

CLIFFWATER^{LLC}

INVESTMENT ADVISORY SERVICES

Los Angeles • New York

Hedge Fund Operations Due Diligence Report
Gracie Credit Opportunities Fund, L.P.
Gracie International Opportunities Fund, Ltd.

July 2011

Investment Due Diligence Report provided under separate cover.

Hedge Fund Operations Due Diligence Report

Firm Name:	Gracie Asset Management		
Fund Name:	Gracie Credit Opportunities Fund, L.P. Gracie International Opportunities Fund, Ltd.		
Style:	Credit	Location:	New York, NY
Review Date:	July 27, 2011	Reviewer:	[REDACTED]

Operations Score: [REDACTED]			
1. Business Management	[REDACTED]	4. Valuation	[REDACTED]
2. Trading and Investment Operations	[REDACTED]	5. Risk Management	[REDACTED]
3. Financing and Counterparty Risk	[REDACTED]	6. Investor Related Practices	[REDACTED]

Summary

The Gracie Credit Opportunities Fund (“Gracie”) was founded in 2004 and is currently managing approximately \$2.3 billion of assets. The fund follows a global long/short credit strategy that primarily invests in various instruments including investment grade, high-yield, distressed and emerging market products. On occasion, Gracie may hedge the portfolio by utilizing products outside of the credit markets and may also establish independent macro positions. The manager has 30 full time business professionals who are all located in the New York office. The non-investment team is headed by a Chief Financial Officer, a Chief Compliance Officer and a Chief Operating Officer. Gracie is not currently registered as an Investment Advisor with the SEC, although the manager is prepared to register by the March 2012 deadline.

Gracie’s team of 12 non-investment professionals effectively manages all trading and business operations and meets nearly all industry operational best practices except that the Valuation Committee includes investment professionals and the manager does not have a dedicated internal risk manager to oversee the risk management process. These departures from best practices do not materially increase operational risk as several senior non-investment professionals are also voting members of the Valuation Committee and the risk management process is a collaborative effort among the three portfolio managers.

Section 1: Business Management

Score:	[REDACTED]
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Gracie meets all business management best practices which assess firm organization, compliance, investor protections and disaster recovery.

Mary Nir serves as the firm’s Chief Compliance Officer (“CCO”) as well as the in-house counsel. The manager has established a five member Compliance Committee which is led by the CCO and is also comprised of the Chief Financial Officer, the Chief Investment Officer, the Chief Operating Officer and a Portfolio Manager. The committee meets on a quarterly basis to review the firm’s compliance policies and to determine if any amendments or additional controls may need to be implemented to the compliance program. The manager has a comprehensive compliance manual including a Code of Ethics which all employees are required to read and certify on an annual basis. Gracie is not currently registered with the SEC, although the manager is prepared to register by the March 2012 deadline. All personal trading requires pre-clearance from the Compliance Committee and the policy seeks to ensure that any employee trading does not create any potential conflicts with the firm’s clients. Employees cannot establish a personal trading account with a financial institution with which a prime brokerage relationship

This report reflects information only through the date hereof. Our due diligence and reporting rely upon the accuracy and completeness of financial information (which may or may not be audited by the fund manager) and other information publicly available or provided to us by the fund manager, its professional staff, and through other references we have contacted. We have not conducted an independent verification of the information provided other than as described in this report. Our conclusions do not reflect an audit of the investment nor should they be construed as providing legal advice. Past performance does not guarantee future performance. The information contained herein is confidential commercial or financial information, the disclosure of which would cause substantial competitive harm to you, Cliffwater LLC, or the person or entity from whom the information was obtained, and may be protected from disclosure by applicable law.

exists without pre-clearance and all transactions must be automatically reported to the CCO. Soft dollar arrangements have been established with two brokers, although the usage is nominal. These relationships are reviewed by Compliance Committee to ensure the arrangements comply with the safe harbor provisions of Section 28(e). The manager's administrator, [REDACTED], is primarily responsible for the anti-money laundering procedures. In addition, the manager does not use expert consulting networks as a component of its research process, although the compliance manual does address insider trading policies.

