

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

**Item 1.** Cover Page

**IONIC CAPITAL MANAGEMENT<sup>®</sup> LLC**

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February 18, 2011

This brochure is intended to present a general summary of the qualifications and business practices of Ionic Capital Management LLC. If you have any questions about the contents of this brochure, please contact us at (212) 294-8500 and/or FormADV@ionicap.com. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about Ionic Capital Management LLC is also available on the SEC's website at [www.ionicap.com](http://www.ionicap.com) or [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

The information contained herein is accurate as of the date hereof and is likely to change.

Being a "registered investment adviser" or describing ourselves as being "registered" does not imply a certain level of skill or training.

Ionic Capital Management LLC<sup>®</sup> is a registered trademark of Ionic Capital Management LLC that is protected in the United States, Canada and elsewhere around the world.

THIS BROCHURE SHALL NOT CONSTITUTE AN OFFER TO SELL OR THE  
SOLICITATION OF ANY OFFER TO BUY ANY SECURITY.

**Item 2. Material Changes**

Not applicable.

**Item 3. Table of Contents**

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**Item 4. Advisory Business**

Ionic Capital Management LLC is a Delaware limited liability company that was founded in 2006. We and our affiliates, Ionic Capital Advisors LLC and Ionic Capital Partners LP (collectively, “Ionic”), provide advice on a discretionary basis to privately-offered multi-strategy funds (the “Capital Funds”), limited-strategy funds (the “Select Opportunities Funds”) and single-strategy funds (the “Convertible Funds” and, together with the Capital Funds and the Select Opportunities Funds, the “Ionic Funds”). The U.S.-domiciled Ionic Funds invest substantially all of their assets in master funds (the “Master Funds”). The non-U.S.-domiciled Ionic Funds operate through a mini-master-feeder structure where the non-U.S.-domiciled Ionic Funds invest substantially all of their assets in intermediate funds (the “Intermediate Funds”) that in turn invest substantially all of their assets in the Master Funds. The operating and trading activities of the Ionic Funds are conducted, and the portfolios of the Ionic Funds are held, by the Master Funds.

Bart Baum, Adam Radosti and Daniel Stone, through their ownership of Ionic Capital Management Holdings LP, are the principal beneficial owners of Ionic Capital Management LLC (collectively, the “Principals”). The Principals collectively control the operations and activities of Ionic and have done so since inception.

Ionic is a multi-strategy market neutral manager focusing on relative value and arbitrage strategies across asset classes. The investment strategies currently employed by Ionic include capital structure arbitrage, closed-end fund arbitrage, convertible arbitrage, correlation, credit convexity, emerging market volatility arbitrage, equity option arbitrage, equity pair trades, structured credit, structured equity, volatility arbitrage and warrant arbitrage. The investment strategies employed by Ionic may be modified from time to time, and the description herein is not exhaustive.

Ionic currently does not provide investment advisory services to clients apart from its management of the Ionic Funds, although it and/or one or more affiliates may do so in the future.

Ionic manages the Ionic Funds’ assets on a discretionary basis. As of February 1, 2011, the total net asset value of the Ionic Funds was \$2,130,916,328.

Please see Items 8 (Methods of Analysis, Investment Strategies and Risk of Loss) and 10 (Other Financial Industry Activities and Affiliations).

#### **Item 5. Fees and Compensation**

Each Ionic Fund pays Ionic a monthly management fee ranging from approximately 0.115% to 0.167% of the month-end gross asset value of each series of shares or each capital account (an annual rate ranging from 1.375% to 2.0%, as applicable). For the non-U.S.-domiciled Ionic Funds, the management fee payable with respect to each series of shares is allocated equally among all shares of such series. The management fee is calculated and paid in arrears as of the end of each month.

As of each December 31, each series of Intermediate Fund shares and each capital account of the U.S.-domiciled Ionic Funds is subject to a performance allocation (“Performance Allocation”) made to Ionic Capital Advisors LLC equal to 20% of any New Net Appreciation attributable to such series or capital account. “New Net Appreciation” is the amount, if any, by which the gross asset value of such series of shares or capital account (without reduction for the Performance Allocation then being made) exceeds the high water mark attributable to such series of shares or capital account, taking into account all fees, losses and expenses of the Ionic Fund directly or indirectly attributable to such shares or capital account. For the non-U.S.-domiciled Ionic Funds, any Performance Allocation is allocated equally among all outstanding shares of such series of shares, and all such shares have the same net asset value.

The high water mark attributable to a given series of shares or capital account is the highest net asset value of such series or capital account as of any preceding December 31 (or the date of initial purchase, if higher), after reduction for the Performance Allocation then made.

When an investor withdraws all or a portion of its investment in the Ionic Funds during any calendar year, a Performance Allocation (if due) is made with respect to the corresponding series of shares or capital account as if the withdrawal date were a December 31 (but only with respect to the shares or amount withdrawn).

Performance Allocations made upon a withdrawal are generally added to the amount of withdrawal request for dollar amounts, so that the investor receives net withdrawal proceeds in the amount of such investor's withdrawal request (doing so increases the number of shares or amount withdrawn and the resulting Performance Allocation).

The fact that Ionic Capital Advisors LLC is eligible to receive performance-based profit allocations from certain Ionic Funds may create an incentive for Ionic to make investments on behalf of the Ionic Funds that are riskier or more speculative than would be the case in the absence of such performance-based profit allocations. In addition, the performance-based profit allocations received by Ionic Capital Advisors LLC are calculated on the basis of the unrealized, as well as the realized, gains and losses. As a result, the performance-based profit allocations could be made to Ionic Capital Advisors LLC in respect of unrealized gains of the Ionic Funds that may never be realized.

Ionic may provide investment advisory services to additional clients in the future that may have similar or different fees than the fees and/or allocations than those of the Ionic Funds. Additionally, Ionic may waive, reduce or rebate management fees and/or Performance Allocations with respect to certain investors, including, without limitation, the Principals, Ionic employees and their family members or other entities organized or formed by any of the foregoing for tax, estate planning or charitable purposes.

In addition, the Ionic Funds pay all operating and administrative costs and expenses of the Ionic Funds which include, without limitation: (i) brokerage commissions and other costs of executing transactions (for a further description of these expenses, see Item 12); (ii) investment expenses and all other expenses (including, without limitation, all commissions, clearing fees, interest charges, financing charges and applicable withholding and other taxes) related to the purchase, sale, transmittal or custody of investments and related items; (iii) legal, accounting, auditing and other professional fees and expenses, including consulting and appraisal fees and expenses; (iv) any taxes and duties payable in any jurisdiction in connection with the Ionic Funds' operations; (v) fees in connection with the custody of the Ionic Funds' assets; (vi) administrative costs (including the fees and out-of-pocket expenses of the administrator), paying agency, transfer agency, accounting verification (if any) and/or investor registrar services; (vii) software licensing, development, purchasing, programming and operating costs; (viii) any other operating or administrative expenses related to accounting, research, due diligence and reporting; (ix) costs and expenses relating to regulatory compliance, including, without limitation, costs of regulatory inquiries and regulatory filings; (x) any indemnification payments; (xi) organizational expenses; and (xii) directors' fees.

Please see Items 8 (Methods of Analysis, Investment Strategies and Risk of Loss), 10 (Other Financial Industry Activities and Affiliations) and 12 (Brokerage Practices).

**Item 6.**            *Performance-Based Fees and Side-By-Side Management*

Ionic only manages the Ionic Funds, which are subject to the Performance Allocations described above. Ionic may provide investment advisory services to additional clients in the future that may have similar or different fees than the fees and/or allocations than those of the Ionic Funds.

Please see Items 5 (Fees and Compensation) and 10 (Other Financial Industry Activities and Affiliations).

**Item 7.**            *Types of Clients*

Ionic currently provides investment advisory services to the Ionic Funds but may in the future provide investment advisory services to additional clients including, but not limited to, individuals, trusts, investment companies, pension plans, sovereign wealth funds, family offices and endowments.

Please see Items 4 and 10.

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

Ionic is a multi-strategy market neutral manager focusing on relative value and arbitrage strategies across asset classes. The investment strategies currently employed by Ionic include capital structure arbitrage, closed-end fund arbitrage, convertible arbitrage, correlation, credit convexity, emerging market volatility arbitrage, equity option arbitrage, equity pair trades, structured credit, structured equity, volatility arbitrage and warrant arbitrage. The investment strategies employed by Ionic may be modified from time to time, and the description herein is not exhaustive.

Ionic has a well defined investment process that it employs to select new positions. The first step is asset allocation across the applicable investment strategies. The Principals make asset allocation decisions through a top-down, team-oriented approach. This is a fluid, dynamic process which enables the Principals to make adjustments in real time in response to changing market conditions. Using its proposed strategy allocations as a guideline (if applicable), Ionic attempts to uncover the cheapest trades within each strategy using a bottom-up approach. Ionic does not typically make “fundamental” bets on individual companies.

Ionic invests assets globally focusing on North America, Europe, Emerging Markets and Asia. Proposed geographic weights and strategy allocations are likely to change as the investment strategies evolve and the markets change, in each case as determined by Ionic in its sole discretion.

The Ionic Funds may invest in all forms of securities and other financial instruments whatsoever including, without limitation: shares or other equity interests in the applicable Master Fund; share capital; stock; shares of beneficial interest; partnership interests and similar financial instruments; bonds; notes; debentures (whether subordinated, convertible or otherwise); commodities; currencies; interest rate, currency, commodity, equity and other derivative products, including, without limitation, (i) future contracts (and options thereon) relating to stock

indices, currencies, securities of any governments, other financial instruments and all other commodities, (ii) swaps, options, warrants, caps, collars, floors and forward rate agreements, (iii) spot and forward currency transactions and (iv) agreements relating to or securing such transactions; equipment lease certificates; equipment trust certificates; loans; credit paper; accounts and notes receivable and payable held by trade or other creditors; trade acceptances; contract and other claims; executory contracts; participations; mutual funds; money market funds; exchange traded funds; structured securities; repurchase agreements; obligations of any government and instrumentalities of any of them; commercial paper; certificates of deposit; bankers' acceptances; choses in action; trust receipts; and other instruments or evidences of indebtedness of whatever kind or nature; in each case, of any person or government whether or not publicly traded or readily marketable or such other form of investment asset or financial instrument as Ionic or the directors may from time to time determine (collectively, "Investment Assets").

Please see Items 4 (Advisory Business), 10 (Other Financial Industry Activities and Affiliations), 11 (Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading) and 12 (Brokerage Practices).

## **Description of the Strategies**

### *Capital Structure Arbitrage*

Capital structure arbitrage strategies attempt to profit from the inefficiencies in the relative pricing of different types of securities within the capital structure of a single issuer. Examples of capital structure arbitrage include: (i) taking a long position in debt and a short position in equity; (ii) taking a long position in secured debt and a short position in unsecured debt; and (iii) taking a long equity position and buying a credit default swap ("CDS"). Through the use of its quantitative models, Ionic expects to identify situations where a company's CDS spread and its equity price have substantially deviated from their historical relationship. In such situations, Ionic may take a long (or short) position in the company's CDS and a long (or short) position in its equity, intending to profit when more normal pricing relationships are restored. Ionic expects to structure these trades such that they are non-correlated.

### *Closed-End Fund Arbitrage*

Closed-end fund arbitrage involves purchasing shares of closed-end mutual funds that are trading at significant discounts to the net asset value of the underlying portfolio of securities held by such funds. By taking long positions in discounted funds, the Ionic Fund has the potential to profit by capturing these mispricings. By taking short positions in the underlying portfolios held by such funds, the Ionic Fund's exposure to adverse price movements in such securities can be controlled.

