

Side Pocket Investments

Given recent events involving volatility and liquidity in the hedge fund industry, the SEC has singled out side pocket investments as an area of special scrutiny. Side pockets are an accounting provision in fund documents which allow the fund manager to segregate an illiquid or hard-to-value security from the normal trading portfolio. The objective of side pockets is to fix ownership in certain securities to only those investors present at a certain point in time. Of particular interest to the SEC is whether hedge funds using this provision have properly assigned a fair value, disclosed it properly to investors, and have determined fees from the side pocketed portion of the fund. The SEC's Asset Management Unit is currently investigating several funds' use of side pockets and appears to be considering bringing enforcement actions in the coming months. In the meantime, fund managers and their service providers are reexamining the side pocket processes used in their funds. This Element provides an overview of the issues and decisions that go along with creating a side pocket within a fund.

What and Why – the Side Pocket Basics

Fundamental to all investment funds is the concept of participants having an "undivided interest" in the assets and liabilities of a fund. Everything the fund owns or owes is commingled into one portfolio and participants simply own a percentage interest in the whole. While management fees and incentive structures may vary participant-by-participant in a hedge fund, the general fund accounting is simplified by everything else being commingled.

Side pockets are exceptions to the commingling process. When securities are illiquid or hard to value and constitute some significant part of a fund's assets, fund documents may provide for "side pocketing" the investment. This means freezing the participation in the security to those participants currently in the fund, with no participation in the side pocket from subsequent investors and no withdrawals permitted until the security is sold. A fund may side pocket a number of different securities over time, each with a different set of participating investors.

Most fund documents provide for side pocketing certain investments at the fund manager's discretion. Typically this provision is used in two circumstances:

- 1) When the investment is less liquid than the normal portfolio, a side pocket can protect the fund from the effect of investor withdrawals that would otherwise result in increasing concentrations of the illiquid security.
- 2) When a fund has periodic openings which require a solid net asset value, the side pocket eliminates the valuation issue for difficult-to-value securities since new investors don't participate and withdrawals are only from the liquid portion.

Side pockets can arise from an initial planned purchase of an illiquid security or the unplanned shift of status for a liquid asset to a compromised status. The latter has occurred in numerous funds-of-funds, where an underlying fund investment becomes illiquid due to events or securities held by that underlying fund. It is in this latter camp where valuation at the time of side pocket creation becomes crucial.

Side pocketed assets, plus the expenses and fees that relate to both the commingled and side pocketed assets, create a number of accounting complexities that should be carefully considered.

Participation

Typically side pocket participation is based on either the investor's pro rata share of the entire fund or proportional to the non-side pocketed capital at the time of acquisition. Funds with more complex participation limits (such as "no investors will have more than 20% of its capital side pocketed") ideally contain specific language in their documents to make ownership and allocations absolutely clear to participants, administrators and auditors. To ensure fairness, a partnership document should carefully address the effects of additions and withdrawals near the side pocket event.

Expenses and Fees

While many documents are vague, the implications of allocating fees and expenses to investors is material and unbiased fairness is critical.

- 1) *Fund-wide Expenses*: Unless the documents contain specific expense allocation language, the partnership percentage of non-side-pocketed capital or total capital can be used for allocating overall expenses. In a fund wind-down when only side pockets remain or when recovery is several years out, some fund managers will set up a cash reserve for expenses and fees pertaining to the specific side pocket for things such as future K1s or legal expenses.
- 2) *Management Fees*: If management fees are charged based on side pocket capital values, the valuation of the side pocket is material to auditors and investors. Therefore valuation of the side pocket must be substantiated.
- 3) *Hold Backs*: If the side pocket portion does accrue expenses, the fund manager can either retain a hold back from withdrawals to offset future expenses or offset the payable from proceeds of the eventual side pocket's liquidation. Obviously the potential value of the investment is key in making this decision as well.

Incentive Allocations

Another important consideration in side pockets and their impact on investor capital is the incentive allocation. While some documents state that the incentive allocation is based on a "realization event" such as a sale or becoming liquid or at the next normal incentive allocation period, some documents are vague. Similarly, sometimes the incentive on the side pocket is calculated independent of the normal trading account while sometimes it is in combination with the normal trading account. Either way, the approach taken should be dictated by the documents and should be approved by the fund auditor and attorney.

