

**PART 2A OF FORM ADV**  
**FIRM BROCHURE**



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**This Brochure provides information about the qualifications and business practices of KLS Diversified Asset Management LP (“KLS”). If you have any questions about the contents of this Brochure, please contact Timothy F. Quinn (the “Chief Compliance Officer”) at 212-905-0800 or by email at [compliance@klsdiversified.com](mailto:compliance@klsdiversified.com). The information in this Brochure has not been approved or verified by the United States Securities and Exchange Commission (the “SEC”) or by any state securities authority, and references in this Brochure to KLS as a “registered investment adviser” are not intended to imply a certain level of skill or training.**

**Additional information about KLS is also available on the SEC’s website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).**

## **ITEM 2 – MATERIAL CHANGES**

This Brochure reflects the following material changes since KLS filed its last annual amendment in March 2013:

- KLS has revised this Brochure to reflect the addition of KLS Credit Opportunities Fund LP and the commencement of the voluntary liquidation of KLS Focus Performance Fund Ltd.
- As reflected in the other than annual amendment filed on September 19, 2013, KLS moved its principal office and place of business to 452 Fifth Avenue, 22<sup>nd</sup> Floor, New York, New York 10018.

## ITEM 3 – TABLE OF CONTENTS

	<b><u>Page</u></b>
ITEM 2 – MATERIAL CHANGES .....	ii
ITEM 3 – TABLE OF CONTENTS .....	iii
ITEM 4 – ADVISORY BUSINESS .....	4
ITEM 5 – FEES AND COMPENSATION.....	6
ITEM 6 – PERFORMANCE-BASED FEES AND SIDE-BY-SIDE MANAGEMENT .....	8
ITEM 7 – TYPES OF CLIENTS .....	9
ITEM 8 – METHODS OF ANALYSIS, INVESTMENT STRATEGIES AND RISK OF LOSS	10
ITEM 9 – DISCIPLINARY INFORMATION .....	17
ITEM 10 – OTHER FINANCIAL INDUSTRY ACTIVITIES AND AFFILIATIONS .....	18
ITEM 11 – CODE OF ETHICS, PARTICIPATION OR INTEREST IN CLIENT TRANSACTIONS AND PERSONAL TRADING .....	20
ITEM 12 – BROKERAGE PRACTICES .....	23
ITEM 13 – REVIEW OF ACCOUNTS.....	27
ITEM 14 – CLIENT REFERRALS AND OTHER COMPENSATION.....	28
ITEM 15 – CUSTODY .....	29
ITEM 16 – INVESTMENT DISCRETION.....	30
ITEM 17 – VOTING CLIENT SECURITIES.....	31
ITEM 18 – FINANCIAL INFORMATION .....	32

## **ITEM 4 – ADVISORY BUSINESS**

### **A. Introduction**

KLS was incorporated in Delaware in November 2007 and began operations in August of 2008. KLS provides discretionary investment advisory services for private investment funds (the “Funds”) and separately managed accounts (the “Managed Accounts,” together with the Funds, the “Advisory Clients”).

The managing partners of KLS are Jeffrey Kronthal, Harry Lengsfeld and John Steinhardt (the “Managing Partners”). The principal owner of KLS is KLS Partners LLC. The Managing Partners collectively own a majority of KLS Partners LLC.

KLS currently advises several Funds that invest generally in a diversified fixed income portfolio. Such Funds include KLS Diversified Master Fund L.P., which invests across rates, credit and structured asset investment strategies, as well as KLS Rates Master Fund LP and KLS Credit Opportunities Fund LP, which invest in different subsets of fixed income assets.

Affiliates of KLS act as general partners to certain of the Funds (the “General Partners”).

### **B. Types of Advisory Services**

KLS generally has broad and flexible investment authority with respect to the Advisory Clients. The Advisory Clients have broad diversified fixed income investment programs and invest across rates, credit and structured asset investment strategies. Advisory Client investments may include the full range of fixed income and other financial instruments including, but not limited to, cash bonds, futures, interest rate swaps, credit default swaps, swaptions, FX, options, equities, mortgage assets and other instruments (together, the “Fixed Income Assets”). It should be noted that each of the Rates Fund and the Credit Opportunities Fund invests in a different subset of the Fixed Income Assets, with dynamic capital allocations among and across broad rates or credit strategies (as applicable).

Each Advisory Client’s investment objectives and strategy are set forth in a private placement memorandum (in the case of each of the Funds) or investment management agreement (in the case of each of the Managed Accounts). Such documents, together with the limited partnership agreements, operating agreements, and other governing documents of the Advisory Clients, are collectively referred to as the “Governing Documents.”

### **C. Client Investment Objectives and Restrictions**

KLS does not tailor its advisory services to the individual needs of investors in the Funds (“Fund Investors”) and does not accept Fund Investor-imposed investment restrictions.

As noted above, KLS does manage certain Funds that invest in subsets of the Fixed Income Assets. The Governing Documents of any of such Funds may impose restrictions on the applicable Fund’s ability to invest in certain securities or types of securities.

KLS has, and in future may, establish separately managed accounts or single investor funds for large or strategic investors. The advisory agreements for such clients are generally heavily negotiated and are subject to different terms than the Funds, including but not limited to, as

regards liquidity, investment objectives, guidelines, restrictions, terms and/or fees.

KLS has entered into side letter agreements with certain Fund Investors. Such agreements may provide such Fund Investors with additional notification and disclosure rights, certain fee arrangements, transfer rights, and certain withdrawal or redemption rights, among others. In the future, KLS may enter into additional side letter agreements. KLS generally enters into side letters pertaining to fee arrangements only with Fund Investors who make substantial commitments of capital. Side letter provisions are typically negotiated prior to investment and are not indefinite in length.

**D. Wrap Fee Programs**

KLS does not participate in wrap fee programs.

**E. Assets under Management**

As of March 1, 2014, KLS manages approximately \$2,640,871,116 of Advisory Client assets on a discretionary basis. KLS does not currently manage any Advisory Client assets on a non-discretionary basis. It should be noted that this is not the amount reported as “regulatory assets under management” on the ADV Part 1 because of (among other factors) the method of calculation of “regulatory assets under management”.

