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FinTech

Cayman Islands: Trends & Developments
Stuarts Walker Hersant Humphries

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Trends and Developments

Contributed by Stuarts Walker Hersant Humphries

Stuarts Walker Hersant Humphries is a 20-strong law firm based in the Cayman Islands, with a Digital, Blockchain and FinTech team that advises on a wide range of legal issues in connection with cryptocurrency and blockchain usage, with particular expertise in advising investment funds, administrators and other service-providers on the use of blockchain technology and smart contracts. Stuarts advises on the establishment of 'crypto-related funds' in the Cayman Islands, security token offerings (STOs) and establishing Cayman Islands companies to conduct STOs and other digital products, and incorporating Cayman Is-

lands companies to hold cryptocurrencies (such as bitcoin, ether, litecoin, etc). Stuarts advises cryptocurrency funds and vehicles on the anti-money laundering regulations and 'know your client' challenges associated with accepting bitcoin, ether and other cryptocurrencies as a means of payment of subscription monies, and advising on how changes to participants and service providers can be reflected once a blockchain or smart contract is launched. The firm has worked on close to 100 ICOs and STOs and is well placed to provide advice on a prospective ICO, STO, exchange or fund investing in crypto or other blockchain entities.

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company and partnership formation, management, private equity, project finance, regulatory and financial services, and PCL and anti-money laundering.

The Cayman Islands has long been the global jurisdiction of choice for the formation of investment funds. It is therefore the natural choice of jurisdiction for funds looking to invest in cryptocurrencies, security-token offerings (STOs) or funds establishing, for example, a platform to onboard STOs or invest in multiple projects.

The neutral tax treatment, political stability and respected legal regime of the Cayman Islands have proved to be equally attractive to developers looking to set up STOs. Additionally, many blockchain businesses have moved their operations to the Cayman Islands and set up in the special economic zone.

The Cayman Islands also offers world-class service-providers, fast processing times, a widely admired regulatory structure and first-class infrastructure, making it a natural choice for exchanges and all digital or blockchain-related products.

STOs are becoming an increasingly popular means of fundraising for new projects that utilise blockchain technology. The typical example of an STO is where a project (usually operated through an entity) seeks investment in the form of fiat currencies or cryptocurrency and, in exchange, offers tokens. If the project fails to reach its fundraising target, it

will not launch and the commitments are typically returned to investors. For instance, an author could use an STO to fund the publishing of their book, with each token entitling the holder to a copy of the book when it is published. These tokens can then also be traded.

Whilst no specific legislation has been passed by the Cayman Islands Government in connection with STOs and cryptocurrencies, nor is any proposed, it would be incorrect to say that STOs are 'unregulated'. The fact is that some of the existing legislation in the Cayman Islands can, and in certain circumstances will, be applicable.

We have set out the most relevant legal considerations in the Cayman Islands for funds investing in cryptocurrency, STOs, cryptocurrency exchanges and other digital and blockchain products below. We suspect that more specific legislation will eventually be created, although for the time being the regulators and legislators in the Cayman Islands are keen to avoid rushing through any legislation before the potential benefits and pitfalls are properly understood.

Choice of Structure

Foundation companies

Businesses looking to build a decentralised product with no restrictions on investments, and that will be governed by a community, will be looking for an ownerless vehicle. A foundation company which operates much like an incorporated trust structure can achieve this. A foundation company is a body corporate with limited liability and separate legal personality from its members, directors and officers.

Foundation companies can be structured to stand alone, without members and with restrictions on issuing shares and the payment of dividends and distributions. Investors get the comfort of knowing that all proceeds raised are used to fulfil the objectives of the foundation company.

Exempted companies

Businesses launching a token for utility purposes on a platform are often launching technology with a traditional ownership structure and will find that the exempted company will meet their needs. An exempted company is a limited liability company with a traditional board of directors and shareholders with the ability to pay dividends. Exempted companies are required to have a minimum of one shareholder and one director and there is no requirement to have a Cayman Islands resident director. Additionally, the exempted company is typically used for exchanges and funds.

Crowd-funding vehicles like the ones described above are operating in an ever-changing regulatory environment and, therefore, it is usually advisable to ring-fence the liabilities of token-issuers from those on the platform vehicle which builds value. It is very popular to achieve this separation by using two entities.

Depending on risk appetite and other tax consideration, some clients incorporate a separate intellectual property (IP) holding company in the Cayman Islands. If the entity is conducting intellectual property business and is not tax resident in another jurisdiction, the International Tax Co-operation (Economic Substance) Law would require the entity to have 'economic substance' in the Cayman Islands and specific advice should be obtained in this regard.

