Crypto Funds in Hong Kong – An Overview

pwc

Tiang & Partners
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A.

Our strengths

1. Tiang & Partners' Funds practice

Tiang & Partners is an independent Hong Kong law firm that collaborates closely with PricewaterhouseCoopers Limited ("**PwC**"). The Funds and Regulatory practice consists of two partners and a team of dedicated investment funds lawyers and legal staff covering the entire spectrum of investment funds, from private equity, hedge, hybrid to retail and authorised funds, and all non-contentious regulatory issues related to investment management activity in Hong Kong.

services include advising on:

- Structuring and regulatory issues for cryptocurrency ("**Crypto**") funds, drafting documentation for Crypto funds;
- Legal restrictions on marketing internationally (with the assistance of our global network of firms);
- SFC licensing and application processes in relation to Crypto-related activities, including Crypto-asset management, Crypto-exchanges, Crypto-trading and distribution of Crypto products;
- Regulatory issues for fund managers including disclosures of interests; and
- Structuring and setting up Crypto-fund management businesses.

2. Tiang & Partners is a full service asset management law firm

Tiang & Partners also boasts expertise across all areas that are relevant or related to asset management activity, including:

- Negotiating prime brokerage and trading documentation (including ISDA Master agreements, CFD, repo and other futures and options agreements);
- Advising on strategic and transactional matters, including fund mergers and acquisitions ("**M&A**"), illiquid investments and active investment situations;
- Advising on all aspects of the employment relationship (both contentious and non-contentious) including employment contracts, employee entitlement and protection, employee documentation, termination disputes and redundancies.

3. "One-stop shop" services for Crypto funds

Tiang & Partners' lawyers work closely with PwC's Asset & Wealth Management and Financial Services Lines of Service to provide integrated advice and support on operational, regulatory, and transactional aspects to fund managers, sponsors and investors in the Crypto landscape.

With a wide spectrum of service offerings, we are able to provide an end-to-end solution across the entire life cycle of Crypto funds, from their inception, to operation (e.g., project investments, on-going governance, accounting and audit, fund restructuring), through to termination. In addition, drawing from expertise across the entire legal and wider PwC network, we are able to provide services across all aspects of a fund's operation and in relation to asset management activity generally.

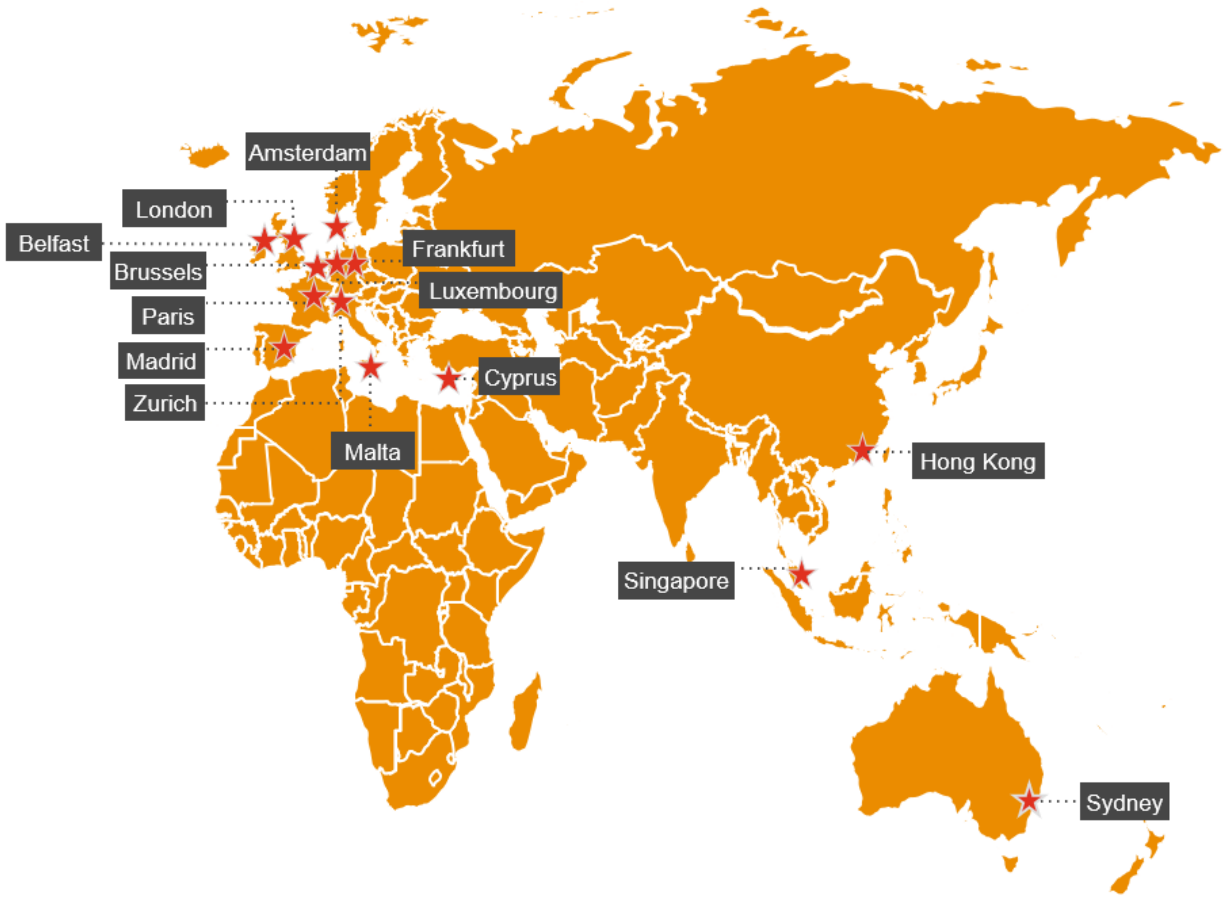
Example of service offerings		
Strategy	• Market competitor scan • Service provider scan	• Defining your crypto investment strategy • Roadmap and implementation
Tax	• Transfer pricing • Management/ employee incentive plan • Individual tax advisory (e.g., funders, employees, etc.) • Investor tax reporting	• PPM and prospectus review • Intellectual property structures • Corporate tax compliance • CRS & FATCA reporting
Legal and Regulatory	• Jurisdiction scan • Fund structuring • Fund documentation including preparation of PPM, management and advisory agreements, subscription and redemption forms etc. • Management company structuring • Due diligence on investment assets	• Onshore/offshore legal structuring • Regulatory licensing advice, application and support • Employment agreements • Regulatory compliance • Fund investment representation • Negotiations with third party service providers
Operations and Governance	• Fund and management company governance • Risk management policy • Investment policy • Valuation policy • Internal controls • Reporting frameworks	• Management of liquidity risk review • Third-party assurance SOC reporting • IT governance and review • Cyber attack simulation • Application penetration testing • Key management advisory • Wallet management advisory
Accounting and Audit	NAV calculation policies Accounting treatments (e.g., fees, investments, remuneration in tokens)	Accounting treatment of crypto investments Review of third party assurance SOC report of custodians Crypto accounting software implementation support
Deals and Trasnsactions	Deal/ transation structuring Project/ target due diligence	Valuations framework Operational due diligence review

4. The PwC Global Legal Practice

The PwC global legal services network connects the expertise of over 3,700 legal professionals in nearly 100 territories, bringing the right combination of legal insight, business understanding and technological innovation to transform how you work and make the right decisions.

Investments funds and regulations need global perspective with local knowledge. The PwC Global Legal Funds team has a presence in many of the key jurisdictions in which funds clients invest or operate, and has established alliances with leading law firms in many other jurisdictions. Working with us is not just about legal advice – by collaborating closely with PwC's Tax, Assurance, Risk and Regulatory Compliance, Deals and Crypto Advisory teams, our team provides asset and wealth management clients with an integrated, end-to-end business solution to all of their asset management and investment fund needs.

