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SIDE POCKETS ON THE RISE – ISSUES, ANALYSIS, AND IMPACT

Illiquid or hard-to-value investments segregated in “side pockets” of hedge funds generally are not included in net asset value for purposes of performance fees or for processing subscriptions or redemptions. Their use protects long-term investors from forced sales of such investments to fund redemptions, but also raises issues of valuation, disclosure, and reduced liquidity.

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Hedge funds use separate accounts known as “side pockets” to segregate and hold illiquid assets in order to manage hybrid portfolios of marketable securities and illiquid investments. With the expansion of hedge fund strategies to include private equity and other longer-term illiquid investments, side pocket arrangements have become more prevalent and, consequently, the subject of increased investor attention and regulatory scrutiny.

This article describes the terms and operation of a basic side pocket account, discusses the origin and rationale underlying the use of side pockets (including valuation conflicts and liquidity issues that the side pocket structure was created to address), analyzes the reasons for the growth in the use of side pockets, and looks at various issues raised by the use of side pockets, including the current “hot button” issue for both regulators and investors – valuation – and the resultant impact on performance and fee calculation.

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SIDE POCKETS – A PRIMER

A “side pocket” is a structural accounting tool used by hedge fund managers to separate certain illiquid or otherwise hard-to-value assets from the fund’s main portfolio of liquid assets. Each investment that is designated for, or moved into, a side pocket is segregated in its own account and is valued, on an investment-by-investment basis, separately from the remainder of the fund’s portfolio. Traditionally, side pocket investments have been valued at cost.¹ Each side pocket investment remains segregated in its own account until the investment is sold, or the manager decides to transfer the investment back into the fund’s liquid

¹ Financial Accounting Standard (FAS) 157, which is the new fair value measurement standard that must be used for fiscal years beginning after November 15, 2007, is discussed below in the section captioned “Recent Issues.”

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portfolio (generally as a result of a valuation or liquidity event such as an IPO). Accordingly, investments in side pockets generally are not included in the fund's net asset value ("NAV") for purposes of calculating performance and fees or for processing subscriptions and redemptions.

In general, only the investors in a fund at the time the side pocket for a particular investment is created participate in the subsequent profits, losses, or expenses attributable to that investment.

Typically, investors with ownership interests in side pockets will be subject to an unlimited lock-up period with respect to their share of the assets contained in those side pockets; an investor that seeks to fully redeem from a fund generally will be required to maintain an ownership interest in the fund to the extent of its *pro rata* share of side pocket accounts, which will continue to be subject to market risk and to be charged management fees and expenses.² The investor will not receive distribution proceeds with respect to its *pro rata* share of side pocket accounts until the assets in those accounts are disposed of or otherwise become part of the fund's liquid portfolio.

Side pocket investments typically are included in periodic calculations of management fees,³ but performance fees generally are not calculated or taken with respect to side pocket investments until a valuation or liquidity event occurs.

² It should be noted that Treasury Regulations under Section 409A of the Internal Revenue Code make it potentially problematic to accrue management fees in a side pocket when the regular shares have been fully redeemed. Some managers deal with this issue by funding such management fees with advances in respect of the investor's remaining interest in the side pocket. Upon payment of the redemption proceeds relating to the side pocket, the sum of such advances, plus interest, is deducted from such proceeds.

³ Some offering documents provide that the 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 occurs.

RISE IN THE USE 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. The reasons for this increase are discussed below.

In general, the traditional hedge fund is structured as an open-ended fund that invests in publicly traded liquid assets that can be priced accurately and sold quickly. The overall value of the fund can be "marked to market" on a regular basis and the fund's assets can be reduced to cash quickly. The fund's liquidity allows the manager to process subscriptions and redemptions on a regular and continuous basis and to charge fees (both management- and performance-based) based on marked-to-market values at regular and periodic intervals.

