STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Side-Pocketing in ILS Funds

SBai Toolbox

1. Introduction

Side-pocketing occurs across multiple alternative investment strategies and is the process of segregating assets that have become illiquid or hard-to-value from the main portfolio. The purpose of this segregation is to ensure that where there is valuation uncertainty and/or illiquidity, value is allocated fairly between redeeming, existing and incoming investors, and fees are charged appropriately.[1]

In insurance linked strategies ("ILS"), this valuation uncertainty is often caused by the occurrence of large loss events where the losses have yet to be defined or realised. After such events, insurance strategies can suffer prolonged periods of valuation uncertainty because of the extended process of loss discovery and settlement. Side-pockets[2] are widely used in such times and can play a valuable role in mitigating the consequences of valuation uncertainty. This SBAI Toolbox Memo sets out some considerations and recommendations for asset managers and investors relating to the mechanics of side-pocketing within ILS Funds.

This memo examines:

- The Objectives of Side-Pockets for ILS Funds,
- ILS Specific Considerations in Side-Pockets, and
- What the SBAI Alternative Investment Standards say

The memo also includes a list of questions for investors to consider when evaluating side-pockets during their due diligence, and the appendices offer a more detailed insight into some of the topics discussed in the memo.

There are a variety of approaches to side-pocketing that ILS managers can use including variations in how side-pockets are formed and unwound, fee arrangements, and the discretion exercised by the asset manager. This SBAI Toolbox Memo is not prescriptive in many of these areas, but makes some recommendations, particularly in areas already covered by the SBAI Alternative Investment Standards.

2. Objectives of Side-pockets for ILS Funds

In ILS, the use of side-pocketing is generally seen as an investor-friendly practice and there are many potential objectives for the formation of side-pockets such as:

[1] Whilst capital activity impacts may be more applicable to multi-investor funds, other side-pocket considerations such as the appropriate charging of fees will also be applicable in single investor fund vehicles.
[2] Also sometimes referred to as Designated Investments, Development Classes or Special Investments

- Protecting **new investors** from valuation uncertainty arising from specified events that occur prior to their subscription.
- Ensuring **investors that remain in the fund** retain any potential upside from the specified events since they are also taking the downside.
- Protecting **all investors** from paying fees calculated on uncertain valuations.
- Protecting **new investors** from potential earnings drag from any trapped collateral[3] associated with contracts affected by specified events that occur prior to their subscription.
- Protecting **remaining investors** from the impact of redemptions by other investors at uncertain values or in distressed circumstances.

Several of the objectives stated above refer to protection for investors. Whilst most side-pockets offer substantial protection in some or all the above circumstances, complete protection requires that all contracts with any possible loss exposure are included in the side-pocket. This could result in very large side-pockets that increase portfolio concentration in the main fund and decrease capital efficiency, therefore in practice, exposures will typically only be side-pocketed if they are deemed to have a reasonable likelihood of being affected. As a result, in most cases, there remains a (remote) risk that new investors could be affected by loss events that occurred prior to their subscription.

At the expiry of a contract, some collateral may become trapped within a trust to act as a buffer against loss reserves – known as trapped collateral[4]. This trapped collateral cannot be used for underwriting of new risk exposures and as such can cause a drag on earnings. Protecting new investors from the earnings drag related to events prior to their subscription, requires all such collateral to be assigned to the side pocket. The methods of dealing with the allocation of trapped collateral are discussed later in this memo.

3. Side-pocket Structuring

In theory, there are two ways that a side-pocket can be structured, although in practice the most common method used is the creation of a new share class.

	Creation of a New Share Class[5]	Creation of a New Legal Entity
Creation	A new share class is created within the same legal entity as the main fund. This is typically operationally simpler and more cost effective than the creation of a new legal entity.	A new legal entity is created which is distinct from the main fund. This is typically operationally more complex and expensive.
Asset Transfer	Contracts and collateral are notionally assigned to the new share class.	In theory, contracts and collateral are transferred or novated to the new legal entity. In practice, it is difficult to transfer or novate a contract and its associated collateral between legal entities without the cedant's consent. A new entity acting as a reinsurer for the affected contracts may solve the issue of risk transfer, but it

[3] Trapped collateral is a buffer set aside to provide some protection to a counterparty against future deterioration in losses after the expiry of a contract. This will be discussed in full detail later in this memo.
[4] For example, a side-pocket may be set up containing most of the affected contracts, but when all affected contracts expire, there may be some outside of the side-pocket that have contractual trapped collateral.
[5] This may also be achieved by creating a new cell within a Segregated Portfolio Company which achieves slightly more protection from leakage of losses to the main fund.

