

Cayman Islands blockchain and cryptocurrency regulation 2022

Briefing Summary: Alistair Russell, Chris Duncan and Jenna Willis have authored the Cayman Islands chapter of Global Legal Insight's fourth edition guide to blockchain and cryptocurrency regulation. The chapter covers the Cayman Islands legal requirements relating to cryptocurrency and blockchain including government attitude, taxation, mining and licensing requirements.

Service Area: Banking and Finance, Banking Regulation, Corporate, Corporate Regulation and Compliance, Dispute Resolution and Litigation, Corporate Disputes, Investment Funds, Fund Regulation and Compliance, Funds Strategies and Asset Classes, Listing Services, Regulatory, Banking Regulation, Corporate Regulation and Compliance, Fund Regulation and Compliance, Trusts and Private Wealth, Estate Planning

Sector: Blockchain, Digital Assets and Tokenisation, Fintech and Regtech

Location: Cayman Islands

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Created Date: 07 January 2022

Government attitude and definition

The Cayman Islands is a leading global financial centre and has developed a reputation as one of the world's most innovative and business-friendly places to operate. The jurisdiction offers a stable society and political system, judicial and legislative links to the United Kingdom, tax neutrality, sophisticated service providers, and a proportionate regulatory regime that focuses closely on the financial services industry, and in particular those catering to sophisticated and institutional investors based elsewhere.

It is this reputation and these attributes that have helped the jurisdiction become an obvious choice for many of those proposing to establish fintech-related structures, whether it be in the form of a fund vehicle investing into digital assets, an exchange or initial coin or token offering or the launch of a decentralised finance protocol or network.

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Each of the Cayman Islands Government, the Cayman Islands Monetary Authority (“**CIMA**”), and industry bodies such as Cayman Finance and the Cayman Islands Blockchain Foundation, acknowledge the importance of continuing to attract fintech and digital assets business to the jurisdiction and ensuring the further growth of the sector. They are also aware, however, of the need to balance this approach with maintaining the Cayman Islands’ commitment to the highest standards of financial probity and transparency and the specific considerations that can accompany digital assets.

Consequently, in May 2020, recognising the newly adopted international standards set by the Financial Action Task Force, a new framework for the supervision and regulation of virtual asset services businesses was introduced in the Cayman Islands, namely the Virtual Asset (Service Providers) Act,¹ 2020 (the “**VASP Act**”). The features of the VASP Act are described further in this chapter; however, it is important to note that at the time of writing, this new legislation is only partially in force; the VASP Act is being introduced in two phases, with the first primarily dealing with anti-money laundering (“**AML**”) regulations and requiring virtual asset service providers (“**VASPs**”) to be registered, and the second phase dealing with licensing and other matters. A specific date for implementation of phase two of the VASP Act has not yet been announced, but it is expected to be in the near term.

Overall, the new framework continues to make the Cayman Islands an attractive jurisdiction for virtual asset services businesses, as it provides a flexible regulatory foundation with a great deal of certainty for those wishing to operate in the space, while furthering Cayman’s commitment to international standards.

Under the VASP Act, a “virtual asset” is broadly defined as a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes. Specifically excluded from this are digital representations of fiat currencies, as well as “virtual service tokens”, which are digital representations of value that are not transferrable or exchangeable with a third party at any time (including 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).

To provide further clarity on the VASP Act, the Virtual Assets (Service Providers) Regulations (the “**VASP Regulations**”) were introduced in October 2020. The VASP Regulations include the registration application requirements and details of fees as well as providing some further guidance as to virtual asset issuances (as discussed further below).

Cryptocurrency regulation

The VASP Act clearly establishes the legitimacy of digital assets and cryptocurrencies in the Cayman Islands and regulates businesses providing services related to virtual assets. Virtual assets themselves and parties dealing with virtual assets for their own purposes are generally not subject to specific regulation in the Cayman Islands.

