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CUMMINGS PEPPERDINE

CUMMINGS PEPPERDINE ON HOW TO SET UP A CRYPTO FUND

INTRODUCTION

Starting a fund which invests in a crypto strategy is in many ways similar to starting any other fund.

Many of the initial issues to think about and structure will be the same, and information on all of these is set out below.

However, due to the nature of the asset class there are some points to consider which are specific to crypto investing.

In this note we set out those crypto specific details to look at when setting up a crypto fund, and wider fund structuring issues to be considered.

CRYPTO ISSUES

Custody

The fund will need to appoint a specialist custodian for all crypto assets. This should be an independent party.

The provision of wallet services as a "custodian wallet provider" is regulated under The Fifth Money Laundering Directive ((EU) 2018/843) ("MLD5"). In brief summary only, a custodian wallet provider is a firm or sole practitioner who, by way of business, provides services to safeguard, or to safeguard and administer cryptoassets on behalf of its customers and private cryptographic keys on behalf of its customers to hold, store and transfer cryptoassets. Therefore, the fund's crypto custodian should be regulated.

The exchange of cryptoassets

The same point on regulation applies to any cryptoasset exchange provider which the fund may use. Again in brief summary only, a cryptoasset exchange provider is defined as a firm or sole practitioner who, by way of business, provides one or more of three services, including doing so as creator or issuer of any of the cryptoassets involved, when providing these three services. The relevant services are: exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets; doing the same with a view to the exchange of one cryptoasset for another; and operating a machine that uses automated processes to exchange cryptoassets for money or money for cryptoassets. This may mean that the investment manager needs to check the regulatory status of each party in the chain of a transaction, including its own.

Risk factors

Every fund needs to set out substantial risk factors in its offering documentation. With a crypto fund these risk factors need to include specific crypto risk factors. These may include issues such as the uncertainty of the regulatory arena and the legal status of some cryptoassets, the lack of protection, ownership problems, staking risks, malicious actors, forks and the risks of technology such as losing private keys.

INITIAL STRUCTURING ISSUES

When setting up a crypto fund, you will need to consider the following matters:

- Jurisdiction
- Regulatory considerations
- Fund structure
- Eligible investors
- Authorisation and regulation
- Directors and other service providers
- Share classes
- Fees
- Equalisation or series accounting
- Lock up, redemption periods and gates
- Listing

In order to determine these issues, you will need to seek professional advice from your tax advisors and legal counsel. You may also find our new funds questionnaire useful in helping distil your thoughts:

cummingspepperdine.com/Cummings-Pepperine-on-New-Funds-Questionnaire.pdf

JURISDICTION

It is common for funds to be incorporated in an offshore jurisdiction, such as the Cayman Islands, the British Virgin Islands, Bermuda, Guernsey or Jersey, so that the investor, rather than the fund, pays tax on the increase in value of the fund's portfolio. For some investment managers, jurisdictions such as Luxembourg, Malta and Ireland are more attractive, due to perceived EU advantages, while others are deterred by the regulation which comes with an EU alternative investment fund ("AIF") as well as an EU alternative investment fund manager ("AIFM"). Which jurisdiction you choose will often depend upon the type of fund structure used, regulatory factors and the tax environment of the fund's potential investors.

Not all jurisdictions are as welcoming or experienced in crypto funds as others and this will also be a consideration.

FUND STRUCTURE

The types of fund structure most commonly seen are: stand-alone, master/feeder and umbrella funds, segregated portfolio companies (SPCs) and side-by-side.

Stand-alone fund

A stand alone fund is a single fund in which investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets.

Master/feeder fund

A master/feeder structure is generally used if the fund is being promoted to two separate categories of investor: (i) US taxable investors and (ii) US non-taxable and non-US investors. These two categories will, for US tax and compliance reasons, wish to invest in separate entities and this is generally achieved by setting up a master/feeder structure with two feeders, one for each category, which both feed into the master fund. Investors subscribe for shares in the relevant feeder and each feeder then subscribes for shares in the master fund, which then trades on behalf of the feeder funds.