## ITEM 5 – FEES AND COMPENSATION

It is critical that Fund Investors and Managed Account clients refer to the relevant Governing Documents for a complete understanding of fees and expenses they may pay to KLS. The information contained herein is a summary only and is qualified in its entirety by such documents.

### **A. Advisory Fees and Compensation**

All Managed Account clients and Fund Investors are “qualified purchasers” under the Investment Company Act of 1940. Each of the Funds pays KLS a management fee based on a percentage of the net assets of the applicable Fund attributable to each Fund Investor’s account (the “Management Fee”) and a performance-based fee or allocation calculated on a high watermark basis (the “Incentive Allocation”). KLS has the discretion to alter, reduce or waive the standard management fees and/or Incentive Allocations set forth in the Governing Documents of the Funds. KLS allows current KLS employees who are authorized to invest in the Funds to do so on a fee-free basis, and KLS (or an affiliate) has agreed in some cases to waive or reduce fees for certain Fund Investors.

Fee arrangements for Managed Accounts and single investor Funds are generally individually negotiated and may differ from those of the Funds.

### **B. Payment of Fees**

KLS generally deducts its fees from Fund Investors’ assets invested in the Funds. Fund Investors do not have the ability to choose to be billed directly for fees incurred. The Management Fee generally is paid from the relevant Fund to KLS quarterly in advance.

Generally, the Incentive Allocation applicable to each Fund Investor is made to the relevant General Partner as of the end of each year, on a high watermark basis. The Incentive Allocation applicable to a Fund Investor may be made at the time a Fund Investor withdraws/redeems from the applicable Fund.

Managed Accounts are generally charged Management Fees and are invoiced quarterly or monthly in advance for such fees. In addition, to the extent a Managed Account pays a performance-based fee, such fee will generally be deducted from such Managed Account’s assets on an annual basis (or at such other time as the agreement is terminated) after the Managed Account receives an invoice.

### **C. Other Client Fees and Expense**

Expenses paid by the Advisory Clients may include: management fees; legal and accounting fees and disbursements; audit and tax preparation expenses; indemnification expenses; investment related expenses (including without limitation: commissions; clearing fees; fees, interest and other costs on margin accounts or other financings or re-financings; borrowing charges on securities sold short; custodial fees; bank service fees; investment and trading consultant expenses; research, pricing and quotation fees and expenses; portfolio management expenses; expenses in connection with proposed transactions (including transactions that fail to close); and any other reasonable expenses (at the discretion of the General Partner or KLS, as applicable) related to the purchase, sale, holding or transmittal of assets or liabilities); liability insurance premiums with respect to the General Partner and

KLS; expenses relating to maintaining the registered offices of a General Partner and certain Funds in the Cayman Islands, expenses relating to all necessary filings with and all fees required by any U.S. federal or state government agency, the Cayman Islands Registrar or other U.S. or foreign government body; third-party administrator fees; extraordinary expenses and other similar expenses. Please refer to Item 12 of this Brochure for a description of KLS's brokerage practices.

In addition, certain of the Funds invest substantially all of their assets in a master fund through a "master feeder" structure. Each such Fund will indirectly bear the administrative and other expenses of such master fund pro rata based on its interest in such master fund.

**D. Advance Payment of Fees**

As noted above, Management Fees applicable to Fund Investors are paid quarterly in advance. If a Fund Investor withdraws/redeems from a Fund prior to the end of a calendar quarter, KLS will typically reimburse such Fund Investor a pro-rated amount of the pre-paid management fee. Managed Account holders have generally negotiated any fee refund terms on a case by case basis. All Fund Investors and Managed Account Holders should refer to the relevant Governing Documents.

In the case of all of the Funds, withdrawals or redemptions will be subject to significant conditions and restrictions, including without limitation, prior written notice requirements, a lock-up (in the case of the Credit Opportunities Fund) and restrictions on the timing and method (i.e. in cash or kind) of withdrawal/redemption payments. The conditions, restrictions, and limitations for each Fund are set out in the respective Fund's Governing Documents.

KLS (or an affiliate) may waive or modify the conditions relating to withdrawals or redemptions for certain Fund Investors, including Fund Investors that are principals, employees or affiliates of KLS or its affiliates.

**E. Compensation and Commissions**

Not applicable to KLS.

## **ITEM 6 – PERFORMANCE-BASED FEES AND SIDE-BY-SIDE MANAGEMENT**

As described in Item 5.B above, KLS (or an affiliate) receives performance-based compensation from the Funds and from certain Managed Accounts.

It should be noted that the possibility that KLS (or an affiliate) may receive performance-based compensation creates a potential conflict of interest in that it may create an incentive to make investments that are riskier or more speculative than in the absence of such performance-based fee. Fund Investors and Managed Account clients are provided with clear disclosure as to how performance-based compensation is charged with respect to a particular Fund or Managed Account and the risks associated with such performance-based compensation prior to making an investment.

The possibility that KLS (or an affiliate) will receive performance-based compensation from certain Fund Investors and Advisory Clients, but not from others, creates a potential conflict of interest in that it may create an incentive for KLS to direct more profitable investment ideas to, or allocate trades in a manner that favors, those Managed Account clients and Fund Investors that pay a performance fee or allocation. In order to manage such potential conflicts, the Advisory Client portfolios are under continuous review by the Managing Partners (as described in Item 13.A). In addition, KLS has implemented a detailed allocation policy and KLS regularly reviews its trade allocations (as described in Item 12.B). KLS, to the extent within its control, will not favor itself in any way to an Advisory Client's detriment and will act in a manner that it believes over the long term is fair and equitable to all its Advisory Clients.



## **ITEM 7 – TYPES OF CLIENTS**

KLS provides investment advisory services to the Funds and the Managed Accounts.

The Funds offer interests/shares only to certain qualified investors and admission to the Funds is not open to the general public. The minimum initial contribution for Fund Investors is generally \$1,000,000, subject to reduction or waiver at the discretion of the relevant General Partner or Fund directors, as applicable (though not below applicable Cayman Islands minimums, where relevant).

## ITEM 8 – METHODS OF ANALYSIS, INVESTMENT STRATEGIES AND RISK OF LOSS

### A. Investment Strategies and Methods of Analysis

KLS utilizes a variety of investment strategies and has broad discretion in making investments for the Advisory Clients. Each Advisory Client's investment strategy is set forth in a confidential private placement memorandum (in the case of the Funds), and a managed account agreement (in the case of the Managed Accounts).

