Recent PwC Report ranks Cayman Islands and British Virgin Islands as the preferred jurisdictions for crypto open-ended funds

August 2022

In June 2022, PwC published their 4rd Annual Global Crypto Hedge Fund Report (the "**Report**"), an overview of the global crypto open-ended fund landscape that takes a deep dive into the different elements that define these funds, including but not limited to their preferred location, size of the market, their fees, investors type, liquidity terms, strategies and performance, custody and governance.

In the Report, PwC focusses on those funds which invests/trades in liquid, public cryptocurrencies and other instruments and excludes crypto index funds and crypto venture capital funds.

Location

The Report found that the most common jurisdictions where crypto open-ended funds are domiciled are:

1. **Cayman Islands** - is the preferred place with almost half of the market (49%).

2. **British Virgin Islands** ("**BVI**") with 13%. The BVI has overtaken the United States as the second most popular location. Each location saw its share of the market increase slightly year on year, Cayman Islands from 48% to 49% and British Virgin Islands from 11% to 13%.

3. **The United States** saw their market share reduced from 46% to 10% during 2021.

The Report lists factors which influence the decision on crypto hedge fund domiciles and the most popular answers were due to 'crypto friendly' (22%), 'regulations' (20%) and 'fund friendly' regulations (17%). This indicates that as many governments and authorities still take a rather unfriendly or indifferent approach towards the crypto industry, or rather are still trying to figure out the correct mix of regulations, other jurisdictions like Cayman and the BVI have stepped up and provided solutions that appear to tick most of the boxes for making them attractive as domiciles for these types of investment funds.

Market Size

As per the Report, the total assets under management ("**AUM**") of crypto open-ended funds increased by 8% to about $4.1 billion in 2021, compared to $3.8 billion reported by respondents to the Report in 2020. According to the Report, there were fewer funds with lower levels of AUM at the end of 2021, while at the other end of the spectrum, the number of funds managing larger amounts of assets was considerably higher.

A significant detail shown in the Report is that 89 hedge funds accounted for an estimated US$436 billion in AUM.

Fees

According to the Report, the average management fees for 2021 in crypto open-ended funds remained the same (2.2%). The lack of significant change in management fees is likely to reflect the fact that running costs could have remained at a similar level in relation to previous years. The average performance fee slightly decreased (from 22.5% to 21.6%). The decreased performance fees are likely to be a result of competitive pressures starting to increase, as more funds enter the cryptocurrency space and compete to attract new investors, leading to slightly lower overall fees.

The Report raised concerns regarding the upcoming higher organizational cost of crypto open-ended funds as worldwide regulations are becoming more detailed and investors are demanding more professional and institutional set-ups.

Investors

The Report identified High-net worth individuals ("**HNWI**") as the most common investor type in crypto open-ended funds, with more than 80% of surveyed funds stating them as their usual type of investor. HNWIs are followed by family offices accounting for 66% and fund-of-funds representing just over 53% in third place, where HNWIs are also the largest investors within these fund-of-funds.

Having in mind that the Report surveyed retail crypto open-ended funds, the average number of investors per fund is 54. However, a more representative value could be the median number of investors, which is 30.

The Report found that the average investment made into crypto open-ended funds is $1.63M but most funds have a ticket size of less than $0.5M.

Cryptocurrencies

The Report states that 29% of the crypto open-ended funds surveyed have at least half of their daily cryptocurrency trading volume in Bitcoin compared with 56% in 2020.

The top three sectors that crypto hedge funds have invested into are Store of Value (Bitcoin and Litecoin) with 86%, DeFi (Uni, Aave and Sushi) with 78%, and Infrastructure (Ethereum) with 74% based cryptocurrencies.

In 2021 more altcoins have been traded by over 40% of the funds compared to last year where only one altcoin (Ethereum) was traded by more than 40% of the funds. 2021 shows that Ethereum (ETH, 83%), Solana (SOL, 51%), Polkadot (DOT, 48%), Terra (LUNA, 45%), and Avalanche (AVAX, 42%), were the top traded coins (stable coins were excluded).

However, the recent incident of the collapse of LUNA could become a setback for the general crypto industry in the short term.

Strategies

- **Market Neutral**: The most common (30%) investment strategy among crypto open-ended funds is Market Neutral. These funds aim to profit regardless of the direction of the market, usually using derivatives to mitigate or eliminate broader market risk.