As the hedge fund industry has developed, the amount of capital under management and available for investment has swelled to an estimated \$1.5 trillion. In order to maximize returns in a crowded and competitive marketplace, 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, activist investing, and other illiquid asset classes.⁴ These asset classes cannot be sold as quickly as exchange-traded or over-the-counter positions and it often is difficult to determine their market value on a monthly, quarterly, or even an annual basis.

Managing these less liquid asset classes within the traditional hedge fund framework has posed valuation and administration problems for hedge funds, which, as

⁴ Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 *Buff. L. Rev.* 251 (2006); Michael G. Tannenbaum, *Convergence of Hedge Funds and Private Equity Funds*, Mar. 21, 2006, <http://www.thehfa.org/Articles.cfm?CFID=5497691&CFTOKEN=89425966>.

discussed above, historically have been structured to mark the fund's value to market on a daily basis and to report results to investors (both on realized and unrealized gains and losses) on a periodic and regular basis. Consequently, hedge fund managers increasingly are turning to side pockets to manage "hybrid" portfolios of marketable securities and illiquid assets.⁵ Managers also are using side pockets to hold investments with unrealized value, such as control positions acquired by activist investors or distressed debt investments. Side pockets allow the manager to maintain a liquid open-ended structure for the fund's core liquid portfolio holdings (charging management fees on NAV and performance fees annually on realized and unrealized profits), while simultaneously operating an investment-by-investment closed-end private equity approach for the fund's illiquid holdings, with management fees calculated based on cost and incentive fees charged only on actual realized proceeds.

POTENTIAL BENEFITS

The side pocket structure was created to address administrative, accounting, valuation, and redemption issues for hedge funds whose portfolios contain illiquid assets. Valuation conflicts that otherwise would arise every reporting period, and with each new subscription and redemption, are avoided by limiting participation in a side pocket investment to investors who are in the fund at the time the side pocket account is created for that investment.

Side pockets also can serve to protect longer-term investors by reducing their illiquidity risk with respect to the fund's illiquid investments. In the absence of side pockets, the fund would likely sell liquid assets to satisfy investor redemptions, thereby leaving the remaining investors with a disproportionate amount of illiquid assets. After the fund's liquid assets were depleted, the fund would be forced to sell the illiquid assets at discounted "fire sale" prices to satisfy later redemptions. Thus, side pockets can protect longer-term investors who remain in a fund against the adverse timing of unexpected or unexpectedly large redemptions, which might otherwise result in those investors being left with

⁵ *Hedge Funds: Side Deals Move to Front*, Sec. Industry News, May 8, 2006; Jeff Benjamin, *Hedge Funds Increase Use of 'Side Pocket' Investments; Isolate Hard-To-Price Assets Such as Private Equity from Rest of Portfolio*, Investment News, Dec. 12, 2005; Susan Barreto, *Pocket Protectors: Private Equity and Hedge Funds Mix*, HedgeWorld Daily News, Nov. 17, 2005; Janet Lewis, *More Hedge Funds Aim for Side Pockets*, Investment Mgmt. Wkly., Oct. 24, 2005.

difficult-to-value illiquid positions, while the early departing investors reaped the benefit of the fund's liquid positions.

RECENT ISSUES

As part of the larger and more general interest in hedge fund valuation procedures, particularly with respect to illiquid securities,⁶ the improper use of side pockets has emerged over the past few years as an SEC enforcement priority.⁷ The following are some of the key issues and important developments.

Valuation, Performance, and Fee Calculation

Although the side pocket structure generally prevents a hedge fund manager from artificially inflating the value of the fund's *illiquid* investments in order to boost returns, many fund documents provide the manager with the discretion to move investments into a side pocket at any time. Regulators have expressed concern that some managers may have abused this discretion to inflate artificially the value of the fund's *liquid* portfolio.⁸

The SEC has noted that if poor-performing assets are segregated in a side pocket, and thus excluded from portfolio valuation, investors could be getting an incomplete or inaccurate picture of the fund's performance.⁹ Further, from a risk-management perspective, if side pocket investments are excluded, the fund's diversification numbers may not accurately capture the true nature of the portfolio. All of these factors have the potential to skew the analysis of a

