

# Emerging hedge fund managers - challenges and solutions

Insights - 10/01/2022

*Who would want to be a start-up hedge fund manager? Simon Schilder, partner at Ogier in Jersey, and TEAM BVI UK member with BVI Finance, examines the challenges facing the next generation...*

The challenges facing the next generation of hedge fund managers are starker than ever before, with increased barriers to entry caused by an ever increasing regulatory burden coupled with the continued existence of a macro-economic environment impacting upon investment performance.

For emerging managers seeking to attract investor allocations, the need to be able to demonstrate a proven track record to prospective investors has never been more important. Generally institutional investors will look to a three-year track record as a pre-requisite for investing, whilst funds-of-funds, family offices and high net worth investors will frequently be comfortable with a shorter track record than this (perhaps 12 to 18 months?). The challenge facing an emerging manager therefore is how does it achieve this track record as cost effectively as possible without drowning under the operational constraints of running an investment management business. In addition to surviving long enough to develop a track record, the "holy grail" of target assets under management (**AUM**) has long been spoken as being an AUM of USD100 million, as that number then very quickly becomes USD200 million or USD300 million as the fund suddenly comes onto the radar of institutional managers whose own investment restrictions prevent them allocating their investment capital to smaller funds.

With the deck very much stacked in favour of established hedge fund managers, where does this leave emerging managers without the benefit of significant seed capital to rely upon it getting through the early years? For most emerging managers, their survival during these early years depends upon their ability to manage their cost bases efficiently and effectively. As part of doing this comes the choice of the most appropriate jurisdiction for domiciling their fund vehicle.

Given its historic cost advantages, the British Virgin Islands (**BVI**) has long been the natural

choice of jurisdiction for emerging managers looking for a jurisdiction to domicile their hedge funds. For such managers, the traditional route was to establish as either a "Professional Fund" (being a fund for "professional investors with a minimum investment of USD100,000) or a "Private Fund" (being a fund for a maximum of 50 investors, making offers to invest on a private basis). These two categories of funds remain consistently the most popular fund vehicles for managers establishing their funds in BVI. To complement these established fund products, during 2015, the BVI introduced two new categories of funds aimed specifically at the small/mid-sized/emerging managers, in the form of the "Incubator Fund" and the "Approved Fund". These two new fund products offer such managers solutions which might not otherwise be available to them.

Whilst an Incubator Fund and an Approved Fund are broadly similar fund products, there are subtle differences, which appeal for different types of investment managers.

The Incubator Fund product is aimed at the start-up investment managers, with one key feature of the regime being that upon the second anniversary of being an Incubator Fund or, if sooner, once the fund has grown beyond a stated minimum size (more than 20 investors or assets under management of more than USD20 million for two consecutive months), the Incubator Fund is required to convert to either a Private Fund, a Professional Fund or an Approved Fund. This therefore gives start-up/emerging managers an opportunity to get a foot in the door, by offering them a cost effective regulated fund solution to bring their funds to market whilst managing their operational cost base. A point of note is that an Incubator Fund has no mandatory service providers, such that in establishing an Incubator Fund, the promoters are free to appoint as many or few service providers as it wishes, further enabling it to manage fund expenses during the early years.

An Incubator Fund is available to "sophisticated private investors" only (for these purposes, to be a "sophisticated private investor" a person must be invited to invest and the amount of his or her minimum initial investment must not be less than USD20,000). As mentioned above, Incubator Fund status is limited to two years (with a possible further 12 month extension available at the discretion of the BVI's regulatory, the Financial Services Commission), following which the Incubator Fund must either (i) convert into a Private Fund; Professional Fund; or an Approved Fund or (ii) cease operating as a fund.

An Approved Fund by contrast is very much aimed at family offices and friends and family offerings. As with Incubator Funds, an Approved Fund is available to a maximum of 20 investors, but distinct from an Incubator Fund, its maximum aggregate assets under management may not exceed USD100 million (or its equivalent in another currency). Additionally and unlike an Incubator Fund, there is no time limit on the duration in which a fund can take advantage of its eligibility for Approved Fund status, such that an Approved Fund's status is indefinite. To the extent that an Approved Fund exceeds 20 investors or assets under management of more than USD100 million for two consecutive months, it is required to notify the FSC of that fact in writing

and submit an application to convert and so become recognised as either a Private Fund or a Professional Fund. Other than a requirement to have a fund administrator, there are no other mandatory service providers.

In both cases, the conversion process for an Incubator Fund or an Approved Fund is reasonably straight forward and can be implemented reasonably expediently and, critically, at the time of converting (and so availing the fund to a more onerous regulatory regime), the longer term financial viability of their investment management business will be much more certain.

***This article first appeared in Hedgeweek in September 2016***

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## Meet the Author



Simon Schilder

Partner

British Virgin Islands

E: [simon.schilder@ogier.com](mailto:simon.schilder@ogier.com)

T: [+44 1534 514298](tel:+441534514298)

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