Under the VASP Act, all VASPs are required to be licensed or registered with CIMA, obtain a waiver or hold a sandbox licence. A “VASP” is an entity that is incorporated or registered in the Cayman Islands and that provides a virtual asset service as a business or in the course of business.

A “virtual asset service” for this purpose means the issuance of virtual assets or the business of providing any of the following services or operations for or on behalf of another person or entity:

- exchange between virtual assets and fiat currencies;
- exchange between one or more other forms of convertible virtual assets;
- transfer of virtual assets;
- virtual asset custody service, which is the business of safekeeping or administration of virtual assets or the instruments that enable the holder to exercise control over virtual assets; or
- participation in, and provision of, financial services related to a virtual asset issuance or the sale of a virtual asset.

Cryptocurrency and other digital asset businesses that are not caught by any of the above categories may still be subject to regulation in the Cayman Islands that does not specifically target digital assets, such as the Securities Investment Business Act (“SIBA”), the Money Services Act and AML regulations (each described further below).

>Sales regulation

VASP Act

As set out above, the issuance of virtual assets, the provision of financial services related to a virtual asset issuance or the sale of a virtual asset, as well as the transfer of virtual assets, if being carried out by a Cayman Islands entity as a business on behalf of another party, will likely constitute virtual asset services and require a licence or registration with CIMA under the VASP Act.

Under the VASP Act, any issuance of virtual assets requires CIMA’s prior approval. For this purpose, an issuance means the sale of newly created virtual assets to the public in exchange for fiat currency, other virtual assets or other consideration. “Public” is not defined in the VASP Act so should be interpreted broadly for this purpose; however, helpfully the VASP Regulations distinguish a “private sale”, broadly defined as a sale that is not advertised and is sold to a limited number of persons by private agreement from a sale to the public (meaning that registration under the VASP Act may not be required for certain sales). The sale of virtual service tokens will also be excluded from this requirement and any transfer that is not for consideration (e.g. a bonus or “airdrop”) should be excluded.

Direct issuances will be subject to a prescribed maximum threshold, which, at the time of writing, has not been fixed. The threshold will not apply where the issuance is facilitated by way of one or more virtual asset trading platforms or obliged entities, provided that the relevant platforms are either licensed under the VASP Act or regulated in another non-high-risk jurisdiction.

Investment funds

An entity that operates as an investment fund that is formed or registered in the Cayman Islands and that issues digital assets may come within the ambit of the Mutual Funds Act (for open-ended funds) or the Private Funds Act (for closed-ended funds), and be required to obtain a registration or licence thereunder to the extent such digital assets constitute equity or investment interests. This will of course depend on a number of aspects, including the terms of the issue and the nature of the assets, and specific advice should be sought. For example, under the Mutual Funds Act, the definition of “equity interest” has recently been amended to include “any other representation of an interest”, which is likely broad enough to capture a variety of forms of digital asset.

Additionally, any pooling vehicle that is investing into the digital asset space, or accepting digital assets by way of subscription and then investing into more traditional asset classes, would be advised to seek Cayman Islands legal advice on the point.

Securities Investment Business Act

Pursuant to SIBA, an entity formed or registered in, or that is operating from, the Cayman Islands that engages in dealing, arranging, managing or advising on the acquisition or disposal of digital assets, may come within the ambit of SIBA and be required to obtain a registration or licence from CIMA thereunder (which may be in addition to a registration or licence required under the VASP Act). This applies to the extent that the relevant digital assets constitute “securities” for the purposes of SIBA.

Notably, the definition of “securities” thereunder includes virtual assets that can be sold, traded or exchanged immediately or at any time in the future and that (i) represent or can be converted into another form of traditional securities (e.g. equity interests, debt instruments, options or futures), or (ii) represent a derivative of traditional securities. Consequently, consideration will need to be given on a case-by-case basis as to whether the digital asset in question falls within one of the above categories.