KLS seeks to preserve capital while delivering high risk-adjusted absolute returns with low volatility and low correlation to equity and bond markets. KLS generally seeks to provide a diversified fixed income portfolio through dynamic capital allocation among and across broad rates, credit and structured product investment strategies.

- **Rates:** The rates investment strategies focus on trades in and between cash and derivative government securities, agency issues, mortgage pass-throughs, foreign exchange, and various LIBOR and funding curves utilizing a combination of both macro and specific issue-level fundamental and technical analyses.
- **Credit:** The credit investment strategies emphasize a fundamentally-oriented, bottom-up process utilizing the KLS investment teams' extensive research experience. KLS seeks to identify the most appropriate credit products for its investment strategy (including, for example, senior and/or subordinated bonds, loans, and credit default swaps).
- **Structured Products:** The structured product investment strategy is focused on a variety of mortgage products (including, for example, residential mortgages, commercial mortgage backed securities, mortgage derivatives and non-mortgage asset-backed securities). Investment strategies throughout this asset class are shaped by broad macroeconomic views on housing, the health of the consumer, commercial real estate markets, the economy, and interest rates. This is combined with detailed loan-level analyses of specific transactions and structures.

Notwithstanding the above, the Rates Funds (and any Managed Account utilizing the same or similar investment strategy) generally invests across broad rates strategies, including but not limited to, U.S. Treasuries, global sovereigns, currencies, municipal bonds, and global agency obligations via cash, derivative, repo, options, swaps, credit default swaps, mortgage-backed securities and futures products. The Rates Fund may also utilize various hedging strategies for risk management purposes, and from time to time may invest in non-rates-oriented products.

The Credit Opportunities Fund (and any Managed Account utilizing the same or similar investment strategy) generally invests in a diverse portfolio of originated loans (funded and unfunded), bonds and other credit opportunities created in part by tighter regulatory, risk and capital parameters for banks. The Credit Opportunities Fund may also utilize various hedging strategies for risk management purposes, and from time to time may invest in non-credit-oriented products.

An investment with KLS may be deemed speculative and is not intended as a complete investment program. Investing in the securities markets involves significant risk. Investments in the Funds and Managed Accounts are only appropriate for experienced and sophisticated persons who meet certain eligibility criteria, are able to bear the risk of loss or some or all of an investment, and have a limited need for liquidity.

**B. Material Risks of Investment Strategies and Methods of Analysis**

Portfolio strategies and the risks associated with them are analyzed and managed as a whole. Listed below are some of the key risk factors associated with KLS trading strategies.

**Leverage**

The Advisory Clients make extensive use of borrowed funds and other forms of leverage for the purpose of making investments and to hedge exposure to market and credit risk. The use of leverage creates special risks and may significantly increase investment risk. Leverage creates an opportunity for greater yield and total return but may also increase exposure to capital risk and interest costs. Any investment income and gains earned on investments made through the use of leverage that are in excess of the interest costs associated therewith may cause the value of the interests to increase more rapidly than would otherwise be the case. Conversely, where the associated interest costs are greater than such income and gains, the value of the interests may decrease more rapidly than would otherwise be the case.

**Liquidity of Investments**

The Advisory Clients may acquire thinly-traded investments, which are difficult to dispose of quickly. In addition, investments that were once liquid may become illiquid, making it difficult to acquire or dispose of them at the prices quoted on the various exchanges. In that event, KLS's ability to respond to market movements may be impaired and the Advisory Clients may experience adverse price movements upon liquidation of investments.

**Financial Model Risk**

KLS's investment strategies may utilize (in varying degrees) various quantitative and qualitative models developed by KLS and third-parties. As market dynamics (for example, due to changed market conditions and participants) shift over time, a previously highly successful model often becomes outdated or inaccurate, perhaps without KLS recognizing the change before significant losses are incurred. In addition, although most investments have market prices, in the absence of any readily determinable market value, certain investments may be valued based partially or entirely on internal KLS models. For such investments, the valuations so determined may differ materially from realized values.

**Spread Trading Risks**

KLS's trading operations may involve spreads between two or more positions. To the extent the price relationships between such positions remain constant, no gain or loss on the positions will occur. In addition, such positions entail substantial risk that the price differential could change unfavorably, causing a loss to the spread position.

### **Arbitrage Transaction Risks**

Arbitrage strategies attempt to take advantage of perceived price discrepancies of identical or similar financial instruments, on different markets or in different forms. KLS may employ any one or more of these arbitrage strategies. If the requisite elements of an arbitrage strategy are not properly analyzed, or unexpected events or price movements intervene, losses can occur which can be magnified to the extent such Advisory Client is employing leverage. Moreover, arbitrage strategies often depend upon identifying favorable “spreads,” which can also be identified, reduced or eliminated by other market participants.

### **Possible Positive Correlation**

One of the goals in incorporating non-traditional investment strategies such as those to be utilized by KLS into a portfolio or series of portfolios is to provide a potentially valuable element of diversification. However, there can be no assurance, particularly during periods of market disruption and stress, when the risk control benefits of diversification may be most important, that the Fund will, in fact, be negatively-correlated or non-correlated with a traditional portfolio of stocks or bonds.

### **Lending Risks**

Advisory Clients may originate and arrange as well as invest in loans. Such lending activities may entail a number of risks: (1) *General Credit Risks* - The Advisory Clients may be exposed to losses resulting from default and foreclosure; (2) *Lower Credit Quality Loans* - There are no restrictions on the credit quality of the Advisory Clients’ loans; and (3) *Equitable Subordination*. Loans to companies operating in workout modes or under Chapter 11 of the Bankruptcy Code are, in certain circumstances, subject to certain potential liabilities which may exceed the amount of an Advisory Client’s loan.

### **Short Selling**

KLS may engage in short selling on behalf of the Advisory Clients. Short selling involves selling securities that may or may not be owned and borrowing the same securities for delivery to the purchaser, with an obligation to replace the borrowed securities at a later date. Short selling allows the Advisory Clients to profit from declines in market prices to the extent such decline exceeds the transaction costs and the costs of borrowing the securities. However, since the borrowed securities must be replaced by purchases at market prices in order to close out the short position, any appreciation in the price of the borrowed securities would result in a loss. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating the loss.

