

# **Discovery Group I, LLC**

## **Form ADV Part 2A Brochure**

**This brochure provides information about the qualifications and business practices of Discovery Group I, LLC. If you have any questions about the contents of this brochure, please contact Mark Buckley at (312) 265-9600 and at [MBuckley@thediscoverygroup.com](mailto:MBuckley@thediscoverygroup.com). The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.**

**Additional information about Discovery Group I, LLC is also available on the SEC's website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). The searchable IARD/CRD number for the Adviser is 156924.**

Discovery Group I, LLC is applying to be a Registered Investment Adviser with the Securities & Exchange Commission. Registration with the United States Securities and Exchange Commission or any state securities authority does not imply a certain level of skill or training.

April 1, 2011

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## **Advisory Business**

Discovery Group I, LLC (“DGI” or “Adviser”) is a Delaware limited liability company that has been operating since 2002 pursuant to the private adviser exemption of Rule 203(b)(3) of the Investment Advisers Act of 1940 (“Advisers Act”). Its advisory business is discretionary investment management. Discretionary investment management services involve managing money according to a set of parameters set forth by a client. The Adviser is free to buy or sell securities without prior discussion with the client. DGI, as general partner, provides discretionary management services to one private investment fund, Discovery Equity Partners, L.P., an Illinois limited partnership (the “Fund”) and one discretionary account, Pleiades Investment Partners-D, L.P. (the “SMA account”).

The two principals of DGI, Daniel Donoghue and Michael Murphy, have been engaged in the business of discretionary management since May 2002 as employees of Piper Jaffray & Co., a registered broker-dealer. The Piper Jaffray affiliation ended effective January 1, 2006. Discovery Group Holding Company, LLC, (“DGHC”) the original parent company of DGI, became registered as its own broker-dealer and member of the Financial Regulatory Association (“FINRA”). DGI is currently owned in varying amounts by Daniel Donoghue, Michael Murphy, DGHC, Jamie Witt and Mark Buckley, all of whom are associated persons of DGI. DGHC is owned in turn equally by Daniel Donoghue and Michael Murphy, the principals of DGHC.

### **Objective of the Adviser**

DGI relies upon the experience of the two managing principals of the DGI, Donoghue and Murphy. The objective of DGI is to seek capital appreciation in its Fund by actively managing a portfolio of long positions in U.S. equity securities through the Fund. The Fund is perpetual, with no stated maturity. The Fund is deployed in an investment strategy involving the identification of undervalued small capitalization, publicly traded companies. The Fund determines the suitability of the investments in the Fund by relying upon the information and parameters set forth in the Fund’s Confidential Private Placement Memorandum (“PPM”) dated most recently as of January 2008. It does not allow investors in the Fund to place restrictions upon investments or investment types. There are approximately 60 limited partners invested in the Fund as of December 31, 2011.

### **Assets Under Management**

As of December 31, 2011, DGI had assets under management of \$261 million.

## **Fees and Compensation**

Form ADV Part 2A, Item 5

### **Management Fee**

DGI charges the Fund a management fee of 2% annually, payable monthly and in advance. The management fee is based on the net asset value of the Fund (“NAV”) as of the last day of the previous month. The fee is charged directly to the Fund’s account and deducted accordingly. In addition, DGI charges a performance fee, as described more completely in Item 6, Performance Fees.

DGI may, in its discretion, waive or reduce the management fee on an individual limited partner basis.

### **Transaction and Other Costs**

Clients of DGI, including the Fund, will pay costs and expenses incurred in connection with the investment and reinvestment of the Fund’s assets, including the following: (i) brokerage commissions, dealer mark-ups, mark-downs and spreads, (ii) related clearing and settlement charges, (iii) all administrative, legal, accounting, auditing, record-keeping, tax form preparation costs and third party database expenses associated with the Fund’s operations, (iv) expenses associated with borrowing, (v) insurance costs and expenses to defray the Fund’s insurable liabilities, (vi) custody costs and expenses, (vii) indemnification obligations, (viii) due diligence costs for investigating and monitoring portfolio companies, and (viii) any extraordinary expenses.

DGI is responsible for all salaries, bonuses and employee benefit expenses of its principals and employees who are involved in the management and conduct of the business and affairs of the Fund (as well as related overhead, including office space and equipment, utilities, telephone and fax costs, and other similar items).

Brokerage practices are discussed further in the section of this brochure entitled “Brokerage Practices.”

## **Performance-Based Fees and Side-By-Side Management**

Form ADV Part 2A, Item 6

The Fund and SMA Account pay a performance-based allocation (“New Appreciation”) to DGI, which is payable as of the each calendar quarter end.