Offerings within the Cayman Islands

In relation to the offering sale, or issuance of interests within the Cayman Islands, certain regulatory provisions should be borne in mind. For example, the Companies Act prohibits any exempted company formed in the Cayman Islands and not listed on the Cayman Islands Stock Exchange from offering its securities to the Cayman Islands public. The Limited Liability Companies Act includes a similar prohibition in relation to limited liability companies (“LLCs”). Even persons based, formed or registered outside the Cayman Islands should be careful not to undertake any activities in relation to a sale or issuance of digital assets that would constitute “carrying on a business” in the Cayman Islands. To do so may entail various registration and licensing requirements and financial and criminal penalties for those who do not comply. There is no explicit definition of what will amount to “carrying on a business” for these purposes and, consequently, persons who propose to undertake concerted marketing to the Cayman Islands public, particularly if it involves engaging in any physical activity in the Cayman Islands, are encouraged to seek specific legal advice.

In practice, however, these restrictions do not generally pose a significant practical concern for issuers given that:

- the “public” in this instance is taken to exclude other exempted companies, exempted limited partnerships, and LLCs (which together comprise the majority of Cayman Islands entities); and
- issuers’ target investors tend not to include other persons physically based in the Cayman Islands.

Taxation

There are no income, inheritance, gift, capital gains, corporate, withholding or other such taxes imposed by the Cayman Islands Government, including with respect to the issuance, holding, or transfer of digital assets.

Stamp duty may apply to original documents that are executed in the Cayman Islands or are brought into the Cayman Islands following execution. However, the sums levied are generally of a nominal amount.

Entities formed or registered in the Cayman Islands may apply for and, upon the payment of a fee of a relatively small amount, receive a tax exemption certificate confirming that no law enacted in the Cayman Islands after the date thereof imposing any tax to be levied on profits income, gains or appreciations shall apply to such entity or its operations. Such certificates will generally apply for a period of between 20 and 50 years (depending on the type of entity).

Money transmission laws and anti-money laundering requirements

Money transmission laws

Pursuant to the Money Services Act, any person carrying on a “money services business” in or from the Cayman Islands must first obtain a licence from CIMA thereunder. Any breach of this requirement will constitute a criminal offence.

For the purposes of the foregoing, a “money services business” means the business of providing, among other things, money transmission or currency exchange services.

Although there is no clear authority on the extent to which the foregoing would be seen to include such transactions in cryptocurrency or other digital assets, a cautious and substantive reading of the statute may, in some cases, warrant it. In particular, if the digital assets in question are primarily used to facilitate the transfer of fiat currency from one party to another, or the conversion between fiat currencies, the legislation may well apply. Consequently, persons wishing to establish such businesses are encouraged to consider closely the application of the Money Services Act and consult appropriate advisors.

Anti-money laundering requirements

The very nature and, in some cases, the intended features of digital assets can present heightened compliance risks and practical hurdles to addressing the same. Such features may include the lack of a trusted central counterparty, increased anonymity, and ease of cross-border transfer without any gating or restriction.

Consequently, the Cayman Islands authorities have maintained a keen focus on balancing the jurisdiction’s long track record of innovation and the promotion of a business-friendly environment with its commitment to the prevention of crime and maintaining robust standards of transparency. In general, this has been done not by establishing an entirely separate regime for digital assets, but by applying the purposive approach enshrined within the existing framework, which focuses on the specific activity and the nature of the assets in question so as to properly quantify the risk that the same may be used to facilitate illegal activity.

Pursuant to the provisions of the Proceeds of Crime Act, the Anti-Money Laundering Regulations, and the guidance notes thereon (together, the “AML Laws”), any persons formed, registered or based in the Cayman Islands conducting “relevant financial business” are subject to various obligations aimed at preventing, identifying, and reporting money laundering and terrorist financing.

“Relevant financial business” is defined in the Proceeds of Crime Act and includes the provision of virtual asset services (which is defined slightly differently for this purpose than under the VASP Act).

