

## Side-Pocket Checklist

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.

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 considered and addressed within a fund’s offering documents. This discussion addresses the common accounting and structural issues associated with side-pockets and provides a rudimentary checklist for document review.

*Note: One drafting strategy that is especially relevant to side pocket complexity is the use of generalities versus specifics whenever possible. While it is important to understand the specific choices outlined below and to communicate those choices to the administrator and auditor, it may be possible to simplify things in the offering documents. An expense discussion, for example, might be generalized by saying, “Each Limited Partner shall bear its share of fund expenses and fees attributable to its side pocket investments, with such allocation procedures and adjustments as the General Partner, in its sole discretion, may deem necessary.”*

### Definitions for this Checklist

1. “SS” is a “Side-pocket Security” or “Special Situation” investment.
2. “SSA” is a Side-pocket Sub Account – a participant’s interest in a specific SS.
3. “NCA” is the “normal” capital account – commingled undivided interest in the liquid securities portfolio.

### When Side Pockets Apply

- Define illiquid securities and state general conditions when the fund’s manager may elect to “side pocket” an illiquid security and when it may not.
  - Is there a general threshold based on individual position or aggregate capital size? Example: “If less than 10% of portfolio is illiquid, fund will generally commingle; if a SS purchase would cause the percentage to exceed 10%, fund will generally sidepocket new purchases or perhaps some of the existing ones.”
  - What are the conditions where a SS could cease to be in a sidepocket (even if still illiquid)?

### Limits

Does the fund specify fund-level or participant-level limits? If the limit is defined as a percentage of overall fund capital, individual early investors’ capital in SSs could easily exceed the fund-level limits. For example, if a new fund immediately side-pockets to a 15% limit, the initial investors will have 15% in SSAs. If fund size then doubles and the fund is again taken up to a 15% fund-level limit in side-pockets, the first investors will have 22.5% in SSAs; the second group will have 7.5%.

- Is there language which limits allocations to SSAs? For example, “by partnership percentage, subject to the X% limit.”
- Are disclosures appropriate in either case?
  - If solely a fund-level limit, consider disclosing that individual participants’ interests in SSAs may exceed the general fund limit.

#### Limits continued

- If a participant-level limit, consider disclosing that some investors may not participate fully or at all in some investment opportunities because of the limit.

*Note: In a fund with participant-level limits, the capital available for side-pockets will be the sum of capital determined to be available participant-by-participant.*

#### Allocations

- For fund-level limits, we recommend defining SSA participation as based on either aggregate (NCA plus SSA) capital partnership percentages or just NCA partnership percentages at the time of acquisition.
- For participant-level limits, we recommend defining the limit based on either current or contributed capital; then, allocations to SSAs by partnership percentage, subject to the X% limit. This method will eventually consume 100% of an investor's potential SSA capital. After X% of capital is in SSAs, no participation in later transactions.

*Note: Avoid proportionality tied to "total available capital for SSAs." Unless 100% of an investor's remaining SSA capital is consumed by one last purchase, the investor would continue to have diminishing participations in each subsequent SSA, since they will always have some proportion of available SSA capital available. The proportion allocated to earlier-arriving investors will decline over time, so a provision to terminate future de minimis SSA participation would have to exist. One negative consequence is that insignificant participations in later SSAs will cause reporting and accounting complexities with likely minimal economic benefit.*

#### Timing

- Ensure that establishing a SSA doesn't trigger a fiscal period mid-month. Since a fund usually uses monthly fiscal periods, use partnership percentages at the beginning of a month to determine participation.
- Record liquidations as capital and profits coming back into NCAs as of month-end.

#### Expenses and Fees

- How are fund-wide expenses allocated to SSAs?
  - If offering documents contain specific expense allocation language, a definition would likely be needed for a partnership percentage that includes both NCA and SSAs. Otherwise, SSAs will not pay their share of expenses.
- Where does cash for fees and expenses come from?
  - From NCA
  - SSA is set up with a cash reserve for expenses and fees
- If LP withdraws from NCA?
  - Minimal NCA balance required to be retained for fees and expenses?
- Fees and expenses accrue as a payable from proceeds of eventual SSA liquidation
  - Interest charged?
  - What adjustments would occur if SSA becomes valueless?

#### Valuations

Fair Value is determined how often and how does it affect asset-based fees?