### *Convertible Arbitrage*

Convertible arbitrage strategies involve purchasing convertible securities, generally convertible bonds and may also involve purchasing equity, options, and other securities and instruments that are convertible, exchangeable or equity-linked. The convertible arbitrage strategies generally involve hedging a portion of the equity, credit, interest rate and/or volatility risk inherent in the

convertible securities by entering into interest rate swaps, credit default swaps, equity options and/or futures. Convertible bonds are often mispriced as a result of the complexities associated with the valuation of these hybrid securities. By neutralizing exposure to fairly priced components of a convertible bond, it is possible to profit from perceived mispricings of other components. For example, Ionic intends to generate profits by isolating the embedded call option of convertible bonds by shorting the underlying common stock and/or buying credit derivatives or entering into asset swaps. Additionally, Ionic intends to extract profits from the mispriced credit risk of issuers of high yield convertible bonds by taking a long position in such bonds while shorting the common stock. In its convertible arbitrage strategies, Ionic most frequently structures trades that have positive convexity. In certain circumstances, Ionic will invest in deep-in-the-money convertible bonds (trading with a “high delta” to the share price of the issuer’s underlying stock), which convertible bonds and the related arbitrage may exhibit a compelling opportunity in a scenario of increasing volatility, particularly from large moves in equity prices on the downside.

### *Correlation*

Correlation strategies are relative value strategies which utilize options and other derivatives as a means of trading movements in inter-asset and/or intra-asset correlation. Correlation strategies, the techniques of which can be similar to those of volatility arbitrage and/or equity option arbitrage, may also attempt to capture the variance between implied and realized correlation. Historically there has been a strong relationship between correlation and volatility, although these two measures can and have diverged from time to time. The current macro-economic conditions and other factors, such as the increase in high-frequency trading and an increase in the trading of index futures and ETFs generally, have driven correlation levels higher and in some cases to historically high levels. Ionic intends to utilize, among other techniques, dispersion trades (for example, trading options on the underlying constituents of an equity index versus trading options on the index itself), correlation swaps, volatility swaps, interest rate swaps and variance swaps to attempt to capture mispricings and, in some cases, the normalization of correlation.

### *Credit Convexity*

Credit convexity is similar to capital structure arbitrage except that these strategies attempt to extract value from the mispricing of *pari passu* securities issued by a single issuer (for example, taking a long position in a thirty year bond and buying a five year CDS). Within the credit convexity strategy, trades may be structured to capture anomalies in the “shape” of an underlying credit curve or to create undervalued synthetic securities (for example – forward credit default swaps). In addition, trades may also be structured as default options, namely buying deeply discounted bonds of highly levered companies and hedging with matched maturity CDS. Ionic intends to profit from these mispricings by structuring trades that are typically positive convexity.

### *Emerging Market Volatility Arbitrage*

By utilizing techniques similar to those of volatility arbitrage and credit convexity, emerging markets volatility arbitrage strategies seek to extract value from inefficiencies and high volatility

in the credit markets of emerging market economies. For example, similar to volatility arbitrage, these strategies frequently involve isolating the embedded option within a fixed income security; provided, however, in this strategy, such securities are issued by sovereign countries or instrumentalities thereof. Ionic also utilizes local interest rate options and currency options to capture changes in volatility in these markets. Additionally, utilizing credit convexity techniques, Ionic attempts to profit from mispricings in the debt of such countries by capturing anomalies in the shape of the credit curve (*e.g.*, structuring forward credit default swaps by buying 2 year CDS and selling 5 year CDS).

### *Equity Option Arbitrage*

Equity option arbitrage strategies attempt to profit from changes in volatility, regardless of overall directional equity price movement. Trades may be structured in an attempt to capture mispricings in: (i) volatility of individual stocks or of stock indices and exchange traded funds; (ii) the embedded options in mandatory convertible bonds; and/or (iii) dispersion (for example, trading options on the underlying constituents of an index versus trading the options on the index itself). Additionally, Ionic may enter into variance swaps and options on variance swaps to capture mispricing over the whole option surface.

### *Equity Pair Trades*

Equity pair trades strategies involve identifying independent but highly correlated equity securities whose price ratio, or spread, is substantially different from its historical mean. Typically, a larger spread between the securities indicates a higher magnitude of mispricing, creating a greater profit potential. By taking a long position in one of the securities and a short position in the other, profits can be captured when the spread reverts back to its historical mean. Ionic intends to profit from such mispricings in correlated securities including, but not limited to, dual listed securities, voting and non-voting securities of the same issuer and the securities of a parent corporation and its publicly traded subsidiary or publicly traded tracking stock.

### *Structured Credit*

Structured credit strategies typically involve investing in collateralized debt obligations (“CDOs”) or other types of asset-backed securities (“ABS”), in both the cash and synthetic markets. These securities are issued in connection with the securitization of related assets and typically in multiple tranches with different risk-return profiles. These tranches typically range from investment grade debt to unrated equity. Ionic intends to extract value from the mispricing of these securities while maintaining clear and quantifiable risk parameters. In particular, highly distressed CDOs present opportunities to structure trades that have positive carry and are uncorrelated to the markets.

### *Structured Equity*

Similar to convertible arbitrage, structured equity strategies typically involve buying a convertible bond and shorting the underlying common stock. Unlike typical convertible arbitrage strategies, the convertible bonds are frequently issued in a semi-private, negotiated Rule 144A transaction and tend to have higher interest rates and lower premiums.



### *Volatility Arbitrage*

Volatility arbitrage strategies utilize options and other derivatives (such as credit default swaps and swaptions or over-the-counter options on bonds, indices, commodities, currencies and interest rates) as a means of trading changes in market volatility, regardless of directional movements in the underlying security. Where options are embedded within a fixed income security, such as with callable and puttable bonds, the market pricing of these securities is often materially less efficient, creating profit opportunities. In addition, when credit spreads tighten in a manner improperly valuing default risk, it is possible to structure credit default puts by purchasing baskets of credit default swaps in specific sectors outright without owning the underlying security. Ionic intends to capitalize on these inefficiencies while largely neutralizing the effect of overall directional price movements

### *Warrant Arbitrage*

Similar to equity option arbitrage, warrant arbitrage involves structuring trades designed to capture inefficiencies in the pricing of volatility. However, warrants are generally less liquid than options and are frequently issued directly by companies in privately-negotiated transactions. The illiquid nature of these instruments creates opportunities to capture structural inefficiencies and illiquidity premiums. Ionic may also take outright directional positions in warrants.

### **Private and Illiquid Investments**

Ionic anticipates that the bulk of each Ionic Fund's portfolio will be maintained in liquid, readily marketable Investment Assets. However, Ionic believes that in certain cases the risk/reward profile of private, longer-term investments justify investing in assets for which there is no ready market or clear value.

The Ionic Funds' private investments are typically longer-term "value" positions, seeking to recognize gains when the actual value of an asset is recognized through a refinancing, public offering or private sale.

### **Hybrid and Other Strategies**

Ionic may implement hybrid strategies incorporating elements of directional, relative value, event-driven and other approaches, as well as a variety of opportunistic investment tactics. As market conditions and profit opportunities change, so will Ionic's market approaches and implementations.

### **Evolving Strategies and Allocations**

Ionic has complete flexibility in selecting the assets traded and the investment strategies implemented by the Ionic Funds and emphasizes the use of investment strategies in which Ionic believes that the proprietary valuation models, research capabilities and market experience of Ionic personnel provide a competitive advantage. The investment strategies, approaches and techniques discussed herein may evolve over time due to, among other things, market developments and trends, the emergence of new or enhanced investment products, changing industry practice and/or technological innovation. As a result, these investment strategies,

approaches and techniques may not reflect the investment strategies, approaches and techniques actually employed by Ionic. Nevertheless, the investments made on behalf of the Ionic Funds will be consistent with the Ionic Funds' investment objectives. Ionic anticipates that it will develop and implement new proprietary trading and investment strategies on an ongoing basis, as Ionic seeks to exploit profit and investment opportunities on a global basis. In implementing the Ionic Funds' investment strategies, the Ionic Funds may trade any investment asset.

There are no material restrictions on the strategies, leverage, markets or instruments which may be incorporated into the Ionic Funds' portfolios or the percentage of the Ionic Funds' assets that may be committed to any of the foregoing; provided, however, Ionic shall not invest the Ionic Funds' assets in designated investments. The investment and/or trading strategies employed by Ionic may be modified from time to time, and the description herein is not exhaustive.

## **Risk Management**

Ionic seeks to identify investment opportunities which it believes have superior risk/reward parameters. In addition, Ionic closely monitors the risk parameters and expected volatility of the Ionic Funds' overall portfolio (not just the individual positions considered on a stand-alone basis) in an effort to prevent an over-concentration of the portfolio in any particular asset, strategy or market. Diversification is an integral part of Ionic's overall portfolio risk management strategy. Ionic has established targeted limits with respect to the percentage of the Ionic Funds' assets that may be invested in any particular issuer, industry, sector, market and investment strategy; provided, however, such limits are not fixed guidelines and are monitored and adjusted from time to time by Ionic in its sole discretion.

In addition to risk limits, Ionic employs comprehensive scenario analysis. The emphasis is on stress testing the portfolio in order to monitor net convexity levels and to increase the likelihood that the Ionic Funds will be profitable in market crash and flight-to-quality scenarios. Ionic's risk software aggregates exposures of the various Ionic Funds enabling Ionic to monitor the net exposures to equities, interest rates, currencies, commodities, volatility and credit spreads, as applicable.

Ionic does not, in general, attempt to hedge all market or other risks inherent in the Ionic Funds' portfolios, and hedges certain risks, if at all, only partially (certain risks by their nature are not capable of being hedged). Specifically, Ionic may choose not, or may determine that it is economically unattractive, to hedge certain risks — either in respect of particular positions or in respect of an Ionic Fund's overall portfolio — and may rely instead on diversification in an attempt to mitigate such risks.

In investing in the Ionic Funds, subscribers are relying on the discretionary market judgment of Ionic, trading in a wide range of strategies, markets and instruments, as well as in investing in positions with a wide range of different durations, without being subject to any diversification, leverage or other form of trading limitations.

## General Risks

The following considerations, which do not purport to be a complete indication of all risks involved in an investment in the Ionic Funds, should be carefully evaluated before deciding

whether to invest in one or more of the Ionic Funds. An investment in the Ionic Funds involves a high degree of risk. The Ionic Funds cannot assure any investor that any such Ionic Fund's investment objective will be achieved or that such investor will not lose all or substantially all of such investor's investment.

### **Risk of Loss**

An investment in the Ionic Funds involves a high degree of risk, including the risk that the entire amount invested may be lost.

The past performance of the Ionic Funds is not necessarily indicative of its future results — particularly given the speculative nature of its strategies and the rapidly changing conditions (structural, economic and regulatory) of the markets in which the Ionic Funds invest.

### **Possible Positive Correlation with Stocks and Bonds**

One of the goals in incorporating a non-traditional investment such as the Ionic Funds into a portfolio is to provide a potentially valuable element of diversification, including a complement to a broader portfolio of long-biased investments and alternative investments. 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 Ionic Funds will, in fact, experience a low level of correlation with a traditional portfolio of stocks and bonds or with the debt or equity markets generally.

