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A number of regulatory developments have been introduced into the Cayman Islands over the last 12 months as it takes further steps to ensure the transparency and integrity of its financial funds industry stands up to global scrutiny.

Many of these regulatory changes do not necessarily impact fund managers directly, but more so their service providers, although the Data Protection Law, 2017, which was published in the Cayman Islands Gazette on 5th June 2017, will impact all Cayman entities in respect of how they process and protect personal data.

**Data Protection Law, 2017**

The Data Protection Law is due to come into effect in January 2019 and will enable the jurisdiction to comply with data protection standards (in the form of GDPR) in Europe.

“At the moment, it is possible to transfer fund data from the EU to the Cayman Islands or other jurisdictions outside of the EU as long as one of a number of tests are passed; the most common being consent to transfer data to somebody outside the EU.

“There will be no need to obtain consent before data is transferred, however, if the jurisdiction to which data is being transferred...
We provide timely, exceptional legal advice and representation to our clients in connection with their commercial transactions, structures, liabilities and obligations in the Cayman Islands.

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Cryptocurrency and blockchain technology in the Cayman Islands

By Chris Humphries

Blockchain technology offers an exciting, unprecedented and innovative opportunity for the Cayman Islands investment funds industry. Whilst cryptocurrencies (such as Bitcoin) have been around for a number of years, we are now seeing a surge of activity in this area. Funds are being established in the Cayman Islands which will focus entirely on blockchain and cryptocurrency strategies. In addition, funds are seeking to innovate by accepting cryptocurrencies as a payment mechanism for subscription proceeds.

We expect smart contracts (discussed below) to become more mainstream in connection with subscriptions into and redemption out of funds. Such technology would enable investors to set parameters for those transactions without needing to take specific additional action each time they requested such a transaction to take place.

Cayman Islands vehicles are also used to execute initial coin/token offerings (ICOs). Where an ICO is structured through the Cayman Islands, the vehicle of choice seems to be a Cayman Islands exempted company. However, following the enactment of the new foundation company regime in the Cayman Islands, we expect to see these structures being increasingly used too.

It is, of course, an ever-changing and fast-paced market and we expect funds to continue to adopt smart contracts and cryptocurrencies in order for the funds to remain competitive and attractive to potential investors.

Smart contracts

Aside from the obvious potential for value creation, perhaps the most interesting application of blockchain technology for the legal market is the ability to generate "smart contracts". In the context of cryptocurrencies and blockchain, smart contracts are self-executing software programmes running on blockchain databases that enable transactions to be executed based on specific rules or triggers.

Once encoded onto the blockchain, a smart contract can then be definitive in the sense that, if one party performs their end of the bargain, the other contracting party's performance is automatic and guaranteed. The lack of human interaction required in executing the terms of the smart contract therefore limits the ability for error or disputes to arise. However, this automation also means that ensuring the contractual terms are accurate in the first instance is of vital importance.

Transparency

Blockchain technology is a decentralised digital ledger in which transactions made in Bitcoin or another cryptocurrency are recorded chronologically and publicly. The blockchain operates in a similar way to a spreadsheet and is a shared and continually reconciled database. When a transaction occurs and is verified by the network, the ledger records one fixed and highly secure copy of the transaction that all users are able to see at the same time.

The funds industry is now looking at blockchain technology as a way to provide a fast, streamlined method of communicating with investors or recording and transferring shares or other securities.

Blockchain technology could offer a higher level of transparency because the distributed ledger reflects the real-time ownership and
movement of a company’s shares or other securities. The blockchain system could therefore be used to quickly distribute a share dividend and to correct the Register of Members of a fund contemporaneously with the underlying transactions.

Is hacking a real concern?
If someone wanted to hack into a particular block in a blockchain, a hacker would not only need to hack into that specific block, but all of the proceeding blocks going back the entire history of that blockchain. In addition, the hacker would need to make the same change on every ledger in the network (numbering in the millions) simultaneously. Blockchain technology is therefore far less susceptible to hacking attacks than existing, centralised databases such as those used by intermediaries and banks.

Cayman’s involvement in cryptocurrencies
Cayman’s existing legal framework provides the flexibility to allow technologies like blockchain to flourish. As the leading offshore jurisdiction for the establishment of funds it is the natural fit for funds investing in blockchain and cryptocurrency strategies and it is a welcome jurisdiction for new ICOs.

“As the leading offshore jurisdiction for the establishment of funds it is the natural fit for funds investing in blockchain and cryptocurrency strategies and it is a welcome jurisdiction for new ICOs.”

Blockchain raises a wide range of legal issues including data protection, document retention, changes to participants and service providers once a blockchain is launched and verification of source of funds. Legal advice will also be critical to the process of development and launch of blockchain products, including smart contracts.

Stuarts Walker Hersant Humphries has an Investment Funds Team focusing on investments using cryptocurrencies. Our team is a market leader in advising managers on the set-up and establishment of a broad range of investment funds in the Cayman Islands.
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The importance of effective directors for troubled funds

Interview with Tammy Jennissen & Abali Hoilett

With the global financial crisis of 2008 now a decade in the past, much has changed in terms of how offshore private funds are governed and monitored. The highly publicised Weavering case in 2009 brought the role of fund directorships into sharp focus, specifically the lack of robust independent oversight.

Both the financial crisis and the Weavering case highlighted significant deficiencies in the way some fund managers approached the role of appointing directors to the board resulting in more independent non-executive board members now being appointed.

The overall quality and scope of directorship services work in the Cayman Islands continues to be enhanced with professional director firms such as Maples Fiduciary establishing the highest possible standards.

Maples Fiduciary, a division of Maples FS, offers a number of qualified, seasoned professionals to act on fund boards, distinguishing itself by the quality of its professional staff, considerable experience and expertise across a broad range of structures and investment strategies.

“When considering a board appointment, we review all of the relevant fund documents to ensure that the documentation is in line with best practices and that the documents provide appropriate transparency to investors,” explains Tammy Jennissen, Senior Vice President, Maples Fiduciary.

“Once the fund is launched, we have monthly or quarterly information provided to us by the relevant service providers, which we review to obtain an overview of the activities and performance of the fund and market as a whole.”

As part of exercising fiduciary oversight, directors at Maples Fiduciary actively participate in board meetings for the investment funds they represent. During each board meeting, directors discuss various topics with service providers to ensure they are operating within the parameters stipulated in the fund documents. Part of this discussion involves reviewing the investment portfolio so that a director can better assess portfolio composition with a view to mitigate potential risks, for example, looking at whether the portfolio is heavily weighted towards illiquid securities.

While high quality, engaged independent directors add value throughout the life of a fund, these individuals play an especially critical role when a fund is facing challenges.

There are a number of issues that can arise with troubled funds, says Abali Hoilett, Senior Vice President, Maples Fiduciary. “When that happens, we provide guidance on what the fund should consider when seeking to resolve issues in the most effective and compliant manner, at all times ensuring that investors are being treated fairly.”

While there are basic best practices that directors should be well versed in, dealing with issues affecting troubled funds largely depends on the specific considerations of each situation.

In some instances there may be valuation issues that require the fund director to engage external valuation agents. “There are myriad issues that we have to deal with when funds encounter difficulties. The process in some situations can be fairly straightforward, and others, not so straightforward. The key in these situations
is to effectively apply our knowledge and experience to the issues at hand, seeking appropriate advice, where required, to determine the best solution for the specific situation," explains Jennissen.

If a manager proposes a side letter that violates the terms of the funds constituent documents, a director would be expected to step in, often getting fund counsel involved to make sure that the letter does not get signed before the issues are resolved. However, in some instances, managers may execute side letters without bringing the letter to the attention of the full board and that is typically when issues can arise.

“If during the course of a board meeting, we determine that a side letter has been executed without our knowledge, we would immediately get involved. Depending on the terms agreed in the letter, we would typically not ratify the execution of the letter until we were comfortable that the letter did not favour certain investors unfairly. In a worst case scenario, the board may have to ask that the letter be re-issued to fix specific terms agreed, which is never a good situation,” adds Jennissen.

Other areas that require fund directors’ involvement include the emergence of non-standard capital activity within a fund, as well as dispute resolution.

Hoilett explains that non-standard capital activity can relate to anything that is raised or requested outside of the terms of the current offering.

“Non-standard capital activity may include, though not be limited to, extra redemption or subscription dates, in-kind subscriptions and capital activity where a security is impaired. We would initiate a fact gathering exercise, making sure all the information is available and then would then give due consideration to the fund to make decisions within the bounds of the legal documents,” he says.

Dispute issues can arise for various reasons. It may originate from a disagreement between the partners or principals of the management company and, depending on the severity of the dispute, the director would need to think about what recourse to take and reach out to fund counsel to ensure that investors are being treated fairly.

Equally, it may originate with a disgruntled investor that may not be happy with the fund’s activities or the performance of the portfolio manager.

In such a situation, says Jennissen, “The board would want to determine what, if anything they think the investment manager did wrong. If the issue was regulatory, we would query what had been done and whether the alleged breach impacted the fund. As long as there is consistent and transparent dialogue between the directors and the investment manager appropriate disclosure and action can be taken to ensure the interests of the investors are safeguarded.”

Directors can also play an active role in the winding down of a fund. If the fund’s performance has been poor for a considerable period of time and redemption activity is increasing, it is often not a surprise to investors that directors might consider, with the manager, an orderly wind down of the fund.

