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Additional information about Waterstone Capital Management, L.P. also is available on the SEC’s website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

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## **Item 4: Advisory Business**

### *General*

Throughout this brochure, Waterstone Capital Management, L.P. is referred to as “Waterstone,” “we,” “our,” “us” or similar terms.

Our principal place of business is located in Plymouth, Minnesota. Shawn Bergerson founded Waterstone in January 2003. As of January 1, 2015, we had approximately \$251,948,000 in client [net] assets under management. Shawn Bergerson is our primary owner.

### *General Description of Advisory Services*

Waterstone provides the following primary services on a discretionary basis:

- managing commingled investment funds

Our overall investment objective is to produce attractive risk-adjusted returns largely uncorrelated to broad market indices. The primary driver for our investment analysis is relative valuation, incorporating fundamental analysis, quantitative models, scenario analysis and past experience. We primarily focus on and evaluate markets for convertible securities, corporate bonds, distressed securities, options, equities and derivatives to choose securities with the best risk-adjusted source of return. We generally use a “bottom up” approach to identify idiosyncratic situations where we believe there is a discrepancy between our perception and the market’s perception of fair market value. Geographically, we focus our strategies primarily on issuers and market factors in North America, although we sometimes invest on a more global basis.

## **Item 5: Fees and Compensation**

### *Asset-Based Compensation*

We provide discretionary investment management services to commingled investment funds. We receive two forms of compensation – a management fee and a performance allocation or performance fee. We typically receive a 2.0% per annum management fee from each fund and account based on net assets under management. The management fee is paid quarterly, in advance, based on the net assets of each fund or account as of the beginning of each calendar quarter, adjusted for subscriptions made during the quarter and without accrual of any performance compensation. Our management fee is prorated for any period less than a full calendar quarter.

Our performance compensation is typically equal to 20% of each investor's and client's annual net profits, if any, subject to a cumulative "loss carryforward" or "high-water mark" provision. We generally receive performance compensation based on annual (calendar year) performance. We receive performance compensation based on partial calendar year performance to the extent an investor in a fund or a client in a separately managed account receives a redemption or a withdrawal prior to the end of a calendar year and the "loss carryforward" or "high-water mark" is otherwise not applicable. We receive performance compensation in compliance with Rule 205-3 under the Investment Advisers Act.

In limited instances, our management fee and performance compensation rates are negotiable. In our sole discretion, we may waive or reduce the management fee and/or the performance compensation rates with regard to investors in commingled funds that are employees or our affiliates, relatives or friends of such persons and for certain strategic clients.

#### *Payment of Fees*

With respect to the commingled investment funds, we calculate and deduct fees from the applicable fund. The funds' independent third party administrator verifies our calculation of fees.

#### *Other Fees and Expenses*

In addition to paying the management fee and performance compensation, funds are also subject to other investment expenses such as custodial charges, brokerage fees, commissions and related costs; interest expenses; taxes, duties and other governmental charges; transfer and registration fees or similar expenses; costs associated with foreign exchange transactions, if any; other portfolio expenses; and costs, expenses and fees that may be necessary or incidental to such investments, funds or accounts. Investors in investment funds will bear their pro rata share of the underlying fund's operating and other expenses including, in addition to those listed above: legal expenses; external accounting, audit and tax preparation expenses; and organizational expenses. With respect to commingled investment funds, we may invest assets in a master-feeder structure. Feeder funds will bear a pro rata share of the expenses associated with their underlying master fund. Fund and account assets may be invested in money market mutual funds, exchange-traded funds or other registered investment companies. In these cases, you would bear your pro rata share of the management fee and other fees of the fund, which would be in addition to the management fees and performance compensation we receive.

#### *Prepayment of Management Fee*

Clients generally pay the management fee quarterly, in advance. We refund pre-paid fees if your advisory contract is terminated or a withdrawal is made from a fund or account before the end of the applicable quarter. Any such refunds will be determined on pro rata basis with respect to the amount of time remaining in the applicable quarter.

#### *No Additional Compensation*

Neither we nor any of our supervised persons receive compensation for the sale of securities or other investment products to any funds.

## **Item 6: Performance-Based Fees and Side-by-Side Management**

As described in Item 5, we charge performance-based compensation. In addition, our personnel are typically compensated on a basis that includes a performance-based component. When we manage more than one fund or account, a potential exists for one fund or account to be favored over another.