### **Financing Arrangements; Availability of Credit**

The use of leverage is integral to many of the investment strategies implemented by the Ionic Funds, and the Ionic Funds depend on the availability of credit in order to finance their portfolios. There can be no assurance that the Ionic Funds will be able to maintain adequate financing arrangements under all market circumstances. As a general matter, the banks and dealers that provide financing to the Ionic Funds can apply essentially discretionary margin, haircut, financing, security and collateral valuation policies. Changes by banks and dealers in such policies, or the imposition of other credit limitations or restrictions, whether due to market circumstances or governmental, regulatory or judicial action, may result in margin calls, loss of financing, forced liquidation of positions at disadvantageous prices, termination of swap and repurchase agreements and cross-defaults to agreements with other dealers. Any such adverse effects may be exacerbated in the event that such limitations or restrictions are imposed suddenly and/or by multiple market participants at or about the same time. The imposition of such limitations or restrictions could compel the Ionic Funds to liquidate all or a portion of their portfolios at disadvantageous prices. In recent years banks and dealers have substantially curtailed financing activities and increased collateral requirements, forcing many hedge funds and other market participants to liquidate positions. 2008–2009 saw this chain of events repeated numerous times. There can be no assurance that the Ionic Funds will be able to obtain adequate financing to pursue its investment program and achieve their objectives.

## **Credit Analysis and Credit Risk**

The investment strategies to be utilized by Ionic may require accurate and detailed credit analysis of issuers. There can be no assurance that Ionic's credit analysis will be accurate or complete. The Ionic Funds may be subject to substantial losses in the event of credit deterioration or bankruptcy of one or more issuers in their portfolios. While the Ionic Funds generally intend to hedge their credit risk with short positions in both cash and synthetic securities, there can be no assurance the Ionic Funds will have the ability to establish such hedges in the market place or, if established, that the hedges will offset losses.

## **Credit Ratings**

The credit ratings of structured finance products as well as other debt instruments and investments represent the rating agencies' opinions regarding their credit quality and are not a guarantee of future credit performance of such securities. Rating agencies attempt to evaluate the safety of the timely payment of principal and interest (or preferred dividends) and do not evaluate the risks of fluctuations in market value. The ratings assigned to securities by rating agencies do not purport fully to reflect the true risks of an investment. Further, in recent years many highly rated structured securities have been subject to substantial losses as the economic assumptions on which their ratings were based proved to be materially inaccurate.

## **Reliance on Corporate Management and Financial Reporting**

Many of the strategies implemented by the Ionic Funds rely on the financial information made available by the issuers to which the Ionic Funds have exposure. Ionic has no ability to independently verify the financial information disseminated by the thousands of issuers included in its universe of potential investments and is dependent upon the integrity of both the management of these issuers and the financial reporting process in general. Recent history has demonstrated the material losses that investors such as the Ionic Funds can incur as a result of corporate mismanagement, fraud and accounting irregularities.

## **Potential Strategy Saturation**

Although the amount of capital committed to alternative investment strategies decreased during and immediately following the market turmoil of 2008, such amount of capital has generally increased dramatically during recent years and is expected to increase again. At the same time, market conditions have become significantly more adverse to many of such strategies than they were in previous years. The profit potential of the Ionic Funds may be materially reduced as a result of the "saturation" of the alternative investment field.

## **Counterparty Risk**

The Ionic Funds may invest in complex derivative instruments that seek to modify or replace the investment performance of particular financial instruments such as equities, options, commodities, currencies, interest rates or indices. These instruments generally have counterparty risk and may not perform in the manner expected by Ionic, thereby resulting in greater loss or gain to the Ionic Funds. These instruments are subject to additional risks that can result in a loss of all or part of an investment, in particular, interest rate and credit risk volatility, world and local

market price and demand, and general economic factors and activity. Some of the markets in which the Ionic Funds may effect derivative transactions are “over-the-counter” or “interdealer” markets. The participants in such markets are typically not subject to credit evaluation and regulatory oversight to the same extent as are members of “exchange-based” markets. This exposes the Ionic Funds to the risk that a counterparty will not settle a transaction in accordance with its terms and conditions because of a credit or liquidity problem with the counterparty and the recent turbulence in the financial markets highlights the importance of being aware of counterparty risk resulting from “over-the-counter” derivative transactions. Delays in settlement may also result from disputes over the terms of the contract (whether or not bona fide) since such markets may lack the established rules and procedures for swift settlement of disputes among market participants found in “exchange-based” markets. These factors may cause the Ionic Funds to suffer a loss due to adverse market movements while replacement transactions are executed or otherwise. Such “counterparty risk” is present in all “over-the-counter” derivative transactions, and is accentuated for contracts with longer maturities where events may intervene to prevent settlement, or where the Ionic Funds have concentrated their transactions with a single or small group of counterparties. The Ionic Funds generally are not restricted from dealing with any particular counterparty or from concentrating any or all of their transactions with one counterparty.

The financial failure of a derivatives counterparty could also result in substantial losses as the Ionic Funds deal with such persons as principals, and there is no requirement that such parties segregate counterparty funds held by them in respect of such trading. Further, the Ionic Funds are subject to additional risks where they are a party to a securities lending arrangement and the counterparty to the arrangement becomes insolvent and/or defaults on its obligations, including, without limitation, the risk that collateral will not be returned and/or repurchased or the Ionic Funds will not be permitted to exercise their remedies in accordance with the provisions of the relevant securities lending agreement.

Recent collapses of large derivative dealers illustrate the risks of such trading.

### **Broker and Custodian Insolvency**

Especially in light of the recent turbulence in the financial markets, there are significant risks involved in dealing with the custodians or brokers who settle the Ionic Funds’ trades. Brokers that carry the accounts of the Ionic Funds generally segregate all customer assets. If such assets were not so segregated, the Ionic Funds would be subject to the risk of the failure of the broker. Even given proper segregation, in the event of the insolvency of a broker, the Ionic Funds may be subject to a risk of loss of their assets and may be able to recover only a *pro rata* share (together with all other securities customers of such broker) of their assets, such as securities specifically traceable to the applicable Ionic Fund’s account. In broker insolvencies, customers have, in fact, been unable to timely access assets in their account and/or recover from the broker’s estate the full amount of their “customer property” and/or funds. In addition, under certain circumstances, such as the inability of another client of the broker or the broker itself to satisfy substantial deficiencies in such other client’s account, a customer (including an Ionic Fund) may be subject to a risk of loss of its assets held with a broker, even if such assets are properly segregated. In the case of any such bankruptcy or loss, the Ionic Funds might recover, even in respect of property specifically traceable to the customer, only a *pro rata* share of all

property available for distribution to all of the broker's clients. The Ionic Funds may trade with or hold accounts at foreign brokers registered under the laws and regulations of other countries. Such brokers and/or dealers may not be subject to the same or similar customer fund regulations (including customer segregation requirements) as those existing in the United States and, in some jurisdictions, the Ionic Funds may only be an unsecured creditor of their respective broker in the event of bankruptcy or administration of such broker.

The effects of the Lehman Brothers bankruptcies, as well as the ensuing events, led to a dramatic contraction in credit (including even inter-bank lending) and steep monetary losses in the financial sector. The ramifications of the Lehman Brothers bankruptcies are unlikely to be resolved for a number of years, but demonstrate the material level of systemic risk to which the financial sector was, and may still be, subject, and could be adverse to the prospects for the Ionic Funds and/or private investment funds in general. Moreover, the Lehman Brothers bankruptcies have demonstrated the systemic risks of any comparable failure. It is not possible to predict if or when one or more such failures might occur. Were this to happen, the results could be materially adverse to the Ionic Funds.

The earlier bankruptcy of Refco, Inc. had very little systemic effect, but demonstrated that a significant portion of customer funds on deposit with CFTC-regulated futures brokers are, as a matter of practice, maintained in "unregulated" rather than "regulated" accounts at the futures broker. The futures brokers do not have to maintain "net capital" with respect to amounts on deposit in unregulated accounts. However, amounts in unregulated accounts are not subject to "customer protection" in the event of the futures broker's bankruptcy — in which case such amounts become simply unsecured debts of the futures broker.

### **Sub-Custodian Risk**

The Ionic Funds, their prime brokers or custodians may appoint sub-custodians in certain non-U.S. jurisdictions to hold the assets of the Ionic Funds. The Ionic Funds' primary custodians may not be responsible for cash or assets held by sub-custodians in certain non-U.S. jurisdictions, or for any losses suffered by the Ionic Funds as a result of the misconduct, bankruptcy or insolvency of any such sub-custodian. The Ionic Funds may therefore have potential exposure on the default of any sub-custodian and, as a result, many of the protections that would normally be provided to a fund by a U.S. custodian will not be available to the Ionic Funds. Custody services in certain non-U.S. jurisdictions remain undeveloped and, accordingly, there is transaction and custody risk of dealing in certain non-U.S. jurisdictions. Given the undeveloped state of regulations on custodial activities and bankruptcy in certain non-U.S. jurisdictions, the ability of the Ionic Funds to recover assets held by a non-U.S. sub-custodian in the event of the sub-custodian's bankruptcy would be in doubt. Even where a custodian, including a registered broker-dealer, is located and regulated in the United States, U.S. protections and regulations may be insufficient and the ability of the Ionic Funds to recover assets could be delayed or in doubt. Each Ionic Fund reserves its right to change its brokerage and custodial arrangements without prior notice to, and without the consent of the investors in the relevant Ionic Fund; provided, however, the directors of the relevant Master Fund approve any new prime brokerage relationships.

### **Reliance on Principals**

Ionic has a wide ranging mandate to direct the Ionic Funds' trading. While each of the Ionic Fund's investment strategies rely primarily on the Principals' market experience and judgment, certain aspects may rely on quantitative trading systems and mathematical pricing and valuation models. When making the decision to invest, investors are relying on the general market performance and ability of the Principals, not on any patented trading system or strategy.

### **Market Risks in General**

Ionic's investment strategies are subject to material market risk. There can be no assurance that what is perceived as an investment opportunity will not, in fact, result in substantial losses due to one or more of a wide variety of factors. Certain general market conditions could materially reduce the Ionic Funds' profit potential, and even in favorable market conditions the Ionic Funds can only be successful if Ionic is able to invest successfully in the face of competition with funds and management firms with resources that materially exceed that of both the Ionic Funds and Ionic.

All of Ionic's strategies are subject to some dimension of market risk: directional price movements, deviations from historical pricing relationships, changes in the regulatory environment, changes in market volatility, "flights to quality," "credit squeezes," etc. Ionic's style of alternative investing (including its relative value trading) may be no less speculative than traditional investing strategies. On the contrary, alternative investment strategies have from time to time incurred sudden and dramatic losses.

The diversification of the Ionic Funds' positions and strategies may not always be significant and, even if significant, may not provide meaningful risk control, even though it may reduce the Ionic Funds' profit potential as a result of certain strategies being unprofitable while others are profitable.

The particular or general types of market conditions in which the Ionic Funds may incur losses or experience unexpected performance volatility cannot be predicted, and the Ionic Funds may materially underperform other investment funds with substantially similar investment objective and approaches.

### **Volatility**

The prices of the instruments to be traded by the Ionic Funds have been subject to periods of excessive volatility in the past and such periods can be expected to recur. Price movements are influenced by many unpredictable factors, such as market sentiment, significant changes in inflation rates, interest rates, commodities, credit spreads, currencies and general economic and political conditions.

Volatility can disrupt historical or theoretical pricing relationships, causing what should otherwise be comparatively low risk positions to incur losses. On the other hand, the lack of volatility can also result in losses for many of the Ionic Funds' strategies that are effectively "long" volatility. In periods of trendless and/or stagnant markets, the Ionic Funds' strategies may have materially diminished prospects for profitability.

The majority of the investment strategies that are employed by the Ionic Funds rely for their profitability on market volatility contributing to the mispricings that they are designed to identify.

Volatility is one of the principal components of options pricing, and can result in the Ionic Funds incurring major losses on options sold (written) by the Ionic Funds that are never, in fact, “in the money.”