Gracie maintains professional insurance policies which includes D&O and E&O coverage for up to \$15mm, in addition to key man insurance on two of the firm's partners. The manager has implemented a detailed disaster recovery plan which includes electronic back up and recovery of data to servers located in [REDACTED]. The disaster recovery plan is tested at least annually with the most recent test conducted in May of 2011.

Best Practices Comparison

Organization and Governance		Yes	No
1	[REDACTED]		
2	[REDACTED]		
3	[REDACTED]		
4	[REDACTED]		
Compliance			
5	[REDACTED]		
6	[REDACTED]		
7	[REDACTED]		
8	[REDACTED]		
9	[REDACTED]		
10	[REDACTED]		
11	[REDACTED]		
12	[REDACTED]		
13	[REDACTED]		
14	[REDACTED]		
Investor Protections			
15	[REDACTED]		
16	[REDACTED]		
17	[REDACTED]		
18	[REDACTED]		
19	[REDACTED]		
20	[REDACTED]		
21	[REDACTED]		
22	[REDACTED]		
23	[REDACTED]		
24	[REDACTED]		
Disaster Recovery			

25	[Redacted]
26	[Redacted]
27	[Redacted]

Background

Criteria	Cliffwater Comments
Firm structure: [Redacted]	[Redacted]
Fund structure and domicile [Redacted]	[Redacted]

[Redacted]	[Redacted]
<p>Compliance policies:</p> <p>[Redacted]</p>	[Redacted]
<p>Specific policies:</p> <p>[Redacted]</p>	[Redacted]
<p>Legal proceedings</p> <p>[Redacted]</p>	[Redacted]

[Redacted]	[Redacted]
Regulatory authorities: [Redacted]	[Redacted]
Systems and platforms: [Redacted]	[Redacted]
Backup procedures: [Redacted]	[Redacted]
Business continuity and disaster recovery plan: [Redacted]	[Redacted]
Insurance coverage: [Redacted]	[Redacted]

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Section 2: Trading and Investment Operations

Score:

Gracie meets all trading and investment operations best practices which assess outside service providers, infrastructure, trading and accounting processes, counterparty monitoring and cash management.

██████████ is the independent administrator for the feeder funds and the master fund. ██████████ is responsible for maintaining the official accounting books and records including the investor capital accounts, as well as the processing of subscriptions and redemptions. ██████████ are the prime brokers to the fund’s assets. ██████████ serves as the US legal counsel and ██████████ serves as the legal counsel for Cayman matters.

Gracie has three dedicated execution traders within the investment team, although the portfolio managers and several senior analysts are also authorized to execute orders depending on the product. Trade orders are generally communicated to the counterparties verbally for bonds and credit default swaps (“CDS”) and electronically via ██████████ for equities. Trade blotters are maintained for all filled orders which are compared to the trade recaps provided by the executing brokers. Once trades are confirmed and booked into ██████████ the accounting system, the trades are sent to the various clearing counterparties including the prime brokers for equities, bonds and listed options and ██████████ for CDS. ██████████ serves as the intermediary for a vast majority of the CDS trades. Cash and positions are reconciled daily by the operations team. At month end, the administrator performs tri-party reconciliations to the funds accounting records and to the various counterparties.

██████████ is responsible for the monitoring and facilitation of all investor subscriptions and redemptions. All cash transfers initiated by the manager require the approval and signature from two of four authorized individuals.


