODD team votes to block an investment.

While 81% of responding funds of funds has an explicit veto right, only 43% of institutional investors has an explicit veto right (see page 32, "Explicit veto right"). The gap between these two investor groups narrowed significantly when the same question was asked regarding a qualified veto where 89% and 88% of institutional and fund of funds respondents, respectively, can issue a qualified veto.

Responding investors indicated that many of the reasons for an explicit veto can also lead to a qualified veto. For each issue, there is a spectrum of acceptability and it is the responsibility of the manager to provide the investor with the appropriate level of comfort in the standards of the firm's people, processes and technology. Whether the veto is a "deal breaker" or not can often depend on a manager's willingness to engage with the investor and work toward resolving the issue. At the completion of an unsatisfactory ODD review, many investors will provide the manager with a list of operational deficiencies, or reasons why they have issued the veto. Anecdotally, investors have expressed that emerging managers, or those trying to increase assets, tend to be more engaged and willing to find a solution to make the investment work.

Qualified veto use (by investor type)

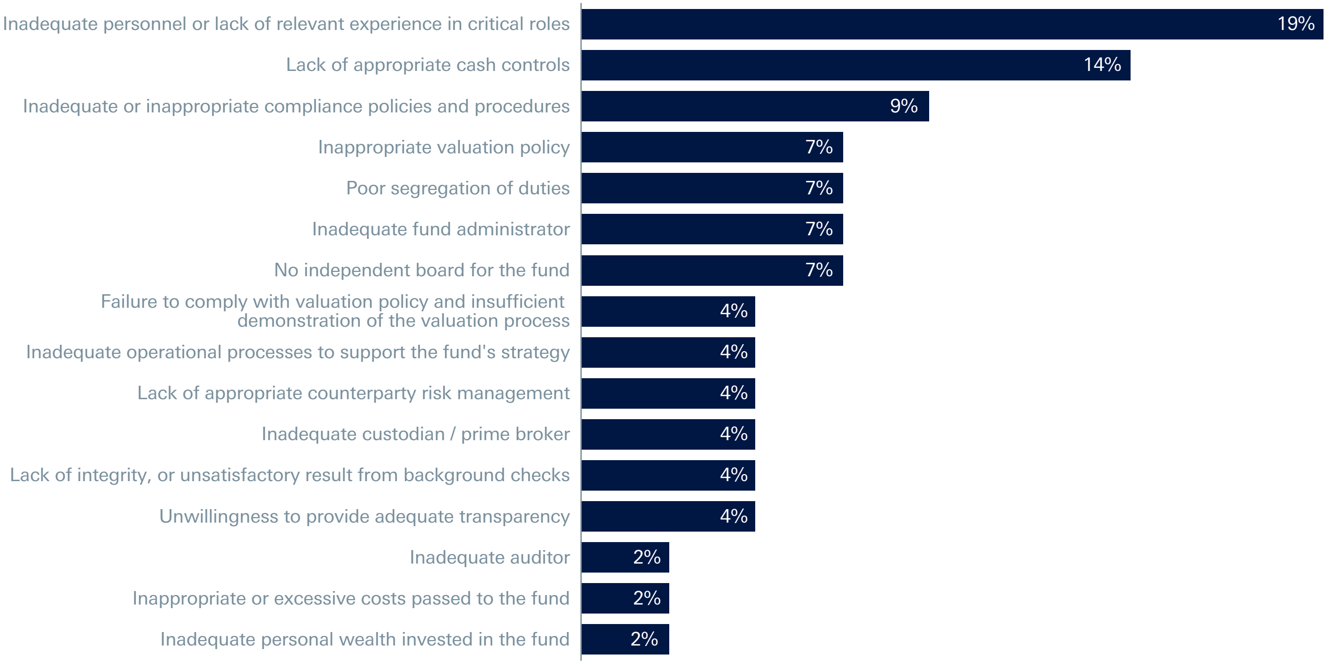
Have you ever issued a qualified veto?



Source: 2014 Deutsche Bank ODD Survey

Top reasons for a qualified veto

Of the managers that received a qualified ODD veto in the past year, indicate how many times each of the below was the primary factor for the veto.



Source: 2014 Deutsche Bank ODD Survey

> "We will always try to find a solution first – veto is a last resort."
>
> Fund of funds respondent, Europe

Red flags: top five reasons an investor will veto an investment

Respondents highlighted thirteen reasons why they will veto an investment, underscoring the sheer volume of issues the non-investment side of the business is tasked with monitoring. Respondents noted that in some cases, a veto is not issued for just one reason, but rather as a result of multiple "yellow" flags.

The top five factors cited as the primary reason for a veto include:

1. Unwillingness to provide adequate transparency (22%):
Each investor has a target level of transparency they want to achieve concerning the portfolio and the operational structure of a fund. During their initial review, ODD teams will seek transparency into multiple areas of a manager's operations, including trade processing, controls over cash movements, valuation processes and service provider relationships. Failing to provide any one of these items is not necessarily grounds for a veto, but refusing transparency into several areas of the non-investment function can lead to a negative review.

