

CLIFFWATER^{LIC}

INVESTMENT ADVISORY SERVICES

Los Angeles • New York

**Hedge Fund Operations Due Diligence Report
Capula Global Relative Value**

March 2011

Investment Due Diligence Report provided under separate cover.

Hedge Fund Operations Due Diligence Report

Firm Name:	Capula Investment Management LLP		
Fund Name:	Capula Global Relative Value		
Style:	Fixed Income	Location:	London, UK
Review Date:	March 9, 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

Since Cliffwater’s last operational review in the March 2010, there have been two material changes. The manager launched a new fund called Capula Tail Risk Master Fund which has had strong capital inflows and now contains roughly \$1.5 billion. This fund launched in March 2010 to meet investor demand for a product that seeks to perform well during periods of market stress. The other material change is that the manager has decided to conduct a level 1 SAS 70 as of December 31, 2010. The results of this will probably be released to investors in April 2011. The manager also intends to conduct a level 2 review but has not determined the exact timing of the testing, although it will very likely be sometime in 2011. In addition, the manager is working on the following changes:

- Adding [REDACTED] as an additional custodian in December 2010. [REDACTED] was chosen as the new additional custodian because the manager believed [REDACTED] had a global presence and was impressed with its ability to maintain a wide range of products including Chinese bonds.
- Hiring Mr. Russell Chipperfield in October 2010 to run the back office team. This addition has allowed Mr. Bell, who used to have this oversight responsibility, to focus more on legal and regulatory matters.
- Making the daily reconciliation system between the prime brokers and the manager more automated.
- Establishing a counterparty risk committee. The treasury group and senior portfolio managers have always monitored counterparty risk but this process is now more formalized.
- Preparing to register with the SEC. The manager has hired [REDACTED] to ensure it meets SEC requirements. The manager is planning to implement a “Global Framework” whereby they will hold all employees and offices to the highest standard imposed by the SEC and FSA whenever possible.
- Adding additional seats to its disaster recovery site.
- Increasing its professional liability coverage from \$20 million to \$40 million for Capula Global Relative Value. In addition, the new Capula Tail Risk Master Fund has a very similar policy for up to \$20 million.

In addition, the manager may consider revising the personal trading policy to prohibit trading all equities. The manager believes this policy would be simpler to implement and, from a practical perspective, would not affect that many individuals as most employees do very little trading in single name equities.

Capula’s team of 19 non-investment professionals effectively manages all trading and business operations and meets all industry operational best practices. This London-based fixed income firm has a total of fifty-five employees and an ancillary office in Tokyo with eight employees. The vast majority of the products are very liquid and the valuation of the positions is very transparent. The manager has made a substantial investment in its back office infrastructure and has hired more execution-only traders than

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firms with a similar asset base to ensure it has sufficient resources to execute its over-the-counter trades. In addition, the firm has hired an experienced external administrator which has the systems that are able to capture the unique attributes of the products it trades.

Section 1: Business Management

Score:

Capula meets all best practices which assess firm organization, compliance, investor protections and disaster recovery.

Mr. Chris Bell serves as both the General Counsel and the Chief Compliance Officer and has over ten years of experience in this role. He continuously updates the written compliance manual, ensures the fund's policies are adhered to, monitors personal trading and files regulatory reports as necessary. The fund is registered with the FSA and affiliate is registered with the Financial Services Agency in Japan as a discretionary investment advisor. The firm has a comprehensive compliance manual which outlines all its policies on numerous issues.

There are no past or pending regulatory investigations or sanctions involving Capula. There is a Staff Dealing policy which requires almost all personal trades to be pre-approved by the compliance team with some exceptions made for broad based mutual funds and other index products. Duplicate confirmations and monthly statements must be submitted to the compliance team. As mentioned above, the compliance team is considering making the personal trading policy more restrictive and prohibiting trading in individual equity names, but at this time it is still allowed with pre-approval. The compliance team also monitors position sizing to ensure it meets all regulatory filing requirements; however, the firm typically is not required to file holdings reports triggered by position size limits because its most concentrated positions are typically not in exchange-traded equities.

As mentioned above, Capula carries professional liability insurance inclusive of an errors and omission policy with a \$40 million limit for Capula Global Relative Value. Capula Tail Risk Master Fund has a similar policy for up to \$20 million. The firm also has a written disaster recovery plan and has hired [REDACTED] to ensure that its business continues in the event of a disaster. SunGard maintains a backup facility at a site near [REDACTED] and spare servers are housed at technical centre in [REDACTED]. As mentioned above, the manager expanded the [REDACTED] site so that it now has more seats for individuals. All critical risk and position information is backed up using replication software on a real-time basis. In addition, data is backed up to magnetic tape on a daily basis and stored off-site, and the administrator keeps all the official books and records.