	Creation of a New Share Class[5]	Creation of a New Legal Entity
		remains difficult to transfer collateral in trust to the side-pocket.
Leakage to Main Fund	In this method, all share classes are unsecured creditors of the whole fund, so in extreme circumstances it may not provide complete protection from the leakage of losses between share classes.	As the side-pocket is a separate legal entity this method, in theory, prevents leakage of losses to the main fund.

4. ILS Specific Considerations

Trapped Collateral

Most collateralised contracts contain an agreement between the fund and the cedant to retain some collateral in trust after the end of the exposure period of the contract if a large enough level of losses is expected. Typically, this retained collateral will include any loss reserves plus a "buffer" for further loss development that can depend on the nature of the event, the terms of the cover in relation to the size of the loss, and the time since the loss event occurred. The collateral retained after the expiration of the contract that is in excess of the loss reserve is commonly referred to as "trapped" collateral[6], as it is held in the trust until the loss reserves have been finalised and cannot be redeployed for new investments. Where side-pockets are created prior to the expiration of a contract and managers wish to allocate all potential trapped collateral to a side-pocket, there may be a need to estimate the amount of collateral likely to be trapped at expiry using the contractual terms, loss reserve estimates and buffer tables[7].

Trapped collateral is typically set as a percentage of underlying losses and this multiple declines over time potentially allowing some trapped collateral to be released from the trust.

Trapped collateral is created by agreements between cedants and the fund, and this process occurs independently of whether a side-pocket is being formed. Trapped collateral, however, is of concern to investors because it can create a drag on returns since it cannot be reinvested into new insurance risk and is illiquid.

There is further detail on the relationship between trapped collateral and side-pockets in Appendix C.

Side-Pocketing Methodologies

There are two approaches to side-pocketing that are common among ILS managers:

Side-Pocketing by Contract

Side-pocketing by contract is the most common side-pocketing approach. All contracts that are reasonably deemed to have a material risk of exposure to an event, together with any associated collateral, are transferred to a side-pocket. Once the side-pocket is created, all future gains, losses and premiums for each contract moved across are allocated to the investors in the side-pocket.

[6] Other names include "Locked-In" Collateral

[7] In this memo when referencing the allocation of "trapped collateral" to side-pockets this can be taken to mean either collateral trapped at the expiration of the contract or an estimated value of the collateral likely to be trapped when the contract expires.

Side-Pocketing by Event

Rather than contracts, in this methodology the value of assets transferred to the side-pocket is the sum of the premium that would be required for the side-pocket to take on responsibility for all future loss payments for the specified event (which is equal to and therefore offset by the fair value of loss reserves), and any additional assets required to fully collateralise what the manager calculates to be a reasonable maximum likely loss related to the event(s). The side-pocket is then required to indemnify the main fund for all future loss payments but is not entitled to any unearned premiums on the contracts impacted by the loss event(s) as these will remain within the main fund.

Illustrations of both these methods can be found in Appendix B.

Comparison of Side-Pocketing Approaches

	Side-Pocket by Contract	Side-Pocket by Event
Complexity	Relatively easier to process, set up and administer.	Relatively more complex to understand and articulate to investors.
Allocation of Trapped Collateral	The contracts and all associated collateral are transferred into the side-pocket at the time of formation meaning collateral that becomes trapped at the expiry of the contract will already be in the side pocket. If a contract outside the side-pocket has associated trapped collateral, a manager will need to assess the materiality to determine whether a new side-pocket for these contracts may be required.	Managers estimate the likely maximum aggregate loss to the portfolio. Then, at the expiry of contracts the amount of trapped collateral can be notionally assigned to the side-pocket up to that maximum aggregate loss level. As loss-affected contracts in the main fund do not have to be individually identified, if a contract that was assumed to be unaffected subsequently proves to be affected, its losses will nevertheless be covered (up to the side-pocket limit).
Impact on Portfolio and Investors	Contracts allocated to the side-pocket may contain exposures which are not related to the specified event(s) and will therefore also become locked up in the side-pocket. This can result in a relatively larger share of an investors value in the fund becoming illiquid via its side-pocket holding. This may reduce diversification in the main fund for new investors and (where released collateral is not returned to the main fund) reduce the availability of capital to deploy for new investments.	Side-pocketing by event removes the main fund's exposure to losses caused by the nominated event(s) which become the responsibility of the side-pocket. All other risks and premium remain in the main fund. Additional assets may also need to be transferred into the side-pocket to fully collateralise the side-pocket's obligations and these assets therefore also become illiquid. This method potentially results in greater diversification within the main fund and additional premium income being available to new investors in the main fund.
Implication for redeeming investors	A redeeming investor will have exposure to the loss event(s) plus potential exposure to unassociated risks, since whole contracts will have	A redeeming investor will retain exposure only to the losses from the event(s) through its side-pocket holding.

