THE VIRTUAL CURRENCY REGULATION REVIEW

Editors
Michael S Sackheim and Nathan A Howell

THE LAWREVIEWS

THE VIRTUAL CURRENCY REGULATION REVIEW

Reproduced with permission from Law Business Research Ltd
This article was first published in November 2018
For further information please contact Nick.Barette@thelawreviews.co.uk

Editors
Michael S Sackheim and Nathan A Howell

THE LAWREVIEWS

PUBLISHER
Tom Barnes

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGERS
Thomas Lee, Joel Woods

SENIOR ACCOUNT MANAGERS
Pere Aspinall, Jack Bagnall

ACCOUNT MANAGERS
Sophie Emberson, Katie Hodgetts

PRODUCT MARKETING EXECUTIVE
Rebecca Mogridge

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Anne Borthwick

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-912228-77-5

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

PREFACE

On 31 October 2008, Satoshi Nakamoto published a white paper describing what he referred to as a system for peer-to-peer payments, using a public decentralised ledger known as a blockchain and cryptography as a source of trust to verify transactions. That paper, released in the dark days of a growing global financial market crisis, laid the foundations for Bitcoin, which would become operational in early 2009. Satoshi has never been identified, but his white paper represented a watershed moment in the evolution of virtual currency. Bitcoin was an obscure asset in 2009, but it is far from obscure today, and there are now many other virtual currencies and related assets. In 2013, a new type of blockchain that came to be known as Ethereum was proposed. Ethereum's native virtual currency, Ether, went live in 2015 and opened up a new phase in the evolution of virtual currency. Ethereum provided a broader platform, or protocol, for the development of all sorts of other virtual currencies and related assets.

Whether Bitcoin, Ether or any other virtual currency will one day be widely and consistently in use remains uncertain. However, the virtual currency revolution has now come far enough and has endured a sufficient number of potentially fatal events that we are confident virtual currency in some form is here to stay. Virtual currencies and the blockchain and other distributed ledger technology on which they are based are real, and are being deployed right now in many markets and for many purposes. The technology has matured beyond hypothetical use cases and beta testing. These technologies are being put in place in the real world, and we as lawyers must now endeavour to understand what that means for our clients.

Virtual currencies are essentially borderless: they exist on global and interconnected computer systems. They are generally decentralised, meaning that the records relating to a virtual currency and transactions therein may be maintained in a number of separate jurisdictions simultaneously. The borderless nature of this technology was the core inspiration for *The Virtual Currency Regulation Review* (*Review*). As practitioners, we cannot afford to focus solely on our own regulatory silos. For example, a US banking lawyer advising clients on matters related to virtual currency must not only have a working understanding of US securities and commodities regulation; he or she must also have a broad view of the regulatory treatment of virtual currency in other major commercial jurisdictions.

Global regulators have taken a range of approaches to responding to virtual currencies. Some regulators have attempted to stamp out the use of virtual currencies out of a fear that virtual currencies such as Bitcoin allow capital to flow freely and without the usual checks that are designed to prevent money laundering and the illicit use of funds. Others have attempted to write specific laws and regulations tailored to virtual currencies. Still others – the United States included – have attempted to apply legacy regulatory structures to virtual

currencies. Those regulatory structures attempt what is essentially 'regulation by analogy'. For example, a virtual currency may be regulated in the same manner as money, or in the same manner as a security or commodity. The editors make one general observation at the outset: there is no consistency across jurisdictions in their approach to regulating virtual currencies. That is, there is currently no widely accepted global regulatory standard. That is what makes a publication such as *The Review* both so interesting and so challenging to assemble.

The lack of global standards has led to a great deal of regulatory arbitrage, as virtual currency innovators shop for jurisdictions with optimally calibrated regulatory structures that provide an acceptable amount of legal certainty. While some market participants are interested in finding the jurisdiction with the lightest touch (or no touch), most of our clients are not attempting to flee from regulation entirely. They appreciate that regulation is necessary to allow virtual currencies to achieve their potential, but they do need regulatory systems with an appropriate balance and a high degree of clarity. The technology underlying virtual currencies is complex enough without adding layers of regulatory complexity into the mix.

