The rise of digital asset funds

The Cayman Islands has not passed bespoke regulation covering investments in cryptocurrencies, but the sector is steadily growing using existing laws. Sean Inggs of International Management Services explains to *Cayman Funds* why this is just the start.

Unlike some other offshore jurisdictions, the Cayman Islands has been conservative with regard to passing regulations designed to monitor the way cryptocurrencies are used by investors and funds. However, this may be a good thing for the sector, according to Sean Inggs, a professional independent director at International Management Services (IMS) and an expert in this sector.

Inggs explains that the number of alternative investment funds entering the cryptocurrency and digital asset class in the Cayman Islands is increasing and that, so far, the country's existing regulatory standards have proved more than adequate for managing this fast-growing sector.

While other countries may have rushed in legislation designed to either encourage the growth of this sector or regulate it (for better or for worse), Cayman remains the leading jurisdiction in the Caribbean for investment funds participating in the digital asset class.

"Cayman is definitely the leading domicile for both blockchain-related companies offshore and for funds investing in cryptocurrencies," he says.

"If you dig into the statistics for new funds being formed, something like 20 percent of them over the past 12 months are participating in this space in some way. That is a lot of new formations in this relatively new asset class.

"We think that the rise of funds that invest in cryptocurrencies or digital assets in some form is continuing—we have not seen a slowdown at all. If Cayman is at the centre of that offshore it can only be a good thing, but the service providers in this industry need to keep pace with what is required by this fast-growing sector."

As such, there is a growing core of local experts with an understanding particular to these funds and how they operate and the best ways to structure them. Inggs says that most fund managers understand the need for appropriate expertise.

"They know they need individuals with appropriate experience in cryptocurrencies who understand the unique risks involved, which are very different from those of other types of asset classes. From director level to the fund administrators, this is important.

"Not every fund administrator has the tools and reporting capabilities right now to provide these services; not every audit firm is geared up to take on an audit of a digital asset investment fund," he says.

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> "In no other investment-related sector is cyber risk more important and more pertinent than in this one."

Rationalising the virtual

For the uninitiated in the world of cryptocurrencies, it is worth explaining what they are and how funds are investing in them.

A cryptocurrency is a digital currency that is based on the use of encryption techniques to allow for or manage the creation of new units of currency and monitor the transfer of these units. Importantly, they typically exist independently of a centralised body such as a central bank.

There are many types of cryptocurrencies, the best known probably being Bitcoin. They also vary in their value, which fluctuates anyway and, depending on the particular cryptocurrency, how easy it is to identify the source of the funds and their ownership.

Investment funds invest in digital assets in three main ways, Inggs explains.

In the first model, it is possible for open-ended funds to accept subscriptions in either cryptocurrencies or fiat currencies (depending on the controls set up within the particular fund) and then invest the proceeds in, for example, index-based positions whereby they will invest in the top cryptocurrencies for a period on some sort of rotational basis (essentially holding liquid assets).

In the second structure, open-ended funds again accept subscriptions in either cryptocurrencies or fiat currencies and invest directly into certain listed or liquid cryptocurrencies while also taking positions in companies operating in this sector raising early stage capital often in the form of initial coin offerings (ICOs).

These investments are akin (in some but not all aspects) to a venture capital-style investment and the complex question for these funds is how and when they allow redemptions to be made: does the fund look to lock up capital for a specific period?

In the third investment model a close-ended investment fund accepts investments in fiat currencies (and potentially cryptocurrency) and invests more deliberately in private equity or venture capital-type investments whereby the fund's capital will be locked up for, typically, between five and seven years depending on the life cycle of the fund.

From a compliance and governance perspective, one of the key considerations for all these funds, says Inggs, is that they can trace where the assets come from and the ultimate beneficiary of the named investor. Some cryptocurrencies are less transparent than others on this front, and funds make risk-based judgement calls on this basis with the vast majority of these funds accepting only Bitcoin or Ethereum.

Sources of funds behind cryptocurrencies such as Bitcoin and Ethereum are easier to trace than say, Monero or Zcash, and typically these types of funds will accept and deal in the former without issue but within the existing regulatory laws and subject always to the vetting and know-your-customer (KYC) requirements and undertakings within the fund documents.