	Side-Pocket by Contract	Side-Pocket by Event
	been side-pocketed. They will also continue to receive the benefit of earnings on these exposures.	

Subjectivity in the creation of Side-Pockets

Managers typically will not use the collateral in the side-pocket to write new business to preserve the side-pocket's capacity to meet losses if necessary, and to increase capital efficiency there is an incentive for managers to keep side-pockets as small as possible. In practice, this means that managers often make judgements about which contracts to include in a side-pocket by contract or the estimated maximum loss in a side-pocket by event that requires collateralisation. In either case, a reduction in the collateral available to pay any losses means there is a possibility of "leakage" of losses back into the main fund if losses from the event are greater, or affect the portfolio more broadly, than initially anticipated[8].

Transactions between the Side-Pocket and the Main Fund

In some instances, the main fund may borrow assets from the side-pocket to act as collateral for new investments, in effect leveraging the main fund. This raises questions on what terms these transactions should take place:

- On an "arm's length" basis, where the cost to the main fund for borrowing the assets is at a market rate i.e., the amount paid for borrowing the assets from the main fund to the side-pocket is the same as would have been paid in the open-market for a similar transaction, or
- A zero or negligible cost, based on the argument that the risk to the side-pocket is immaterial and that the investor base is largely the same (unless there has been a significant number of new investors into the fund).

In general, an asset manager should look to complete any transactions between the side-pocket and the main fund on an "arm's length" basis or clearly disclose where this is not the case. The ability of the main fund to utilise collateral from the side-pocket should also clearly be disclosed to both investors and to the fund's governing body.

5. What the SBAI Alternative Investment Standards Say

The SBAI Alternative Investment Standards ("SBAI Standards") cover several aspects in relation to side-pocketing, including disclosure, governance arrangements, side-pocketing approach, ongoing reporting, and the handling of fees and expenses[9].

Full details of the applicable standards and observations on ILS side-pockets can be found in Appendix A.

Disclosure of Side-Pockets

> The SBAI Standards require disclosure of instances where normal redemption mechanics may not apply and disclosure of the side-pocketing process.

[8] In a side-pocket structured as a new share class there will be recourse directly to the main fund; within a separate legal entity losses not paid by the side pocket (for example, from a contract being left out of the side-pocket) will also have to be paid by the main fund.
[9] Text within boxes in this section describe the requirements of the SBAI Standards with further guidance on robust practices that comply with these standards provided in the text underneath the boxes.

These disclosures could be within the fund's governing documents or a separate Side-Pocket Policy. At a minimum, the fund's governing documents should disclose that side-pockets may be put in place in certain situations. Whilst a manager may choose to make further disclosures about the side-pocketing practices in the governing documents, it may instead or also make more detailed disclosures in a Side-Pocket Policy that is available to investors for review.

Disclosures should typically include:

- **Side-Pocket Triggers** – what criteria would trigger the creation of a side-pocket (e.g., an event, or a certain level of valuation uncertainty) and at what point will the side-pocket be created (e.g., when there is capital activity)
- **Type of Side-Pocket** – By event or by contract
- **Structure** – New share class or separate legal entity including detail on the allocation of exposures, loss reserves, and contract economics such as premiums
- **Valuation** – Disclose if fair value will not be used to value the side-pocket and provide details of the valuation methodology to be used
- **Fees** – what fees will be charged on side-pocket assets and when will they be crystallised
- **Duration and Exit Criteria (where possible)** – It may not be possible to define the duration or exit criteria since each event is likely to have different characteristics. Asset managers may use exit criteria such as the commutation of contracts but where this is not possible, the disclosure should state how investors will be kept informed of progress towards unwinding of a side-pocket (e.g., updates in monthly newsletters)

Governance Arrangements

The SBAI Standards require that the fund governing body be consulted on, and consent to, the creation of side-pockets.

There is also a standing agenda item on side-pockets in the SBAI's Standardised Board Agenda[10].

Governing body approval should be more than a "tick box" exercise and therefore enough information to make an informed decision should be provided. This may include:

- **Rationale for creating a side-pocket** – the event that has occurred and why there is a higher level of valuation uncertainty associated with these assets.
- **Timing of the side-pocket** – is this to be created immediately after the event occurs or when there is capital activity and the rationale for this choice.
- **Size and Structure of the side-pocket** – This should include details of any proposed transactions between the main fund and the side-pocket. Where the side-pocket is not a separate legal entity, details of the allocation of assets, liabilities, trapped collateral, and income should be documented.
- **Fees** that will be charged on the side-pocket and when they will be crystallised (where side-pockets have occurred before are these fees in line with prior side-pockets and if not, why).
- Proposed **exit criteria** for release of the side-pocket assets back to investors or into the main fund (as discussed above this may not always be possible at the creation of the side-pocket).

