

DEMYSTIFYING SIDE POCKETS

INTRODUCTION: WHY ARE WE DISCUSSING SIDE POCKETS?

The unprecedented volatility and reduced liquidity we have witnessed in the financial markets since the second half of 2007, mainly arising from sub-prime mortgages in the US, the liquidity crisis and the alleged fraud cases involving investment managers or brokers-dealers have frozen financial markets. In the absence of liquid markets, issues are arising regarding valuation of most securities. While risk aversion and lack of confidence are becoming the trend, certain investment funds are suffering massive redemptions. In order to fund these redemptions, liquid assets are being sold, sometimes at an excessive discount, generating negative performance and dissatisfaction for remaining investors. As the proportion of liquid assets in the relevant fund progressively decreases, valuation issues become more difficult.

Let's take an example: assume a fund with a weekly NAV facing recurrent major redemption requests. As the fund is mainly invested in liquid assets, the investment manager sells them in priority. The table below illustrates how, with time, the portion of liquid assets may go down, from 90% to 75% of the NAV.

When looking at this example, the following questions might arise:

- To what percentage of NAV can the ratio of illiquid assets increase?
- Are the remaining shareholders being fairly treated?
- Should a side pocket be created to isolate illiquid assets?
- Are there any alternative methods for resolving these issues?

ORIGIN AND PRINCIPLES OF SIDE POCKETS

Side pockets emerged in the late 1980's and early 1990's as a way for hedge funds to invest in real estate and distressed securities. Originally, side pockets were a tool that managers employed on a relatively limited basis. In recent years, however, managers have been employing side pockets with increased frequency. As the hedge fund industry has developed, hedge fund managers are expanding their investment strategies beyond the traditional arena of hedged liquid public securities to include less liquid asset classes, including private equity, venture capital, real estate, distressed debt, mezzanine lending and other illiquid asset classes. These asset classes cannot be sold as quickly as exchange-traded or over-the-counter positions and it is often difficult to determine their market value on a monthly, quarterly, or even an annual basis.¹ A theoretical valuation is most of the times possible, sometimes with unrealistic discounts and/or without taking into account credit risk. In order not to discriminate against redeeming investors, hedge funds may decide to implement a side pocket. In that context, side pocketing can be regarded as a technique to manage illiquidity.

The side pocket aims to segregate illiquid or difficult-to-value assets from the marketable securities held in order to enable the fund to continue offering redeemable shares while protecting the potential value of the isolated assets. Each investment moved into the side pocket is valued on line-by-line basis and remains isolated until it is sold or transferred back into the fund's liquid portfolio. When the assets in the side pocket are realised, the investors participat-

ing in the side pocket receive the realisation proceeds of these assets.

While several techniques exist, the following two techniques are the most commonly used:

- Creation of a side pocket sub-fund;
- Creation of a side pocket share class.

HOW TO SET UP A SIDE POCKET SUB-FUND?

A Fund has one sub-fund, A, with significant illiquid assets. On a specific day, its Board of Directors defines criteria to identify and isolate illiquid assets. A new sub-fund B is launched and illiquid assets from sub-fund A (together with correlated assets and accrued interest, if any) are transferred to sub-fund B. The fund is now comprised of two sub-funds (instead of one).

Shares of sub-fund B are allocated to shareholders of sub-fund A at the time of the transfer of the illiquid assets in proportion to their existing holdings. Such allocation is realised by the exchange of shares of sub-fund A into shares of sub-fund B. Shares representing assets transferred into sub-fund B are treated generally as redeemed from sub-fund A as of the date of the exchange.

Immediately after the transfer, sub-fund B is closed for subscriptions and suspended for redemptions.

Sub-fund B is valued regularly, using the most relevant market, fair valuation prices or amortised cost method, as determined by the board of directors.

Shares of sub-fund B are redeemed progressively (at the fund's initiative) when illiquid assets are realised (in the same proportion for all investors).

Once all illiquid assets in sub-fund B are realised, sub-fund B is definitively closed.

NAV calculation date	Total NAV	Liquid assets	Liquid assets in % of NAV	Illiquid assets	Illiquid assets in % of NAV	Total redemption requests
02-Feb-09	100 000 000	90 000 000	90.00%	10 000 000	10.00%	12 500 000
09-Feb-09	87 500 000	77 500 000	88.57%	10 000 000	11.43%	11 000 000
16-Feb-09	76 500 000	66 500 000	86.93%	10 000 000	13.07%	14 000 000
23-Feb-09	62 500 000	52 500 000	84.00%	10 000 000	16.00%	13 000 000
02-Mar-09	49 500 000	39 500 000	79.80%	10 000 000	20.20%	9 500 000
09-Mar-09	40 000 000	30 000 000	75.00%	10 000 000	25.00%	8 000 000

HOW TO SET UP A SIDE POCKET SHARE CLASS?

The process is similar to the creation of a side pocket sub-fund, except that a new share class (ex: Z class) is created in the existing sub-fund and illiquid assets (together with correlated assets and accrued interest, if any) are allocated to that Z share class. The rest of the process is the same.