Although a detailed consideration of the specific requirements of the AML Laws falls outside of the scope of this chapter, any person subject to the regime will generally need, among other things, to do the following:

- appoint a named individual as an AML compliance officer to oversee its adherence to the AML Laws and to liaise with the supervisory authorities (and, under the VASP Act, a VASP must have such office approved by CIMA);
- appoint named individuals as the money laundering reporting officer and a deputy for the same to act as a reporting line within the business; and
- implement procedures to ensure that counterparties are properly identified risk-based monitoring is carried out (with specific regard to the nature of the counterparties, the geographic region of operation, and any risks specifically associated with new technologies such as virtual assets), proper records are kept, and employees are properly trained.

In addition, CIMA has issued specific AML-related guidance for VASPs and new regulatory requirements have been put in place to ensure sufficient information is obtained relating to transfers of virtual assets by intermediaries.

In our experience, most parties will be best advised to consult specialist third-party providers to assist with this process.

>Promotion and testing

Sandbox licences

The VASP Act has introduced a sandbox licence, intended for providers of virtual asset services or other fintech services that utilise innovative technology or use an innovative method of delivery. A sandbox licence provides flexibility such that CIMA can impose additional requirements or allow certain exemptions, to cater for the relevant business.

Sandbox licences will be temporary, available for a maximum of one year, during which we anticipate that CIMA will assess how best to regulate the business in the future, including whether that requires legislative change, to further promote and monitor the use of the relevant innovation. Further details as to eligibility are not yet available.

Special Economic Zone

Additionally, the Cayman Islands Government has been active in promoting the Special Economic Zone (the “**SEZ**”) to those wishing to develop fintech related products from the jurisdiction

The SEZ offers businesses focused on the fintech industry the opportunity to establish physical operations within the Cayman Islands in a more streamlined manner. It provides several benefits including a simpler, more rapid, and cost-effective work permit process, concessions with respect to local trade licences and ownership requirements, the ability to be operational within four to six weeks, and allocated office space.

When coupled with the other benefits of the jurisdiction and its recently updated intellectual property laws, the SEZ has proven highly popular with the fintech industry, with the number of blockchain-focused companies established within it continuing to grow.

Ownership and licensing requirements

The Cayman Islands does not impose any restrictions or licensing requirements that are specifically targeted at the ownership, holding or trading of digital assets by those doing so for their own account.

As described above, under the VASP Act, all VASPs (as defined above) are required to be licensed or registered with CIMA, obtain a waiver or hold a sandbox licence. The applicability of other regulatory regimes, such as the Mutual Funds Act and SIBA (each as further detailed above), should also be considered.

Pursuant to the VASP Act, a VASP is required to ensure that its beneficial owners are approved by CIMA as fit and proper persons to have such control or ownership. Subject to possible exceptions for publicly traded companies, ownership interests or voting rights totalling 10% or more in a VASP cannot be issued or voluntarily transferred without CIMA's prior approval.

Mining

The mining of digital assets is not regulated or prohibited in the Cayman Islands currently, nor will it (in and of itself) be regulated or prohibited under the VASP Act. We would note, however, that the import duties applicable to computing equipment and the high cost of electricity production in the Cayman Islands are likely to present practical deterrents to the establishment of any material mining operations within the jurisdiction. It is possible that the increased availability of renewable energy options, and the falling price of the same, may mitigate this somewhat in the future.

Border restrictions and declaration

The Cayman Islands does not impose any general border restrictions on the ownership or importation of digital assets.

As part of the Cayman Islands' commitment to combatting money laundering and terrorist financing the Customs (Money Declarations and Disclosures) Regulations mandate that individuals transporting money amounting to CI\$15,000 (approximately US\$18,292) or more into the Cayman Islands must make a declaration in writing to customs officer at the time of entry. However, the Customs Act defines "money" as being confined to cash (i.e. bank notes or coins that are legal tender in any country) and bearer-negotiable instruments (i.e. travellers' cheques, cheques, promissory notes, money orders). As such, we would not expect such a requirement to apply to virtual assets or any other type of digital asset. Further, given the nature of these assets, particularly those based or recorded on a distributed ledger, there is a conceptual question of what would amount to the importation or transportation of such assets.