In future meetings of the governing body (or on an ad hoc basis where there is a material event) managers should consider providing updates on any progress towards releasing side-pocket assets and updates for any changes to the positions that have been side-pocketed.

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[10] See https://www.sbai.org/toolbox/standardised-board-agenda/ (Section 5)

Timing, Duration and Valuation

The SBAI Standards require a side-pocket to be created either at the time the relevant asset is purchased or when it becomes hard-to-value.

Timing of Side-Pocketing

In ILS funds, rather than at the point the asset becomes hard-to-value, the side-pocket is typically formed when there is capital activity[11] in the fund[12]. Whilst the primary reason for the timing of side-pocket creation is typically to delay the operational burden of creating a side pocket until there is capital activity, there is sometimes an advantage from delaying the creation of a side-pocket in that it may allow more time for valuation uncertainty to decrease.

If side-pockets are not formed at the time a large loss event occurs, there are implications of this delay that investors should be aware of:

- **Fees:** There may be a period where there is a significant level of valuation uncertainty in the main fund prior to the side-pocket being created. Fees would be charged at the same rate and frequency as the main fund but would be based on uncertain values. This may be a different fee structure to that which would be charged in a side-pocket.
- **Liquidity Transparency:** Investor's liquidity monitoring may become distorted where assets remain in the main fund but would not be paid out should the investor redeem. An understanding of the liquidity of external holdings is important information for an investor. As such asset managers should consider disclosing the portion of the investors' assets in the main fund that cannot be redeemed on the fund's standard liquidity terms (i.e., assets that will be transferred into a side-pocket when there is capital activity.)

Duration of the Side-Pockets

Side-Pockets should ideally be assessed as frequently as possible, in line with receipt of updated information, to understand the remaining valuation uncertainty and decide on the possible return of collateral and unexpired contracts ("assets) from the side-pocket. If uncertainty over loss reserves and therefore fair valuation declines sufficiently, side-pocket assets may be able to be returned to the main fund before their maturity. It is more common, however, for assets to be moved out of a side-pocket after maturity and effective commutation[13]. It is important to communicate regularly with the investor on progress towards unwinding the side-pocket and any material changes to the risk profile of the assets held there.

Valuation

In relation to a side-pocket, the SBAI Standards require that the initial valuation of an asset entering a side-pocket should be at cost, the last available market price (as appropriate) or a lower number, or nil.

In the case of side-pocketing within ILS funds, the side-pocket is usually created for an asset that is already held in the portfolio. In this case the valuation of the asset should be at "fair value" on the date of

[11] Capital activity refers to subscriptions into or redemptions out of the fund by investors.
[12] The SBAI Standards are based on a comply or explain mechanism. Asset managers can provide explanations where their processes differ from those recommend in the Standards.
[13] Managers may seek to commute loss-affected contracts with counterparties, paying an amount to settle the fund's obligations with a counterparty in return for a release from any further loss payments.

(or just prior to) any capital activity in the fund. For more information see the SBAI ILS Valuation Toolbox Memo.

Reporting

The SBAI Standards require periodic reporting on the value of side-pockets

Performance Reporting

Performance reporting to investors needs to reflect performance for the period being reported on for all assets including those in the side-pocket. Performance should also be presented to a broader audience in such a way that potential and existing investors will be able to make meaningful comparisons between different asset managers. The purpose of the information is likely to determine how this is presented:

- **Prospective Investors**: Reporting of a track record that includes all main fund and side-pocket performance and which shows returns as they would have been for a day one investor (this method should also be used for any inception to date reporting provided to investors and third parties),
- **Current Investors**: Reporting of both the main fund and side-pocket performance separately. This will typically take the form of account statements from fund administrators. Where this is used in newsletters or marketing materials, side-pocket performance should ideally be presented with as much prominence as the main fund performance (i.e., not solely visible in footnotes or end notes).

Asset managers should disclose the performance calculation methodologies and where a synthetic track record is used (i.e., blending the performance of the side-pocket and the main fund over time), it should be clearly disclosed that the track record is synthetic and what the methodology for creating the blended return was.

Fees and Expenses

The SBAI Standards require that fees should be calculated on the lower of cost, last available market price, or fair value.

Management fees

The charging of management fees on side-pockets can be complex and there are many factors that investors should consider. Asset managers may either charge the same fees on the side-pocket as the main fund (as an indicator of the work involved in maintaining the side-pocket) or offer a fee discount on the side-pocket assets (as a reflection of the illiquidity of the position). Any management fee structure should both align the interests of the asset manager and the investor, and ensure that the side-pocket remains in place for as long as it is prudent, but not for an extended period.