Funds legal services coverage:



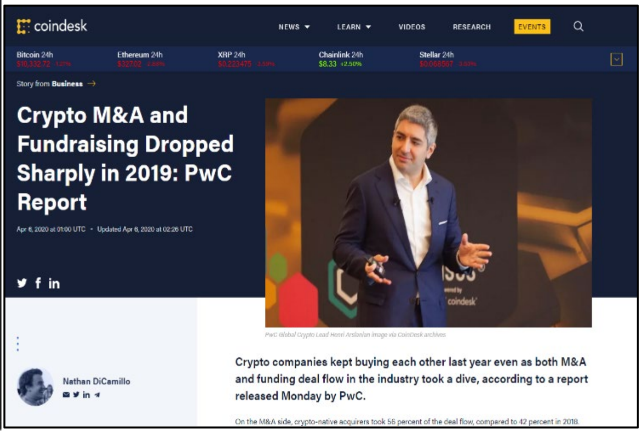
5. Our experience is widely recognized

PwC's expertise in the digital assets space and its market leading fund management practice are widely recognised by the industry. PwC has worked on numerous digital assets projects for crypto custodians, exchanges and regulators.

PwC's Global Crypto Team has over 150 professionals active in over 25 countries. In 2019, PwC was awarded "Top 10 Strongest" Brands and post an elite AAA+ brand strength rating for the 9th consecutive year.

Our thought leadership publications have been quoted by the media

PwC had released reports on "Crypto Hedge Fund" as well as the "Global Crypto M&A and Fundraising" landscape. The takeaways can be found on crypto media agencies such as CoinDesk and Cointelegraph.



We have been rated as one of the top service providers for Hedge Fund and asset wealth managers

According to an insights report issued in April 2020 by the HFM, PwC was regarded as one of the top service providers in hedge fund audits and holds some of the most influential hedge fund clients in the industry.

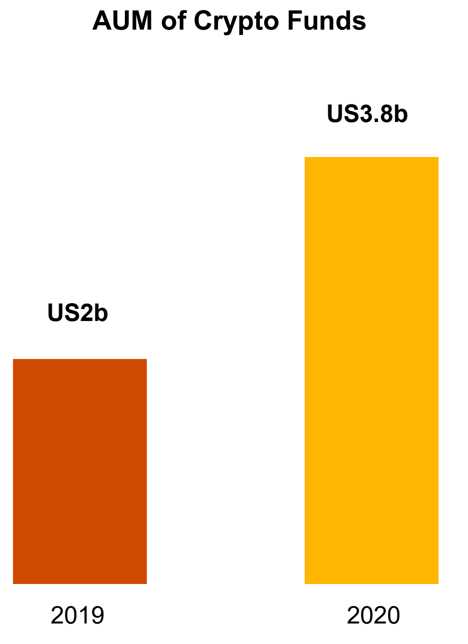
B.

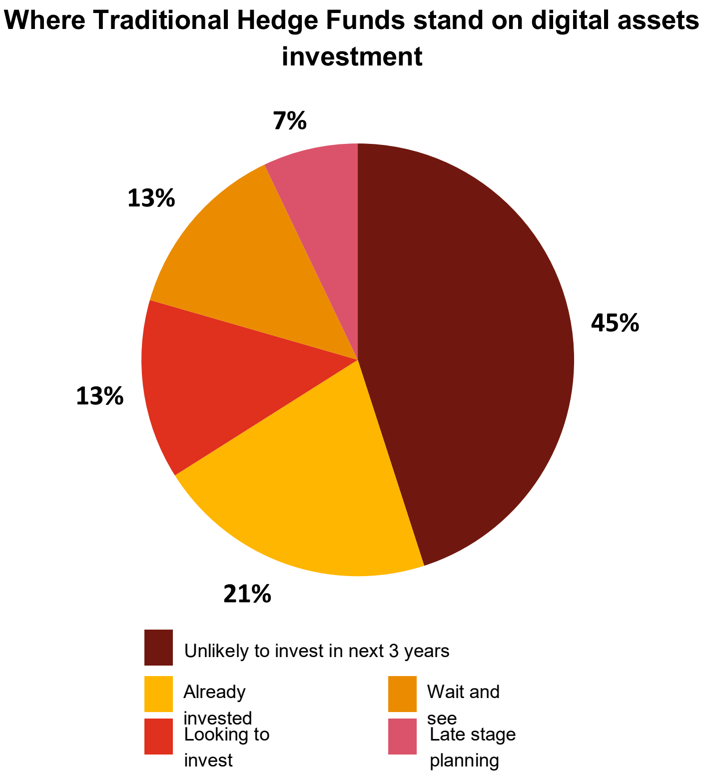
Crypto funds in Hong Kong – An overview

Introduction

Bitcoin, Ethereum, and other cryptocurrencies / digital assets have become all the rage of late, not only among the general investing public who have been captivated by the reports of Bitcoin's dizzying climb in value, but also among fund managers looking to set up Crypto funds.

The Crypto fund ecosystem has seen an increase in activities in 2020. The total global Assets Under Management ("**AUM**") of Crypto funds has grown by 90% as compared to the previous year, reaching an estimated US$3.8 billion in 2020. Traditional hedge funds are also making their move to start investing in digital assets. 21% of traditional hedge funds have already invested in digital assets and more are considering gaining exposure.





Source: 3rd Annual Global Crypto Hedge Fund Report PwC

Key considerations for setting up a Crypto fund

(1) Licensing

Type 9 (Asset Management) licence for management of virtual assets

A Type 9 (Asset Management) licence is required if you want to carry on a business of managing a portfolio of "securities" or "futures contracts" ("**SF Assets**") in Hong Kong. The question of whether digital tokens or other digital assets amount to SF Assets remains to be settled, although the Securities and Futures Commission of Hong Kong (the "**SFC**") has indicated that this would require an analysis of the features and properties of each individual asset in the proposed portfolio of the Crypto fund you are setting up.

In its "*Statement on initial coin offerings*" (5 September 2017), the SFC set out that where digital tokens in an initial coin offering ("**ICO**") represent equity or ownership interests in a corporation (for example, where they give a token holder shareholder rights to receive dividends, or to vote, or to participate in a distribution on winding up), or if they give a holder rights that would be akin to the holding of debt or a liability (like a debenture), those tokens are likely to be considered "securities" under the Securities and Futures Ordinance (Cap. 571) (the "**SFO**"). In contrast, utility tokens that do not possess these qualities are considered "virtual commodities" and are not "securities" for the purposes of the SFO.

This licensing regime in relation to the management of virtual asset portfolios was confirmed in the statement titled *"Regulatory standards for licensed corporations managing virtual asset portfolios*" (1 November 2018), in which the SFC explicitly recognised, using Bitcoin and Ethereum as examples, that a firm managing a portfolio of virtual assets which do not amount to SF Assets will not require a Type 9 licence.

As a result, if you were to take the view that nothing in your proposed fund's portfolio would constitute an SF Asset under the SFO, then a Type 9 licence **should not** be required.

Pro forma terms and conditions for licensed corporations and the Type 9 VA expanded licence regime

Nevertheless, the SFC now has a licensing regime that governs managers seeking to directly manage a portfolio of "virtual assets" (defined to include assets such as Bitcoin and Ethereum), which is modelled as an expansion on the existing Type 9 (Asset Management) regulated activity licence (the "**Type 9 VA Licence**").

The Type 9 VA Licence regime was officially introduced in October 2019 to ensure that licensed corporations will observe essentially the same regulatory and compliance requirements in managing virtual asset portfolios and to afford better protection to investors.

