

# Cryptocurrency Funds: Risk or opportunity for the Cayman Islands?

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It may be surprising to learn that the word “cryptocurrency” was added to the Oxford English Dictionary in 2014, since many industry participants would not have come across the word until 2017 when the rapid increase in the price of certain cryptocurrencies garnered mainstream media attention.

**The most well publicised of these price increases was Bitcoin, which saw its value increase from approximately US\$950 in December 2016 to a peak of US\$19,783 in December 2017 (an astonishing 1,982% increase in less than one year).**

As a result, stories and articles about “Bitcoin Billionaires”, plans to turn Puerto Rico into a “Crypto Paradise” and Satoshi Nakamoto all

became front page news. However, by November 2018, the price of Bitcoin had slumped to slightly above US\$4,000. The volatility is not limited to Bitcoin; all cryptocurrencies have experienced volatility.

High volatility potentially makes cryptocurrencies a promising opportunity for alternative investment funds. Institutional investors are actively pursuing these opportunities and are leveraging their experience in traditional asset classes to seek to minimise the risks associated with investing in cryptocurrencies. As the most popular offshore jurisdiction for alternative investment funds, the Cayman Islands has already experienced significant activity in this space and is well positioned to see this increase.

The Cayman Islands must ensure it protects its reputation as the pre-eminent offshore jurisdiction for investment funds by developing laws, rules and regulations which encourage the establishment of cryptocurrency funds in the Cayman Islands without undermining the jurisdic-

tion's well-earned reputation. There are also some key risks associated with cryptocurrency funds that are being navigated by service providers in order to take advantage of the opportunity presented by this relatively new asset class.

## **Effective legislation**

The legal and regulatory framework in the Cayman Islands is designed to facilitate growth and enterprise and to provide a flexible business environment, while at the same time maintaining its position as a leading financial centre. Cayman has well-tested structures with which both managers and investors are familiar and comfortable. These structures accommodate a wide range of investment strategies, differing liquidity requirements and, specific to cryptocurrencies, the issuance of tokenised equity interests. This flexibility is vital to the innovative area of cryptocurrencies. We have seen cryptocurrency funds established in both the hedge fund and venture capital space, using exempted company, exempted limited partnership and limited liability company vehicles.

The Cayman Islands has comprehensive anti-money laundering (AML) legislation, which complies with global standards by adopting in principal a risk-based approach. Where subscription proceeds are received in-kind for cryptocurrency funds, the requirement to identify and verify the investor and relevant source of funds becomes more difficult. This presents a new challenge for fund administrators and a key

risk for AML compliance officers and fund operators. Some administrators have had to partner with tech providers to be able to track the provenance of the coins and satisfy themselves on the source of funds in order to confirm compliance with Cayman Islands AML laws. Cryptocurrency funds with tokenised equity interests have had to embed qualified purchaser requirements and AML requirements into their smart contracts for transfers of their tokenised equity interests on the blockchain platform. Given the importance of AML in the cryptocurrency space, the number of AML providers specialising in cryptocurrencies has increased significantly, however all participants must be mindful to ensure AML providers are not merely collating the AML information (rather than confirming compliance with Cayman Islands AML standards).

## **Safe and effective custody**

It is usual for cryptocurrencies to be stored in "hot" and "cold" storage facilities. Hot storage is kept online and connected to the Internet. It offers better liquidity, but as it is connected to the Internet there is more risk that it may be hacked. Cold storage is kept offline and disconnected from the Internet. It offers less liquidity but significantly reduces the risk of hacking. Neither hot nor cold storage provides a perfect solution, and one alternative option is to keep the cryptocurrency in cold storage with a small percentage in hot storage to facilitate liquidity requirements to the extent that this is practicable.

The security and storage of cryptocurrencies have emerged as additional challenges for cryptocurrency funds. There have been numerous incidents of hacking and security compromises, which have had a negative and detrimental effect on the reputation of cryptocurrencies as a mainstream investment. To address this concern, Cayman based custodians need to have robust policies and procedures in place to satisfy funds and their investors as to the security of cryptocurrency that they are holding. Some cryptocurrency funds are self-custodying (to the extent that they are able to do so under applicable laws) being of the view that they have the technology available in-house to self-custody securely, compared to third party custodians.

In light of the risk of theft or hacking, custodians, crypto exchanges, cryptocurrency funds and their fund directors are also looking at insurance options. Again, this is a developing area with few insurers providing insurance against theft or hacking. Some insurers have chosen not to provide "Directors and Officers" insurance to directors of cryptocurrency funds until the market is further developed, while those insurers who are providing insurance in this space are able to command higher premiums.

**Proper valuations**

The ways in which traditional assets classes are valued are well established, and fund administrators and calculation agents in the Cayman Islands can perform valuations quickly

and efficiently. On the other hand, the valuation of cryptocurrencies has presented new challenges and it is not easy, or in some cases not possible, to apply standard valuation formulas to cryptocurrencies. In addition, there is not a single established exchange from which a valuation can be marked. This is especially problematic when you consider that the difference in the price of Bitcoin on the top two (by volume) cryptocurrency exchanges is US\$200 and that there are 2000+ cryptocurrencies. Market practices are continuing to develop, but this remains a key area of focus for fund administrators, calculation agents and auditors.

The market capitalisation of all cryptocurrencies sits at approximately US\$137 billion. That is exceeded by the US\$8.8 trillion that the alternative investment industry manages, and is miniscule when compared to the estimated US\$300 trillion market capitalisation of all traditional asset classes. However, these figures do not take into account that Bitcoin, generally considered to be the first cryptocurrency, only recently had its ten-year anniversary. This is a very new asset class that has exceeded all expectations to this point. Some believe cryptocurrencies will replace fiat currencies. Some believe cryptocurrencies are just a part of the wider blockchain revolution. What is clear is that there are plenty of opportunities in this space for the Cayman Islands, and its experienced service providers are already working through the particular challenges that cryptocurrency funds present. 🐼



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