Umbrella fund

An umbrella fund is a single legal entity which has several distinct sub-funds, each of which are traded in effect as individual funds. This allows a fund to create different classes of shares, which generally trade different strategies by investing in underlying companies which conduct all trading. By this use of subsidiaries, the assets and liabilities of each share class are generally segregated from those of the other classes of shares. This type of structure is often used, for example, if the fund wants to apply leverage to some shares and not to others and the segregation means that any downside (or upside) as a result of a riskier strategy will, in most circumstances, only affect that share class and not those share classes pursuing a less risky strategy. The umbrella fund can also be the master fund in a master/feeder structure.

SPCs

An SPC, referred to as a protected cell company or similar in certain jurisdictions, is a fund which segregates the assets and liabilities of different portfolios, or cells, from each other and from the general assets of the SPC itself. The segregated portfolios (or cells) are each a separate legal entity with the intention being that only the assets of each segregated portfolio are available to meet liabilities to creditors in respect of that segregated portfolio. A point to note, however, that although SPCs are found in a number of jurisdictions, in one form or another, the concept of segregation has not been fully tested in the courts. An SPC can also be the master fund in a master/feeder structure.

Side-by-side fund

A side-by-side fund structure comprises two single funds, each of which takes a different category of investor but trades the same strategy. Again, investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets.

ELIGIBLE INVESTORS

The promotion of funds is restricted by law and they may only be promoted to certain categories of investors as set out under relevant law; as a result they are generally directed at institutional investors, such as pension funds, and sophisticated high net worth individuals and, save with the exception of UCITS funds, are not available to the general public. The investment manager and/or any other distributor of a hedge fund is responsible for ensuring that shares in the fund are being offered only to eligible investors. UCITS may be offered to retail clients, but this is due to the fact that a UCITS fund incorporates certain investor protection mechanisms.

There are also issues relating to the promotion of cryptoassets which may need to be considered. In its policy statement PS19/22 (the policy statement to which the FCA's cryptoassets guidance is appended) the FCA stated that it expects all authorised cryptoasset market participants to apply the financial promotion rules and communicate financial promotions for products and services (whether or not regulated) in a clear, fair and not misleading way.

Where an authorised firm decides to offer access to unregulated cryptoassets (such as exchange tokens, like Bitcoin) it must not suggest in the communication that their authorisation extends to those unregulated cryptoassets.

Additionally, as with all financial promotions, any such communication must be transparent to ensure consumers are aware which activities the firm is authorised for (and so which activities the consumers have regulatory protections for). The FCA addressed this issue in a Dear CEO letter from January 2019 to firms which explained the need for clarity in promotions about regulated and unregulated business. Currently, the government is consulting on proposals to bring certain additional cryptoassets into the scope of financial promotion regulation.

Remember that the promotions of cryptoassets are separate to the rules on the promotion of AIFs. Where a crypto fund is established it will be an AIF and the marketing rules found in the AIFM and those with a UK domestic genesis apply.

AUTHORISATION AND REGULATION

In the UK the financial regulator is the FCA. The FCA regulates entities which conduct specified investment activities in relation to specified types of investment. More information on this can be found in our publication on the FCA's regulatory role by following this link: cummingspepperdine.com/Cummings-Pepperine-on-FCA-Regulated-Activities-and-Investments.pdf

The fund

Unless the fund is exempt from regulation in the relevant jurisdiction (due to its size or the number of its investors, for example), it will be necessary to register the fund with the relevant authority, such as the Cayman Islands Monetary Authority (CIMA), the Central Bank of Ireland or CSSF (the Luxembourg regulator), for example, and will be regulated by that authority accordingly. Depending on the type of fund, this regulation can range from paying a prescribed annual fee and submitting the fund's prospectus to obtaining approval of the service providers and any subsequent changes to those service providers.

The investment manager

In the EU and the USA, an investment manager is required to be authorised to carry out regulated activities and most investment managers will usually be based in these jurisdictions. In the UK, an investment manager must be authorised by the Financial Services Authority and it can take up to six months for an application to be approved. As part of the approval process, the investment manager has to demonstrate that it has adequate financial resources, has determined the systems and controls it will need to put in place and has appropriate staff carrying out controlled functions.