The performance fee charged by DGI is equal to 20% of any new profit in each investor’s capital account, as of each calendar quarter end. This is the New Appreciation. It is the increase in the Net Asset Value of a limited partner’s capital account, prior to reduction in the accrued allocation of DGI being calculated, over the highest previous calendar quarter-end Net Asset Value of such capital account, after reduction for DGI’s allocation (the “High Water Mark”). The performance fee is deducted from each limited partner’s account after computation at the quarter end.

Monies removed or transferred by a limited partner from his or her capital account will result in a proportional reduction of the High Water Mark for purposes of calculating subsequent DGI allocations. Conversely, capital contributions to a limited partner’s account increase the High Water Mark on a dollar-for dollar basis. DGI may, in its discretion, waive or reduce its allocation payable by a limited partner without waiving or reducing its own allocation for any other limited partner.

DGI does not currently manage any accounts that have a different fee structure, so there is no conflict with side-by-side management of clients with fee structures without a performance component.

## Types of Clients

Form ADV Part 2A, Item 7

DGI provides investment management services to the Fund and the SMA Account. Investment in the Fund is available to investors (individuals or entities) that meet the Fund's investment eligibility criteria. Each investor must be an "accredited investor" under Regulation D of the Securities Act of 1933 and a "qualified client" under Rule 205-3 of the Advisers Act. In addition, an investor must also be a "qualified purchaser" under Section 2(a)(51) of the Investment Company Act of 1940, as amended.

DGI typically imposes a minimum investment in the Fund of \$1,000,000; however, DGI may from time to time in its sole discretion admit investors who invest less than \$1,000,000.

The criteria for investing in the SMA Account may be similar to that of the Fund; however, DGI is not the General Partner of that fund.

## Methods of Analysis, Investment Strategies and Risk of Loss

Form ADV Part 2A, Item 8

### General

DGI focuses its investment strategy in the area of small-cap U.S. equities. It seeks to exploit the valuation discount often associated with small capitalization public stocks with equity market capitalizations generally in the range of \$50 million to \$1 billion. The Fund acquires minority stakes in a diversified portfolio of companies with strong operating fundamentals and invests in those that are likely to experience significant improvement in valuation based on specific anticipated business developments.

### Small Capitalization Stock Anomaly

Fundamentally sound, small capitalization companies are often valued at a substantial discount to larger companies due in significant part to a lack of institutional investor interest and the absence of analyst coverage. Wall Street investors tend to focus on larger capitalization companies, especially those included in the major securities indices, such as the Dow Jones Industrial Average and the Standard & Poor's 500 Stock Index (the "S&P 500"). The obscurity of smaller issuers in the public markets tends to depress their market value. The Fund acquires the securities of such companies at prices that the Principals believe to be significantly below their inherent value.

### Investment Strategy

The principals of DGI identify small capitalization investment candidates based on a disciplined analytical process. The Fund maintains a concentrated portfolio, with ownership stakes that may reach a significant percentage of a particular company's outstanding shares. Sometimes The Fund is the largest shareholder. The principals are generalists and diversify the portfolio across a broad range of industries. The principals have extensive backgrounds securities analysis and corporate finance and use that experience to identify undervalued companies with promising opportunities to see improved share valuations in the next two to three years.

### Risks

*Risk Management at the Partnership Level*



The depressed valuations of the stocks in which the Fund seeks to invest should reduce the downside risk of each of these investments considered individually, although there can be no assurance that this will be the case. In addition, diversification of the Fund's portfolio among a variety of different stocks is an integral component of DGI's risk management. DGI does not anticipate that the Fund will generally commit more than 10% of its capital to any one issuer, although the Fund could do so at the discretion of DGI. In no event will the Fund commit more than 15% of its capital to any one issuer.

### *General Risks*

All investment programs have certain risks that are borne by the investor. DGI's investment approach constantly keeps the risk of loss in mind. Investors face the following investment risks:

- **Interest-rate Risk:** Fluctuations in interest rates may cause security prices to fluctuate.
- **Market Risk:** The price of a security may drop in reaction to tangible and intangible events and conditions. This type of risk is caused by external factors independent of a security's particular underlying circumstances. For example, political, economic and social conditions may trigger market events.
- **Inflation Risk:** When any type of inflation is present, a dollar today will not buy as much as a dollar next year, because purchasing power is eroding at the rate of inflation.
- **Currency Risk:** Investments are subject to fluctuations in the value of the dollar against the currency of the investment's originating country. This is also referred to as exchange rate risk.
- **Reinvestment Risk:** This is the risk that future proceeds from investments may have to be reinvested at a potentially lower rate of return.
- **Liquidity Risk:** Liquidity is the ability to readily convert an investment into cash. Generally, assets are more liquid if many traders are interested in a standardized product. For example, Treasury Bills are highly liquid, while real estate properties are not. Investments made by DGI may or may not be liquid. Moreover the Fund interest itself is an illiquid security.