It is perhaps ironic that the sources of strength of virtual currencies – decentralisation and the lack of trusted intermediaries necessary to create a shared truth – are the same characteristics that the regulators themselves seem to be displaying. There is no central authority over virtual currencies, either within and across jurisdictions, and each regulator takes an approach that seems appropriate to that regulator based on its own narrow view of the markets and legacy regulations. We believe optimal regulatory structures will emerge and converge over time. Ultimately, the borderless nature of these markets allows market participants to 'vote with their feet', and they will gravitate toward jurisdictions that achieve the right regulatory balance. It is much easier to do this in a virtual business than it would be in a brick and mortar business. Computer servers are relatively easy to relocate. Factories and workers are less so.

The Review is intended to provide a practical, business-focused analysis of recent legal and regulatory changes and developments, and of their effects, and to look forward at expected trends in the area of virtual currencies on a country-by-country basis. It is not intended to be an exhaustive guide to the regulation of virtual currencies globally or in any of the included jurisdictions. Instead, for each jurisdiction, the authors have endeavoured to provide a sufficient overview for the reader to understand the current legal and regulatory environment.

Virtual currency is the broad term that is used in *The Review* to refer to Bitcoin, Ether, tethers and other stable coins, cryptocurrencies, altcoins, ERC20 tokens, digital, virtual and crypto assets, and other digital and virtual tokens and coins, including coins issued in initial coin offerings. The term is intended to provide rough justice to a complex and evolving area of law, and we recognise that in many instances the term virtual currency will not be appropriate. Other related terms, such as cryptocurrencies, digital currencies, digital assets, crypto assets and similar terms, are used throughout as needed. In the law, the words we use matter a great deal, so where necessary the authors of each chapter provide clarity around the terminology used in their jurisdiction, and the legal meaning given to that terminology.

We hope that you find *The Review* useful in your own practices and businesses, and we welcome your questions and feedback. We are still very much in the early days of the virtual currency revolution. No one can truthfully claim to know what the future holds for virtual currencies, but as it does not appear to be a passing fad, we have endeavoured to provide as

much useful information as practicable in *The Review* concerning the regulation of virtual currencies.

The editors would like to extend special thanks to Ivet Bell (New York) and Dan Applebaum (Chicago), both Sidley Austin LLP associates, without whom *The Review*, and particularly the US chapter, would not have come together.

Michael S Sackheim and Nathan A Howell
Sidley Austin LLP
New York and Chicago
October 2018

Chapter 8

CAYMAN ISLANDS

Ian Gobin and Daniella Skotnicki[1]

I INTRODUCTION TO THE LEGAL AND REGULATORY FRAMEWORK

Due to its neutral tax treatment, political stability and respected legal regime, the Cayman Islands is the global jurisdiction of choice for the formation of investment funds, which are increasingly investing in cryptocurrencies and taking advantage of the investment opportunities in this space.

The Cayman Islands securities regime is more favourable to initial coin offerings (ICOs) than those of many other jurisdictions, and Cayman Islands entities have gained popularity as the token generation vehicles for ICOs and platform development companies. There have also been a number of cryptocurrency exchanges launched by Cayman Islands entities. The Cayman Islands Special Economic Zone provides a simplified route to establishing a physical presence and employing staff in the Cayman Islands.

The Cayman Islands has no specific existing or proposed legislation or regulation regarding ICOs, cryptocurrency exchanges or investment vehicles investing in cryptocurrency; nor has any Cayman Islands case law considered issues arising in the cryptocurrency space. The application of existing laws needs to be considered in relation to this developing space.

i Structuring of virtual currency businesses

There is no direct taxation imposed on Cayman Islands entities, and structuring will largely be driven by onshore tax considerations and business needs.

Exempted companies

The most common type of entity used to form investment funds investing in digital assets, issuers of ICOs and cryptocurrency exchanges in the Cayman Islands is the exempted company. Exempted companies are companies that conduct business on the basis of a declaration by the incorporating subscriber that the operations of the company are to be carried on mainly outside the Cayman Islands.

An exempted company must have a minimum of one shareholder and one director. The appointment of officers is optional. There is no requirement for Cayman-resident directors or officers.