Knowing the headline fee level; however, will not be enough for an investor to complete a comparison of fees between two asset managers. The following factors should be disclosed to investors:

- **Frequency of Payment**: Is the management fee accrued for the duration of the side-pocket and adjusted for payment at the end of the life of the side-pocket or is the management fee paid at the same frequency as the main fund?[14]
- **Trapped Collateral**: Is the management fee charged on trapped collateral? Management fees might not be charged on the value of trapped collateral as the collateral cannot be used to support ongoing

[14] There may be a hybrid version of this where a portion of management fees are paid regularly with a claw back provision in place.

business. From an investor's perspective, it is important to understand where the trapped collateral is being held (i.e., is it held in the main fund and therefore under the main fund fee structure or is it the side-pocket and therefore potentially fee free.)

From an investor perspective, it may be preferred to charge management fees based on the final realised value as it mitigates against the scenario where a manager is charging fees based on the lower of cost and fair value, but the ultimate realised value turns out to be lower.

Performance Fees

The SBAI Standards require that performance fees should accrue for the duration of the existence of the side-pocket and should be paid only at the point which the asset is finally disposed of or a liquid market price is available.

The general principle is that a manager should not receive a higher performance fee in the year that a side-pocket is formed than it would have if no side-pocket were formed.

In practice, there are different ways this can be achieved including the below examples:

- Charging the performance fee within the side-pocket at the point any assets are released to the main fund (and adjusting the main fund HWM or loss carry forward accordingly at both the creation of the side-pocket and when the assets are returned to the main fund),
- Treating the side-pocket and the main fund as one for performance fee calculation purposes by netting of gains and losses from the side-pocket against the gains and losses from the main fund,
- Only charging performance fee on assets in the main fund – in this scenario the movement of any value from the main fund to the side-pocket is treated as a loss in the main fund and the return of assets is treated as a gain for performance fee (and loss carry forward) purposes, or
- Making other specific adjustments for side-pocket assets that achieve the same result such as combining the value of the main fund and the side-pocket for performance fee calculations.

Investors need to understand the implications of performance fees through to the end of the life of the side-pocket to be able to complete comparisons between asset managers. Asset managers should be willing to provide worked examples of calculations to investors to facilitate this understanding.

Performance fee calculations can be complex, and investors should ensure that asset managers are shadowing the often-manual calculations that are being completed by administrators to ensure there are no errors in the calculation.

Potential Misaligned Incentives - Fees

Charging the same level of fees on side-pockets and the main fund may create an incentive for managers to delay the wind up the side-pocket in an open-ended fund in the scenario where distributions from the side-pocket go directly to investors (for example, where investors have already redeemed from the main fund), as the manager will not receive any further fee income from these redeemed investors once the side-pocket is released. Whilst charging lower (or even zero fees) on side-pockets assets may reduce this incentive, it can create a different incentive to underestimate losses or be stricter about contracts allocated to a side-pocket (and as such reducing its size) therefore increasing the risk of loss leakage to the main fund.

6. Questions for Investors to Ask

The following are some questions that may help an investor understand the approach to side-pocketing taken by ILS managers:

General Approach	• Is the asset manager an SBAI signatory?
	  – If yes, is the manager following SBAI guidelines and what is the rationale if they are not,
	• Is there a Side-Pocket Policy in place and is it disclosed to investors?
	• What objectives does the manager seek to achieve through side-pocketing?
	• What types of side-pockets are used?
	  – By contract or by event
	  – New share class or separate legal entity

Creation of a Side-Pocket	• Who makes the decision to create a side-pocket – the asset manager or the fund's governing body?
	• What triggers the formation of a side-pocket (e.g., loss event occurrence, capital activity etc,)?
	• Is the process strictly rules-based or is there discretion involved?
	• What is the process for determining the initial size of the side-pocket?
	  – If stress testing is used to determine the side-pocket size, how does the manager determine the levels to stress to?
	  – Is the size of a side-pocket related to the amount or expected amount of trapped collateral?
	• Is there a concept of materiality e.g., a level of uncertainty below which a contract will not be side-pocketed, or a side-pocket not formed?
	• What is the risk of losses from the specified event(s) not being contained within the side-pocket?
	• What are the different contract structures (e.g., aggregate, multi-peril etc.) that may be side-pocketed, and do any of them present additional complexities in the side-pocket process? If so, what are these?