- **Quantitative Long Short**: This investment strategy makes up for a quarter of all currently active crypto funds with a 25%. Quantitative funds, also called quant funds, are investment funds where crypto are chosen based on numerical data compiled through quantitative analysis. Liquidity is key for these strategies and restricts these funds to only trading more liquid cryptocurrencies.

- **Discretionary long only**: This investment strategy represents a 14% of all the crypto fund. For crypto open-ended funds involved in investing in early token and coin offering and investing and holding in other more liquid cryptocurrencies and digital assets.

- **Discretionary long/short strategy**: This investment strategy represents a 12%. For crypto open-ended funds, discretionary long/short strategy involves buying cryptocurrencies and digital assets that are expected to increase in value and selling short cryptocurrencies and digital assets that are expected to decrease in value.

- **Multi-strategy funds**: Lastly, the multi-strategy funds (a combination of all the above) represent a much smaller proportion with barely 12% of the market.

In terms of performance these strategies had very different results. Market Neutral funds gave an average performance of +37%, Discretionary Long an average performance of +420% and Quantitative Long/Short an average performance of +116%. Against the trend from previous years, the crypto hedge funds had a median performance of 63.4% in 2021, slightly outperforming BTC's price, which went up about 60%.

Functionaries

Custodian: Interestingly, as the crypto ecosystem continues to mature and institutional investors' demands are allocated, the Report shows that the digital asset custody market has expanded. This has led to the utilization of independent custodians. Compared to the 2020 data, the use of independent custodians has increased from 76% to 82%, with funds opting either for third-party, or exchange custodians. For example, quantitative fund, discretionary long/short and multi-strategy funds may have their cryptocurrencies and digital assets directly with the exchanges that they use to trade continuously. Therefore, having a well-defined and updated risk management policy is more important than having a custodian.

Independent Directors: The Report reflects that in 2021, there has been an increase in the percentage of crypto open-ended funds with an independent director on their board from 38% to 51%. This number increased due to three main reasons:

1. A growing number of newly formed, governance-conscious funds driving demand for independent directors;
2. existing crypto hedge funds becoming more structured and financially capable of hiring senior talent; and
3. A growing supply of board directors possessing industry-specific expertise and knowledge as the industry further matures.

Administrator: 91% of the crypto open-ended funds surveyed for the Report have appointed and use independent third-party administrators. The main service required by these funds from the administrators is to independently calculate and verify the net asset value and prepare all the required information for the auditor.

Institutional and/or sophisticated investors are increasingly unwilling to invest in a crypto open-ended fund that has not appointed an independent fund administrator.

Regardless of the choice of fund administrator, the valuation policy needs particular focus. Most funds will have their valuation methodologies and frameworks set out in the Private Placement Memorandum (PPM). It is important for any fund to ensure that it complies with the key terms of the offering set out in its offering documentation.

Conclusions

1. Institutional and Sophisticated investors are familiarized with the Cayman Islands and BVI and the regulatory regime for open-ended funds. These investors feel more comfortable investing in crypto open-ended funds established in Cayman and BVI as these two offshore jurisdictions have a track record, infrastructure and regulation that facilitate the operation of these funds.

2. The investment funds industry is slowly starting to consider the cryptocurrencies and other digital assets as other underlying assets that an open-ended fund can invest in.

3. The tax neutrality of the Cayman Islands and the BVI provides the perfect location for crypto open-ended funds and investors to manage their tax affairs in the most effective manner.

4. The laws of the Cayman Islands and the BVI are a combination of common law and statute and are based heavily upon English common law. This gives Cayman Islands and BVI law and their respective legal systems a common origin with those of many of the jurisdictions of its users, including the United States. It also means that a fund registered in the Cayman Islands or the BVI and its participating shares are well recognised and accepted around the world.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice on Crypto open-ended funds, please contact your usual Loeb Smith attorney or :

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About Loeb Smith Attorneys

Loeb Smith is an offshore corporate law firm, with offices in the British Virgin Islands, the Cayman Islands, and Hong Kong, whose Attorneys have an outstanding record of advising on the Cayman Islands' law aspects and BVI law aspects of international corporate, investment, and finance transactions. Our team delivers high quality Partner-led professional legal services at competitive rates and has an excellent track record of advising investment fund managers, in-house counsels, financial institutions, onshore counsels, banks, companies, and private clients to find successful outcomes and solutions to their day-to-day issues and complex, strategic matters