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]		

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Investor Protections	
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Disaster Recovery	
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26	
27	

Background

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

<p>[Redacted]</p>	<p>[Redacted]</p>
<p>Legal proceedings</p> <p>[Redacted]</p>	<p>[Redacted]</p>
<p>Regulatory authorities:</p> <p>[Redacted]</p>	<p>[Redacted]</p>
<p>Systems and platforms:</p> <p>[Redacted]</p>	<p>[Redacted]</p>
<p>IT staff size and turnover:</p>	<p>[Redacted]</p>
<p>Backup procedures:</p> <p>[Redacted]</p>	<p>[Redacted]</p>
<p>Business continuity and disaster recovery plan:</p> <p>[Redacted]</p>	<p>[Redacted]</p>

Insurance coverage:	
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Section 2: Trading and Investment Operations

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

_____ serves as the fund's administrator, and _____ are the prime brokers. The _____ and _____ serve as the custodian. The law firms of _____ are retained to advise the funds as needed.

The funds use _____ as its order management and portfolio management system. At the end of the day, trades are also sent to _____ for the funds they each administer. The independent administrators conduct a full reconciliation of all positions, cash, and trades on a daily basis for each of the funds they administer. The professionals in Capula's back office review and sign-off on the administrators' reconciliation and help investigate any trade breaks. The majority of over-the-counter trades are confirmed using _____ and the remainder are confirmed by the administrator who receives a hard copy of the confirmation.