### **The Risks of Trading Options Volatility**

Trading option volatility is one of the most complex of all financial strategies and requires significant quantitative and mathematical resources and capabilities. The pricing of options involves a wide variety of factors — including the variability of interest rates, the time to expiration, the price of the underlying, the volatility of the underlying and general market sentiment. Not only will different traders differ among themselves concerning the correct theoretical value for a given option, but actual and theoretical values may diverge for extended periods of time. There can be no assurance that Ionic will correctly value its options positions or that where theoretical and actual values of an option diverge the actual value will, in fact, regress to theoretical values; consequently, substantial losses could be incurred by the Ionic Funds.

### **Lack of Liquidity**

The Ionic Funds trade in markets that either are or may become illiquid. Lack of liquidity can make it economically unfeasible for the Ionic Funds to recognize profits on open positions or to close out open positions against which the market is moving. In addition, illiquidity can disconnect market values from the historical pricing indicators used in certain aspects of Ionic’s investment analysis, as the fewer transactions that take place the greater the risk of market values not reflecting true pricing relationships or actual values.

Trading in illiquid securities often requires more time and results in higher brokerage charges, dealer spreads and other transaction expenses than are incurred in the trading of more liquid interests.

### **Market Disruptions**

Market disruptions can damage the Ionic Funds in ways which cannot be predicted. Such disruptions occur from time to time and typically result in material losses for many alternative investment strategies. Because of the leverage used by such strategies as well as the complexity that frequently characterizes the position, alternative investment strategies are dependent on a certain level of liquidity in the markets so that they may liquidate certain positions in order to meet the margin calls necessary to maintain their portfolio. In addition, during periods of market disruption, the terms of the credit extended to traders by dealers are commonly made materially more onerous by their dealers which may force the traders to liquidate their portfolios prematurely.

In 1994, 1998, 2001 and again in 2008-09, a sudden restriction of credit by the dealer community resulted (and may again result) in forced liquidations and major losses for a number of private investment funds applying strategies similar to certain of those that are implemented by the Ionic



Funds. Market disruptions caused by unexpected political, regulatory, military and terrorist events may from time to time cause dramatic losses for the Ionic Funds, and such events can result in otherwise historically low-risk strategies performing with unprecedented volatility and risk.

### **Suspension of Trading**

A financial exchange may from time to time suspend or limit trading. Such a suspension could render it difficult or impossible for the Ionic Funds to liquidate positions against which the market is moving. There is also no assurance that non-exchange markets will remain liquid enough for the Ionic Funds to close out positions.

### **No Material Limitations on Investment Strategies**

Ionic trades opportunistically and without restriction on behalf of the Ionic Funds. There are no material limitations on the instruments, markets or countries in which the Ionic Funds may invest or on the investment strategies it may employ.

The investment strategies currently implemented by Ionic will continually evolve, and Ionic is in no respects limited to applying only such strategies.

### **Single-Strategy Approach**

Because Ionic will generally only engage in convertible arbitrage trades on behalf of the Convertible Funds (and any hedges as determined by Ionic), such Convertible Funds' portfolio will be more concentrated than the portfolios of the other Ionic Funds, which may expose the Convertible Funds' portfolio to higher volatility, greater mark-to-market fluctuations and greater risk of loss than the other Ionic Funds.

### **Convertible Arbitrage Strategy Risk**

Convertible arbitrage generally involves acquiring convertible bonds or other securities and selling short a corresponding amount of the underlying equity security or vice versa. Risks that could affect the results of this strategy, include, but are not limited to the following: (i) a decrease or stagnation of volatility; (ii) dramatically rising interest rates or declining market volatility that adversely affects the relationship between securities; (iii) a constriction of the financing market that disrupts the convertible bond market generally; (iv) a widening in credit spreads without a corresponding move in rates that leads to a decrease in the price of convertible bonds without a corresponding increase in yield; (v) the difficulty in entering and profitably existing relative value trades focused on convertible securities as compared to entering into two separate trades on the underlying securities, as convertible securities tend to be significantly less liquid and have wider bid/offer spreads than the underlying equity; (vi) the inherently imperfect and dynamic hedging relationship involved in convertible hedging which may change at any time (for example, based on changing volatility and interest rates) and must be adjusted on an ongoing basis; (vii) convertible arbitrage involves selling securities short (which was not permissible for certain securities in the United States and certain international jurisdictions during periods of 2008 and thereafter and certain jurisdictions have indicated that they may ban short selling again during future periods of similar market dislocation); and (viii) a material

change in the dividend policy or credit rating of, or corporate actions or transactions by, the issuer of relevant convertible securities may have a material adverse effect on such convertible security's price.

Convertible arbitrage strategies generally incurred major losses in 2008 as regulatory limitations limited hedging and market liquidity and available leverage became severely restricted.

### **Directional Trading**

Certain of the positions taken by the Ionic Funds may be designed to profit from forecasting absolute price movements in a particular instrument. Predicting future prices is inherently uncertain and the losses incurred, if the market moves against a position, will often not be hedged. The speculative aspect of attempting to predict absolute price movements is generally perceived to exceed that involved in attempting to predict relative price fluctuations.

### **Long/Short Trading**

In long/short strategies, certain of the Ionic Funds intend to assemble a long portfolio of stocks, or options thereon, expected to outperform or a short portfolio of stocks expected to underperform the general market. There can be no assurance that the stocks in question will be correctly identified, and as there will not be any pricing relationship between the stocks held long or short, or options thereon, both portfolios may incur losses at or about the same time.

### **Relative Value Strategies**

The success of the Ionic Funds' relative value trading is dependent on Ionic's ability to exploit relative mispricings among interrelated instruments. Although relative value positions are considered to have a lower risk profile than directional trades as the former attempt to exploit price differentials rather than overall price movements, relative value strategies are by no means without risk. Mispricings, even if correctly identified, may not converge within the time frame within which the Ionic Funds maintain their positions. Even pure "riskless" arbitrage — which is rare — can result in significant losses if the arbitrage cannot be sustained (due, for example, to margin calls) until expiration. The Ionic Funds' relative value strategies are subject to the risks of disruptions in historical price relationships, the restricted availability of credit and the obsolescence or inaccuracy of its or third-party valuation models. Market disruptions may also force the Ionic Funds to close out one or more positions. Such disruptions have in the past resulted in substantial losses for funds employing relative value strategies.

The Ionic Funds expect that a major component of their relative value trading will involve spreads between two or more positions. To the extent the price relationships between such positions remain constant, no gain or loss may occur. Such positions do, however, entail a substantial risk that the price differential could change unfavorably and, due to the leveraged nature of the Ionic Funds' spread trading, result in increased losses. Changes in the shape of the yield curve can cause significant changes in the profitability of hedging or spreading operations. In the event of an inversion of the yield curve, the reversal of the interest differential between investments of different maturities can make previously profitable spread techniques unprofitable for the Ionic Funds.

In recent market conditions, the profitability of relative value trading has been materially reduced — in part due to the number of market participants seeking to exploit the same perceived mispricings. Additionally, given the Ionic Funds’ emphasis on positive convexity, it will be difficult to generate outsized returns in stagnant, non-trending markets, and if there were to be a liquidity crisis and dislocation in the Ionic Funds’ strategies (*e.g.*, summer 1998, first quarter 2005) the Ionic Funds would most likely experience a mark down.

### **Hybrid and Other Strategies**

In certain market conditions, the trading components combined in a hybrid strategy may detract from rather than complement each other, and the combination of these components may involve unanticipated risks.

### **Illiquid and Longer-Term Investments**

Certain Ionic Funds may invest in a variety of illiquid and longer-term positions, including thinly-traded securities and other less liquid assets, such as investments in private companies and in certain physical commodities.

Ionic may determine the fair value of the Ionic Funds’ illiquid longer-term investments for accounting purposes using valuation models and market information. However, the Ionic Funds’ valuation of these positions may differ materially from the value ultimately realized upon the liquidation of such investments, particularly as certain of such investments tend to have realization and/or events which cause their value to increase or decrease suddenly in a manner not previously reflected in the net asset value at which investors have recently subscribed and/or redeemed.

There will often be no trading market for the Ionic Funds’ illiquid longer-term investments, and the Ionic Funds might only be able to sell these positions, if at all, at materially disadvantageous prices.

### **Developing Investment Strategies**

The Principals apply strategies based on those they have implemented in the past, but these strategies will necessarily develop and change on an ongoing basis as Ionic’s resources and infrastructure change. In addition, Ionic may add new strategies to those the Principals have previously implemented. Ionic is not restricted from using certain of the Ionic Funds’ capital to develop and incubate new strategies, including those in which the Principals have limited experience. There can be no assurance that Ionic will be successful in developing existing or implementing new strategies or that such Ionic Funds will not suffer material losses as a result of the development or incubation of a given strategy.

### **Diversification Policies**

Diversification is an integral part of Ionic’s overall portfolio risk management strategy. Ionic has established targeted limits with respect to the percentage of certain Ionic Fund’s assets that may be invested in any particular issuer, industry, sector, market and investment strategy; provided,

however, such limits are not fixed guidelines and are monitored and adjusted from time to time by Ionic in its sole discretion.

### **Equity Securities**

A number of Ionic's trades are based on attempting to predict the future price level of different equity or equity-related securities. Numerous inter-related and difficult-to-quantify economic factors, as well as market sentiment, subjective and extraneous political, climate-related and other factors, influence the cost of equities; there can be no assurance that Ionic will be able to predict future price levels correctly.

Equity price levels are particularly subject to actual or perceived mismanagement and/or accounting irregularities at issuers.

Ionic's directional equity positions are typically leveraged, so that even comparatively minor adverse market movements can result in substantial losses.

### **Debt Securities**

The debt securities in which certain Ionic Funds may invest may be subject to price volatility due to various factors including, but not limited to, changes in interest rates, market perception of the creditworthiness of the issuer and general market liquidity. In addition to high investment grade debt securities, the Ionic Funds invest in low investment grade or non-investment grade debt securities, which are typically subject to greater market fluctuations and risks of loss of income and principal than lower yielding, investment grade securities and are often influenced by many of the same unpredictable factors which affect equity prices. In addition to the sensitivity of debt securities to overall interest-rate movements, debt securities involve a fundamental credit risk based on the issuer's ability to make principal and interest payments on the debt it issues. The applicable Ionic Funds' investments in debt securities may experience substantial losses due to adverse changes in interest rates and the market's perception of issuers' creditworthiness.

### **CDO Investment Related Risks**

The market value of CDOs will generally fluctuate with, among other things, the financial condition of the obligors on the underlying debt obligations or, with respect to Synthetic Securities (as defined below), of the obligors on or issuers of the Reference Obligations (as defined below), general economic conditions, the condition of certain financial markets, political events, developments or trends in any particular industry and changes in prevailing interest rates. Prospective investors must understand that certain securities may constitute all or a significant portion of the underlying securities held by a CDO, Synthetic Security or other investment of the Ionic Funds and that CDOs are therefore subject to risks particular to such securities.

CDOs are subject to credit, liquidity and interest rate risks. In particular, investment-grade CDOs will have greater liquidity risk than investment grade sovereign or corporate bonds. There is no established, liquid secondary market for many of the CDO securities the Ionic Funds may purchase. The lack of such an established, liquid secondary market may have an adverse effect on the market value of such CDO securities and the Ionic Funds' ability to sell them. Further, CDOs will be subject to certain transfer restrictions that may further restrict liquidity. Therefore,

no assurance can be given that if an Ionic Fund were to dispose of a particular CDO held by the Ionic Fund, it could dispose of such investment at the previously prevailing market price.

The performance of CDOs is adversely affected by macroeconomic factors, including (i) general economic conditions affecting capital markets and participants therein; (ii) the economic downturns and uncertainties affecting economies and capital markets worldwide; (iii) the effects of, and disruptions and uncertainties resulting from, the terrorist attacks of September 11, 2001 and the actual and potential military responses thereto and other consequences thereof and similar events; (iv) recent concern about financial performance, accounting and other issues relating to various publicly traded companies; and (v) recent and proposed changes in accounting and reporting standards and bankruptcy legislation.