2. Inadequate or inappropriate compliance policies and procedures (19%):
The evaluation of a firm's compliance program begins with a review of the firm's written policies and procedures with some investors further requesting evidence of adherence to stated policies. Over 85% of investors will meet with the CCO during the on-site review and over half will meet with the rest of the compliance team (see page 23 "Key personnel met during on-site review"). In meeting with the key personnel of the fund, investors will want to observe the correct "tone from the top" regarding senior management's commitment to a robust and best-in-class compliance program and culture of compliance.

3. Poor segregation of duties (12%):
Investors will focus on the controls that segregate the responsibilities of staff in order to help prevent fraud and misappropriation. Broadly, this means separating the approvals and instructions (e.g., trading and cash movements) from accounting, reconciliation and custody.

"A robust and scalable operational infrastructure is critical to appeal to quality investors. Not only do teams need to prove their ability to generate stable alpha for their investors, they must also demonstrate strong operational experience and tested business management skills."

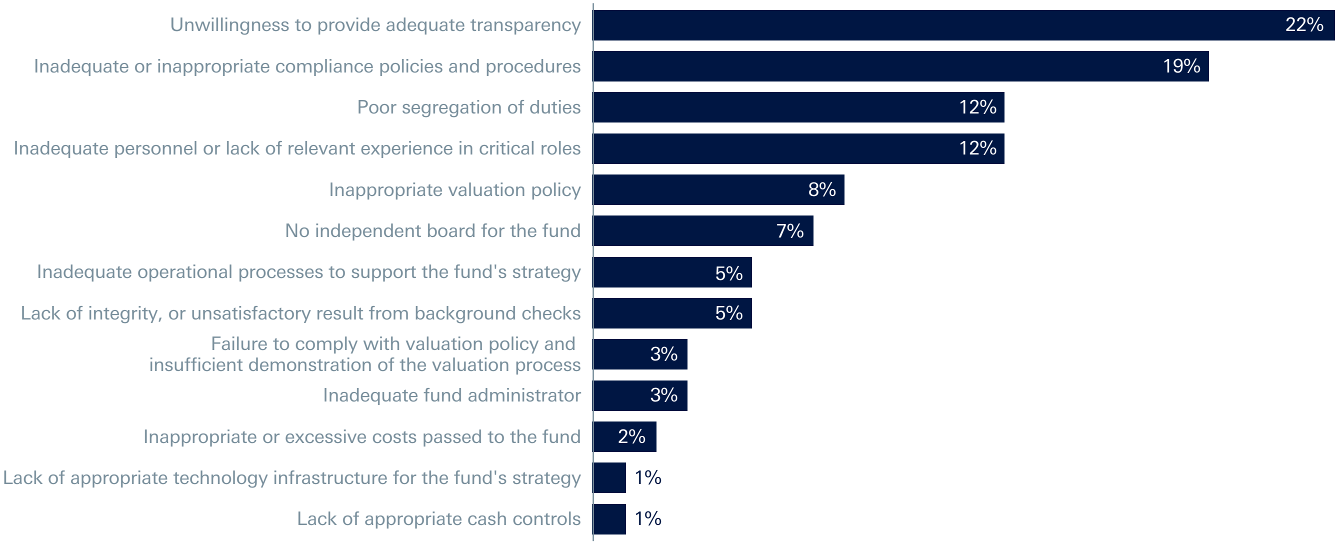
2014 Deutsche Bank Alternative Investment Survey

4. **Inadequate personnel or lack of relevant experience in critical roles (12%):**
Inadequate personnel or lack of relevant experience in critical roles received the same number of vetoes as those issued for poor segregation of duties. As part of the assessment of segregation of duties, investors frequently also evaluate the capabilities of key staff.

5. **Inappropriate valuation policy (8%):**
Valuation was a common theme throughout the survey with respondents indicating that they will verify that adequate policies and resources necessary to support independent pricing for determining the NAV. 100% of investors will request to review the firm's written valuation policy which should include the price source for each instrument type and hierarchy used (see page 21, "Documentation time frame"). Investors may also verify how broker quotes are obtained and utilized, independent verification of proprietary valuation models, and the process for handling and communicating to shareholders any illiquid, side-pocketed assets.

Top reasons for an explicit veto

Of the managers that received an explicit ODD veto in the past year, indicate how many times each of the below was the primary factor for the veto.

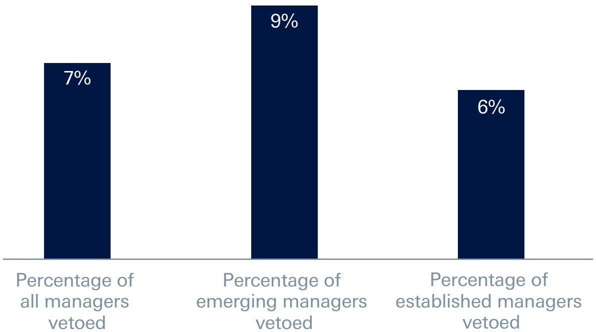


Source: 2014 Deutsche Bank ODD Survey

As indicated in “Emerging vs. established managers” (see page 8), respondents in this year’s survey were asked to distinguish their veto issuance between established and emerging managers. Emerging managers were slightly more likely to receive an ODD veto than their more established peers; however, investors noted that emerging managers are often more willing to work toward a solution in order to make an investment work. Anecdotally, we find that managers with seed capital tend to score a higher ODD rating than those without which may come as a result of the additional coaching and assistance in setting up the business from the seed investor.

