

Mutual Funds in the British Virgin Islands

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Introduction

British Virgin Islands is the global leader in registration of offshore mutual funds. More than 3,000 mutual funds are currently registered in the BVI, with the total of over US\$100 billion under management.

How long does it take to form a Mutual Fund in the BVI?

This depends on a number of factors. Assuming the Promoter of the fund has a clear investment strategy, target investor market, the largest time factor is the drafting of the prospectus. Taking into account various revisions and drafts this could take a month to six weeks. Obviously if the client has a prospectus that has been used previously, particularly in the BVI, then it will simply need to be reviewed by BVI counsel and the proposed administrator, custodian and so on which could be done within one or two weeks.

While this is going on, arrangements can be made with the various professionals involved (manager, administrator, banker, auditors, custodian) but they will all wish to see at least a first draft prospectus and references and other information regarding the promoter in order to conduct their due diligence as required by the Code of Conduct. Unless the bank is also acting as custodian or administrator, or has a pre-existing relationship with the client, it can take a couple of weeks to open the bank account.

Preparation of the Mem & Arts or other formation documents should not start until the prospectus is in near final form and then can be completed within a week or so. Formation of the entity can be done in a day once all of the documents are ready. Recognition of a Private or Professional fund with the Registrar of Mutual Funds can also be achieved in a day following receipt of a completed application. A professional fund can be legally recognized up to 14 days after commencing operations.

Therefore, a typical fund can be established within six weeks to two months. A second or more fund based on a previous model can be established within two to three weeks. If the fund is a public fund, then the process will take longer, partly because of the somewhat higher level of due diligence. We do not yet know how long the Registrar will take to process an application for registration. However, there is a pre-registration procedure to help keep the process moving.

How much does it cost to form a fund in the BVI?

Costs obviously vary according to the complexity of the proposed fund structure and so on. Again the biggest cost factor is the drafting of the prospectus. If this is required, the costs should be in the range of \$15,000 to \$20,000.

What are the annual running costs of the Fund?

The government fees payable vary according to the size and nature of the fund. A public fund, with an authorized share capital of more than \$50,000 will incur annual company licence fees of \$1,000 and Mutual Fund registration fees of \$500. For a company with a smaller share capital the fee is \$300 per annum and for a private or professional fund the fee is \$350 per annum. The other

principal running costs (management, administration and custody) will generally be based on a percentage of NAV (subject to certain agreed minimum fees) and therefore, their impact upon overall performance is predictable.

Are there any limits on the fees that promoters and managers can charge?

Not at present. These are a function of what is competitive in the market place, provided they are all set out clearly in advance.

Does the Mutual Fund have to be administered or operated in the BVI?

No. A BVI fund can be administered or managed anywhere in the world. However, there must be a registered office and registered agent in the BVI and public funds must have accounting records available for inspection in the BVI.

What is the purpose of having different classes of share capital?

There are a number of legal and marketing reasons why funds typically have more than one class of capital. Under BVI legislation, there is practically no limit to the number of classes of shares that can be created, the currencies or denominations in which shares can be created and the different rights which attach to the different share classes.

There are three principal reasons for creating different classes of shares: a) To distinguish management from investors. Management shares, which control the appointment of the directors and therefore the overall policy of the fund, the selection of professional advisors and so on, will have voting rights but generally no participation in the equity or any dividends, distributions or redemptions of the fund. Investors shares will carry all of the economic benefits but only limited rights to vote, where for example, there is a proposal to change their share rights or to change control of the fund; b) To distinguish between different asset classes in which the fund invests. E.g. different currencies, bonds as opposed to equities, geographical areas and so on. This enables investors to have a certain choice as to their portfolio mix and usually, to change the mix under certain conditions; c) To distinguish between different investors. Where investors are given full discretion as to their portfolio mix, so that each investor will have a different performance, it is necessary to separately identify the portfolio and results of each investor. This is typically done in cases where the purpose of the fund is to facilitate the investment by individuals in a series or menu of other funds, in which the fund invests on a pooled basis, where the individuals could not do so themselves.

How does the regulatory scheme work?

The purpose of the regulatory scheme is to ensure that only fit and proper persons are involved in the BVI mutual funds industry. Therefore the focus is on due diligence on the promoters and the various professionals involved. Obviously with respect to public funds there are also additional specific requirements for investor protection, such as mandatory audit and prospectus. However, generally, the Registrar's office will not involve itself, in the internal operation or marketing of a fund. Furthermore, the Act lays down what is described as a differentiated scheme. That is to say it recognizes different levels of regulation for different circumstances.

