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The Cayman Islands and British Virgin Islands – Good Alternatives for a Crypto Fund

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A recent report published by AIMA, the [4th AIMA Annual Global Crypto Hedge Fund Report 2022](#), highlighted the continued growth in the AUM being allocated to this asset class during 2021.

The Report notes that crypto-specialist hedge funds are becoming increasingly sophisticated in terms of management and structuring and that, of the traditional funds surveyed, one in three is now investing in digital assets, with two thirds intending to allocate more capital into the asset class in 2022.

Whilst the data was collected before the recent market meltdown, the indications are that, in time, the allocation to this asset class is likely to continue to increase both amongst specialist funds and traditional funds.

According to the Report, the Cayman Islands remains the top location for the establishment of crypto hedge funds (with around 50% market share), with the British Virgin Islands (BVI) holding second place (with 13% market share).

The purpose of this article is to provide an overview of the fund regimes in each of the Cayman Islands and the BVI for people wondering where they might set up their crypto fund. It should be noted that the focus of this article will be on crypto funds with liquid strategies that provide investors with a right to redeem (even if subject to some redemption restrictions). Accordingly, these “open-ended” funds must always have enough cash or liquid assets in the fund to meet such redemption demands.

Both the Cayman Islands and the BVI offer comprehensive fund regimes. They have a proven track record, are appropriately regulated, tax neutral jurisdictions that are “crypto-friendly”.

Funds can be set up as companies, (including limited liability companies), segregated portfolio companies that allow for assets and liabilities to be separated into distinct pools amongst its segregated portfolios, limited partnerships or unit trusts depending on the particular needs or preferences of different types of investor, whether to reflect market convention, taxation or other considerations. These will then register with the applicable regulatory authority, being the Cayman Islands Monetary Authority (CIMA) in the Cayman Islands and the Financial Services Commission (FSC) in the BVI.

Funds will generally have an investment manager, administrator, auditor and custodian/prime broker, as appropriate. A few things to consider:

- **Investment Manager – a BVI Approved Manager**

Establishing an investment manager can be problematic, especially in the context of managing crypto assets. Many jurisdictions have fairly prescriptive rules governing the regulation of investment managers. One solution for a Cayman or BVI fund, may be to set up an “approved manager” in the BVI, which can then enter into an advisory agreement with an investment advisor, located in the applicable “onshore” local jurisdiction.

Registering an approved manager is a relatively straightforward process and an approved manager is not required to have personnel physically located in the BVI. Although regulated by the FSC, its ongoing obligations are limited, which is one of its key attractions.

An approved manager is subject to a cap of aggregate assets under management of US\$400 million for open ended funds. It is required to comply with the BVI AML/CFT regime and appoint an AML officer. In addition, it must submit an annual return and financial statements, but there is no requirement for those financial statements to be audited.

The FSC will need to ensure that the people behind the approved manager are “fit and proper”; however the approved manager may commence business if the FSC does not raise any questions in the seven days following submission of a completed application.

In a recent crypto-focused straw poll undertaken by Conyers, an overwhelming 85% of the respondents indicated that they would consider using a BVI approved manager.

- **Administrator**

From a practical perspective, a fund should seek to appoint a fund administrator that has genuine expertise and experience with Cayman or BVI funds. Each of these fund regimes permit “in kind” subscriptions, but AML verification of subscribers and source of funds generally falls on the administrator, which will also value the underlying crypto assets. Finding fund administrators that are sufficiently experienced and comfortable taking on this role has in the past proved problematic. However, there are now a number of good administrators with specialist expertise in this area.

- **Auditor**

Most of the major accounting firms will now take on crypto funds as audit clients.

- **Custodian**

A number of banks will now act as cash custodians for crypto funds and many of the well-known digital asset exchanges (e.g. Coinbase, Binance) are acceptable for crypto asset custody.

- **Offering Memorandum**

Generally, Cayman and BVI funds will file a copy of an offering memorandum with the relevant regulator. However, there are few restrictions as to what the fund may invest in or how the strategy would be deployed, which make Cayman and BVI attractive jurisdictions for crypto strategies.

Cayman Islands Crypto Funds

An open-ended crypto fund will be caught under the Mutual Funds Act (MFA), unless exempted. This usually means being regulated as a “registered” fund on the basis that the minimum initial subscription by an investor is not less than US\$100,000, unless listed on a recognised stock exchange. This is an institutional grade fund vehicle and most of the large open-ended funds set up in the Cayman Islands by established managers will fall into the category.

A fund with 15 or fewer investors, who have the power to appoint and remove the operator (i.e. directors, general partner or trustee), will also be subject to regulation by CIMA under the MFA. Historically, these did not have to be registered with CIMA, and were popular for closely held, “friend and family” type funds, but since the Mutual Funds (Amendment) Act 2020 did away with many of the perceived advantages of this type of fund, they have become less attractive as an option.

The operator of a Cayman fund will be expected to conduct business in a sound and prudent manner.

The fund’s offering memorandum must describe the interests on offer and must contain sufficient information as is necessary to enable a prospective investor to make an informed decision as to whether to make an investment. It should include a detailed description of the fund’s objectives and investment strategy and the related risks, as well as other details such as fees, the directors, the investment manager and other service providers and is subject to certain Contents Requirements, as prescribed by CIMA including its policies relating to segregation of assets and calculation of asset values.