“At this point, the board of directors and the investment manager would consider the redemption activity, assess the potential for future redemptions and compare that with the liquidity profile of the remaining assets. At some point a decision may need to be made to wind down the fund by either moving straight to cash and mandatorily redeem all investors or whether the directors need to invoke fund gates or a full suspension of redemptions is required to ensure that remaining investors who had not yet submitted redemption requests are not left with a basket of illiquid investments.

“Following a decision to terminate a fund, a notice would be sent out to investors stating that all external capital will be returned on a specified date, which is typically the next month if it is a fully liquid portfolio. If it is more illiquid, it might require a longer wind-up process. For the most liquid part of the portfolio, the aim would be to return this capital to investors as soon as practicable, but in a way that ensures investors are getting the best return possible given the illiquid positions,” concludes Jennissen.
is deemed to have equivalent data protection measures to the EU. By implementing the DPL, the Cayman Islands are beginning the process towards achieving “equivalence” status,” explains Lucy Frew, Partner at Walkers and head of its Regulatory & Risk Advisory Group.

Before DPL comes into effect, a working group consisting of both private sector leaders and government employees will review the law to help draw up plans to implement the paradigm shift in local privacy protection.

The working group will be chaired by Acting Information Commissioner Jan Liebaers. The seven-member panel will include local attorneys Peter Broadhurst, Tim Dawson, and Peter Colegate, as well as Cabinet Office staffers Nadira Lord and Garfield Ellison, and Paul Morgan of OfReg, Cayman’s utilities and commodities regulator.

“The Cayman Islands legal industry has properly prepared for data protection,” comments Sean Inggs, Fund Director at International Management Services Ltd, which provides directorship services to Cayman funds.

“The law is similar to the main elements of the UK’s Data Protection Act, 1998 and GDPR. A Cayman data protection ombudsman will be established. Most of the obligations on data controls will all be applicable here in Cayman, which is good because it will keep the jurisdiction in line with European regulatory standards.”

Data protection has become a hugely important issue for offshore financial centres in the wake of high-profile cybersecurity breaches in Panama and Bermuda. The ability to protect sensitive data on HNW investors, fund investments, deal activity, etc, has rapidly become a top priority.

“This is an area that I think many have at the top of their priorities list for 2018,” says Frew. “Cyber attacks and data leaks are a worldwide phenomenon and obviously not limited to just the hedge funds industry or offshore jurisdictions. The sorts of attacks happening today means that the risks involved are previously unimagined.

“We have invested an enormous amount of resources in technology and specialist cybersecurity staff. Maintaining the security and confidentiality of client information is of the greatest importance to us.”

More than anything, hedge fund businesses are concerned about the risks a jurisdictional cybersecurity attack could have on their commercial reputation in the marketplace.

Although the two are separate issues, there is a cybersecurity element to DPL regulation in terms of how Cayman entities process data and the controls they have in place to ensure sensitive data does not get damaged or leaked.

“GDPR will have an impact on any Cayman Islands hedge funds that have touch points with the EU - for example, service providers, actual or prospective investors, marketing contacts or representative offices. It is conceivable that some hedge funds will have no touch points with the EU and will not be caught within the scope of GDPR. If a Cayman Islands hedge fund is within scope of the GDPR, it will have to comply with all its requirements. As the DPL is based on UK and EU data protection legislation, its definitions and concepts will look familiar to UK or EU managers or service providers to Cayman Islands hedge funds,” she says.

**CIMA increases enforcement powers**

Another regulatory update is the Monetary Authority (Amendment) Law, 2016, which was passed on 24th October 2016 and came into force on 15th December 2017, the same date as the Monetary Authority (Administrative
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Changes to beneficial ownership
The Companies Law and the Limited Liability Companies Law of the Cayman Islands (Regime) requires certain Cayman Islands corporate entities (each a company) to maintain a beneficial ownership register (Register) at their relevant registered office, the information of which will be stored in encrypted form on a secure, stand-alone search platform established by the Minister of Financial Services of the Cayman Islands, as the competent authority (Competent Authority).

The purpose of the Regime, explains Piers Alexander, Partner at Conyers Dill & Pearman, is to make beneficial ownership information normally held by corporate service providers, “readily accessible to the Competent Authority in response to proper requests from specified law enforcement agencies (currently limited to those in the Cayman Islands and the United Kingdom). The search platform is not publicly accessible and may only be searched by or on behalf of the Competent Authority.”

Unless subject to an exemption, each company must take reasonable steps to identify any individual beneficial owner of the company and all relevant legal entities.

“Not all beneficial owners or relevant legal entities will be entered on the Register; only registrable persons. Registrable persons fall into two categories: (a) an individual beneficial owner who holds, directly or indirectly, more than 25 per cent of the shares or the voting rights in the company; or has the right, directly or indirectly, to appoint or remove the majority of the directors of the company; or has the legal right to exercise, or actually exercises, significant direct or indirect influence or control over the company through the ownership structure (other than solely as a director, professional adviser or professional manager) and (b) a relevant legal entity, which, in relation to the company, is incorporated, formed or registered under the laws of the Cayman Islands and would be a beneficial owner of the company if it were an individual,” explains Alexander.

The available exemptions to the Regime include any legal entity, or its subsidiary, which is either listed on the Cayman Islands Stock Exchange or an approved stock exchange; or registered or licensed under a Cayman Islands regulatory law (such as the Mutual Funds Law, the Securities Investment Business Law (SIBL) or the Banks and Trust Companies Law); or managed, arranged, administered, operated or promoted by an approved person as a special purpose vehicle, private equity fund, collective investment scheme or investment fund (Fund).

An approved person is a person, or its subsidiary, that is regulated, registered or licensed either under a regulatory law or in another recognised jurisdiction under the Anti-Money Laundering Regulations (including China, Hong Kong, Singapore, the United Kingdom and the United States) (Recognised Jurisdiction); or listed on the Cayman Islands stock exchange or an approved stock exchange under the Companies Law.

On 27th November 2017, the Cayman Islands Government published, but has not yet enacted, an amendment to the Regime (Amendment), which introduced further clarification on the exemptions.

For example, a legal entity which is managed, arranged, administered, operated or promoted by an approved person as a Fund will now include where that Fund is a Cayman Islands exempted limited partnership.

“This will ensure that a company which acts as the general partner of a Cayman Islands exempted limited partnership, for example, has appointed a manager licensed by the Securities and Futures...
chime with the view that the middle class in China will be a key economic driver,” states Alexander.

Another factor in driving outward economic growth will be the Belt and Road initiative, intended by the Chinese government to improve the infrastructure of overland and maritime routes between East and West in order to facilitate the flow of capital, goods and services.

“The Belt and Road reflects the ancient Silk Road, which transformed international trade and cultural exchange along a number of intercontinental trade routes,” says Alexander. “The ‘Belt’ is the land route from China across Central Asia into Europe and the ‘Road’ is the maritime route out of China encompassing South-East Asia, the Indian Sub-Continent, East Africa, the Middle East and into the Mediterranean.”

Through the Belt and Road initiative, China will access over 65 countries representing more than 60 per cent of the world’s population and around 30 per cent of global GDP. Not only will China gain new markets but it will also be in a position to secure key commodities, minerals and energy resources.

A core aim is to make it easier for businesses operating in and out of China to reach the middle classes along the Belt and Road. The view being that, if infrastructure development leads to urbanisation in developing countries along the routes, the domestic economies will also develop. If domestic demand drives activity across the region, the economic landscape for China and other countries along the Belt and Road will move away from debt-fuelled investments and reliance on exports. This will also release over-capacity pressure should China’s traditional markets not be able to continue to absorb its available exports.

“Offshore financial centres (OFCs), such as the British Virgin Islands and the Cayman Islands, have been an integral part of the development and financing of Asian infrastructure projects and cross-border deals for over 30 years. With the flexibility afforded by the available structures for debt and equity financing, whether as investment funds, capital market offerings or bond issues, OFCs are ideally positioned to continue that relationship for the Belt and Road,” concludes Alexander.
Looking for an independent director?

Formed in 1974, International Management Services (IMS) is one of the longest established offshore company management firms in the Cayman Islands. Our Fiduciary Team focuses on the provision of directors and trustees to hedge funds. We have over 200 years of collective experience in the fund industry and provide services to some of the largest global hedge fund organizations.

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IMS (International Management Services Ltd) is one of the leading providers of directorship services in the Cayman Islands. Its directors bring a wealth of experience to the funds they represent. One area of corporate governance that has become increasingly pertinent relates to the growing threat of cybersecurity.

It is, according to Sean Inggs, Fund Director at IMS, typical for board meetings to dedicate a portion of time to an investment fund’s cybersecurity processes. Directors should be considering and enquiring after how a fund’s digital and electronic processes are set up and monitored, not just at the fund manager level but also at the fund administration level? Has the fund suffered any cyber breaches? Have any of the fund’s service providers suffered any cyber breaches? If so, what steps were taken following the breach?

“When considering compliance at the fund board level, it is one of the key areas for fund directors today,” says Inggs. “Almost all my US clients are engaging cybersecurity professionals. It’s encouraging to see that the funds industry has been proactive on this issue over the last 12 months.”