1 Ian Gobin is a partner and Daniella Skotnicki is a senior associate at Harneys.

Exempted limited partnerships

Exempted limited partnerships are more commonly used to form closed-ended funds investing in cryptocurrencies, which may be investing in illiquid ICOs rather than more commonly traded cryptocurrencies. The Exempted Limited Partnership Law (ELP Law) governs the formation of exempted limited partnerships in the Cayman Islands.

The ELP Law also contains provisions relevant to the affairs of an exempted limited partnership, being the primary legislation governing partnerships generally. An exempted limited partnership is a partnership consisting of at least one general partner (who has responsibility for the business affairs of the partnership) and any number of limited partners that is registered as such under the ELP Law.

An exempted limited partnership is not a separate legal entity. It is instead a set of contractual obligations affecting the partners, between themselves, where a general partner is vested with certain powers and obligations in relation to a business and the assets of the business.

Exempted limited partnerships are often treated differently to companies for onshore tax purposes, typically being treated as fiscally transparent. The general partner holds the partnership's assets in statutory trust for the partners, and is tasked with managing the business and affairs of the exempted limited partnership. In the event that the assets of the partnership are inadequate to satisfy the claims of creditors, the general partner is liable for the debts and obligations left unpaid.

Foundation companies

A foundation company shares many of the features of an exempted company. A foundation company is a body corporate with limited liability and separate legal personality from its members and directors and other officers. It can sue and be sued and hold property in its own name. The key feature of a foundation company that often makes it an attractive vehicle for ICOs is that such company is not required to have members following incorporation. This is a particularly useful structure for those projects that will ultimately be decentralised and governed by the community.

A foundation company must, however, unlike an exempted company, appoint a qualified person as a secretary, being a person who is licensed or permitted by the Companies Management Law (Revised) to provide company management services in the Cayman Islands, and that secretary must maintain a full and proper record of its activities and enquiries made for giving notice.

Trusts

If ownership and autonomy are concerns, which may be relevant particularly for an ICO, they can be addressed to a certain degree by having a Cayman Islands charitable trust or STAR trust hold all the shares in issue of the exempted company. A Cayman Islands STAR trust is a non-charitable purpose trust that can hold assets for a specific purpose. The trustee must be a licensed trustee in the Cayman Islands.

ii Summary of certain Cayman laws to be considered in the virtual currency space

The following Cayman Islands statutory and regulatory regimes must be considered when structuring a virtual currency business through the Cayman Islands:

a the Proceeds of Crime Law (PCL), the Anti-Money Laundering Regulations (AML Regulations) and existing guidance notes, and the Terrorism Law;

b the Securities Investment Business Law (SIBL);
c the US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard (CRS);
d the beneficial ownership regime;
e the Money Services Law (MSL);
f the Mutual Funds Law (MFL); and
g the Stock Exchange Companies Law.

II SECURITIES AND INVESTMENT LAWS

i SIBL

SIBL regulates securities investment business in the Cayman Islands. Securities investment business refers to dealing in securities, arranging deals in securities, managing securities and advising on securities.

The definition of a security is set out in SIBL, and contains a list of instruments that are common in today's financial markets (securities, instruments creating or acknowledging indebtedness, instruments giving entitlements to securities, certificates representing certain securities, options, futures and contracts for differences), and does not in and of itself include virtual currencies.

Digital assets that take the form of warrants, options, futures or derivatives for securities or commodities may still be securities. If a Cayman entity was deemed to be issuing securities, it would be exempt from any form of licensing under SIBL if the nature of the security was an equity interest, debt interest, or a warrant or similar for equity or debt interests.

If a Cayman entity was issuing or trading digital assets that were options, futures or derivatives, it would need to consider the implications of SIBL in respect of licensing. A business considered to be conducting securities investment business must be licensed under SIBL unless it is considered to be conducting excluded activities, which include those businesses that are only providing services to sophisticated persons, high-net-worth persons or a company, partnership or trust (whether or not regulated as a mutual fund) of which the shareholders, unitholders or limited partners are one or more persons falling within such definitions. Excluded persons must register with the Cayman Islands Monetary Authority (CIMA) and pay an annual fee.

ii MFL

The MFL gives CIMA responsibility for regulating certain categories of funds operating in and from the Cayman Islands.