Percentage of ODD vetoes issued

How many of the managers you reviewed
in the past 12 months received each type of ODD veto?



Source: 2014 Deutsche Bank ODD Survey

7
Current areas of focus for investors

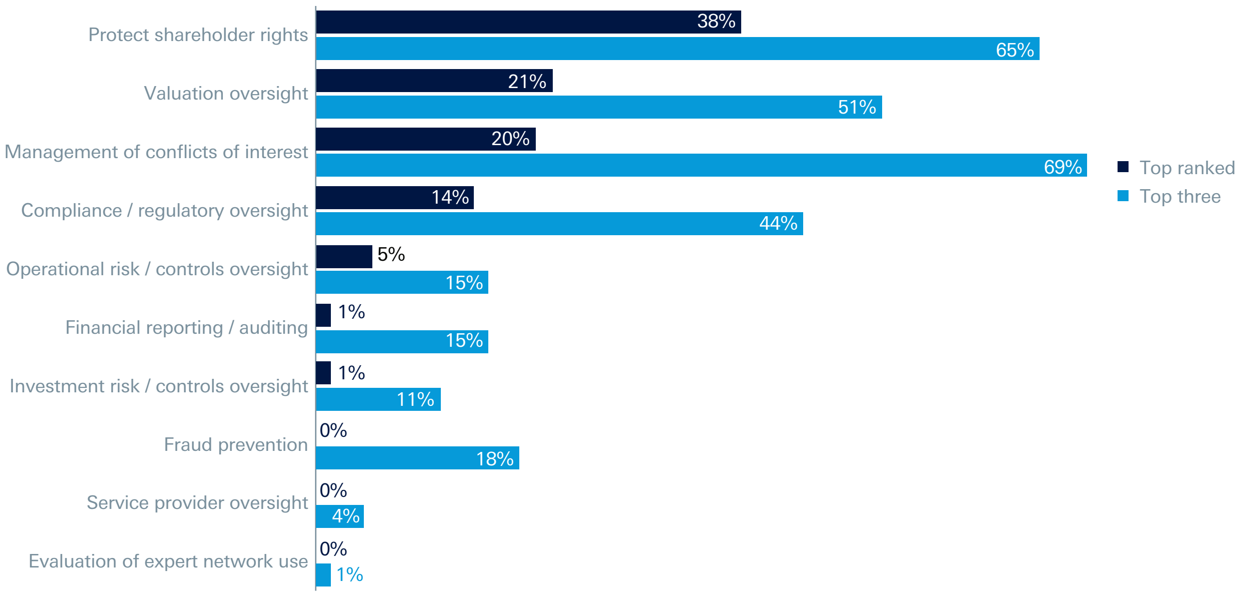
Corporate governance

Over the past year, much of the discussion on corporate governance by regulators and industry participants alike has focused on codifying the duties and obligations of a fund's board of directors in the form of "codes of conduct." We asked investors to rank the most important functions of the fund's board of directors. 38% of respondents ranked protection of shareholder rights as the most important function, with valuation oversight (21%), management of conflicts of interest (20%) and compliance / regulatory oversight (14%) also ranking among the top reasons.

Given the numerous (and growing) duties of fund directors, respondents indicated that there should be a limit on the number of boards on which an independent director serves. On average, respondents do not want an independent director to serve on more than 24 boards, but responses to this question ranged from just 1 to as many as 100. Investors noted that their preferred limitation on directorship was somewhat arbitrary and may change depending on the structure and business model of the directorial firm, the needs and complexity of the director's existing manager relationships, and the amount of time the director can commit to the fund.

Functions of the fund's board of directors

Rank the top three most important functions of the fund's board of directors.



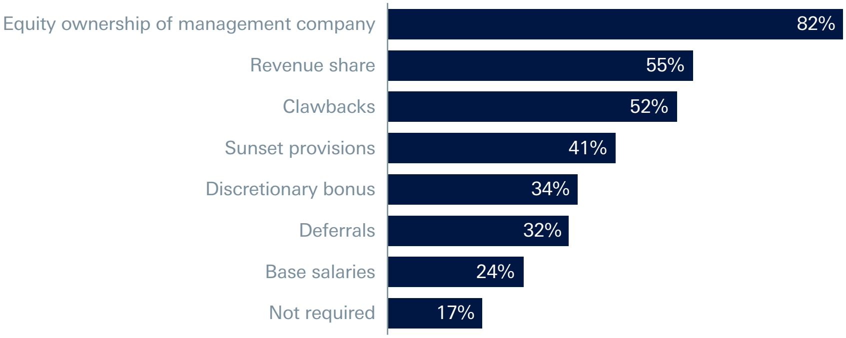
Source: 2014 Deutsche Bank ODD Survey

Transparency on compensation and retention structures

Compensation structures are one of the best methods to ensure a strong alignment of interests between managers and investors. 82% of responding investors will request transparency on the equity ownership of the management company and over half will also want to understand revenue share and clawbacks. Investors place particular emphasis on investigating compensation structures that may erode segregation of duties or introduce conflicts of interest. Investors will also focus on employee compensation that is charged to the fund.