“Synthetic Security” is any derivative financial instrument with respect to a debt instrument, in the form of a swap transaction or other form of derivative purchased or entered into, by an Ionic Fund with or from a synthetic security counterparty, which investment contains similar probability of default, recovery upon default (or a specific percentage thereof) and expected loss characteristics as those of the related Reference Obligation (without taking account of such considerations as they relate to the counterparty), but which contain a maturity, interest rate and other non-credit characteristics that may be different from the Reference Obligation to which the credit risk of the Synthetic Security relates.

“Reference Obligation” means a debt security or other obligation upon which a Synthetic Security is based.

“Reference Entity” means the relevant obligor of a Reference Obligation.

### **Synthetic Securities**

To the extent an Ionic Fund has a position in a Synthetic Security but not the underlying Reference Obligation, it will typically have a contractual relationship only with the counterparty of the Synthetic Security, and not with the Reference Entity that issued or, in some circumstances, guarantees the Reference Obligation. The Ionic Fund will have no right pursuant to the Synthetic Security to directly enforce compliance by the Reference Entity with the terms of the Reference Obligation nor will it have any rights of setoff against the Reference Entity or rights with respect to the Reference Obligation. The Ionic Fund will not directly benefit from the collateral supporting the Reference Obligation and will not have the benefit of the remedies that would normally be available to a cash holder of such Reference Obligation. In addition, in the event of the insolvency of the counterparty, the Ionic Fund generally will be treated as a general unsecured creditor of such counterparty, and will not have any claim with respect to the Reference Obligation. Consequently, the Ionic Fund will be subject to the credit risk of the counterparty as well as that of the Reference Entity. As a result, concentrations of Synthetic Securities entered into with any one counterparty create an additional degree of risk with respect to defaults by such counterparty as well as by the Reference Entity.

### **Insolvency of Issuers of CDOs**

If a court in a lawsuit brought by an unpaid creditor or representative of creditors of a U.S. issuer of a CDO, such as a trustee in bankruptcy, were to find that the issuer did not receive fair

consideration or reasonably equivalent value for incurring the indebtedness constituting the CDO and, after giving effect to such indebtedness, the issuer (i) was insolvent; (ii) was engaged in a business for which the remaining assets of such issuer constituted unreasonably small capital; or (iii) intended to incur, or believed that it would incur, debts beyond its ability to pay such debts as they matured, such court could determine to invalidate, in whole or in part, such indebtedness as a fraudulent conveyance, to subordinate such indebtedness to existing or future creditors of the issuer or to recover amounts previously paid by the issuer in satisfaction of such indebtedness. The measure of insolvency for this purpose varies. Generally, an issuer would be considered insolvent at a particular time if the sum of its debts was then greater than all of its property at a fair valuation or if the present fair saleable value of its assets was then less than the amount that would be required to pay its probable liabilities on its existing debts as they became absolute and matured. There can be no assurance as to what standard a court would apply in order to determine whether the issuer was insolvent after giving effect to the incurrence of the indebtedness constituting the CDO or that, regardless of the method of valuation, a court would not determine that the issuer was insolvent upon giving effect to such incurrence. In addition, in the event of the insolvency of an issuer of a CDO, payments made on such CDO could be subject to avoidance as a preference if made within a certain period of time (which may be as long as one year) before insolvency.

In general, if payments on a CDO are voidable, whether as fraudulent conveyances or preferences, such payments can be recaptured.

The preceding description applies only to issuers of CDOs organized in the United States. Insolvency considerations will differ depending on the country in which each issuer is located or domiciled and may differ depending on whether the issuer is a non-sovereign or a sovereign entity.

### **Asset-Backed Securities**

Asset-backed securities are subject to interest rate risk and prepayment risk. Asset-backed securities are subject to additional risks in that, unlike mortgage-backed securities, asset-backed securities generally do not have the benefit of a security interest in the related collateral. Each type of asset-backed security also entails unique risks depending on the type of assets involved and the legal structure used. For example, credit card receivables are generally unsecured and the debtors are entitled to the protection of a number of state and federal consumer credit laws, many of which give debtors the right to set off certain amounts owed on the credit cards, thereby reducing the balance due. Asset-backed securities typically experience credit risk. For example, there is an increasing supply of subordinated securities rated lower than AA (down to B or first loss) and senior securities that may be rated lower than AAA, as well. There is also the possibility that recoveries on repossessed collateral may not, in some cases, be available to support payments on these securities because of the inability to perfect a security interest in such collateral.

### **Hybrid Debt Securities**

The Ionic Funds may invest in certain hybrid debt arrangements, which are subject to risks in addition to overall interest-rate movements and the issuers' ability to pay the debt in accordance

with its terms. For example, if an Ionic Fund invests in syndicated debt such as loan participations, it would be subject to certain additional risks as a result of having no direct contractual relationship with the borrower of the underlying loan. In such circumstances, the Ionic Fund would generally depend on the lender to enforce its rights and obligations under the loan arrangements in the event of a default by the borrower on the underlying loan and would generally have no voting rights with respect to the issuer, as such rights are typically retained by the lender. Such investments are subject to the credit risk of the lender (as well as the borrower) since they will depend upon the lender forwarding payments of principal and interest received on the underlying loan. There can be no assurance that the lender will not default on its obligations under such arrangements, resulting in substantial losses to the Ionic Fund.

### **Distressed and High Yield Securities**

The Ionic Funds may invest in the securities of issuers in weak and/or deteriorating financial condition, experiencing poor operating results, needing substantial capital investment, perhaps having negative net worth, facing special competitive or product obsolescence problems or involved in bankruptcy or reorganization proceedings. Investments of this type may involve specialized financial and business risks that can result in significant or even total losses. Among the risks inherent in investments in financially troubled issuers is the fact that it is frequently difficult to obtain reliable information as to their true financial condition. The market prices of distressed and high yield securities are subject to abrupt and erratic market movements, excessive price volatility, an unusually wide “bid-ask” spreads as well as sustained periods of illiquidity.

### **Derivatives**

The Ionic Funds invest in certain derivative financial instruments, including, without limitation, warrants, options, swaps, swaptions, options on convertible securities, notional principal contracts, contracts for differences, forward contracts, futures contracts and options thereon, and may use derivative techniques for hedging and for other trading purposes. The use of derivative instruments involves a variety of material risks, including the extremely high degree of leverage often embedded in such instruments and the possibility of counterparty non-performance as well as of material and prolonged deviations between the theoretical and realizable value of a derivative (*i.e.*, due to nonconformance to anticipated or historical correlation patterns). These anticipated risks (and other risks that may not be anticipated) may make it difficult as well as costly to the Ionic Funds to close out positions in order either to realize gains or to limit losses.

Many of the derivatives currently traded by the Ionic Funds are principal-to-principal or “over-the-counter” contracts between the relevant Ionic Fund and a third party entered into privately, rather than on an exchange. As a result, the Ionic Funds will not be afforded the regulatory and financial protections of an exchange or its clearinghouse (or of the government regulator that oversees such exchange and clearinghouse). In privately negotiated transactions, the risk of the negotiated price deviating materially from actual value is substantial, particularly when there is no active market available from which to derive benchmark prices.

Many derivatives are valued on the basis of dealers’ pricing of these instruments. However, the price at which dealers value a particular derivative and the price which the same dealers would

be willing to pay for such derivative should the relevant Ionic Fund wish or be forced to sell such position may be materially different. Such differences can result in an overstatement of the Ionic Fund's net asset value and may have a material adverse effect on the Ionic Fund in situations in which the Ionic Fund is required to sell derivative instruments. The Ionic Funds' use of derivatives and other techniques (such as short sales) for hedging purposes involves certain additional risks, including (i) imperfect correlation between movements in the asset on which the derivative is based and movements in the asset being hedged; and (ii) possible impediments to effective portfolio management or the ability to meet short-term obligations because of the percentage of the Ionic Funds' assets segregated to secure its obligations under derivatives contracts. By hedging a particular position, an Ionic Fund limits the potential gain from an increase in value of such position, but may not achieve a commensurate increase in risk control.

Substantial disruption in the derivatives markets followed the recent bankruptcies and insolvencies of major financial institutions and market participants. Given the uncertainty relating to the government bailout of certain market participants and relating to various other government interventions, such disruption may occur again. Such disruption can cause substantial losses if related events trigger early termination provisions of derivatives transactions. The early termination of derivative transactions may result in substantial losses for the Ionic Funds as the Ionic Funds may not be able to replace the terminated positions and accordingly may be exposed to previously hedged risks, may be forced to close out of valuable or potentially valuable positions and may be forced to close out of other positions at a loss. Additionally, where the events described above have caused the bankruptcy or default by an Ionic Fund's counterparty, the relevant Ionic Fund may experience a significant delay in receipt or complete loss of payment owed to the Ionic Fund by the counterparty upon early termination. The relevant Ionic Fund's losses may extend to collateral it has posted to its counterparty.

The Ionic Funds may utilize a wide range of derivative instruments as part of their trading strategies. The terms of many derivative contracts that will be entered into will generally allow the counterparty to terminate such derivative contracts in numerous circumstances, including based upon credit-risk related contingent features (*e.g.*, significant redemptions or decline in net asset value) and various other default provisions. Additionally, if a counterparty terminates its derivatives contracts with an Ionic Fund based upon such credit-risk related contingent features or default provisions, cross-acceleration provisions in that Ionic Fund's trading documents, including without limitation master derivatives agreements, may be triggered giving that Ionic Fund's other counterparties the right to close out that Ionic Fund's positions under all of its trading documents. Such an event would have a material adverse effect on the value of that Ionic Fund's portfolio.

Ionic Funds may have a unilateral optional early termination right (*i.e.*, in a non-default scenario) under such derivative contracts, but may be required to pay breakage fees and expenses to terminate certain derivative contracts pursuant to such an optional early termination provision.

## **Options**

The seller (writer) of a call option that is covered (*i.e.*, the writer holds the underlying security) assumes the risk of a decline in the market price of the underlying security below the purchase price of the underlying security less the premium received, and gives up the opportunity for gain



on the underlying security above the exercise price of the option. The seller of an uncovered call option assumes the risk of a theoretically unlimited increase in the market price of the underlying security above the exercise price of the option. The securities necessary to satisfy the exercise of the call option may be unavailable for purchase by such writer except at much higher prices. Purchasing securities to satisfy the exercise of the call option can itself cause the price of the securities to rise further, sometimes by a significant amount, thereby exacerbating the loss. The buyer of a call option assumes the risk of losing its entire investment in the call option.

The seller (writer) of a put option that is covered (*i.e.*, the writer has a short position in the underlying security) assumes the risk of an increase in the market price of the underlying security above the sales price (in establishing the short position) of the underlying security plus the premium received, and gives up the opportunity for gain on the underlying security below the exercise price of the option. The seller of an uncovered put option assumes the risk of a decline in the market price of the underlying security below the exercise price of the option. The buyer of a put option assumes the risk of losing its entire investment in the put option.

## **Currency Markets**

The Ionic Funds may invest in currencies and foreign exchange. Such transactions involve a significant degree of risk and the markets in which foreign exchange transactions are effected are volatile, specialized and technical. Significant changes, including changes in liquidity and prices, can occur in such markets within very short periods of time, often within minutes. Foreign exchange trading risks include, but are not limited to, exchange rate risk, maturity gaps, interest rate risk and potential interference by foreign governments through regulation of local exchange markets, foreign investment or particular transactions in foreign currency.