ADVANTAGES OF SIDE POCKET SUB-FUND AND SIDE POCKET SHARE CLASS

A side pocket account presents advantages for investors, directors and conducting officers of the fund:

- The creation of a new sub-fund or share class does not constitute a distribution to the investors and, as a consequence, is not considered as a tax event (as it could be in case of redemption in kind).
- Fair treatment of all shareholders is ensured: the manager is not forced to sell liquid assets to meet investor redemptions, leaving the remaining investors with a disproportionate amount of illiquid instruments.
- The suspension of redemptions of the share class or sub-fund does not prevent the investor trading the shares received on a secondary market (or over-the-counter market).
- While maintaining the side pocket account within the fund structure, conducting officers and directors retain their decision making power and there is no change in the roles and responsibilities of the depositary bank.
- There is no specific issue with the counterparty risk or issuer risk for institutional investors (such as fund of funds) as they remain invested in the same type of investment funds.

DISADVANTAGES OF SIDE POCKET SUB-FUND AND SIDE POCKET SHARE CLASS

A side pocket account may also present disadvantages. Some of them are listed below.

- Depending on the nature of the fund, side pockets are rarely pre-authorised in the fund's documents. Prospectus, articles of association or management regulations may need revision.
- For funds registered in foreign jurisdictions for public authorisation, foreign authorities must be notified of the suspension of the

calculation of the net asset value and may impose strict conditions on the operation of the side pocket account or the distribution of the fund.

- Creation of a side pocket may be wrongly perceived or understood by investors and markets and could result in additional redemption requests.
- Side pocket activity is difficult to explain to retail investors.

SOME TIPS WHEN ENVISAGING SIDE POCKETS

Before deciding to opt for a side pocket solution, conducting officers and directors must act in good faith in the best interests of the fund and of all investors. The following questions may be raised:

- 1) Is the side pocket technique compatible with the investment policy and global structure of the fund? Let's take a few examples.
 - A fund aims to invest in a long debt instruments portfolio and, through the use of total return swaps, the return on the long portfolio is exchanged for the return on an index. When building the side pocket, is it possible to transfer the respective portion of the swap to the side pocket?
 - Is it possible to transfer the positions on financial derivatives instruments (credit default swaps, forward contracts) used to hedge the long portfolio?
 - How are illiquid assets the subject matter of securities lending arrangements dealt with?
- 2) Has an adequate portion of illiquid assets been transferred in the side pocket? If, some time after the creation of a side pocket account, the fund is again facing illiquidity issues, the process needs to be started again. As investors and market conditions are not the same, side pocket accounts previously created can not be used to isolate further assets. In this context, it is very important to clearly define criteria to identify and isolate illiquid assets.
- 3) Is the project feasible from an administrative and accounting point of view? In other words, is it possible to allocate a portfolio of securities to a share class in the accounting software? How many investors are there in the fund? Are all investors listed in the register of shareholders of the fund or is the fund distributed mainly via nominees? Are nominees able to operate side pockets?

- 4) Can administrative or custody expenses be charged to the side pocket? Fees should not exceed more than the total expenses ratio of the sub-fund at the origin of the side pocket and should be limited to fees disclosed in the prospectus of the fund. Traditionally, in the hedge funds industry, investments in side pockets generally are not included in a fund's NAV for purposes of calculating performance fees. Side pocket investments are included in periodic calculations of management fees, but performance fees are not calculated or taken with respect to side pocket investments until a valuation or liquidity event occurs. Some offering documents provide that management fees attributable to a side pocket are paid out of the fund's liquid portfolio. Others provide that the management fees are accrued but not actually paid until a valuation or liquidity event occurs².
- 5) At what frequency and how will the side pocket be valued?
- 6) How will the side pocket be monitored? How will it be included in the risk management process of the fund?
- 7) How will investors be informed? Will the marketing networks have the information needed to answer investors' queries? How can consistent information be made available on their website?

CAN WE APPLY SIDE POCKET IN UCITS FUNDS?

In October 2008, the Association of the Luxembourg Fund Industry ("ALFI") set up a working group on side pockets, discussing potential implementation of side pocket techniques in Luxembourg funds. Meetings were also organised with the CSSF.

Side pockets must remain under the control of the fund and its depositary bank. Techniques such as side pocket sub-funds and share classes comply with this requirement. Conducting officers and directors of the fund should be highly involved in the managerial and monitoring process. Side pockets should only be envisaged in extreme cases when no other alternative is preferable with regard to the interests of the fund and its investors. Side pocketing remains exceptional and should be limited to a small portion of assets. Shareholders should be duly and regularly informed about valuation techniques and evolution of the side pocket liquidity.

