

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Guidance Note

The use of Side Pockets by Collective Investment Schemes

31st May, 2010

This guidance note applies to Professional Investor Funds which are in the process of being established and which contemplate the use of Side Pockets in their Offering Memorandum when and if such need arises.

1.0 Introduction

- 1.1 Side pockets are devices used by some funds (ordinarily hedge funds), as a means of addressing issues arising where certain assets within the fund's portfolio become illiquid or comparatively hard to value. Where an asset is illiquid, this may affect the ability of the fund to realise the asset (or realise the asset at a reasonable price) in order to meet redemption obligations. Where an asset can not be valued accurately, the risk arises that prices for any subscriptions and redemptions in respect of the relevant portfolio of the fund will not accurately reflect the fair value of the relevant asset with the resulting concentrative and dilutive effects for investors. The creation of a side pocket normally involves the designation of an asset as illiquid or hard to value and the transfer of that asset into a specially created new class (or Side Pocket) within the fund (and conversion of the corresponding fund Units held by investors into side pocket Units or the issue of new Units in the side pocket). Thus illiquid or comparatively hard to value assets are separated from the main pool of more liquid investments allowing continued issue and redemption of Units in the liquid pool while reducing the risks highlighted above.
- 1.2 Typically, at the point that an asset enters a Side Pocket class, only the existing participants in the fund acquire Units in the Side Pocket (pro rata to their interest in the Side Pocket asset). Subsequent investors in the fund will not acquire an interest in the existing Side Pockets but will acquire interests in any future Side Pockets.
- 1.3 Side Pocket investments are typically valued at cost (or the value at which they were transferred into the Side Pocket) until circumstances are such that a revaluation can be made.
- 1.4 Maltese Retail Schemes including UCITS and non- UCITS Schemes may not use Side Pockets.

- 1.5 Before introducing a Side Pocket arrangement, the Scheme's Manager should assess its capacity to manage these assets from an operational risk management perspective, liaising with the Scheme's Administrator (if any), as necessary.

2.0 Use of Side Pockets

Schemes which have constituted sub-funds

- 2.1 A Professional Investor Fund which has issued one or more classes of Units constituting a Sub-Fund may allocate certain assets within the portfolio of that Sub-Fund (generally illiquid assets or those that cannot be reliably valued) to a Side Pocket (within the same Sub-Fund). The Scheme will be required to create and issue a new class of Units within the same Sub-Fund (or take equivalent steps). The illiquid/ hard to value assets will be allocated to the Side Pocket so established. Existing investors in the Sub-Fund will in turn be allocated a pro rata holding in the new class of units representing the illiquid assets. The other classes of units within the Sub-Fund will accordingly cease to have an interest in the illiquid assets. This re-allocation of the illiquid assets to the new class of units will result in a diminution in the net asset value of these classes of units, although the Fund may opt for possible alternatives such as conversion of units into side pocket units (rather than the issue of new side pocket units without cancelling existing units), to avoid an adverse effect on performance figures, fee calculations etc.
- 2.2 In view of the fact that the new class of units constituting the Side Pockets will be created within the same Sub-Fund, the rules relating to the segregation of assets and liabilities will continue to apply. Thus the illiquid assets referred to above may be used to satisfy any other obligations relating to the other classes of units within the same Sub-Fund.

Schemes which have not constituted sub-funds

- 2.3 A Professional Investor Fund which has issued one or more classes of units which do not constitute a Sub-Fund may allocate part of its portfolio (generally illiquid assets) to a Side Pocket. The Scheme will be required to create and issue a new class of units (the Side Pocket) and allocate the illiquid assets to such class of units. Existing investors in the Scheme will in turn be allocated a pro rata holding in the new class of units representing the illiquid assets. The other classes of units within the Scheme will accordingly cease to be exposed to the illiquid assets. This re-allocation of the illiquid assets to the new class of units will result in a diminution in the net asset value of the original classes of units.

2.4 Example

To illustrate, a Scheme has issued Class A units which constitute the first Sub-Fund of the Scheme (Sub-Fund 1). Sub-Fund 1 had an investment in a listed security which has recently been delisted. The Directors of the Scheme resolved to allocate this holding to a Side Pocket to be created within the same Sub-Fund. The Scheme will thus be required to:

- Create a new class of units within Sub-Fund 1 (Class B);
- Allocate the holding in the unlisted security to the new Class B within the same Sub-Fund;
- Issue/convert/allocate Class B Units to existing holders of the Class A Units pro rata to their holding in the Class A Units or pro rata to the interest in the asset.

Depending on the mechanism for allocating Side Pocket Units to investors, the Net Asset Value of the Class A Units will decrease in view of the removal of the illiquid Security from the portfolio of assets representing such Class A Units within Sub-Fund 1.

Existing investors in the Class A Units will continue to be exposed to the illiquid security via their holding of Class B Units (as indicated above). Subsequent investors in the Class A Units will not be issued Class B Units but may acquire interests in any future Side Pockets.

In view of the above, the Side Pocket classes [of units] within the same Sub-Fund will not give an entitlement to the assets in the main liquid portfolio of the Sub-Fund and each Side Pocket class will [generally] be exposed exclusively to the illiquid security.

The above is only to be construed as a guide and Schemes may wish to create yet another class of units for unit-holders investing in the Scheme following the creation of the Side Pocket.

3.0 Disclosure to investors

The Offering Memorandum of the Scheme would need to include the following information disclosed in a clear, fair and not misleading manner:

- the circumstances/ criteria where a Side Pocket may be employed; the policy for transferring assets to Side Pockets, including the nature of the assets that may be allocated to Side Pockets and the circumstances in which such allocations may be made as well as the procedure for the allocation of investments to Side Pockets;

- the policy and procedure to be followed by the Scheme for transferring assets out of Side Pockets or for redeeming such assets as well as the procedure to be followed for the redemption or re-conversion of the units representing the Side Pocket. In this regard, upon the occurrence of a ‘liquidity event’ whereby an asset allocated to a Side Pocket becomes liquid or capable of valuation, the Scheme may decide to redeem such asset or to transfer such asset to the liquid pool of assets – details pertaining to the policy and procedure to be adopted are to be clearly disclosed in the Offering Memorandum;
- limits (where applicable), on the size of Side Pockets, including the maximum percentage of the fund / sub-fund which can be allocated to Side Pockets in aggregate, and in the case where no limits are set, disclosure to this effect;
- policies for the valuation of assets allocated to a Side Pocket. Such disclosure should be comprehensive on the methodology for the valuation of these types of assets and should also refer to a consistent approach to be adopted when valuing such assets. *[Note. In line with the best practice recommendations of the Hedge Fund Working Group¹ (HFWG), it is expected that the initial valuation of an asset on entering a Side Pocket is at cost, the latest available market price (as appropriate) or a lower value or nil] ;*
- fee structure relating to the class of units representing the Side Pocket; and *[Note. In line with HFWG’s best practice recommendations, in the case of Management fees, it is expected that these are calculated on the basis of the lower of cost and fair value and that performance fees are not crystallised before the asset is disposed of or becomes liquid.]*
- relevant risk warnings, in particular arising from the fact that Side Pocket assets may be hard to value, the illiquidity of Side Pocket assets, the difficulty which investors may find to exit from an investment in a Side Pocket rather than from a “normal” share class in the Scheme, and associated restrictions in realising interests in such assets.

¹ January 2008 – Hedge Fund Standards: Final Report