The "regime" works, in essence, by the SFC imposing additional terms and conditions on the licence of an existing Type 9 (Asset Management) regulated entity (the "**Pro Forma T&Cs**").

It is important to note that the Type 9 VA licensing regime is part compulsory, and part optional. How so?

- For managers who are already licensed under a regular Type 9 (Asset Management) licence, AND who wish to manage a portfolio consisting of virtual assets directly (with such virtual assets accounting for 10% or more of that portfolio's gross asset value), it would be ***compulsory*** for those managers to expand their licences to a Type 9 VA Licence by agreeing to have the Pro Forma T&Cs imposed on their existing licences. (Managers who keep the portion of virtual assets in their total AUM under 10% would only need to notify the SFC that they intend to manage such virtual assets – there is technically no need to wait for consent of the SFC, although in practice, most managers prefer a more nuanced approach).

- However, for new managers who intend to manage a portfolio of pure virtual assets, even if no part of that portfolio consists of “securities” (thus not technically requiring those managers to be licensed in Hong Kong), they may *opt-in* to the Type 9 VA licence regime and subject themselves to the jurisdiction of the SFC.

In addition, Type 1 (Dealing in Securities) licensed corporations which manage or intend to manage funds solely investing in virtual assets which are non-SF Assets and distribute or plan to distribute the same in Hong Kong would also need to have the Pro Forma T&Cs imposed on their licences.

Of note is that the Pro Forma T&Cs do not apply to licensed corporations which only manage funds of funds. For a new manager proposing to manage a fund of Crypto funds ("**Crypto FoFs**"), the SFC has a "half-way house" regime that is not as onerous as the full Type 9 VA Licence, but slightly more involved than a regular Type 9 Licence. We have experience with having helped a licensed manager in Hong Kong obtain the first of this type of licence (and also launch their Crypto FoFs).

The Pro Forma T&Cs provide for, among other things, general principles relating to:

- virtual asset fund management;
- organisation and management structure of virtual asset fund managers;
- management rules (e.g., best execution, prohibition on market misconduct, order allocation, participation in initial offerings, cross trades, risk management, leverage, liquidity management);
- custody of portfolio assets and client monies;
- record keeping;
- audits;
- portfolio valuation;
- marketing activities;
- fees and expenses; and
- reporting obligations to the SFC.

Overview of the Type 9 VA application requirements

Would an existing manager (or a new applicant) want to be licensed under the Type 9 VA regime? For one thing, it is not a straight-forward application to make (to date, only two managers in Hong Kong have successfully managed to obtain this licence and the first licence application (which was led by key members of our regulatory team) took close to two years from submission to grant).

Further, from our interactions with the SFC, here is an overview of what applicants should expect if they are to undertake such an application.

Business plan and compliance manual

Type 9 managers who want to manage a portfolio of virtual assets will need to update their business plans and compliance manuals (and new applicants will need to have these drawn up) which, in essence, reflect all the requirements of the Pro-Forma Terms and Conditions for Type 9 VA management.

From our dealings with the regulator, it is clear to us that the SFC expects any potential applicant to have considered the process thoroughly, and actually applied its mind to what it would take to manage a portfolio of virtual assets.

To begin with, an applicant seeking to expand its Type 9 licence will be provided with a set of comprehensive due diligence questions which will address the specific terms, characteristics and operational arrangements of the virtual asset fund they are proposing to manage. Applicants who intend to seek the consent of the SFC in respect of the New Standards will have to provide the requested information and adequately address further requisitions from the SFC as part of the application (for new applicants) or business plan update (for existing licensed corporations) process.

The requirements imposed by the SFC can largely be separated into six main categories, and require applicants to provide detailed information about their qualifications as well as the nature of the virtual assets portfolio it proposes to manage. The six main categories are summarised below:

(1) Organisational information

The SFC has previously raised concerns over the volatility of virtual assets and the susceptibility of these assets to market manipulation and other abusive activities.

As part of the New Standards, applicants are therefore expected to have sufficient relevant experience (relevant in this context would involve high risk markets such as venture capital, private equity, start-up investments and other virtual asset management) or adopt appropriate arrangements to address such risks. Applicants should be prepared to submit information such as number of staff in each of the following departments:

- portfolio managers;
- dealing;
- risk management;
- operations; and
- compliance.

In addition, the SFC would expect detailed background information with a special focus on the relevant virtual assets experience of the senior management of the firm, including department heads, team leaders, and in respect of key investment personnel (such as the CEO and CIO), their virtual assets fund management experience in the past 6 years.

As for the fund itself, the SFC would also request detailed information regarding any flagship virtual asset fund the company plans to launch and the intended asset allocation between particular virtual assets and non-virtual assets. Such information would include, inter alia, the actual types of securities vs virtual assets proposed to be managed (including top 20 liquid coins, other coins, ICO tokens, SAFTs etc), the fund's structure, main counterparties, investment strategy and asset allocation, target clients, fees and expenses and subscription and redemption policy.

In terms of internal compliance, applicants are expected to address whether they have conduced any self-assessment or gap analysis on their ability to comply with the existing requirements of the Fund Manager Code of Conduct ("**FMCC**") (and if so, to specify the gaps identified and how those will be remedied to ensure compliance).

Finally, the SFC expects information about the entire group (and not just the licensed entity), in particular, whether any other group company engages in virtual asset related businesses or whether they invest in virtual assets.

(2) Fund management activities

The SFC will drill down into details such as portfolio construction process, whether there is any investment committee that will be involved in the decision making process, risk management procedures, and the research and due diligence processes to be followed in relation to ICO token investments.

As for counterparties, the SFC expects managers to perform more robust vetting procedures and due diligence on the selection of counterparties including trading platforms and custodians (and whether they have assessed the financial strength, track record, and availability of insurance coverage in the event of a loss of the assets under custody, of these counterparties). Given the lack of experienced service providers in this area, many of which may be presently unregulated, managers should confirm that any intended counterparty has the experience and track record to handle virtual assets and be able to justify their appointment to the SFC. Applicants should also be prepared to address how ongoing due diligence and compliance monitoring (of execution quality, for example) will be undertaken.

In relation to custody arrangements, applicants will be asked about custody procedures (e.g., transfer to third parties), the breakdown of % of gross asset value ("**GAV**") by custodian, trading platform and self-custody, safe-keeping and security measures to prevent misappropriation, and how assets will be segregated. Applicants are expected to address controls over the access to private keys of wallets, and controls for the transfer of assets between different locations. If assets are proposed to be self-custodied, applicants will have to satisfy the SFC that insurance policies are in place and answer specific questions around wallet arrangements, including % GAV proposed to be held in hot vs cold wallets, hardware and software infrastructure and security controls over key generation, storage, management and transaction signing and cybersecurity risk management.

(3) Fund distribution activities

As a starting point, the fund is expected to be marketed only to professional investors and applicants will have to describe how they will ensure that happens.

The SFC expects fund managers to disclose the method by which the virtual asset fund will be distributed to investors and explain procedures to ensure compliance with selling restrictions of virtual assets (which are set out in the SFC circular dated 1 November 2018). Please see the following link to the circular:

https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=18EC77

To the extent the fund proposes to allow for subscriptions in kind, the manager is also expected to describe how anti-money laundering ("**AML**"), know-your-client ("**KYC**") and counter-financing of terrorism measures will be implemented.

(4) Conflicts of interest

The SFC has identified potential conflicts of interests regarding service providers, such as trading platforms that may potentially act for clients and principals when facilitating the distribution of virtual assets. As such, applicants should be able to identify potential sources of conflicts and elaborate on the measures put in place to address such conflicts.