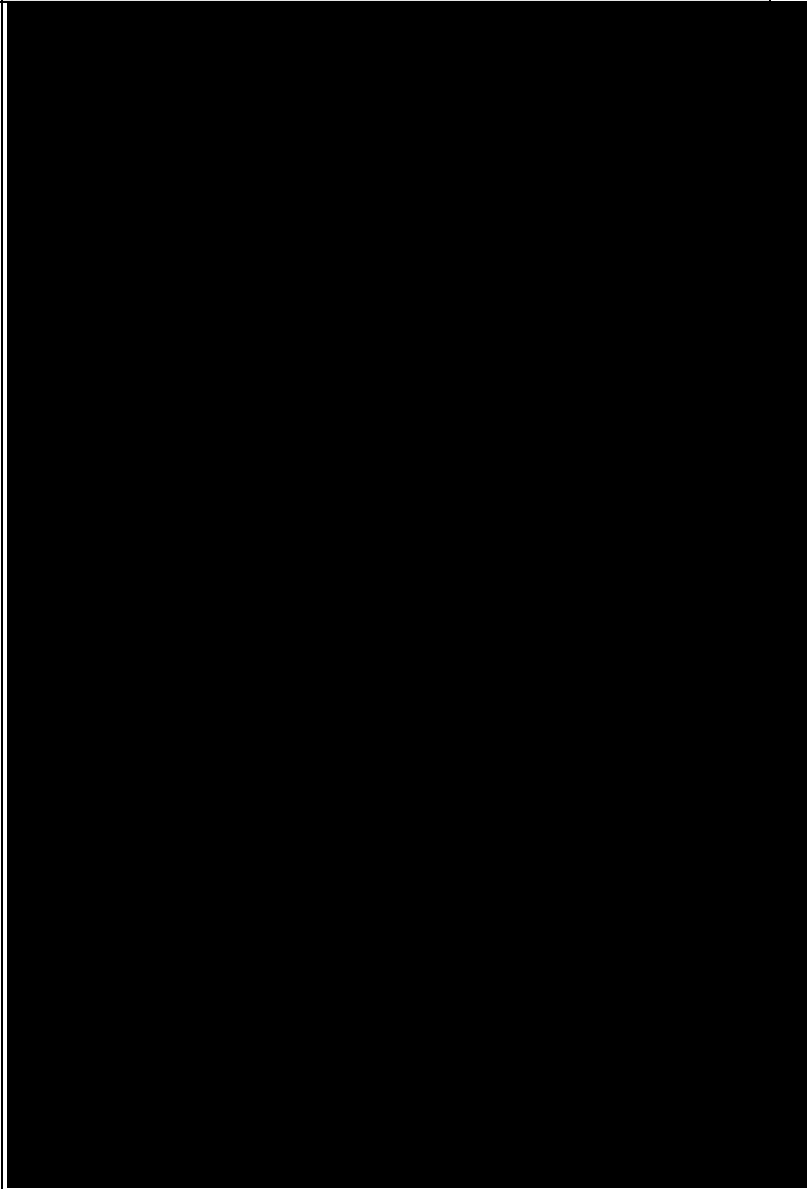




Best Practices Comparison







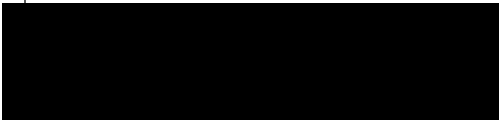

Outside Service Providers		Yes	No
28			
29			
30			
Infrastructure			
31			
32			
33			
34			
35			
36			
Trading Practices			
37			
38			
39			

40	
41	
42	
43	
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Core Accounting Processes	
46	
47	
48	
49	
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51	
Cash, Margin, and Collateral Management	
52	
53	
54	
55	
56	

Entity and Contact	Onshore	Offshore
Prime Broker		
Administrator		
Audit		
Legal		
Tax		
Other (including custodian if not PB)		
Changes in providers (3 yrs)		
Any issues encountered in audit of firm or		

Entity and Contact	Onshore	Offshore
its products?		

Criteria	Cliffwater Comments
Organizational Structure: 	
Control structure and oversight 	
Trading team: 	

Types of securities traded 	
Trading practices: 	
Trade flow process: 	
Trade confirmation and reconciliation: 	

Specialized groups	[REDACTED]
Reconciliation process with administrator:	[REDACTED]
Cash movements:	[REDACTED]

Section 3: Financing and Counterparty Risk

Score:

Gracie meets all financing and counterparty monitoring best practices which assess how the manager finances its portfolio and manages its cash.