### **Regulatory Risks**

Following severe global market volatility and dislocations, financial institution failures and defaults, and large financial frauds in recent years, U.S. and foreign governmental authorities, agencies and representatives have called for financial system and participant regulatory reform, including additional regulation of investment funds (such as the Funds) and investment managers (such as KLS) and activities, including registration requirements, compliance, risk management, anti-money laundering procedures and

reporting and disclosures requirements. The duration, severity, and ultimate effect of recent market conditions and government actions cannot be predicted. Governmental regulatory activity, especially that of the Federal Reserve Board, may also have a significant effect on interest rates and on the economy generally, which in turn may affect the performance of Advisory Client investments.

**C. Material Risks of Securities Recommendations**

KLS does not recommend any particular type of security to its Advisory Clients. Instead, it engages in various securities transactions in order to best achieve the investment objectives of the Funds and Managed Accounts. Listed below are the key securities traded by the Funds and Managed Accounts and the associated risks.

**Options**

The Advisory Clients trade options. Options are speculative and highly leveraged. Specific market movements of the securities underlying an option cannot accurately be predicted. The purchaser of an option is subject to the risk of losing the entire purchase price of the option. The writer of an option is subject to the risk of loss resulting from the difference between the premium received for the option and the price of the security underlying the option which the writer must purchase or deliver upon exercise of the option.

**Derivatives**

A substantial portion of the Advisory Client's assets are typically invested in derivative financial instruments. In addition, the Advisory Clients may from time to time utilize both exchange-traded and over-the-counter futures, options and contracts for differences, for hedging purposes, as well as other derivatives. Such derivative instruments are highly volatile, involve certain special risks and expose investors to a high risk of loss. The low initial margin deposits normally required to establish a position in such instruments permit a high degree of leverage. As a result, a relatively small movement in the price of a contract may result in a profit or a loss which is high in proportion to the amount of funds actually placed as initial margin and may result in unquantifiable further losses exceeding any margin deposited. Further, when used for hedging purposes there may be an imperfect correlation between these instruments and the investments or market sectors being hedged.

The trading of over-the-counter derivatives subjects Advisory Clients to a variety of risks, including: (1) counterparty risk, (2) basis risk, (3) interest rate risk, (4) settlement risk, (5) legal risk, and (6) operational risk. Counterparty risk is the risk that one of the Advisory Client's counterparties might default on its obligation to pay or perform generally on its obligations. Basis risk is the risk that the normal relationship between two prices might move in opposite directions. Interest rate risk is the general risk associated with movements in interest rates. Settlement risk is the risk that a settlement in a transfer system does not take place as expected. Legal risk is the risk that a transaction proves unenforceable in law or because it has been inadequately documented. Operational risk is the risk of unexpected losses arising from deficiencies in a firm's management information, support and control systems and procedures. Transactions in over-the-counter derivatives may involve other risks as well, as there is no exchange market on which to close out an open position. It may be impossible to

liquidate an existing position, to assess the value of a position or to assess the exposure to risk.

### **Debt Securities**

The Advisory Clients invest in debt securities. Debt securities are subject to the risk of an issuer's ability to meet principal and interest payments on the obligation (credit risk), and are also be subject to price volatility due to such factors as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity (market risk). Changes in interest rates may cause a decline in the market value of an investment. With bonds and other fixed income securities, a rise in interest rates typically causes a fall in values, while a fall in interest rates typically causes a rise in values. Bonds and other fixed income securities generally involve less market risk than stocks. However, the risk of bonds can vary significantly depending upon factors such as the issuer and maturity. The bonds of some companies may be riskier than the stocks of others.

### **High-Yield Securities**

The Advisory Clients invest in "high yield" bonds and other debt securities which are rated in the lower rating categories by the various credit rating agencies (or in comparable non-rated securities). Debt securities in the lower categories are subject to greater risk of loss of principal and interest than higher-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than debt securities with higher ratings in the case of deterioration or general economic conditions.

### **Distressed Securities**

Advisory Clients purchase, directly or indirectly, debt securities and other obligations of companies that are experiencing significant financial or business distress, including companies involved in bankruptcy or other reorganization and liquidation proceedings. Although such purchases may result in significant returns, they involve a substantial degree of risk and may not show any return for a considerable period of time. In some circumstances, such debt securities may be converted to equity as part of the reorganization. The level of analytical sophistication, both financial and legal, necessary for successful investment in companies experiencing significant business and financial distress is unusually high. There is no assurance that KLS will correctly evaluate the nature and magnitude of the various factors that could affect the prospects for a successful reorganization or similar action. In any reorganization or liquidation proceeding relating to the company in which the Advisory Clients invest, the Advisory Clients may lose their entire investment or may be required to accept cash or securities with a value less than the Advisory Clients' original investment.

### **Loan Participations and Assignments**

Advisory Clients invest in debt securities in the form of loan participations and assignments of portions of such loans. When purchasing loan participations, an Advisory Client assumes the credit risk associated with the corporate borrower and may assume the credit risk associated with an interposed bank or other financial intermediary, and may

only be able to enforce its rights through the lender, and may assume the credit risk of the lender in addition to the borrower. The participation interests in which the Advisory Client invests may not be rated by any nationally recognized rating service. Investments in loans through a direct assignment of a financial institution's interests with respect to the loan may involve additional risks to an Advisory Client.

### **Mortgage-Backed and Asset-Backed Securities**

Advisory Clients invest in mortgage-backed and asset-backed securities. Mortgage-backed securities represent an interest in a pool of mortgages. When market interest rates decline, more mortgages are refinanced and the securities are paid off earlier than expected. Prepayments may also occur on a scheduled basis or due to foreclosure. When market interest rates increase, the market values of mortgage-backed securities decline. At the same time, however, mortgage refinancings and prepayments slow, which lengthens the effective maturities of these securities. As a result, the negative effect of the rate increase on the market value of mortgage-backed securities is usually more pronounced than it is for other types of fixed-income securities. Asset-backed securities are structured like mortgage-backed securities, but instead of mortgage loans or interests in mortgage loans, the underlying assets may include, but are not limited to, such items as motor vehicle installment sales or installment loan contracts, leases of various types of real and personal property, and receivables from credit card agreements. The ability of an issuer of asset-backed securities to enforce its security interest in the underlying assets may be limited. Asset-backed securities are subject to many of the same risks as mortgage-backed securities.