In his view, governance professionals are best advised to take a practical approach to this issue by asking specific questions aimed at determining what practical steps a fund manager is adopting towards cybersecurity.

“Those steps include appointing a properly qualified third party cybersecurity provider or, for a larger fund that has the financial resources, hiring professionals within their existing IT team to handle cybersecurity. They should also involve reviewing the fund’s service providers to check they are adequately prepared and have proper policies and procedures in place.

“We see some investors committing quite a large amount of time during due diligence asking cyber-related questions. They want to know what policies the manager has in place, what their disaster recovery plans are, and so on. Having something written down is very important.

“For example, directors should be assessing cybersecurity risks within their general risk management responsibility that comes with being a director. Many private equity fund boards have separate risk meetings or, if not, they certainly form part of their quarterly board meetings. Cybersecurity risks now have to be part of a fund’s ongoing risk assessment,” states Inggs.

“This increased oversight is part of a wider trend of alternative fund managers embracing regulatory compliance and corporate governance more completely.

“The pressure placed on new managers to take governance and board composition seriously is still there. Investors are still asking all the usual questions, in terms of how many appointments a fund director has, what their experience is, do they have experience in a particular asset class and so on. I am seeing more questions on risk management and compliance as well.

“Interestingly, one trend we have started to see is more fund directors being appointed to the internal governance committee inside a fund, to provide an additional layer of corporate governance and independent oversight at the master fund level. This is being driven by a number of large institutional investors, among others.

“We are seeing this with some of our US clients where they have independent directors sat at the master fund level as well as at the offshore feeder fund level. That is a positive shift in my opinion,” concludes Inggs, adding that he hopes to see this hedge fund trend spread to LPACs of private equity funds.”
The FCA and SEC have long had the ability to impose fines; now CIMA will have the power to do so as well,” says Frew. “Previously, there were too few penalty options for CIMA; this now gives it more flexibility to right-size the penalty to the offence. The regulator has always been able to impose sanctions but it never had the ability to impose financial sanctions at a range of different levels in the way that it has now.”

Over the years, Cayman has made a number of changes aimed at enhancing transparency and good governance within the financial sector, including the introduction of a Beneficial Ownership regime in 2017.

This explicitly brings private equity funds and hedge funds that weren’t formerly registered with CIMA within the AML regulatory regime. Anti-Money Laundering Regulations, 2017 (‘AML Regulations’) came into force on 2nd October 2017. The thrust of the changes to the AML Regulations has been to close gaps that remained between Cayman’s robust anti-money laundering regime and the Financial Action Task Force 2012 recommendations (FATF Recommendations).

In terms of ensuring compliance with the AML Regulations, Gary Smith, a partner in the Corporate and Investment Funds Group at Loeb Smith Attorneys, says that a Cayman fund already registered with and regulated by CIMA will typically have delegated the maintenance of AML and Combatting of Financial Terrorism (CFT) procedures on behalf of the Fund to a fund administrator.

“The Monetary Authority (Amendment) Law helps to enhance the jurisdiction and can serve to support enhanced governance,” comments Tammy Jennissen, Senior Vice President, Maples Fiduciary, a division of MaplesFS.

“It doesn’t change the way we do business, however. When the Statement of Guidance (SoG) was issued under the Mutual Funds Law, it highlighted expectations of fund directors, many of which had long been standard procedure for us.”

Abali Hoilett, Senior Vice President, Maples Fiduciary, believes that the SoG brings a more consistent approach to fund governance. “It raises the bar for Cayman directors and underscores the importance of fund governance and the critical role it plays in Cayman’s alternative investment funds industry.”

The Monetary Authority (Amendment) Law now allows CIMA to impose fines for regulatory breaches. It is set out to apply to various regulatory laws including the Development Bank Law (2004 Revision) and the Directors Registration and Licensing Law, 2014 among others. To the extent that those laws do not impose fines, this new legislation instantly provides CIMA with the ability to issues financial penalties.

“Managers should therefore check that the scope of delegation to their fund administrator is sufficiently broad to cover the requirements of the AML Regulations (e.g. check (i) whether the AML regime being applied in respect of the Fund is the Cayman AML regime or the regime of jurisdiction recognised as having an equivalent AML regime, and (ii) if it is the latter whether or not the relevant administrator is actually subject to the AML regime of that jurisdiction.”

Asked what managers of previously unregistered Cayman funds need to be mindful of, Smith remarks: “Unregulated
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Besides the Data Protection Law, 2017, which was gazetted on 5th June 2017 and is expected to come into force in January 2019, the main regulatory development, in terms of its impact on Cayman regulated hedge funds, is The Monetary Authority (Amendment) Law, 2016.

The law was passed on 24th October 2016 and came into force on 15th December 2017, the same date as The Monetary Authority (Administrative Fines) Regulations, 2017 were published and came into force.

The new rules allow the Cayman Islands Monetary Authority (‘CIMA’) to impose a range of penalties from non-discretionary fines of CI$5,000 for minor breaches to discretionary fines of up to CI$100,000 on individuals and CI$1 million on entities for very serious breaches. CIMA can impose cumulative fines of up to CI$20,000 for ongoing occurrences of the same minor breach.

So far, the new rules only encompass breaches of The Anti-Money Laundering Regulations, 2017, but other regulatory laws are expected to be added shortly. The regulatory laws of most interest to hedge funds will be the Mutual Funds Law (as revised), the Securities Investment Business Law (as revised) and The Directors Registration and Licensing Law, 2014.

“CIMA has been consulting with the financial services industry on an administrative fines regime for some time and draft regulations have been in circulation for a while,” comments Jarrod Farley, Partner, Carey Olsen.

“I think because of the CFATF inspection in December 2017, CIMA felt the need to prioritise their enforcement powers in relation to the AML Regulations, but I would expect the other regulatory laws to be added in the next few months. It’s quite a sea change on the enforcement side. Up until now, CIMA had the ability to impose certain penalties but they were mostly for low-level breaches, such as being late paying annual fees on time.

“Most serious breaches of the regulatory laws are offences that until now have only had criminal sanctions. This meant that enforcement has required a criminal prosecution, which takes it outside CIMA’s immediate control and is generally a slower, more costly process with a need to meet the criminal burden of proof (i.e. proof beyond a reasonable doubt). An administrative fines regime will definitely make it quicker and easier for CIMA to enforce Cayman’s regulatory laws."

The introduction of the new enforcement regime complements the new Anti-Money Laundering Regulations, 2017, which have been strengthened and which replace the Money Laundering Regulations (2015 Revision). Both were introduced ahead of the CFATF inspection that took place in December 2017. CIMA will now have the ways and means to sanction those who breach the AML regulations. This is important within an OECD context, as it demonstrates that Cayman’s regulatory regime is effective and that CIMA has the ability to properly enforce the rules.

“Typically, a lot of the things that hedge funds trip on every year will largely be characterised as non-serious breaches, but these now have a fixed CI$5,000 penalty. For regulated hedge funds, their annual fees don’t even come to that amount. Even though it’s a modest offense, it will come as somewhat of a financial jolt to some investment managers.

“One example of a non-serious breach would be a fund filings its audited accounts late, without having obtained prior permission from CIMA, which a substantial number of hedge funds are quite bad on. CIMA understands that there can be delays,
especially if it’s a fund-of-hedge-funds that needs to wait for the underlying funds to report before they can finalise their audited accounts, and it is willing to give waivers to extend the filing deadline by one or two months. But funds are supposed to go and ask for that extension. They can’t just not file on time and expect there to be no consequences.

“In the past, CIMA simply did not have a big stick to enforce the rules; now they will, going forward. And I expect them to do so quite quickly. I think CIMA will be keen in the first 12 months to show that they are using those enforcement powers,” explains Farley.

One important point that Farley makes is that following a consultation between CIMA and the Cayman Islands’ service provider community, CIMA agreed to include a 30 day rectification period for non-serious breaches, which demonstrates that the purpose of the new enforcement regime is to encourage compliance, rather than simply raising revenue.

Most of the regulatory changes that have happened in Cayman over the last 12 months by and large involved tightening up rules ahead of the recent CFATF inspection. For example, unregulated hedge funds and PE funds are now subject to the requirements of the AML Regulations.

Most hedge funds won’t need to worry too much because for the most part they will be outsourcing AML compliance to their administrator; who in turn will have in place a Money Laundering Reporting Officer and Compliance Officer, now referred to as an Anti-Money Laundering Compliance Officer. In addition, the entity conducting AML and KYC activities will need to appoint a Deputy Money Laundering Reporting Officer under the new regulations.

“The provisions around delegation are such that as long as the fund is delegating to an administrator that is subject to AML regulation in Cayman or an equivalent jurisdiction (as set out in a list approved by the AML Steering Group), or is directly complying with the AML regulations, there’s no real change and basically business as usual.

“It looked for a while as though every Cayman hedge fund might need to appoint its own MLRO but CIMA has since clarified this and the role can still be outsourced on a delegated basis,” confirms Farley. He says that the AML changes are more focused on encouraging a risk-based approach than on adding more prescriptive requirements.

“The big change is for unregulated funds such as hedge funds that fall within the section 4(4) exemption. These are funds that have no more than 15 investors where the investors can appoint and remove the operators by majority vote. They fall outside the requirement to register with CIMA, and weren’t automatically subject to the previous AML regulations. These investment vehicles do now have to comply with the updated AML regulations,” adds Farley.

