

Overview of the regulatory regime for virtual assets in the Cayman Islands

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The Virtual Asset (Service Providers) Act (Revised) (the **VASP Act**) of the Cayman Islands derives from recommendations made by the Financial Action Task Force and provides for the regulation of virtual asset businesses and for the registration and licensing of persons who are providing "virtual asset services".

The VASP Act is being implemented in phases. Phase one, which focuses on anti-money laundering (**AML**) and countering the financing of terrorism (**CFT**) compliance, supervision and enforcement, came into effect on 31 October 2020.

Under phase one, persons engaged in or wishing to engage in virtual asset services must be registered with the Cayman Islands Monetary Authority (**CIMA**) pursuant to the VASP Act. However, where such persons are already subject to CIMA's supervision under another regulatory law, they must notify (in the case of licensees) or register with (in the case of registrants) CIMA pursuant to the VASP Act.

Provisions of the VASP Act which relate to enforcement, penalties or offences commenced on 31 January 2021. Persons engaging in virtual asset services on or after 1 February 2021, that have not registered or notified CIMA (as applicable), will be subject to penalties and other enforcement measures from CIMA pursuant to the VASP Act, including potential orders to cease and desist providing virtual asset services.

Phase two will bring into force the licencing and virtual asset issuance approval process. It is now expected that phase two will commence in 2023.

Businesses wishing to carry on any virtual asset service (including virtual asset custody services, operating a virtual asset trading platform or selling virtual assets to the public) must first register with or notify CIMA (as applicable) but they need not apply for a licence or for permission to issue tokens (as applicable) until such time as the relevant provisions in the VASP

Act are commenced under phase two.

In addition to the VASP Act, the Government has amended a number of existing laws to extend them to virtual assets. These include the Mutual Funds Act (Revised) (the **MF Act**), the Securities Investment Business Act (Revised) (the **SIB Act**), the Proceeds of Crime Act (Revised) (the **PC Act**) and the Anti-Money Laundering Regulations (Revised) (the **AML Regulations**). These amendments are already in effect.

This briefing provides a high level summary of the VASP Act and the amended legislation above.

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Virtual Assets (Service Providers) Act (Revised)

What are virtual assets?

The VASP Act defines virtual assets as "a digital representation of value that can be digitally

traded or transferred and can be used for payment or investment purposes but does not include a digital representation of fiat currencies".

This wide definition will likely capture all cryptocurrencies, security tokens, utility tokens or other digital assets that are tradeable or transferable, with the exception of digital fiat currencies. Whilst the term "digital expression of fiat currencies" is not defined, we are of the view this is likely to apply only to government-issued virtual currencies as opposed to Tether, GUSD and the like.

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What are virtual asset services?

The VASP Act applies to any person providing "virtual asset services". Virtual asset services are defined as the issuance of virtual assets or the business of providing one or more of the following services or operations for or on behalf of a natural or legal person or legal arrangement:

- (a) exchange between virtual assets and fiat currencies;
- (b) exchange between one or more other forms of convertible virtual assets;
- (c) transfer of virtual assets;
- (d) virtual asset custody service; or
- (e) participation in, and provision of, financial services related to a virtual asset issuance or the sale of a virtual asset.

This includes issuers of virtual assets, virtual asset custodians, virtual asset trading platforms, as well as entities providing financial services related to the sale of a virtual asset such as virtual asset dealers.

With the exception of virtual asset issuances, the VASP Act will only affect persons that carry out virtual asset services as a business or in the course of a business for or on behalf of other persons. It does not appear to affect persons that carry out those functions only for themselves. With regards to virtual asset issuances, this distinction does not apply. This means that most issuers of virtual assets for their own benefit will be subject to the VASP Act.

The VASP Act also addresses those persons that promote themselves as carrying on virtual asset services, even though technically they may not be performing a virtual asset service (as defined under the VASP Act). Additionally, natural persons are prohibited from carrying on virtual asset services as a business or in the course of business in or from within the Cayman Islands.

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Issuance of Virtual Assets

The "issuance of virtual assets" means the sale of newly created virtual assets to the public in or from within the Cayman Islands in exchange for fiat currency, other virtual assets or other consideration but does not include the sale of virtual service tokens. For these purposes, a virtual service token means a digital representation of value which is not transferrable or exchangeable with a third party at any time and includes digital tokens whose sole function is to provide access to an application or service or to provide a service or function directly to its owner.