*The past performance of the Fund is not necessarily indicative of its future*

*performance. An investment in the Partnership is speculative and involves a high degree of risk. Investors must be prepared to lose all or substantially all of their investment in the Fund.*

### **Disciplinary Information**

Form ADV Part 2A, Item 9

Neither DGI nor any of its principals, owners or executive officers has any disciplinary information to report.

### **Other Financial Industry Activities and Affiliations**

Form ADV Part 2A, Item 10

Discovery Group Holdings Group, LLC, one of the owners of DGI, is a registered broker-dealer and a member of FINRA. Daniel Donoghue and Michael Murphy, combined majority shareholders in DGI, also own DGHC. It is not capitalized or licensed to execute trades, or take proprietary positions in any securities. Accordingly, it does not execute the Fund's transactions.

Therefore, there is no conflict of interest with DGI's affiliation with its related broker-dealer, DGHC, that affects investors in the Fund or any future advisory client of DGI.

## **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

Form ADV Part 2A, Item 11

DGI has adopted a Code of Ethics (the “Code”) for the purpose of instructing its personnel in their ethical obligations and to provide rules for their personal securities transactions. DGI and its personnel owe a duty of loyalty, fairness and good faith towards their clients and have an obligation to adhere not only to the specific provisions of the Code but to the general principles that guide the Code. The Code covers a range of topics that includes: general ethical principles, personal securities trading and reporting, reporting ethical violations, distribution of the Code, review and enforcement processes and supervisory procedures. In addition, the Code also defines material nonpublic information and the restrictions on trading with material non public information, along with policies and procedures pertaining to security of confidential and client information, and the receipt and delivery of gifts by DGI personnel. DGI will provide a copy of the Code to any client or prospective client upon request.

### **Personal Securities Trading**

DGI has implemented a policy that its personnel and related persons are prohibited from investing in equity positions of companies that are an investment of the Fund or under analysis by the Fund. All other trades in their personal accounts require the prior consent of DGI’s chief compliance officer. DGI will not knowingly trade for its own account or allow its access persons to trade in a manner that is detrimental to the Fund or any future DGI advisory client.

## Brokerage Practices

Form ADV Part 2A, Item 12

### Brokerage Arrangements - Generally

DGI has chosen the use of Charles Schwab & Co. (“Schwab”) as custodian and broker-dealer for its clients’ trades. In determining which broker to use with respect to the Fund’s securities transactions, DGI has taken into consideration the following factors: financial strength, reputation, execution, pricing, research, and service. The commissions and/or transaction fees charged by Schwab may be higher or lower than those charged by other broker-dealers.

Clients of DGI, including the Fund, may incur transaction costs in addition to any commissions charged by the broker-dealer when securities traded over-the-counter are effected on their behalf through the broker-dealer on an agency basis. Broker custody of client assets may limit or eliminate DGI’s ability to obtain best price and execution of transactions in over-the-counter securities.

### Soft Dollars

DGI may receive services from Schwab for the brokerage that it places there. These services include, without limitation, in addition to research, services such as special execution capabilities, clearance, settlement, net pricing, online pricing, block trading and block positioning capabilities, willingness to execute related or unrelated difficult transactions in the future, online access to computerized data regarding clients’ accounts, performance measurement data, consultations, economic and market information, portfolio strategy advice, industry and company comments, technical data, recommendations, general reports, financial strength and stability, efficiency of execution and error resolution, quotation services, referral of prospective investors, custody, travel, entertainment, recordkeeping and similar services, as well as paying for a portion of the Fund’s costs and expenses of operation, such as newswire and data processing charges, quotation services, subscription fees to periodicals and other reasonable expenses incurred by DGI in performing services on behalf of the Fund.

Section 28(e) of the Securities Exchange Act of 1934 provides a “safe harbor” to investment managers who use commission dollars generated by their advised accounts to obtain investment research and brokerage services from companies that provide lawful and appropriate assistance to the manager in the performance of investment decision-making responsibilities. Conduct outside of the safe harbor afforded by Section 28(e) is

subject to the traditional standards of fiduciary duty under state and federal law. Notwithstanding its good-faith determination that the amount of commissions paid is reasonable in relation to the value of brokerage and research services provided, to the extent, if any, that DGI determines to use commission dollars to pay for products or services from companies that provide administrative or other non-research assistance to DGI, such payments may not come within the safe harbor of Section 28(e).