Compensation transparency

Do you require transparency on any of the below compensation and retention structures?

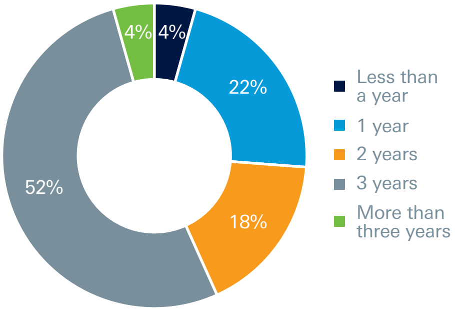


Source: 2014 Deutsche Bank ODD Survey

Almost a third of investors will require information regarding deferral policies. On average, investor preference is that 44% of partner and senior management level professionals' total compensation is deferred. Responses to this question ranged from 10% to 80%, indicating that this percentage may vary depending on several factors such as the seniority of the individual or the portion of total compensation that is fixed versus variable. 96% of those respondents that require transparency into deferrals prefer that the deferral is held for more than a year, with 52% preferring three years or more. The overwhelming majority (96%) of respondents indicated that the deferral should be held in the fund during the vesting period.

Deferral period for senior management

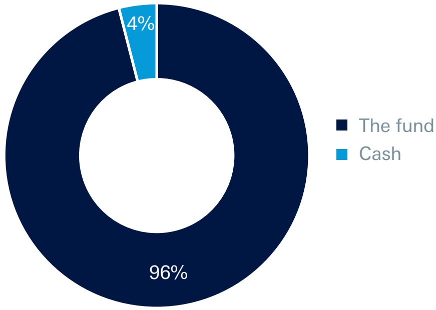
How long would you require partner and senior management level professionals to defer compensation?



Source: 2014 Deutsche Bank ODD Survey

Deferral instrument preference

In which form do you require partner and senior management level professionals' deferrals to be held?



Source: 2014 Deutsche Bank ODD Survey

Expenses

Fund expenses are disclosed in the offering documents of each fund and normally include fund administration, audit, tax, legal, directors, brokerage, insurance, communication with respect to investor servicing and other miscellaneous expenses. These expenses often represent a small proportion of overall expenses in relation to management and performance fees. Given that offering documents are typically drafted broadly to enable flexibility for managers, some include other expenses such as market data, systems and travel. We have summarized investor preferences with respect to some of these other line item expenses in the graph "Expenses charged to the fund."

Investor respondents expect a well thought-out approach to expense management and feel that the management fee should provide for a fund's operational infrastructure. They commented on the need for a documented expense management process, with strong controls including a review by the fund's third party administrator at each dealing date.

According to the 2014 Deutsche Bank Alternative Investment Survey, "increasing institutional demand in an environment of low interest rates and single digit returns has placed heavy pressure on the standard 2&20 model. As a result, conversations around fee arrangements are playing an ever more critical role in investors' selection process." With this in mind, we asked investors whether they place any type of limit on individual expenses. Many investors look at the overall expense amount as a percentage which, as a benchmark, we would estimate to be 20-30 bps conservatively. 64% of respondents, however, will look at some or all individual line items and expect a manager to place a reasonable limit on a case-by-case basis. Although it is not likely that exceeding a fee cap will result in a veto, inappropriate or excessive costs passed to the fund resulted in 2% of explicit veto cases and an additional 2% of qualified vetoes last year (see page 36, "Top reasons for an explicit veto" and page 34 "Top reasons for a qualified veto").