One of the natural upsides to any jurisdiction that works hard to strengthen its regulatory regime is that it gives greater confidence to investment managers and, importantly, their end investors.

In that regard, Cayman is no exception. Confidence in the jurisdiction remains as high as ever.

“What you can see in the numbers is that they have pretty much stabilised at around 7,500 registered funds. We’ve seen considerable growth in fintech funds over the past year, most recently in those focused on crypto assets, and we expect that trend to continue.

“The recent enhancements to Cayman’s AML regime and CIMA’s enforcement powers continue Cayman’s tradition of complying appropriately with international standards in a market-sensitive way, and will continue to support Cayman’s reputation as the pre-eminent hedge fund jurisdiction.”
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investment entities should also check that the scope of delegation to their Administrator is sufficiently broad to cover the requirements of the AML Regulations. Investment entities which have not appointed a Fund Administrator (e.g. because the investment manager maintains the AML / CFT procedures on the Fund’s behalf) should check the same matters outlined above and additionally, whether or not the delegate has the requisite personnel (in terms of numbers, training and experience) to maintain the AML / CFT procedures on the Fund’s behalf.”

AML is taken very seriously by firms to uphold the Cayman Islands’ whiter than white reputation but these latest updates have refreshed everybody’s focus on the topic. A lot of what was already in the guidance notes has been moved into the new AML regime, which has introduced more of a risk-based approach, thereby bringing it into closer alignment with the FATF’s requirements.

Greater pressure on directors
All of the above developments, from DPL to the Monetary Authority (Amendment) Law and AML Regulations, place far greater pressure on fund directors as they seek to ensure that a fund’s investment activities are being adhered to, not just by the Fund Manager, but by their appointed service providers.

“Data protection is playing a bigger role with GDPR set to come into effect in Europe this May. It should be on the minds of any proactive boards of directors,” says Inggs.

Jennissen says that directors should be able to ask poignant questions in every board meeting in terms of what managers are doing from a data protection perspective.

We get reports from IT teams as well as service providers that cover how data is being protected, how this process is being managed and the level of resources this requires. Our goal is to ensure the manager is able to focus the majority of his attention on the investment strategy rather than some of these back-office tasks,” comments Jennissen

From a director’s perspective, transparency is vital. “We want to ensure the proper message is being communicated to investors and sometimes that requires challenging the notification approach being taken by the manager,” adds Hoilett.

The rise of digital asset strategies presents the latest challenge to fund directors as they seek to understand the operational mechanics of such funds. One of the unique aspects to these funds, from a security perspective, is the cryptographic keys; and more specifically, where those keys are being held.

“There is a serious question of risk when it comes to whom is tasked with holding the private keys to the fund’s digital currency,” asserts Inggs. “As an independent director I would want to know where and how are the keys being held? Where are they stored? Are they held on exchange, which may be risky, and if so what percentage of the fund’s digital assets are being kept on the exchange?”

Given the pace of regulatory and asset class developments, Cayman directors are being kept busier than ever. With a clearer, more comprehensive governance framework in place, and CIMA’s new enforcement powers, the jurisdiction is doing what it needs to do to maintain its global reputation.
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Fintech to be a focus of continued innovation

Q&A with Jude Scott

How would you assess the current health of Cayman’s funds industry?
Cayman continues to be a top jurisdiction for formation of Alternative Investment fund products, with the world’s top managers using Cayman Islands vehicles in their structures. All of us will be well aware of Cayman’s strength in hedge funds, with the Cayman Islands being home to over 10,000 registered hedge funds. Cayman’s fund offering also includes a significant number of Alternative Investment funds outside of the traditional hedge fund, including many thousand private equity, venture capital and real estate funds. In fact, many estimates would put the size of Cayman’s PE fund industry as comparable to that of its more well-known hedge fund industry. This is a story we would like to tell more.

The Cayman market reflects many of the themes industry participants are seeing onshore, particularly in the US investment funds market. Investors have consistently ranked performance as the most significant factor in selecting new funds, as well as the most significant driver for reducing allocations. The indicators are that investors are allocating capital to fewer managers and as more traditional asset managers continue to migrate into private funds. We have seen increasing consolidation amongst investment managers and predict this will continue along with competition for capital and pressure on fees.

Where are the main growth areas in terms of fund registrations?
We still see the Cayman Islands as the primary offshore jurisdiction for private fund managers in North America, the UK and parts of Asia, including Japan.

We continue to see a demand for credit funds although we have seen an increase in real estate funds, particularly those with underlying assets in Asia. As the global markets continue developments and enhancements in the AI and fintech space, we expect continued interest by managers and funds in this area with a growing interest in cryptocurrency offerings.

We also observe an increased popularity with Cayman Islands segregated portfolio companies (SPCs), liked for their flexibility, speed to market and the cost efficiencies for managers with multiple portfolios. The majority of SPCs tend to be regulated by the Cayman Islands Monetary Authority (CIMA) unless meeting the criteria for exemption from registration with CIMA.

The Cayman LLC vehicle was introduced just over a year ago. How well has this been received among fund managers and why was it important that Cayman introduced such a product?
We now routinely see Cayman Islands exempted limited partnerships formed with Cayman LLCs as their general partner, or with general partners in existing fund structures being replaced by, or converted into, Cayman LLCs. Managers may be seeking to either move their fund structures entirely to Cayman by swapping out existing Delaware LLC general partners, or to replace Cayman exempted company general partners with LLCs that offer greater flexibility with regards to governance structures, fiduciary duties and the allocation of carried interest amongst individual managers.

That the Cayman LLC has quickly become a recognised and established vehicle utilised frequently by managers only confirms the significance of the introduction of this product that delivers greater choice for fund structuring, and further complements the existing stable of legal vehicles available...
in the Cayman Islands for international transactions, including exempted limited companies, exempted limited partnerships and exempted unit trusts.

Cayman Islands LLCs have been available for only a relatively short while, however we anticipate that there will already be approximately 1,000 Cayman Islands LLCs registered by the end of Q1 2018.

The main Cayman Islands vehicles available for structuring funds remain the exempted company (e.g. for open-ended alternative investment funds), the exempted limited partnership (e.g. for closed-ended alternative investment funds) and the trust (e.g. the unit trust is often the preferred investment vehicle for certain Asian investors). These vehicles are as popular as ever, but the Cayman Islands Government responded to requests, particularly from the investment funds industry, to offer an additional structuring solution - the Cayman Islands LLC.

In most cases, it is the more general corporate and commercial applications that resonate with the funds industry, such as the use of LLCs as joint venture companies, for management holding vehicles, carried interest distribution vehicles or as general partner entities.

What initiatives are you pushing to further enhance Cayman’s reputation in the market?

A key area for continued innovation by Cayman is financial technology. Fintech will disrupt the full range of financial services, including the institutional investor sector that Cayman plays such a leading role in. However, the disruption won’t just be to the marketplace but to the existing regulatory regime as well. Cayman intends to establish itself as a jurisdiction that is adjusting its business, legal and regulatory practices to match the changes fintech will ultimately produce, which will position us as a leader in the new marketplace.

Our specific focus is ‘smart fintech regulation’. This approach will allow new technology to be successfully utilised within the financial services industry, including for alternative investment funds. In particular Cayman is focused on the development of a certified digital identity platform, which can improve business efficiency and quality, streamline costs and support effective regulation.

The Cayman Islands was not included on the EU’s list of non-cooperative tax jurisdictions at the end of last year. Could you comment on this?

Cayman Finance and the Cayman Islands Government worked hard together to address concerns the European Union raised during the process if considering non-cooperative jurisdictions last year. I think the outcome reflects that Cayman is at the forefront of regulatory and tax compliance and information exchange.

The Cayman Islands meets or exceeds the highest global financial standards, sharing the same OECD rating as many EU Member States. We were an early adopter of international best practices and standards for transparency and cross-border cooperation and the more EU officials learned about that the more they came to regard Cayman as a cooperative jurisdiction.

There is more work to be done but I am confident we will be able to address any areas that require further clarification.

Where will you be focusing your efforts in 2018?

Over the last year we have been looking at the fintech industry and specific aspects of fintech that fit synergistically with the overall Cayman business model.

In 2018, our industry, Government and Regulator will continue to work closely together to evolve a Legislative and Regulatory approach to leverage the benefits of cryptocurrencies, blockchain and similar technologies in an environment that contains the trusted elements of sound regulation most suited to these new technologies.

We will also continue to press ahead with our formal launch last year of reinsurance as a new industry sector.

While still in the early stages, the reinsurance entities established to date have already become a significant portion of all insurance related assets under management in the jurisdiction. Cayman has seen firms such as Greenlight Re, Knighthead, OxbridgeRe and more either open on island or grow their businesses. We will be focused on supporting growth in this key sector in 2018.
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Cybersecurity and data protection

By Lucy Frew

Significant developments in the regimes for data protection and cybersecurity, together with increasing investor awareness, mean that these are key issues for hedge fund businesses in 2018.

Technological advances have brought great opportunities and efficiencies to the alternative investment fund industry but not without also introducing previously unimagined risks, irrespective of geographical location.