The Chief Financial Officer, Mr. Greg Pearson, has oversight of the firm’s treasury and financing activities. The funds primary sources of financing are via the prime brokers, reverse repo transactions and by engaging in over-the-counter transactions governed by ISDA master agreements. The manager does not have any term margin agreements in place with any prime broker. Any excess cash is held either at the prime broker or is invested in a US Treasury money market fund at [REDACTED]. Gracie has negotiated ISDA agreements with approximately 18 counterparties. The ISDA agreements are all bi-lateral for margin and the manager is currently establishing a tri-party arrangement with the [REDACTED] and [REDACTED] to segregate the initial margin required for ISDA transactions. Counterparty exposure and collateral balances are monitored on a regular basis.

Best Practices Comparison

Financing and Counterparty Risk		Yes	No
57	[REDACTED]		
58	[REDACTED]		
59	[REDACTED]		
60	[REDACTED]		
61	[REDACTED]		
62	[REDACTED]		
63	[REDACTED]		
64	[REDACTED]		
65	[REDACTED]		

Background

Criteria	Cliffwater Comments
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Sources of financing:	[REDACTED]
Counterparties and terms of arrangements:	[REDACTED]
Prime broker financing:	[REDACTED]
Repo agreements	[REDACTED]
ISDAs	[REDACTED]
Other (i.e. CDOs, debt offerings, etc.)	[REDACTED]

Section 4: Valuation

Score: [REDACTED]

Gracie meets all valuation best practices except that its Valuation Committee includes the three Portfolio Managers. However, the inclusion of these investment professionals does not materially increase valuation risk as the committee is also comprised of the CFO, the Director of Operations and the Operations Manager. In addition, the vote of the CFO will be counted twice in the event of a tie among the voting members.

The manager, under the supervision of the CFO, is responsible for the valuation of the portfolio at each month end. Gracie utilizes several valuation sources including [REDACTED] to price the portfolio. The firms' valuation policy outlines the methods by which each of the various products will be valued. [REDACTED] also performs an independent monthly review of the valuations determined by the manager. Any pricing variance on a particular security that is greater than 2 basis points is reviewed between the administrator and the manager in an effort to obtain additional support. [REDACTED] generally

validates the pricing of at least 95% of the portfolio. Approximately 14% of assets are deemed level 1, 85% are level 2 and 1% are level 3 under FAS 157 as of June 30, 2011.

As noted, the manager has established a Valuation Committee which meets on a monthly basis. The committee is primarily responsible for reviewing the valuations determined by the CFO or the front office, resolving disputed valuations and approving the broker/dealers that can provide quotes, if needed.

Best Practices Comparison

Valuation Personnel		Yes	No
66	[Redacted]		
67			
Valuation Policy			
68	[Redacted]		
69			
70			
71			
72			
73			
74			
75			
76			
77			
78			
Pricing Sources and FAS 157 Companies			
79	[Redacted]		
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83			
84			
85			
86			
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Positions with No Readily Ascertainable Market Value			
89	[Redacted]		
90			
91			
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93			
94			
Valuation Committee			
95	[Redacted]		
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Background

Criteria	Cliffwater Comments
Month end closing process <div style="background-color: black; height: 60px; width: 100%;"></div>	
Valuation of exchange traded (level 1) <div style="background-color: black; height: 60px; width: 100%;"></div>	
Valuation of OTC / illiquid instruments / private placement (level 2 and 3) assets <div style="background-color: black; height: 60px; width: 100%;"></div>	

Section 5: Risk Management

Score:

Gracie meets all risk management best practices except that the firm does not employ an independent risk manager to oversee the risk management process for the organization. The three portfolio managers, James Palmisciano, Manbir Singh and Michael Robertson, maintain the overall responsibility for the risk management of the portfolio.

Gracie has established various risk guidelines that are used to manage and mitigate the risk of the investments within the portfolio. The composition of the portfolio is generally limited to between 75 and 100 positions and approximately 65% of the individual names are to be comprised of US companies. Concentration limits are also defined based on segment as well as on the risk of the individual credits. The risk management process also includes the review of risk reports that are provided by [REDACTED]. In addition, the manager also relies on proprietary models to run stress tests and to perform scenario analyses on the portfolio.

The manager does not generally employ significant leverage although the fund may lever the portfolio up to three times of its Net Asset Value. The liquidity of the portfolio is also monitored by the portfolio managers with a majority of the individual positions receiving multiple broker quotes. The manager estimates that approximately 90% of the portfolio can be liquidated within 45 days.