We have produced information on the regulation of the investment manager and certain routes to authorisation, which can be found in the following links:

cummingspepperdine.com/Cummings-Pepperdine-on-Making-an-FCA-Application.pdf

cummingspepperdine.com/Cummings-Pepperdine-on-Appointed-Representatives.pdf

cummingspepperdine.com/Cummings-Pepperine-on-regulatory-hosting-platforms.pdf

The investment manager will also need to be properly constituted from a legal perspective. It may be a limited liability company which requires a shareholders agreement, or a limited liability partnership which requires a partnership agreement.

We have questionnaires in relation to each such agreement which can help at the structuring stages. These can be found in the following links:

cummingspepperdine.com/Cummings-Pepperdine-on-Shareholder-Agreements.pdf

cummingspepperdine.com/Cummings-Pepperdine-on-LLP-Agreements.pdf

AIFM Directive

The Alternative Investment Fund Managers Directive (AIFMD) is a European Directive which was transposed in UK law by 22 July 2013. All alternative investment funds managers established in the EU, whether they manage EU or non-EU AIFs, are subject to the AIFMD. The AIFMD also governs the marketing in the EU of AIFs managed by non-EU AIFMs.

The scope of the AIFMD is broad and, with a few exceptions, covers the management, administration and marketing of AIFs. Its focus is on regulating the AIFM rather than the AIF. An AIF is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes crypto funds as well as hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others. The AIFMD established a framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, and for strengthening the internal market in alternative funds which was originally harmonious in the EU. It still applies in the EU and has been onshored to the UK post Brexit. It also includes requirements for firms acting as a depositary for an AIF.

All investment managers established in the EU, whether they manage EU or non-EU funds, are subject to the AIFMD. In order to get permission to market their funds in the EU, an investment manager must be authorised by the regulator in the EU country in which it is established. Once the investment manager is authorised, it can then market its funds throughout the EU. Investment managers based outside the EU will be prohibited from marketing their funds in the EU, unless they meet various fiscal and regulatory requirements. Investment managers based in the EU who run funds established outside the EU are also subject to additional restrictions. The Directive contains provisions on:

- Scope
- Organisational requirements
- Leverage
- Depositary
- Delegation
- Risk management
- Liquidity management
- Reporting/disclosure requirements
- Annual report

The impact of the AIFMD on AIFMs depends on the size of the assets under management of the AIFM, which determines whether the AIFM is a "full-scope" AIFM or a "sub-threshold" AIFM. Full-scope AIFMs are those AIFMs whose assets under management exceed €100 million, or €500 million where the portfolios of AIFs consist of AIFs that are unleveraged and where investors cannot redeem their interest in the first five years after investing. Full-scope AIFMs are required to comply with all aspects of the AIFMD. AIFMs whose assets under management fall below the full-scope threshold will fall into the category of small, or sub-threshold, AIFM and will be regulated as such (although a small AIFM may elect to be regulated as a full-scope AIFM). This can be described as falling under a "register and report" regime. As stated above, the AIFMD was onshored after Brexit and continues to apply to UK investment managers.

MiFID II

As of 3 January 2018, the MiFID II Directive and the Markets in Financial Instruments Regulation (MiFIR) repealed and recast MiFID. Together, the MiFID II Directive and MiFIR ("MiFID II") will form the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third country firms providing investment services or activities in the EU. They are further developed by a series of regulatory technical standards, implementing technical standards and the EU Commission's delegated directive (the "Delegated Directive"). MiFID II does not only apply to MiFID II firms. On 3 July 2017, the FCA published its policy statement (17/14) which set out those parts of MiFID II which will impact non-MiFID firms, such as alternative investment fund managers ("AIFMs") and UCITS management companies. The impact of MiFID II on an investment manager will, of course, depend on the specific circumstances of such manager. However, the AIFM may wish to

consider the following in light of MiFID II: (i) inducements and unbundling of research, (ii) taping and communications, (iii) conflicts of interest, (iv) product governance; and (v) client order handling. As with the AIFMD, MiFID II was onshored after Brexit and continues to apply in the UK.