With the introduction of new domestic legislation in the form of the Data Protection Law, 2017 (DPL), new international regulation in the form of the General Data Protection Regulation (GDPR) and heightened regulatory scrutiny from the Cayman Islands Monetary Authority (CIMA), investor demands, as well as commercial and reputational risk sensitivity, mean that data protection and cybersecurity are topping hedge fund businesses priorities lists for 2018.

**Regulation**

Across the world, including the Cayman Islands, governments and regulators have been steadily increasing their focus and resources on cybersecurity. Ironically, it is also the legal and regulatory obligations to collect personal data resulting from new international data sharing regimes combined with cybersecurity concerns and innovative technology deployments which are making the regulation of personal data more complex than ever before.

CIMA had already announced in May 2016 that it sees cyber attacks as one of the key risks facing the financial sector in today’s digital environment.

CIMA had already made clear it will review licensees’ approaches to data security risk management and examine technical controls, incident response, and staff training. As part of its reviews, CIMA will also consider licensees’ ability to protect the confidentiality, integrity and availability of sensitive customer and other information.

Financial regulators, including CIMA, are typically not being prescriptive in setting out rules and standards to which alternative investment funds sector businesses must adhere. This makes sense given the breakneck pace of sophistication of both cyber attacks and prevention. However, CIMA is certainly increasing its focus on the issues of cyber risks and cybersecurity within the industry, especially as the industry is playing an ever-increasing role in financing the economy.

**General Data Protection Regulation and the Cayman Islands**

Commencing 25th May 2018, GDPR will replace the current EU data protection regime. It will apply not only to organisations in the EU but also to organisations based outside the EU if they collect or process personal data of EU individuals; for example, in the context of a fund, when collecting anti-money laundering, FATCA or CRS information.

The Cayman Islands is not part of the EU and has not implemented GDPR. Nevertheless, one of the key changes under GDPR is the extension of territorial scope to include data controllers and processors that are not established within the EU but whose data processing activities relate to ‘offering goods and services to individuals in the EU’ or ‘monitoring behaviour taking place in the EU’.

A number of alternative investment fund sector businesses that were not within scope of the predecessor regime will now be captured and will need to ensure that their processes are compliant with GDPR.
In terms of what is meant by “offering”, it is important to distinguish the application of GDPR from that of the AIFMD. Offering will only be within scope of GDPR if personal data is actually processed. In other words, if a third country manager hands a non-individually addressed offering document to a prospective investor in the EU, the manager would likely be regarded as marketing under the AIFMD but not necessarily without more, as processing personal data for the purposes of GDPR. However, any related processing of personal data would constitute processing activities related to the offering of goods and services in the EU.

Conversely, activity may constitute processing of personal data for the purposes of GDPR even if there is no marketing within scope of the AIFMD. For example, a manager may collect investor contact details with a view to a future fund offering without, at that point, attempting to communicate with such investors. Nevertheless, such collection of personal data would likely constitute processing of personal data under GDPR.

The other basis which might bring a hedge fund business with no EU establishment and no EU investors into scope relates to “monitoring behaviour taking place in the EU”.

A processing activity should be considered monitoring where EU data subjects are “tracked on the internet.” This includes the possible subsequent use of the acquired data for the purposes of “profiling a natural person, particularly in order to take decisions concerning her or him or for analysing or predicting her or his personal preferences, behaviours and attitudes”. This is relevant where, for example, a manager outside the EU uses alternative data or data analytics based on behavioural monitoring of data subjects in the EU.

Relationships with entity investors, as well as individual investors, are likely to involve the processing of personal data of natural persons. An individual who invests in a fund is usually required to provide a host of personal data. A company, partnership or trust investor in the fund is usually required to provide personal data in relation to its individual directors, members, shareholders and other beneficial owners. It follows that even if all investors are located outside the EU, one cannot rule out the possibility that onboarding will involve personal data of individuals in the EU.

**The Data Protection Law, 2017**

The DPL will introduce for the first time a data protection regime in the Cayman Islands. The DPL was gazetted on 5th June 2017 and will come into force on a date set by Cabinet Order, expected to be January 2019. Meanwhile, regulations will be made in relation to various provisions of the DPL. As the DPL is based on the UK and EU data protection legislation, its definitions and concepts will look very familiar to UK or EU managers or service providers to Cayman Islands hedge funds.

Similar to its predecessor legislation, GDPR restricts transfers of personal data beyond the EU to ensure it is being sent to a country which provides for adequate data protection. By implementing the DPL, the Cayman Islands are beginning the process towards achieving “equivalence” status. Meanwhile, transfers of personal data can be made in the absence of adequacy decisions in various circumstances including where the individual has consented.

**Data protection and cybersecurity**

Compliance with GDPR and DPL overlap to a significant degree with hedge fund businesses’ cybersecurity measures. Controllers must implement appropriate technical and organisational measures to ensure the protection of personal data during processing and transfer and to prevent unauthorised or unlawful processing of personal data and accidental loss or destruction of, or damage to, personal data.

**Sanctions for failure to secure personal data and enforcement**

The DPL contains significant financial penalties but these do not compare to the size of those under the GDPR, where businesses that fail to comply with the GDPR’s data security requirements may face fines of up to EUR20 million or 4 per cent of total worldwide annual revenue; whichever is greater. The extent to which EU authorities will investigate and take enforcement action against organisations with no EU establishment remains to be seen especially if, as is likely in the case of hedge funds, there is little to no detriment to the retail public.
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The Cayman Islands is fast becoming the go-to jurisdiction for software developers and fund managers alike as they look to establish cryptocurrency funds and ride what is, if one looks at the price of Bitcoin, a hugely volatile wave.

Funds such as EKT Active Fund, an actively traded cryptocurrency and ICO fund established by Australian hedge fund veteran Damien Hatfield in partnership with Steve Bellotti, former Head of Global Markets for ANZ Bank, have been keeping law firms busy as the demand for crypto-asset strategies builds serious momentum.

“There are various crypto-currency and digital asset strategies being implemented by the Cayman Islands investment funds that are coming to market in this space,” comments Richard Spencer, Partner, Campbells, one of the Cayman Islands’ leading law firms. “Much of the money being attracted at present is coming from family offices and HNW individuals rather than institutional or pension fund money.”

Crypto-assets have gone more mainstream over the last 12 months and although they are not quite at the stage of being an institutional play for investors, there’s definitely been enough investor interest for fund managers to want to either set up funds to invest in a broad range of crypto-assets - which may or may not include Bitcoin and Ethereum - or to use them as bolt-ons to their existing strategies.

“The reason they have not yet been a fully institutional play is because of the inability to do anything other than to hold them long,” says Matthew Taber, Partner,
Loeb Smith

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Why did the Cayman authorities need to revamp/update its existing AML regulations and what was the catalyst?
The new Anti-Money Laundering Regulations, 2017 of the Cayman Islands (AML Regulations), which came into force on 2 October 2017 and the Proceeds of Crime Law (2017 Revision) (PCL) which came into force in May 2017 have together expanded the scope of Cayman Islands anti-money laundering regime (AML), including application to investment funds generally and specifically to (i) private equity funds and other closed-ended funds (e.g. real estate funds) and (ii) structured finance vehicles that are not registered with the Cayman Islands Monetary Authority (CIMA).

The main aim behind the changes to the AML Regulations has been to more closely align Cayman Islands’ AML regime to the Financial Action Task Force 2012 recommendations. The AML Regulations introduce a new risk-based approach to AML in the Cayman Islands, including requiring persons subject to the AML Regulations (Financial Service Providers) to take steps appropriate to the nature and size of their business to identify, assess, and understand its money laundering and terrorist financing risks in relation to a customer, the country or geographic area in which the customer resides or operates, the Financial Service Provider’s products, service and transactions, and the Financial Service Provider’s delivery channels.

Could you provide a few salient points on the gaps that have been addressed in the new AML regime?
The scope of the AML Regulations is still defined by reference to “relevant financial business”. Persons undertaking “relevant financial business” in the Cayman Islands must comply with the requirements of the AML Regulations. The definition of “relevant financial business” that was included in previous versions of the anti-money laundering regulations has been removed from the AML Regulations and has instead been placed in Section 2 of the PCL. The definition continues to cover (emphasis added) “mutual fund administration or the business of a regulated mutual fund within the meaning of the Mutual Funds Law (2015 Revision)” which covers all funds registered with and regulated by CIMA. The definition had also covered and continues to cover investment managers licensed by or registered with CIMA (e.g. those who have applied for and obtained a SIBL Exemption). However Section 2 and Schedule 6 of the PCL now extends the meaning of “relevant financial business” to cover activities which are “otherwise investing, administering or managing funds or money on behalf of other persons.” The net effect of expanding the meaning of relevant financial business to include activities of “otherwise investing, administering or managing funds or money on behalf of other persons,” is that now all unregulated investment entities (as well as regulated investment entities) are covered and will need to maintain AML procedures in accordance with the AML Regulations.

AML Procedures
Going forward all Cayman unregulated investment entities (as well as regulated investment entities) will be required to have the following AML procedures in place:
• identification and verification (KYC) procedures for its investors/clients;
• adoption of a risk-based approach to monitor financial activities;
• record-keeping procedures;
• procedures to screen employees to ensure high standards when hiring;
• adequate systems to identify risk in relation to persons, countries and activities which shall include checks against all applicable sanctions lists;
• adoption of risk-management procedures concerning the conditions under which a customer may utilise the business relationship prior to verification;
• observance of the 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;
• internal reporting procedures (i.e. appointment of a money laundering reporting officer and deputy money laundering reporting officer); and
• such other procedures of internal control, including an appropriate effective risk-based independent audit function and communication as may be appropriate for the ongoing monitoring of business relationships or one-off transactions for the purpose of forestalling and preventing money laundering and terrorist financing.