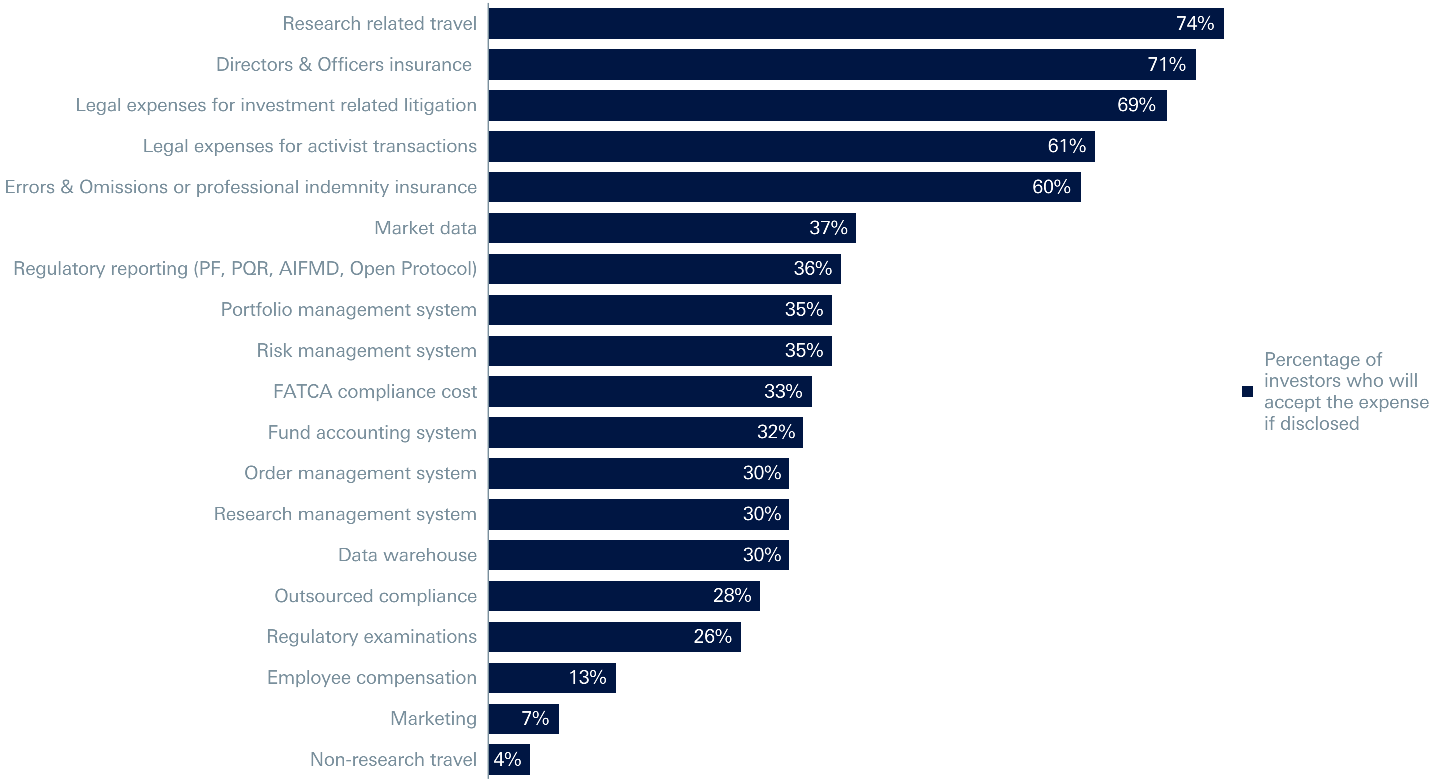
Another controversial expense for investors is employee compensation charged to the fund. While this fee structure is not common among managers who have launched in recent years, several respondents highlighted that managers in the nascent years of the hedge fund industry often charged employee costs to the fund, including the cost of the traders who were rewarded by a percentage of the profits they earned. They also added that these managers' performance net of fees often justified the cost. In today's era of increased focus on fees, however, other investor respondents indicated this fee structure would result in an automatic veto.

Regulators are also becoming more thorough in their analysis of fees charged to the fund. In fact, in April of this year, SEC Chair White testified before the United States Congress and highlighted expenses as one of the common deficiencies that the SEC identified in 2013 when examining registered advisers.[5]

[5] http://www.sec.gov/News/Testimony/Detail/Testimony/1370541674457

Expenses charged to the fund

Which of the following expenses would you accept as a fund expense if disclosed in the prospectus / offering memorandum?



Source: 2014 Deutsche Bank ODD Survey

Shadow accounting

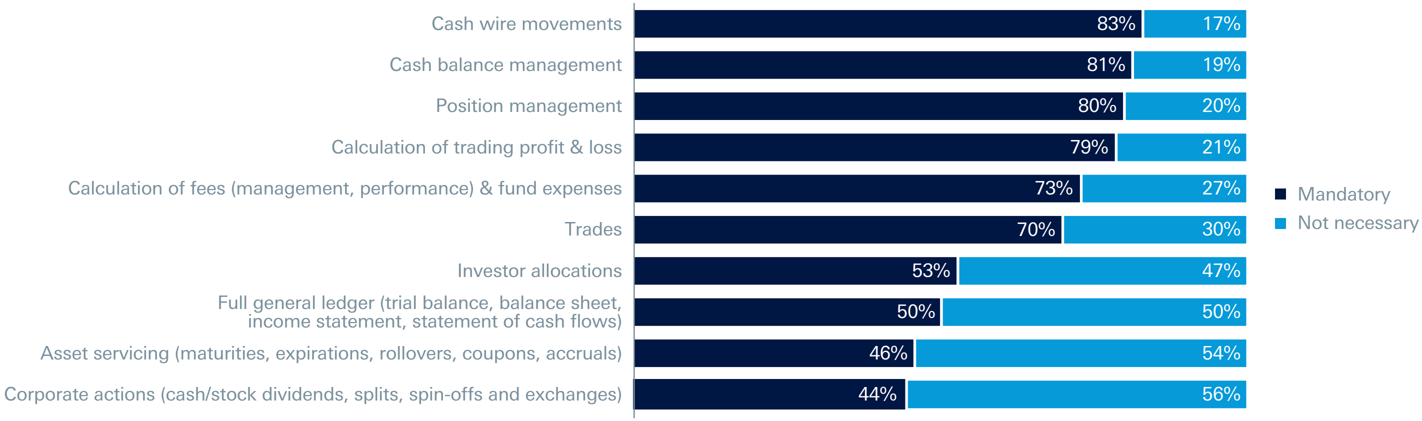
As discussed previously (see page 26, “Outsourcing”), over 84% of respondents find it acceptable for managers to outsource some or all aspects of the middle office and we find that more hedge fund managers are using their fund administrator’s systems and middle office operational services. Investors have varied opinions as to the types of functions they prefer to see a manager perform in order to oversee and control this outsourcing arrangement.