Trapped Collateral	• Do all collateralised contracts contain a Collateral Release Agreement? If not, what are the arrangements for determining how much collateral is retained after the expiry of the contract? • Is all trapped collateral (notionally or physically) contained within the side-pocket? • Is the asset manager willing to provide investors with a projected aggregate collateral release profile over time at regular intervals and the terms of the collateral release mechanisms?
Managing and Unwinding a Side-Pocket	• Can an un-expired side-pocketed contract be returned to the main fund at a later point? • How frequently does the asset manager assess the side-pocket to determine whether any assets can be released? • Has the asset manager ever created a new side-pocket for the same event at a later point due to omitting a transaction, or underproviding for the event, at the time the initial side-pocket was created? • How are decisions on commutation of contracts taken and on what basis? Does the manager seek side-pocket investor approval? • Is cedant clawback on collateral releases possible? Does this create a contingent liability for side-pocket investors? • What is the default treatment for distributions – are they returned as cash to investors or automatically reinvested back into the main fund? ○ If reinvestment is the default treatment, can an investor elect to receive cash instead, and if so, how much notice is required?

	• Does the manager continue to provide any FX hedging on the side-pocket before and after the contract exposure period, and is there a point at which the asset manager would consider stopping hedging the exposure?
Accessing Collateral Within Side-Pockets	• Does the asset manager seek to obtain financing against or borrow trapped or excess collateral in side-pockets to facilitate further investment in the main fund? • If financing is used, what type of financing does the asset manager use and with what type of counterparties? • If the manager is financing investments in the main fund using assets in the side-pocket as collateral, does the lender have recourse to other assets in the side-pocket in the event of a default? • Does the side-pocket receive compensation if any of its assets are used as collateral for loans or borrowed and if so, how is this determined?
Redeeming Investors	• Do investors who have redeemed from the main fund have contingent liabilities beyond ownership of any side-pocket shares? • If the manager's approach is to compulsorily exchange side-pocket shares into main fund shares at each distribution point, does an investor who has redeemed from the main fund get further main fund shares or cash? • Are there any options (either via the fund or on a secondary market) for an investor to dispose of their side-pocket shares for cash?
Reporting	• How frequently is the side-pocket valued and does the manager provide estimates outside of official valuation points? • Are any independent third parties involved in determining or validating the valuation of the side-pocket? • How does the manager report performance numbers and AUM to investors? • Does the manager report performance to third parties and do these numbers account for side-pocket performance? • Does the manager include historical side-pocket performance in marketing materials?
Fees	• Does the manager charge management fees on side-pockets and are they the same or different to the management fees on the main fund? • Where management fees are accrued on side-pockets, are these paid periodically or only at the point when the side-pocket distributes? • Does the manager adjust either accrued or paid management fees to account for changing values in the side-pocket? • Does the manager charge performance fee on side-pockets? If so, what is the performance fee calculation methodology and can a worked example for both the side-pocket and the main fund be provided? • Would the manager crystallise a performance fee when the main fund shares are above a high watermark, but a related side-pocket still exists? If so, what is the manager's approach to incentive fee clawback if the related side-pocket subsequently deteriorated? • If the side-pocket is formed after the event, does the manager have a fee adjustment mechanism in place to account for any changes in value relating to the event up to the point where the side-pocket takes effect?
Governance	• What is the decision-making process for actions in relation to side-pockets? • Is there a committee that decides on such matters, or makes recommendations to the Fund Board? • Are decisions in relation to the creation and structure of side-pockets documented, and are they auditable?

7. Appendices

Appendix A - What the Alternative Investment Standards Say

The SBAI Alternative Investment Standards ("SBAI Standards") and the SBAI Toolbox resources cover several aspects in relation to side-pocketing, including in the areas of disclosure, governance arrangements, side-pocketing approach, ongoing reporting and handling of fees and expenses.

Standard 2.1: The commercial terms applicable to the relevant interests being offered in a particular fund should be disclosed in the fund's offering documents in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors).

The SBAI envisages that in most circumstances such disclosure would, amongst other things, include:

- *Details of any other measures which may be considered by the fund governing body in circumstances where normal redemption mechanics might not apply or may be suspended – for example:*
  - *Fund level gating, investor level gating, lock-ups, suspension of redemptions, penalties for revoking redemption requests (to the extent that the fund's constitutional documents/offering documents do not already provide for such mechanisms)*
  - *Side-pocketing*
  - *Restructuring the fund to incentivise investors to accept, or switch to an alternative share class offering reduced liquidity (for example, in exchange for lower fees)*

Side-pockets are typically used where normal redemption mechanics may not apply and therefore per the SBAI Standards should be disclosed in the Offering Memorandum[15]. In some jurisdictions to change liquidity rights (for example, the addition of side-pockets) within the Offering Memorandum documents may require investor consent. For this reason, if there is a likelihood that side-pockets may be required – as is the case in ILS funds – then disclosure of the potential use of side-pockets should be inserted in the offering memorandum at the launch of the product.

