CAREY OLSEN

Cayman Islands update: what do recent regulatory proposals in Hong Kong mean for offshore virtual assets exchanges?

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Background

2021 has seen significant volatility in the prices of major cryptocurrencies. With such volatility, fortunes have been made and lost, with losses often borne by inexperienced retail clients.

It's therefore unsurprising that we have seen increased focus from international regulators in the cryptocurrency space.

The Cayman Islands was ahead of other jurisdictions in developing a bespoke regulatory framework for the provision of services relating to virtual assets. This was implemented by way of the Virtual Asset (Service Providers) Act (the "**VASP Act**") of the Cayman Islands, which became effective from 31 October 2020 (subject to phased implementation).

In Hong Kong, the Financial Services and the Treasury Bureau published its conclusions paper (the "**FSTB Proposals**") on 21 May 2021 following a three month public consultation on a licensing regime for virtual asset services providers.

This note is focused on the operation of a virtual assets trading platform (a "**VA Exchange**") which would be subject to regulation under the VASP Act or FSTB Proposals. Platforms whereby the exchange does not come into custody or control of virtual assets during the course of its operation (e.g. peer to peer platforms matching buyers and seller for off-platform trading) will not require licencing under the VASP Act[1] and are also excluded from the FSTB proposals. Accordingly, this note is focused on factors relevant to operators of VA Exchanges which do come into custody or control of virtual assets during the course of their operation and which may be considering whether to become regulated in the Cayman Islands.

The FSTB Proposals

The FSTB Proposals observe that virtual assets activities outside VA Exchanges are negligible in Hong Kong and accordingly are primarily focused on the business of operating a VA Exchange in Hong Kong.

Any person operating a VA Exchange in Hong Kong would require a licence from the Hong Kong Securities and Futures Commission (the "**SFC**") and would require a local presence by being incorporated or registered in Hong Kong. Significantly, an SFC-licenced VA Exchange would only be permitted to offer services to professional clients and would be restricted from serving retail clients.

Based on timing outlined in the FSTB Proposals, the new Hong Kong regulatory regime is likely to be put in place during 2022.

Cayman regulatory regime

The VASP Act regulates the provision of virtual assets services 'in or from within' the Cayman Islands. Use of the phrase 'in or from within' the Cayman Islands means that the VASP Act extends to the provision of virtual assets services *outside* the Cayman Islands (e.g. in Hong Kong) using a vehicle (e.g. an exempted company) established *within* the Cayman Islands.

1 Operators of peer to peer platforms will however need to ensure they are not providing any of the other prescribed 'virtual assets services' which may require registration with or licensing by CIMA.

A licence from the Cayman Islands Monetary Authority ("**CIMA**") will be[2] required for the operation of a VA Exchange in the course of a business using a Cayman Islands entity or otherwise from within the Cayman Islands.

The VASP Act also imposes other requirements for a VA Exchange in respect of annual accounts, security of personal data, protection of client virtual assets and various information and notification requirements to CIMA.

Strict compliance with anti-money laundering ("**AML**") and counter-terrorist financing ("**CTF**") regulations is required of a VA Exchange under the VASP Act. A VA Exchange based in the Cayman Islands will require a designated officer with responsibility for AML and CTF compliance and CIMA will consider the AML and CTF controls that a prospective VA Exchange has in place for the purposes of deciding whether to grant a licence.

Cayman and Hong Kong compared

The VASP Act and the FSTB Proposals both rightly place a primary emphasis on regulatory compliance and client protection.

Both also broadly adopt the Financial Action Task Force definition of virtual assets (being a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes but not including a digital representation of fiat currencies).

The concept of a VA Exchange is also broadly aligned, with both the VASP Act and FSTB Proposals applying to trading platforms which come into custody or control of virtual assets during their operation. Peer to peer platforms matching buyers and sellers for off-platform trading are accordingly excluded.

However, there are also some key differences which will be relevant to operators of VA Exchanges considering where to become regulated. The most significant of these is that the FSTB Proposals provide that an SFC-licenced VA Exchange will *not* be permitted to provide services to retail clients whereas the VASP Act does not contain a similar prohibition.

This means that a CIMA-licenced VA Exchange may, under Cayman Islands law, provide services to retail clients in the Cayman Islands or elsewhere.

A CIMA-licenced VA Exchange is required to have a registered office in the Cayman Islands. There are no specific requirements in the VASP Act with respect to Cayman resident officers or employees. CIMA will however take into account the knowledge, expertise and experience of the applicant (which by implication includes its staff and senior management) in deciding whether to grant a licence. In addition, the issuance of a licence by CIMA may be made subject to such requirements as CIMA considers to be in the best interest of the users of the VA Exchange. Accordingly, the approach that CIMA will take to operational requirements such as staff 'on the ground' is yet to be determined.

An important consideration for an offshore (e.g. CIMA-regulated) VA Exchange will be the extent to which the laws of other jurisdictions (e.g. Hong Kong) limit the ability of the offshore VA Exchange to provide services to the public in those jurisdictions. The FSTB Proposals would prohibit a VA Exchange which is not SFC-licensed from '*actively marketing*' to the public of Hong Kong (whether in Hong Kong or elsewhere).

It remains to be seen whether this prohibition will mean that an offshore VA Exchange (which does not 'actively market' to Hong Kong residents) will be unable to accept Hong Kong clients (including retail clients) who approach the relevant offshore VA Exchange on their own initiative. Offshore VA Exchanges will need to seek local Hong Kong law advice on this point (and any other aspects specific to the FSTB Proposals).

Conclusion

VA Exchanges often seek regulated status as a 'badge of quality' offering assurance to their clients, the public and, often, their investors and financiers.

The Cayman Islands offers a VA Exchange a path to regulated status on the basis of a clear regulatory framework which is already in place, with no local law restrictions on providing services to retail clients.

It will be interesting to observe whether the implementation of more restrictive regulatory regimes in competitor jurisdictions (e.g. Hong Kong) serves to drive VA Exchange business to offshore financial centres such as the Cayman Islands.

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2 At the time of writing, the relevant provisions of the VASP Act requiring the licensing of VA Exchanges had not come into effect, but are expected to be made effective imminently by way of commencement order. As part of the phased implementation of the VASP Act, persons engaged in or wishing to engage in the operation of a VA Exchange are required to register with CIMA with a view towards obtaining full licensing once the relevant provisions of the VASP Act come into force.

Continued

Key contacts

For further information or professional advice please contact our lawyers below:

Michael Padarin
Partner

D +852 3628 9006
E michael.padarin@careyolsen.com

Daniel Moore
Counsel

D +852 3628 9022
E daniel.moore@careyolsen.com

FIND US

Carey Olsen Hong Kong LLP
Suites 3610-13
Jardine House
1 Connaught Place
Central
Hong Kong

T +852 3628 9000
E hongkong@careyolsen.com

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