Best Practices Comparison

Structure		Yes	No
110	[REDACTED]		
111	[REDACTED]		
112	[REDACTED]		
113	[REDACTED]		
114	[REDACTED]		
115	[REDACTED]		
116	[REDACTED]		
117	[REDACTED]		
118	[REDACTED]		
119	[REDACTED]		
Risk Manager			
120	[REDACTED]		
121	[REDACTED]		
122	[REDACTED]		
123	[REDACTED]		
124	[REDACTED]		
125	[REDACTED]		
Risk Limits and Testing			
126	[REDACTED]		
127	[REDACTED]		
128	[REDACTED]		
129	[REDACTED]		
130	[REDACTED]		
131	[REDACTED]		

Leverage and Liquidity Risk	
132	
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Background

Criteria	Cliffwater Comments
Structure of risk management group: <div style="background-color: black; height: 40px; width: 100%;"></div>	
Liquidity risk and funding: <div style="background-color: black; height: 40px; width: 100%;"></div>	

Section 6: Investor Related Practices

Score:

Gracie meets all disclosure and investor terms best practices. The PPM details the investment terms, fees, and conditions. The fees are calculated based on the audited financial statements and based on the dollar of value added. The lock-up and gate provisions protect the fund from having to liquidate the portfolio at a discount to meet investors redemptions.

Performance estimates are provided by the manager within 5 calendar days after each month end. Investors will receive their final NAV statement from the administrator within 25 calendar days after the close of each month. All investors receive a detailed performance, risk, attribution and exposure report on a monthly basis. Investor letters are provided quarterly which include market commentary and statistics related to fund performance and portfolio composition. Fund expenses averaged 32 basis points and 40 basis points for the onshore and offshore funds, respectively, from 2008 to 2010.

Gracie's most recent financial statements were audited by [REDACTED], who replaced [REDACTED] as the auditor as of November 2010. The audited financial statements are typically provided to investors within 90 calendar days after the fiscal year end, which is slightly timelier than the industry standard. Schedule K-1s are usually provided to investors by the end of March after each year end. The manager will prepare tax estimates for investors upon request.

Best Practices Comparison

Initial Disclosures	Yes	No
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Fees and Expenses	
146	
147	
148	
149	
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151	
Ongoing Information Provided to Investors	
152	
153	
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155	
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160	
Financial Statement and Tax	
161	
162	
163	
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Investor Terms	
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169	
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Background

Criteria	Cliffwater Comments

Meeting History

Date	Location	Cliffwater Attendees	Manager Attendees
July 27, 2011	New York, NY		Marc L. Friedman (COO), Greg Pearson (CFO), Mary Nir (CCO), Irina Tsoneva (IR), Laura Anker (IR)

