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# Fund innovation and incubators in a digital world

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In this article, Christian and Simon revisit the incubator fund – ever-popular with hedge fund managers and family offices – focusing on the structure's new popularity among crypto and digital investors.

Ever been told you have 20-20 vision – well what about 20-20-20 foresight? Innovation is not new to the British Virgin Islands (BVI) – in fact they are becoming rather used to it – take their Private Investment Fund regime launched in 2020 which brought a new regulatory regime for close-ended funds. This coupled with its welcome 2020 "white-listing" on financial crime by the European Union bodes well for the continued business growth trajectory. Not long ago, they introduced a new regime for Incubator Funds – often known as 20-20-20 funds.

This structure was devised in 2015 before anyone had even heard of a bitcoin, but fortuitously it provided the perfect set-up for light-touch, short-term crypto vehicles. The BVI incubator fund incorporates a '20- 20-20 criteria' – it allows a maximum of 20 sophisticated investors, each of whom must make a minimum initial investment of USD20,000 but the fund must not exceed a cap of USD20 million in terms of the aggregate value of its investments.

The BVI has one of the largest cryptocurrency markets in the world, featuring in the top five geographical markets by USD denominated trade volume, as indicated by CoinShares Research CryptoReport.

**Innovation is key**

The crypto hedge fund is a new phenomenon, created by entrepreneurial investment managers looking to take advantage of the huge gains that cryptocurrencies have experienced over the last three years. At present, the sector is still in its fledgling phase. A 2019 report by PwC estimated that there are fewer than 200 active crypto hedge funds collectively being managed today, with only USD1 billion in total assets under management (AUM).

It seems more a sector for plucky managers who see the potential in the asset class for now – the average crypto hedge fund team is seven to eight people, managing just USD21.9 million in AUM according to PwC. That said, the cumulative average investment management experience for crypto funds is 24 years, indicating that an increasing number of experienced investment professionals are moving into the space. The BVI is home to one in six of these crypto hedge funds – in fact it is a top three jurisdiction for such funds, according to PwC. So why are start-up investment teams choosing to domicile their new funds in the BVI and what do we foresee for the future of the asset class.

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**A great fit**

Indeed, the most popular fund structure that crypto hedge fund managers are choosing in the BVI is the incubator fund. It provides the ability to setup and run a cost-efficient legal entity for trading an investment strategy with limited on-going obligations. This product appeals to the increasing number of pioneer managers who are looking to gain a track record before converting the Incubator Fund to a more sophisticated fund product. It works well for the growing fintech and crypto-asset fund type.

Hedge fund managers are often attracted to this structure as offshore funds are typically subject to significant administration costs and high levels of supervision, whereas the BVI incubator fund minimises initial requirements so as to enable start-up crypto managers to come to market faster and more seamlessly.

**Taking advantage of the crypto bounce**

While many hedge fund managers enjoyed the 2017 highs of crypto assets, the last 18 months have been more challenging with bitcoin down 72 per cent alone. That said, things are looking up once again thanks, in part, to the mainstream acceptance of crypto assets and the spectre of Facebook having launched its own crypto currency, Libra. Since January 2019 the asset class has bounced, with bitcoin up more than 160 per cent over the last nine months.

Just recently, Tesla, the electric car company headed by billionaire Elon Musk, has become the first Fortune 500 corporation to get bitcoin exposure to its balance sheet as it bought USD1.5 billion in bitcoin last month. Tesla has become the second corporation to add bitcoin to its balance sheet, a trend started by the business intelligence company MicroStrategy, which already received a massive return on its bitcoin investment

To take advantage of this bounce, hedge fund managers will be seeking jurisdictions that do not over-regulate but rather support and encourage the asset class – and the BVI is doing just that and its progressive FinTech and Sandbox regime (which allows businesses to trial new products and services under the supervision of the BVI FSC without the need to apply for a license to conduct financial services business) is testament to this fact.

**Light-touch regulation**

Incubator Funds and Approved Funds were introduced in the British Virgin Islands under the Securities and Investment Business (Incubator and Approved Funds) Regulations, 2015. Both are lightly regulated fund products reflect the Financial Services Commission's (Commission) awareness of global funds market trends and are designed to meet the needs of the asset management industry reinforcing its commitment to ensuring that the BVI remains a pre-eminent, dynamic and attractive domicile for investment funds products which maintaining best practice in international standards. These funds have answered the call for a recognised need in the market for a lightly regulated investment vehicle that can easily grow along with a first time or start up manager as their business and assets under management grow.

**The need for speed**

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The new fund structures are designed to facilitate rapid and cost-efficient setup, with reduced requirements as to fund service providers and an accelerated FSC approval process. Incubator and approved funds can be brought to market very quickly. The Regulations provide that the funds can commence business two days after submitting the application to the Commission, provided that the application is complete and the Commission does not raise any questions in this two day period. The reduced establishment and operating costs, speed to market and the flexibility to appoint only 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.

**Ease of operation**

An incubator fund does not need to appoint an administrator, custodian, investment manager or auditor providing significant cost advantages. Provided it continues to meet the 20-20-20 criteria, the Incubator Fund can operate for a period of two years (which may, on application to the FSC, be extended by one additional year) before it needs to either convert to a more sophisticated structure, such as an Approved Fund (see below) or a private or professional fund, or wind-up its operations. The approval process is fast and the Incubator Fund can commence business two business days following receipt of the application by the Commission.

An incubator fund is required to provide a written description of its investment strategy and a document containing certain risk warnings to investors, but it is not required to have an offering document. Restricted to sophisticated private investors and so perfect for savvy hedge fund and crypto investors. If an incubator fund exceeds the maximum number of investors or the maximum NAV thresholds over a period of two consecutive months, it is required to submit an application for conversion into a private, professional or approved fund.

**Approved Fund**

The approved fund is aimed at managers seeking to establish a low-cost, unsupervised fund for the longer term, but on the basis of a more private investor offering. The approved fund is particularly suited to family offices.

An approved fund is suitable for sophisticated private investors and has a net assets cap of USD100 million and no more than 20 investors are permitted, but with no minimum investment criteria. An approved fund may operate without appointing a custodian, investment manager, or auditor, but unlike an incubator fund will need an administrator. An “Approved Fund” is similar to a BVI private fund, but is subject to less stringent regulation, has no requirement for an auditor, has lower on-going costs, and targets investment managers originating out of the family office/friends and family market.

An approved fund may, at any time, voluntarily apply to the Commission for recognition as a private or professional fund, and is required to convert into a private or professional fund if it exceeds one of the applicable thresholds over a period of two consecutive months.

**Conclusion**

Hedge fund managers are starting to make a name for themselves using crypto assets, working with great minds to develop smart assets and the BVI is dedicated to ensuring that they are not stymied by unnecessary

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bureaucracy in this process. Its Sandbox regime is testament to this business friendly approach. Clearly, the BVI is making its place as one of the preferred jurisdictions when looking to establish an enterprise in the fintech, blockchain or digital asset space. We look forward to continuing making the BVI the global hub for this exciting type of investment into the future.

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