Approval of the CSSF should be obtained in each individual case. The implementation of side pocket within an investment fund subject to Part I of the Law of 20th December, 2002 on undertakings for collective investment, as amended, is restricted and needs to be discussed with the CSSF on a case by case basis. In consultation with ALFI³, the CSSF has approved a fast-track authorisation procedure for the implementation of side-pocket in:

- investment funds subject to Part II of the Law of 20th December, 2002 on undertakings for collective investment, as amended
- specialised investment funds subject to the Law of 13th February, 2007 relating to specialised investment funds

This fast-track procedure can be used if the assets proposed to be placed in the side pocket represent less than 20% of the total assets of the investment fund. The side pocket should not be used to solve temporary valuation issues or unconfirmed (*i.e.* presumed or potential) illiquidity of assets. The fast-track procedure and related conditions are described in the ALFI newflash dated March 24, 2009³.

On March 13, 2009, ALFI published "technical guidelines for funds of funds concerning the valuation of investment funds affected by Bernard L. Madoff Investment Securities, LLC ("Madoff"). Given the very recent emergence of the alleged fraud and its extent, there is no clear guidance on valuing investments in Madoff exposed funds. When the fund assesses that its exposure in Madoff is significant, measures should be taken to ensure equal treatment of investors and to protect existing shareholders from arbitrage. One of the techniques suggested in the guidelines consists of the creation of a side pocket into which the affected investments are transferred.

ANY NEWS FROM OTHER COUNTRIES?

In Switzerland, The Swiss Funds Association ("SFA") consulted the Swiss Financial Market Supervisory Authority ("FINMA") about side pockets, mainly for funds of hedge funds ("FoHFs"). The key point is that FINMA placed great emphasis on investor protection in its decision, given that in Switzerland – unlike abroad – FoHFs are also sold as retail products. FINMA is prepared to offer assistance in finding quick and flexible solutions within the framework of the fundamental decisions it sets down. That

said, it wishes to refrain from issuing abstract, general rules, and would rather check and discuss the specific problems with applicants on a case-by-case basis⁴.

FINMA confirmed that in light of the current market situation, in the case of Swiss FoHFs and foreign FoHFs authorized for public distribution which resort to measures such as side pocketing, the issue of units of the Swiss FoHFs and distribution of foreign FoHFs must in principle be suspended, both for the liquid and illiquid segments. At present, FINMA does not want to define for how long this suspension of the issue of units of Swiss FoHFs and distribution of foreign FoHFs will continue. Finally, FINMA referred representatives and distributors once again explicitly to their duty to observe the code of conduct set down in the Collective Investment Schemes Act (CISA) and in particular their duties in respect of loyalty, due diligence and disclosure of information pursuant to Art. 20 CISA¹.

In France, the Autorité des Marchés Financiers ("AMF") published recommendations for management companies managing French funds that may be affected by the Madoff affair. In case of significant investments in Madoff, if the management company deems that the information available means it is not possible to accurately value holdings in these investment funds, it must assess the relevance and feasibility of different approaches. One of these approaches consists in the use of side pockets, in accordance with the provisions of Articles L. 214-19 (SICAVs) and L. 214-30 (FCPs) of the Monetary and Financial Code. In the case of SICAVs, an extraordinary general meeting must be called for this type of arrangement. The time required for these procedures may require a prolonged suspension of the NAV quotation, which may harm the investors' interests. Alternative solutions should therefore be examined, such as winding up the fund or depreciating the investment under the procedures proposed for funds with non significant exposures.

ALTERNATIVE METHODS TO SIDE POCKETS?

The following section briefly describes some alternative methods to side pockets.

- Gating: the prospectus of the fund may permit the "gating" of redemptions to delay the redemption process. A typical gate limits redemptions to a fixed percentage of

each redemption request. An alternative method consists in restricting the total amount to be paid by the fund at any redemption period to a fixed percentage of the fund's assets.

- NAV suspension: prospectus or articles of association of funds often enable the conducting officers to suspend the NAV calculation and/or the redemptions.
- Redemption in-kind: upon investor's approval, the fund may propose redemptions in kind.

Gating and suspension can only be considered as short term solutions and do not represent effective solutions to the liquidity issues.

The redemption in-kind alternative presents a lot of constraints: approval of each investor, intervention of the réviseur d'entreprises, ability to value the securities fairly. In addition, it is considered as a tax event in several countries.

CONCLUSION

In a world of constant evolution and unstable market conditions, nobody is currently able to predict the end of the turmoil in the worldwide economy. In that context, side pocketing may be considered as a technique to manage illiquidity while ensuring fair treatment of investors. However, this technique should be used with prudence so as not to reinforce the current lack of confidence and risk aversion thereby potentially resulting in additional trends of massive redemptions.

Side pockets can only be a useful tool if investors are duly informed about the benefits of such action. The involvement of conducting officers and directors in the decision and monitoring process is crucial. ■

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¹ "Side Pockets on the rise – Issues, Analysis, and Impact" – The Review of Securities & Commodities Regulation, Vol. 41, No. 13, July 16, 2008.

² "Side Pockets on the rise – Issues, Analysis, and Impact" – The review of Securities & Commodities Regulation, Vol. 41, No. 13, July 16, 2008.

³ Special ALFI newflash of March 24, 2009 "Side pockets : fast-track procedure for autorisation by the CSSF".

⁴ Extracts from "SFA News 1/09 Spring 2009".