Investors were asked to indicate their preference for replicating a third party administrator’s books and records. It is clear from our survey results that investors strongly prefer some form of shadow records with the majority of responding investors indicating that they require managers to keep records of trades, cash, positions and P&L; all sensitive areas where quick responses to errors are critical. Investors were more divided about whether managers need to keep shadow records of investor allocations and the full general ledger, functions typically outsourced to the fund administrator.

Over half of investors noted the importance of considering the strategy complexity, trade volume and AUM of the fund to determine the level of shadow accounting required. Several respondents noted that while full shadow accounting is considered best practice, a lack of shadow accounting is not necessarily a “deal breaker.” Indeed, none of the respondents to this survey indicated that a lack of shadow accounting led to a veto over the past 12 months.

Shadow accounting preference

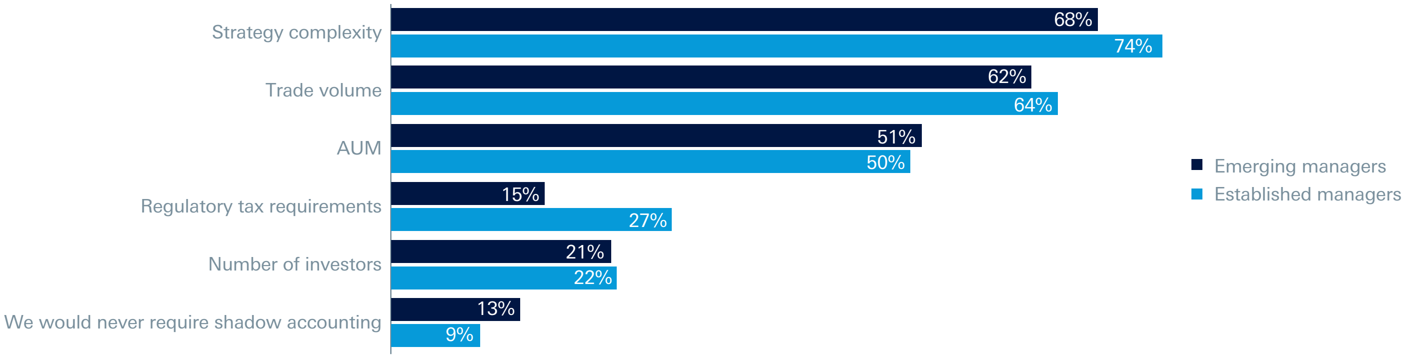
When looking into a fund's operating model, what level of shadow accounting is required?



Source: 2014 Deutsche Bank ODD Survey

Factors considered for shadow accounting

What factors do you consider when deciding whether or not to require shadow accounting? (Select all that apply)



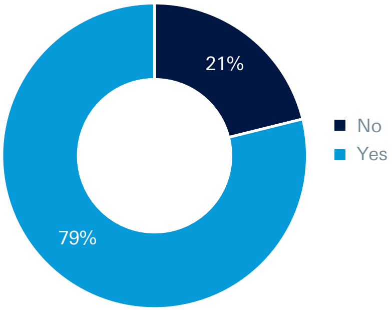
Source: 2014 Deutsche Bank ODD Survey

Fund structure

While 79% of respondents indicated that they will invest in a fund that does not have a Board of Directors due to its legal structure (e.g., a limited partnership), many noted they would expect to see an advisory board in place to provide the appropriate level of independent oversight of the manager. It is likely that the investor will want to understand the agreed terms and conditions as to when the advisory board would be convened (e.g., NAV redemptions, principal transactions, loans or major conflicts of interest).

Fund structure governance

Will you invest in a fund if it does not have a board of directors due to its legal structure (i.e., a limited partnership)?



Source: 2014 Deutsche Bank ODD Survey

Personal trading policy

Investors expect a comprehensive personal trading policy and an established ongoing monitoring process with a clearly defined individual or team responsible for ensuring adherence to the stated policy. 72% of responding investors prefer that there is no personal trading in either securities or asset classes traded by the fund. Furthermore, 10% may prefer a policy that prohibits personal trading entirely.

Personal trading policy preference

Which of the following personal trading policies would you require?

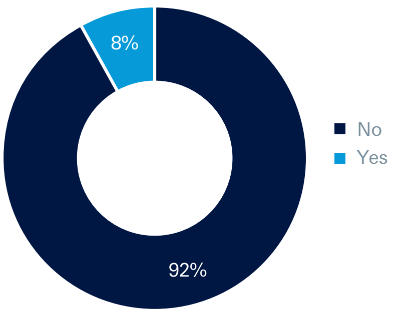
Source: 2014 Deutsche Bank ODD Survey

Expert networks

92% of respondents may allow a fund to use expert networks provided there are appropriate controls and robust compliance procedures in place. In addition to reviewing the policies and procedures around expert network utilization, investors may also seek to fully understand the manager's reason for using expert networks, the type and frequency of interaction and the effectiveness of expert network use (i.e., fund trading).