We have adopted and implemented policies and procedures intended to address conflicts of interest. We regularly monitor the performance of similarly-managed funds to determine whether there are any unexpected performance discrepancies. In addition, we generally allocate investment opportunities to funds with similar strategies pro rata based on asset size and require, to the extent orders are aggregated, client orders be price-averaged. Our procedures also require an objective allocation for limited investment opportunities (such as initial public offerings and private placements) to seek to ensure fair and equitable allocation among funds.

## **Item 7: Types of Clients**

We provide investment advisory services on a discretionary basis to clients that are commingled investment funds.

Investors in our funds typically are high net worth individuals, banks and thrift institutions, insurance companies, private funds, pension and profit sharing plans, trusts, estates, charitable organizations, corporations and other business entities that are “qualified purchasers” under the United States Investment Company Act of 1940, as amended.

We do not have any fixed requirement for opening or maintaining a “single investor fund” or separately managed account. With respect to investors in commingled investment funds, any initial and additional subscription minimums are disclosed in the offering memorandum for the commingled investment fund. If the account size falls below the minimum requirement due to market fluctuations only, an investor or client would not be required to invest additional funds to meet any minimum investment minimum or account size.

## **Item 8: Methods of Analysis, Investment Strategies and Risk of Loss**

### *Methods of Analysis and Investment Strategies*

Our overall investment objective is to produce attractive risk-adjusted returns largely uncorrelated to broad market indices. The primary driver of our investment analysis is relative valuation, incorporating fundamental analysis, quantitative models, scenario analysis and past experience. We primarily focus on and evaluate markets for convertible securities, corporate bonds, distressed securities, options, equities and derivatives to choose securities with the best risk-adjusted source of return. Specifically, we search for what we believe are mispricings between two or more related securities. We attempt to capture these mispricings by purchasing the undervalued security and selling short related securities. From time to time, we may make directional investments based on our fundamental research to profit if a particular security moves up or down, respectively. We have broad flexibility to change the weightings of each security class and other portfolio metrics in our discretion. We seek to hedge much of a fund’s or account’s aggregate exposure to the stock market, interest rates and currencies and manage exposure to convertible securities relative valuations, credit and volatility risk.

We use several quantitative methods, such as theoretical models for convertible valuation and risk parameters, but the investment decisions are primarily based on more qualitative factors such as:

- creditworthiness;
- equity valuation and implied expectations;
- potential changes in a company's dividend policy or capital structure through such actions as debt/equity exchanges, new issues, financial policy changes and bankruptcy filings; and
- opinions about the liquidity of markets, potential catalysts, market sentiment and expectations for supply and demand of a particular security.

We pursue a “bottom up” approach to identify idiosyncratic situations where we believe there is a discrepancy between our own perception and the market's perception of fair value. As the market's perception of future returns and risks change, we actively seek to manage exposure to credit spreads, volatility and asset classes (i.e., stocks vs. convertible securities vs. corporate bonds vs. listed options).

We engage in short selling strategies. In a short sale transaction, we sell a security we do not own in anticipation that the market price of that security will decline. We make short sales:

- as a form of hedging to offset potential declines in long positions in similar securities;
- for profit; and
- in order to maintain flexibility.

Our strategies involve the risk of loss to clients, who must be prepared to bear the loss of their entire contribution/investment.

#### *Certain Material Risks*

The following summary identifies the material risks related to our significant investment strategies and should be carefully evaluated before making an investment with us; however, the following does not intend to identify all possible risks of an investment with us or provide a full description of the identified risks. For further discussion of the risks pertaining to an investment with us, please refer to our offering materials.

Our strategies will involve investment in highly speculative instruments. Investments in our commingled funds employing our strategies are not intended as a complete investment program. Further, they are designed only for sophisticated persons who are able to bear the economic risk of the loss of their investment and who have a limited need for liquidity in their investment.

