SPECIAL REPORT
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The *long* and the *short* of it

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PROUD TRADITION

A robust yet flexible regulatory framework helps secure Malta's position as a leading domicile

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Laragh Cassar of **Camilleri Preziosi** outlines the implications of the use of side pockets in a distressed market within the hedge fund industry

Alleviating issues of liquidity

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The difficulty in valuing underlying investments of funds has been one of the direct impacts of the unprecedented turmoil in the world economy resulting in a number of funds holding positions in investments which are increasingly hard to value or are illiquid. This has brought on the imposition of gates on redemptions or the indefinite suspension of redemptions.

Gates normally limit the amount of redemption to a percentage of the fund's net-asset value. The creation of side pockets in the fund context involves the separation of such investments from other liquid investments through a creation of a separate fund or class of shares which are allocated to existing participants. Such participants will therefore hold units within the liquid as well as the illiquid portfolio. On the basis of the nature of the investments, the fund would thus be in a position to resume or continue to value the liquid assets and to enable the redemption and transfer of the units associated therewith.

On the other hand, the participants investment in the illiquid class of shares would typically be locked until such time as assets within the illiquid portfolio are capable of being realised. This would necessitate the fund having the power to suspend the determination of the net-asset value of the side-pocket portfolio until such time as they deem necessary. 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. The fair valuation of assets prior to their transfer is required to ensure that any losses are appropriately allocated to existing shareholders of the fund.

Attracting new investors

Furthermore, side pockets may, depending on investor appetite, seek to attract new investors in the liquid units; however, particular attention would have to be provided to avoid the possible upturn that new investors may get from the realisation of the illiquid investments. Once the fund is in a position to value illiquid investments or when trading thereon can be resumed, the fund may choose to realise that investment and distribute the proceeds thereof to investors typically through the redemption of units. This, however, may not always be possible depending on the constitutional documents of the fund. Alternatively, the fund may choose to transfer such investments from the illiquid to the liquid class of shares. In doing so, the consideration of such transfer would need to be attributed directly to the investors that appeared on the register of members at the time when the side pocket was created. This will serve to establish a fair approach to the old and new investors. The form of wind-down operation of the illiquid portfolio of investment used may also have taxation implications and therefore ought to be analysed within such a context.

Exit fees and dilution levies

One of the issues faced by the fund relates to the risk of a run by investors on the liquid class of shares. Funds have sought to address this issue by seeking to implement measures aimed at acting as a disincentive to investors to exit the fund, namely, the introduction of exit fees and dilution levies and the increase of redemption notice periods. Furthermore, management fees generally chargeable to the fund are often waived or deferred with respect to the illiquid portion of units, in particular, in respect of management and performance fees.

Needless to say, the introduction of side-pocket arrangements and the measures presently described are to be analysed both in the context of the regulatory framework of the fund in question, as well as the contractual undertakings issued by the fund pursuant to its offering document and service contracts. Furthermore, transparency remains imperative to ensure that investors properly understand the impact and benefit of the introduction of side-pocket arrangements.

Within the context of the Maltese market, the regulator (the Malta Financial Services Authority) has issued guidelines of the introduction of side-pocket arrangements. The said guidelines are applicable to certain types of non-retail funds generally used as vehicles for hedge funds and regulate the disclosures required to be given to investors, as well as the manner in which such side pockets are