Reporting requirements

VASPs registered or licensed under the VASP Act will be required to:

- prepare audited accounts and submit them to CIMA annually;
- obtain prior approval from CIMA to appoint senior officer or AML compliance officers;
- provide certain notices to CIMA confirming compliance with AML Laws and data protection laws and ensuring that all communications relating to the virtual asset service are accurate;
- undertake audits of their AML systems and procedures at the request of CIMA; and
- notify CIMA of any licence or registration in another jurisdiction or the opening of an office or establishment of a physical presence in another jurisdiction, the holding or acquisition of a controlling interest in another person engaged in virtual asset service.

Additional reporting and other requirements may apply and may be imposed, which in some cases differ based on the type of virtual asset service being provided.

To the extent that any payment or transfer is made in the context of the conduct of a “relevant financial business” for the purposes of the AML Laws, there may of course be an obligation to make certain filings or reports in the event that there is a suspicion of money laundering or other criminal activity.

Estate planning and testamentary succession

Neither the VASP Act nor any other particular regime under Cayman Islands law deals specifically with the treatment of virtual assets upon the death of an individual holding them. This means that, in principle, and assuming Cayman Islands law governs succession to the deceased’s estate, virtual assets will be treated in the same way as any other asset and may be bequeathed to beneficiaries in a will, or, if a person dies intestate, will be dealt with under the intestacy rules in the Cayman Islands Succession Act.

As is the case in many jurisdictions beyond the Cayman Islands, there is likely to be some uncertainty as to where the situs of a virtual asset is located (or indeed whether or not a situs can be determined at all). To the extent that the asset can be analysed under traditional conflict-of-laws rules as sited in the Cayman Islands, then a grant of representation would be required from the Cayman Islands court to preclude the risk of intermeddling claims in dealing with the asset in the Cayman Islands (even though the grant itself would not necessarily prevent someone with access to the private keys associated with a digital asset from dealing with the same).

The main potential difficulty that may arise is practical; namely, that anyone inheriting a virtual asset will, on the face of it, often only be able to access that virtual asset if the personal representative of the deceased or the beneficiary (as the case may be) has or can obtain the information needed in order to gain access and control over that virtual asset (e.g. a private key to the wallet in which it is stored). Most exchanges have policies in place to transfer virtual assets to next of kin but these policies, and the transfer requirements, will vary across exchanges and it is generally regarded as prudent to avoid leaving significant value on exchanges for any length of time due to the risks of hacking and insolvencies.

If you have any questions relating to blockchain and cryptocurrency regulation or about our services in this sector, please contact one of the lawyers listed or visit our crypto and blockchain service page.

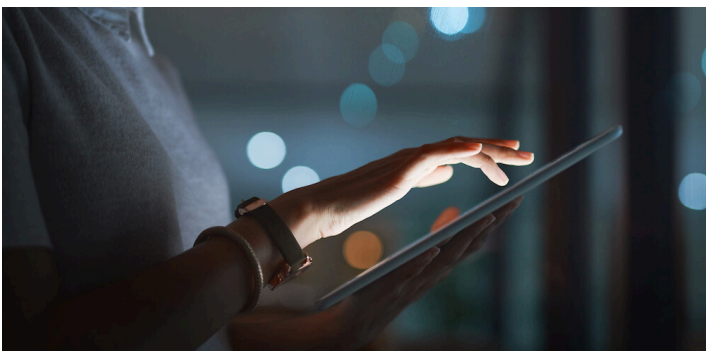
The full GLI guide to blockchain and cryptocurrency regulation 2022 covers 29 jurisdictions and includes 17 general chapters.

1 Known as the VASP Law until a recent change amending the way in which Cayman Islands primary legislation is referred to.

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