While not a list of all risks that could affect our investment analysis and performance, the following risks should be carefully evaluated:

## A. *General Investment Risks*

### Nature of Investments

We provide investment advisory services on a discretionary basis and have broad discretion in implementing our strategies. Investments will generally consist of convertible securities, corporate bonds, distressed securities, options, equities, derivatives, swaps and other assets that may be affected by business, financial market or legal uncertainties. We cannot provide any assurance we will correctly evaluate the nature and magnitude of the various factors that could affect the value of and return on investments. Prices of investments may be volatile, and a variety of factors inherently difficult to predict, such as domestic or international economic and political developments, may significantly adversely affect our performance and the value of investments we purchase.

### Market Risks

Our strategies could be subject to some macro risks related to the relative valuation of convertible securities, the levels of credit spreads, credit default risk and the implied price of equity volatility expected over the life of convertible securities and options. The market for credit spreads is often inefficient and illiquid, making it difficult to accurately calculate discounting spreads for valuing financial instruments.

### Lack of Diversification

Our strategies may result in portfolio composition that may not be as diversified among a wide range of types of securities or industry sectors as other investment funds. Accordingly, the investment portfolio of our funds may be subject to more rapid change in value than would be the case if the funds were required to maintain a wider diversification among types of sectors, securities and other instruments.

## B. *Strategy Risks and Instrument Risks*

### **Strategy Risks**

#### Convergence Risk

We pursue relative value strategies by taking long positions in securities believed to be undervalued and short positions in securities believed to be overvalued. In the event the perceived mispricings underlying the positions we purchase were to fail to converge toward, or were to diverge further from, relationships we expect, losses would likely be incurred.

#### Interest Rate Risk

Our primary strategies are subject to interest rate risk. Generally, the value of fixed income securities will change inversely with changes in interest rates. As interest rates rise, the market value of fixed income securities tends to decrease. Conversely, as interest rates fall, the market value of fixed income securities tends to increase. This risk will be greater for long-term securities than for short-term securities. We intend to manage the exposure of our strategies to interest rate changes

through the use of interest rate swaps, interest rate futures and/or interest rate options. There can be no guarantee, however, we will be successful in fully mitigating the impact of interest rate changes.

### Leverage

We may utilize substantial amounts of leverage in our strategies. The use of leverage increases investment returns if the strategies earn a greater return on leveraged investments than the cost of such leverage. The use of leverage, however, creates additional levels of risk, such as: (i) should the value of securities pledged to brokers to secure margin accounts decline in value, the brokers could make a “margin call” requiring either the deposit of additional funds with the lender or the mandatory liquidation of the pledged securities to compensate for the decline in the securities’ value; (ii) greater losses from investments than would otherwise have been the case; and (iii) losses where leveraged investments fail to earn a return that equals or exceeds the cost of leverage.

### Hedging

For funds and accounts that involve a market neutral investment component, we sometimes engage in hedging activities to isolate and minimize correlations common with directional investing. There can be no assurances any such hedge would be appropriate, or risks are measured properly. Further, while we may enter into hedging transactions to seek to reduce risk, such transactions may result in poorer overall performance and increased (rather than reduced) risk for our investment portfolios than if we did not engage in any such hedging transactions.

### Portfolio Turnover

Our strategies may involve frequent trading. As a result, brokerage commission expenses and taxes of our funds may significantly exceed those related to other investment managers.

### Counterparty Risk

We may use swaps, derivative or synthetic instruments, repurchase agreements or other over-the-counter transactions in implementing and managing our strategies. These instruments involve counterparty credit risk. These risks may differ materially from those entailed in exchange-traded transactions that generally are backed by clearing organization guarantees, daily marking-to-market and settlement, and asset segregation and minimum capital requirements applicable to intermediaries. Transactions entered directly between two counterparties generally do not benefit from such protections and expose the parties to the risk of counterparty default.

### **Instrument Risks**

#### Convertible Securities

One of our primary strategies involves investing in convertible securities. Convertible securities are securities that may be exchanged or converted into a predetermined number of the issuer’s underlying shares or the shares of another company or that are indexed to an unmanaged market index at the option of the holder during a specified time period. Convertible securities may take the form of convertible preferred stock, convertible bonds or debentures, stock purchase warrants, zero-



coupon bonds or liquid-yield option notes, stock index notes, mandatories, or a combination of the features of these securities. Prior to conversion, convertible securities have the same general characteristics as non-convertible debt securities. As with all debt securities, the market value of convertible securities tends to decline as interest rates increase and, conversely, increase as interest rates decline. Convertible securities, however, also appreciate when the underlying common stock appreciates, and conversely, depreciate when the underlying common stock depreciates.