With respect to the licensing of fund administrators and managers, at the highest level, namely an unrestricted license for entities physically operating in the BVI, where the BVI is the prime regulator, The Registrar, goes further and does examine the detailed structure, resources, expertise and operations of the applicant. At the moment there are no rules as to how day to day operations should be conducted but a Code of Conduct is anticipated. Generally, the Registrar has shown that they are prepared to strike a balance between the need for effective regulation and the desire to avoid burdensome regulation, which could have an adverse effect on the industry. However, of paramount importance is the Government's desire to maintain the integrity of the industry in the Territory and ultimately, to gain worldwide recognition of the standards of regulation in the Territory.

Can BVI Mutual fund shares be offered anywhere in the world?

So far as the BVI is concerned, the answer is yes. However, advice will need to be sought as to the securities laws of each jurisdiction in which the shares are to be offered as to the legal requirements for offering securities for sale to residents of those jurisdictions. In due course we can assist on this issue.

What about Internet marketing?

Internet marketing will generally be considered as an offer to the public, unless it is clear that for example the offer can only be accepted by professional investors. Furthermore, whether or not a web page constitutes an offer of securities in a particular jurisdiction, which is a very complex issue, many jurisdictions will have securities laws based upon where shares are sold. Unless the investor is physically out of the jurisdiction when the sale is consummated, it may be that the jurisdiction will seek to enforce its laws, in cases of sales to its residents, resulting from Internet marketing. This is a very live issue and careful consideration must be given in every case.

Part A – The BVI Public Fund

A public fund is a mutual fund the shares of which are offered to the general public. Public funds must be registered, or have consent to registration under a pre-filing procedure, before carrying on business or engaging in any activity in the BVI. A public fund must issue and file a prospectus including the information required by the Act and must produce and distribute audited annual financial statements. Registration is at the discretion of the Minister/Registrar of Mutual Funds.

The registration application includes details of all directors and professionals involved in the management of the fund, as the Registrar will wish to ensure that these are all fit and proper persons.

The Act requires a public fund's prospectus to make full disclosure of all matters affecting the price or value of the shares being offered. However, the disclosure requirements are not as burdensome as those typically found under U.S., U.K. or similar securities legislation. Prospectuses are, therefore, typically much shorter.

In the event of any misrepresentation in the prospectus of a public fund, investors have the right to rescind their purchase, or recover damages. However, the investor must commence any action within 6 months after becoming aware of the misrepresentation and within 1 year after the shares

were purchased. Furthermore, damages will be limited to the public offering price of the shares, plus fees and charges paid.

All managers or administrators of mutual funds in the BVI must be licensed by the Government. In order to obtain a license, the applicant must show, among other things, that it has the financial, human and administrative resources and facilities necessary for the competent and efficient conduct of its business. Where the manager is either a non-resident BVI IBC or a subsidiary of a manager licensed in another approved, regulated jurisdiction, a simplified application process is available.

The Registrar is responsible for supervising all licensed persons and mutual funds, processes all applications for licenses, registration and recognition and ensures compliance with the provisions of the Act. The Registrar of Mutual Funds will maintain public records, listing the basic details of all private funds, public funds and licensed managers and administrators. The Registrar also collects the annual fees payable by each fund and licensed person (\$500 for a public fund \$350 for a recognized private or professional fund).

To see the initial levels of information that will be required, along with the supporting documentation that will be needed I have attached the actual application form that will need to be completed in due course. This may also assist you to meet and discuss your strategy and objectives further.

Part B - Structure of Offshore Mutual Funds

The four principal elements that govern the structure of mutual funds include: a) the nature of the underlying investments in which the mutual fund intends to specialize, b) the way in which the fund intends to market its shares, c) the way in which investors earn their returns and realize their investments, d) the way in which the fund's manager and other professionals earn their fees. Each of these issues is briefly considered below.

The Underlying Investments

Although most funds permit themselves the full range of investments, they generally specialize in a particular area, such as equities, bonds, currencies, or particular geographical areas or market sectors. Some funds may be hedge funds that rely to a greater or lesser extent upon the use of derivative instruments (i.e., options, futures and swaps based upon the underlying principal investment). In addition, some funds may rely heavily on the use of leverage or trade upon margin in order to boost returns. The latter are obviously the highest risk funds, in particular where these are also based upon derivatives.