In order to allow unregulated investment entities not previously subject to the AML/CFT regime to implement appropriate procedures (or delegation arrangements) to comply, the AML Regulations have been amended to provide a grace period until 31 May 2018 within which to assess their existing AML/CTF procedures and to implement policies and procedures which are in compliance with the AML Regulations.

What are the enforcement powers that CIMA will be able to bring to bear for those entities who fail to comply?
The Monetary Authority (Amendment) Law, 2016 (the Amendment Law) which came into force on 15th December 2017 gives CIMA the power to impose administrative fines for non-compliance on entities and individuals who are subject to Cayman Islands regulatory laws and/or the AML Regulations.

For a breach prescribed as minor fine would be CI$5,000 (approximately US$6,000). For a breach prescribed as minor the Authority also has the power to impose one or more continuing fines of CI$5,000 each for a fine already imposed for the breach (the “initial fine”) at intervals it decides, until the earliest of the following to happen:

a) the breach stops or is remedied;
b) payment of the initial fine and all continuing fines imposed for the breach; or
c) the total of the initial fine and all continuing fines for the breach reaches CI$20,000 (approximately US$24,000).

For a breach prescribed as serious, the fine is a single fine not exceeding: (a) CI$50,000 (approximately US$61,000) for an individual; or (b) $100,000 (approximately US$122,000) for a body corporate. For a breach prescribed as very serious, the fine is a single fine of not exceeding: (a) CI$100,000 (US$122,000) for an individual; or (b) CI$1,000,000 (US$1,220,000) for a body corporate.

The Monetary Authority (Administrative Fines) Regulations, 2017, which came into force immediately after the Amendment Law came into force sets out, among other things, rules and guidance regarding the amount of fines, different categories of breaches, the criteria for exercising fine discretions, including procedures of imposing fines, appeals, payment and enforcement.

How would you assess the overall improvements made in the new AML regulations, vis-à-vis other global funds jurisdictions?
The AML Regulations are intended to more closely align Cayman Islands’ AML regime to the Financial Action Task Force 2012 recommendations which are intended to set the standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The changes introduced by the AML Regulations enhances the Cayman Islands’ AML regimes adherence to such international standards and its reputation as one of the premier offshore financial centres.

What advice would you give to fund managers who rely on their service providers to handle AML/KYC checks?
Fund managers should check (i) whether the AML regime being applied in respect of their Fund is the Cayman AML regime or the regime of jurisdiction recognised as having an equivalent AML regime, (ii) if it is the latter whether or not the relevant delegate is actually subject to the AML regime of that jurisdiction, and (iii) whether or not the delegate has the requisite personnel (in terms of numbers, training and experience) to maintain the AML / CFT procedures on the Fund’s behalf.
Innovative

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In a recent landmark decision of the Grand Court in A Company and A Funder, the Court has approved a third party litigation funding agreement and in doing so given a roadmap to funders as to what conditions it will apply in such cases. While previous decisions of the Grand Court have approved third party funding agreements in principle, the Court's observations have until now been restricted to the use of funding for the benefit of impecunious liquidation estates. This was a case involving a large multinational seeking to take advantage of funding for other commercial reasons.

**Background**

The plaintiff, a large Korean company, sought comfort from the Grand Court that it could legally avail itself of funding from a third party commercial funder in connection with proceedings that it intended to issue for the recognition and enforcement of a New York arbitration award and related judgments. Mindful that the common law crimes and torts of maintenance and champerty have yet to be formally abolished in the Cayman Islands, it sought a declaration from the Grand Court to the effect that the funding agreement was not unlawful and that the commencement of proceedings in the Cayman Islands with funding made available pursuant to the agreement would not be contrary to Cayman Islands public policy. Broadly speaking, maintenance is the assistance in proceedings of someone who has no relevant interest in the outcome, and champerty is an aggravated form of maintenance in which the assistance is provided in exchange for a share of any proceeds. Whilst the form of the proceedings was somewhat unorthodox, the Court recognised that the plaintiff was entitled to know whether it risked committing an offence under Cayman Islands law.

**Public policy factors considered**

The Court’s analysis centred around a number of public policy principles. It focused in particular on the question of whether the funding agreement had the tendency to “corrupt public justice, undermine the integrity of the litigation process and give rise to a risk of abuse”, the test that had been laid down many years earlier by the English Court of Appeal in Giles v Thompson.

The Court considered the particular features of the relationship between a litigant and a commercial funder and helpfully set out a number of factors which will be taken into account when deciding whether or not to approve such agreements:

1. The extent to which the funder controls the litigation: a funder who is bound to act on the reasonable advice of attorneys will generally be considered to have done enough to prevent any assertion that he maintains an improper degree of control.

2. The ability of the funder to terminate the funding agreement at will or without reasonable cause: an agreement is unlikely to be approved if a funder can terminate the agreement at will because it would give him inappropriate leverage in the making of key decisions.

3. The level of communication between the funded party and the attorney: a funder should not be able to control the litigation by being able to give instructions to the attorneys conducting the proceedings. If the attorneys are independent of the
funder and alive to the possibility of abuse or conflict of interest, it will assist the prospects of the agreement being approved.

4. The prejudice likely to be suffered by a defendant if the claim fails: a funding agreement under which the funder is not liable to meet any adverse costs order raises a risk of abuse. However, this can be mitigated against by requiring the funded party to take out after the event (ATE) insurance.

5. The extent to which the funded party is provided with information about, and is able to make informed decisions concerning, the litigation.

6. The amount of profit that the funder stands to make: where the funded party is no longer in a position to derive a real benefit from a successful outcome, the funding agreement is more likely to be treated as champertous.

7. Whether or not the funder is a professional funder and/or is regulated: an important consideration is likely to be whether the funder is a member of a professional body with its own rules of conduct, such as the UK Association of Litigation Funders.

In the instant case, having regard to the above factors and the developments in the law of maintenance and champerty in other common law jurisdictions, the Court concluded that – subject to one change being implemented – the proposed funding agreement did not give rise to a tendency to corrupt public justice and was not unenforceable in the Cayman Islands as a matter of public policy.

**Conclusion**

The decision highlights the Grand Court’s recognition of the growing limitations of the doctrines of maintenance and champerty in relation to modern practice. As Segal J. put it: “Cayman has an important, world-class court system and litigation culture and there is no reason why responsible, properly regulated commercial litigation funding undertaken in accordance with the principles I have set out should not have a place in this jurisdiction. As has been accepted in other leading financial centre common law jurisdictions and as the Chief Justice noted in Quayum, the law of maintenance and champerty has evolved reflecting the evolution of public policy and that evolution should be reflected in Cayman law.”

It should be said that statutory reforms have also been proposed in this complicated area of practice which, if implemented, may go even further than the scope of the decision in A Company and A Funder. For now, though, this is a decision that is likely to be welcomed by litigants and commercial funders alike as expanding the options available for the use of funding in appropriate, court-approved cases.
Jarrod Farley, Partner, Carey Olsen, says that the firm has been “very cautious” in terms of the work it is willing to engage in, at this stage. This echoes the views of other service providers who are staying on the sidelines and waiting to see how this asset class develops before diving in. Last year, for example, an executive at Eisner Amper said that until there is regulatory oversight for these funds, “we have taken the position that we will not audit them.”

“We are quite comfortable with regular funds that are investing in crypto as an asset class; particularly hedge funds because if they are regulated they are already subject to AML regulations, have compliance procedures in place and are used to the idea of monitoring money laundering risks,” comments Farley.

He says that even if Bitcoin blows up, the blockchain technology underlying cryptocurrencies has value to the financial system. “It is likely to persist,” adds Farley.

Those considering setting up a standalone fund vehicle would typically want to choose the exempted Cayman 4(4) fund. This is an open-ended fund structure that has 15 or fewer investors and does not have to register with CIMA, under an exemption set out in section 4(4) of the Mutual Funds Law. The 4(4) exemption is popular for funds with only one investor, friends and family funds and start-up funds.

For larger crypto fund managers with 15 or more investors, a fully registered 4(3) Cayman fund product would be the main route to market.

“We are seeing people with significant expertise in crypto-currencies and distributed ledger technology set up Cayman Islands fund structures notwithstanding that they have not managed external capital before. We are also seeing existing hedge fund managers set up new Cayman Islands fund structures and new segregated portfolios of existing SPCs to develop crypto-focused strategies.

“It is not uncommon for crypto-focused funds to invest in illiquid tokens and DLT businesses as well as relatively liquid mainstream crypto-currencies. We see side pockets and other measures being used to accommodate the differing liquidity profiles of these digital assets,” explains Spencer.
The Cayman Islands has recently taken a number of measures to reinforce its position in the global financial services market.

It has overhauled its anti-money laundering and counter terrorist financing legislation, which includes explicitly bringing unregistered (i.e. not registered with CIMA) hedge funds and private equity funds, under its revised AML regulatory regime.