## **Credit Derivatives**

The Ionic Funds may purchase and sell credit derivatives. Credit derivatives trading is subject not only to the credit risk of the issuer of the underlying obligations to which such derivatives are referenced, but also to the credit risk of the counterparty entering into the credit derivative itself. In certain cases, the credit derivatives market is significantly less liquid than the market in the underlying debt obligations, due to the generally customized and individually negotiated terms of certain of such derivatives. In addition, over-the-counter derivatives have been the subject of recent legislative proposals that would require them to be cleared on exchanges.

## **Credit Default Swap Agreements**

The Ionic Funds may be either the buyer or seller in credit default swap transactions. The “buyer” in a credit default contract is obligated to pay the “seller” a periodic stream of payments over the term of the contract, as well as an upfront payment in certain circumstances, in return for a contingent payment upon the occurrence of a “credit event” with respect to the underlying Reference Entity. Generally, a credit event means the bankruptcy or insolvency of the Reference Entity, the failure to pay a debt obligation by the Reference Entity and in some instances the restructuring of one or more debt obligations of the Reference Entity. If a credit event occurs, the seller typically must pay the contingent payment to the buyer up to the notional amount of the contract. Credit default swaps may be cash or physically settled following a credit event.

Under cash settled credit default swaps, the seller is required to pay to the buyer the notional amount of the contract less the recovery amount (*i.e.*, the post-default market value) of a debt obligation of the Reference Entity with a principal amount equal to the notional amount of the contract. Under physically settled credit default swaps, the seller is required to pay to the buyer the notional amount of the contract upon receipt from the buyer of any deliverable obligation of the Reference Entity in a principal amount equal to the notional amount of the contract.

Following recent industry efforts to improve the credit derivatives trading infrastructure, a “determinations committee” comprised of active credit default swap dealers and a limited number of other market participants was established to make binding determinations with respect to credit default swaps for issues such as whether a credit event has occurred; whether a settlement auction will be held; and whether a particular obligation is “deliverable” (*i.e.*, may be used as a basis for valuation in the auction). As a result of the related documentation standardization, the majority of standard credit default swaps are cash settled through centralized auctions. In circumstances where the determination committee determines not to hold an auction and the credit default swap is physically settled following a credit event, if an Ionic Fund, as a buyer of the credit default swap, does not own any of the debt obligations that are deliverable under the credit default swap, that Ionic Fund would be exposed to the risk that deliverable obligations will not be available in the market, or will be available only at unfavorable prices, as would be the case in a so-called “short squeeze.” In certain recent instances of a potential credit event with respect to a Reference Entity, it has been unclear whether such event met the actual definition of credit event under the standard industry documentation for credit default swaps. Similarly, there have been recent circumstances in which there did not exist the publicly available information required by the standard industry documentation for credit default swaps to enable the determinations committee to consider whether a credit event has occurred. In either of these cases, the Ionic Fund as a buyer of a credit default swap, may not be able to realize the full value of the credit default swap even though the Ionic Funds may have concluded that a credit event has occurred. Furthermore, if the determinations committee determines that a “succession event” has occurred with respect to a Reference Entity (as a result of a merger, restructuring or similar event) the credit default swap may be deemed to be amended to reference one or more successor Reference Entities. If such a succession event occurs, certain or all obligations that would have been deliverable under the credit default swap prior to such deemed amendment may not be deliverable under the amended credit default swap, which may have a material adverse effect on the value of the credit default swap to the buyer.

As a seller of credit default swaps, an Ionic Fund would incur leveraged exposure to the credit of the Reference Entity and is subject to many of the same risks it would incur if it were holding debt obligations of the Reference Entity. However, the Ionic Fund would not have any legal recourse against the Reference Entity and would not benefit from any collateral securing the Reference Entity’s debt obligations. In addition, where a credit default swap is physically settled, the credit default swap buyer would have broad discretion within parameters established upon entry into the credit default swap to select which of the Reference Entity’s debt obligations to deliver to the Ionic Fund following a credit event and would likely choose the obligations with the lowest market value (the “cheapest to deliver”) in order to maximize the net payment it receives from the Ionic Fund.

Credit default swaps involve additional risks than if the Ionic Fund had invested in the deliverable obligation directly. In addition to general market risks, credit default swaps are subject to liquidity risk, counterparty credit risk and regulatory risk. A buyer also may lose its investment and recover nothing should no credit event occur under the relevant credit default swap(s). If a credit event were to occur, the value of the deliverable obligation received by the seller (or the market value of the deliverable obligation used to calculate a cash settlement payment), coupled with the periodic payments previously received, may be less than the full notional value it pays to the buyer, resulting in a loss of value to the seller.

In addition to the settlement risk discussed above with respect to physically settled credit default swaps, payment under either physically settled or cash settled credit default swaps may be delayed beyond the time frame originally anticipated by the counterparties. Such delays may adversely impact the relevant Ionic Fund's ability to otherwise productively deploy any capital that is committed with respect to such contracts or to settle related hedges timely.

### **Futures Contracts**

The Ionic Funds may from time to time hold futures contracts. Futures markets are highly volatile and are influenced by complex and inter-related factors, such as, among other things, changing supply and demand relationships, changes in interest and exchange rates, governmental, commercial and trade programs and policies designed to influence prices and/or exchange rates and world political and economic events. Trading in futures and futures options contracts involves a high degree of leverage. The Ionic Funds' futures positions may also be subject to periods of illiquidity due to "daily price fluctuation limits" or "daily limits" imposed by certain exchanges. During a single trading day no trades may be executed at prices beyond the daily limits. Once the price of a contract for a particular futures contract has increased or decreased by an amount equal to the daily limit, positions in such contract can generally neither be taken nor liquidated. This could prevent the Ionic Funds from promptly liquidating unfavorable positions and subject it to losses.

### **Structured Investment Products**

The Ionic Funds may invest in a variety of different structured investment products – *e.g.*, total return swaps, contracts for differences, participating notes, options and collateralized debt obligations. These structured products involve not only the risk of the underlying "reference asset," but also the risks (including acceleration of the financing embedded in the structure and/or restrictions imposed on the management and nature of the permissible reference assets) and costs of creating the structured products.

### **Non-U.S. Securities and Emerging Markets**

The Ionic Funds may trade and invest in securities of companies domiciled or operating in one or more non-U.S. countries and make other investments in entities located outside the U.S., including in countries that are considered to be "emerging markets." Investing in these securities involves considerations and possible risks not typically involved in investing in securities of companies domiciled and operating in the United States, including instability of some non-U.S. governments, the possibility of expropriation, limitations on the use or removal of funds or other

assets, more limited disclosure and access to information from issuers than is customary in the U.S., changes in governmental administration or economic or monetary policy (in the United States or abroad) or changed circumstances in dealings between nations.

The application of non-U.S. tax laws (*e.g.*, the imposition of withholding taxes on dividend or interest payments, income taxes and excise taxes) or confiscatory taxation, as well as various other laws and regulations, including anti-money laundering laws, may affect the Ionic Funds' investment in non-U.S. securities and its other investments in entities located outside the U.S. The Ionic Funds may incur higher expenses from investment in non-U.S. securities and outside the U.S., in particular, in emerging markets, than from investment in U.S. securities and in non-emerging markets because of the costs that must be incurred in connection with conversions between various currencies and because non-U.S. brokerage commissions may be higher than commissions in the United States. Non-U.S. markets also may be less liquid, more volatile and subject to less stringent governmental supervision than in the United States. The Ionic Funds' investments in non-U.S. countries could be adversely affected by other factors not present in the United States, including lack of uniform accounting, auditing and financial reporting standards and potential difficulties in enforcing contractual obligations and in hedging market risk.

### **Commodities Trading and Investing**

The Ionic Funds may invest in certain commodities markets, including energy and energy-related markets, metals, agriculture and crude oil, through investments in derivative instruments.

The energy and energy-related markets (*i.e.*, derivatives instruments related to electricity, natural gas and oil) are susceptible to significant short-term price volatility, potentially to a greater extent than the financial instruments markets, as a result of a variety of factors, including weather-related events, the inability to store electricity and rate and tariff regulation and consumer advocacy. The energy markets are also subject to price volatility as a result of breakdowns in the facilities necessary to produce, transport, store and deliver physical energy.

The price of metals has fluctuated widely over the past several years. Several factors may affect the price of metals, including: global supply and demand, which is influenced by such factors as forward selling by producers, purchases made by producers to unwind hedge positions, central bank purchases and sales, and production and cost levels in major metals producing countries; investors' expectations with respect to the rate of inflation; currency exchange rates; interest rates; investment and trading activities of hedge funds and commodity funds; and global or regional political, economic or financial events. The volatility of metals prices may increase the risk of loss to the relevant Ionic Funds.

Trading in agricultural products is subject to the risks affecting supply and demand, including climatic conditions, transportation difficulties, natural disasters and other events which affect the availability of agricultural staples in certain models. As the agricultural markets tend to be less liquid than at least certain financial markets, the risk of a limited group of investors materially affecting prices are likely to be greater in the agricultural market. The restrictions on "insider trading" and the broad dissemination of information are generally not applicable to the agricultural markets. Consequently, the Ionic Funds may often be trading in these markets at a

material disadvantage to other market participants with better market access and/or information sources.

### **Private Investments; Illiquid Investments; Estimated Values**

Certain Ionic Funds may from time to time invest in illiquid and restricted, as well as thinly-traded, instruments (including privately placed securities). There is often no trading market for these investments, and the Ionic Funds might only be able to liquidate these positions, if at all, at disadvantageous prices. The Ionic Funds may be required to hold such investments despite adverse price movements. In addition, if an Ionic Fund makes a short sale of an illiquid holding, it may have difficulty in covering the short sale, resulting in a potentially unlimited loss on that position.

Ionic values the illiquid investments in the Ionic Funds' portfolio in its good faith discretion. Although there can be no assurance that these valuations accurately predict the price at which an arm's-length buyer would be willing to purchase the investments, these valuations are part of the calculation of the Ionic Funds' respective net asset values.

In order to ascertain the net asset values of the Ionic Funds, Ionic uses an estimated fair value (determined by Ionic) for its illiquid investments. Any such fair value may differ materially from the value ultimately realized upon the liquidation of these investments. Nevertheless, management fees are paid, performance allocations made, the participation of new subscriptions in the profits and losses of the Ionic Funds determined and redemption proceeds calculated based on the fair value determinations. Inevitably, using such fair values may adversely affect investors over time.

### **Model Risk**

Certain of Ionic's strategies require the use of quantitative valuation models that it has developed, as well as valuation models developed by third parties and made available to Ionic. As market dynamics (for example, due to changed market conditions and participants) shift over time, a previously highly successful model is subject to becoming outdated or inaccurate, likely without Ionic being able to recognize that fact before substantial losses are incurred. There can be no assurance that Ionic will be successful in continuing to develop and maintain effective quantitative models.

The Ionic Funds' model risk extends to the valuation of a number of its less liquid investments which are made on the basis of internal models, taking into account market inputs, where available, and the results of any valuation analyses of independent valuation consultants retained by Ionic, in the absence of any readily-determinable market values. The valuations so determined may differ materially from the value ultimately realized upon the liquidation of such investment.

## **Importance of Market Judgment**

Although Ionic uses quantitative valuation models in evaluating the economic components of certain prospective trades, Ionic's strategies are by no means wholly systematic; the market judgment and discretion of Ionic's personnel are fundamental to the implementation of these strategies. The greater the importance of subjective factors, the more unpredictable a trading strategy becomes.

## **Duration of Investment Positions**

Certain Ionic Funds are expected to be heavily comprised of relative value and arbitrage trades that can require a long holding period to realize returns. While such trades can have very attractive long-term risk-reward characteristics, in the short-term there can be high mark-to-market volatility. Ionic typically will not know (except in the case of certain options or derivatives positions which have pre-established expiration dates) the maximum — or, often, even the expected (as opposed to optimal) — duration of any particular position at the time of initiation. The length of time for which a position is maintained varies significantly, based on Ionic's subjective judgment of the appropriate point at which to liquidate a position so as to augment gains or reduce losses.