### Distressed Securities

We may invest in securities, claims and obligations of entities experiencing significant financial or business difficulties. Distressed securities may lose a substantial portion or all of their investment or may be retired or exchanged for cash or securities with a value less than the purchase price or fair market value. Among the risks inherent in investments in entities experiencing significant financial or business difficulties is frequently it may be difficult to obtain information as to the true condition of such issuers. Such investments also may be adversely affected by state and federal laws relating to, among other things, fraudulent conveyances, voidable preferences, lender liability and the bankruptcy court's discretionary power to disallow, subordinate or disenfranchise particular claims. The market prices of such instruments are also subject to abrupt and erratic market movements and above average price volatility and the spread between the bid and ask prices of such instruments may be greater than normally expected. In trading distressed securities, litigation is sometimes required. Such litigation can be time-consuming and expensive, and can frequently lead to unpredicted delays or losses.

### Lower-Rated Securities

We may invest in fixed income securities rated lower than Baa3 by Moody's or lower than BBB- by S&P, or securities that are not rated. Securities rated lower than Baa3 by Moody's or lower than BBB- by S&P are sometimes referred to as "high yield" or "junk" bonds. Investing in lower-rated securities involves special risks in addition to the risks associated with investments in higher-rated fixed income securities, including a high degree of credit risk. Lower-rated securities may be more susceptible to losses and real or perceived adverse economic and competitive industry conditions than higher-grade securities. The secondary markets on which lower-rated securities are traded may be less liquid than the market for higher-grade securities. Less liquidity in the secondary trading markets could adversely affect and cause large fluctuations in the value of the portfolio in our funds. Adverse publicity and investor perceptions, whether or not based on fundamental analysis, may decrease the values and liquidity of lower-rated securities, especially in a thinly traded market.

### Futures

The prices of futures contracts and options used for speculation and hedging purposes may not correlate with price movements of the underlying commodities or securities. Although we generally intend to purchase or sell commodity futures contracts only if there is an active market for each such contract, no assurance can be given that a liquid market will exist for the contracts at any particular time. In addition, because of the low margin deposits normally required in commodity futures trading, a high degree of leverage may be involved. As a result, a relatively small price movement in a commodity futures contract may result in substantial losses.

## **Item 9: Disciplinary Information**

This item is not applicable.

## **Item 10: Other Financial Industry Activities and Affiliations**

Waterstone may enter into agreements, or “side letters”, with certain prospective or existing investors whereby such investors may be subject to terms and conditions that are more favorable than those set forth in the applicable offering memorandum. For example, such terms and conditions may provide for special rights to make future investments; special redemption rights, including relating to frequency or notice; a reduction or rebate in fees and/or other terms; rights to receive reports on a more frequent basis or that include information not provided to other investors (including, without limitation, more detailed information regarding portfolio positions) and such other rights as may be negotiated.

## **Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

### *A. Code of Ethics*

High ethical standards are essential for the mutual success of investment advisors and their clients. In recognition of our fiduciary duty to our clients and our desire to maintain high ethical standards, we have adopted a Code of Ethics (the “Code”) containing provisions designed to prevent improper personal trading and address certain other potential conflicts of interest. All of our personnel are required to put our investors’ and clients’ interests before their own personal interests, and to act honestly and fairly in all respects in dealings with investors and clients. All of our personnel must also comply with all federal securities laws, including complying with laws to prevent the misuse of material non-public information.

We will provide investors in commingled funds and clients a copy of our Code upon request. Requests should be made by contacting us at +1 (952) 697-4100.

### *B. Investing in Securities Recommended to Clients.*

Our Code requires personal trading in certain securities by our covered associates<sup>1</sup> be pre-approved, subject to certain permitted exceptions, by our Chief Financial Officer. We will approve a personal securities transaction if we believe the transaction is not likely to have any adverse economic impact on our clients.

