Loeb Smith

Digital Assets. Five Questions to Ask Your Cayman Counsel

In our guidance note Top Ten Best Practices for an ICO Founders' Team: A View from the Cayman Islands, ICO founder teams and promoters looking at the Cayman Islands for incorporation of their company or companies were warned that, while the Cayman Islands had flexible pragmatic rules encouraging business and innovation, they also had stringent anti-money laundering ("**AML**") and know-you-customer ("**KYC**") requirements. In addition, other regulatory requirements may be applicable and the company and even its directors and founders may be held liable, under certain circumstances, for any misleading statements made in the White Paper or in additional documentation communicated to token purchasers.

Based on our experience of advising initial coin offerings (ICOs) and security token offerings (STOs) and of undertaking legal due diligence for institutional clients seeking to acquire tokens in ICOs and STOs, in this brief update, we discuss what we view as the five most important questions to discuss with Cayman Islands legal counsel, either prior to setting up, or as soon as possible thereafter, in order (i) to reduce your risk of contravening Cayman Islands law, (ii) to facilitate listing on crypto-exchanges, and (iii) to facilitate better relationships with other participants in the growing digital assets space (e.g. banks to open accounts, institutional investors and investment funds which will undertake due diligence as part of the process of acquiring tokens in an ICO or STO).

1. What are the duties of a Director of a Cayman Islands company?

The constitutional documents of a Cayman Islands company, the Memorandum of Association and the Articles of Association ("**Articles**"), set out the governance rules and the powers of the Directors. However, the Directors also owe fiduciary duties and certain duties of skill and care under English common law. Among the principal **fiduciary duties owed to the Company**, the Directors are required to:

i. act, in good faith, in what they consider reasonably to be the best interests of the Company;

ii. exercise their powers under the Articles for the purposes for which those powers are conferred;

iii. avoid conflicts of interests or (where conflicts are permitted by the Articles) ensure that any conflicts are properly disclosed during Board meetings;

iv. exercise their powers independently, without subordinating to the will of others; and

v. not misuse the property of the Company and not make secret profits from their position as a Director.

The Directors should also acquire and maintain a sufficient knowledge of the business on a continuing basis and attend diligently to the affairs of the Company, duties which need to be carried out with reasonable care, diligence and skill. In addition, the Directors also have certain statutory obligations under the Cayman Islands Companies Law (2018 Revision) (the "**Companies Law**").

Directors are generally not liable except in cases of negligence, fraud, breach of fiduciary duty, or an action not within their authority which is not ratified by the Company. They may be indemnified by the Company against personal liability for losses incurred arising out of the Company's business, including in case of negligence and breach of duty (other than breaches of fiduciary duty), except in cases of willful default or fraud.

2. Is there any specific legislation or regulation I should be concerned with?

The Cayman Islands Monetary Authority ("**CIMA**") has not issued statements or guidance on virtual currencies, blockchain technology, ICOs or STOs, other than a warning notice dated 23rd April 2018 which specifically flagged a number of risks specifically associated with ICOs and virtual currencies.

However, the following legal provisions may be applicable and should be carefully considered by promoters, investors and their advisors:

i. The Cayman Islands Securities Investment Business Law (Revised) ("**SIBL**") defines securities by reference to a list of instruments, including shares and stock of any kind in the share capital of a company, debentures and any other instruments creating or acknowledging indebtedness other than certain exceptions specified, instruments giving entitlements to securities, certificates conferring rights with respect to securities, etc.

The term "instrument" refers to any record and specifically includes an electronic record as defined in the Electronic Transactions Law (2003 Revision), *i.e.* a record processed and maintained by electronic means.

Accordingly, CIMA may qualify coins/tokens issued on blockchain as stock or debt if the rights attached to the coins/tokens (as represented in the White Paper or the token sale documentation) resemble rights normally attached to equity interests or debt.