An asset manager may also maintain and disclose a separate Side-Pocket Policy that details the mechanics for determining the treatment of a side-pocket. It will likely be more efficient (and cost effective to the fund) to update (and re-disclose) this Side-Pocket Policy as needed versus updating same material in the Offering Memorandum.

Standard 7.1: Where a fund manager performs in-house valuations of hard-to-value assets or is otherwise involved in providing final prices to the valuation service provider, valuation procedures for such assets which are aimed at ensuring a consistent approach to determining fair value should be adopted and such procedures should be set out in the Valuation Policy Document.

Standard 7.2: If using side-pockets, a fund manager should ensure that the fund governing body has been consulted on, and consented to, the circumstances in which side-pockets may be used. Furthermore:

- *The types of asset eligible for side-pocketing should be described in the Valuation Policy.*

[15] "Offering Memorandum" as used in this memo should be taken to refer to the principal governing document of the fund.

- *Document and the side-pocketing process should be disclosed in the fund's offering documents.*
- *Side-pocketing should occur either on or about the time the relevant asset is purchased or on or about the point at which the relevant asset becomes hard-to-value. The initial valuation of an asset on entering a side-pocket should be at cost, the last available market price (as appropriate) or a lower number or nil.*
- *Where a limit to the total amount of assets which may be included in side-pockets is disclosed in the fund's offering documents, such limit should not be breached.*
- *Management fees, for the side-pocketed assets, if charged, should be calculated on no more than the lower of cost (or last available market price in the case of a previously liquid asset) or fair value.*
- *Any performance fees should accrue for the duration of the existence of the side-pocket and should be paid only at the point at which the asset is finally disposed of or a liquid market price is available.*

The SBAI’s Standardised Board Agenda for fund directors contains a standing agenda item on this topic also: “Review (approval of) side-pockets”.

Standard 2.1: The commercial terms applicable to the relevant interests being offered in a particular fund should be disclosed in the fund’s offering documents in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors)

The SBAI envisages that in most circumstances such disclosure would, amongst other things, include:

- *Fees and expenses:*
    - *Fair disclosure of the methodology used to calculate performance fees;*
    - *The basis of calculation for any base management fee and details of the nature of any expenses which may be payable or reimbursed by the fund to the manager*

Standard 2.5: The fees and expenses (including but not limited to management and performance fees) charged to the fund should be disclosed in the fund’s audited financial statements. This includes explanations in the annual report which allow investors to compare, readily, the fees and expenses charged with the description of such fees and expenses set out in the fund's offering documents where this is not obvious from the disclosure in the financial statements.

Standard 2.6: On the establishment of a fund, a fund manager should liaise with the fund’s administrator to ensure that the methodology for calculating fees payable to the manager (and in particular performance fees) is agreed in advance. Such methodology should be accurately described in the fund’s offering documents.

Standards
Standard 8.3: The value of side-pockets should be reported periodically in the fund’s audited annual accounts in accordance with applicable accounting standards.

Performance Reporting

As discussed in Section 5 it is important that investors receive regular reporting that identifies the performance of their total holding inclusive of side-pocket holdings. Prospective investors should also be provided with a track record that reflects the performance of the fund (including side-pockets) and with a clearly disclosed performance methodology.

Appendix B - ILS Side-Pocketing Mechanisms

	Side-Pocketing by Contract	Side-Pocketing by Event
Side-Pocket Creation	A side-pocket share class is created that includes all contracts that might reasonably contribute to the valuation uncertainty of the fund from a set of given events.	A side-pocket share class is created with enough collateral to reasonably satisfy its responsibility to indemnify the main fund against all future loss payments in relation to the specified event(s).
Side-Pocket and Main Fund Exposure	Within the side-pocket investors are exposed to the fair value of all transferred contracts including all associated premiums and other economics. Within the main fund the investors are exposed to the fair value of the remaining contracts including all associated premiums and other economics.	Within the side-pocket investors are exposed to the development of loss reserves for the event. Within the main fund investors are exposed to the fair value of all contracts (including those that were impacted by the loss) along with any associated premium recognition which is calculated on the assumption that all future loss payments from the event(s) that triggered the creation of the side pocket, will be indemnified by the side-pocket. Premium recognition for contracts in the main fund is calculated consistent with the levels of fair value reserves.
Investor Exposure to Side-Pocket	In advance of any capital activity, a portion of existing investors' interest in the main fund shares is converted into an interest in side-pocket shares which are issued pro-rata to each investor's share of the main fund.	In advance of any capital activity, a portion of existing investors' interest in the main fund shares is converted into an interest in side-pocket shares which are issued pro-rata to each investor's share of the main fund.
Valuation of Side-Pocket	The side-pocket value is the sum of the fair values of the contracts contained within it.	The side-pocket value is the difference between the limit and the fair value of the side-pocket's indemnity obligations.
Capital Activity	Existing investors can redeem their main fund shares but typically cannot redeem side-pocket shares until trapped collateral is released from the trust account, contracts have been commuted, or valuation	Existing investors can redeem their main fund shares but typically cannot redeem side-pocket shares until the liability for losses related to the event becomes certain and the amount (if any) of excess collateral is known. (There may be partial redemptions over time if