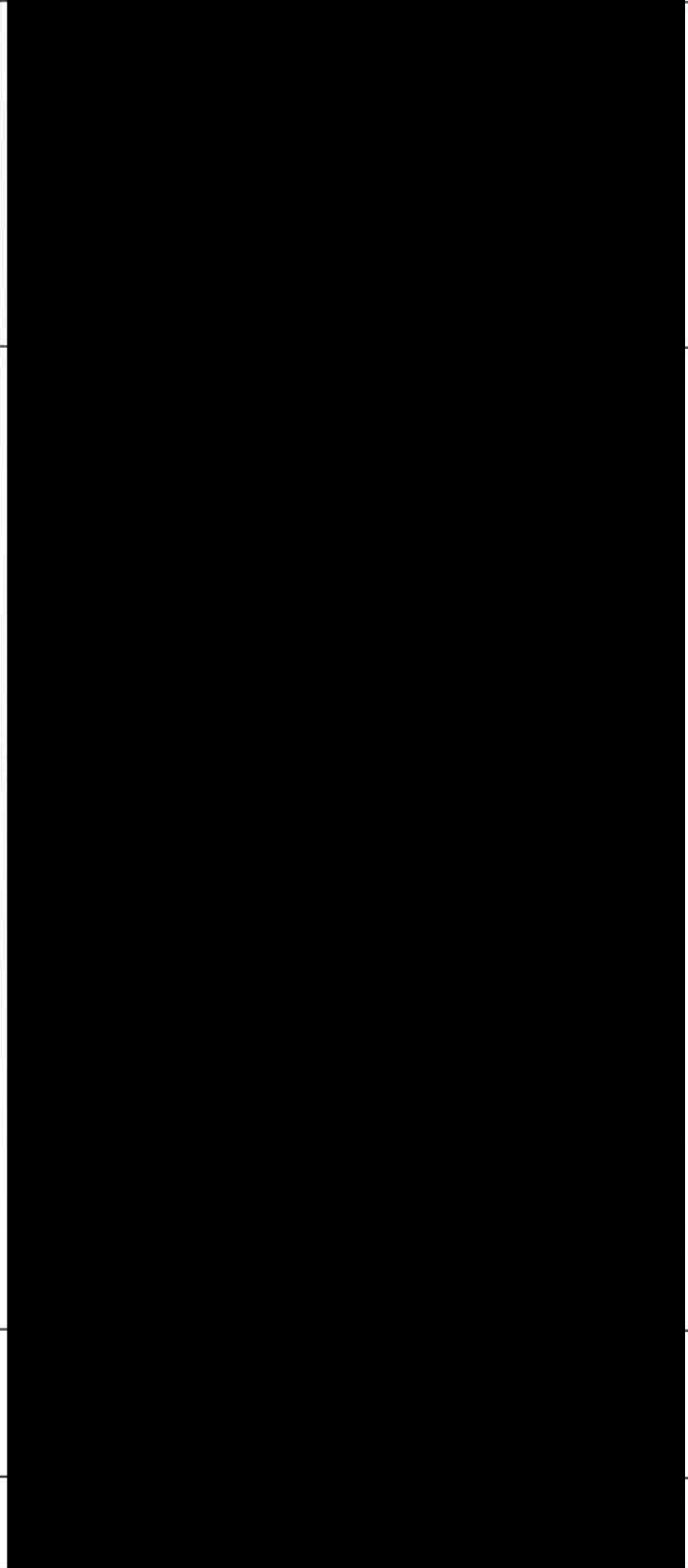

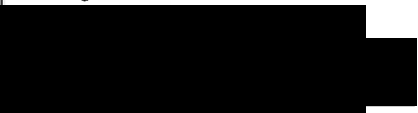

Best Practices Comparison

Outside Service Providers		Yes	No
28			
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30			
Infrastructure			
31			
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Trading Practices			
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Core Accounting Processes			

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Cash,	
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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 its products?		

Criteria	Cliffwater Comments
Organizational Structure: [Redacted]	[Redacted]

	
<p>Control structure and oversight</p> 	
<p>Trading team:</p> 	
<p>Types of securities traded</p> 	

<p>Trading practices:</p> <p>[REDACTED]</p>	<p>[REDACTED]</p>
<p>Trade flow process:</p> <p>[REDACTED]</p>	
<p>Trade confirmation and reconciliation:</p> <p>[REDACTED]</p>	
<p>Specialized groups</p> <p>[REDACTED]</p>	

Reconciliation process with administrator:	
Cash movements:	

Section 3: Financing and Counterparty Risk

Score: [REDACTED]


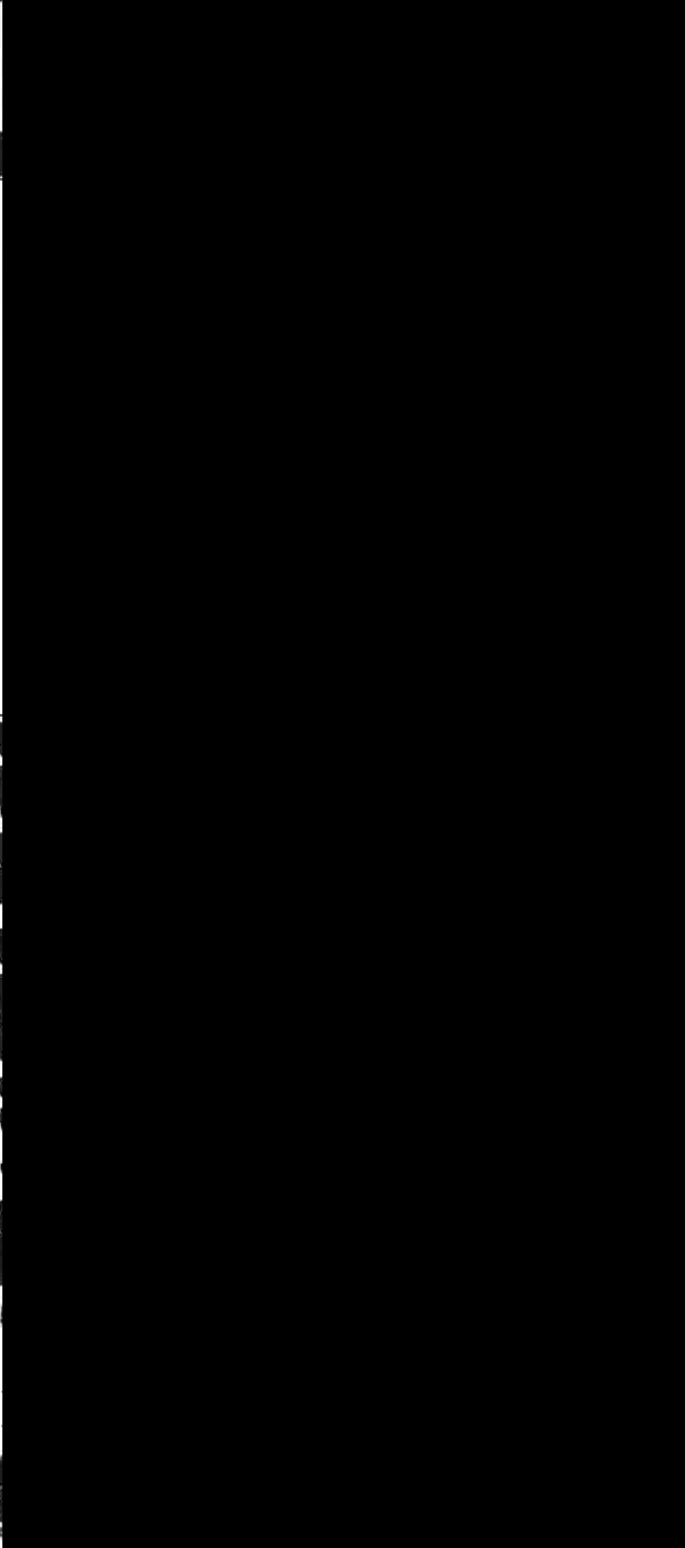
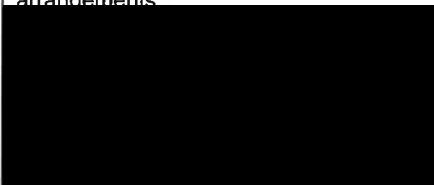
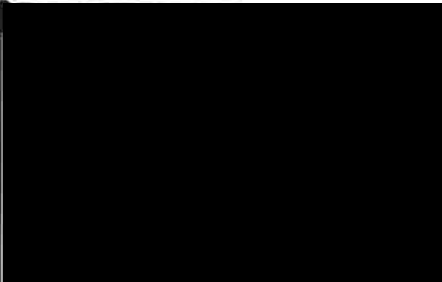