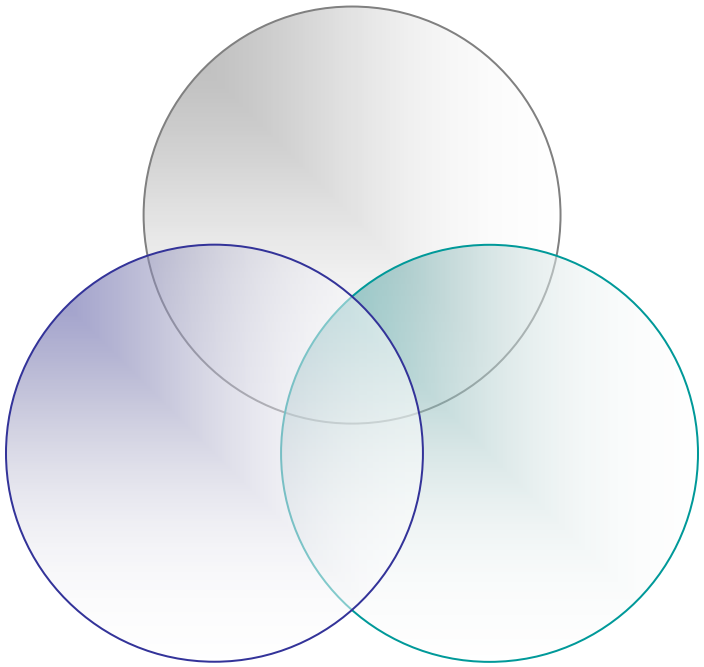
ii. In certain circumstances, a registration with or a license from CIMA may be required:

(a) under the Cayman Islands Money Services Law (Revised), if the coins/tokens issued could give access to money transmission or currency exchange services;

(b) under SIBL, if the coins/tokens may qualify as securities, for all persons engaging, "in the course of business", in securities investment business, *i.e.* among other things buying, selling, subscribing for or underwriting securities as agent or principal, arranging deals, managing securities, or advising an investor on buying, selling, underwriting, subscribing for or exercising any right in securities; and/or

(c) under the Mutual Funds Law (2015 Revision) if the issuer of the coins/tokens is essentially a collective investment scheme and the coins/tokens are attached to redemption rights for investors.

Utility tokens not deemed to be securities, designed to be used for access to services platform and/or burned. No rights attached to tokens.



Tokens giving certain economic rights.

Tokens represent Participating Shares in investment fund, with redemption rights. Mutual Funds Law (2015) and SIBL will apply.

3. Should I be concerned by beneficial ownership reporting?

All Cayman Islands companies with certain exceptions such as listed companies, certain companies registered or licensed in the Cayman Islands, companies which are promoted, managed or administered by certain regulated persons, etc. are required to maintain a beneficial ownership register (a "**BO Register**") at the registered office.

The BO Register will record details of individuals holding (directly or indirectly):

i. more than 25% of the shares or interests of the company;

ii. more than 25% of voting rights of the company; and/or

iii. the right to appoint or remove a majority of the Board of Directors.

If none of the conditions above are satisfied, an individual will still be a beneficial owner and therefore reportable on the BO Register if he has the absolute and unconditional right to exercise or actually exercises, significant influence or control over the company (other than solely in the capacity of director or manager, professional advisor or professional manager).

4. How do I ensure compliance with the AML regulations?

Token issuers and other companies operating in the digital assets space may be deemed to be undertaking "**relevant financial business**" in the Cayman Islands, as defined in Schedule 6 of the Proceeds of Crime Law (2018 Revision). The definition includes (but is not limited to):

1. Acceptance of deposits and other repayable funds from the public.

2. Lending.

3. Financial leasing.

4. Money or value transfer services.

5. Issuing and managing means of payment (e.g. credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money).

6. Financial guarantees and commitments.

7. Trading in (a) money market instruments (cheques, bills, certificates of deposit, derivatives etc.); (b) foreign exchange; (c) exchange, interest rate and index instruments; (d) transferable securities; or (e) commodity futures trading.

8. Participation in securities issues and the provision of financial services related to such issues.

9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings.