To be categorised as a mutual fund under the MFL:

a the fund must be issuing equity, and not debt or contractual interests: in other words, shares, limited partnership interests, LLC interests or trust units. This therefore excludes token issuers;
b the fund must be a collective investment vehicle effecting the pooling of investor funds;
c the fund must issue equity interests that are redeemable or repurchasable at the option of the investors; and
d the fund must be established in the Cayman Islands or be a foreign fund seeking to make an offer or invitation to the public in the Cayman Islands to subscribe for its equity interests.

Some funds are not regulated, and therefore are not required to be registered with or licensed by CIMA:

a single investor funds (which are not master funds) are not mutual funds, as there is no pooling of investor funds;

b closed-ended funds that do not permit the redemption or repurchase of investor equity (e.g., private equity funds) are not mutual funds;

c exempted funds are funds (that are not master funds) that fall within the definition of a mutual fund, but the equity interests of which are held by not more than 15 investors, a majority of whom (in number, and without reference to the number of shares or other equity interests held by each investor) are capable of appointing or removing the operator of the fund; and

d listed or otherwise regulated funds that are not incorporated or established in the Cayman Islands and that make invitations to the public in the Cayman Islands to subscribe for a fund's equity interests through a person licensed under SIBL, provided that the fund in question must be either listed on a stock exchange recognised for the purpose by CIMA; or regulated in a category and by a regulator recognised for the purpose by CIMA.

III BANKING AND MONEY TRANSMISSION

i MSL

The MSL regulates money services businesses in the Cayman Islands. Such businesses include the business of providing (as a principal business) money transmission and currency exchange. The applicability of this law will depend upon the specifics of any ICO or cryptocurrency exchange. While any specific ICO may, by its nature, fall within the remit of the MSL, the MSL is unlikely to apply to most ICOs.

The MSL provides that an entity in the business of providing, *inter alia* (as a principal business), money transmission or currency exchange requires a licence. The meaning of a currency exchange is not defined by the law; however, the Penal Code defines currency notes as legal tender in the country in which they are issued.

ii Bank and Trust Companies Law

Cayman entities require licences to conduct banking business or trust business. Banking business means the 'business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise'. Trust business means the 'business of acting as trustee, executor or administrator'. This may be relevant to cryptocurrency exchanges, as discussed below.

IV ANTI-MONEY LAUNDERING

i PCL (2018 Revision)

The PCL has general application to all Cayman-domiciled entities. It is an offence under the PCL to enter into or become concerned in an arrangement that a person knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property

by or on behalf of another person (commonly known as money laundering). In addition, the PCL prescribes ancillary offences to money laundering, including aiding, abetting, counselling or procuring money laundering.

Schedule 6 of the PCL provides that certain businesses that are considered to be conducting a relevant financial business (RFB) must also comply with the AML Regulations.

The following business are included in the definition of RFB, which may be relevant to the virtual currency sector:

a investing, administering or managing funds or money on behalf of other persons;

b issuing and managing means of payment (e.g., credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money);

c safe custody services; and

d money or value transfer services.

ii AML Regulations

If an entity is conducting an RFB and therefore is subject to the AML Regulations, it is required to implement know your client (KYC) and anti-money laundering (AML) policies and procedures that comply with the AML Regulations.

In addition to monitoring the business of an entity and downstream investment activities, the AML Regulations require that the entity obtain customer due diligence information, including regarding the source of funds and information on the beneficial owners of customers.

The AML Regulations require that an entity conducting an RFB (or its delegate, i.e., the service provider):

a appoint an anti-money laundering compliance officer (AMLCO) at a managerial level: the role of the AMLCO is to ensure that the entity adopts measures as set out in the AML Regulations and functions as a point of contact for CIMA;

b appoint a money laundering reporting officer (MLRO), which may be the same person as the AMLCO, and a deputy MLRO: the entity must maintain procedures with respect to internal reporting of suspicious activity to the MLRO or deputy MLRO, and the MLRO and deputy MLRO are responsible for reporting to the Financial Reporting Authority;

c maintain, and comply with, identification and verification procedures in accordance with the AML Regulations: this refers to the maintenance of customer due diligence procedures, which are detailed further below;

