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Keeping options open – the growing demand for BVI hybrid funds

Hedge funds and private equity funds were traditionally considered to be two completely different alternative investment classes, but as managers and investors increasingly seek to take advantage of exposure to both asset classes, the industry has witnessed a significant rise in the popularity of hybrid funds.

"Such fund structures aren't new – the concept has been around for quite a while now. However, in the last couple of years, we've seen an increased demand for them, as many managers wish to establish funds with flexible mandates that combine elements of both hedge funds and private equity," says Eric Flaye, counsel, Conyers.

A hybrid fund is one which holds a mix of both liquid and illiquid investments and seeks to combine elements of fund terms that are customary for both hedge funds (that is, liquid investments) and private equity funds (for the illiquid element), within a single fund vehicle.

Flaye outlines the potential advantages of creating such a structure from a sponsor's perspective: "They will only need to focus on launching and operating one single vehicle and can preserve the ability to follow quite a broad investment mandate across both liquid and illiquid asset classes.

"Through such a hybrid structure, managers can have the flexibility to opportunistically invest in listed equity or tokens or liquid cryptocurrencies, for example, while not precluding the possibility of investing in something less liquid like seed equity, warrants or instruments subject to lengthy lock-up periods and vesting schedules."

Managers often want to preserve such flexibility within a single fund vehicle, especially those operating smaller or first time funds. "Such groups are hoping they can yield significant cost and administrative efficiencies by operating this broader mandate within a single fund vehicle (as opposed to setting-up and operating two or more separate funds)," Flaye points out.

For investors, the potential appeal lies in the ability to make a single allocation to a single fund. Flaye outlines: "It will give them exposure to broader investment or asset classes on a cost-efficient basis. And this is potentially very attractive, particularly if they have a lot of faith in that specific sponsor group."

The element of trust is always critical within the asset management industry as a whole, but when considering hybrid funds, the relationship between manager and investor is thrown into sharper focus.

Trust and expertise

Flaye explains how a number of these hybrid funds first launch as start-up efforts, often marketed to a manager's friends and family and close business network. In these cases, the level of trust is generally high as the connection between the manager and the investors makes this implicit.

However, once those budding managers look to evolve further and set their sights higher by aiming to raise capital from third party professional investors, their value proposition and marketing pitch may need to shift. "You need a very compelling story to tell in order to be able to successfully launch off the back of a hybrid strategy," Flaye notes.

Marketing can be a potential challenge for hybrid funds, as investors may be confused about the core investment philosophy of the fund and whether it is more akin to a private equity fund or a hedge fund (which may be important for investors' own internal allocations and investment committee approval processes). And the sponsor may need to resist the temptation to try to cherry-pick the most favourable aspects of both PE and hedge fund terms for the benefit of the sponsor group, as that may not prove acceptable to a sophisticated investor base.

The manager will also need to assure their target investor base they have the requisite expertise and track record in all relevant asset classes the fund will be investing in, given they may have broad and diverse profiles. For example, cryptocurrency trading strategies are markedly different from early-stage venture capital-style investments in emerging blockchain businesses. Flaye stresses: "It may be tempting for a sponsor to say they're leading experts in all things crypto and digital assets generally. But they probably will need to be able to clearly articulate to investors that they have genuine expertise and a demonstrable track record in all of the relevant areas, if they want to be able to successfully launch a hybrid fund with sophisticated professional investors."

Investors also need to place significant trust in the manager's ability to get the liquidity profile right and in ensuring the redemption terms of the fund are appropriate. Flaye advises: "If the fund is primarily a hedge fund, or it holds the majority of its assets in liquid investments, but has a fairly meaningful portion in illiquid investments as well, then the fund sponsor has to be very careful to make sure that significant investor lock-up periods apply and/or they have the ability to side pocket or otherwise effectively segregate the illiquid portfolio or suspend withdrawals in the case of a significant run of redemptions."

Therefore, it's inherent that hybrid funds are generally a more complicated and bespoke product, both in terms of investment strategy and fund terms but also from an operational perspective. A sponsor choosing to launch such a fund needs to have the necessary internal operational expertise in order to effectively operate and manage the various different strategies and differing liquidity profiles.

Asset classes

Historically, hybrid funds were commonly used for activist investing, distressed investing and certain credit strategies. The structure lends itself well to such strategies – e.g. activist investors take stakes in publicly listed entities, acquiring what is effectively a liquid security, but at the time of making the investment, they don't know exactly whether they're going to hold it for days, months or potentially even years. A hybrid structure allows them to effectively manage differing liquidity profiles in such scenarios.

Flaye notes that distressed investing is also an asset class which is well placed to benefit from a hybrid structure: "You can acquire listed securities that end up becoming delisted or otherwise illiquid."

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The emerging crypto and digital assets space is another area enjoying success with the use of hybrid structures. However, Flaye argues that, given the nascent nature of the asset class. a little more work may be required on behalf of a sponsor looking to convince sophisticated investors to invest in a hybrid strategy.

Regulatory choices

Considering the BVI perspective in terms of hybrid funds, alternative investment funds in the jurisdiction are typically either regulated as hedge funds (or what are called "mutual funds" in BVI parlance) or as venture capital/private equity-style funds (or what are called "private investment funds" in BVI).

"These are two distinct, separate regulatory regimes and although there are commonalities between them, each imposes slightly different requirements for the funds in terms of mandatory service providers, audit, fund administration, and the various different restrictions on numbers of investors, assets under management, and minimum investor buy-in amounts, etc.," says Flaye.

Therefore, managers planning to launch a hybrid fund in the BVI will need to consider which regime they are required to follow and this largely depends on the primary investment strategy of the fund, he notes: "For some hybrid funds, it's very obvious which is the correct one...if it's mostly an illiquid fund that has a small portion of liquid holdings, then it should be regulated as a private investment fund.

"Conversely, if it's really akin to a hedge fund that also wants the ability to have up to, say, 20% to 30% of its holdings in illiquid assets at any given time, then you would need to be regulated as a mutual fund. If the assets are closer to 50-50, then it's a judgement call for the manager and its legal counsel to make."

Ultimately, the regulatory regime selected needs to appropriately reflect the liquidity profile of the fund and the investments within it. Flaye warns: "It is quite tempting for a manager to choose one; to cherry-pick the one they think will work best for them from an operational perspective. But they just need to be careful to make sure the most appropriate category of regulatory license is obtained in light of the true characteristics of the fund structure, to keep in good standing with the BVI Financial Services Commission and their investors." Flaye concludes by noting that: "While hybrid structures can present certain unique issues and challenges in terms of structuring, the BVI fund industry is very well adapted to cater to such demands given the jurisdiction's flexible legal regime and unique set of innovative and cost-competitive fund products."

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Eric Flaye is counsel and head of the London office of Conyers. He is a leading advisor on all aspects of offshore investment funds, including pre-formation strategy, organisational structure, regulatory compliance and transactional activities, for both private equity funds and hedge funds. Eric is also a key member of Conyers' growing fintech (blockchain and digital assets) practice.