10. Money broking.

11. Individual and collective portfolio management and advice.

12. Safekeeping and administration of cash or liquid securities on behalf of other persons.

13. Safe custody services.

14. Financial, estate agency, legal and accounting services provided in the course of business relating to (a) the sale, purchase or mortgage of land or interests in land on behalf of clients or customers; (b) management of client money, securities or other assets; (c) management of bank, savings or securities accounts; and (d) the creation, operation or management of legal persons or arrangements, and buying and selling of business entities.

15. The services of listing agents and broker members of the Cayman Islands Stock Exchange as defined in the CSX Listing Rules and the Cayman Island Stock Exchange Membership Rules respectively.

16. The conduct of securities investment business.

17. Dealing in precious metals or precious stones, when engaging in a cash transaction of fifteen thousand dollars or more.

18. The provision of registered office services to a private trust company by a company that holds a Trust licence under section 6(5)(c) of the Banks and Trust Companies Law (2018 Revision).

19. Otherwise investing, administering or managing funds or money on behalf of other persons.

20. Underwriting and placement of life insurance and other investment related insurance.

For a company undertaking relevant financial business, the Proceeds of Crime Law (2018 Revision) and the Anti-Money Laundering Regulations (2018 Revision) of the Cayman Islands (the "**AML Regulations**") will apply, and the company will be required 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 products, service and transactions, and the delivery channels.

The following AML procedures are required under the AML Regulations currently in force:

i. identification and verification (KYC) procedures for investors/purchasers;

ii. adoption of a risk-based approach to monitor activities;

iii. record-keeping procedures;

iv. procedures to screen employees to ensure high standards when hiring;

v. adequate systems to identify risk in relation to persons, countries and activities which shall include checks against all applicable sanctions lists;

vi. adoption of risk-management procedures concerning the conditions under which a customer may utilize the business relationship prior to verification;

vii. 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 (FATF);

viii. internal reporting procedures; and

ix. 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.

For all such companies, the AML Regulations also impose the designation of natural persons, at managerial level, to act as Anti-Money Laundering Compliance Officer ("**AMLCO**"), Money Laundering Reporting Officer ("**MLRO**") and Deputy Money Laundering Reporting Officer ("**DMLRO**"). CIMA requires that a person acting as MLRO / DMLRO must (i) act autonomously; (ii) be independent (have no vested interest in the underlying activity of the investment fund); and (iii) have access to all relevant material in order to make an assessment as to whether an activity is or is not suspicious. The AMLCO role should be performed by someone at management level, who will be the point of contact with the supervisory and other competent authorities.

CIMA Guidance to the Cayman AML Regulations requires that an AMLCO must be a person who is fit and proper to assume the role and who:

i. has sufficient skills and experience;

ii. reports directly to the Board of Directors ("**Board**") or equivalent;

iii. has sufficient seniority and authority so that the Board reacts to and acts upon any recommendations made;

iv. has regular contact with the Board so that the Board is able to satisfy itself that statutory obligations are being met and that sufficiently robust measures are being taken to protect the Fund against money laundering/terrorist financing risks;

v. has sufficient resources, including sufficient time and, where appropriate, support staff; and

vi. has unfettered access to all business lines, support departments and information necessary to appropriately perform the AML/CFT compliance function.

CIMA has the power to impose fines for non-compliance on entities and individuals who are subject to the AML Regulations, starting from approximately US$6,000 for a minor breach to fines of US$61,000 (for an individual) or US$122,000 (for an entity). For a breach prescribed as very serious, the fines may reach approximately US$122,000 (for an individual) and approximately US$1,220,000 (for an entity). If a breach is also a criminal offence, the imposition by CIMA of a fine will not preclude separate prosecution for that offence (or be limited by the penalty stipulated for that offence).

5. How do I limit my risks?

Beyond discussing with your counsel and understanding what are the continuing obligations of a Cayman Islands company, the duties of a Director, the applicable laws and required AML compliance, it is essential that token issuers and other companies operating in the digital assets space be aware of the solutions they may have under Cayman Islands laws for mitigating their risk exposure, such as indemnification agreements, specific provisions to be included in the Memorandum and Articles of Association, risk factors to be disclosed and other disclaimers, specific dispute resolution mechanisms, etc.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice, please contact your usual Loeb Smith attorney or either:

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