### **Currencies**

Advisory Clients may engage in various trades relating to currencies, including forward currency contracts and options thereon. Such contracts are not traded on exchanges and are not standardized; rather, banks and dealers act as principals in these markets, negotiating each transaction on an individual basis. Forward and "cash" trading is substantially unregulated; there is no limitation on daily price movements and speculative position limits are not applicable. The principals who deal in the forward markets are not required to continue to make markets in the currencies they trade, and these markets can experience periods of illiquidity, sometimes of significant duration. There have been periods during which certain participants in these markets have refused to quote prices for certain currencies or have quoted prices with an unusually wide spread between the price at which they were prepared to buy and that at which they were prepared to sell.

Disruptions can occur in any currency market traded in by an Advisory Client due to unusually high trading volume, political intervention or other factors. The imposition of controls by governmental authorities might also limit forward currency trading to less than that which KLS would otherwise recommend, to the possible detriment of an Advisory Client. Currency market illiquidity or disruption could result in major losses to an Advisory Client.

Price movements of forward, futures and other derivative contracts relating to currencies in which an Advisory Client's assets may be invested are influenced by, among other things, interest rates, changing supply and demand relationships, and trade, fiscal, monetary and exchange control programs and policies of governments, and national and

international political and economic events and policies. In addition, governments from time to time intervene, directly and by regulation, in currency markets. Such intervention often is intended directly to influence prices and may, together with other factors, cause the applicable currency markets to move in a volatile and unpredictable manner.

### **Sovereign Instruments**

An Advisory Client may invest in securities issued or guaranteed by non-U.S. governments in developing or developed countries or their authorities, agencies or instrumentalities as well as derivatives related to those securities. As the risk on government debt issued by a developed market country shifts from being driven primarily by the prevailing level of interest rates to being driven by the likelihood of a default or restructuring, pricing inefficiencies are likely to develop. An Advisory Client may hedge such positions by selling debt short or engaging in credit default swap transactions. The sovereign debt of many developed nations is governed by the domestic laws of the issuing country and as such is subject to the vagaries of changes in such laws and any redress of a violation of the terms of the debt would have to be pursued in the local legal system.

Investments in developing and emerging markets instruments, while generally providing greater potential opportunity for capital appreciation and higher yields than investments in more developed market instruments, may also involve greater risk. Investing in such securities involves certain considerations not usually associated with investing in securities of the U.S. government, including, among other things, political and economic considerations, such as greater risks of expropriation, nationalization and general social, political and economic instability; the small size of the securities markets in such countries and the low volume of trading, resulting in potential lack of liquidity and in price volatility; fluctuations in the rate of exchange between currencies and costs associated with currency conversion, imposition of withholding and other taxes and certain government policies that may restrict an Advisory Client's investment opportunities. In addition, accounting and financial reporting standards that prevail in many foreign countries are not equivalent to U.S. standards and, consequently, less information may be available to investors in companies located in foreign countries than is available to investors in companies located in the U.S. Generally, there is also less regulation of the securities markets in many foreign countries than there is in the U.S.

Fund Investors and prospective Fund Investors are provided with a confidential private placement memorandum that contains a detailed description of additional material risks related to an investment in the Funds, and are advised to carefully review all risk factors set forth in the relevant confidential private placement memorandum.



## **ITEM 9 – DISCIPLINARY INFORMATION**

KLS does not have any reportable disciplinary information relating to the firm or its personnel.

## ITEM 10 – OTHER FINANCIAL INDUSTRY ACTIVITIES AND AFFILIATIONS

### A. Management Persons as Registered Broker-Dealers

Not applicable to KLS

### B. Management Persons as Commodities Traders

KLS is registered as a commodity pool operator (“CPO”) with the Commodity Futures Trading Commission (the “CFTC”) and is a member of the National Futures Association (the “NFA”). In connection with the firm’s CFTC registration/NFA membership, certain KLS employees are listed/registered with the NFA as “Principals” and/or “Associated Persons” of KLS.

### C. Material Relationships with Related Persons

Affiliates of KLS serve as General Partners of certain of the Funds. As described in Item 6, this creates a potential conflict of interest in that it may cause KLS or the respective General Partner to take a greater risk than they may have otherwise.

As noted above in Item 10.B, KLS is registered with the CFTC and a member of the NFA. KLS does not believe that this registration/membership poses any material conflict of interest with respect to Managed Account clients or Fund Investors.

While not a “related person,” Merrill Lynch, Pierce, Fenner & Smith Incorporated (a wholly owned subsidiary of Bank of America Corporation, together with its affiliates, “Merrill Lynch”) owns a non-voting minority equity interest in KLS and the General Partners entitling Merrill Lynch to participate in the net income of KLS and the General Partners. As an equity owner, Merrill Lynch will participate ratably in capital transactions involving KLS and the applicable General Partner. Merrill Lynch has limited veto and consultation rights with respect to certain KLS and General Partner decisions (consistent with its minority equity interest), but has no input into or control over KLS’s trading with respect to the Funds or any other fund managed by KLS or its affiliates. This relationship could cause conflicts of interest, including but not limited to:

- KLS may use Merrill Lynch as a prime broker, but KLS has no agreement whatsoever that it will use Merrill Lynch for brokerage services. Nevertheless, prospective Fund Investors must recognize that Merrill Lynch may receive significant economic benefit from the Advisory Clients other than through its equity interest in KLS and the General Partner. KLS manages this conflict through rigorous adherence to its Best Execution Policy as detailed in Item 12.A.1 below.
- An affiliate of Merrill Lynch is a holding company which owns broker-dealers, banks, insurance companies and other subsidiaries involved in financial services. Merrill Lynch affiliates and/or subsidiaries may loan money to the Advisory Clients in the form of margin loans or otherwise. Conflicts of interest between the Advisory Clients and these affiliated entities may include, but are not limited to, those described herein. Such conflicts are managed through monitoring of client accounts and through adherence to the policies and procedures in the client’s respective Governing Documents.

- Fund Investors should refer to the Governing Documents for a complete list of conflicts related to Merrill Lynch. Certain additional conflicts are discussed in Item 11 below.

**Item 10.D. – Selection of of Other Investment Advisers**

Not applicable to KLS.