The complete legislation and regulations (which have been updated over the last 12 months) came into force in December 2017.

Specifically talking about the impact on investment funds, Matthew Taber, Partner, Harneys comments: “Previously there was a lacuna in the legislation and regulations, which meant that only those funds registered with CIMA were explicitly caught by the AML regulations. That gap, to the extent that it wasn’t plugged voluntarily, has now been closed by the updated legislation. It’s now explicit, that if you are investing, managing or administering funds or money on behalf of other people, you must have a comprehensive AML compliance programme in place either being operated by the fund itself or, more usually, being delegated to a third party such as a fund administrator”.

In practice, investment funds were already operating on the basis that they needed proper AML checks and controls in place anyway; now the legislation simply codifies this.

This is important in respect to Cayman’s latest Caribbean Financial Action Task Force inspection in December, and in respect of the Paradise Papers leak in November, which threw offshore financial jurisdictions under the spotlight of mainstream media. The more Cayman ensures that its AML legislation is up to date, says Taber, the more it “demonstrates that the jurisdiction is operating in line with global best practices”.

With technology advancing so rapidly, financial services providers could potentially use blockchain technology (or broader distributed ledger technology) to further reinforce investor transparency and guard against nefarious activity.

“The way in which AML/KYC processes will potentially overlap with DLT is very interesting. Rather than being a check-the-box regime, the updated Cayman AML regime emphasises that AML compliance should be risk based. If you look at the ability of technology to enhance transparency and certainty in relation to, for example, identity confirmation, the financial services industry could greatly benefit from digital identity solutions which combine modern solutions (e.g. facial recognition or biometrics such as fingerprint scanning) with something like DLT.

“If a certified or verified digital ID were to exist within a globally accepted blockchain ecosystem that takes things to yet another level. Then you’ve got a certified digital ID approved by a bank that can be used in Cayman, or globally, and this could significantly enhance AML capabilities and reduce compliance costs. In part, the changes to our AML regime will allow us to explore these new technologies using risk as a guiding factor,” explains Taber.

The Paradise Papers leak/cyber attack reflects a wider data protection and cyber security challenge that offshore jurisdictions must contend with. The Cayman Islands has a laser focus on this, recently passing new Data Protection Law (‘DPL’) with a view to
putting Cayman in a position to allow it to be confirmed by the European Commission as having adequate data protection safeguards, enforceable rights and legal remedies as part of the introduction of the GDPR in Europe. It is currently expected that the DPL will come into force with necessary amendments after the GDPR comes into force in Europe.

“As a leading offshore jurisdiction with a focus on financial services, ensuring that there are no restrictions to global data flow through Cayman is important. The intention of passing the DPL and when they are available, the associated regulations, is to allow Cayman to have equivalency to European standards with respect to data protection,” comments Taber.

He further adds: “As a result, much as happened in the late 1990s in the UK when the original Data Protection Act was passed, the Cayman financial services industry will need to ensure that systems and procedures are compliant. That said, many Cayman financial service providers are already operating to very high standards in this regard and compliance should be straightforward for most.”

In addition to these other regulatory changes, the Monetary Authority (Amendment) Law 2016 and associated regulations are now in force, which allow CIMA to impose a range of penalties from non-discretionary fines of KYD5,000 for a minor breach up to KYD1 million for a serious breach of regulatory laws.

“CIMA needed to change its legislative regime to give it more ability to impose financial penalties and to put it on a level playing field with onshore regulates. For example, it can now properly deal with funds and investment managers who ignore their regulatory obligations.

“It is right that regulators have the power to impose appropriate fines for bad behaviour in offshore jurisdictions to ensure compliance with laws and regulations and this is being seen as a welcome move in the industry,” concludes Taber.
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The stratospheric rise in the value of cryptocurrencies throughout 2017, coupled with significant price volatility, caught the attention of the world at large. Opinions remain polarised, with regulators warning “Main Street investors” of the risks associated with purchasing virtual currencies and cryptographic tokens. The underlying distributed ledger technology is far less controversial, with well-known global financial institutions investing heavily in this space.

Investment managers looking to launch crypto-focused investment funds aimed at professional investors often wish to set up a standalone, master-feeder or mini-master fund structure in the Cayman Islands. With many global digital asset and virtual currency exchanges preferring offshore counterparties, managers of domestic funds also find themselves establishing Cayman Islands vehicles.

Typical considerations that arise when establishing a crypto-focused investment fund include whether to accept crypto-denominated subscriptions from investors and how best to implement a satisfactory custody solution.

Fund managers often wish to have the flexibility to invest in a wide range of digital assets, including liquid cryptocurrencies and illiquid tokens, and also to acquire equity interests in blockchain oriented businesses. In this regard, it is important to ensure that the fund documents include appropriate redemption and valuation mechanisms, and to consider the implementation of side pockets at the outset. In addition, fund managers must keep abreast of developments in the global legal and regulatory landscape that may impact their investments in tokenised securities and other digital assets.

As recently as early 2017, only a handful of boutique service providers were available to crypto-focused investment funds, but we have seen the larger fund administration and audit firms move into this space in recent months. Fund managers may also consider engaging service providers that utilise blockchain technology, and will need to weigh up the advantages and disadvantages in doing so. Proponents of blockchain technology cite fraud-proof record keeping as a key advantage, by virtue of the immutable nature of data in a blockchain, and point to consequential cost-savings. Others are concerned that blockchain services and solutions have not been stress-tested, as they are still in their infancy.

The Cayman Islands’ legal and regulatory landscape supports the development and monetisation of distributed ledger technology. The Electronic Transactions Law and the recently revised trade mark registration regime complement the “zero tax” status of Cayman Islands exempted companies.

Global distributed ledger technology businesses are increasingly considering whether to establish a physical presence in the Cayman Islands. Such businesses can often benefit from a fast-track trade licensing process that is aimed at attracting software developers and computer programmers to the Cayman Islands, with a view to diversifying the Cayman Islands economy. Coupled with developments in cloud computing and the Cayman Islands’ geographical proximity to the United States, we are finding that establishing a Cayman Islands office is very appealing to both established global businesses and individual entrepreneurs.

Having worked with the first movers in this space, we are delighted to see the Cayman Islands emerge as the jurisdiction of choice for crypto-focused investment funds and the development and monetisation of the underlying distributed ledger technology. With significant resources being deployed to develop this technology, the Cayman Islands are well positioned to provide an ecosystem that is conducive to the proliferation of crypto-focused investment funds and blockchain technology.
“A lot of these tokens or coins do trade on exchanges but as we’ve seen in the last few weeks there have been some significant spikes in volatility. There are spreads across different exchanges so coming up with a solid valuation policy to determine how the manager arrives at a fair market price for each position is important. Fund managers shouldn’t be cherry picking one exchange over another, depending on the market scenario,” advises Griego.

Another key piece of this is custody of the assets. In a normal hedge fund, it’s pretty simple. The assets might be held with Goldman Sachs, for example, to whom the auditor then sends a confirmation that they are indeed holding the assets. With respect to crypto-assets, the problem is that there are not yet many custodians in the market.

“If you wanted to buy a crypto currency there are plenty of options but when it comes to putting the crypto currency with a custodian there are limited options,” says Griego. “You can buy it on an exchange but generally you would want to move the cryptocurrency (given past cyber attacks on exchanges) to secure cold storage locations.

“With a lack of custodians, people are often forced to self-custody themselves using their own hard disk onto which they move their tokens. We will continue to see developments in this area as more custodians enter the arena and more products become available for individuals to self custody.

“As an auditor, we need to know what the custody position is for the fund, and if they do have a custodian, do they generate any sort of report on their internal controls? If the manager self-custodies, who has access to the cold storage? How are they protecting the encryption keys? What back-ups do they have in place in the event that the manager misplaces the hard drive or it gets stolen?

“A lot of these are common sense questions but they tend to get overlooked.”

If a manager is taking in crypto-assets as in kind subscriptions, then it becomes very difficult for the MLRO at a fund administrator to check the source of that subscription.

Farley says that the sensible ones who are taking this business on “are demanding the investment manager do full AML due diligence checks on investors to verify their...
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BDO Cayman is responsible for approximately 450 fund audit engagements ranging in size from a million to billions in assets. The funds cover a multitude of strategies, structures, jurisdictions of the managers and other service providers and accounting standards. The Cayman office currently has four partners and a staff of thirty five most of whom are qualified accountants.

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Establishing best practices for a crypto fund audit

Interview with Ignacio Griego

For most new fund managers the concept of having to prepare for a financial audit is entirely novel. Knowing what is involved and how best to prepare, in terms of applying best practices, is a new discipline, yet it is one that is crucial to running a successful fund management business.

With respect to the meteoric rise of cryptocurrency funds, there are only a handful of auditors that really know what they are doing, in terms of supporting them. For these managers, therefore, choosing the right auditor is important. If not, and they run into difficulties because the appointed auditor does not fully understand the asset class, it could lead to delays and result in additional fees down the line.

“Doing that initial due diligence on service providers, so that managers have the confidence that their service providers know what they are doing in this space, is crucial,” says Ignacio Griego, Assurance Partner, BDO, speaking from the firm’s San Francisco office.

“There are a lot of people that don’t know what they are doing with respect to crypto funds as more and more service providers try to get into this space. The type of people launching crypto funds can include engineers without fund operational experience or traditional fund managers without the technical crypto background. Having a complimentary team with a foundation in both areas is a prerequisite to running a successful crypto fund business.”