An entity that is carrying on high-risk IP business (the definition of which includes companies that: own intellectual property that has been acquired from or created by another entity in its group and licensed by it to other entities or own intellectual property but do not primarily generate revenue by marketing, distribution or research and development activities in the Cayman Islands), is presumed not to have met the required economic substance for a financial year, unless the relevant entity can demonstrate that there was a high degree of control over the development, exploitation, maintenance, enhancement and protection of the intangible

asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Cayman Islands, and provides sufficient information to the relevant Cayman Islands authority in relation to that financial year to rebut this presumption.

Segregated portfolio companies

The use of segregated portfolio companies (SPCs) is hugely popular for funds investing in this market. SPCs are a special category of the exempted company that are single legal entities but with separate 'pots' or 'pools' called segregated portfolios.

The benefit of SPCs can be significant in that these structures benefit through the ability to set up a statutory 'ring-fence' to protect against cross-liability issues between assets and liabilities of the segregated portfolios within an SPC, as such separation of assets and liabilities is intended to survive the liquidation of the company. Where a fund is intending to invest into different types of assets with greatly different risk ratings, this can be very advantageous. For example, one segregated portfolio might invest in various cryptocurrencies and another segregated portfolio might invest in STOs.

Regulation of STOs

The Cayman Islands has established a comprehensive and robust anti-money laundering (AML) regime which is comprised of the following specific laws, regulations and guidance notes:

- the Proceeds of Crime Law (2017 Revision) (the PCL);
- the Anti-Money Laundering Regulations, 2017 (the 'AML Regulations');
- the Terrorism Law; and
- the Guidance Notes on the Prevention and Detection of Money Laundering and Terrorist Financing in the Cayman Islands.

The PCL is of general application to all Cayman Islands entities and requires them to take certain steps in the prevention of money laundering and terrorist financing, including the imposition of various penalties for non-compliance.

The PCL requires businesses carrying on relevant financial business (RFB) to comply with the AML regime. RFB is defined by reference to a specific list of activities. The most obviously relevant of these activities to an STO would be:

- acceptance of funds and other repayable funds from the public;
- issuing and managing means of payment;
- money-broking; and
- money or value transfer services.

If an STO issuer's activities fall within this definition, it would need to establish written AML procedures, conduct identification verification checks and appoint specific officers (a Compliance Officer, a Money Laundering Reporting Officer and a Deputy Money Laundering Reporting Officer), among other things. It is therefore imperative that legal advice be sought as to whether the STO in question constitutes RFB and, if so, how compliance with the AML Regulations is achieved. In particular, advice may be required as to how best to conduct identification verification checks when the cryptocurrencies being paid in respect of the STO are, by their very nature, encrypted. In circumstances where a Cayman Islands entity is not engaged in RFB it would be advisable nonetheless to comply with AML Regulations.

The Mutual Funds Law (the MFL) regulates certain categories of funds operating in and from the Cayman Islands which are issuing equity interests. Although an STO is not intended to operate as a fund, it may be subject to the MFL. The current definition of equity interests does not typically include tokens. Additionally, the MFL does not regulate closed-ended vehicles and most STOs do not provide the token-holder the right to require the issuer to repurchase the tokens. Instead, token-holders are typically permitted to sell their tokens on an exchange. Such STOs would not be considered open-ended or be subject to the MFL.

Where tokens are construed as securities (explored further below) and are redeemable as an asset, the obligations to register under the MFL would need to be revisited because the STO may be construed as issuing equity interests and be open-ended, thus subject to registration.

The Securities Investment Business Law (2015 Revision) (SIBL) is the Cayman Islands' primary legislation relating to the regulation of investments in 'securities' and associated businesses. Essentially, no person shall carry on (or purport to carry on) securities investments business unless that person is the holder of an appropriate licence or is excluded from the requirement to hold a licence. The term 'securities' is defined in SIBL by reference to a list of particular types of security (including shares, stock, partnership interests, instruments acknowledging indebtedness, options, futures, etc) and does not specifically refer to a cryptocurrency or token. It is generally accepted that an STO should fall outside of SIBL.

However, where tokens possess all the rights of a typical share and those rights are entrenched in the constitutional documents, the tokens might be construed as securities (albeit in a digital form). Nevertheless, when a token issuer is issuing its own securities, such activity would typically be regarded as an excluded activity under SIBL, in which case the issuer would not be required to be registered or licensed with the Cayman Islands Monetary Authority (the 'Authority').

The Electronic Transactions Law (2003 Revision) (the 'ET Law') is the Cayman Islands' primary legislation relating to the conclusion of transactions/contracts electronically. Given the nature of STOs, the ET Law is of critical significance when establishing the terms and conditions of the STO (whether in the form of purchase agreements or otherwise) and how contracts are concluded. All terms and conditions governing the STO, and its mechanics, should be considered in the context of the ET Law to ensure compliance.