## **ITEM 11 – CODE OF ETHICS, PARTICIPATION OR INTEREST IN CLIENT TRANSACTIONS AND PERSONAL TRADING**

### **A. Code of Ethics**

KLS's Code of Ethics (the "Code") is designed to meet the requirements of Rule 204A-1 of the Investment Advisers Act of 1940 (the "Advisers Act"). The Code applies to KLS's "Access Persons." Access Persons include, generally, any partner, officer or director of KLS and any employee or other supervised person of KLS who, in relation to the Advisory Clients, (1) has access to non-public information regarding any purchase or sale of securities, or non-public information regarding securities holdings or (2) is involved in making securities recommendations, executing securities recommendations, or has access to such recommendations that are non-public. All KLS employees are deemed to be Access Persons.

The Code sets forth a standard of business conduct that takes into account KLS's status as a fiduciary and requires Access Persons to place the interests of Advisory Clients above their own interests and the interests of KLS. KLS seeks to meet the requirements of Rule 204A-1 in several ways. The Code requires Access Persons to comply with applicable federal securities laws. Further, Access Persons are required to promptly bring violations of the Code to the attention of KLS's Chief Compliance Officer or his designee. All Access Persons are provided with a copy of the Code and are required to acknowledge receipt of the Code upon hire and on at least an annual basis thereafter.

The Code also sets forth certain reporting and pre-clearance requirements with respect to personal trading by Access Persons. Access Persons must provide KLS's Chief Compliance Officer or his designee with a list of their personal accounts and an initial holdings report within 10 days of becoming an Access Person. In addition, KLS's Access Persons must provide annual holdings reports and quarterly transaction reports in accordance with Advisers Act Rule 204A-1.

In addition, the Code seeks to ensure the protection of nonpublic information about the activities of the Advisory Clients. Advisory Clients or prospective investors may obtain a copy of the Code by contacting the compliance team at [compliance@KLSdiversified.com](mailto:compliance@KLSdiversified.com).

### **B. Conflicts of Interest in Connection with Investment Recommendations or Transactions**

The General Partners and KLS's principals and employees also invest directly in certain of the Funds but such investments generally are not subject to the management or performance-based fees described in Item 5 above.

The fact that the General Partners and KLS's principals and employees have financial ownership interests in the Funds creates a potential conflict in that it could cause KLS to make different investment decisions than if such parties did not have such financial ownership interests. Such potential conflicts are addressed by the personal securities transaction pre-clearance and holding requirements described in Item 11. A. and 11. C.

KLS addresses these potential conflicts through regular monitoring of the Advisory Client portfolios for consistency with Advisory Client objectives, strategies, and target capacity. Further, the Managing Partners carefully consider the risks involved in any investments and KLS provides extensive disclosure to clients regarding the potential risks that come with an

investment with KLS. The Code requires Access Persons to place the interests of Advisory Clients and investors over their own or those of KLS, and all Access Persons are required to acknowledge their receipt and understanding of the Code.

Further, KLS (and the relevant General Partners) receives management and performance-based compensation. The Management Fees are payable without regard to the overall success or income earned by the Funds and therefore may create an incentive on the part of KLS to raise or otherwise increase assets under management to a higher level than would be the case if KLS were receiving a lower or no management fee. Performance-based fees may create an incentive for KLS to make investments that are riskier or more speculative than in the absence of such Incentive Allocation.

Although not a related person, Merrill Lynch, its affiliates and its employees manage other investment funds, including funds proprietary to Merrill Lynch, or discretionary accounts that may pursue investment objectives similar to those of the Advisory Clients. Merrill Lynch is actively engaged in transactions in the same securities and other instruments in which the Advisory Clients may invest. Merrill Lynch is not under any obligation to share any investment opportunity, idea or strategy with the traders for KLS. A conflict of interest could exist here in that Merrill Lynch or its affiliates could, theoretically, take an investment opportunity that would otherwise be available to one or more of the Advisory Clients. KLS does not share information regarding its investment decisions with Merrill Lynch prior to it making an investment. As such, if Merrill Lynch or its affiliates were to participate in a similar investment such entity would have sourced the investment through channels independent of KLS. KLS also monitors these conflicts through enforcement of its Code.

Merrill Lynch entities are authorized to execute agency and other cross transactions between the Advisory Clients and other Merrill Lynch clients and may receive commissions from both parties to such transactions. Agency cross and similar transactions will be effected by Merrill Lynch entities only to the extent permitted by applicable law.

The Advisory Clients may purchase investments that are issued, or the subject of an underwriting or other distribution, by Merrill Lynch. The Advisory Clients may invest, directly or indirectly, in the securities of issuers affiliated with Merrill Lynch or in which Merrill Lynch has an equity or participation interest. The purchase, holding and sale of such investments by the Advisory Clients may enhance the profitability of Merrill Lynch's own investments in such companies.

**C. Personal Trading By Firm Personnel in Securities Recommended to Clients**

Access Persons are permitted to make securities transactions in their personal accounts. This presents potential conflicts in that an employee could improperly use information regarding an Advisory Client's holdings or future transactions or research paid for by the Advisory Clients. An Access Person could take for himself or herself an investment opportunity available to an Advisory Client or could engage in "front-running" of an Advisory Client's trade.

KLS seeks to manage the potential conflicts of interest inherent in Access Person personal trading by rigorous enforcement of its Code, which contains strict pre-clearance and reporting guidelines for Access Persons. KLS requires that Access Person transactions be pre-cleared with the Chief Compliance Officer (or his designee) and one of the Managing Partners, with very limited exceptions. Pre-clearance decisions are based on a number of factors, including whether any of the Advisory Clients hold or are contemplating an investment in the given

security. Further, in an attempt to deter and prevent improper personal trading, KLS generally imposes a 180-day holding period on personal securities transactions. In addition, KLS receives transaction and holdings reports in accordance with Advisers Act Rule 204A-1. The Chief Compliance Officer or his designee also reviews Access Persons' personal transaction and holdings reports to make sure each access person is conducting his or her personal securities transactions in a manner that is consistent with the Code.

**D. Personal Trading and Contemporaneous Recommendations to Clients**

Please refer to Items 11.A, 11.B, and 11.C.