(5) Auditors of the fund

Since there are currently no approved standards and practices for auditing and valuation of virtual assets, to protect investors from possible fraudulent activities, potential auditors must be qualified and have experience in assessing those virtual assets that form part of the fund's investment strategy. Managers should be prepared to answer questions such as the name of the audit firm, the responsible partner, the experience of the auditor in dealing with virtual assets and the steps to be taken by the auditor in verifying the ownership of, and control over, the virtual assets.

(6) Cybersecurity risk management

One of the most significant risks associated with virtual assets is the susceptibility of an online environment to cyber-attacks and network disruption. The SFC therefore expects the applicant to establish robust IT infrastructure and have business contingency arrangements in place to manage potential cybersecurity risks prior to the launching of any virtual asset funds or managing Non-SF Assets.

The SFC requires fund managers to disclose to the SFC its cybersecurity management and supervision arrangements and tools (such as intrusion prevention systems, key storage medium, hardware modules (including HSM ratings) and anti-DDoS mechanisms) and infrastructure and security management (such as anti-virus solutions, interface authorisation, private key protection and other physical security arrangements). Proper contingencies must also be in place to prevent service or trading disruptions. To the extent any infrastructure security management is outsourced, managers have to describe how operations that are outsourced remain subject to adequate security controls, and that confidentiality and integrity of data and information will not be compromised. Managers will also have to provide detailed information about the background and experience of these service providers.

(7) Regulatory capital

Finally, it should be noted that the minimum capital requirements for a Type 9 VA manager are significantly more onerous than for a standard Type 9 manager. In short, the following minimum amounts are required:

- Liquid capital: HK$ 3,000,000
- Paid-up capital: HK$ 5,000,000 (however, if the licensed corporation is subject to a condition not to hold "client assets", this will be not be applicable).

To be licensed or not?

As noted, the SFC intends to undertake a rigorous due diligence and approval process before it provides consent to manage and distribute virtual asset funds. In order to adequately address the requisitions from the SFC, managers are effectively required to have largely finalised the terms, characteristics and operational arrangements of any proposed virtual asset funds and should have those specific arrangement in place or almost in place before reaching out to the SFC to commence the application or business plan update process. In addition, after getting licensed, the burden of compliance (to stay licensed) would be high. The Pro Forma T&Cs themselves are thorough (they run to over 30 pages in length) and on top of that, a manager would have to comply with all of the usual obligations imposed on a regulated entity (for example, under the Code of Conduct for Persons Licensed by or Registered with the SFC, and the FMCC).

Of course, being licensed does come with its benefits, including:

- Facilitating fund raising not only because having the Type 9 VA Licence would enable the manager to market the fund to individual and corporate professional investors (that is, family offices and high-net worth individuals) - who, for this type of investment product, would be the primary target market (without such a licence, the manager would need to rely on a third party distributor / placement agent with a Type 1 (Dealing in Securities) licence to market the fund, which comes with having to pay placement fees and etc.), but also because investor perception of a manager that is regulated by the SFC (which is very well regarded in the region and internationally) would be much better;
- Ease of dealing with service providers (such as fund administrators, custodians, auditors and advisors), many of whom would not onboard a manager that is not SFC licensed (although there are increasingly more players willing to make exceptions for Crypto fund managers); and
- Ease of bank account opening.

However, even if a manager were to come out on the side of applying for the Type 9 VA Licence after going through the cost benefit analysis above, there is one very important variable that remains as a material hurdle - and that is taxation.

(2) Taxation

Prior to the introduction of the Unified Fund Exemption Regime (see below), only offshore non-SFC authorised funds that met certain criteria were exempt from Hong Kong profits tax on their earnings (introduced by the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance of 2006 which amended the Inland Revenue Ordinance (Cap. 112) (the "**IRO**")). For this reason, historically, almost all of the funds structured out of, and managed in, Hong Kong, were Cayman Islands entities.

In 2019, the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (also known as the "**Unified Fund Exemption Regime**" or "**UFE Regime**") was introduced. Under the UFE Regime, any "fund" can qualify for an exemption from Hong Kong profits tax regardless of its domicile or jurisdiction of incorporation, and irrespective of their size, type and location of central management and control, provided that qualifying transactions are carried out or arranged in Hong Kong by or through a specified person (essentially an SFC-licensed corporation or an SFC-registered authorised financial institution) or that the fund is a qualified investment fund.

Relevantly, one of the requirements (see Section 20AN of the IRO) for the tax exemption is that the profits are earned from transactions in assets of a class specified in Schedule 16C to the IRO, including but not limited to securities, shares, stocks, debentures, loan stocks, funds, futures contracts.

In a nutshell, therefore, in order for a fund to avail itself of an exemption under the UFE Regime, there are three key requirements:

- There needs to be a "fund" (essentially defined in the same way as a "collective investment scheme" under the SFO);
- The fund needs to carry out its transactions through an SFC licensed entity (effectively, there must be a Type 9 licensed manager); and
- The fund must have in its portfolio certain assets that amount to "securities".

The bad news for Crypto funds that invest in a portfolio of pure virtual assets that are utility tokens (or that otherwise do not amount to "securities" as defined under the SFO), is that the fund may not qualify for a tax exemption under the UFE regime.

This is the case even if the manager were to obtain the Type 9 VA Licence because unless all of the virtual assets comprising fund's portfolio are "securities" (as defined under the SFO, and therefore fall into the definition of a "qualifying transaction"), the fund would not be able to avail itself of an exemption from profits tax in Hong Kong.

In that case, having the Type 9 VA Licence may, in fact, be disadvantageous from a taxation perspective as it would mean the fund has a presence in Hong Kong, and if the fund were to be managed from Hong Kong, this increases the risk of the fund being "pulled onshore" into the Hong Kong tax net (even if it were structured as an offshore vehicle).

There are, of course, ways to structure around this, including, for example:

- using derivative instruments (e.g., total return swaps or futures) that may qualify as "securities";

- ensuring that the fund only transacts offshore and that there are no HK sourced profits; or
- avoiding a management presence in Hong Kong entirely by setting up an offshore manager.

The third option above appears to be the most popular for the vast majority of Crypto fund managers in Hong Kong, but this comes with it two major limitations:

- First, with the introduction of economic substance requirements in popular offshore jurisdictions such as the Cayman Islands, maintaining an offshore manager would require that entity to meet certain substance requirements, which would include needing to have things such as a company secretary, office space, holding regular meetings, issuing certain reports from the offshore jurisdiction, and having a director who is physically based in that jurisdiction. While there are providers who can now provide certain services / facilities that will enable the manager to meet such "substance" requirements, the fees / costs of doing so are not insignificant (and tend to increase in cases where a manager needs to carry out more intensive management activities in respect of a fund (for example, an opportunistic or quant strategy as opposed to a tracker strategy). It is worth noting that as an interim measure at least, the British Virgin Islands ("**BVI**") does have a regime which effectively allows for the use of a BVI management entity that does not need to meet economic substance requirements so long as it is registered with the BVI authorities as an "approved manager". The registration process is quite straightforward and involves making filings only. It remains to be seen, however, how long this option remains viable before it is removed and the BVI follows in the steps of the Cayman Islands to impose economic substance requirements.

- The frequency of management decisions - obviously, the more investment discretion needs to be exercised (which would necessitate a board meeting offshore), the more the directors of the manager will need to travel out of Hong Kong. This could become practically infeasible where these meetings need to take place on a regular basis (and post-Covid, physical meetings would be completely unfeasible, although video conferences remain an option). Similarly, if the manager were to engage a service provider to try to meet substance requirements in the offshore jurisdiction, the costs may become prohibitive for funds that employ a strategy requiring constant managerial intervention.