⁶ Mara Der Hovanesian, *The SEC Isn't Finished With Hedge Funds*, Bus. Wk., July 17, 2006, available at http://www.businessweek.com/magazine/content/06_29/b3993055.htm?chan=search. (Susan Ferris Wyderko, former acting director of the SEC's Investment Management Division, said in congressional testimony that many past enforcement cases against hedge funds involved the "valuation of fund assets in order to hide losses or to artificially boost performance" -- and that this became a significant part of the examination process.)

⁷ Sabrina Willmer, *Side Pockets Emerge as SEC Enforcement Priority*, Alternative Investment News, Nov. 6, 2006; see also Chidem Kuras, *SEC Seeks Info on Side Pocket Misuse*, HedgeWorld Daily News, Nov. 8, 2006.

⁸ See, e.g., Speech by SEC Commissioner Roel C. Campos: Remarks Before the SIA Hedge Funds & Alternative Investments Conference (June 14, 2006), available at <http://www.sec.gov/news/speech/2006/spch061406rcc.htm>.

⁹ Sabrina Willmer, *Side Pockets Emerge as SEC Enforcement Priority*, Alternative Investment News, Nov. 6, 2006.

fund's returns, making it difficult to compare performance across different strategies, funds, and firms.

FAS 157

Financial Accounting Standard (FAS) 157, which is the accounting industry's new fair value measurement standard, is likely to raise additional challenges for valuation of illiquid or alternative assets, particularly with respect to side pocketed investments. FAS 157 requires firms to determine fair value based on an exit price, using assumptions that market participants would use in pricing the asset or liability. The clarification by FAS 157 that fair value is based on exit price, not entry price, may result in a change of practices for investment managers that typically have carried side pocket investments at cost for significant periods of time. Valuation on the basis of cost will no longer be sufficient, unless it can be demonstrated that such valuation comes closest to meeting the new fair valuation standard. In many cases, further valuation steps will be expected, including the use of comparable company transactions, performance multiples, or other approaches, to determine the "exit value" of fund components as of the reporting date.

Adequacy of Disclosure

The SEC also has expressed concern as to whether the use, terms, and associated risks of side pockets are adequately disclosed to investors.¹⁰ At issue is the adequacy of disclosure with respect to (1) whether a particular fund uses, or has the authority to use, side pockets, (2) the restrictions and criteria, if any, for when fund managers are permitted to move existing investments into side pockets, and (3) the attendant risks and conflicts involved with the use of side pockets.

Reduced Liquidity

Because the documentation of most funds permits fund managers to move investments into side pockets at any time, and because investors generally are permitted to make withdrawals from a side pocket only to the extent that the side-pocket investments are sold or otherwise transferred back to the fund's liquid portfolio, side pockets could be used to "lock up" investors' funds. However, given that the documentation for most funds provides the manager with broad authority, under a variety of circumstances, to limit or suspend withdrawals

and to defer the determination of NAV, the additional liquidity risk posed by side pockets is minimal.

A potential investor with concerns about a side pocket's impact on liquidity should conduct appropriate due diligence to assess the fund's historic use of side pockets and the conditions governing the manager's use of side pockets in the future. In addition, investors can attempt to negotiate directly with the fund manager to obtain provisions that would mitigate the resultant impact of side pockets on the investor.