## ITEM 12 – BROKERAGE PRACTICES

### A.1. General Brokerage Practices and Best Execution

KLS has the authority to select the broker-dealer used in each transaction for the Advisory Clients and for negotiating the fees to be paid to the broker-dealer in connection with such transactions. KLS recognizes its duty to obtain “best execution.” Consistent with such duty, in determining best execution, KLS takes into account the full range and quality of a broker-dealer’s services, including research and other services. KLS does not select broker-dealers solely on the basis of lowest possible commission costs, but by the best qualitative execution.

Consistent with such policy, consideration is given to a variety of factors, including but not limited to one or more of the following:

- Cost of execution;
- Execution expertise;
- Ability to perform execution services
- Ability to source or provide liquidity;
- Access to market information;
- Research;
- Providing trade ideas;
- Brokers’ efficiency in booking and settling trades;
- Providing access to multiple markets and venues (including foreign markets);
- Ability to execute transactions in liquid and illiquid markets at competitive prices without disrupting the market for a particular security;
- Range of services provided and products offered (including research and brokerage services);
- Quality and timeliness of market information provided;
- Ability to maintain confidentiality;
- Credit worthiness and financial responsibility;
- Likelihood of execution within a desired time frame;
- Ability to execute in desired volume;
- Willingness and ability of counterparty to make a market in particular securities;

- Reputation;
- Willingness of counterparty to commit capital to a particular transaction;
- Ability to provide capital introduction services and referrals of potential investors; and
- Ability of counterparty to execute difficult transactions in unique and/or complex securities.

While KLS's primary consideration in allocating portfolio transactions to broker-dealers is to obtain favorable prices and efficient executions, KLS does not have an obligation to, and does not always seek to, obtain the lowest priced execution regardless of qualitative considerations. Commission rates are generally negotiable and thus selecting brokers on the basis of considerations that are not limited to the applicable commission rates may result in higher transaction costs than would otherwise be obtainable.

KLS does not utilize "soft dollars." If in the future KLS utilizes soft dollars, it will amend its Form ADV as appropriate. It should be noted, however, that broker-dealers utilized by KLS on behalf of Advisory Clients may include research, certain services or access to certain information as part of the brokerage service provided to Advisory Clients.

It should be noted that KLS, while having authority to designate brokers or dealers through whom all purchases and sales on behalf of Managed Accounts are made, makes commercially reasonable efforts to consider the established relationships between a Managed Account and its counterparties in making these designations. Such agreements with Managed Accounts present a potential for conflict in that KLS may utilize broker-dealers with whom the applicable Managed Account client has an established relationship even when such broker-dealers do not provide the lowest possible commission to (1) such Managed Account or (2) all of the Advisory Clients, in a situation in which trades are aggregated. KLS addresses this potential conflict through periodic and systematic evaluations of broker-dealers.

## **A.2. Capital Introduction**

In selecting brokers, KLS takes into account the factors listed in Item 12.A.1 above. As part of its "best execution" analysis, KLS considers a broker-dealer's ability to provide KLS with the opportunity to participate in capital introduction events sponsored by the broker-dealer and to refer Investors to the Funds. It should be emphasized that KLS does not select broker-dealers solely in return for referrals.

KLS recognizes that it may have an incentive to favor broker-dealers that provide capital introduction services to KLS or refer Investors. KLS receives asset-based fees and accordingly would receive a financial benefit from the increase in assets under management that result from capital introduction services and Fund Investor referrals. Similarly, KLS receives a performance-based fee and accordingly could receive a larger performance-based fee in any given profit period as a result of an increase in assets under management that results from capital introduction services and Fund Investor referrals. The potential for higher fees presents a potential conflict in that KLS has an incentive to favor broker-dealers that provide services that have a direct impact on fees even if those broker-dealers rate unfavorably in other categories that are part of KLS's best execution analysis. From time to time, in addition to the evaluation process described in Item 12.A.1 above, KLS may consider this potential conflict as a part of its best execution review process, which requires that key KLS individuals look at a broker-dealer's performance in a wide variety of categories. Such reviews allow KLS to



determine when broker-dealers that outperform in capital introduction and Fund Investor referrals under perform in other areas. In such situations, KLS may provide heightened scrutiny to a relationship with a broker-dealer.

**A3. Directed Brokerage**

KLS does not have directed brokerage arrangements.

**B. Aggregation of Securities Transactions**

Upon determination to buy or sell the same security on behalf of more than one Advisory Client (based upon the investment mandates of such Advisory Clients), KLS will generally aggregate trades, subject to best execution. Notwithstanding the prior sentence, it should be noted that KLS is of the view that there may be limited circumstances in which it would be more operationally efficient to fill trades on an Advisory Client-by-Advisory Client basis.

In managing Advisory Client portfolios, KLS will generally aggregate trades when more than one Advisory Client is capable of purchasing or selling a particular security based on investment objectives, available cash and other factors. KLS may aggregate Advisory Client orders when doing so will result in a better overall price for Advisory Client trades. KLS will generally aggregate orders unless aggregation is not consistent with its duty to obtain best execution and the terms of the investment guidelines and restrictions of each Advisory Client for which trades are being aggregated. No Advisory Client will be favored over any other Advisory Client; each Advisory Client that participates in an aggregated order will participate at the average price for all of KLS's transactions in that security on a given business day, with transaction costs shared pro rata based on each Advisory Client's participation in the transaction.

KLS seeks to act in a fair and reasonable manner in allocating investment and trading opportunities among the Advisory Clients. In furtherance of the foregoing, KLS considers participation in all appropriate opportunities within the purpose and scope of each Advisory Client's objectives, and KLS evaluates such factors as it considers relevant in determining whether a particular situation or strategy is suitable and feasible for each Advisory Client. When allocating investment opportunities among Advisory Clients, the KLS approach generally begins with the assumption that investment opportunities will be allocated pro rata based upon assets under management (with respect to the Advisory Clients for whom the trade in question would be permitted or appropriate in light of such Advisory Client's investment strategy), and then takes into account for each such Advisory Client a variety of factors, including, but not limited to, investment objectives, investment criteria, risk parameters, cash levels, liquidity, counterparty exposure, leverage, and operational, legal and tax requirements. KLS will often also apply, with respect to certain of its Advisory Clients, based on such Advisory Clients' investment parameters, a risk-based overlay to the allocation process, resulting in an investment allocation based upon risk-based targets, rather than pro rata based upon assets under management.