The term "public" is not defined and therefore should be interpreted with caution and given a broad meaning. However, limited private sales to owners, affiliates and employees are not likely to be within scope of the meaning of a virtual asset issuance. Furthermore, as the definition is limited to sales for consideration, airdrops and bonus issues should also be excluded.

Persons wishing to issue virtual assets from the Cayman Islands must first register with CIMA as discussed further below. Once registered, and prior to issuance, they must then submit a request to CIMA for the approval of a virtual asset issuance and the issuance must not exceed a prescribed threshold that will be an amount in fiat currency that can be raised by an issuer within a given timeframe. Such threshold has not yet been announced. Issuers that intend to raise funds over the prescribed threshold will be required to conduct the sale in the fashion of an "IEO" through a licensed VATP (as defined below).

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Exchange and Transfer of Virtual Assets

The VASP Act does not regulate businesses that exchange, trade or transfer virtual assets for and on behalf of themselves for their own benefit.

It does, however, capture service providers and other intermediaries. In particular, "virtual asset trading platforms" (**VATP**) will require a licence under the VASP Act. Broadly, a VATP is any digital platform that facilitates the exchange of virtual assets for a benefit (such as a fee or commission) and which either holds custody of or controls virtual assets on behalf of its clients to facilitate an exchange or matches bids and sales. It does not include a platform that only provides a forum where sellers and buyers may post bids and offers or a forum where the parties trade in a separate platform or in a peer-to-peer manner.

Persons that do not operate a VATP but do carry out exchanges or transfers of virtual assets for or on behalf of others will not require a licence so long as there is no custody of the assets. However, they will be required to register under the VASP Act.

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Custody

Virtual asset custody services are defined as the business of safekeeping or administration of virtual assets or the instruments that enable the holder to exercise control over virtual assets. These service providers will also require a licence under the VASP Act. This definition will likely capture all persons (including virtual wallet providers) that hold or have access to, for or on behalf of other persons, the private keys or similar attributes that can control a virtual asset. This will directly affect custodians and administrators that operate in this space from within the Cayman Islands.

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Financial services related to virtual asset issuances or sales

While the term "financial services" is not defined under the VASP Act, until such time that regulatory guidance on the point is issued, we recommend that businesses that consider themselves to be financial service providers either apply for registration or apply for a waiver from CIMA (as briefly described below) before providing services for virtual asset issuances or sales.

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Registration or Licensing?

Businesses providing custodial services of virtual assets and businesses that operate or intend to operate a VATP will require a licence. All other persons carrying on or intending to carry on virtual asset services will require registration. Depending on the extent of the activities, CIMA may require an applicant for registration to apply for a licence instead.

Existing licence holders under other regulatory laws (for example, the MF Act, SIB Act and the Companies Management Act (Revised)) must notify CIMA if they wish to carry on virtual asset services and may request a waiver from registration or licensing under the VASP Act. CIMA will apply the same considerations to a waiver as to the grant of registration or a licence under the VASP Act.

Applications for registration or licensing are subject to a non-refundable assessment fee of CI\$1,000 (US\$1,220) payable at the time of application.

An application fee of between CI\$1,000 (US\$1,220) and CI\$15,000 (US\$18,293) (less the assessment fee) will also be payable by a successful applicant. When notifying the applicant of the successful outcome of its application for registration or licence, as the case may be, CIMA will specify the application fee applicable to that applicant. The amount of the application fee

will be determined in accordance with prescribed factors, including but not limited to, the type of virtual asset services business to be undertaken and CIMA's assessment of the nature, size, scope and complexity of the applicant's virtual asset services (where applicable). Successful applicants are also required to pay an annual renewal fee equal to the application fee amount. This annual renewal fee is to be paid to CIMA by 15 January of each subsequent year.

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CIMA Considerations

CIMA shall consider, amongst other matters:

- (a) the size, scope and complexity of the virtual asset service, underlying technology, method of delivery of the service and virtual asset utilised;
- (b) the knowledge, expertise and experience of the applicant;
- (c) the AML procedures and data protection safeguards in place for the applicant;
- (d) the similarity of the virtual asset service to activities under the SIB Act or any other regulatory laws;
- (e) the risks that the virtual asset service may pose to existing clients, future clients, other licensees or to the financial system of the Cayman Islands;
- (f) the net worth, capital reserves and financial stability of the applicant;
- (g) the applicant's ability to comply with the VASP Act and the relevant requirements of the AML Regulations; and
- (h) whether the applicant's senior officers and ultimate beneficial owners are fit and proper persons.

