




# BLOCKCHAIN: A PATH TO INNOVATION

In the same way that the Cayman Islands has innovated to stay ahead of the curve in other areas, it must ensure that it leverages new technologies such as blockchain, writes Daniella Skotnicki from Harneys.



Since the introduction of the Mutual Funds Law in the Cayman Islands more than 25 years ago, there have been few major developments in the way Cayman Islands investment funds are structured or regulated.

Blockchain, or distributed ledger technology, has the potential to bring disruption and opportunities to the investment funds market in terms of the structure of funds and through back office administration efficiencies. Funds that take advantage of these opportunities may reduce costs and offer increased liquidity to investors by creating genuine secondary markets for these products.

Regulators globally have been considering existing regulatory frameworks in light of the growth in popularity of blockchain technology over recent years. In order to maintain its position as the leading jurisdiction for global funds, the Cayman Islands should introduce appropriate regulation to safeguard the jurisdiction and to take advantage of the opportunities created by the new technologies.

Solutions to regulatory concerns, primarily relating to the identification and verification of investment holders, will continue to be developed such as digital identities and regulated crypto exchanges.

## Offering fund interests on the blockchain

An investor's interest in a Cayman investment fund is generally represented by either a share or a limited partnership interest recorded on a register which is maintained by an administrator. The investor subscribes for interests by submitting subscription documents in a form approved by the fund. The administrator ensures that the investor is eligible to invest, ie, compliance searches are done, and records the interest on the register. This is a time-consuming and largely manual process.

Interests could instead be recorded on the blockchain and, subject to appropriate information-sharing in terms of identity of beneficial owners and tax residencies, there may not be any need for the centralised approval of transactions. This would significantly reduce transaction costs and the likelihood of errors.

It is also possible to "tokenise" funds—rather than offering shares or limited partnership interests, interests in the fund are represented by a token and the investor's rights dictated by the terms of a smart contract. The smart contracts can include details of the constitution, investment strategy and rules of the fund.

The primary concern for regulators is not the form of the interests being offered but whether they are offered on private or public blockchain-based ledgers.

## Public vs private blockchains

Public permissionless blockchains such as Bitcoin and Ethereum are open to anyone with an internet connection to participate in, without requiring registration or providing identification. A private permissioned blockchain restricts access to those who are permitted to access it. In a public blockchain, participants can remain anonymous or pseudonymous.

The benefit of blockchain technology for the Cayman funds industry is the ability to establish private permissioned blockchains for approved investors. These investors may be approved by the rules of a regulated exchange or by the establishment of an accepted digital identity.

Recently, some tokenised funds have been established on the public blockchain and listed on existing crypto exchanges. Public blockchains offer the advantage of facilitating a secondary market. However, purchasers on the secondary market are not identified and verified by the token issuer but, at least in theory, may be identified or identifiable by the relevant exchange.

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## Regulatory Issues

Regulators globally are responding to the challenges that blockchain applications and cryptocurrencies present in different ways; from banning the sale of cryptocurrencies altogether to amending the existing regulatory framework or creating a new crypto-specific regulatory framework.

Traditionally, managers of Cayman funds (which are rarely a retail product) would consider the securities laws of each jurisdiction in which they are marketing interests, which is possible when each investor must be provided a form of offering document and subscription agreement.

Interests offered on a public blockchain are potentially available to investors globally and although the terms of the offering may prohibit investors from certain jurisdictions by asking those investors to represent that they are not located in a certain jurisdiction, it is potentially more difficult to enforce.

The fund could become subject to legislation in jurisdictions which prohibit the sale of these interests or limit investment to certain accredited investors.

The key challenges presented by existing Cayman Islands legislation for interests offered on a public blockchain are compliance with the anti-money laundering regulations and the US Foreign Account Tax Compliance Act (FATCA)/AEOI due diligence and reporting requirements, as described below.

## Mutual Funds Law

Generally, Cayman investment funds which issue interests redeemable at the option of investors are required to comply with the Mutual Funds Law. However, the definition of a mutual fund does not currently capture a tokenised fund as it does not issue shares, trust units or partnership interests.

Purely tokenised funds are therefore not currently required to comply with the Mutual Funds Law or to register with the Cayman Islands Monetary Authority. This definition may be expanded in the future to require open ended tokenised funds to comply with the Mutual Funds Law.

## Anti-money laundering

The Cayman Anti-Money Laundering (AML) Regulations apply to any business conducting relevant financial business (RFB). Schedule 6 of the Proceeds of Crime Law provides that a business “investing, administering or managing funds or money on behalf of other persons” is conducting RFB and as such, is required to comply with the AML Regulations.

Investment funds by their very nature are managing money on behalf of investors and are required to comply with the AML Regulations regardless of whether they are tokenised. The AML Regulations require the fund to obtain customer due diligence information, including source of funds and identification of beneficial owners, in respect of both the initial purchaser of the interests and subsequent transferees.

This is currently challenging in the context of interests which are freely transferable on a public blockchain as there is no central control of transfers or holders of interests. Conversely, introducing a digital

ID and tracking the ownership of funds on a blockchain would permit some information on the blockchain to be shared with regulators which could enhance AML/know your customer (KYC).

## FATCA and OECD Common Reporting Standard (CRS)

Investment funds generally fall within ‘financial institution’ definitions contained in Cayman legislation implementing both FATCA and CRS. As such, they are required to classify the tax residency of all of their ‘account holders’ or the holders of investment interests in the fund (which would very likely include token holders).

Holders of interests are therefore required to provide self-certification forms to allow the fund to comply with FATCA/CRS due diligence requirements and the fund in turn reports relevant information to the Cayman Tax Authority on an annual basis. It would be difficult to obtain self-certification forms from purchasers on a secondary market if the interests are available on a public blockchain.

## Potential solutions to regulatory issues

The regulatory challenge presented by blockchain technology is the inherent difficulty in identifying and verifying token transaction counterparties, if the interests are offered on a public blockchain where the use of pseudonymous digital wallets means that identifying the holder is not a simple process.

However, the development of private permissioned blockchains for the transfer of interests in the fund, whether in the form of shares, limited partnership interests or tokens, has the potential to significantly reduce the costs of administering funds.

Potential solutions would include the use of securities token platforms on which only investors who satisfy investment criteria (eg, accredited investors) are allowed to participate and the tokens used to gain access to the platform would contain an investor’s certified digital identity and full details required to comply with FATCA/AEOI legislation.

The investor screening process will be facilitated by anticipated future developments such as regulated service providers offering digital identities which can then be used to verify investors.

Subject to appropriate risk analysis, Cayman Islands AML Regulations allow for the acceptance of digitised forms of identity verification and developments in this area are likely to improve the quality of the AML screening processes and the data captured over traditional methods.

The challenge for the Cayman Islands is to ensure that the Cayman Islands retains its position as a global leader in the investment funds industry, while also allowing participants to take full advantage of the benefits that new technologies offer. ■



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