AOI HEDGE FUND INVESTING PRINCIPLES

The Alignment of Interests Association ("AOI") has worked to increase the level of communication between hedge fund investors, with the goal of sharing ideas on ways to improve the industry for the long-term benefit of all its participants. AOI's members have collectively contributed to the AOI Hedge Fund Investing Principles, a document that outlines suggested best practices in relation to aligning the interests of managers and investors. The concepts outlined in this document are intended to serve as a basis for continued discussion between investors and their hedge fund managers. The points included in the Principles were developed though the collaborations of hedge fund investors involved with AOI, and represent some of the ideas exchanged between participants throughout the past several years.

INVESTOR STEERING COMMITTEE

The Principles were developed though the collective contributions of hedge fund investors worldwide, with guidance and oversight from AOI's Steering Committee. The Steering Committee serves to add institutional guidance and continuity on AOI's activities and helps to determine which issues merit member collaboration and communication. The AOI Steering Committee includes members from each of the following institutions:

- Alfred P. Sloan Foundation
- Employees' Retirement System of Rhode Island
- Employees Retirement System of Texas
- Fire & Police Pension Association of Colorado
- MetLife
- OMERS Capital Markets
- San Bernardino County Employees' Retirement Association
- Siemens Financial Services GmbH
- South Carolina Retirement Systems' Investment Commission
- State Board of Administration of Florida
- Teacher Retirement System of Texas
- The University of Texas Investment Management Company
- University of Toronto Asset Management

AOI PRINCIPLES - OVERVIEW

Following are the AOI Hedge Fund Investing Principles, which are comprised of three major areas:

- Economic & Liquidity Terms
- Documentation & Governance
- Transparency, Valuation & Disclosures

ECONOMIC & LIQUIDITY TERMS:

Management Fees & Expenses

- Management fees should not function to generate profits but rather should be set at a level to cover reasonable operating expenses of a hedge fund manager's business and investment process.
- Normal expenses covered by the management fee should include: overhead, staff compensation, compliance costs related to the fund and other general administrative items.
- Managers should provide investors with sufficient information regarding management company operating expenses and break-even asset levels so that investors can assess the appropriateness of the management fees being charged.
- A detailed break-down of the expenses charged to the fund should be provided to investors at least annually, or upon request.
- Management fee rates should decline as a firm's/fund's/strategy's AUM increases to account for economies of scale.
- Management fees should decrease or be eliminated entirely within a reasonable timeframe following the imposition of a suspension of redemptions.
- Audit holdbacks generally should not exceed a reasonable margin of error in the fund's reported NAV (5% maximum) and should be applied only with respect to a redemption request of all or substantially all (e.g., 95%) of an investor's NAV. The amount held back should be invested in a risk-free asset (e.g., T-bills) to avoid investment risk transfer to the non-redeeming investors, and whatever interest is earned on the holdback should be payable pro rata to the party or parties ultimately entitled to the principal.
- Audit holdback language often only specifically addresses what happens if the NAV of the fund was overstated as of a redemption date. Audit holdback provisions should also provide for payment of the underpaid amount to a redeemed investor in the event the fund's NAV was understated as of a redemption date.

Performance Fees

- High water marks should be perpetual (i.e., rolling high water marks are discouraged).
- If a "modified" high water mark is used (i.e., where a manager is paid a lower performance fee while the fund's net asset value is below the high water mark), it should be structured to avoid repeated payment of performance fees on the same performance range.
- The use of a clawback mechanism is recommended and performance fees should not crystallize more frequently than annually. Investment strategies with longer investment time horizons and/or investor lock-ups should include commensurately longer performance crystallization periods or multi-year clawbacks.
- The creation of new performance fee models designed to pay managers on alpha generation is encouraged, as is the use of performance fee hurdles (e.g., cash-based, beta-based or absolute return based, etc.).

Manager Investment

- The manager's senior investment professionals should have a significant amount invested (on both a dollar and percentage-of-net-worth basis) in the same fund(s) offered to investors, and it is a best practice for managers to re-invest a substantial portion of performance allocations back into their fund(s).
- Managers should notify all investors of any pending material redemptions by insiders with sufficient time for outside investors to redeem on the same date.
- Employees of the manager and their affiliates should have liquidity terms that are no more favorable than those offered to outside investors (other than for redemptions related to personal tax expenses and with respect to withdrawing performance allocations). Redemptions by insiders of performance allocations should be allowed only on standard dealing dates.
- Liquidity restrictions on insiders should not be circumvented by waivers of redemption notice periods. As such, notice period waivers for redemptions should not be granted to employees of the manager or their affiliates, and if granted, should be offered contemporaneously to outside investors.

Liquidity

- Redemption notice periods should reflect a combination of the liquidity of the fund's underlying securities, together with some level of sensitivity to the manager's business stability concerns.
- Gates can be an appropriate approach to managing business risk and the liquidity of the fund, but should not be used to maintain fees or for other non-investment related reasons.
- Investors should have an exit right without penalty for key-person departures and for material changes in fees, liquidity, transparency rights, or ownership/control of the manager, regardless of whether such changes are approved by other investors.

Side Pockets

- Illiquid investments should be designated as side pocket positions at the time of purchase. Any investment transferred into a side pocket after purchase should be subject to transparent disclosure as to the rationale for such change in status and when liquidity on the investment is expected.
- Information on new and existing side pocket investments should be reported to investors on a regular basis.
- Management fees should diminish or cease to be applied to side pocket investments after a reasonable period of time, except with respect to actively managed private investments.
- Performance fees on side pocket investments should only be paid upon realization of the investment.
- If an investor has redeemed from the fund, performance fees that accrue on side pocket investments as they are realized should be netted with unrealized losses on any remaining side pocketed investments.
- Performance fees on side pocket investments should be offset by any remaining unused loss carryforward / high water mark credit on non-side pocketed investments, even if the investor has partially or otherwise fully redeemed.
- Side pocket investments should be offered as a distribution-in-kind to investors after a reasonable period of time.
- Where side pockets are expected to be used, managers should offer investors the ability to opt out of investments known to be illiquid at the time of purchase by offering a non-side pocket share class or similar structure.