### **Directed Brokerage**

DGI does not allow for a limited partner to direct its brokerage away from the custodian.

### **Trade Aggregation**

DGI has two advisory clients. DGI has full discretionary authority over the trading and investing activities of the Fund, subject only to the restrictions (if any) described in the Confidential Private Placement Memorandum relating to the Fund. DGI, may, but is not required to, bunch orders for multiple accounts. In that event, each client shall receive the same average price; commissions may vary due to the size of the account or the method of confirmation receipt. In the event that DGI must allocate a partial fill of a limited security, or a bunched order was not possible, DGI will base its allocation pro-rata on the original allocations made prior to trading, or based on an alternative fair methodology.

DGI has full discretion to select brokers and dealers that execute the securities transactions on behalf of its clients, and DGI negotiates the brokerage commission rate paid by its clients.

### **Brokerage for Client Referrals**

DGI does not direct client transactions to a particular broker-dealer in return for client referrals. DGI does not engage in any directed commission relationships or permit clients to direct brokerage.

### **Review of Accounts**

The principals of DGI, namely Daniel Donoghue and Michael Murphy, review account transactions and client accounts on an ongoing basis.

DGI provides each investor in the Fund with periodic reports no less frequently than annually that include audited financial statements, information concerning valuations, profits, gains and losses. In addition, DGI provides each investor in the Fund with tax-related information on an annual basis.



### **Client Referrals and Other Compensation**

Form ADV Part 2A, Item 14

Neither DGI nor its employees have any arrangements to receive any type of economic benefit from someone who is not a client in connection with giving advice to clients.

## **Custody**

Form ADV Part 2A, Item 15

Schwab Institutional (“Schwab”), a division of Charles Schwab & Co., Inc., will be the Fund’s custodian. Schwab provides back office and other services to independent investment advisors. The custodian’s address is 101 Montgomery Street, San Francisco, CA 94104. Schwab will send to clients, at least quarterly, statements setting forth the holdings of their account, its value and any transactions in the account.

### **Investment Discretion**

Form ADV Part 2A, Item 16

DGI has full discretionary authority over the trading and investing activities of the Fund, subject only to the restrictions (if any) described in the Limited Partnership Agreement relating to the Fund. If DGI is engaged by other clients, it will have full discretionary authority as well. In addition, DGI has full discretion to select brokers and dealers that execute the securities transactions on behalf of its clients, and DGI negotiates the brokerage commission rate paid by its clients.

## Voting Client Securities

Form ADV Part 2A, Item 17

DGI acknowledges and agrees that it has a fiduciary obligation to its clients, including the Fund, to ensure that any proxies for which it has voting authority are voted solely in the best interests and for the exclusive benefit of its clients. The policies detailed below are intended to guide DGI and its personnel in ensuring that proxies are voted in such manner without limiting DGI or its personnel in specific situations to vote in a predetermined manner. These policies are designed to assist DGI in identifying and resolving any conflicts of interest it may have in voting client proxies. Clients may obtain a copy of DGI's proxy voting policies and procedures upon request.

### **Voting Principles, Policies and Procedures**

DGI will abide by the following principles and procedures in voting client proxies:

1. DGI will at all times ensure that client proxies are voted with attention to the best interests and for the sole benefit of its clients.
2. DGI will use its reasonable efforts to ensure that each decision regarding how to vote a client proxy is based on reasonably complete information with respect to the issue to which the proxy relates such that the Adviser can make an informed decision.
3. DGI will determine a client's best interest based on the maximization of investor value, which is defined as an increase in long-term value through capital appreciation and dividends.
4. DGI will ensure that each and every proxy is voted unless the responsible principal affirmatively determines to abstain from voting such proxy because such abstention is in the best interest of its clients.
5. If DGI determines that there is an actual conflict of interest between the client and DGI, as adviser, with respect to a specific proxy issue, DGI will disregard its own interest and will vote solely in the interest of its clients.
6. DGI will maintain a client proxy file to retain records relating to the proxies voted by DGI on behalf of its clients. This file will contain, at a minimum, the proxy materials distributed by the issuer of the security to which the proxy relates and a record of how DGI voted that proxy. If DGI conducts additional research into the proxy issue, it will maintain copies of such research in the file as well.
7. Upon written request from a client, DGI will disclose to that client how its proxies were voted.

### **Financial Information**

Form ADV Part 2A, Item 18

DGI does not solicit prepayment of fees of \$1200 more than six months in advance from clients and has not been subject to a bankruptcy petition at any point. DGI does not have any financial information to report.