Given the above, it may be necessary to consider structural options that do not involve an offshore manager, for example, having the fund directly managed by its directors, or in the case of a limited partnership, by its own general partner.

Having nailed down the management structure for the fund, fund sponsors should next turn their attention to how the fund itself should be set up.

(3) Typical fund structures

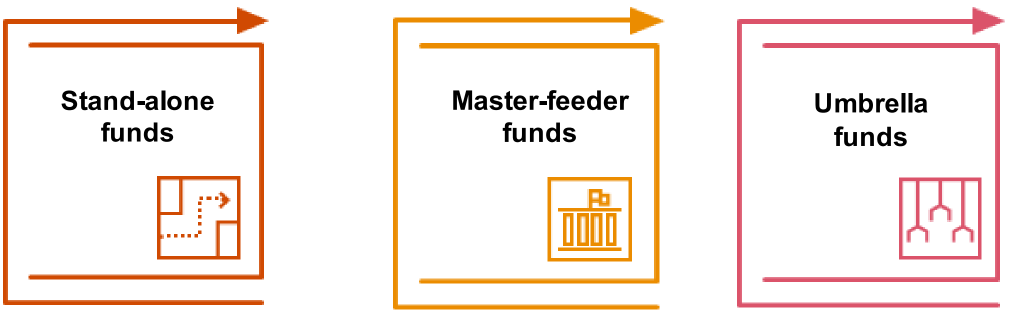
Open-ended vs Closed-ended

The cardinal rule for considering the structure of a Crypto fund (or any investment fund) is liquidity matching. Is the underlying portfolio liquid, highly illiquid, or something in between? In general:

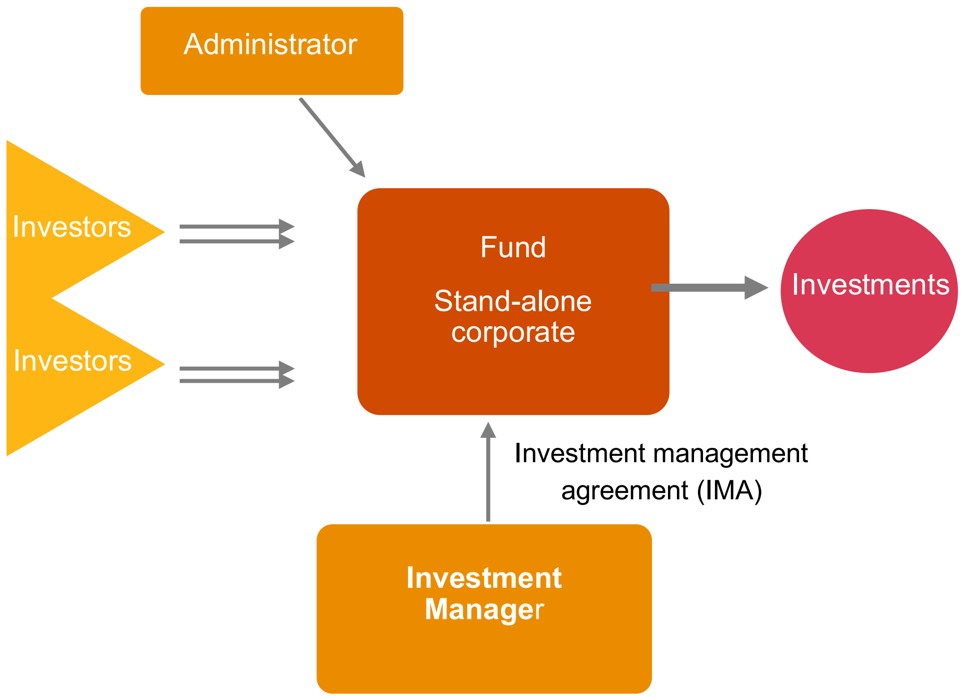
- **Closed-ended PE-styled** funds are the "gold standard" for illiquid assets;
- **Open-ended hedge fund-style** funds are best suited for liquid portfolios; while
- An **"in-between" hybrid structure** may be an open-ended structure that imposes hard locks on redemption (up to 3 or 4 years, for example).

Open-ended funds

Offshore vehicles are typically organised into a combination of, or a variation on, the following structures:

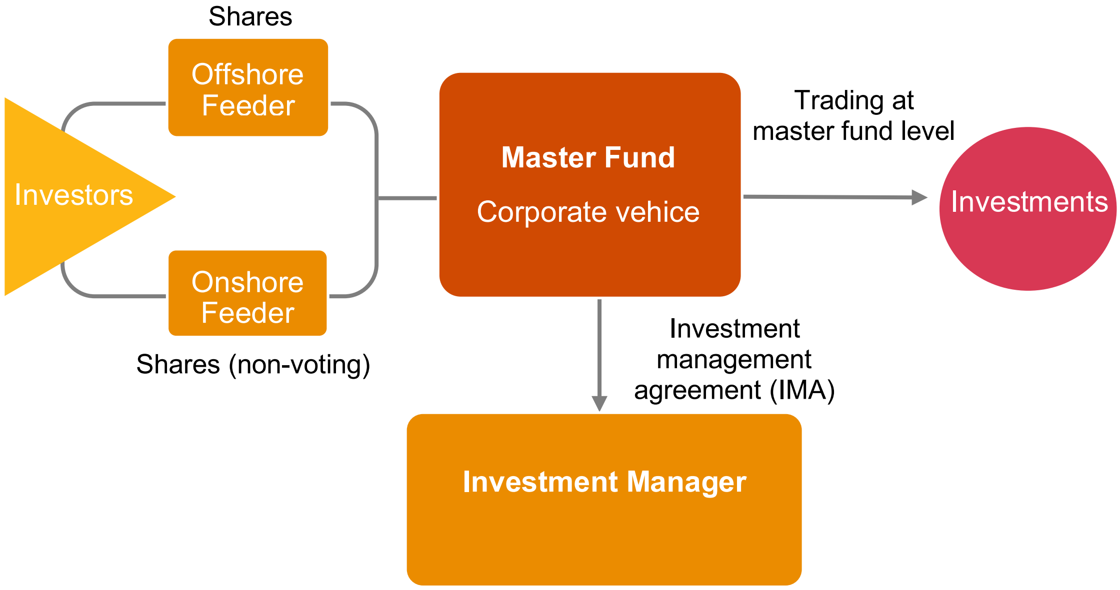


- ***Stand-alone funds***



A stand-alone structure comprises a single vehicle with a single investment strategy. This type of fund most commonly uses an open-ended, limited liability company established in the Cayman Islands as its main vehicle.

- ***Master feeder funds***



In a master-feeder structure, multiple funds (the "**Feeder Funds**") invest into a single, separate, central vehicle (the "**Master Fund**"). Each Feeder Fund is commonly established for a different group of investors (typically one for US investors, and one for non-US investors). Investors invest and pay management and performance fees at the Feeder Fund level, while trading and investment occur at the Master Fund level.

This is the preferred structure for most large-scale institutional launches in Hong Kong. It is also increasingly popular for funds that are open only to non-US taxable investors to be launched in Hong Kong using a master-feeder structure although these funds would adopt a "single-legged" structure, which comprises of only the offshore Feeder Fund and the Master Fund.

While the offshore (non-US) feeder would typically be a Cayman Islands corporate entity, there are different choices for the structure of the onshore (US) feeder, ranging from a Cayman Islands corporate entity, a limited partnership, to a Delaware limited partnership or LLC. Over the course of the last 10 years, however, the Cayman Islands open-ended investment company (which then makes a "check-the-box election" to be treated as a partnership for US tax purposes) has become the mainstay for both the offshore and the onshore feeder. The main reason for this is that documentation for the onshore fund can be more easily replicated from the offshore fund (which is usually documented first - with changes then being needed only for US tax, the Employee Retirement Income Security Act ("**ERISA**") and securities law disclosures). This results in reduced time and cost in establishing the fund overall. At the same time, as the US feeder is able to make the check-the-box election to be treated as a partnership for US tax purposes, there is no appreciable disadvantage to US taxable investors investing into such a structure.

