Side Pockets

by Ernest Morrison

Introduction

As the fund industry continues to evolve and reacts to the enormous influx of capital and investors, many operators find that some strategies have been overrun and effectively commoditized. Managers have been forced to disinvest and move capital to strategies, markets and asset classes where they can retain an edge. The purpose of this article is to describe one aspect of this evolution and the corresponding need to implement side pocket accounting.

The clear trend in the hedge fund industry is for multi-strategy funds to encounter an escalating number of private investment opportunities. The diverse number of strategies, markets and asset classes in which funds participate puts them squarely in the intersection of opportunities that, though private in nature, flow from the manager's involvement and expertise in public market investments. Indeed, it is now apparent that the skills that have been honed in the public markets, including those in credit and fundamental analysis, quantitative modeling, distressed investing and restructuring tactics, financing, deal structuring and evaluating, hedging and managing risk, have put managers in an advantageous position to source and exploit such opportunities.

For example, public market investment activities in the distressed and structured finance spaces have led managers to private investment opportunities that are considered compelling. While in some cases these private investments may be illiquid in nature, an illiquidity that managers believe they are being well compensated to assume, this is not their defining characteristic. Rather, these investments are distinguished by their profit profiles (which tend to be "hockey stick" or "digital" in nature and, therefore, are generally held at cost until there is an event that triggers the profit realization) and, in some instances, by the difficulty in regularly establishing a fair market valuation. Properly establishing fair value for physical assets, private enterprises and other similar investments generally requires expensive and time consuming appraisals or valuation studies.

A number of the private opportunities that have come across the plates of hedge fund managers have been extraordinarily compelling. They believe that these are major alpha opportunities that, within the limits of prudent liquidity management, they want their investors to share. While often few in number and small as a percentage of capital, managers expect to find additional highly desirable private investments to add to the portfolio. Moreover, it is anticipated that there will be increasing instances in distressed investing where, as a result of the restructuring process, investments in public securities will naturally evolve into private investments.

The exposure of managers to, and ability to find and properly manage, private investments is the result of considerable advance ground work and is no accident. This work has been fueled by the "convergence" that all serious participants have seen occurring in the asset management business. Over the past two years, many

management groups have been supplementing their existing investment team with first class, experienced talent in select private asset classes. Part of this effort stems from the desire to create new fund structures focused solely on investments that can never properly be a dominant part of a highly diversified, liquid fund.

More than ever before, optimizing returns in the public markets will require skill sets, day-to-day knowledge of market conditions and access to quality deal flow from asset classes and industry sectors that have traditionally been the domain of private investors, such as private enterprise, physical assets, energy, non-syndicated lending, select real estate opportunities and intellectual property. Managers are seeking to take advantage of investments in these areas and believe that a growing stable of investment talent will enhance their client fund's public market and private investing.

Side Pockets

Both established and new fund managers have made accommodations in their fund structure for the convergence of public and private market opportunities. Side pockets are intended to protect the interests of current shareholders in such private investments in several respects, including potential dilution of investments in the fund.

Under the side pocket mechanism, when a "side pocket" eligible investment is made, only the investors in the fund at that time may participate in that investment, and those investors cannot redeem this portion of their capital in the fund until the investment is liquidated. This prevents the interests of the original investors from being diluted by subsequent investors who will not have shared in the risk of the investment, which will be valued at fair value (most often will be cost) until the investment is realized. No incentive compensation is collected on such investments until the investment is realized, which aligns the manager's compensation with such realization event.

Typically, a limited portion of an investor's capital will be tied up for a longer and less certain period of time, but manager believes that the very attractive return opportunities will more than compensate investors for this inconvenience. Correspondingly, it is appropriate that managers must defer performance compensation in order to capitalize on these investments and are prepared to do so for what they perceive to be compelling opportunities. Ideally, given that such investments will be staggered over time, the realization events will also be staggered. Accordingly, investors will obtain additional liquidity as these investments "roll off" and the proceeds are removed from the side pockets and placed back into the main portion of the Fund. Although some of these side pockets may have brief life spans, the average life will generally be in the two to three year range (although some may be even longer than that).

A side pocket not only eliminates the potential unfairness associated with future dilution, it also enables managers to invest more efficiently and effectively because the side pocketed investments will not impact unforeseen redemption pressures. The comings and goings of individual investors will not force premature sales of portions of the side pocketed investments, which by virtue of their illiquid or indivisible nature may be ill suited for piecemeal sales. Also large-scale withdrawal pressures would not require managers to make the Faustian choice of either redemptions in-kind or over-concentrating the remaining investors with less liquid investments.

Certain investors are unable to remain invested in funds that implement side pockets Many funds we are consequently implementing a new class of shares that investors may select, which will not participate in

any side pocket investments. This new class of shares will usually be subject to management fees which are consistent with the terms of many of large, multi-strategy funds.