Regulation of Tokenised Funds or Funds Investing into the Digital Market

Tokenised funds

As explained above, the MFL does not currently regulate the issue of most tokens. Therefore, a tokenised fund (one issuing tokens in place of shares) will not, under the current legislation, be required to register under the MFL. This may not apply to funds which issue tokens which possess all the rights of a typical share if those rights are also entrenched in the constitutional documents, as such a token might be construed as a share in the fund issuer.

Many tokenised funds are also considered closed-ended in that the token holder does not have the right to request the fund repurchase the tokens at the token-holder's option. Closed-ended funds are not required to register under the MFL. However, where the tokens are redeemable for an asset, the obligations to register under the MFL would need to be revisited because the fund may be construed as issuing equity interests (see above), categorised as open-ended and therefore subject to registration.

Funds issuing shares and investing in digital assets

A fund which issues equity interests and grants the holder the right to require the fund to repurchase the equity interest at the holder's option is considered open-ended. Any open-ended fund issuing equity interests will need to consider the implications of the MFL. Generally speaking, an open-ended fund established in the Cayman Islands and issuing equity interests to more than 15 investors will be required to register with the Authority pursuant to the MFL.

Such registration of a fund with the Authority requires (amongst other things) the filing of an offering document with the Authority, the appointment of a local auditor and the payment of an annual regulatory fee of approximately USD4,600. There is also a statutory minimum investment requirement by all prospective investors into registered funds of at least USD100,00

Regulation of Exchanges

The Stock Exchange Company Law (as Revised), grants the Cayman Islands Stock Exchange the sole and exclusive right to operate one or more securities markets in the Cayman Islands. Therefore, an exchange must ensure it is not operat-

ing within the Cayman Islands and consideration must be given to where its employees and servers are located.

As discussed above, the PCL requires businesses carrying on RFB to comply with the AML regime. RFB includes money or value transfer services which are likely to be relevant on an exchange. Exchanges would therefore be expected to comply with all relevant anti-money laundering laws and regulations.

The Money Services Law regulates money services businesses in the Cayman Islands. Although this includes providing money transmission and currency exchange, the definition of currency exchange is not set out in this law. However, guidance can be taken from the Penal Code, which defines currency notes as legal tender in the currency in which they are issued, and as cryptocurrencies are generally not legal tender in any country, cryptocurrency exchanges are not likely to be considered a currency exchange and be regulated by this law. Whether an exchange is conducting a money services business will need to be determined on a case-by-case basis depending on the services being offered.

If an exchange is issuing or trading in digital assets that are options, futures or derivatives then the implications of SIBL will need to be considered.

Other Cayman Islands Laws to Consider

Automatic exchange of information (AEOI)

The Cayman Islands has entered into a Model 1B (ie, non-reciprocal) intergovernmental agreement with the United States in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA) and has also entered into a Multilateral Competent Authority Agreement to implement the Organization for Economic Cooperation and Development's Global Standard for Automatic Exchange of Financial Account Information Common Reporting Standard (the CRS). A detailed summary of the implications of FATCA and CRS is beyond the scope of this article, but an entity which is considered a 'financial institution' under these regimes would be under an obligation to identify and report on its account-holders.

Register of beneficial ownership

All 'in scope' Cayman Islands companies are required to establish registers of their beneficial owners (ordinarily those who directly or indirectly hold more than 25% of the interests in the entity or who otherwise control it). Typically, we would not expect token-holders to be considered registrable persons for these purposes although, of course, this will depend on the nature of the tokens and the offering.

Cayman Enterprise City

The Cayman Islands has established a special economic zone allowing companies to benefit from specific advantages such as zero taxes, offshore presence and fast-track work permits.

Cayman Tech City, part of the Cayman Enterprise City Special Economic Zone, provides a time-efficient and cost-effective solution for media and technology development businesses seeking to establish a physical presence in the Cayman Islands. There are currently 125+ such businesses operating from within Cayman Tech City, 25 of which are involved in FinTech development activities utilising innovative blockchain technology.

Economic substance

The Cayman Islands Government has passed The International Tax Co-operation Economic Substance Law, 2018 (the 'Law'). The Law has been issued in response to the Cayman Islands' commitment to the global initiative to combat base erosion and profit-shifting.

If a Cayman Islands entity is conducting any of the specified relevant business activities (and that entity is not tax-resident in another jurisdiction), the Law would require the entity to have 'economic substance' in the Cayman Islands.

We have discussed this above in relation to IP holding companies, but other activities may be caught such as fund management business, holding company business or headquarters business and, therefore, once the full extent of the business activities of a particular fund, STO or exchange are known, specific attention can be given to the applicability of this law.

Tax

Although Cayman Islands companies are not subject to tax in the Cayman Islands, when considering establishing in the Cayman Islands, it is advisable that an entity should obtain tax advice on its own jurisdiction.

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