GDPR

The General Data Protection Regulation ("GDPR") will come into effect on 25 May 2018. The GDPR aims to protect: (i) natural persons with regard to the processing of personal data and rules relating to the free movement of personal data and (ii) fundamental rights and freedoms of natural persons and in particular their right to the protection of personal data. "Controllers" and "processors" of personal data in the EU are regulated by the GDPR and have legal obligations to, among other things, provide guarantees of their ability to comply with GDPR requirements, maintain records of personal data and processing activities and implement safeguarding measures of personal data. The GDPR is quite broad in scope and the fines for breaching can be costly, therefore managers will want to ensure compliance with GDPR requirements.

DIRECTORS AND OTHER SERVICE PROVIDERS

Directors

The fund will require at least two directors, who for a listed fund must be independent and this is often required for governance issues. For UK tax reasons they must be based offshore of the UK and if the fund has more than two, the majority must be based offshore of the UK. This is to ensure that central management and control is exercised, and is seen to be exercised, offshore of the UK for tax purposes and there is no danger of the fund being regarded as resident onshore or having inadvertently created a permanent establishment in the UK (and taxed accordingly). This must be adhered to strictly, as a tax authority, such as HMRC, will examine the position carefully and if they consider that acts of controlling power and authority are exercised to a substantial degree onshore, then despite the fund's jurisdiction, it will be taxed as resident wherever the person or persons exercising that control actually exercises it. This means that all meetings and conference calls should be held offshore and no decision taken without a majority of the board offshore and no UK based director may act or think in that role while in the UK. The directors are permitted to delegate certain duties, such as the discretionary investment management and administration, but must realise that they retain ultimate responsibility for management of the fund. The directors will commonly hold quarterly meetings, at least once a year in person, and may be required at other times; it is important to choose directors who will make themselves available and will execute documents promptly and efficiently and are fully suitable.

The Investment Manager Exemption

The Investment Manager Exemption (IME) allows an offshore fund to appoint a UK-based investment manager without creating a risk of UK taxation for itself. Through a series of qualifying tests, the IME ensures that overseas investors are not charged to UK tax in relation to investment transactions conducted on their behalf and that any fees received by a UK-based investment manager for services performed for the non-resident are fully chargeable to UK tax. The IME only applies to certain 'investment transactions', set out in government regulations. In addition to a transaction being an investment transaction, there are several conditions which must be met in a specific time limit for the IME to be satisfied. Broadly, these are as follows:

- the UK investment manager is in the business of providing investment management services;
- the transactions are carried out in the ordinary course of that business;
- the investment manager acts in relation to the transactions in an independent capacity;
- the requirements of a '20% test' (ie the investment manager and associates do not make up 20% or more of the fund investors) are met; and

- the investment manager receives remuneration for provision of the services at not less than the rate that is customary for such business.

Other Service Providers

In addition to an investment manager, a fund requires an independent administrator, an independent auditor, and, depending on the details of the investment strategy, a custodian and/or prime broker.

Entities which provide wallets will need to be registered with the FCA under money laundering rules. For more details, please see our note on the regulation of cryptoasset business which can be found at:

cummingspepperdine.com/Cummings-Pepperdine-on-FCAs-regulation-of-cryptoasset-businesses.pdf

Some funds appoint a manager as well as an investment manager and this is often done for tax reasons, as the manager is usually based offshore. The fund will also require legal counsel, who will be responsible for establishing the fund and preparing and negotiating the various fund documents, including the prospectus, the material contracts between the fund and its service providers and incorporation documents. The fund will also need to consult tax advisors to enable the relevant parties to determine which structure is suitable in their own circumstances.

SHARE CLASSES

It is common for a fund to create management shares and investment shares. The management shares hold the voting rights, but do not participate in the profits of the fund, while the investment shares are non-voting, but do participate in the profits and are redeemable. The reason for this is to avoid having to seek the consent of the investors, who could be numerous, for decisions arising in the day to day management of the fund. The management shares can be held by the investment manager or, as is commonly found in Cayman funds, by a star trust.

