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### Alternative Investments in the Cayman Islands: Crypto Funds and Digital Assets Thrive Under Innovative Legislation

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## Alternative Investments in the Cayman Islands Crypto Funds and Digital Assets Thrive Under Innovative Legislation

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*The Cayman Islands has seen a significant rise in the establishment of alternative investment funds and digital assets. This article explores the various types of funds, their structures, regulations and benefits. It also looks at new innovative virtual asset legislation that is driving the growth of the digital assets marketplace and opening new doors of opportunity for investment.*

### Crypto Funds and Digital Assets in the Cayman Islands

The Cayman Islands has been the leading offshore jurisdiction for the establishment of mutual funds and private funds for more than 30 years. Its' phenomenal reputation has been due in part to the use of innovative legislation and the absence of taxation and exchange controls. This, together with the presence of sophisticated and professional service providers has resulted in the jurisdiction's reputation for responsible supervision and regulation of funds. Strengthening its position as a global leader, the Cayman Islands has introduced innovative legislation to regulate virtual asset service providers, opening the doors to the digital asset marketplace.

It is no surprise therefore that when fund managers and virtual asset service providers are looking for the best jurisdiction to establish alternative funds investing in cryptocurrencies, Web3 and blockchain products and to set up digital asset entities, the Cayman Islands is the jurisdiction of choice.

### Fund Types and Regulation Requirements in the Cayman Islands

The Cayman Islands are home to both regulated mutual funds (open-ended) and regulated private funds (closed-ended) both of which may be utilised in cryptocurrency and blockchain structures as detailed below.

#### Mutual Funds

Mutual Funds are regulated under the Mutual Funds Act (the "MFA"). The MFA defines a mutual fund as a company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investor risk and enabling investors to receive profits or gains from the acquisition, holding, management or disposal of investments. Equity interests are defined as a share, trust unit or partnership interest or any other representation of an interest that carries an entitlement to participate in the profits or gains of the company, unit trust or partnership, as the case may be, and which may be redeemed or repurchased at the option of the investor.

The MFA applies to all open-ended funds (funds in which the investors have the right to redeem their interests at their option), except those specifically excluded from regulation. Therefore, any tokens which are issued by a fund which carry an entitlement to participate in the profits or gains of the company will require registration under the MFA if they are redeemable at the option of the holder.

## **Types of Regulated Mutual Funds**

Currently there are six (6) types of mutual funds that are subject to regulation and supervision under the MFA by the Cayman Islands Monetary Authority ("**CIMA**") but the one most popular for open-ended Crypto Funds is the Registered Mutual Fund which has a streamlined registration procedure available where:

- the initial minimum equity interest purchasable by an investor is US\$100,000; or
- whose equity interests are listed on an approved stock exchange such as the CSX.

## **Director Registration**

Directors of Registered Mutual Funds and master funds (if applicable) are required to register with CIMA and maintain such registration on an annual basis pursuant to the Directors Registration and Licensing Act (as Revised). Directors must also actively deregister from CIMA where such registration is no longer required (or will be subject to ongoing annual fees until such time as they deregister).

## **Private Funds**

Private Funds are regulated under the Private Funds Act (as Revised) (the "**PFA**"). The PFA defines a private fund as a company, unit trust or partnership that offers or issues or has issued investment interests, the purpose or effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity's acquisition, holding, management or disposal of investments, where:

- the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and
- the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly.

The PFA applies to all closed-ended funds (funds in which the investors do not have the right to redeem their interests at their option), except those specifically excluded from regulation.

## **Types of Registered Private Funds**

There are two (2) types of private funds that are subject to registration with CIMA: (i) the Registered Private Fund and (ii) the Registered Restricted Scope Private Fund. The most popular structure for closed-ended Crypto Funds is the Registered Private Fund.

## **Material Changes to Information filed with CIMA**

Where a fund (mutual or private) (a) makes any changes, or becomes aware of any changes, that materially affects any information submitted to CIMA under the provisions of the MFA or the PFA; or (b) changes its registered office or the location of its principal office, the fund must within 21 days after making the change or becoming aware of the change, as the case may be, file with CIMA the details of the changes.

## **Funds Exempt from CIMA Registration**

It is worth noting what is *not* a mutual fund or a private fund. A fund with a single investor has no co-mingling of assets and is not registerable under the MFA or the PFA. Equity interests do not include debt so a fund which issues debt is not subject to the registration process under the MFA or the PFA. Lastly, the definition of a private fund does not include any 'non-fund arrangement'. These include pension funds, joint ventures, securitisations, SPVs, holding vehicles and others, which Stuarts can advise on, on a case-by-case basis. Care must be taken to ensure that a fund structure is not caught under a different regulatory regime in the Cayman Islands such as the virtual asset regime which would require separate regulation by CIMA.