Following the rules

Inggs stresses that the Islands' adherence to the existing anti-money laundering regime and KYC legal requirements ensures that compliant cryptocurrency funds are as legitimate as any other compliant investment funds.

"The legal regime sets the parameters; these investor proceeds and fund investments are not untraceable; any reputable investment fund documents should require the investor to make certain disclosures around the source of the funds in the same way you would expect for a fiat currency-derived fund," he explains.

"In most cases you actually go through a few extra hoops in vetting investors and source of funds by, for example, detailing the wallet addresses that hold the currencies and remitting proceeds back to investors to the same wallet address which has been associated with a particular investor."

Inggs asserts that for an independent board member, such checks and balances and controls mean that the risk of money laundering is greatly reduced. It also means that there has been no pressing need for additional legislation. He notes that Cayman has considered this option but is watching and waiting to see how regulators in other jurisdictions choose to treat this form of investment generally.

Key to this will be the US Securities and Exchange Commission (SEC), which is expected to detail how it plans to treat various types of ICOs and security token offerings (STOs) from a US securities regulation perspective. This could be pivotal in determining how the sector might develop and grow in the future.

"The market is hopeful that the SEC will make some sort of positive decision soon—maybe by July," Inggs says. "There are still big question marks around how the SEC plans to treat ICOs, in particular whether a distinction will be drawn between STOs and ICOs or so-called 'utility tokens' for securities law purposes.

"The fact is, if the SEC's comments are favourable, we can expect to see a very bullish reaction by the sector and more capital-raising; if not, it could stymie its development."

He notes another key challenge the sector must solve around the security of these digital investments is who holds the assets, where and in what form.

"In no other investment-related sector is cyber risk more important and more pertinent than in this one—these are digital assets and that is another complex layer of challenges for these funds to navigate and for fund directors and administrators to carefully consider," he says.

"The whole issue of the custody of these assets, and how secure they are, is a big question right now. There are some bespoke custody solutions on offer but that also complicates the issue of how accessible they are and thus how easily and flexibly they can be accessed for trading, but the issue of cybersecurity is a big item for anyone involved in these funds to consider (see box).

"You need to consider potential brokerage, custody and storage of digital assets.

"Certain cryptocurrencies will have to be traded and held in exchange accounts and important considerations for directors and managers should be placed on where and how these are transferred to offline (cold) storage.

"Who then has access to the cold storage devices and who has set them up? Where are the recovery phrases kept? Will the fund use multi-signature wallets and who are the signatories for these wallets? What exchanges is the fund exposed to?"

Despite the rapid growth of this sector on Cayman, Inggs adds, there seems to be a number of investors and other service providers waiting in the wings for further clarity on a number of issues from regulatory issues to digital asset security. This means that as these issues are resolved and greater certainty is gained, he expects the sector to grow further.

"We are beginning to see more of the established investment managers seriously looking at this sector. This is just the start," Inggs says. ■

Ensuring cybersecurity

Inggs stresses that the issue of cybersecurity should be central to every agenda for fund directors. He says that directors must seek either assurance that a robust cyber risk governance framework will be put in place for an investment fund, or seek help to implement one.

"The positives here are many: a fund will see improved decision-making processes, which will lead to better service development while at the same time providing more comprehensive assurance that risks are being identified, quantified, managed and mitigated," he says.

When it comes to cryptocurrencies specifically, he says, the issue of cybersecurity should be raised and addressed at every relevant board meeting. "You need to be asking the right questions and asking for reports," he says.

"Has the fund suffered any cyber breaches? Have any of the fund's service providers suffered cyber breaches? If so, what steps were taken following the breach? How is the fund executing documents and is it using DocuSign or other browser signing programmes? Are documents password-protected?

"Many of our clients already engage cybersecurity professionals, be they third party cybersecurity firms or staff in-house. This increased oversight is part of a wider trend of alternative fund managers embracing regulatory compliance and corporate governance more completely. They recognise the value of having independent board directors in place as the risks facing investment funds continue to grow.

"Prospective investors should also be committing some time to this subject as part of their due diligence processes. Investors should be asking questions around what policies the manager has in place or will have in place, what the manager's disaster recovery plans are, and so on. Having written policies and procedures is very important."

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