d adopt a risk-based approach to monitor financial activities, including identifying high-risk activities, which requires the entity to identify risks and to implement policies, controls and procedures to mitigate those risks;

e ensure that appropriate records of documentation and information obtained to comply with the AML requirements are maintained;

f maintain adequate systems to identify risk in relation to persons, countries and activities, including checks against all applicable sanction lists;

g adopt risk management procedures concerning the conditions under which a customer may utilise the business relationship prior to verification;

h observe a list of countries, published by any competent authority, which are non-compliant or do not sufficiently comply with the recommendations of the Financial Action Task Force;

i implement such other procedures of internal control, including appropriate, effective risk-based independent audit and communication functions, as may be appropriate for the ongoing monitoring of business relationships; and

j provide employee training in respect of money-laundering risks and procedures.

iii Risk assessment

An entity (or its delegate) is required to undertake an assessment of the risks of money laundering and terrorist financing based on its customers, the country in which customers reside or operate, the products and services offered, and the delivery channels by which they are offered, and determine the appropriate level and type of mitigation of such risks.

It is arguable that, as most business involving virtual currency is conducted online, this represents a delivery channel with a higher risk of money laundering, and therefore should be considered in the risk assessment undertaken by a business.

iv Customer due diligence

If simplified due diligence cannot be applied (as discussed below) and a customer is a legal person or arrangement, identification and verification procedures need to be applied not only to the legal person or arrangement itself, but also its beneficial owner.

The due diligence information and documentation required will depend on whether the customer is an entity or an individual. However, original or certified documentation of identity (i.e., a certified copy of a passport), address (i.e., a certified copy of a utility bill), and source of funds or wealth in respect of an individual and corporate documents in respect of entities, are generally required.

Simplified due diligence procedures

In certain instances, the RFB can rely on simplified due diligence procedures.

If simplified due diligence is permitted, and the payment for subscriptions is remitted from an account held in a customer's name at a bank in the Cayman Islands or a bank regulated in an equivalent jurisdiction, detailed verification might not be required at the time of subscription (although evidence identifying the branch or office of the bank from which the monies have been transferred, verification that the account is in the name of the applicant and the retention of a written record of such details is required). However, verification of the identity of the customer will need to be carried out prior to any payment of proceeds or distributions.

If simplified due diligence cannot be applied, and the customer is a legal person or arrangement, identification and verification procedures need to be applied not only to the legal person or arrangement itself, but also its beneficial owner.

Simplified due diligence cannot be applied to any business relationship or one-off transaction believed to present a higher risk of money laundering or terrorist financing by the entity. However, where a customer has been assessed as lower risk, a entity is permitted to apply simplified due diligence. Any assessment of lower risk must be consistent with the findings of CIMA or any risk assessment carried out by the Cayman Islands Anti-Money Laundering Steering Group.

Depending on the circumstances, it may be possible to apply simplified due diligence where:

a the customer is an RFB required to comply with the AML Regulations, or is a majority-owned subsidiary of such a business;

b the customer is acting in the course of a business in relation to which a regulatory authority exercises regulatory functions, and which is in an equivalent jurisdiction or is a majority-owned subsidiary of such a customer;

c the customer is a central or local government organisation, statutory body or agency of government in the Cayman Islands or an equivalent jurisdiction;

d the customer is a company that is listed on a recognised stock exchange and subject to disclosure requirements that impose requirements to ensure adequate transparency of beneficial ownership, or is a majority-owned subsidiary of such a company;

e the customer is a pension fund for a professional association or trade union, or is acting on behalf of employees of an entity referred to above; or

f the application is made through an intermediary that falls within one of the above categories and provides written assurance from that intermediary in accordance with the AML Regulations.

Enhanced due diligence

Where a customer relationship has been assessed as higher risk by an entity, persons conducting an RFB must apply enhanced due diligence. Enhanced due diligence must also be applied to politically exposed persons (and their family members and close associates); and when a customer or business is from a country that has been identified by credible sources as having serious deficiencies in its anti-money laundering and combating of financing of terrorism regime, or a prevalence of corruption.