Appendix: Glossary

Administrator	A service provider such as Citco or International Fund Services that handles administrative responsibilities such as calculating the fund’s NAV on a monthly basis, sending the investors performance reports, and maintaining the official books and records of the fund.
Fair Value (FAS 157)	FASB Statement No. 157, Fair Value Measurements (“FAS 157”), defines fair value as <i>“the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”</i> Cliffwater reviews valuations according to the Fair Value hierarchy established by FAS 157, the three levels of which are described below.
Level 1 assets	Liquid assets with readily observable prices, and therefore a reliable market value. Level 1 assets typically include stocks, bonds, mutual funds, and any other assets that have a regular “mark to market” pricing mechanism.
Level 2 assets	Assets with a value based on market inputs that are not directly observable on a central exchange. These assets are often priced via quotations from dealers. An example of a level 2 asset is a credit default swap which is typically priced via indicative quotations from broker dealers.
Level 3 assets	Illiquid assets with a value that cannot be determined by observable measures. The fair value of a Level 3 asset can only be estimated by using significant assumptions as inputs to the valuation model. Illiquid private equity investments are an example of this type of asset. Each manager may derive its own internal valuation policy regarding the classification of Level 3 assets depending on available pricing sources, or other factors, however.
Leverage	<p>The use of explicit debt (i.e. borrowing) or implicit debt (i.e. derivatives) to achieve investment positions that exceed invested capital (NAV), thereby amplifying return but also increasing risk. A common leverage calculation is the ratio of gross notional exposure to invested capital. For example, a \$100 investment in BP stock coupled with a \$100 short sale of Exxon stock yields gross notional exposure of \$200. Leverage in this example can be described in at least two ways:</p> <ol style="list-style-type: none"> a. The portfolio has 200% gross exposure (equal to \$200 gross notional exposure divided by \$100 NAV) b. The portfolio is one time (1x) levered (equal to \$100 in debt divided by \$100 NAV) <p>As illustrated in the example, the \$200 gross notional exposure equals the absolute value total of both \$100 long (“gross long”) and \$100 short (“gross short”) asset exposures. The measurement of gross notional exposure varies by asset class:</p> <ul style="list-style-type: none"> • <i>Equities</i> – the market value of long and short positions • <i>Corporate Debt and Municipal Bonds</i> – the market value of long and short positions • <i>US Treasuries (and other highly rated government debt)</i> – the market value of long and short positions, adjusted to a 10 year bond equivalent maturity (approximate 9 year duration), so that a \$100 exposure to a 2 year duration bond is recognized as a lower risk compared to a \$100 20 year duration bond. The \$100 3 year duration bond is said to have a \$33 10 year bond equivalent exposure (\$100 times 3, divided

	<p>by 9) while the \$100 20 year duration bond is said to have a \$222 10 year bond equivalent exposure (\$100 times 20, divided by 9)</p> <ul style="list-style-type: none"> • <i>Options</i> – the delta adjusted exposure rather than the total notional value of the underlying reference asset. Delta adjusted exposure represents the implied shares/holdings necessary to hedge the options position • <i>Credit Default Swaps</i> – total notional exposure of the underlying reference credit • <i>Interest Rate Swaps</i> – total notional exposure (expressed as 10-year bond equivalent, per the duration adjustment process described above) to reference security or index • <i>Futures/Forwards</i> – total notional exposure to reference security or index
Net Asset Value (NAV)	A fund's total assets less total liabilities.
Notional Exposure	The total dollar exposure represented by a position. Due to leverage, this amount may be greater than the equity in the position. For example, a CDS contract offering \$1 million of protection has a notional value of \$1 million even though the cost of the contract itself is likely to be a small fraction of that amount.
Gross Long	The total notional exposure of all long positions in a portfolio. Long positions benefit from increases in securities prices.
Gross Short	The total notional exposure of all short positions in a portfolio. Short positions benefit from decreases in securities prices.
Net	The difference between a portfolio's gross long and gross short exposures. A net long position indicates a higher portion of long positions in the portfolio, and that the portfolio should generally benefit from an increase in asset prices. A net short position indicates the opposite.
Total Gross	The sum of a portfolio's gross long and gross short exposures.
Operations Score	A measure of how well the firm meets best practice standards on a scale of A (meets all best practice standards) to F (does not meet several best practice standards). A rating of "C" or lower indicates Cliffwater believes the firm's departure from best practices could hurt returns or lead to the misappropriation of firm assets.
Prime Broker	A prime broker custodies assets, provides settlement services, facilitates the borrowing of securities for short positions, and may provide performance reporting for hedge funds. JPMorgan, Goldman Sachs, Morgan Stanley and UBS are large prime brokers.
Side Pocket	A segregated portion of a portfolio that may be used to hold illiquid, less frequently priced securities. Once a holding is placed in a side pocket, only current investors participate in its performance. Subsequent investors do not share in the gains/losses associated with assets previously placed in side pockets. Performance fees are paid when side pocket investments are realized. Assets placed into side pockets are not available for withdrawal until the investments are realized.
Soft Dollars	Commission credits from trading securities that can be used to pay for research or other services that brokers provide to hedge funds and that are intended for the benefit of investors. Most funds operate under the SEC 28e safe harbor rules that restrict soft dollar use to research only.
Unencumbered Cash	Unencumbered cash is equal to cash holdings less margin requirements.