Many of the Ionic Funds' transactions involve acquiring related positions in a variety of different instruments or markets at or about the same time. Frequently, optimizing the probability of being able to exploit the pricing anomalies among these positions requires holding periods of significant length — often many months to a year or more. Actual holding periods depend on numerous market factors which can both expedite and disrupt price convergences. There can be no assurance that the Ionic Funds will be able to maintain any particular position, or group of related positions, for the duration required to realize the expected gains, or avoid losses, from such positions.

The Ionic Funds' investments may not have a defined time horizon to the extent that they are based upon the realization of the enterprise value of an investment as it develops and evolves. The longer the duration of an investment by the Ionic Funds, the greater the exposure of such position to the risks of general economic changes as well as changes in the Ionic itself.

The Ionic Funds' ability to realize value from illiquid investments is often dependent on a "valuation" event — an initial public offering, sale, refinancing, etc. The specific "exit strategy" for such investments may not be determined at the time that the Ionic Fund commits to such investment, and changing market conditions may preclude the execution of the "exit strategy" that Ionic might have expected to implement.

## **Short Sales**

As an integral part of its trading strategies, the Ionic Funds routinely sell securities "short." A short sale is effected by selling a security that the relevant Ionic Fund does not own, or selling a security that the Ionic Fund owns but that it does not deliver upon consummation of the sale. In order to make delivery to the buyer of a security sold short, the relevant Ionic Fund must borrow the security. In so doing, it incurs the obligation to replace that security, whatever its price may be, at the time it is required to deliver it to the lender. The relevant Ionic Fund must also pay to

the lender of the security any dividends or interest payable on the security during the borrowing period and may have to pay a premium to borrow the security. This obligation must, unless such Ionic Fund then owns or has the right to obtain, without payment, securities identical to those sold short, be collateralized by a deposit of cash or marketable securities with the lender. Short selling is subject to a theoretically unlimited risk of loss because there is no limit on how much the price of a security may appreciate before the short position is closed out. There can be no assurance that the securities necessary to cover the short position will be available for purchase by the relevant Ionic Fund. In addition, purchasing securities to close out the short position can itself cause the price of the relevant securities to rise further, thereby increasing any loss incurred by such Ionic Fund. Furthermore, the Ionic Fund may be forced to close out a short position prematurely if a counterparty from which the relevant Ionic Fund borrowed securities demands their return, resulting in a loss on what might otherwise have been a profitable position. Furthermore, U.S. and non-U.S. regulatory authorities have recently instituted new limitations on short sales, including temporary bans and ongoing reporting requirements, while also restoring the “uptick rule” in certain circumstances, in which case it is generally prohibited to initiate a short sale unless the last quote for a stock was higher than the immediately prior quote. The long-term impact of such requirements on strategies that make material use of short sales is unclear, but if bans on short sales continue to be reinstated such bans may make it impracticable or uneconomical to implement some of the Ionic Funds’ investment strategies.

### **Securities Lending**

The Ionic Funds borrow and lend securities on an ongoing basis.

Third parties that borrow securities from an Ionic Fund may not be able to return those securities on demand (possibly causing an Ionic Fund to default on its obligations to other parties), or may default on the payment obligations owed to an Ionic Fund in connection with such securities loans, potentially resulting in substantial losses to the Ionic Fund.

Conversely, the third parties that lend securities to an Ionic Fund may recall such securities at any time — potentially requiring such Ionic Fund prematurely to close out the related positions, resulting in substantial losses.

### **Hedging**

Ionic will cause the Ionic Funds to enter into hedging transactions with the intention of reducing or controlling risk. However, even if Ionic is successful in doing so, the hedging will reduce the Ionic Funds’ returns. Furthermore, it is possible that hedging strategies will not be effective in controlling risk, due to unexpected non-correlation (or even positive correlation) between the hedging instrument and the position being hedged, increasing rather than reducing both risk and losses.

To the extent that Ionic hedges, its hedges will not be static but rather will need to be continually adjusted based on Ionic’s assessment of market conditions, as well as the expected degree of non-correlation between the hedges and the portfolio being hedged. The success of Ionic’s hedging strategies will depend on Ionic’s ability to implement such strategies efficiently and

cost-effectively, as well as on the accuracy of Ionic's ongoing judgments concerning the hedging positions to be acquired by the Ionic Funds.

Ionic will not, in general, attempt to hedge all market or other risks inherent in the Ionic Funds' positions, and will hedge certain risks only partially, if at all. Specifically, Ionic may choose not to hedge certain risks or determine that hedging is economically unattractive — either in respect of particular positions or in respect of the Ionic Funds' overall portfolio. The Ionic Funds' portfolio composition may result in various directional market risks remaining unhedged, although Ionic may rely on diversification to control such risks to the extent that Ionic believes it is desirable to do so.

Ionic may not have the ability to hedge many of the Ionic Funds' illiquid investments as there are no instruments available to do so, given the illiquid nature of such investments.

### **Leverage**

The Ionic Funds may invest on a highly leveraged basis, both through their borrowings and through the significant degree of leverage typically embedded in the derivative instruments in their portfolios. Ionic measures total leverage as a fraction with the numerator being the total long market value of all positions in the relevant Ionic Fund as calculated by Ionic in accordance with its internal models and assumptions and the denominator being the net asset value. This method of calculating leverage captures borrowings by the relevant Ionic Fund but does not capture the embedded leverage in the derivative instruments in the portfolio. Utilizing other measurements of risk or exposure, such as gross notional exposure or value at risk, could yield materially different results.

In markets with fewer opportunities, Ionic anticipates decreasing leverage and in very cheap and/or dislocated markets it might increase leverage. Different strategies will have different degrees of leverage. Losses incurred on the Ionic Funds' leveraged investments increase in direct proportion to the degree of leverage employed.

Leverage includes not only increased risk, but substantial interest expense. Irrespective of the risk of increased losses resulting from leverage, even if the leveraged positions are profitable but do not generate incremental gains in excess of the interest expense incurred, the Ionic Funds will incur losses on such positions.

### **Trade Execution Risk**

Certain of the trading techniques that may be utilized by the Ionic Funds require the rapid and efficient execution of transactions. Inefficient executions can eliminate the small pricing differentials that Ionic seeks to exploit and impact, possibly materially, the profitability of the Ionic Funds' positions.



## **Trading Error Risk**

Trading errors are an intrinsic factor in any complex investment process, and will occur, notwithstanding the execution of due care and special procedures designed to prevent such errors. If trading errors do occur, they are for the account of the relevant Ionic Fund, unless they are the result of conduct inconsistent with the standard of care set forth in the relevant investment advisory agreement.

## **High Portfolio Turnover**

Certain of the strategies employed by the Ionic Funds require frequent trading, increasing portfolio turnover, brokerage commissions and other transaction fees and expenses, as well as the risk of trading error.

## **“New Issue” Trading**

The Ionic Funds invest in “new issues” as defined under rules of FINRA. Pursuant to FINRA Rule 5130, certain investors are restricted from fully participating in the profits and losses generated by “new issues.” In addition, the Ionic Funds in certain cases limits the participation of certain investors in “new issues” to a greater extent than required by FINRA Rule 5130. To date, the Ionic Funds have never allocated profits and losses from “new issues” to restricted investors (who elect to participate) pursuant to a “*de minimis*” exemption under FINRA Rule 5130, rather than allocating all such profits and losses to non-restricted investors. The Ionic Funds may revisit this policy in the future and will notify investors of any change.

## **Interest Rate Fluctuations**

The prices of portfolio investments tend to be sensitive to interest rate fluctuations and unexpected fluctuations in interest rates could cause the corresponding prices of the long and short portions of a position to move in directions which were not initially anticipated. In addition, interest rate increases generally will increase the interest carrying costs to the Ionic Funds of borrowed securities and leveraged investments.

## **Settlement Problems**

Delays in settlement can result in temporary periods when a portion of the assets of the Ionic Funds is uninvested and no return is earned thereon. The inability of the Ionic Funds to make intended security purchases due to settlement problems could cause the Ionic Funds to miss attractive investment opportunities or cause delays in distributing redemption proceeds. The inability to dispose of securities due to settlement problems could result either in losses to any Ionic Fund due to subsequent declines in value of the security or, if the Ionic Fund has entered into a contract to sell the securities, could result in possible liability to the purchaser.

## **Item 9. Disciplinary Information**

None.

**Item 10.** Other Financial Industry Activities and Affiliations

The following is a list of the Ionic Funds together with the names of the applicable investment advisors and/or managers:

<b><u>Ionic Fund</u></b>	<b><u>Investment Advisor</u></b>	<b><u>Manager</u></b>
Ionic Capital LLC	Ionic Capital Partners LP	Ionic Capital Advisors LLC
Ionic Capital International Ltd.	Ionic Capital Partners LP	N/A
Ionic Capital International Intermediate Ltd.	Ionic Capital Partners LP	N/A
Ionic Capital Master Fund Ltd.	Ionic Capital Partners LP	N/A
Ionic Convertible Fund LLC	Ionic Capital Management LLC	Ionic Capital Advisors LLC
Ionic Convertible Fund Ltd.	Ionic Capital Management LLC	N/A
Ionic Convertible Intermediate Fund Ltd.	Ionic Capital Management LLC	N/A
Ionic Convertible Master Fund Ltd.	Ionic Capital Management LLC	N/A
Ionic Select Opportunities Fund LLC	Ionic Capital Management LLC	Ionic Capital Advisors LLC
Ionic Select Opportunities Fund Ltd.	Ionic Capital Management LLC	N/A
Ionic Select Opportunities Intermediate Fund Ltd.	Ionic Capital Management LLC	N/A
Ionic Select Opportunities Master Fund Ltd.	Ionic Capital Management LLC	N/A

Please see Items 4 (Advisory Business), 8 (Methods of Analysis, Investment Strategies and Risk of Loss), 11 (Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading) and 12 (Brokerage Practices).

**Potential Conflicts of Interest**

The Ionic Funds are subject to a number of actual and potential conflicts of interest, as described below:

## Management Time

Ionic and its affiliates, owners, officers, directors, managers and employees (“Ionic Parties”) are required to devote only such business time and attention to the conduct of the business and affairs of the Ionic Funds as Ionic may deem necessary or advisable. Ionic Parties are free to devote such time and attention as they may determine to other Ionic Funds or to other activities unrelated to the affairs of a single Ionic Fund. Neither an Ionic Fund nor its investors (in its capacity as such) has any rights in or to such other activities or the income or profits derived therefrom.

Each Ionic Fund may have different terms of investment such as different fee and liquidity terms. Ionic utilizes many of the same investment strategies for each of the Ionic Funds, employing the most investment strategies for the Capital Funds and least for the Convertible Funds. There are no restrictions on the ability of Ionic to in the future manage accounts of other clients, whether the accounts follow the same or different investment objectives, philosophy and strategies as those used by the Ionic Funds. Ionic may in the future render investment advisory and other services to other persons or entities with respect to Investment Assets which advice may be identical, dissimilar or contrary to the advice that Ionic provides to the Ionic Funds.

Ionic may determine that an investment opportunity is appropriate for a particular Ionic, or for itself, but not for other Ionic Funds. Situations may arise in which certain Ionic Funds have made investments that would have been suitable for investment by other Ionic Funds but, for various reasons, were not pursued by, or available to, such other Ionic Funds. To the extent that entities affiliated with Ionic invest in a particular investment, the ability of one or more of the Ionic Funds to invest in the same investment may be adversely affected by any limitation on availability of the investment. In addition, Ionic may be required to choose among one or more of the Ionic Funds in allocating investments.