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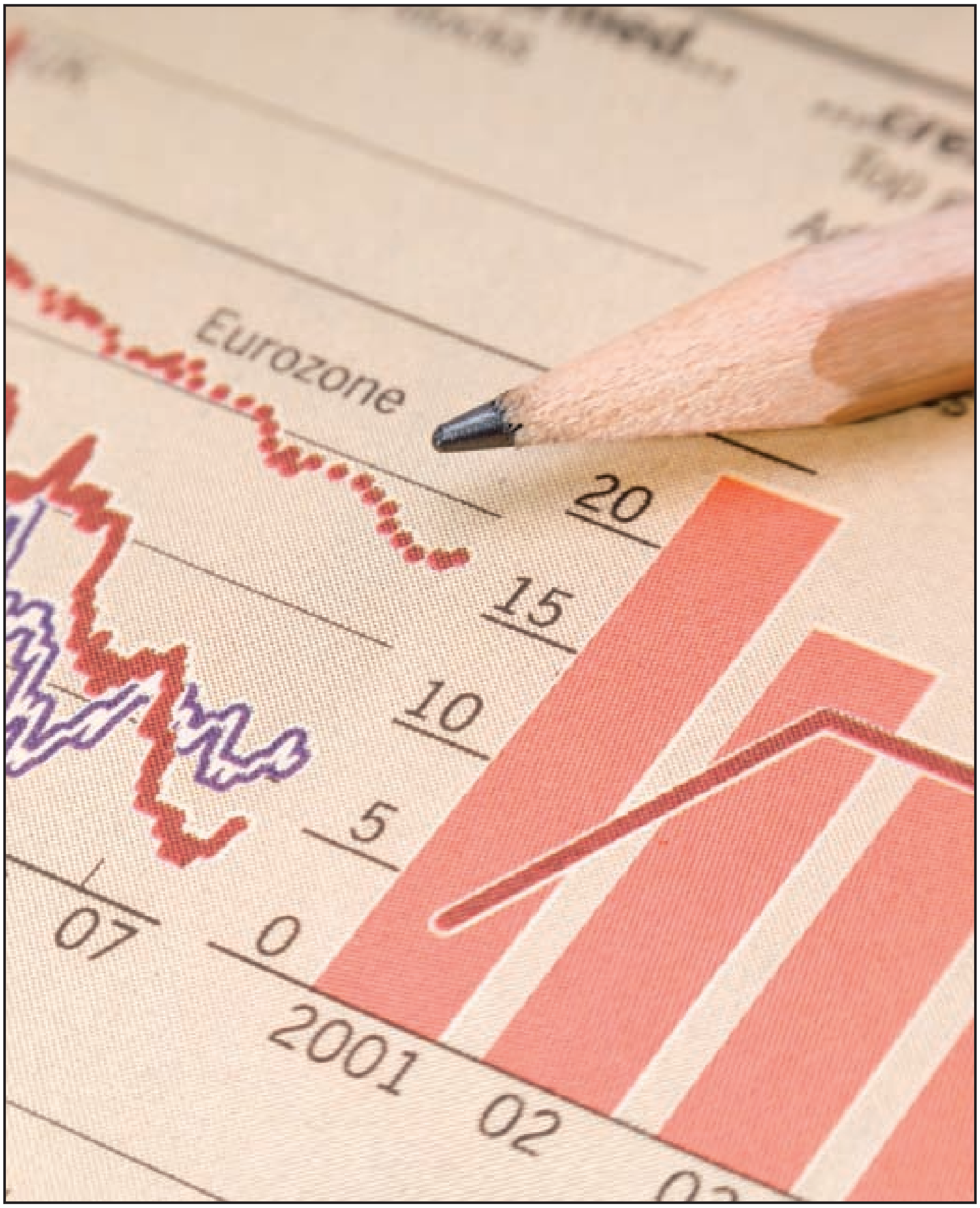

created. The MFSA contemplates the creation of a separate class of units holding the illiquid portfolio. One of the repercussions under Maltese law in respect of multi-fund/multi-class funds relates to the creation of separate patrimonies. While in terms of Maltese law, a multi-fund company may elect to have the assets and liabilities of each sub-fund comprised in that company treated for all intents and purposes of law as a patrimony separate from the assets and liabilities of each other sub-fund of such company, this benefit is not attributed to a class of shares not constituting a separate sub-fund of the company.

Separation of patrimonies

Accordingly, once a company registered in terms of the Maltese Companies Act creates a separate class of units to hold the illiquid portfolio of investments, creditors of that class of shares still retain their right of recourse against the liquid portfolio of assets. In the light of this, funds have sought to enter into arrangements with existing creditors of the fund to contractually achieve this separation of patrimonies. However, this may prove to be difficult, or not all possible, in relation to future creditors of the fund and appropriate risk warnings to investors would need to be provided particularly within the context of future investors in the liquid class of units.

Once the illiquid portfolio has been transferred or realised in its entirety, the fund will close the illiquid class of units through the redemption of the said units. The introduction of properly documented and structured side pockets may help to alleviate liquidity issues for both the fund and its investors and may avoid an unnecessary closure of the fund potentially realising investments at an undervalue. ■