Disclosures

When a fund side pockets an investment, disclosure to investors should be made to explain the "what, when, why and for how long." Investor statements can be noted in a variety of ways to assist in this transparency. The year-end audit will also provide specific information pertaining to the side pocket including limitations on participation and valuation.

Offshore Structures

Side pockets are less common in offshore funds due to the added complexities of share accounting as well as apparent higher levels of concern about liquidity by non-US investors. Typically the side pocket is purchased in a special class with new classes or series for each transaction. Capital is obtained via share redemptions from existing "normal" series.

Expense Allocations. Since participation in a side pocket class is not proportional with respect to all "normal" classes or series of shares, expenses attributable to side pocket shares must either be pre-funded (with a cash reserve held in each Class) or funded periodically by specific equivalent share redemptions from participants' other holdings.

Incentive Compensation. In a conventional offshore fund, incentive fees are charged separately to the series within each class. Accordingly, there is no conventional option to determine an incentive fee based on aggregate performance in combination with the normal trading account.

ALPS Price Meadows ('APM') Reporting Results in Side Pocket Funds

It is customary for APM to provide two types of participant-oriented reports on funds we administer. One is the Investor Statement for the period that contains capital account values and other details unique to each investor. The other is the Performance Report which is a fund level view of performance usually from fund inception, with selected statistics and comparisons with market indexes (plus all the notes that would be appropriate).

Because side pockets are not shared by all investors, they are not typically included in a fund-level report of performance. An investor or prospect seeking information about side pocket results would normally be shown more qualitative information plus economic outcomes for side pocketed positions. It is standard practice to report the "normal" capital account and side pocket capital separately. There are several reasons why:

- The percentage return on normal comingled capital can be considered very accurate. Adding in side pocket valuations, which are typically not accurate on an interim basis, diminishes the value of the participant statement.
- Participant returns can vary slightly due to fee arrangements and timing, but differences would magnify if side pockets were included.
- Side pocket pay-offs (or write-downs) typically are event-driven: the company has an IPO; defaults; or there is a significant financing that justifies a price change. In many cases, a side pocket that is held at a static value, or with just small adjustments at audit time, may rocket or plunge in a single month when valuation becomes apparent. Since it is likely that the result in question was actually earned over a longer time period, plugging that number into a monthly return for an investor may be misleading.

For these reasons, reporting provided by APM defaults to show a percentage return only on "normal" capital and properly notes that on the statements. For special cases, where the above objections are deemed irrelevant, or legal counsel advises a different approach, APM may be able to employ other processes to include side pockets in individual returns on participant statements.

Closing a fund with side pockets

One of the most challenging aspects for a fund with side pockets is deciding a fair and acceptable process for closing the fund. There are several approaches the fund manager can take. One option is to simplify the state of the fund and

decrease expenses but keep it open until the side pockets can be sold at a fair value. Once the fund has liquidated all of the other holdings to cash, the fund manager can pay out the liquid portion less a hold back for future costs. Management must analyze the future cost of holding the fund open for the side pockets in terms of bookkeeping, audit and tax returns and hold back that amount in cash for the worst case scenario, if the side pocket is worthless. A second option is to find a buyer for the side pocket. Since this most likely would be at a discounted price, the fund manager must weigh the cost against the benefit of being able to close the fund immediately. On occasion, a single investor or the fund manager will buy the side pocket from the other investors. A reasonable fair market value must be agreed upon in order to strike a final net asset value. After the fund's final closing period, the security is distributed to that investor and the remaining cash paid out to close the fund.

Conclusion

There is a time and place for a side pocket in a fund. Whether the creation of the side pocket came about because of an opportunity to invest in an illiquid or hard to value investment or because of an unfortunate turn of events affecting the liquidity of the portfolio, the ultimate goal should be fairness and transparency to existing and new investors. Because of the new complexity they add, materiality must also play a part. It is always advisable to consult with fund counsel, auditors and administrator to make a well informed decision specific to each fund.

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