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Side Pockets

Luxembourg Authorities Create Fast-Track Procedure for Approval of Transfers of Illiquid Assets to Hedge Fund Side Pockets

Jul. 23, 2009
By Christopher Faille, *Hedge Fund Law Report*

The financial regulatory authority in the Grand Duchy of Luxembourg, the Commission de Surveillance du Secteur Financier (CSSF), has approved a new fast-track authorization procedure for the use of side pockets by hedge funds in two specific situations: the spin-off from an existing share/unit class to a new share/unit class and the spin-off from an existing subfund to a new subfund.

Specifically, in March 2009, the Association Luxembourgeoise des Fonds d'Investissement (ALFI), the Luxembourg fund industry association, issued a "Newsflash" describing the fast-track procedures worked out in consultations between ALFI and the CSSF. Renaud Graas, a Senior Associate at Allen & Overy in Luxembourg told the Hedge Fund Law Report: "This 'Newsflash' is not a CSSF circular letter or administrative guidance, although the CSSF clearly has given its blessing to the procedure the ALFI has outlined."

Régis Malcourant, a Partner and Head of the Hedge Fund Team at PricewaterhouseCoopers Luxembourg, told the Hedge Fund Law Report: "If the conditions are met, and all the necessary information is provided in the application, then the CSSF will get back to the applicant within one week – sometimes with oral approval of the side pocketing, which will be followed by a more formal letter, sometimes with comments and questions, or an objection."

Luxembourg

The new side pocket rules may well be seen as a step in the continuing effort by the authorities in Luxembourg to make their country a hedge-fund friendly domicile. See "European Hedge Funds: The Alternatives," Hedge Fund Law Report, Vol. 2, No. 25 (Jun. 24, 2009).

Graas said that a Luxembourg domicile has a number of attractions. "Obviously, tax efficiency is one of them." But a qualified labor force and infrastructure are important as well. "In recent days the use of offshore banking centers has come under a lot of political pressure, and managers may want to avail themselves of Luxembourg as a first-class business location with an excellent track record and an experienced work force."

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A side pocket is a segregated account created by a hedge fund manager in accordance with provisions in the fund's governing documents (its limited partnership agreement, for example, or its articles of association) to hold portfolio assets that the manager deems illiquid or less liquid. Assets in side pockets generally are excluded from periodic calculation of the net asset value of the liquid portfolio. See "Secondary Buyers of Private Equity Fund Interests are Looking at Assets in Hedge Fund Side Pockets," Hedge Fund Law Report, Vol. 2, No. 28 (Jul. 16, 2009); "Side Pockets: Operation, Valuation, Practical Considerations," Hedge Fund Law Report, Vol. 2, No. 1 (Jan. 8, 2009).

Hedge fund managers generally do not charge performance fees on side pocketed assets until they are realized or deemed realized. Although management fees often accrue with respect to side pocketed assets, they only become payable on realization or deemed realization.

Side pockets are also one of several measures that managers have used in times of crisis to control illiquidity and limit redemptions. Shares or interests representing side pocketed assets generally cannot be redeemed prior to realization. See "Hedge Fund Managers Using Special Purpose Vehicles to Minimize Adverse Effects of Redemptions on Long-Term Investors," Hedge Fund Law Report, Vol. 2, No. 15 (Apr. 16, 2009).

Side pockets in funds organized in Luxembourg operate much like side pockets in funds organized in other jurisdictions. As Graas explained, "side pocketing is not prohibited prima facie in Luxembourg. The fast track procedure is mainly designed to provide fund managers with reasonable certainty as to the time frame within which they will be able to get approval from the CSSF if the conditions set out in the Newsflash are met."

Funds of Hedge Funds

In Luxembourg, there is an important legal distinction between Undertakings for Collective Investments in Transferable Securities (UCITS) and Specialized Investment Funds (SIFs). See "UCITS: An Opportunity for Hedge Fund Managers," Hedge Fund Law Report, Vol. 2, No. 27 (Jul. 8, 2009). The creation of side pockets within a UCITS is highly restricted. The Newsflash said that such an application would have to be analyzed with the CSSF on a case-by-case basis.

The fast-track procedure is chiefly intended for SIFs. This category may include both funds of hedge funds and the underlying funds. Christophe Lentschat, Head of Product Development and Marketing at European Fund Administration SA (EFA), a fund administrator, told the Hedge Fund Law Report that historically Luxembourg has been a very receptive jurisdiction for the organization of funds of hedge funds. Between two-thirds and three-quarters of the assets under management by Luxembourg funds, Lentschat said, are in funds of hedge funds.

Lentschat noted that the agreement between ALFI and CSSF in March was largely a response to a backlog in side pocket approvals. "We had a lot of funds trying to set up a side pocket, and there was a backlog that was accumulating. So the idea was to say that for funds that comply with a certain number of preconditions, they will go through the fast track and be able to establish their side pockets in an easier, more straightforward, faster way."

Preconditions and Percentages

The fast track procedure is not to be used if the assets to be side pocketed represent more than 20 percent of the total assets of the relevant fund or subfund. Also, the procedure requires that

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the board of directors of the management company of the affected fund confirm that the proposed side pocketing complies with the fund's articles of incorporation or rules; that the administrator is technically capable of servicing the contemplated side pocket; and that it not be implemented to solve "temporary valuation problems" or to address a merely "potential or presumed illiquidity."