## **Preferred Crypto Fund Structure and Benefits**

There are many vehicles available in the Cayman Islands through which to operate a mutual fund or private fund. The fund can be structured as an exempted company with limited liability, a segregated portfolio company ("SPC"), a limited liability company, partnership or a unit trust. Each of these structures are quick to set up and easy to maintain.

### **Segregated Portfolio Company (SPC)**

The vehicle which has found the most traction for Crypto Funds is the SPC. An SPC is a single legal entity with different "cells" or "pools" called "segregated portfolios" whose assets and liability are separated and protected (under Cayman Islands statute) from the liability of all other segregated portfolios in the same SPC.

The principal advantage of an SPC over a standard exempted company is that it protects the assets of one segregated portfolio from the liabilities of another segregated portfolio. This has been particularly attractive for Crypto Funds where many classes of assets are traded, and some have significantly more risk than others. The fund managers naturally wish to isolate the risk of the different strategies and the SPC structure provides the mechanism for this.

The Companies Act (as Revised) of the Cayman Islands (the "**Companies Act**") states that a creditor will only have recourse to assets from segregated portfolios with which it has contracted, and creditors will have no recourse to the assets of other segregated portfolios of the SPC which are protected under the Companies Act. The articles of association of the SPC will have provisions which reflect the Companies Act in this respect.

SPCs facilitate a streamlined offering structure for certain mutual funds enabling the SPC to be used by multiple managers who can be quickly onboarded into their own segregated portfolio with its own investment objective and assets all contained in an SPC structure that has its service providers already selected and in place.

## The Growth of Digital Assets through Innovative Legislation

New innovative legislation is pushing the boundaries of possibilities for Web3, DAO and De-Fi products in the Cayman Islands. In particular, the Cayman Islands has emerged as a leader in this digital revolution with cutting edge legislation which continues to quickly evolve and has resulted in a significant rise in the number of Web3 and digital asset entities being established in recent years.

In the dynamic landscape of Web3 and digital assets, the Cayman Islands stands out with its progressive legislation, notably the Virtual Asset (Service Providers) Act (as Revised) ("**VASPA**") and the Special Economic Zones Act (as Revised) ("**SEZA**"). These laws have played a pivotal role in enabling the growth of Web3 and other virtual asset entities and those wishing to be set up in the special economic zone. VASPA sets a robust regulatory framework monitored through CIMA, fostering a secure and transparent environment for these entities to thrive.

### VASPA Regime

The Cayman Islands Government passed the Virtual Asset (Service Providers) Act in 2020. VASPA, with accompanying amendments to supporting regulatory laws in the Cayman Islands, altogether seek to provide regulatory certainty and a solid foundation for legitimate financial services innovators who are operating in or from within the Cayman Islands, whilst also complying with emerging global standards surrounding virtual assets.

VASPA applies to any persons involved in providing one or more of the 'virtual asset services'. VASPA provides that a "virtual asset" means 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.

VASPA regulates "virtual asset services" which means 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: (i) exchange between virtual assets and fiat currencies; (ii) exchange between one or more other forms of convertible virtual assets; (iii) transfer of virtual assets; (iv) virtual asset custody service; or (v) participation in, and provision of, financial services related to a virtual asset issuance or the sale of a virtual asset.

### VASPA Registration and Licensing

All virtual asset service providers (a "**VASP entity**") are required to register with, or be licenced by, CIMA. The licensing regime has not yet taken effect and all VASP entities must register with CIMA and any entities caught by the licensing regime will need to register under such regime in the future. Virtual asset service providers must not conduct any virtual asset business without such registration or licensing in place subject to penalty.

### Changes to Shareholding and Information filed with CIMA

Where a VASP entity makes any changes to the information submitted to CIMA as part of its application, it

must within 15 days after making the change, file with CIMA the details of the changes. No shares totalling ten per cent or more of the total shares in a VASP entity shall be issued, and no issued shares or interests shall be voluntarily transferred or disposed of, without the prior approval of CIMA.

## Types of Digital Asset Structures

Virtual asset entities including, for example, token issuers, non-fungible tokens ("**NFTs**"), decentralised autonomous organisations ("**DAO**"), decentralised finance entities, virtual asset trading platforms, centralised and decentralised exchanges and intellectual property holding entities typically set up as an exempted company or a foundation company. A Cayman Islands special economic zone company can also be used for virtual asset businesses that desire to move to and physically set up shop in the Cayman Islands within the Special Economic Zone ("**SEZ**"). The SEZ provides a conducive environment for innovation, offering tax incentives, streamlined regulatory and immigration processes, and a collaborative ecosystem for digital asset businesses to thrive.

### Preferred Digital Asset Structures and Benefits

The Cayman Islands offers flexible vehicles which may be formed for, and used in, a variety of contexts. For digital assets, the preferred vehicles are the exempted company and the foundation company.