- Affects if either upward or downward
- Only affects if valuation is downward
- Doesn't affect

#### Incentive Allocations

Universally, changes in valuations do not result in incentive allocations until a "realization event" occurs – such as a sale or if the security becomes freely tradable as a result of an IPO. The incentive charge can occur either:

1. At the next normal Allocation Time after the proceeds of sale of the SS are re-contributed to the NCA
  - Note this means SSA incentives are conditioned on NCA high water mark.
  - Need to assess fund document language re capital moves to and from SSA

### Incentive Allocations continued

- Ensure that the transfer of assets from NCA to SSA is handled as a withdrawal from the NCA, so that it doesn't become a "loss to be made up."
  - To ensure that gain and loss are accurate, the re-contribution will contain a capital component equal to original transfer from NCA to SSA, plus an income amount equal to the P&L on the SSA.
2. Or, in the SSA at the time of liquidation.
- Independent of NCA high water mark?
  - Some other mechanism of recognizing NCA high water mark?
  - Some method of recognizing aggregate SSA high water mark?

### Considerations RE "Follow-on" Investments

If the SS investment is a commitment to a private equity or venture capital fund where cash calls occur in installments over a period of time, there should be special procedures outlined related to funding.

- **Maintaining initial proportions.** To avoid a number of issues re interim valuation and fairness, the participants and proportions in any single SS should be kept constant over the funding period. However, the simplest solution – taking the entire commitment amount into the SSA initially – is usually unacceptable because of the distaste for cash. Accordingly, there will often be sequential contributions to a single SSA from the same participants in the same original proportions,
- **Withdrawals.** There should be limits on NCA withdrawals equal to each investor's share of any commitments not yet called. What if NCA returns are negative and, as a result, the withdrawal limits weren't sufficient? In that case, one solution may be a new SSA (and new investor mix) to cover the shortfall. If the amount is de minimis, it may be appropriate for the fund as a whole to make the investment and treat that small interest as an ordinary asset rather than a side pocket.
- **Cash availability.** Cash calls on VC and PE funds typically must be met within 10 days or so. Accordingly, there must be provisions to access cash or liquidate other investments in time to meet the calls.

- **Timing.** Mid-month funding of cash calls should be considered withdrawals from NCAs as of the beginning of the period.

### Disclosures

- If fund-level limits exist, note that a 15% fund-level limit does not mean that individuals may not significantly exceed that limit.
- If participant-level limits exist, disclose that some investors may not participate fully or at all in some side-pockets because of the limit.
- Illiquidity; lack of accurate valuation; indeterminate allocation amount; etc.

### Offshore Structures

*Note: SSAs 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. There are a number of accounting issues:*

1. **Structure.** SSs are purchased in a "SS Class" with new classes or series for each SS transaction. Capital is obtained via share redemptions from existing "normal" series.
2. **Expense allocations.** Since participation in a SS Class is not proportional with respect to all "normal" classes or series of shares, expenses attributable to SS shares must either be pre-funded (with a cash reserve held in each SS Class) or funded periodically by specific equivalent share redemptions from participants' other holdings.
  - **Which holdings?** Documents should probably suggest FIFO or permit Administrator to choose – proportional redemptions among several share series within a class would be cumbersome.
  - **When?** Monthly redemptions would create a tracking nightmare for investors as well as the administrator, so it's best to specify that it occur on a quarterly or annual basis.

### Offshore Structures continued

3. *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 of both "normal" and SS shares.

It may be possible to reduce the level of complexity in an offshore fund by utilizing a memorandum master feeder arrangement – where "memorandum" accounts are maintained in a master-level partnership for each feeder-fund participant. See the Hedge Fund Elements discussion on Memorandum Master Feeders.

**The Side Pocket Parameter Table is located on the following page.**

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### Side Pocket Parameter Table

**Fund:** \_\_\_\_\_

- When side pocket accounts are established
- All illiquid securities at time of purchase
- If a single illiquid security exceeds \_\_\_\_\_% of capital at time of acquisition
- If illiquid securities, in aggregate, exceed \_\_\_\_\_% of capital

#### Limits

- Limited to \_\_\_\_\_% of fund capital at the time of most recent acquisition
- Limited to \_\_\_\_\_% on a participant level; allocated "by partnership percentage, subject to that limit"
  - based on current capital
  - based on contributed capital

#### Expenses and Fees

- Paid from "normal capital accounts"
  - Limit withdrawals while an investor still has side pockets, requiring a minimum of \_\_\_\_\_% in "normal capital"
  - No withdrawal limit; expense share paid by fund overall; reimbursed when SSA is sold, with interest to fund overall at \_\_\_\_\_% rate
- Reserve of \_\_\_\_\_% to be established in each SSA

#### Incentive Allocation

- Incentive rate on side pockets is different from "normal" accounts: \_\_\_\_\_%.
- Charged separately in each side pocket at the time of a realization event
- Charged at the side pocket level, with a high water mark related to other side pockets
- Charged after a "realization event" when proceeds are transferred to investors' "normal capital accounts" with a high water mark related to the overall capital account (including other closed side pockets) at the normal incentive calculation period

#### Valuations & Asset-based Fees

- Affects fees if valuations go either upward or downward
- Affects only if valuation is downward
- Doesn't affect – based solely on cost
- Side pocket capital excluded from asset-based fees

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