The RFB is required to develop and implement procedures in circumstances where enhanced due diligence is required, such as obtaining additional information from customers and updating it more frequently, enhanced monitoring, or requiring additional information in respect of the source of funds.

v Penalties

Any person who breaches the AML Regulations commits an offence and is liable on summary conviction to a fine of up to CI$500,000, or on indictable conviction to an unlimited fine and imprisonment for two years. Where an offence is committed by an entity with the consent or connivance of, or is attributable to neglect on the part of, a director, member, partner, manager, secretary or other similar officer as applicable, that person is liable as well as the entity.

In addition, under amendments to the Monetary Authority Law (2016 Revision) and the Monetary Authority (Administrative Fines) Regulations, 2017, CIMA will have the power to impose administrative fines for non-compliance with the AML Regulations.

The penalties under the PCL for the offences described in Section IV are on summary conviction, a fine of CI$15,000 or imprisonment for a term of two years, or both; or on conviction on indictment, to imprisonment for a term of 14 years or to a fine, or both.

vi Terrorism Law

Section 19 of the Terrorism Law (TL) makes it an offence to solicit, receive or provide property with the intention that it be used, or having reasonable cause to suspect that it may be used, for the purposes of terrorism.

According to Section 20 of the TL, it is an offence for a person to use property for the purposes of terrorism or to possess property intending that it be used, or having reasonable cause to suspect that it may be used, for the purposes of financing acts of terrorism, terrorists, or terrorist organisations.

Section 21 of the TL makes it an offence for a person to enter into or become concerned with an arrangement as a result of which property is made available to another knowing, or having reasonable cause to suspect, that it will or may be used for the purposes of terrorism.

Under Section 22 of the TL, a person commits a money laundering offence if he or she 'enters into or become concerned in an arrangement that facilitates the retention or control by or on behalf of another person of terrorist property by concealment, by removal from the jurisdiction or by transfer to nominees'.

V REGULATION OF EXCHANGES

i Stock Exchange Company Law (Revised)

The Stock Exchange Company Law was introduced to regulate traditional stock exchanges. However, there is no specific legislation in respect of crypto trading platforms. The application of the Stock Exchange Company Law needs to be considered.

Pursuant to the Stock Exchange Company Law, the Cayman Islands Stock Exchange has the sole and exclusive right to operate one or more securities markets in the Cayman Islands. A securities market is defined broadly, and includes offering a place where, or a facility or arrangement by which (and situated in whole or in part in the Islands), securities are listed, or regularly offered for purchase or sale.

Securities are defined to include securities of all descriptions. As there is no further definition of securities under the Stock Exchange Company Law, without evaluating the characteristics of each cryptocurrency offered, there are likely to be many cryptocurrencies that fall within this definition.

Whether a stock exchange is operating within the Cayman Islands will need to be determined based on the operations of the exchange: for instance, where its employees and servers are located.

ii PCL

The PLCL applies to all Cayman-domiciled crypto trading platforms, which will need to ensure that they implement policies and procedures to avoid breaching the PCL.

An exchange conducting business that is considered to be an RFB will be required to comply with the AML Regulations. As stated earlier, RFB includes money or value transfer services, which is likely to be relevant in the context of an exchange.

The requirements applicable to businesses conducting an RFB are detailed in Section IV, and includes obtaining KYC and AML information in respect of both the initial purchasers and subsequent purchasers of tokens.

iii MSL

As cryptocurrencies (subject to very limited potential exceptions) are not legal tender in any country, a cryptocurrency exchange is likely not to be considered a currency exchange, and therefore would not require a licence.

A cryptocurrency exchange that only permits crypto-to-crypto exchange is not likely to be considered as offering, as a principal business, a money transmission service. However, whether a cryptocurrency exchange is considered to be a money services business will need to be determined on a case-by-case basis depending on the service offered on the platform.

iv SIBL

If an exchange is issuing or trading in digital assets that are options, futures or derivatives, it will need to consider the implications of SIBL in respect of licensing.

A business considered to be conducting securities investment business must be licensed under SIBL unless considered to be conducting excluded activities, including those businesses that are only providing services to sophisticated persons, high-net-worth persons or a company, partnership or trust (whether or not regulated as a mutual fund) of which the shareholders, unitholders or limited partners are one or more persons falling within such definitions. Excluded persons must register with CIMA and pay an annual fee.

v Bank and Trust Companies Law

A Cayman entity carrying out the business of acting as a trustee requires a licence pursuant to the Bank and Trust Companies Law. Depending on the operation of the platform, a Cayman entity operating an exchange may be considered to be carrying out trust business under the law.