Where the intended investments are relatively liquid, the typical fund will be an "open-ended" fund, in which investors can subscribe and redeem their shares for cash on a regular basis. If the intended asset classes are illiquid investments, such as real estate developments or film finance, then a "closed-end" fund may be more appropriate. With this type of fund, subscriptions are limited by reference to the number of shares or a specified offer period. Investors only receive a return of capital after a specified period or when management so decides, in both cases after the fund has liquidated its investment.

A fund may intend to invest in a variety of asset classes and to offer investors a choice of portfolio mix, with the option to switch between asset classes at minimal cost. A common structure is the "Fund of Funds" or "Umbrella Fund". Such funds work in one of two ways. The fund itself may establish a number of sub-funds in which investors can spread their investments. Subfunds may be for, e.g., equities, bonds or different currencies. Alternatively, the fund may offer a menu of third party funds from which investors can choose. This may give investors access on a pooled basis to funds to which they would have no access individually. A similar result can be achieved by creating a single fund with different share classes each representing a different type of investment (e.g. dollar, sterling and deutschmark denominated shares for investment in each currency).

Method of Marketing Shares

Mutual fund structure is also affected by where and to whom the funds are offered. For example, will the fund be offered to the general public or only to "sophisticated professional investors"? (Sophisticated professional investors normally means individuals with a net worth of at least one million dollars or institutions, including other funds.) In addition, is the fund marketing purely directed to the sponsor/manager's existing client base or discretionary managed accounts, or is it also directly or indirectly going out to other investors? Each of these will affect the various regulatory implications that need to be considered. At the end of the day, while there are some BVI regulatory requirements to be considered, regulations in the jurisdiction of the principal target markets will have the most bearing.

Investor Returns

The typical fund is an open-ended fund that issues redeemable shares and is intended to achieve capital growth. There are no restrictions on the number of shares that such funds can issue and there is a potential flow of subscriptions and redemptions, as investors make and redeem their investments.

After a fixed initial period (no more than two or three months) during which the shares are offered at a fixed price, all subscriptions and redemptions are at the Net Asset Value. Being a growth fund, dividends are typically not paid. The frequency of redemption is governed by the liquidity of the underlying investment (i.e., how long the fund needs to realize cash to meet a redemption demand) and by the frequency of valuations. A fund can only redeem shares based on a formal Net Asset Valuation, so as to ensure proper pricing.

Typically, redemption takes place on the last day of each month, following a Net Asset Valuation as at that date. With more liquid investments and if the fund is prepared to bear the administrative costs, valuations can be weekly or even daily. (The typical large institutional funds in the U.S. have daily valuations).

A closed-end fund may pay dividends after an initial period but will only return capital on an irregular basis after the underlying asset is sold. Consider, for example, a real estate investment. While the development is being constructed, there is no return to the investor. Once built, an income stream will develop from rent received from tenants. After a period, the building may be sold realising a capital gain.

Part C - Key Parties and their Fees and Expenses

Sponsor, management and administration functions and their remuneration typically follow the following patterns:

The Sponsor

The Sponsor is the creator of the fund and will typically hold a number of voting shares (perhaps 100) in the fund, but these are not entitled to any distributions or share in the equity. All of the equity belongs to the investors, typically in the form of non-voting "preferred redeemable shares". The voting shares generally control management of the fund, apart from limited major decisions.

The Investment Manager

The Investment Manager determines the investment strategy of the fund and makes the investment decisions. The manager earns fees in the range of 1 to 2% of the NAV per annum, calculated and paid on a regular basis. Typically, these exclude any brokerage commissions and trading expenses which are additional expenses of the fund. In addition, many managers take an incentive or participation fee, based upon any increase in the Net Asset Value. These may range from 6% to 50% of the profit or gain. Usually, there is some adjustment provision such that if the NAV goes down, the manager does not get any further fees until the NAV exceeds the previous high. Some investment managers take a percentage of each subscription as a commission, often up to 5%. This may be added to the investment or deducted from the net proceeds. Typically the fee is taken where the manager has to pay commission to other intermediaries.

The Administrator

The Administrator acts as registrar and transfer agent, keeps the books and records of the fund, and calculates the NAV. Depending on the complexity of the fund, the administrator's fees could be as little as a few thousand dollars a year or as much as 0.5 to 0.65 % of the NAV per annum. Sometimes the administrator's fees are included within the management fee. In certain situations, the administrator subcontracts a part of the work, particularly the NAV certification, to the investment manager.