### *C. Conflicts of Interest Created by Contemporaneous Trading*

Conflicts of interest could arise if we or one of our covered persons contemplates recommending or executing transactions in securities for the benefit of clients at or about the same time we or one of

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<sup>1</sup> Covered associates include our directors, partners, officers and employees, as well as any other person who provides investment advice on our behalf and is subject to our supervision and control if they (i) have access to nonpublic information regarding clients’ purchase or sale of securities or (ii) are involved in making securities recommendations to for the benefit of clients (or who has access to such recommendations that are nonpublic).

our covered persons buys or sells the same securities for their own accounts. We do not engage in proprietary trading. Further, any security being considered for purchase by our funds or accounts generally will not be approved for personal trading by covered persons.

## **Item 12: Brokerage Practices**

### *A. Best Execution in General*

If an investment adviser has the ability to exercise investment discretion, including the ability to select broker-dealers in connection with the execution of transactions it executes, the adviser has a fiduciary duty to evaluate in good faith whether the broker-dealers it uses are providing “best execution.” In general, best execution means an adviser must seek to execute securities transactions so the total cost or proceeds in each transaction are the most favorable under the circumstances. While best price and best commission rates (or spreads) are key to evaluating whether best execution has been obtained, they are not the sole factors. Instead, achieving best execution generally means a transaction was executed using the best qualitative execution based on a variety of factors.

In seeking best execution, we consider the full range of a broker-dealer’s services, including commission rates/spreads, execution price and speed of execution, the value of research provided and execution capability, financial stability and responsiveness. When best price and best commissions may be obtained from more than one broker-dealer, we may execute trades through brokers/dealers who provide other brokerage and research services, even when a particular client may not be the direct beneficiary of the services received. In selecting a broker-dealer to execute transactions (or series of transactions) and determining the reasonableness of the broker-dealer’s compensation, we are not required to solicit competitive bids and do not have an obligation to seek the lowest available commission cost.

### *B. Factors Considered in Selecting Broker-Dealers for Client Transactions*

#### *1. Research and Other Soft-Dollar Benefits*

Since we may use “full service” broker-dealers that sometimes provide their clients proprietary research, we might be deemed to be receiving research services from these broker-dealers. We attempt to negotiate “execution only” commission rates, however, and do not consider the potential receipt of research services as a key factor when selecting brokers-dealers. If we receive any such research services, we believe they would fall within the meaning of Section 28(e) of the Securities Exchange Act of 1934, as amended.

#### *2. Brokerage For Client Referrals*

From time to time, we may participate in capital introduction programs arranged by broker-dealers, including our prime brokers. We might execute transactions with firms who have made such recommendations or provided capital introduction opportunities, if we determine it is otherwise consistent with seeking best execution. We do not select a broker-dealer as a means of remuneration for recommending us as an investment adviser or for recommending any commingled funds we manage.

### 3. *Directed Brokerage*

Waterstone does not have directed brokerage with clients.

### C. *Order Aggregation*

We generally purchase or sell the same security on behalf of funds contemporaneously, using the same executing broker. It is our practice, where possible, to aggregate orders for the purchase or sale of the same security submitted contemporaneously for execution using the same executing broker. Such aggregation may enable us to obtain for clients a more favorable price or a better commission rate based upon the volume of a particular transaction. When an aggregated order is completely filled, we allocate the securities purchased or proceeds of sale pro rata among the participating funds, based on the purchase or sale order. Adjustments or changes may be made under certain circumstances, such as to avoid odd lots or excessively small allocations. If the order at a particular broker is filled at several different prices, through multiple trades, generally all such participating funds will receive the average price and pay the average commission, subject to odd lots, rounding, and market practice. If an aggregated order is only partially filled, we will allocate the securities or proceeds to funds in a manner we believe is fair and equitable.

## **Item 13: Review of Accounts**

### A. *Frequency and Nature of Review*

Shawn Bergerson, our managing member and portfolio manager, monitors the holdings in all of our funds on a continuous basis. Holdings are monitored by Mr. Bergerson in light of market and economic activity, trading activity and significant corporate developments that could affect portfolio holdings.

To the extent any funds participate in aggregated trades, our general policy is that such trades are allocated pro rata across the participating funds. However, trades may not be allocated pro rata to a fund or account due to strategy/trading prohibitions and/or concentration limits specified in advisory contracts or other governing documents, liquidity mismatches or similar constraints, financing/margin constraints, position size limitations, tax considerations and regulatory constraints (e.g., ERISA restrictions on hard-to-value securities), among other factors (e.g., odd lot restrictions). We regularly monitor the performance of funds to determine whether there are any unexpected performance discrepancies to seek fair and equitable allocation among funds.