Finally, investors can always "vote with their feet" if a fund's liquidity falls below a level that is acceptable to them. For example, in August 2006, Mellon Global Alternative Investments decided to drop a longstanding credit fund from two of its funds-of-funds because the credit fund manager introduced the ability to side pocket up to 25% of the fund's assets. Despite the credit fund's strong performance, Mellon determined that the credit fund's ability to use side pockets was not consistent with Mellon's broader liquidity policy with respect to its ultimate investors.¹¹

CASE STUDIES

Ritchie Capital

In 2004, Ritchie Capital, like many other hedge funds, began expanding into private equity. In September 2005, it decided to move a significant portion of the fund's portfolio into side pockets. At an investor meeting held in May 2006, investors expressed their disapproval of this decision. In particular, investors objected that poor-performing debt of Adelphia Communications Corporation, the bankrupt cable company, had been transferred into a side pocket, even though many Adelphia bonds were actively traded, but that the fund's holdings in SemGroup, a closely held energy company, had not been transferred into a side pocket. Investors argued that Ritchie had marked SemGroup too low and that the position would be more beneficial in a side pocket.

After the transfer of the Adelphia debt into the side pocket, Ritchie's flagship fund rose by about 7% through May 2006, but the value of the side pocket investments dropped by approximately 6% through the end of April 2006. If the Adelphia debt had not been transferred into a side pocket, those losses would have reduced the flagship fund's gains to approximately 5% (and Ritchie's performance fee would have been reduced accordingly).

¹⁰ Gregory Zuckerman and Scott Patterson, *Moving the Market – Tracking the Numbers/Street Sleuth: 'Side-Pocket' Accounts of Hedge Funds Studied*, The Wall Street Journal, Aug. 4, 2006.

¹¹ *Mellon Ditches Manager Over Side Pockets*, Alternative Investment News, Aug. 21, 2006.

The side pocket dispute caused a near investor revolt, as investors withdrew an estimated \$1 billion, partly in response to the controversy, and set off a cycle of negotiations between Ritchie Capital and disgruntled investors.¹² Ultimately, Ritchie Capital struck a deal to sell 40% of the portfolio of its multi-strategy fund (including the stake in SemGroup).¹³

Scion Capital

There can be value in allowing managers to transfer investments into a side pocket and to suspend redemptions rather than being forced to value those investments in unfavorable circumstances, or to sell them at a loss to accommodate investors seeking to redeem their investments in a short period of time. Side pockets can, in essence, enable a fund manager to “save investors from themselves” in order to stabilize the fund and allow the true value of the fund’s investments to be realized.

This was the case with Scion Capital, a \$700 million hedge fund in Cupertino, California. In May 2005, Scion concluded that the housing market was in trouble and used credit derivatives to short the riskiest parts of certain subprime mortgage pools issued in 2005, in effect purchasing insurance that would be paid out if the value of the underlying subprime mortgage pools dropped below a certain point.

Because the subprime market continued to flourish in the short term, the credit derivative investments initially hurt the overall performance of the fund. Through the first nine months of 2006, Scion Value Fund and Scion Qualified Value Fund were down 16.4%, with a large part of the loss coming from the credit derivative positions. The funds ended the year down 17%, most of which was attributable to the credit derivative positions.

In the face of rumors that two large investors were planning to redeem their positions in the funds, Scion decided to move the poor performing credit derivative

positions into a side pocket, despite objections by some of the funds’ investors. Scion cited the best interests of investors as the basis for the decision, arguing that side pockets would allow it to stabilize the funds and allow the true value of the funds’ investments to be realized.¹⁴ As it turned out, Scion was right; when the subprime market collapsed, the side-pocket investments became extremely profitable, and investors in the Scion funds benefited from the move, realizing a return of more than 400%.¹⁵

CONCLUSION

Side pockets can provide hedge funds with operational and strategic advantages, including enhancing their ability to take advantage of long-term investment opportunities that have the potential to boost investment returns. Consequently, the authority to use side pockets is now almost market standard for fund documentation. With some of the world’s best-known and largest hedge funds becoming increasingly active in the private equity marketplace, this trend is likely to continue.¹⁶

Although the SEC and others have noted the potential for the abuse of side pockets, this does not appear to have deterred investors. Total hedge fund assets continue to grow, and exchanges in non-US jurisdictions, such as the Irish Stock Exchange, are becoming more liberal with respect to the use of side pockets in listed funds.¹⁷ However, fund managers

¹² Gregory Zuckerman, *Ritchie Capital Tries to Stem Drain of Investors as its Returns Decline*, The Wall Street Journal, Aug. 31, 2006.