Managers must also undertake to "promptly realize the asset as soon as the asset is once again liquid."

These conditions raise some questions of definition. How, for example, are the assets to be valued for purposes of deciding whether the 20 percent cap has been exceeded? Marc Seimetz, a Partner at Dechert LLP in Luxembourg and Member of the firm's Financial Services Practices Group, explained to the Hedge Fund Law Report: "The fund itself, its board and administrators, will apply the valuation methodology set out in the fund's documentation."

On the one hand, some sources stressed that the 20 percent cap applies only to the fast-track procedure, not side pocketing generally. A fund can still request permission to side-pocket 21 percent of its assets, but the review will take longer. On the other hand, Lentschat said, "if you're above the 20 percent, that is when the CSSF will start asking seriously whether there is a better option such as suspension of redemptions."

Temporary Illiquidity

Another question of definition arises from the exclusion of "temporary valuation problems" as an appropriate reason for use of the fast-track procedure. Since, according to the Newsflash, management is required to "undertake" realization as soon as liquidity returns, the CSSF appears to recognizes that side pockets are designed precisely to overcome temporary illiquidity (and, in consequence, valuation) problems. In Seimetz's view, there are different time frames implicit in the use of the word "temporary."

"An example might be a fund of funds that finds it has invested in an underlying fund that has less liquidity than it had expected," Seimetz said. "If that situation is likely to resolve itself quickly, within a month or two, the use of fast-track to spin off this asset would not be appropriate. But if the underlying fund may remain illiquid, for instance, for half a year or more, then this will likely be appropriate."

Soliciting Bids

A related question: what does it mean to exclude "potential or presumed illiquidity"? Does this mean for example that the fund manager should solicit bids for an asset, in order to prove that the illiquidity is real and not "potential or presumed"?

Market participants who spoke with the Hedge Fund Law Report did not think so. According to Graas, of Allen & Overy: "There has been no guidance whatsoever on this point. It is simply a matter of what a reasonable fund manager will do in the relevant circumstances."

And in the view of Dechert's Seimetz: "I don't think that CSSF will require the solicitation of bids to prove the illiquidity of an asset. The requirement that illiquidity be actual, not just potential, is there because the CSSF wants to be sure the use of fast track doesn't become simply a matter of convenience."

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Information to be Provided to the CSSF

The application for authorization to be submitted to the CSSF under the fast-track procedure must include at least the following information:

1. Description of the illiquid assets: (a) the percentage of the assets of the fund or subfund contemplated for the side-pocketing as of the most recent net asset value date; and (b) why they are illiquid (for instance, litigation, or the invocation of a gate or suspension of redemptions by an underlying fund in the fund of hedge funds context).
2. The side-pocketing option: (a) whether this application involves a new share/unit class or classes or a new subfund; and (b) the reasons for selecting the option adopted.
3. Description of the fees to be charged to the side pocket. Does this mean that the CSSF will sit in review of fees? Absolutely, said Lentschat of EFA: "We have had to review some of our fee schedules based on the review from CSSF." The CSSF expects that the fees charged to the side pocket will be at a reduced level, i.e., less than the total expense ratio of the fund or subfund initiating the side pocket. And Malcourant, of PwC, said: "The CSSF expects the management fees charged to the side pocket to be lower, as the side pocketed assets are deemed to be managed less actively than the rest of the portfolio. Nevertheless, they won't require those fees to go to zero."
4. The way in which the implementation of the side pocketing will be communicated to investors (who must receive a holdings report at creation and at a frequency close to the frequency of the holdings report of the fund or subfund initiating the side pocket.)
5. Communication to other authorities (the CSSF wants a list of other countries in which the fund/subfund is registered and wants to know whether those authorities have been or will be informed of the side pocketing.)
6. Confirmation that the periodical reports will describe the side pockets existing as of the date of their issue.
7. Finally, the CSSF wants confirmation that it will receive quarterly information on the status of the side pockets and will be informed once a side pocket is terminated.

Last Stop Before Suspensions

Market participants who spoke to the Hedge Fund Law Report agreed that one animating principle in the development of this procedure has been the CSSF's determination that neither the fast-track nor for that matter side pocketing itself shall become too routine – too regular a part of an investment strategy.

Malcourant put it this way: "They think of it as one of the various ways to control and limit redemptions and to ensure fair and equal treatment of all of a fund's investors where illiquidity makes that necessary, obviously one of the most severe of ways, the last stop before suspensions and liquidations."

The concern of Luxembourg authorities is shared in other jurisdictions. For example, in February 2009, the Asset Managers' Committee of the U.S. President's Working Group on Financial Markets, in its Best Practices Report, recommended that managers include certain policies and guidelines for the use of side pockets, including: appropriate considerations for

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determining if and when assets should be moved into or out of a side pocket, policies for valuation and regular review and approval of any transfer of an investment to a side pocket. See "President's Working Group Releases Final Best Practices Reports for Hedge Fund Managers and Investors," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009).

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