### B. *Factors Prompting a Non-Periodic Review of Funds and Separately Managed Accounts*

We evaluate the portfolio composition of our funds on a continuous basis.

### C. *Content and Frequency of Regular Account Reports*

For investors in commingled investment funds that we manage, we send audited financial statements to investors within 120 days of the funds' respective year-ends. In addition, all investors in

these funds receive commentaries on performance and high-level portfolio analytics at least quarterly. We may also agree to provide additional reporting and or notifications on a case by case basis.

Reports and other information are provided to investors and clients using electronic delivery (e.g., e-mail) unless an investor or client has opted-out of electronic delivery.

#### **Item 14: Client Referrals and Other Compensation**

This item currently is not applicable to us.

#### **Item 15: Custody**

We are deemed under United States law applicable to registered investment advisors to have custody over assets held in investment funds where we serve as the general partner or managing member. For investment funds that have a majority of independent directors, we believe we are not deemed under United States law to have custody over assets held by such investment funds. Except as set forth in the next paragraph, we deliver audited financial statements to investors in each fund within 120 days after the applicable fund's fiscal year end (December 31) regardless of whether we are deemed under United States law to have custody of the funds' assets.

#### **Item 16: Investment Discretion**

We provide investment advisory services on a discretionary basis to our commingled investment funds. Prior to assuming discretion in managing assets, we enter into an investment management agreement or other agreement that sets forth the scope of our discretion.

In general, we have the authority to determine:

- the securities to be purchased and sold for each fund and, subject to restrictions on our discretion set forth in the applicable investment management agreement and any written investment guidelines, each client account; and
- the amount of securities to be purchased or sold for each such fund and, subject to restrictions on our discretion set forth in the applicable investment management agreement and any written investment guidelines, each client account.

To the extent any funds participate in aggregated trades, our general policy is that such trades are allocated pro rata across the participating funds. However, trades may not be allocated pro rata to a fund or due to strategy/trading prohibitions and/or concentration limits specified in investment advisory contracts or other governing documents, liquidity restrictions, financing/margin constraints, position sizes limitations, tax considerations and regulatory constraints (e.g., ERISA restrictions on hard-to-value securities), among other factors (e.g., odd lot restrictions). With respect to participation in transactions that constitute initial public offerings or secondary offerings, our policy is to allocate trades to on a pro

pro rata basis unless we determine in our discretion a pro rata allocation is not appropriate, which generally occurs when a client's investment guidelines explicitly prohibiting participation in initial public offerings or secondary offerings or investors or clients are "restricted persons" under applicable regulations.

If it appears a trade error has occurred, we will review the relevant facts and circumstances to determine an appropriate course of action. To the extent trade errors and breaches of investment guidelines and restrictions occur, we will seek to ensure clients are treated fairly.

In the course of our investment management and other related activities (e.g., creditor committee service), we may come into possession of confidential or material nonpublic information about issuers, including issuers in which we have invested or may invest in on behalf of our clients. While we are in possession of material nonpublic information with respect to an issuer, we will generally be prohibited from purchasing or selling securities of that issuer and therefore our ability to enter into transactions we otherwise would execute will be restricted.

#### **Item 17: Voting Client Securities**

We have the authority to vote proxies on behalf of our commingled investment funds. We exercise our proxy voting authority in a manner we believe is in the best interests of its investors and/or clients. We generally exercise our authority through on-line voting (e.g., proxyvote.com) or as otherwise permitted in written ballots received from custodians for securities in funds. We generally vote on all matters consistent with the recommendations of each issuer's management unless the responsible trader determines voting in a different manner is in the best interests of the relevant clients. We will resolve conflicts of interest we identify, if any, in a manner we believe is in the best interests of investors in our funds (which may include abstaining or seeking input from independent third parties (including fund directors, client input or third-party proxy voting service recommendations)).

#### **Item 18: Financial Information**

This item is currently not applicable to us.

## **Appendix**

### **Item 2.       Material Changes**

Other than routine changes made in the connection with the annual update of this brochure, there have been no material changes to the brochure since the last update.