As compared to a stand-alone or umbrella structure, the advantages of a master-feeder are as follows:

i. Different groups of investors can comply with and benefit from the respective regulatory environment applicable to them more easily. In particular, it allows US taxable investors to invest in an offshore hedge fund in a tax-efficient manner without compromising the tax position of other non-US or US tax-exempt investors.

ii. It gives more flexibility at the investor level. As multiple groups of investors are introduced into the Master Fund through separate Feeder Funds, different demands for different group of investors may be tailored by different operating currencies, fees, subscription terms, liquidity and investment strategies.

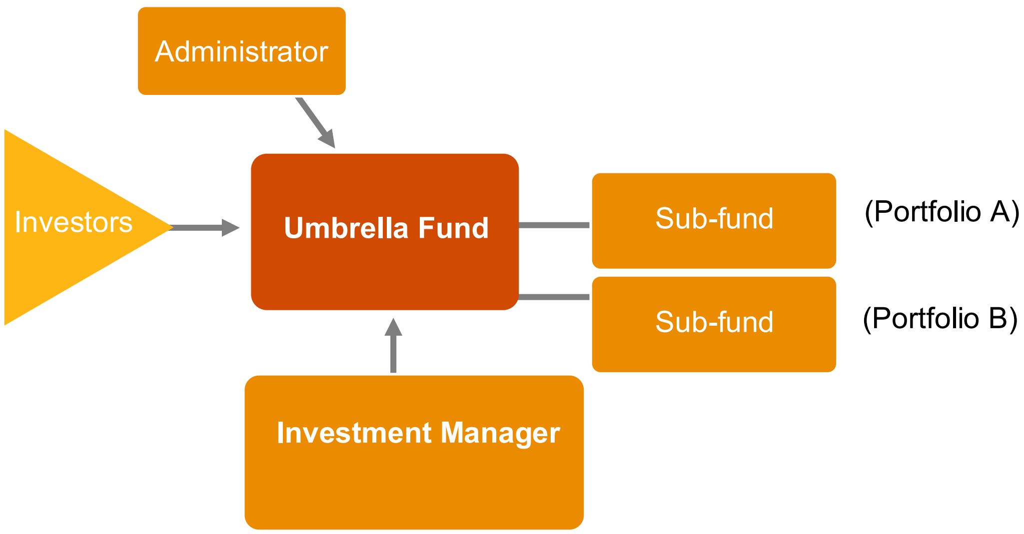
iii. There is also flexibility at the investment level. Since different segregated pools may be created below the Master Fund (each structured as, for example, a wholly-owned subsidiary of the Master Fund), the Master Fund is also able to trade by different strategies, house its own pool of assets, and ensure there is segregation of liabilities.

iv. The fund can benefit from greater economies of scale in its portfolio's management and administration by pooling of assets into a Master Fund, which therefore reduces operational and transactional costs. For instance, it eliminates the need to enter into duplicated agreements with counterparties. The increase in the critical mass of funds under management also helps the manager obtain and maintain credit lines more easily and enhance the fund's ability to meet asset size-based investment qualifying tests.

v. From the perspective of non-US investors, the master-feeder structure allows the segregation of US investors (as US investors are sometimes regarded as more litigious). It lowers litigation risk that may involve non-US investors, and also provides an additional layer of protection for the fund's assets (all of which are housed at the Master Fund level).

- ***Umbrella structure***

An umbrella structure is a generic term. It refers to an overarching investment vehicle with sub-funds beneath it. Each sub-fund can appoint its own manager, adopt its own investment strategy and have its own pool of assets. Importantly, the assets and liabilities of each sub-fund are intended to be ring-fenced from the assets and liabilities of each other sub-fund and the umbrella fund.



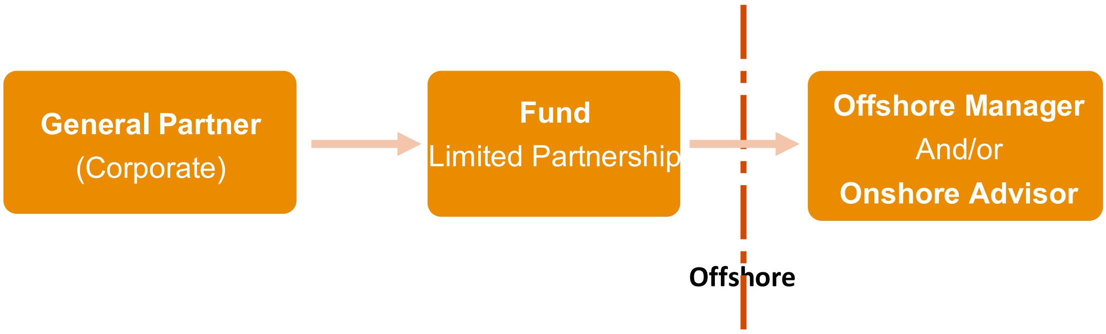
In the Crypto space, we have seen the Cayman Islands segregated portfolio company (“**SPC**”) structure dominate in terms of popularity because, among other things, it allows a manager to run different portfolios and strategies (one for Bitcoin, one for Ethereum, for example) in a segregated manner that effectively works like a "sub-fund", each with its own assets and liabilities that, technically, should not spill over into another portfolio. This, in turn, allows the manager to offer its investors a choice of which portfolio to gain exposure to, without all of it being in a blind pool. Many managers also perceive the ease and relative cost / time efficiency of setting up a segregated portfolio to be an added bonus.

It is possible to combine SPC structures with master-feeder structures. For example, the main SPC may act as the Master Fund, with separate onshore and offshore feeders created on top (which themselves may either be stand-alone structures or SPCs). Each feeder will have separate share classes that feed down into the SPC and further down into separate segregated portfolios beneath the SPC.

Closed-ended funds

In Hong Kong, the majority of PE investment vehicles used by fund managers are limited partnerships established in the Cayman Islands. A fund may be domiciled in Hong Kong, Singapore, US, UK, Guernsey, Jersey, Luxembourg, the Cayman Islands, or Mauritius. Onshore funds generally cost less to set up and maintain.

Typically, in an offshore limited partnership fund structure, an offshore limited liability company owned by the principals/sponsors of the fund, acts as the general partner (“**GP**”).



Advantages of using a Cayman Islands GP/LP structure

- The Cayman Islands GP/LP structure remains a popular choice for PE funds in this region.
- Familiarity with the structure, especially among US and European investors, means that capital raising is easier.
- Closed-ended funds often invest in illiquid investments, and investor interests are not “unitised” in the way open-ended “hedge” funds are (by way of shares). There is (usually) no regular Net Asset Value (“**NAV**”) calculated for the fund, and no regular subscriptions or redemptions. Capital commitments are “called” or “drawn” down to make investments during a set period, and on disposal, returns are distributed following a set “waterfall”. Each investor, known as a “limited partner” (“**LP**”), has its economic interests represented by way of individual partnership accounts, and a “share” in the fund’s economics by way of a partnership interest. This method of accounting provides for a more accurate representation

of an investor's share in the fund's economics as it allows for a truer apportionment of costs, expenses, revenues, gains and losses.

Disadvantages of using a Cayman Islands GP/LP structure

- The disadvantage of using a GP/LP structure centres mainly around costs. Because this is essentially a contractual arrangement, many more aspects of the fund's constitutive documents, including its private placement memorandum ("**PPM**") and its limited partnership agreement ("**LPA**") are open to negotiation and comment from investors. In addition, investors may separately negotiate and demand preferential terms by way of side letters. While the documentation costs of a closed-ended fund may be controlled, the final legal costs involved to get the fund to its final close may be several times more than the initial documentation costs.