Preferential Terms

- It is reasonable for managers to offer preferential terms (e.g., reduced fees, capacity agreements, etc.) to investors who fill a significant role in the formation or stability of the firm. These investors may be "Day 1" or founding share class investors and/or investors who seed strategies and/or investors who contribute capital to enhance organizational stability.
- Preferential terms offered to investors in a given share class should take into account the liquidity of the fund's portfolio.

DOCUMENTATION & GOVERNANCE

Documentation

- Fund documents should reflect the fiduciary nature of the relationship between the manager and investors, and should provide for only a reasonable level of protection for managers.
- Fund documents should be clear and consistent (e.g., offering memoranda should not conflict with fund formation documents).
- Outside of tax-related issues, there should be no significant differences in material terms between onshore and offshore feeders.
- Given the changing investment environment and changing dynamics of the industry, funds are encouraged to review and update their fund documents on a regular basis.

Governance

- Governance rules should be clear and consistent, with clear policies regarding standards of care, fiduciary duties and fiduciary duty waivers, and indemnification and exculpation.
- Roles, rights, responsibilities and liabilities of the directors, general partners, administrators and managers (and any sub-advisors) should be set forth in a clear and consistent manner.
- A fund's Board of Directors should consist of a majority of independent directors, each of whom is reasonably qualified with the skills and experience to fulfill the role. At least one board member should primarily represent outside investor interests.
- The number of boards each fund's board members sit on should be provided to investors along with any other related information requested by investors.
- A breach of the governing documents by management should be considered a violation of the applicable standard of care.
- Managers should implement processes to ensure their fiduciary duties of loyalty and care are understood and adopted by all employees (e.g., obligations to disclose breaches of governing documents).

TRANSPARENCY, VALUATION & DISCLOSURES

Portfolio Transparency

- A high level of transparency is encouraged, in order to facilitate informed decision making by investors and more meaningful discussions regarding investment opportunities, management of the portfolio and risk management.
- For appropriate strategies and if requested by an investor, position-level detail should be provided (by an independent party, such as the fund's administrator) to a third-party risk aggregator on at least a monthly basis. Production of administrator transparency reports and standardized risk reports is encouraged in order to reduce the need to produce numerous custom reports and to enhance comparability across funds.

Valuation

- Managers need to have a clearly defined valuation policy, committee and process, which should be communicated and disclosed to investors. Any material changes in valuation policies or methodologies should be clearly communicated to investors when they occur.
- Specific valuation responsibilities of the manager, third-party valuation agents, administrator and the board of directors or general partner should be clearly outlined in fund documents.
- A policy for the designation of Level 2 and Level 3 assets should be clearly defined and disclosed to investors.
- Valuation of investments by independent third-parties using industry best practices should be sought wherever possible. Level 3 assets should be valued by third-party valuation agents at least annually wherever possible and economically practical.

Disclosures

- Disclosure of key terms granted only to certain investors (e.g., via side letter or new class) should be provided to all investors.
- The following should be disclosed to investors in a fair and timely manner:
    - Non-routine inquiries by legal or regulatory bodies in any jurisdiction (to the extent not prohibited by law).
    - Breach of a provision of the governing documents.
    - Response letters from regulators (to the extent not prohibited by law).
    - Any legal action in which the manager or key personnel are named that may reasonably be expected to impact the manager, key personnel or the fund.
    - Material contingencies or liabilities of the fund or firm.
    - Departure of the portfolio manager, key investment employees, CFO/COO or the general counsel of the firm.
    - Material changes in the actual or beneficial economic ownership of the firm or voting control of the firm.
    - Internal, employee-only funds that are not available to outside investors.

ENDORSING THE PRINCIPLES

AOI's members have collectively contributed to the AOI Hedge Fund Principles, a document that outlines suggested best practices in relation to aligning the interests of managers and investors. The Principles are intended to serve as a framework for continued discussion among and between members of the hedge fund industry for the long-term benefit of all its participants. Endorsement of these Principles is an indication of general support for the efforts of AOI and industry supporters to contribute to an effort to strengthen the basic "alignment of interests" in hedge fund investing. AOI does not seek the commitment of any investor or manager to any specific terms; however, AOI does believe that careful consideration of these terms and best practices will contribute to better long-term prospects for all involved in the industry.

To show support for the AOI Principles, please visit www.alignmentofinterests.org for further information.

ABOUT AOI

The Alignment of Interests Association ("AOI") is a non-profit, investor-driven organization focused on strengthening the alignment between hedge fund industry participants. Its mission is to foster investor collaboration, provide an independent forum for the exchange of ideas and contribute to the sharing of educational resources among investors. Since 2009, AOI has advanced the level of communication between institutional hedge fund investors and has facilitated the sharing of ideas on ways to improve the industry for the long-term benefit of all its participants. To date, over 250 institutional investors (pensions, endowments, foundations, insurance companies and family offices) have participated in AOI's activities. AOI, as an organization, is independent from commercial interests and sponsorship, and is governed by its Board of Directors with guidance from its Steering Committee.

For inquiries:

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Or visit:

WWW.ALIGNMENTOFINTERESTS.ORG