In the event that a determination is made that more than one Ionic Fund should trade in the same securities on the same day, such securities will be allocated among the Ionic Funds in a manner which Ionic believes to be fair and equitable to all of the Ionic Funds, over time taking into account the different investment mandates and investment strategies applicable to the Ionic Funds, current investment positions of the Ionic Funds, the relative capitalization and cash availability of the Ionic Funds, investment time horizon, leverage ratios and other considerations. In particular, because certain of the Ionic Fund’s investment strategy may be narrower than certain options-related strategies employed by other Ionic Funds, allocations of certain options-related trades may not be made on a *pro rata* basis. For example, certain Ionic Funds may receive a lower allocation of certain trades as determined by Ionic in its good faith discretion. Circumstances may occur, however, in which an allocation could have adverse effects on the Ionic Funds with respect to the price or size of securities positions obtainable or saleable.

The investment advisory agreements with the Ionic Funds authorize Ionic to combine purchase and sale orders on behalf of the Ionic Funds and to allocate securities or other assets so purchased or sold on an average price basis among such Ionic Funds.

From the standpoint of the Ionic Funds, simultaneous identical portfolio transactions for the Ionic Funds may tend to decrease the prices received, and increase the prices required to be paid,

by the Ionic Funds for their portfolio sales and purchases. Further, it may not always be possible or consistent with the investment objectives of each of the Ionic Funds for the same investment positions to be taken or liquidated at the same time or at the same price; however, all transactions will be made on a “best execution” basis.

### **Information Sharing with Other Portfolio Managers**

Ionic’s portfolio managers expect to occasionally discuss trading ideas, market conditions and related matters with the staff of competing fund managers. Ionic believes that such discussions are generally beneficial to the Ionic Funds and that the individual portfolio managers (who have no direct business relationship with the other funds or portfolio managers with whom they engage in discussions) will not have a conflict of interest in doing so. However, from time to time, the Ionic Funds may lose a trading opportunity because material nonpublic information conveyed to one of Ionic’s portfolio managers by the portfolio managers of other funds may cause the Ionic Funds to be restricted due to confidentiality obligations or regulatory restrictions.

### **Personal Trading**

Personnel associated with Ionic will trade for their personal and perhaps other accounts at the same time that they will be trading for the Ionic Funds. While Ionic has adopted a code of ethics in an attempt to prevent any such trading harming the Ionic Funds, Ionic’s personnel will have a conflict of interest both in devoting resources to such trading and in allocating investment opportunities among such other accounts (including personal accounts) and the Ionic Funds.

Please see Item 11 (Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading).

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

Ionic has adopted a code of ethics adopted pursuant to SEC rule 204A-1. Our code of ethics requires compliance with all applicable laws and regulations governing the provision of investment management services to our clients. In addition, our code of ethics highlights the fiduciary duty that we owe to our clients, including the affirmative duty to act in the best interests of our clients and to make full and fair disclosure of material facts. We expect each supervised person to act with integrity, competence, dignity, and in an ethical manner when dealing with the public, the Ionic Funds, investors and prospective investors in the Ionic Funds, service providers and fellow supervised persons. We also expect supervised persons to adhere to the highest standards with respect to any potential conflict of interest with clients.

Our code of ethics has specific provisions relating to identifying potential conflicts of interest. The provisions prohibit a supervised person from directing client transactions for the purpose of obtaining a personal benefit. They also generally prohibit certain personal business dealings with clients or investors without the prior approval of our Chief Compliance Officer or his designee. The code of ethics includes provisions relating to accepting offers of gifts or entertainment from third parties.

Access persons are required to conduct all personal securities transactions in full compliance with our code of ethics, and should not take any action in connection with personal securities transactions that could cause even the appearance of unfairness or impropriety, relative to our clients. Ambiguous situations should be promptly brought to the attention of our Chief Compliance Officer or his designee, and should be resolved in favor of client interests.

Finally, our code of ethics requires access persons, among other things, to: (i) have all personal securities transactions involving reportable securities pre-approved by our Chief Compliance Officer or his designee and are subject to a holding period; (ii) report all their personal securities transactions involving reportable securities to our Chief Compliance Officer or his designee periodically in accordance with Rule 204A-1; and (iii) certify their compliance with our code of ethics on at least an annual basis.

All violations of the code of ethics must be promptly reported to our Chief Compliance Officer or his designee, who is primarily responsible for administering and enforcing our code of ethics.

We will provide any client or prospective client with a copy of our code of ethics upon request by contacting our Chief Compliance Officer at the following address:

c/o Ionic Capital Management LLC  
366 Madison Avenue, 9<sup>th</sup> Floor  
New York, New York 10017  
Attention: Chief Compliance Officer  
Telephone: 212-294-8500  
FormADV@ionicap.com

We and our related persons do not recommend to clients, or buy or sell for client accounts, securities in which we or our related persons have a material financial interest. Although the Principals, employees and officers may buy and sell securities for their own account or the account of others, they may not buy securities from or sell securities to the Ionic Funds.

Please see Items 10 (Other Financial Industry Activities and Affiliations) and 12 (Brokerage Practices).

## **Item 12.** Brokerage Practices

Ionic determines the broker or dealer to be used for each securities transaction for the Ionic Funds. In selecting a broker for each specific transaction, we will use our best judgment to choose the broker most capable of providing “best execution” on an over-all basis taking into account the circumstances of each specific transaction. Brokers are selected on the basis of our evaluation of the overall value and quality of the services provided by the broker. No one factor controls our decision. Among other things, we consider the price of the security, commission rate, execution speed, confidentiality, market depth, capital commitment, recent order flow, knowledge of the other side of the trade and the quality of the broker’s service (including, but not limited to, accuracy, reputation, timeliness, research and responsiveness). In selecting brokers or dealers to execute transactions for the Ionic Funds, Ionic is not required to solicit competitive bids and has no obligation to seek the lowest available commission cost. Ionic does not always

negotiate “execution only” commission rates; accordingly, the Ionic Funds may be deemed to be paying for other services provided by the broker to the Ionic Funds, Ionic or their affiliates that are included in the commission rate.

Our application and importance of the specific criteria will vary depending upon the nature of the transaction, the asset class, the market in which it is effected, and the extent to which it is possible to select from among multiple brokers or dealers capable of effecting the transaction.

When we use client brokerage commissions to obtain research or other products or services, we receive a benefit because we do not have to produce or pay for the research, products or services that we might otherwise have to pay for ourselves. We have an incentive to select or recommend a broker-dealer based on our interest in receiving the research or other products or services, rather than based on our clients’ interest in receiving the most favorable execution. Such research or other products and services are utilized in the management of all of the Ionic Funds and the costs are generally proportionally allocated; provided, however, certain Ionic Funds may generate more than their overall pro rata share of the soft credits generated given the different investment strategies and assets under management of each Ionic Fund.

The products and services obtained using client brokerage commissions during our last fiscal year include items acquired from third parties, such as web based market research subscription services, market data from certain exchanges, quotation or other third party pricing services. Section 28(e) of the Securities Exchange Act of 1934, provides a “safe harbor” to investment managers who use soft dollars generated by their advised accounts to obtain investment research and brokerage services that provide lawful and appropriate assistance to us in the performance of investment decision-making responsibilities. The agreements we have with the Ionic Funds permit us to use “soft dollars” for expenses that do not fall within the safe harbor of Section 28(e). However, Ionic, in all cases, attempts to limit its use of “soft dollar” services in accordance with the safe harbor established by Section 28(e) of the Exchange Act, as interpreted by the SEC.

We consider investor referrals in selecting or recommending the prime brokers for the Ionic Funds and have an incentive to select or recommend prime brokers based upon investor referrals, rather than just the most favorable execution. As part of the selection process for the prime brokers to be utilized for the Ionic Funds, the quality of the capital introduction services is a factor in making such decision. However, Ionic does not direct trades to the prime brokers in return for investor referrals.

Ionic will generally aggregate trades, unless it believes that doing so would conflict or otherwise be inconsistent with its duty to seek best execution for its clients, and/or the terms of the respective investment advisory contracts and other agreements and understandings relating to the accounts for which trades are being aggregated. When Ionic believes that it can effectively obtain best execution for its clients by aggregating trades, including, subject to any policy restrictions set forth in Ionic’s code of ethics, it will do so for all clients for which the trades are both suitable and consistent with the respective investment advisory contracts, investment guidelines, and other agreements and understandings relating to such accounts.

**Item 13.**      Review of Accounts

We review the accounts of the Ionic Funds on a monthly basis. During the month-end reconciliation process with the administrator, our Chief Financial Officer and Controller are primarily responsible for reviewing the accounts of the Ionic Funds. As part of that process, they reconcile the internal general ledger, portfolio and P&L to the administrators' independent net asset value calculation prior to the administrator's release of the net asset value statements to investors in the Ionic Funds. In addition, our pricing committee formally meets to approve the month-end estimates and final net asset value for each of the Ionic Funds.

Ionic will furnish to each investor in the Ionic Funds a report of the applicable Ionic Fund's estimated performance as soon as practicable after the end of each week and after the end of each month, as well as its month-end risk report and such other information as Ionic may deem appropriate. In addition, the administrator will send to each investor a monthly statement reflecting the net asset value, including any increase or decrease, of such investor's investment during the preceding month. As soon as practicable after the end of each fiscal year, the Ionic Funds furnish to each investor audited financial statements as of the end of such fiscal year.

**Item 14.**      *Client* Referrals and Other Compensation

Please see Items 10 (Other Financial Industry Activities and Affiliations) and 12 (Brokerage Practices).

**Item 15.**      *Custody*

Not applicable.

**Item 16.**      Investment Discretion

Pursuant to the investment advisory agreements and limited liability operating agreements of the Ionic Funds, we and our affiliates have discretionary authority to manage the Ionic Funds. These agreements generally include a power of attorney given by the Ionic Funds to us and our affiliates.

There are no limitations placed on this authority.

Please see Item 4 (Advisory Business).

**Item 17.**      Voting *Client* Securities

We have been delegated the authority and right to vote proxies received by the Ionic Funds. We have adopted a proxy voting policy that requires us to act in the best interests of our clients when exercising proxy voting authority. We monitor corporate events and vote proxies on behalf of each client that has expressly or implicitly authorized us to do so. If we accept proxy voting authority from a client, we analyze the issues involved with shareholder votes, evaluate the probable impact on corporate operations, and vote proxies in what we view to be in accordance with the best interests of our clients.

Our proxy voting policy does not mandate that we vote every proxy that we receive in regard to securities held in client accounts. There may be circumstances when refraining from voting a proxy is in a client's best interest, such as when and if we determine that the costs of voting the proxy exceeds the expected benefit to the client (such costs include the value of our time). Further, we will not vote proxies for which a client has expressly retained voting authority.

If a proxy vote creates a material conflict between our interests and the interests of the Ionic Funds, we will resolve the conflict before voting the proxies. We will either disclose the conflict to the Ionic Funds or take other steps designed to ensure that a decision to vote the proxy is based on our determination of the Ionic Fund's best interest and is not the product of the conflict.

The Ionic Funds cannot generally direct how we vote in a particular situation.

Clients may obtain, free of charge, a copy of our proxy voting policies and procedures and/or a record of proxy votes cast since the effective date of our registration with the SEC by contacting our Chief Compliance Officer at the following address:

c/o Ionic Capital Management LLC  
366 Madison Avenue, 9<sup>th</sup> Floor  
New York, New York 10017  
Attention: Chief Compliance Officer  
Telephone: 212-294-8500  
FormADV@ionicap.com

**Item 18.** Financial Information

There is no current financial condition that is reasonably likely to impair our ability to meet our contractual commitments to our clients.

**Item 19.** Requirements for State-Registered Advisers

Not applicable.