VI REGULATION OF ISSUERS AND SPONSORS

There is no specific legislation applicable to ICO issuers. However, outlined below are some laws that may be of particular relevance.

i PCL

The PCL applies to all Cayman-domiciled ICO issuers, which will need to ensure that they implement policies and procedures to avoid breaching the PCL.

An issuer conducting business that is considered to be an RFB will be required to comply with the AML Regulations. An RFB includes the following; investing, administering or managing funds or money on behalf of other persons, issuing and managing means of payment (e.g., credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money), and money or value transfer services.

The requirements applicable to businesses conducting an RFB are detailed in Section IV, and include obtaining KYC and AML information in respect of both the initial purchasers and subsequent purchasers of tokens.

ii SIBL

The definition of a security is set out in SIBL and contains a list of instruments that are common in today's financial markets (securities, instruments creating or acknowledging indebtedness, instruments giving entitlements to securities, certificates representing certain securities, options, futures and contracts for differences), but does not in and of itself include virtual currencies. An issuer of an ICO is therefore unlikely to require a licence under SIBL in respect of issuing the tokens.

iii MSL

As cryptocurrencies (subject to very limited potential exceptions) are not legal tender in any country, an ICO is likely not to be considered a money transmission business and therefore would not require a licence.

iv MFL

The current definition of equity interests in the MFL (which is a key determining factor as to whether an entity qualifies as a mutual fund) excludes most ICO issuers, as tokens are not considered to be equity interests and therefore ICO issuers (as distinct from any Blockchain or cryptocurrency asset class focused fund) should not be impacted by the MFL.

VII TAX

There is no taxation imposed on Cayman entities by the Cayman Islands. However, parties interested in virtual currency businesses in the Cayman Islands will need to obtain tax advice in their own jurisdictions. Cayman entities will need to consider their reporting obligations (if any) under FATCA/CRS, as detailed below.

i FATCA, the US–Cayman intergovernmental agreement and implementing legislation, and the CRS

FATCA requires foreign financial institutions and certain other non-financial foreign entities to report on foreign assets held by US account holders, or to be subject to a 30 per cent withholding tax on payments of United States source income and proceeds from the sale of property that could give rise to United States source interest or dividends. The withholding tax provisions of FATCA took effect on 1 July 2014 other than in relation to proceeds from the sale of property, in which case they have been postponed until 1 January 2019. The Cayman Islands has entered into an intergovernmental agreement with the United States in respect of FATCA, and has passed legislation to implement FATCA in the Cayman Islands.

The CRS is a global standard for the automatic exchange of financial account information in respect of holders of financial accounts, and requires participating jurisdictions to obtain and report certain information. The Cayman Islands is a participating jurisdiction of the CRS. The Cayman Islands has passed legislation implementing both FATCA and CRS (AEOI legislation) that imposes reporting obligations on Cayman entities considered to be reporting financial institutions.

The definition of financial institutions for the purposes of the AEOI legislation includes investment entities, which are entities 'that conduct as a business (or is managed by an entity that conducts as a business)' and are 'investing, administering, or managing financial assets or money on behalf of other persons'. The definition of investment entity would include investment funds investing in virtual currency and tokenised funds. The definition of financial assets is very broad, and includes securities and financial instruments; however, it specifically excludes a non-debt direct interest in real property.

An entity that is considered to be an investment entity will be required to implement a compliance and diligence programme to allow the company to identify and report reportable accounts. A reportable account is an account held by one or more reportable persons, or by a passive non-financial entity with one or more controlling persons that is a reportable person.

The definition of an account of an investment entity is 'any equity or debt interest in the investment entity other than interests which are regularly traded on established securities markets'.

It is arguable that the tokens issued by an investment entity do not constitute either equity or debt interest, which are not further defined in respect of an investment entity. However, there are anti-avoidance provisions in both the Cayman FATCA and CRS legislation that would arguably apply to these interests.