	Side-Pocketing by Contract	Side-Pocketing by Event
	certainty has been restored to a sufficient degree and the contracts in the side-pocket can be returned to the main fund[16] (there may be partial redemptions as individual contracts are resolved). As contracts are resolved, side-pocket shares may be either converted back into shares in the main fund or if an investor has fully redeemed from the main fund, distributions will be paid directly to the investor. Incoming investors invest in the main fund shares only and do not participate in any existing side-pocket shares.	individual loss affected contracts in the main fund are resolved). As contracts are resolved, side-pocket shares may be either converted back into shares in the main fund or if an investor has fully redeemed from the main fund, a distribution may be paid directly to the investor. Incoming investors invest in the main fund shares only and do not participate in any existing side-pocket shares.

Appendix C - Further Detail on the Relationship between Trapped Collateral and Side-pockets

Trapped collateral results from contractual agreements between the counterparty and the fund, while side-pockets are an arrangement between the fund and its investors.

Trapped collateral aims to protect the counterparty from a premature reduction in the fund's capacity, and in some cases obligation[17], to pay losses, should those losses deteriorate after the expiry of the contract. Side-pockets aim to protect new, existing, and redeeming investors in the ways described in this memo.

As a result, the value of trapped collateral and the value of the side-pocket can and do differ, sometimes substantially. However, to succeed in protecting new investors from any possible "drag" on returns arising because trapped collateral is not available to reinvest, a side-pocket by event should contain all the trapped collateral and a side-pocket by contract should contain all contracts with trapped collateral.

There are several reasons why the value of the assets in the side-pocket and the amount of trapped collateral may not be the same in practice:

- Collateral can only become "trapped" after the expiry of the exposure period of the contract, whereas side-pockets may be put in place at any time. If a side-pocket is put in place prior to the expiry of the exposure period of all potentially impacted contracts, the manager may have to identify which contracts might have trapped collateral at expiry (side-pocketing by contract) or estimate the total size of the trapped collateral at expiry (side-pocketing by event). In either case, the manager may over or underestimate the potential value of the trapped collateral, but in most cases where some

[16] Contracts can be removed from the side-pocket when the fund and ceding company agree on the conditions under which all obligations for both parties in the agreement are discharged (commutation agreement) or the manager otherwise has reason to believe the valuation uncertainty of the contract is sufficiently low.

[17] The obligation to pay losses under a collateralized contract is often limited to the assets held in trust, in which case a partial release of collateral is equivalent to a partial commutation of the contract. However, some Managers adopt the position that they will pay up to the original limit regardless of the level of assets in the trust.

trapped collateral is left outside of a side-pocket set up as a new share class it can be (notionally) allocated to the side-pocket at a later point.

- The release of trapped collateral typically follows a predetermined contractual release schedule (known as a "Buffer Table" since trapped collateral is regarded as a buffer against increases in losses); whereas the timing of the release of assets from the side-pocket to the main fund or investors is typically at the managers of fund governing body's discretion, and may depend on factors including expected capital flows, availability of new contracts to reinvest the capital, operational considerations, or a view on whether there is recourse on any assets released from the trust. These considerations may result in a time-lag between the release of trapped collateral and the release of assets from the side-pocket which may result in the size of the side-pocket being larger than the amount of trapped collateral for a time. This will impact the liquidity of investors looking to redeem and may cause greater earnings drag to existing investors. It may also potentially be disadvantageous to the manager if reduced fees are being charged on the side-pocket.
- Over time, the asset manager may determine that both the level of trapped collateral and valuation uncertainty for a contract is sufficiently low that the contract can be released back into the main fund (side-pocket-by-contract) or the size of the side-pocket can be reduced (side-pocket by event).
- Contracts without trapped collateral may also be included in a side-pocket and for the manager to hold an additional buffer if collateral is anticipated to be needed to top up the side-pocket capacity.

Managers may have agreed with the cedant that any release of collateral from the trust represents a partial "commutation" of the contract such that there is no recourse to the assets that have been released and the maximum future liability under the contract is capped at the value of the collateral held in trust. In such situations, the assets released from the trust can be immediately paid to the investor or returned to the main fund. If, however, a manager believes it should observe the initial limit of the contract it may retain some or all the released collateral in the side-pocket as a further buffer against "loss creep".

Appendix D - SBAI ILS Working Group Members

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