Corporate structures for closed-ended funds

- Corporate structures are popular among PRC managers and institutions, and lately, have become more prevalent for closed-ended funds.

- The Cayman Islands SPC is particularly attractive to managers looking to invest in specific projects, for example, specific DeFi projects, different tokens, different investment strategies (such as tracker, arbitrage, opportunistic, quant/algorithmic) because it allows specific projects, strategies or token classes to be "housed" under a separate segregated portfolio ("**SP**").

Advantages of the SPC structure

- The SPC allows the issuance of separate share classes in respect of each underlying SP. If a separate project / development is "housed" in each SP, then this allows fund investors to "pick and choose" which projects to participate in, rather than being in a strict blind pool.
- It is much faster and more cost effective (at least from a documentation perspective) to create each new SP as the fund acquires new investments.
- Each SP functions as its own "mini-fund", which means the SPC as a whole becomes evergreen. Each "mini-fund" theoretically provides the ability to "ring fence" assets and liabilities from all other mini-funds or pools.
- Generally, establishment costs are lower as a corporate structure's constitutive documents (namely the Memorandum and Articles of Association) are less open to negotiation/amendment (unlike an LPA for a GP/LP structure).

Disadvantages of corporate structures for closed-ended funds

- A corporate structure is less suited to concepts that are part of the convention for closed ended funds. For example, capital commitment and drawdown – how would one square this with the issuance of shares? Do you issue shares on a fully paid up basis and simply have the commitment and drawdown as a contractual obligation that you adjust as you go along, or do you tie share issuance with drawdown (and issue on a partly paid basis)? In addition, how do you deal with shares that have been issued when capital contributions are reduced from a distribution? Do you partially redeem shares?
- In addition, how would the fund manager ensure that costs and expenses are properly distributed among shareholders? With partnership accounts, the mechanism is simple and

accurate. With shares (and without the benefit of a regular NAV), however, the drafting has to be left deliberately vague to allow the fund manager to make adjustments by issuing/redeeming shares (or parts thereof).

The hybrid solution

- A “halfway” house that managers may want to consider is to structure the fund as a straightforward corporate vehicle that is open-ended (in the same way hedge funds are structured). There will be open redemptions and subscriptions, a regular NAV, and performance fees and management fees that are determined based on NAV/AUM.
- To match liquidity (between the underlying assets – which are illiquid) and redemption, “hard locks” can be imposed (up to say 4 or 5 years) which would prevent redemption of shares. These can be adjusted from share class to share class, depending on the liquidity characteristics of the underlying investment.
- The advantage of this hybrid approach is that documentation costs are materially reduced. The drafting becomes conceptually more straightforward as there is no need to “cram” PE style concepts into a corporate framework, and overall, the fund is easier to manage and operate as an open-ended vehicle.

Other structuring considerations

Two other factors inform this decision:

- What is the manager’s / management team’s experience with running a closed-ended fund versus open-ended fund structures? Keep in mind, the documentation, mechanisms, and operation of each are fundamentally different. Closed-ended PE-styled funds usually do not track NAV, management fees are based on committed and drawn capital, and performance fees (or carry) are determined from a "distribution waterfall". In contrast, open-ended hedge fund-styled funds allow investors to subscribe and redeem at their option, management fees are determined based on NAV, and performance fees are typically charged on appreciation in NAV over a set period, above a "high water mark". As a general rule, prospective managers should stick with a structure that they are familiar with, otherwise, the documentation may be difficult to understand, and the establishment process will become confusing, drawn out, and likely costly.

- Costs also play a big factor. As a general rule, closed-ended PE-styled funds are more expensive to establish because the structure is, essentially, a contractual arrangement, which means there is a lot of room for investor negotiations at closing. If each investor is represented by legal counsel, each with its own set of comments and requests (usually by way of a side letter), the costs can start mounting up pretty quickly and will likely far exceed the documentation costs. Open-ended hedge fund-style funds, on the other hand, are much more straightforward to set up, and there are usually not much more legal costs to be incurred beyond the initial documentation costs.

(4) Documentation

A typical "suite" of fund documents comprises the following:

- Private Placement Memorandum ("**PPM**");
- Constitutional document (Articles or Limited Partnership Agreement ("**LPA**"));
- Subscription / Redemption documents; and
- Management/Advisory agreements.

In addition, the fund will need to enter into contractual agreements with third party service providers such as:

- Fund Administration Agreement;
- Custody Agreement; and
- Brokerage agreements.

The PPM is arguably the key piece in a fund's suite of documents. Contrary to popular belief, the PPM is not merely a marketing document. It also has contractual significance (as investors subscribe to a fund based on the representations and terms that are set out in the PPM and that are imported by reference into the contractual matrix with the fund), and the risk and conflicts disclosures that are set out in the PPM provide important pre-emptive defences against potential claims from disgruntled investors and other third parties.

For it to be effective, therefore, the PPM must be tailored to address the risks, dynamics, and operational features of a cryptocurrency strategy, including, for example:

- digital custody risks;
- blockchain regulatory risks;
- forking (and to that end, do you have the set of tools available to allow you to manage such liquidity risks including side pockets, gating, and suspension of redemptions etc);
- cybersecurity risks including loss and theft of digital assets;
- risk of potential manipulation of blockchain;
- impermanent loss and slippage risks (for staking and liquidity mining strategies); and
- the general volatility of digital assets.

For closed-ended funds structured as limited partnerships, the LPA would also be a key document as it is often heavily scrutinised and negotiated by potential investors prior to a closing.

The subscription and redemption agreements are important for the purpose of ensuring that the fund and the manager have protective representations/warranties given to them by investors for the purpose of ensuring they qualify as accredited / professional investors, and also for AML/KYC purposes. Crypto funds often allow for subscriptions and redemptions "in-kind" (that is, investors may pay for their subscriptions not in fiat but by way of tokens). Whether this is permitted, the mechanism for doing so etc will all need to be set out in the subscription/ redemption forms in detail (in addition to the PPM).

The management and advisory agreements play an important role in two respects:

- in relation to tax – they ensure a proper division of management and advisory services between entities that are "offshore" and those that are located in the domestic jurisdiction (where taxes may be imposed). The flow of revenue and income streams (in the form of performance, management and advisory fees) are also determined by the interplay and structuring of these agreements, and in this regard, it is also crucial to have these analysed from a transfer pricing perspective; and

- from a regulatory perspective – they ensure that there are no activities taking place in a jurisdiction where regulations would otherwise require obtaining a licence.

Finally, in relation to service agreements, the Fund Administration Agreement is a crucial document since the Fund Administrator is not only the gatekeeper (in terms of determining who may be allowed to invest into the fund – which in turn requires the performance of AML/ KYC checks), but is also the party who produces NAV calculations and investor statements, and calculates performance and management fees (or distribution waterfalls). For Crypto funds in particular, key members of the Fund Administrator's staff would be involved in the custody process and the transfers of assets from / to wallets and exchanges – this serves as an important feature of the fund's internal compliance.

(5) Service providers

Most funds that are set up as open-ended vehicles (and that are Cayman Islands Monetary Authority (CIMA) registered) would require, among other service providers, an independent auditor and fund administrator. It is relevant to note that not all auditors and administrators may be equipped or prepared to deal with cryptocurrency funds and the universe of eligible providers is small (although growing rapidly). We have already discussed, above, the importance of the Fund Administrator.