Capula meets all financing and counterparty monitoring best practices which assess how the manager finances its portfolio and manages its cash.

Capula's main sources of financing are margin financing from prime brokers, use of derivative contracts governed by ISDA master agreements, and entering into repurchase agreements. The firm will also enter into reverse-repurchase agreements when it has excess cash. The majority of Capula's prime brokers extend the fund's margin financing for 30 to 45 days. The manager has negotiated ISDA master agreements with 18 to 20 counterparties. As a general rule, the manager tries to limit its over-the-counter counterparty exposure to 20% to a single corporate family. As mentioned above, the manager has formed a counterparty risk committee which meets on at least a quarterly basis to formally review the credit risk of all counterparties. The Risk Committee includes the Chief Risk Officer, the Chief Operating Officer, and members of the treasury group. The relative value funds also have intermediation agreements with [REDACTED] so trades can be "given up" to either bank if Capula becomes uncomfortable with the counterparty risk of its trading partner.

Best Practices Comparison

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

Background

Criteria	Cliffwater Comments
Sources of financing: 	
Counterparties and terms of arrangements: 	
	
Repo agreements 	
	

86	
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Positions with No Readily Ascertainable Market Value	
89	
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Valuation Committee	
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Background

Criteria	Cliffwater Comments
Month end closing process [Redacted]	[Redacted]
Valuation of exchange traded (level 1) assets: [Redacted]	
Valuation of OTC / illiquid instruments / private placement (level 2 and 3) assets [Redacted]	

Section 5: Risk Management

Score:	A
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Capula meets all risk management best practices. Capula uses GlobeOp's risk management platform as its primary risk management system. [Redacted]

These limits and triggers are applied at the fund-level and for each trading portfolio. Capula also implements a macro hedging overlay which increases in periods of overall market volatility.

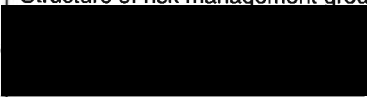
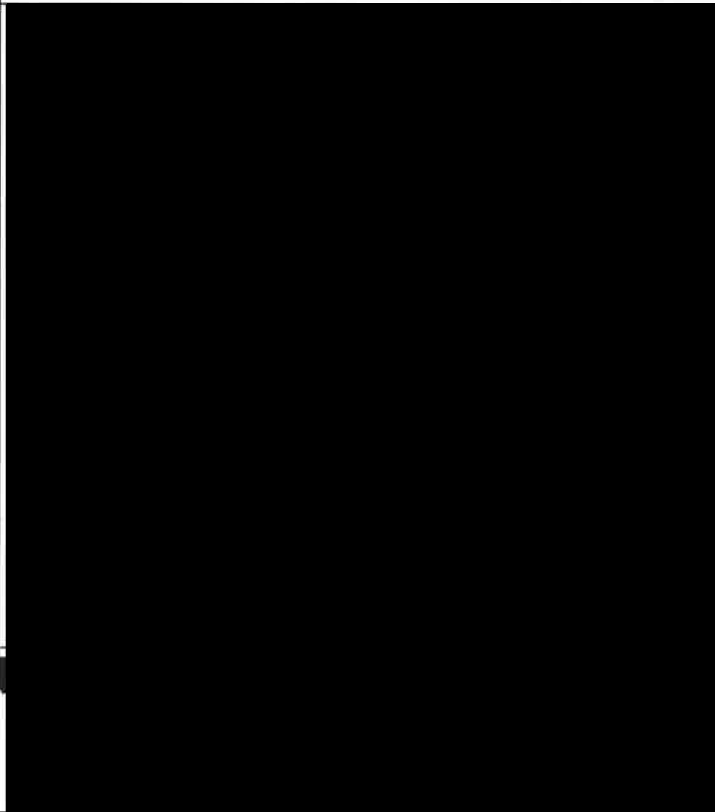
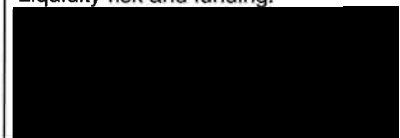
[REDACTED]