There are a few areas that new managers should be discussing with their appointed auditor. One of the most important areas of discussion is the valuation policy. This is true, regardless of what the fund strategy is, but for cryptocurrency strategies it is crucial because of the lack of provenance in handling such funds.

“Many of the tokens or coins in these funds trade on exchanges but as we’ve seen in the last few weeks there have been some significant spikes in volatility. There are spreads across different exchanges so coming up with a solid valuation policy to determine how the manager arrives at a fair market price for each position is important. They shouldn’t be cherry picking one exchange over another in different scenarios,” advises Griego.

As reported by BBC News on 22nd December (citing Coindesk), Bitcoin’s price fell off a cliff, losing almost a third of its value as it dropped from nearly USD20,000 before recovering just north of USD13,000.

In Griego’s view, it is important that managers of crypto funds adhere to Topic 820 (Fair Value) under US GAAP. They should establish the valuation policy when the fund is established with the fund administrator and run that policy by the appointed auditor to check they are comfortable with it.

“This should all be done early, ahead of the financial year-end, so that there will be less of a likelihood that the manager will need to make any adjustments prior to finalising the year-end NAVs. This is good best practice for any new investment fund, be it a crypto fund, a hedge fund or a private equity fund.”

For funds investing directly in blockchain or cryptocurrency related companies, valuation can prove challenging if the company is not generating any revenue. Even for companies producing revenue, walking through the valuation concepts with the auditors is a helpful exercise. Many of these companies are highly specialised, so it is important to hold discussions on comparable companies and other unobservable inputs being used in the valuation. It’s about making sure everyone is on the same page prior to year-end.

“I foresee a lot of potential challenges in 2018 for teams who may have hastily put a
launch together without assembling the right team and dedicating the right amount of resources to operations and service provider diligence. Equally, for many service providers it is the first time they’ve worked with such funds. It is a new era, in many respects,” says Griego.

Another key piece of the financial audit is thinking about the custody of the assets. In a typical hedge fund, this is all pretty simple. The assets will be held at a qualified custodian such as Goldman Sachs, to whom the auditor can send a confirmation that they are indeed holding the assets. Reliance can be placed upon reports received as these qualified custodians typically will obtain a SOC-1 report from an external auditor, which focuses on the custodians’ internal control environment.

However, with crypto assets the problem is that there are not yet many custodians in the market. If you want to buy and sell Bitcoin or other tokens there are plenty of trading options but when it comes to utilising a qualified custodian there are limited options. You can buy it on an exchange, but then need to determine the most secure location to store and if there is even the option of moving to a qualified custodian based upon the token type. In many instances funds are forced to self-custody tokens using their own hard disk ledger wallets.

“As an auditor we need to know what the custody position is for the fund, and if they do have a custodian, does that custodian generate any sort of report on their internal controls such as a SOC-1 report? Auditors need to go through such reports, if indeed they are produced, with a fine tooth comb to ensure the report covers the key internal controls.

“If the manager self-custodies, who has access to the cold storage? How are they protecting the encryption keys? What back-ups do they have in place in the event that the manager misplaces the hard drive ledger or it gets stolen?

“A lot of these are common sense questions but they tend to get overlooked,” explains Griego.

There are plenty of Bitcoin wallets available to use for self-custody. Some of the more popular include Ledger Nano S (a hardware wallet), Mycelium (an open-source Bitcoin wallet) and Exodus (a desktop-only wallet).

“At the end of the day, we want to be aligned with the right teams who have spent the necessary time developing not only their investing strategy, but their operations and infrastructure. We want to understand exactly what they are investing in, what their valuation and custody processes are and what key internal controls have been implemented,” emphasises Griego.

As for how an auditor thinks about cryptocurrency funds in respect of financial reporting under FATCA and Common Reporting Standards, this is a careful exercise because theoretically, if an investor were investing in a crypto fund using tokens rather than cash, how would the investment adviser know who that end investor was?

“The funds I’ve seen have not had any in-kind contributions and they still go through standard AML/KYC checks.

“While there may be instances where it may make sense for an individual or fund to utilise an in-kind contribution of securities or tokens, it oftentimes will result in a headache as the cost basis of these asset lots will need to be tracked separately and specially allocated to those contributing individuals, which can create additional headache, time and costs.

“While many of the legal documents will allow for in-kind contributions, funds should think carefully about the implications should they chose to go this route,“ concludes Griego.
identity and source of funds. Then at least the administrator knows the manager has done everything it reasonably can to ensure everything with the investors is above board.”

“Investors increasingly wish to use their existing crypto-currency holdings to subscribe for shares in crypto-focused investment funds, with fund administrators factoring this into a risk-based approach under the recently overhauled AML regime,” adds Spencer.

**ICOs – a threat to Cayman’s institutional reputation?**

Something that went largely unnoticed earlier in 2017 was the addition of issuing electronic currencies to the list of relevant financial business in the Proceeds of Crime Law, which came into effect in May 2017.

What this means is that if someone launches an Initial Coin Offering (ICO) in Cayman, and are issuing an electronic currency in the form of tokens, they will automatically be caught by the AML Regulations and will be obligated to do proper KYC on the purchasers of said currency, as well as maintain proper records, etc.

“That has actually been quite good at stemming the tide of ICOS,” says Farley, who voices certain reservations. “When you think about it, many ICOs are essentially unregulated retail funds. There’s a big concern that if you let ICOS gallop away ahead of regulation, that could come back to haunt the jurisdiction if a serious blow up occurs.”

It is to Cayman’s advantage that CIMA hasn’t tried to push through ICO regulations like they have in certain other jurisdictions such as the Isle of Man.

“Cayman has always been a jurisdiction for institutional investors and we’d all like to keep it that way,” continues Farley. “It gives us a sense that we are properly insulated from the dangers of dealing in an area that affects retail investors. It has worked for us, as a jurisdiction, for a long time and that is what makes us nervous about ICOS, in particular. People are going to lose money. If that’s the man in the street rather than sophisticated investors it is going to raise the issue to the level of national governments and the spotlight will fall on the jurisdictions and service providers that facilitated it. Cayman has to be careful in that regard.”

Not everyone is necessarily cautious. As Taber confirms, both in the BVI and Cayman, Harneys has worked on a number of ICOs for clients.

“I sit on the Cayman Finance Regulatory and Legislative working group, and I am also involved in a US-based working group involving law firms, auditors and fund administrators. For us, it’s something we cannot ignore as a jurisdiction. We are in the process of considering changes to legislation which will allow more clarity as to what these tokens are, and how they are classified,” opines Taber.

As part of the wider digital technology paradigm emerging, Cayman is also set to be well positioned to benefit from blockchain growth, as well as crypto-asset growth.

By 2020, 80 per cent of financial services will be using some form of distributed ledger technology. One survey* by Bain & Co, estimates that total savings to global financial markets could reach anywhere from USD15 billion to USD35 billion.

Thanks to the absence of any direct taxation on companies or individuals, and its proximity to the US, Cayman lends itself favourably to technology entrepreneurs. Indeed, a local ecosystem is already starting to emerge, with Campbells’ Spencer confirming that an increasing number of cryptocurrency and blockchain businesses are setting up a physical footprint in the Cayman Islands.
Spencer, and many others, thinks that blockchain will likely become more and more disruptive in the asset servicing side of the private funds industry.

Given that Cayman is home to 70 per cent of the world’s offshore investment funds, the opportunity for fund administrators to apply blockchain technologies such as smart contracts could lead to considerable efficiencies. Not only that, but the immutability of distributed ledgers means that the ability to commit fraud is vastly reduced, if not completely, making transfer agency work and fund reporting a more transparent and secure process.

Its applications to AML/KYC are also manifold. Some think that the financial services industry will fall completely under blockchain, be it consortium, private or public, while others believe it will never take off.

“I think it’s probably somewhere in the middle,” says Taber. “As one of the larger offshore financial centres, Cayman simply cannot afford to ignore it. The funds industry here, as a whole, is keen for Cayman to take advantage of opportunities as they arise.

“This technology is fundamentally changing the way companies do business. If you don’t understand how the technology works, you’re not going to be offering clients any value. If you don’t know how a blockchain environment works, how payments are made, how crypto-assets are transferred and so on, your ability to provide real value as an offshore financial services lawyer will be reduced, to a greater or lesser extent.”

If Cayman is to establish a standalone crypto fund vehicle, in future, it will need to mirror the existing investment funds suite; in other words, it will have to be an institutional play and not something aimed at the retail market. It will also depend on legislation and regulation in other countries, were one to set up a token issuer in Cayman.

“Because we have a high number of quality service providers on the Island, it is in none of our interests to take on clients wishing to launch crypto products who may not be of the quality we are used to seeing for traditional fund structures.

“Yes, it’s new technology, but in terms of the way we operate, as service providers, nothing changes. We’ve still got the same AML responsibilities as a firm, and as an jurisdiction. That piece is front and centre of everyone’s mind but what we have to make sure is that we have the right product. Just because the product itself is crypto doesn’t create risk; it’s the type of businesses operating such funds that create risk,” concludes Taber.

*www.bain.com/publications/articles/blockchain-in-financial-markets-how-to-gain-an-edge.aspx*