Custodial institutions and depository institutions are also considered to be financial institutions for the purposes of the AEOI legislation.

The term custodial institution means any entity that holds, as a substantial portion of its business, financial assets for the account of others. An entity holds financial assets for the account of others as a substantial portion of its business if the entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 per cent of the entity's gross income during the shorter of the three-year period that ends on 31 December (or the final day of a non-calendar year accounting period) prior to the year in which the determination is being made; or the period during which the entity has been in existence.

The term depository institution means any entity that accepts deposits in the ordinary course of a banking or similar business.

An entity is considered to be engaged in a banking or similar business if, in the ordinary course of its business with customers, it accepts deposits or other similar investments of funds and regularly engages in one or more of the following activities:

a makes personal, mortgage, industrial or other loans, or provides other extensions of credit;

b purchases, sells, discounts, or negotiates accounts receivable, instalment obligations, notes, drafts, cheques, bills of exchange, acceptances or other evidences of indebtedness;

c issues letters of credit and negotiates drafts drawn thereunder;

d provides trust or fiduciary services;

e finances foreign exchange transactions; or

f enters into, purchases or disposes of finance leases or leased assets.

A cryptocurrency exchange may fall within the above definitions depending on the operations of the exchange.

Financial institutions are required to register with the US Internal Revenue Service for a global intermediary identification number, appoint a principal point of contact and authorised person, and register with the Cayman Tax Information Authority.

Financial institutions are required to report, by 31 May each year, names, addresses, taxpayer identification numbers, dates of birth (where applicable), account numbers, and account balances or values as at the period's end and in respect of any accounts closed during the period.

Financial institutions issuing tokens will need to obtain self-certification forms in respect of the initial purchasers and subsequent transferees of such tokens.

VIII OTHER ISSUES

i Beneficial ownership legislation of the Cayman Islands

The beneficial ownership legislation requires certain companies to maintain details of their beneficial owners and related legal entities on a beneficial ownership register.

If a virtual currency business is established as a Cayman company, the company will need to provide the full name, residential address and identification document details of any entity or person holding more than 25 per cent of the shares or control of the company. If the company is an issuer in respect of an ICO, whether the company will be required to disclose any details in respect of the holders of tokens pursuant to the beneficial ownership legislation will depend on the rights attaching to such tokens.

IX LOOKING AHEAD

Cayman has not yet implemented specific laws relating to virtual currency. However, it is possible that specific legislation regulating issuers, cryptocurrency exchanges and other entities involved in the cryptocurrency space may be introduced in the future.

Appendix 1

ABOUT THE AUTHORS

IAN GOBIN

Harneys

Ian Gobin is a partner in our Cayman office. He advises on the legal and regulatory treatment of investment funds, private equity funds and management companies established in the Cayman Islands and the British Virgin Islands.

Prior to joining us, Ian was the global head of the investment funds teams at Appleby, and before that he was a partner at Walkers. Before going offshore in 2001, Ian trained and qualified as a solicitor at Clifford Chance in London, working in the capital markets group. His current practice is focused on fund managers, their clients and their service providers. He also advises institutional and private clients throughout Europe and North America on funds matters.

Ian is a member of the Law Society of England and Wales, a Cayman Islands attorney-at-law and a solicitor of the Supreme Court of the Eastern Caribbean.

DANIELLA SKOTNICKI

Harneys

Daniella is a member of our Cayman Islands office. She advises Blockchain, FinTech and financial services clients on structuring, fundraising and regulatory matters, as well as providing advice regarding mergers and acquisitions, private placements, restructurings and joint ventures.

Prior to joining us in 2017, Daniella was counsel at Ogier, and practised with Cox Hallett Wilkinson in Bermuda and King & Wood Mallesons in Australia. Daniella has also served as in-house legal counsel at an administrator in the Cayman Islands.

Daniella is a chartered alternative investment analyst.

HARNEYS

4th Floor, Harbour Place
103 South Church Street
PO Box 10240
KY1-1002 Grand Cayman
Cayman Islands
Tel: +1 345 949 8599
Fax: +1 345 949 4451
ian.gobin@harneys.com
daniella.skotnicki@harneys.com
www.harneys.com

ISBN 978-1-912228-77-5