[REDACTED]

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	[REDACTED]		
133	[REDACTED]		
134	[REDACTED]		
135	[REDACTED]		
136	[REDACTED]		

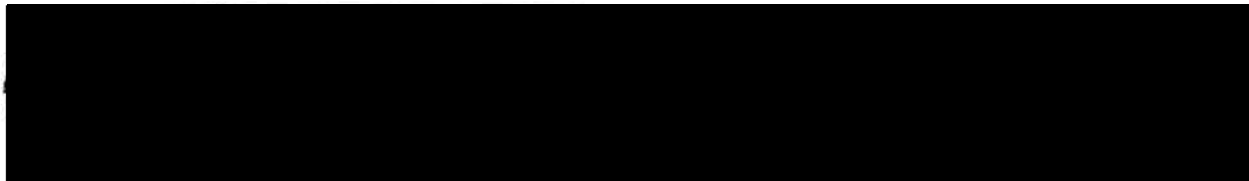
Background


Criteria	Cliffwater Comments
Structure of risk management group: 	
Liquidity risk and funding: 	

Section 6: Investor Related Practices

Score: 

Capula 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.



Capula's financial statements are stated in conformity with International Financial Reporting Standard ("IFRS") and are audited by . Audited financial statements are sent to investors within 120 calendar days of year end, which is in line with the industry standard.


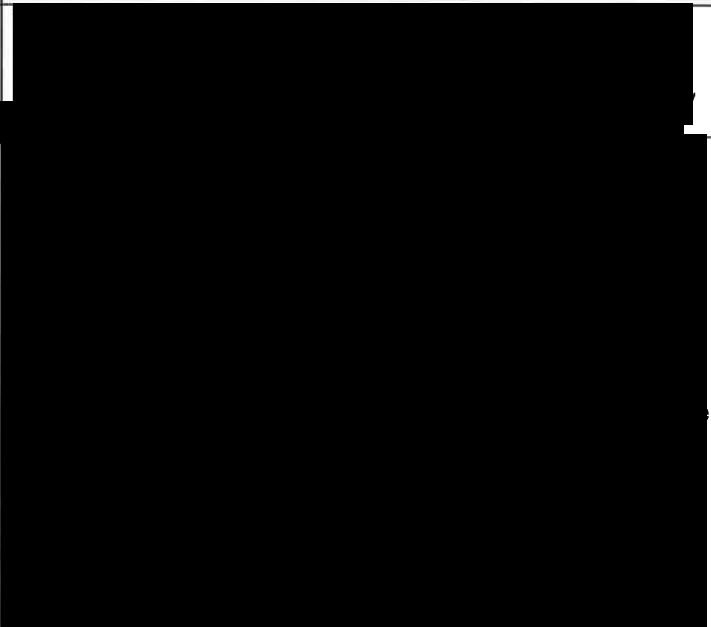
Best Practices Comparison

Initial Disclosures	Yes	No
137		
138		
139		



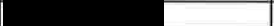
140	
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Fees and Expenses	
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Ongoing	
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Financial Statement and Tax	
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Investor Terms	
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Background

Criteria	Cliffwater Comments
<ul style="list-style-type: none"> Quality and frequency of reporting 	

Criteria	Cliffwater Comments
Fund financial and tax statements: 	

Meeting History

Date	Location	Cliffwater Attendees	Manager Attendees
October 2, 2009	Conference Call		Neil McCallan (COO), Mark Barnett (Treasurer), Ed O'Reilly (IR)
March 25, 2010	London, UK		Neil McCallan (COO), Mark Barnett (Treasurer), Ed O'Reilly (IR)
March 9, 2011	London, UK		Neil McCallan (COO)

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. Mortgage-backed securities are an example of this type of asset.
Leverage	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

	<p>example can be described in at least two ways:</p> <p>a. The portfolio has 200% gross exposure (equal to \$200 gross notional exposure divided by \$100 NAV)</p> <p>b. The portfolio is one time (1x) levered (equal to \$100 in debt divided by \$100 NAV)</p> <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 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) • <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.