The fund will be required to file audited accounts annually as well as an annual report that includes general information about the fund and certain operational information e.g. the nature of investments.

The fund will be subject to the Cayman AML/CFT and sanctions regimes and as such, will be required to appoint AML officers and have in place a written compliance policy and procedures manual. Whilst AML/CFT processing may be delegated to the administrator, this responsibility ultimately remains with the fund.

CIMA has recently allocated more resources to auditing its regulated entities for compliance and we expect CIMA to look more closely at its many regulated funds. A number of regulations have only recently come into effect and funds may not be aware how these apply and their ongoing monitoring obligations. CIMA has extensive investigative powers under the MFA and can impose administrative fines and even de-register a fund in certain circumstances, so the operators of a Cayman fund should ensure that they are up to date with these rules to ensure they are in compliance.

BVI Crypto Funds

BVI funds are regulated under the Securities and Investment Business Act, 2010 (SIBA).

There are four types of open-ended crypto funds; two that are more institutional grade and two that are lower cost, light touch alternatives that might be an attractive alternative for emerging or start-up managers.

The BVI Institutional grade funds are broadly similar to Cayman “registered funds”.

Professional Funds and Private Funds:

- Professional Funds have no limits on assets under management or the maximum number of investors. However, they may only be offered to “professional investors”¹ and the minimum initial investment amount is US\$100,000, except for “exempted investors”.²
- Private Funds have no cap on assets under management, there are no investor qualification requirements, and no minimum initial investment per investor applies. However, they may only be offered to a maximum of 50 investors (or potentially more than 50, provided the offer is made on a “private basis”³ only).

Each must maintain a clear and comprehensive policy for the valuation of fund property with procedures that are sufficient to ensure that the valuation policy is effectively implemented. Although one would normally expect an offering memorandum to be prepared, the FSC may exempt the fund from preparing and submitting an offering document, if it is satisfied as to how information will otherwise be communicated to potential investors.

Each must at all times have a fund manager, a fund administrator and a custodian, unless exempted.

In addition, each is also required to have an auditor and is required to provide a copy of its audited financial statements to the FSC within six months after its financial year end.

BVI Funds must comply with relevant anti-money laundering legislation and regulations including the requirement to have an anti-money laundering reporting officer.

Approved Funds and Incubator Funds

There are two light touch, low cost BVI crypto fund alternatives suitable for start-up/emerging managers looking to prove their investment strategy and establish a track record in the most cost-efficient manner.

- Approved Funds: the only mandatory service provider is a fund administrator. No investor qualification requirements apply, and there is no minimum initial investment per investor. Approved funds must provide a written description of their investment strategy and a document containing certain risk warnings to investors, but are not otherwise required to have an offering document. However, assets under management cannot exceed US\$100m, and the number of investors cannot exceed 20. It must convert to another type of fund (e.g. private or professional fund) upon reaching these thresholds or be wound up.
- Incubator Funds: these have no mandatory service providers. However, assets under management cannot exceed US\$20m, and the number of investors cannot exceed 20, with a minimum initial investment of US\$20,000. They also have a finite life-span of a maximum term of 2 years (although this can be extended by up to 12 months with permission from the FSC), and upon expiry the fund must be converted into another type of fund or otherwise be wound up.

A fund must have two directors, one of whom must be an individual, and whose resume will need to be submitted to the FSC at the time of application. As well, the fund will need an authorised representative in the BVI.

The benefit of an incubator fund is that it does not require an offering memorandum, licensed investment manager, administrator, custodian or auditor. Rather, investors must only be provided with a written description of the investment strategy and a written outline of the risks including the risk of investing in an Incubator Fund.

An incubator fund must submit semi-annual returns to the FSC confirming its continuing eligibility as an incubator fund.

Both types of funds must submit annual returns as well as annual financial statements, although these need not be audited.

Incubator and Approved funds can be brought to market very quickly. Each can commence business two clear business days after submitting a completed application. The reduced establishment and operating costs, speed to market and the flexibility to appoint only

¹ A “professional investor” is a person: (a) whose ordinary business involves, whether for that person’s own account or the account of others, the acquisition or disposal of property of the same kind as the property, or a substantial part of the property, of the Partnership; or (b) who has signed a declaration that he, whether individually or jointly with his spouse, has net worth in excess of US\$1,000,000 and that he consents to being treated as a “professional investor”.

² An “exempted investor” is defined by SIBA as: (a) the manager, administrator, promoter or underwriter of the fund; (b) any employee of the manager or promoter of the fund; and (c) such other class or description of persons as the Commission may, by notice published in the BVI Gazette, specify as “exempted investor”.

³ An invitation made on a “private basis” includes an invitation which is made (a) to specified persons and is not calculated to result in shares becoming available to other persons or to a large number of persons; or (b) by reason of a private or business connection between the person making the invitation and the investor.

such service providers as the fund itself requires for commercial reasons, make Incubator and Approved funds welcome additions to the suite of BVI fund products.

Conclusion

As more crypto funds are being set up, and both existing managers and new entrants consider their options, it is worth noting that the funds regimes of both the Cayman Islands and the BVI have shown they are sufficiently adaptable to cater across a broad range of fund types.

They should rightly be recognised as jurisdictions of choice for setting up crypto funds.

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