Expert network preference

Do you allow the funds in which you invest in to utilize expert networks?



Source: 2014 Deutsche Bank ODD Survey

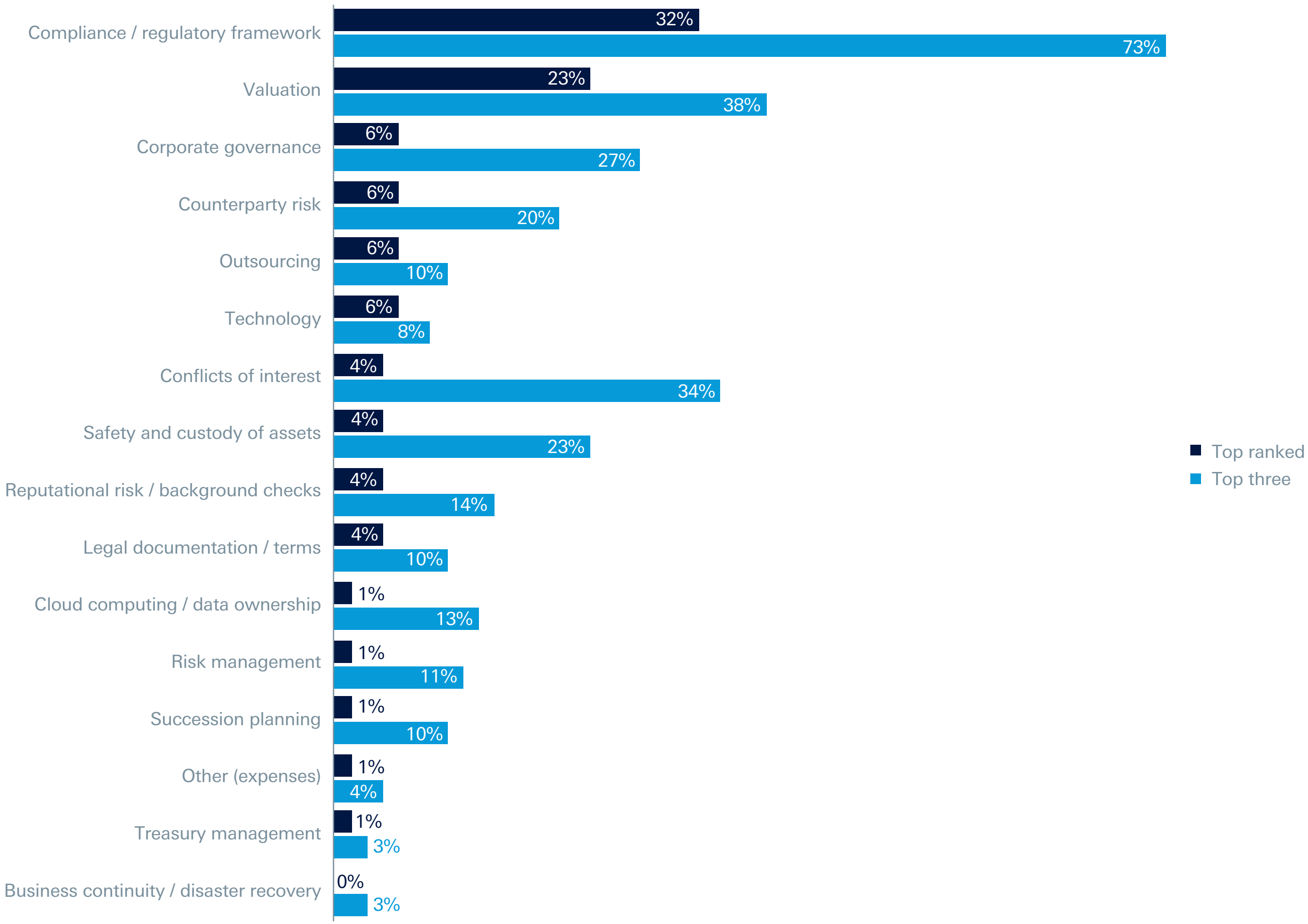
"The usage of expert networks should be accompanied by a proper and formalized Expert Network Policy that adopts industry best practice."

Fund of funds respondent, Asia

8
A look ahead: 2015 and beyond

ODD focus areas for 2015

Rank your top three ODD focus areas for the next 12 - 18 months.