The Custodian

The Custodian holds the fund's cash and investment assets. Commonly, part of the fund's assets is held by one or more brokers who execute trades on behalf of the fund. Custodial Fees can also be a fixed fee or a percentage of NAV. Where a broker acts as de facto custodian, it usually charges on a transactional basis.

In addition, the fund will also be responsible for all of its own legal, accounting and other administrative expenses, excluding overhead expenses of the manager, administrator, etc.

Part D - Formation of a Mutual Fund

There are a series of tasks associated with the formation of an offshore mutual fund in the BVI, which include:

- a) Preparation of the investment plan
- b) deciding on the structure of the mutual fund
- c) drafting of the prospectus
- d) drafting of the mutual fund charter
- e) drafting of agreements with professionals
- f) appointment of bankers, custodian and auditors
- g) formation of fund equity
- h) regulatory filings and approvals
- i) distribution and marketing of the prospectus.

Preparation of Investment Plan

The first task in the formation of a mutual fund is for the sponsor to prepare an investment plan. This plan should lay out the fund's overall investment strategy, indicating the type and area of investments, and the type of instruments. The plan should also specify any specific investment policies or restrictions, such as short selling, margin trading and hedging. The sponsor should also define the target investor market and methods of marketing and distribution.

Deciding on Structure of Mutual Fund

In conjunction with counsel, the fund sponsor will need to decide upon the type of entity through which the fund will operate and the nature of the interests that investors will purchase. This involves defining the share classes, the minimum investment and the redemption and offer rights of shareholders. Factors to be considered include marketability, taxation, securities regulation and matters of corporate law.

Drafting of Prospectus

Once the above variables have been determined, work can start on drafting the prospectus. The purpose of the prospectus is to define what investors may expect from their investment. In order to protect investors, full disclosure is required, particularly as to risk factors. Such disclosure also protects the sponsor and investment manager in the event that less than favourable fund results are achieved. Counsel will draft the prospectus, or will review a prospectus prepared by the client or their legal advisor. Such review is intended to ensure compliance with BVI law, adequate disclosure and consistency with the fund's charter.

Drafting of Mutual Fund Charter

The Memorandum and Articles of Association of an BVI Business Company, Memorandum and Articles of Limited Partnership or Unit Trust Deed, as the case may be, will constitute the charter of the fund.

As well as being the documents necessary for formation of the legal entity, these complex documents define the rights and obligations of management and investors in respect of the fund entity. In addition, they set forth the procedures for subscription and redemption of investor interests, and determination of Net Asset Value. Based upon the prospectus and consultation with the client, counsel will draft the relevant documents to ensure consistency and compliance with applicable law. At this stage I have attached a basic specimen mutual fund Memorandum and Articles of Association just for the purposes of familiarization of the contents and format.

Drafting of Agreements with Professionals

The fund will need to determine the precise responsibilities of the Investment Manager and Administrator, as well as their remuneration. It must be decided who will maintain what records, prepare accounts and NAV certificates, deal with the issuance and redemption of shares and investor relations generally. These matters need to be incorporated into contracts between the fund and the various parties. Counsel can provide forms for the various documents and negotiate terms with the respective legal advisors. We can assist with all such matters.

Appointment of Bankers, Custodian and Auditors

If necessary we can introduce fund sponsors to banks and auditors in the BVI, if requested. Although neither custodian nor auditors are legally required for private or professional funds, they are strongly recommended to enhance investor confidence. Consideration of these appointments should be made at an early stage, to permit time for appropriate due diligence and agreement of terms on both sides. Of course with the Public Fund audit services will be necessary and through auditors P.G. Economides & Co we can accomplish that too.

Formation of Fund Entity

Once the fund charter has been finalised and the prospectus is in near final form, the fund entity can be legally established. Due to the efficiency of the BVI Companies Registry, this can be achieved in a day (although it will take a few days to receive back duly certified documents for distribution). Our BVI office, as a licensed registered agent, on our instructions, will deal with all aspects of formation and organisation of the fund entity.

Regulatory Filings and Approvals

At this stage all regulatory filings whether in the BVI or elsewhere should be made. Apart from a professional fund, no BVI mutual fund can carry on any activities without being registered or recognised. For public funds, it is possible to obtain a pre-registration consent from the Registrar of Mutual Funds in order to speed the process. A professional fund can apply for recognition within 14 days after commencing its activities (the Registrar has indicated that applications for recognition of professional funds will be processed within 24 hours after receipt of complete applications.)

NOTES:

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.