What may be more difficult to find is a custodian that can provide independent third party custody of digital assets. Practically speaking, the starting point for any manager would be to determine what portion of the fund's portfolio would remain "on exchange", and what portion would remain in "hot wallets" (off exchange but still connected to the internet) and in "cold storage" (that is, physically held in an offline secure medium). In our experience, because cryptocurrency and other digital assets are usually "on the exchange", a number of managers take the view that the assets are not capable of being custodised, but instead, would seek to keep most of their private keys in "cold storage", i.e. held offline.

There are a number of institutional custodians of digital assets, but they are generally limited in their offerings. These custodians use multiple layers of cryptography, coupled with physical vaults for cold storage. We have also seen some managers enter into arrangements with specialist third party storage service providers to physically store their private keys in secured vaults.

To this end, it is important to note two points:

- In Hong Kong, if a manager is licensed, it is likely that one of the conditions of its licence would be that it is not to hold client assets (even if it does, standard terms and conditions relating to custody will apply (see Paragraph 4.1A of the Pro Forma T&Cs) although the SFC does recognise the difficulty of true third party solutions for Crypto fund managers, and therefore, would treat assets managed by these Crypto managers as being "self-cusotied" (hence requiring a higher amount of paid-up and liquid capital).

- Under the revised FMCC, licensed managers will need to ensure there is segregation, safeguarding and independent custody of fund assets, as well as processes to ensure proper and independent valuation of portfolio.

Securing a custodian, firming up the custody arrangements for the fund, and ensuring proper valuation processes are in place to ensure compliance with the existing laws and regulations in Hong Kong will, therefore, be of even more importance for any prospective manager going forward, but in particular, a Crypto fund manager (assuming that manager will be licensed by the SFC, as the case may be). To ensure proper valuation processes are in place, Crypto exchanges would provide independent price quotes, however, for portfolios comprising fewer liquid tokens, managers will have to deal with how to source a valuation from an independent third party that satisfies the requirements of the FMCC.

Conclusion

Crypto funds represent a novel and exciting new development in the investment funds space. Trying to fit virtual assets into a more traditional fund framework brings with it a whole host of challenges and issues. For any prospective manager, the task of getting a Crypto fund up and running will be made much simpler by engaging the right service providers and counsel who are equipped with the knowledge and understanding of this new asset class, its unique risks, features and operational dynamics, and the ability to tailor a fund structure to best deal with these issues.

C.

Key contacts

Your primary contact for Investment Funds and Regulatory work:

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Gaven is Head of Investment Funds at Tiang & Partners. Prior to joining Tiang & Partners, Gaven was an equity partner in the investment funds group of Simmons & Simmons (Hong Kong), and before that, a Counsel in the investment funds and disputes group at Sidley Austin (Hong Kong).

In addition to working on a large number of traditional hedge and PE fund launches, Gaven is a pioneer in the crypto fund formation and regulatory advice space, having acted for the VSFG group (Arrano Capital) in getting Hong Kong's first Type 9 VA licence, and before that, Diginex in obtaining Hong Kong's first Type 9 (Asset Management) licence for managing a Fund of crypto funds. In addition to his regulatory work, Gaven has also acted as lead international counsel for a large number of managers in setting up crypto funds, including clients such as the Spartan group, Moonvault, Anduril and IDEG. Prior to becoming a funds lawyer, Gaven was a contentious insolvency lawyer with two other international firms, and is able to advise on the entire lifecycle of investment funds, from inception, restructuring through to termination.

Gaven is listed as a "Up and Coming" lawyer in "Investment Funds" by *Chambers Asia-Pacific*, and a recommended individual in "Investment Funds" by *Legal 500 Asia Pacific* and "Private Funds – Formation" by *Who's Who Legal*. In recent editions of *Chambers*, clients praised Gaven for being "practical and shrewd in terms of getting down to the key points in relation to any matter", "a very bright individual" and for having "good response time and a business mind".

Gaven received his Bachelor of Commerce (Accounting and Finance), LL.B (Hons) and LL.M (Distinction) from the University of Western Australia. He is qualified to practise in Western Australia, Hong Kong and England & Wales. He is fluent in English and Cantonese and conversant in Mandarin.

Areas of expertise

- Virtual assets - crypto fund formation and regulatory
- Investment funds (private hedge, PE and hybrid funds)
- Financial services regulatory (primarily non-contentious)
- Fund and asset management-related disputes

Representative experience

- Advising as lead counsel on the establishment of a number of large and reputable private hedge fund and PE fund launches.
- Advising on a number of crypto fund launches.
- Advising fund managers and sponsors on the virtual assets regulatory regime in Hong Kong and assisting with applications to the SFC for various virtual assets licences.
- Providing general regulatory advice to numerous asset management, investment funds, private equity and other financial services companies.
- Advising on asset management-related disputes.

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- Joyce is a Partner of Tiang & Partners with over 16 years of private practice corporate experience representing Mainland and Hong Kong-based investors and companies in M&A, strategic debt, equity, convertible instrument and hybrid investments, pre-IPO investments, Hong Kong Main Board/GEM listings and post-listing compliance matters.
- Among many other legal project experiences, she has recently advised a Hong Kong based securities firm in its application of virtual asset trading platform Type 7 license from the Securities and Future Commission (SFC).

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- He advises many of the world's leading crypto exchanges, funds, custodians and token issuers on crypto related matters. He also advises the leading financial institutions on their crypto initiatives as well numerous governments, regulators and central banks on crypto regulatory and policy matters.

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- Thomas is a Partner in our Deals group in Hong Kong where he specialises in advising strategic and financial investors looking to make investments or divestments in Asia Pacific region.
- He has a diverse skill set having performed both lead financial advisory and due diligence projects on over 50 deals in Asia, including numerous cross border transactions.
- He recently led financial due diligence and fundraising projects for a leading regulated crypto exchange in Europe.

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- Josephine is a partner in our Financial Services Group in Hong Kong, where she specialises in advising asset management houses, private equity funds, hedge funds and other industry players. She also has 20+ years of auditing and advisory experience, serving banks and brokers.
- In addition to the financial statements audit, she has extensive experience advising clients on best practices in internal control, valuation, regulatory and compliance matters. In recent years, she has been advising Chinese financial institutions on their expansion in Hong Kong and also overseas.

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- Lei is a Partner within the Risk Assurance practice in PwC Hong Kong and has over 17 years of experience in providing governance, risk and controls, regulatory advisory, and assurance services to a number of high profile financial institutions and crypto operators.
- She has focus on crypto related services since 2017, and led numerous governance, Compliance, Risks and Controls Advisory projects for

Blockchain and Digital Asset businesses, including exchanges, custodians, OTC brokers and funds.

- Lei is also a core member of the PwC global Blockchain/Digital Asset team, played a key role in developing our proprietary Digital Asset Assurance Tools and Controls Framework.

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- Peter is a Partner in the Financial Services Transfer Pricing team with over 14 years of international tax and transfer pricing experience.
- Peter has specialised in transfer pricing (TP) since 2005, including TP documentation, end to end implementation projects to audit defense as well as work on managing of permanent establishment thresholds and the attribution of profits to permanent establishments.
- He has been actively involved in a number of cross-border tax advisory, transfer pricing, tax investigations, IPO, ICO and other blockchain / crypto-related projects

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- Adams is a Partner of PwC Hong Kong and is the Leader of the Firm's Financial Services Risk and Regulations Practice. He has over 24 years of experience in providing regulatory and risk advisory services to financial institutions.
- During his career, Adams has successfully assisted more than 30 institutions in applying for the relevant licenses in Hong Kong SAR, and advising them on internal controls and compliance processes, which included a crypto exchange licensed by the SFC.
- Adams has also conducted a large number of internal control and compliance reviews (both voluntary and regulator-driven) for financial institutions.

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