Additional considerations will also apply to virtual asset issuances.

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Ongoing Requirements

Persons registered or licensed under the VASP Act will be subject to ongoing requirements. These include the registrant or licensee:

- (a) undertaking audits of their AML systems and procedures at the request of CIMA;
- (b) preparing audited accounts and submitting those to CIMA annually;

- (c) making sure its senior officers and beneficial owners are fit and proper persons;
- (d) obtaining prior approval from CIMA to appoint senior officers or AML compliance officers;
- (e) providing certain notices to CIMA confirming their compliance with the AML Regulations and data protection laws and ensuring that all communications relating to the virtual asset service are accurate;
- (f) designating an employee as the officer with responsibility for the procedures for combating money laundering, terrorist financing and proliferation financing; and
- (g) obtaining prior approval from CIMA before issuing or transferring shares or other equity interests totalling 10% or more of the registrant or licensee.

Further requirements apply for custody providers and operators of VATPs.

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Sandbox Licence

The VASP Act also introduces the concept of a sandbox licence that provides CIMA with the flexibility to regulate relevant businesses that utilise innovative technologies and activities by imposing additional requirements to, or allowing certain exemptions from, the standard requirements within the VASP Act. A sandbox licence is meant to operate for a limited timeframe so that CIMA can assess how best to regulate a sandbox licence applicant and whether legislative changes may be required to further promote the development of the particular innovative technologies or activity that is subject to the sandbox licence.

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Mutual Funds (Amendment) (No 2) Act (Revised)

The definition of "equity interest" under the MF Act has been amended to include "any other representation of an interest". This amendment is broad enough to capture digital tokens or other virtual assets. Therefore, open-ended funds issuing redeemable tokens instead of shares or other equity interests are now covered by the MF Act and will need to be registered or licensed under that law.

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Securities Investment Business (Amendment) Act (Revised)

The SIB Act has also been amended to extend to virtual assets. In particular, the definition of "securities" now includes virtual assets which can be sold, traded or exchanged immediately or

at any time in the future that

- (a) represent or can be converted into any of the securities listed in Schedule 1 of the SIB Act, or
- (b) represent a derivative of any of the securities listed in Schedule 1 of the SIB Act.

The securities listed in Schedule 1 of the SIB Act are traditional securities including equity interests, debt instruments, options and futures.

Therefore, persons dealing in, arranging deals in, managing or advising on virtual assets that are securities will also be required to register or be licensed under the SIB Act. To avoid regulatory overlap, CIMA may exempt an applicant from registration or licensing under either the SIB Act or the VASP Act. However, an applicant must first apply under either law before having this exemption granted.

One significant exclusion applies for private issuers of virtual assets that are securities under the SIB Act. Where a private issuer issues, redeems or repurchases its own virtual assets that represent shares, limited partnership interests, units in a unit trust, debt or warrants of the private issuer, such activity is an excluded activity. This means that private issuers issuing certain types of security tokens will not be required to register or be licensed under the SIB Act (although they may still need to be registered under the VASP Act).

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Proceeds of Crime Act (Revised) and Anti-Money Laundering (Amendment) (No. 2) Regulations (Revised)

Relevant financial businesses, as defined under the PC Act, are required to comply with the AML Regulations. The definition of a relevant financial business includes the provision of virtual asset services. The PCL Act as the first law in the Cayman Islands to contemplate virtual assets and the definitions used differ slightly to those used in the VASP Act. In particular, the definition of "virtual asset services" does not explicitly include virtual asset issuances. However, the VASP Act requires virtual asset issuers (as well as all persons carrying on virtual asset services) to comply with the AML Regulations.

CIMA has issued specific AML related guidance to virtual asset service providers and the standards of compliance it expects when carrying on virtual asset services.

Furthermore, under the most recent amendments, new regulatory requirements have been put in place to ensure sufficient information is being obtained relating to transfers of virtual assets by intermediaries. Businesses operating virtual asset transfer or exchange services will now have to comply with these higher standards.

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Conclusion

The VASP Act provides a coherent framework that will add a welcome degree of certainty for businesses intending to issue virtual assets and businesses carrying on or intending to carry on virtual asset services. The Cayman government's intention has been to provide for appropriate regulation without stifling innovation. The VASP Act should help to maintain Cayman's position as an attractive domicile for legitimate virtual asset businesses. For further information, or to discuss specific structures, please contact one of our team.

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