KLS is not obligated to purchase or sell for each of its Advisory Client every security which KLS may purchase or sell for other Advisory Clients, as some transactions or investments may appear unsuitable, impractical or undesirable for an Advisory Client. In addition, certain securities are not permitted to be purchased or held by certain Advisory Clients. Accordingly, there are a variety of reasons why investment opportunities may be allocated on bases other than pro rata based upon assets under management among all Advisory Clients, and such non-

pro rata allocations may occur more often than not.

Notwithstanding any of the foregoing, KLS, to the extent within its control, will not favor itself in any way to an Advisory Client's detriment and will act in a manner that it believes over the long term is fair and equitable to all its Advisory Clients.

## **ITEM 13 – REVIEW OF ACCOUNTS**

### **A. Periodic Review of Accounts**

The Advisory Client portfolios are under continuous review by the Managing Partners. Such reviews include a review of investment policy, the suitability of the investments used to meet policy objectives, cash availability, and investment objectives. The Managing Partners consider, among other things, investment performance, the portfolio's sensitivity to market changes, and whether anything has changed subsequent to an initial investment decision that impacts the risk or potential return.

### **B. Other Review of Client Accounts**

Please see Item 13.A. The accounts are under continuous review.

### **C. Client Reports**

Generally, all Advisory Clients receive weekly updates, unaudited monthly statements of net asset value, monthly letters describing the performance of the Funds (as applicable), and annual audited financial statements. In addition, pursuant to individually negotiated side letters with certain Fund Investors, KLS provides monthly risk aggregation reports and return estimates.

## **ITEM 14 – CLIENT REFERRALS AND OTHER COMPENSATION**

### **A. Other Compensation for Provision of Investment Advice**

Not applicable to KLS.

### **B. Compensation to Unsupervised Persons for Client Referrals**

KLS has engaged third party solicitors to refer prospective investors to certain of the Funds. All such referral activities are conducted in a manner that is consistent with relevant SEC guidance. All arrangements with third party solicitors must be approved by a Managing Partner or the Chief Operating Officer. All approved solicitors represent in contract or otherwise that they will comply with all applicable laws, rules, regulations and other regulatory requirements in all material respects whether U.S. or internal, federal state or otherwise and with all applicable rules of any self-regulatory agency of which the solicitor is a member.

Solicitors are compensated based upon (1) a percentage of capital committed to or invested in a Fund or (2) a percentage of asset-based and performance-based compensation payable to KLS or an affiliate.

In accordance with Rule 506(d) of the Securities Act of 1933, (as amended) third party solicitors utilized by KLS are prohibited from participating in exempt securities offerings if they have been convicted of or are subject to court or court or administrative sanctions for securities fraud or other violations of specified laws

## **ITEM 15 – CUSTODY**

KLS or the applicable General Partner is deemed to have custody by virtue of its status as investment manager or general partner, respectively.

To ensure compliance with Rule 206(4)-2 under the Advisers Act, Fund Investors are provided with audited financial statements relating to the applicable Fund within 120 days of the end of such Fund's fiscal year (i.e., generally by April 30). Fund Investors should carefully review such audited financial statements.

KLS does not maintain custody of the Managed Accounts' funds or securities.

## **ITEM 16 – INVESTMENT DISCRETION**

KLS has discretionary authority to manage securities accounts on behalf of the Advisory Clients. KLS is authorized to make transaction recommendations for the Advisory Clients. As explained in Item 4.C above, each Fund's investment strategy is set forth in detail in a private placement memorandum. Fund Investors do not have the ability to impose limitations on KLS's discretionary authority. Fund Investors must execute a subscription agreement in which they make various representations, including representations regarding their suitability to invest in a high-risk investment pool. Further, investors in certain of the Funds must execute a limited partnership agreement that contains a power of attorney.

As noted in Item 4.C, above, KLS has established, and may in the future establish, separately managed accounts for large or strategic investors. Such agreements are heavily negotiated and the holder of a managed account may place limitations on KLS's discretionary investment authority, including limitations on objectives, guidelines, and restrictions.

## ITEM 17 – VOTING CLIENT SECURITIES

### A. Proxy Voting Policy

KLS has authority to vote Advisory Client securities. KLS understands and appreciates the importance of ensuring that its proxy voting procedures are clearly described to Advisory Clients. It should be noted that based upon KLS's investment strategy (and lack of involvement in publicly-traded equities) it is not expected that much proxy voting, if any, will occur. Notwithstanding that fact, KLS follows these procedures when proxy voting is required. KLS votes proxies in the best interests of the Advisory Clients and Fund Investors (as applicable).

Prior to voting any proxies with respect to Advisory Clients, the Managing Partners determine if there are any conflicts of interest related to the proxy in question in accordance with the general guidelines outlined below. If a conflict is identified, the Managing Partners then make a determination (which may be in consultation with outside compliance consultants and/or legal counsel) as to whether the conflict is material or not. If no material conflict is identified pursuant to these procedures, the Managing Partners vote the proxy in question in accordance with the best interest of the Advisory Clients.

If a material conflict is identified, the Managing Partners, the Chief Compliance Officer, or such other designee (in consultation with outside compliance consultants and/or legal counsel) will determine what course of action is in the best interests of the affected Advisory Clients (which may include utilizing an independent third party to vote such proxies). Further, KLS will determine whether it is appropriate to disclose the conflict to affected Advisory Clients and give such Advisory Clients (and Investors, if applicable) the opportunity to vote the proxies in question themselves.

The Chief Compliance Officer or his designee delivers proxies in accordance with instructions related to such proxy. KLS keeps a record of its proxy voting policies and procedures, proxy statements received, votes cast, all communications received and internal documents created that were material to voting decisions and each client request for proxy voting records and KLS's response for the previous five years.

Fund Investors and Managed Accounts do not have the ability to direct proxy votes. Advisory Clients and Fund Investors may obtain additional information about how KLS voted proxies and may obtain a copy of KLS's proxy voting policies and procedures by contacting KLS's compliance team at [compliance@KLSdiversified.com](mailto:compliance@KLSdiversified.com).

### B. Inability to Vote Client Securities

Not applicable to KLS.

## **ITEM 18 – FINANCIAL INFORMATION**

KLS is not currently aware of any financial condition that is reasonably likely to impair its ability to meet contractual commitments to Managed Account clients or Fund Investors.