Side Pocketing in Mutual Funds

- **The side pocketing is a framework** that allows mutual funds (MFs) to segregate the bad assets in a separate portfolio within their debt schemes.
- Under the side pocketing, to protect retail investors from the risky investments, the SEBI has allowed MFs to separate the stressed assets from good quality liquid assets.
- **If a debt instrument is downgraded to default rating by credit rating agencies,** then the MFs have the option to create a side pocket so that good assets can be ring-fenced.
- All existing investors in the scheme are **allotted equal number of units in the segregated portfolio** as held in the main portfolio and **no redemption or subscription is allowed in the segregated portfolio.**
    - Thereafter, the units (**in the segregated portfolio**) have to be listed on a stock exchange within 10 days to facilitate exit of the unit holders.
    - Effectively, this makes **the price discovery of the bad assets** with **investors having the freedom of either selling it at prevailing price or holding it** if they expect the value to recover in future.

Misuse of Side pocketing

- It could be misused by MFs to hide their bad investment decisions.
- The SEBI, however, has put in place checks and balances to minimise any such misuse.
    The Trustees of all fund houses will have to put in place a framework that would **negatively impact the performance incentives of fund managers, chief investment officers (CIOs)**, etc. involved in the investment process of securities under the segregated portfolio.
- The SEBI has also stated that side pocket should not be looked upon as **a sign of encouraging undue credit risks** as any **misuse of the option** would be considered serious and stringent action can be taken.