#### Exempted Company

The exempted company is a form of limited liability company and is the most common structure used by VASP entities. It provides a number of benefits including: being a body corporate with separate legal personality, limited liability protection, shares may be issued with nominal or no par value, no requirement to keep its register of members open for public inspection and no requirement for Cayman resident shareholders or directors.

#### Foundation Company

A foundation company is often the preferred choice for DAOs and developer entities (as detailed further below). The popularity of foundation companies is attributed to several key factors including; being a body corporate with separate legal personality, limited liability protection, the flexibility of a trust (it acts as a hybrid structure which sits between a company and a trust or a civil law foundation in its characteristics), no requirement to have shareholders (thereby fostering a decentralised model), can be established for any lawful purpose, whether commercial, charitable/philanthropic or private purposes, or any combination of them and there is no requirement for Cayman resident shareholders or directors.

Several other structures are utilised for digital assets in the Cayman Islands, offering various advantages and benefits for strategic alternative investments, which are listed below.

#### Token Issuers

A token issuer can be set up as a standalone entity to issue tokens or NFT's (the "**Token Issuer**") or more commonly as a subsidiary of a second entity that develops the platform or protocol (the "**Developer**"). In

this way, much of the regulatory liability of the Token Issuer is separated from the value built up in the Developer entity. For the Developer, many options are available including a foundation company. However, for the Token Issuer, most Web3 and blockchain companies choose an exempted company.

### **Virtual Asset Trading Platforms**

A 'virtual asset trading platform' which requires licensing under VASPA (once that regime comes into effect and requires registration in the interim) means a centralized or decentralized digital platform: (i) which facilitates the exchange of virtual assets for fiat currency or other virtual assets on behalf of third parties for a fee, commission, spread or other benefit; and (ii) which: holds custody of or controls virtual assets on behalf of its clients to facilitate an exchange; or purchases virtual assets from a seller when transactions or bids and offers are matched in order to sell them to a buyer, and includes its owner or operator. These entities are typically set up as exempted companies.

### **Decentralised Autonomous Organisation ("DAO")**

Combining the limited liability protections of a corporate entity with the flexibility of a trust, the foundation company provides DAO projects with a user-friendly option. Foundation companies, unlike trusts or partnerships, have separate legal personality, can hold assets, assume obligations, and can act as corporate parents with subsidiaries.

### **Decentralised Finance ("DeFi")**

The foundation company provides a legal 'wrapper' for DeFi products with corporate personality. In this role, the foundation company can undertake many of the real-world activities as required by the DeFi project. The foundation company can act as a service provider for DeFi projects by signing documents and engaging developers or consultants on behalf of the project. It can also act as a fundraising vehicle for early stage and venture capital private funding, hold a DeFi project's treasury assets to pay for ongoing services, or act as a vehicle for providing marketing services such as airdrops for tokens, NFTs, P2E games and metaverse projects.

### **Bitcoin ETFs**

Bitcoin Exchange-Traded Funds ("ETFs") are a smart way to utilise Cayman law and traditional exchange platforms to maximise investment. ETFs are typically set up as an exempted company. Bitcoin ETFs track the value of Bitcoin and trade on traditional market exchanges rather than cryptocurrency exchanges. They provide investors with a means of investing in Bitcoin without needing to use a cryptocurrency exchange, and they also offer the advantage of price leverage.

Typically, Bitcoin ETFs use futures to replicate the cryptocurrency's performance, and an alternate way to gain exposure to Bitcoin is by investing in companies involved in cryptocurrency and blockchain, which provide market leverage. Establishing a Bitcoin or crypto ETF in the Cayman Islands has many benefits, including access to highly experienced and professional service providers within a safe and robust regulatory environment.

## **Intellectual Property Holding Companies**

As a complementary entity to a DAO, clients often incorporate a separate entity to separate IP holding companies or separate software operators. This choice is often driven by the preferences of each business, its risk appetite and its tax considerations.

The preferred vehicle for an entity established to hold Web3 intellectual property is an exempted company. Any vehicle established for the sole purpose of holding, exploiting or receiving income from intellectual property assets will not be required to register with CIMA under VASPA, but it may be required to satisfy economic substance obligations pursuant to the International Tax Co-operation (Economic Substance) Act (as Revised).

## **Broader Fund and VASP Legal and Regulatory Framework**

In addition to the regulatory oversight by CIMA, the Cayman Islands Fund and VASP Regimes are supported by a comprehensive legal framework aimed at the prevention and detection of money laundering, terrorist financing and proliferation financing in the Cayman Islands, protection of personal information and the automatic exchange of information to assist in efforts to stamp out global tax evasion.