Obviously, the risk (and in some cases the fear) is that the introduction (or presence) of side pocket structures in funds, create a private equity/buyout firm within the fund, which will primarily compete for classic private equity plays being competitively auctioned off amongst the well known private equity firms. The challenge for fund managers is to capture for their investors the very attractive investment opportunities that they find as a matter of course in the areas that exist at the intersection of public and private markets. From investments that evolve from stocks, bonds or bank debts into "still cheap" private equity or physical assets, to smaller opportunities that arise from the specialized niches and unique local relationships focused upon by both the public and private market regional teams of fund managers, it is often believed that such investments fit the objectives of the fund well and complement the diverse spectrum of liquid public market investments that will continue to dominate most funds.

Many, if not most, newly formed large hedge funds have some form of side pocket accounting, and a number of large, established multi-strategy funds have either adopted or are in the process of adopting such accounting. When introducing side pocket arrangements, a primary concern for directors is to strike an appropriate balance between return optimization and liquidity

Typical structure

Typically, funds with side pockets are organized to allow the Fund to hold investments ("Special Investments") in side pockets.. A Special Investment will be any asset or security (and corresponding hedge position) that the manager determines, in its discretion, that either is difficult to establish a market value or should be held until the resolution of a special event or circumstance; provided that the manager is not obligated to deem every such investment as a Special Investment.

For each Special Investment, a separate class of side pocket shares (collectively, "Class S Shares") will be created to hold such Special Investment. Each Shareholder participating in a particular Special Investment will redeem a pro rata portion of its current class of shares ("Shares") at the current Share NAV and will subscribe for the same amount of the class of Class S Shares which will hold such Special Investment. At the time of such redemption, the High Water Mark attributable to such Shares will be reduced proportionately based on the percentage of Shares redeemed. No Incentive Fee will be paid on such redeemed Shares, but any Incentive Fee accrued with respect to such redeemed Shares will be separately accounted for until realization or deemed realization of the corresponding Special Investment (the "Set Aside Accrual").

A Shareholder's participation in Special Investments will typically not exceed a limit, usually expressed as a percentage of the sum of the Share NAV of such Shareholder's Shares and the Original Value (defined below) of such Shareholder's Class S Shares (the "Special Limit"), in all cases calculated at the time of each new Special Investment. If a Shareholder's investment in Special Investments equals the Special Limit, such Shareholder will not participate in new Special Investments. Any such new Special Investments will be allocated among the other Shareholders of the Fund pro rata based on the net asset value of their Shares until such Shareholder's Special Investment participation is no longer at the Special Limit. Accordingly, different Shareholders may have different percentage interests in, and may participate in, different Special Investments.

For purposes of calculating the Incentive Fee, net capital appreciation will take into account only gains and losses with respect to Special Investments only if such Special Investments have been realized or the Manager

determines that they should no longer be treated as a Special Investment (a "deemed realization"). Until such realization or deemed realization, the value of the Special Investment will not be taken into account in determining the net capital appreciation and net capital depreciation for the year. Upon a realization or deemed realization of a Special Investment, such Class S Shares of a Shareholder will be redeemed. The redemption proceeds will be used to subscribe for Shares at the current Share NAV, adjusting the High Water Mark in an amount equal to the deduction of such High Water Mark upon the purchase of such Class S Shares. In addition, the Incentive Fee accrual with respect to the Shareholder's existing Shares shall be adjusted to take into account the Set Aside Accrual and any realized appreciation or depreciation attributable to the redeemed Class S Shares. Equalization Shares may be issued to the extent needed to account for different High Water Marks among the Shares.

For purposes of calculating the Management Fee, the Class S Shares are valued at Original Value, as adjusted by the Administrator in the event the Manager determines that there has been an impairment in value of, or a significant market change that alters the value of the Special Investment according to the Manager's valuation criteria. Each class of Class S Shares will have an initial aggregate net asset value equal to (i) the fair value of the Special Investment (which will generally be cost if the investment is designated as a Special Investment at the time of investment) plus (ii) any accrued amounts for Follow-On Investments (which is an additional investment in the same or similar investment for which the side pocket was established) or maintenance expenses, each as determined by the Manager/Administrator at the time the Special investment is established (the "Original Value").

A Shareholder generally will not be able to redeem any portion of its Class S Shares until such realization or deemed realization. In addition, if a Shareholder redeems all or substantially all of its non-Class S holdings, proceeds with respect to such redemption may be reserved or held back to pay for the Management Fee expected to be earned over the life of the Special Investments. Any unearned portion of the management fee for which such reserve or holdback was made will be paid to the Shareholder at final realization. If a Shareholder has otherwise redeemed from the fund (or is owed outstanding redemption proceeds due to a redemption request), such Shareholder will receive his or her interest in the realized or deemed realized Class S Shares, net of the accrued Management Fees, if any, and the Incentive Fee, if any, with respect to such Class S Shares, within prescribed period after the end of the accounting period in which such realization or deemed realization occurs. Distributions in respect of realized (or deemed realized) Special Investments can be made in cash, or, in the event of dissolution and liquidation of the fund, in kind.

Conclusion

Given the enormous influx of new capital into hedge funds in recent years, fund managers are under substantial pressure to invest in areas not normally associated with hedge funds but which nevertheless provide the prospect of attractive returns for investors. Side pocket accounting allows funds (and their investors) to participate in private and less liquid investments in a way that is intended to be beneficial as well as fair and equitable to all investors.

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