¹³ Jenny Anderson, *Ritchie Capital Said to Be Close to Selling Assets in Major Fund*, The New York Times, Dec. 14, 2006; Gregory Zuckerman and Scott Patterson, *Ritchie Capital Reaches Deal to Sell Assets of Largest Fund*, The Wall Street Journal, Dec. 14, 2006; *Reservoir buys Ritchie Capital assets in \$1 bln deal*, Apr. 26, 2007, Reuters, <http://www.reuters.com/article/mergersNews/idUSN2648139120070426>; Scott Patterson, *How Ritchie Dodged Early Grave With Broad Investment Changes*, The Wall Street Journal, Oct. 17, 2006.

¹⁴ *Scion Investors Irked by Swap ‘Side Pocket’*, Hedge Fund Alert, Nov. 29, 2006.

¹⁵ Jenny Anderson, *Winners Amid Gloom and Doom*, The New York Times, Mar. 9, 2007 (noting that in early August 2006, the cost to insure \$10,000 worth of low-rated tranches of subprime MBS was approximately \$217, and that by the end of February 2007, the cost had risen to almost \$2,000).

¹⁶ Kelly Holman, *ACG InterGrowth Conference: Where Hedge Funds and PE Converge*, Dealscape, May 4, 2007.

¹⁷ Effective April 28, 2006, the Irish Stock Exchange adopted a new rule that makes ISE listing easier for investment funds with separate share classes representing special situation or illiquid investments, *i.e.*, side pockets. Before the rule, ISE treated side pockets as separate funds, making it impossible for most to meet ISE diversification and redemption requirements. The new rule effectively treats side pocket assets and the main portfolio as a single fund for purposes of ISE diversification restrictions. An earlier change eliminated the rule that investors in a side pocket be able to redeem quarterly. The new rule does require that no more than 30% of gross assets of the fund be invested in the side pocket and requires that the fund not permit direct investment solely in the side pocket.

should expect that the SEC and other governing bodies will continue to scrutinize side pockets for potential misuse, as part of the larger regulatory objective to pursue hedge fund misconduct and to push for greater transparency in the hedge fund industry in general.¹⁸

If a hedge fund plans on using side pockets (or desires the flexibility to do so in the future), and wishes to address potential SEC concerns, it is prudent to ensure that the fund offering documents contain detailed disclosure of the applicable terms, including: (i) the extent of the manager's authority to use side pockets; (ii) the types of investments that may be side pocketed, particularly with respect to "troubled" assets with unrealized value; (iii) how side pocket assets are valued

and how liquidity or valuation events are defined and identified; (iv) fee terms, both with respect to the calculation of fees and the timing of their payment; and (v) redemption terms, particularly with respect to fully redeeming investors.

In addition, the offering documents should fully disclose the risks and potential conflicts of interest associated with the use of side pockets. Finally, managers that use side pockets should be cognizant of their general fiduciary duty to act in the best interests of their clients, so that side pockets are used only to benefit the fund and its investors, and not as a tool to further the manager's own interests. ■

¹⁸ *SEC Probes HFs for Misconduct*, Institutional Investor, Oct. 1, 2007; *SEC Intensifies Hedge Fund Misconduct Probes*, FINalternatives, Sept. 27, 2007, <http://www.finalternatives.com/node/2536/print>. *US Treasury Seeks Hedge Fund Best Practices Ideas*, Reuters, Sept. 25, 2007, available at <http://www.reuters.com/article/governmentFilingsNews/idUSWBT00762020070925>; *US Treasury's Private-Sector Advisors to Examine Hedge Fund Risk, Transparency*, AFX News, Sept. 25, 2007, available at <http://www.forbes.com/afxnews/limited/feeds/afx/2007/09/25/afx4154133.html>.