Within the investment shares, the directors can choose to create any number of share classes. All the shares in the same class must be treated equally, thus it is necessary to create different share classes to accommodate varying rights, such as different redemption rights, different fees, the use or non-use of leverage or, most commonly, alternative currencies. A fund will often offer a separate share class for investment solely for the officers and employees of the investment manager, which will not be subject to any management or performance fees so as to avoid the investment manager charging itself fees.

Funds may also consider establishing a class of share for UK taxable investors which could benefit from the reporting regime.

FEES

In addition to the fund start up costs (as to which see below), the investment manager will charge management and performance fees. These can range between 1% - 5% and 10% - 25% respectively, but a typical fee structure for a fund is 1.5% to2% and 20% respectively. Other on-going fees for the fund include administration fees, regulatory fees, auditor fees, custody and brokerage costs, directors' fees and other professional costs.

EQUALISATION AND SERIES ACCOUNTING

Equalisation or series accounting ensures that a performance fee is charged only to those investment shares which have appreciated in value and which equates precisely with each share's performance. Both methods are used by funds and most administrators are able to offer both. Under the equalisation approach, there is one NAV per share for the entire fund and individual adjustments are made to each shareholder's account by issuing a small number of equalisation shares each month, if necessary. Series accounting uses multiple series of shares (one for each period of issue), each with a different NAV per share and each series has its own high water mark.

LOCK UP, REDEMPTION AND GATING

Traditionally, a fund is relatively liquid and investors are able to redeem their shares upon a notice period which reflects the liquidity of the underlying cryptoassets and the investment manger's particular investment strategy. In the event that insufficient notice is given, the investor could be charged a redemption fee (usually between 1% and 5% of the amount being redeemed). However, some funds (increasingly so after the recent financial crisis) may choose to put an initial lock up in place, which means that no share can be redeemed within that lock up period, which could, for example, range from 6 months to 3 years. A fund with a lock up is understandably less attractive to investors as its liquidity is compromised and its imposition will therefore depend on the strategy pursued and, in some cases, the agreement of the seed investor(s).

There has been a recent increase in the use of "investor gates" which impose a gate on redemptions at investor rather than fund level. This can be seen as a compromise to allow a fund to impose a gate but ensure that it does not adversely affect small investors who might be affected if a large investor were to seek to make a redemption which is over the fund's gate.

SIDE POCKETS

Where a fund holds assets that are hard to value reliably or are relatively illiquid (in comparison to the redemption terms of the fund itself), the fund may employ a "side pocket". This is not likely to apply to liquid cryptoassets but may be applicable to less easily tradable assets such as some tokens. A side pocket is a mechanism whereby the fund segregates the illiquid assets from the main portfolio of the fund and issues investors with a new class of shares which participate only in the assets in the side pocket and which cannot be redeemed by the investor. Once the fund is able to sell the side pocket assets, the fund will generally redeem the side pocket shares and pay investors the proceeds. Side pockets therefore allow a fund to ensure that all investors in the fund at the time the relevant assets became illiquid will bear any loss on them equally and allow the fund to continue subscriptions and redemptions in the meantime in respect of the main portfolio. Side pockets are generally used as an emergency measure only.

TIMING

A fund can take an average of approximately three months to set up, but this timing depends on a number of factors, not least the responsiveness and co-operation of the relevant parties and whether the investment manager is authorised or not.

FURTHER INFORMATION

To help our clients, we have published a number of other notes which inform readers about relevant cryptoasset regulations. These can all be found on our website at:

cummingspepperdine.com/client-briefings/

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The Cummings Pepperdine Online Training Programme, includes sections focussing on how to set up a hedge fund, has been designed by a specialist board of compliance consultants, solicitors, chartered accountants, tax advisors and regulatory consultants. We believe that we are the only firm which offers training created by this range of qualified advisors.

Click here now to make it all work

Watch our introductory video

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