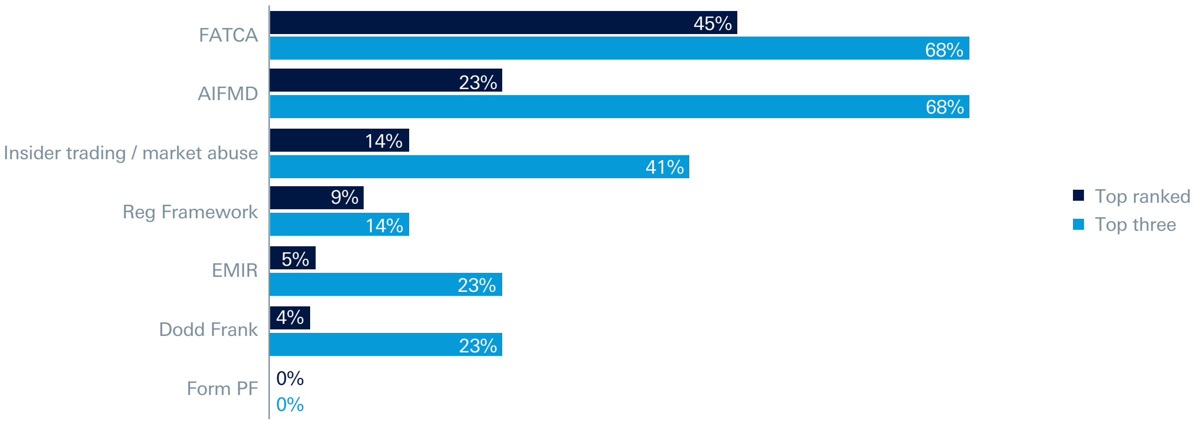


Source: 2014 Deutsche Bank ODD Survey

1. **73% of responding investors plan to focus more closely on the compliance and regulatory framework of a fund, specifically concerning FATCA and AIFMD.**
Investors seek to understand how the manager mitigates regulatory risk by investigating the preparedness of the firm to comply with new regulation, the resources delegated to tackling regulatory reporting challenges and how the overall business will be impacted.

Regulatory and compliance focus areas for 2015

Regulatory / compliance framework: Rank your top three new ODD focus areas for the next 12 - 18 months.



Source: 2014 Deutsche Bank ODD Survey

"The amount of time that COOs dedicate to legal, compliance and regulatory matters has increased substantially over the past two years. Globally, a COO's time spent on legal and regulatory matters has increased up to 50% more for the majority of managers surveyed."

2013 Deutsche Bank "Hedge fund COOs rise to new regulatory hurdles"

FATCA ("Foreign Account Tax Compliance Act"): Within the compliance / regulatory framework, 68% of respondents are focused on FATCA as one of their top three priorities. These investors want to verify that the manager has a realistic plan to meet FATCA requirements and deadlines, has developed policies for ongoing compliance requirements and has identified the right people (both internal resources and external vendors) for initial implementation and ongoing monitoring.

AIFMD ("Alternative Investment Fund Managers Directive"): 68% of respondents also indicated that AIFMD continues to be one of their top three priorities for the next year. Investors are focused on the level of preparedness of the manager as well as the quality of the service providers with which they have contracted (e.g., depositories and reporting systems). Investors are asking more questions about the development and implementation of internal policies to adhere to AIFMD rules.

Insider trading / market abuse: Insider trading / market abuse issues ranked third in respondents' list of compliance and regulatory framework focus areas in large part due to the voluminous list of insider trading convictions obtained by governments and regulators in the last few years. Investors noted that they would focus most on the policies and procedures for expert network usage, as well as a manager's adherence to that framework. Some allocators are exploring the potential for future clawbacks in the event of legal repercussions for those invested with funds which have been party to market abuse. In any case, a manager should be prepared to discuss their insider trading / market abuse prevention policies, provide continuous training and guidance to employees, and ensure that policies and procedures are regularly revisited to ensure compliance with best practices.

2. 38% of respondents will increase focus on a fund's valuation methodology.

Valuation was a topic echoed throughout the entirety of the survey by investors with particular emphasis on independent pricing. Investors will require a clear valuation process and will want to evaluate a manager's compliance with their pricing policy. 100% of respondents indicated that they will review a fund's valuation policy and 78% stated that they will observe the valuation procedure during the on-site review (see page 22, "Functions and technology observed during initial on-site review" and page 21, "Documentation time frame"). The most noted factor by respondents in assessing a fund's valuation methodology was the independence of verification by a third party. Over 92% of respondents will contact the fund's administrator during an ODD review and a growing number of investors said they contact valuation agents as part of their service provider review (see page 24, "Service provider reviews"). Additionally, investors expect a fund's directors to be involved in valuation oversight which respondents ranked second as the most important function of a fund's board of directors (see page 39, "Functions of the fund's board of directors").

3. 34% of respondents will be more focused on conflicts of interest.

Investors are primarily focused on a firm's ability to demonstrate an internal assessment of conflicts of interest and want to be assured that the investment manager has provided an appropriate governing body to oversee any conflicts. These include those that may arise from affiliated entities, sources of revenue, outside business interests, PA dealing, and timely allocation. Regulators too are focused on fund managers' handling of conflicts of interest. As part of its 2014 exam priorities, the SEC highlighted that conflicts of interest are a key area of focus during their presence examination.[6] In Europe, conflicts of interest are a component of both the Level I and Level II text of AIFMD. Respondents also ranked management of conflicts third in the list of most important functions of a fund's board of directors further pointing to the importance of ensuring an appropriate governing body to mitigate these types of issues (see page 39, "Functions of the fund's board of directors").

[6] http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf

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