### **AML Obligations**

Fund and VASP entities are required to comply with the Anti-Money Laundering Regulations (as Revised) (the "**AML Regulations**") and CIMA's Guidance Notes on the Prevention and Detection of Money Laundering and other Cayman Islands laws, rules and regulation relating to anti-money laundering ("**AML**"), combating terrorist financing ("**CTF**") and proliferation financing ("**PF**") and targeted financial sanctions ("**TSF**"). A fund and a VASP entity must establish AML systems and procedures for the purpose of complying with the Cayman Islands AML regime. A fund and a VASP entity must also designate employees to fulfil the roles of AML compliance officer, money laundering reporting officer and deputy money laundering reporting officer that have responsibility for the procedures for combating AML/CTF/PF/TSF and undertake audits of its AML systems and procedures at the request of CIMA. In the Fund context these AML functions roles are often provided by the administrator. A VASP entity is also required to comply with the 'AML Travel Rules' as set out in the AML Regulations which sets out the identification and record-keeping requirements relating to transfers of virtual assets.

### **Data Privacy**

The Cayman Islands Data Protection Act (as Revised) ("**DPA**"), came into force on 30 September 2019. A fund and a VASP entity are typically each a '*data controller*' and must comply with the data protection principles set out in the DPA when processing personal data. They must also ensure that data protection principles are complied with where the personal data is processed on behalf of the data controller (e.g., by the administrator of the fund).



## **Automatic Exchange of Information**

Where a fund or a VASP entity is a '*financial institution*' for Foreign Account Tax Compliance Act ("**FATCA**") or OECD Common Reporting Standard ("**CRS**") purposes it must comply with the automatic exchange of information requirements. Financial institutions must have written policies and procedures in place, in accordance with CRS requirements, and attend to annual FATCA and CRS filings, as applicable.

## **Beneficial Ownership**

The beneficial ownership regime in the Cayman Islands is designed to enhance transparency and align with international anti-money laundering standards. The Beneficial Ownership Transparency Act, 2023 ("**BOTA**") came into effect on 31 July 2024 replacing the previous beneficial ownership regime. Under the old regime, VASP entities and Funds were out-of-scope and are now brought into scope under the new regime. BOTA requires all in-scope entities to identify their 'beneficial owner(s)' and establish and maintain a beneficial ownership register. CIMA registered funds will also have the option of providing the requisite information required on the beneficial ownership register to their corporate service provider in the Cayman Islands (generally their registered office provider) and have such provider maintain their beneficial ownership register. All in-scope entities must regularly update their beneficial ownership records and report any changes. Entities should always consult with an attorney to identify their specific requirements and to assist with the process.

## **The Future of Alternative Investment Funds and Digital Assets in the Cayman Islands**

The Cayman Islands maintains its position as the leading offshore jurisdiction for the establishment of mutual funds and private funds and continues to position itself at the forefront of alternative funds investing in cryptocurrencies, Web3 and blockchain products. Whether utilising a company, partnership or trust structure, the sophisticated regulatory framework in the Cayman Islands can accommodate any mutual fund or private fund seeking a dynamic environment with sophisticated and professional service providers and legal infrastructure conducive to digital innovation.

VASPA together with SEZA are pushing the boundaries of possibilities for Web3 and other digital asset products available in the Cayman Islands. The Cayman Islands has emerged as a leader in this digital revolution with cutting edge legislation and a favourable business environment to support and foster a rapidly evolving industry. The Cayman Islands offers innovative legal structures, such as the exempted company and foundation company, which can be utilised by any cryptocurrency, Web3 and blockchain product. The SEZ provides a practical solution to those businesses seeking to establish a physical presence in the Cayman Islands.

In summary, there are many ways to utilise Cayman Islands' fund structures and innovative VASPA and SEZA legislation to maximise alternative investment strategies including:

- Establishing mutual funds and private funds in the Cayman Islands that invest in cryptocurrencies, Web3 and blockchain products;

- Establishing exempted and foundation companies for token issuers, NFTs, DAOs, DeFi projects, centralized and decentralized exchanges, intellectual property holding entities and other Web3 projects;
- Utilising blockchain technology and smart contracts by funds and VASP entities;
- Incorporating Cayman Islands companies to hold and trade cryptocurrencies and other digital products; and
- Establishing SEZ companies that operate in the digital asset space and physically moving your operations to the Cayman Islands.

## **Disclaimer**

*This publication is for general guidance and is not intended to be a substitute for specific legal advice. Specialist advice should be sought about specific circumstances. If you would like further information, please contact your usual lawyer at Stuarts Humphries or email [info@stuartslaw.com](mailto:info@stuartslaw.com).*

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Our proven track record in advising leading international law firms, investment managers, investment companies and high-net-worth individuals is a result of the deep understanding of our markets.

At Stuarts, we strive to build and maintain lasting relationships with our clients through the combined legal expertise and business acumen of our practice groups and by providing outstanding service.

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