Cryptoassets as an Alternative Investment Class for Cayman Islands Alternative Investment Funds

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Cryptoassets, as a non-correlated asset class, have become much more attractive to investors in recent times. This is primarily due to this asset class being able to provide investors with an alternative to stormy financial markets combined with the mathematically controlled finite supply of a cryptoasset introducing an element of scarcity and thereby being a driver for value.This article examines certain aspects of cryptoassets that directors and investment managers (operators) of Cayman funds consider as part of their strategy for investment in cryptoassets.

Selection of cryptoassets

Investing in cryptoassets can be challenging. The operators of a fund will firstly need to determine its appetite in relation to the type of cryptoassets and amount of exposure to each cryptoasset in its portfolio. Cryptoassets are, for the most part, unregulated products that currently remain outside the scope of ISDA Master Agreements. Cryptoassets are also not traded on any recognised stock exchange but rather are traded on mostly unregulated cryptoexchanges. Cryptoassets can be extremely volatile with thin liquidity and there is very limited history upon which to base Sharpe Ratio calculations.

A number of regulators have issued advisories and investor alerts in relation to investment in cryptoassets. The Cayman Islands Monetary Authority (CIMA) has issued an advisory on the potential risks of investments in ICOs and all forms of virtual currency, and recommends that customers thoroughly research prospective investments.[1] The SEC has also published investor bulletins cautioning investments in this space.

Mechanics of acquiring cryptoassets

Cryptoassets are not easy to acquire. Cryptoassets are typically acquired through cryptoexchanges. Selection of the cryptoexchange in itself requires due diligence by the manager of the fund as a number of cryptoexchanges have been hacked, with investors taking significant losses. Cryptoexchanges generally do not have insurance scheme arrangements in place to compensate for losses. Customers who lose their account passwords may also face being locked out of their accounts, since cryptoasset platforms and exchanges are generally unable to recover their customers' details upon the loss of the account password. The absence of cryptoexchanges that are regulated (by the SEC, FCA, EU, etc) introduces additional challenges.

Banking channel partners used by a fund to acquire cryptoassets also often pose challenges. A sizable number of banks are not allowing their customers to use their accounts and credit cards to buy cryptocurrencies. International correspondent banking arrangements, regulatory and AML compliance requirements are the main reasons that banks and other financial intermediaries will not accept anything that is not “whiter than white” in the crypto arena (see further below in relation to AML).

Cryptoassets acquired by way of fund subscriptions in kind from investors also pose challenges such as in the case of funds registered with CIMA where the minimum initial investment of US$100,000 applies to all prospective investors. In such instances the accounting and valuation methodology used for cryptoassets becomes of paramount importance.

Custody of cryptoassets

Cryptoassets are analogous to digital bearer securities and accordingly it is preferable to find a custodian to hold them in safekeeping. The search for a custodian is challenging since traditional custodians do not offer custody services for cryptoassets. Cryptoexchanges that do offer custody solutions more often lack regulatory oversight. Regulated asset managers tend to shy away from cryptoassets mainly due to the lack of regulated custodians. SEC-registered investment advisers are bound by the SEC's “custody rule” which requires them to appoint custodians that meet certain standards for maintaining custody of client assets. A majority of investment managers keep client assets with broker-dealers, banks or other qualified custodians who do not provide cryptoasset custody services. Until SEC-registered entities start offering custodial services, US-based institutional investors may choose to stay on the side lines. The reported investment by Yale University’s endowment in a new blockchain and cryptocurrency focused fund is, if correct, a significant step.

Some smaller start-up funds use cryptowallets, which in turn raise other concerns about unknown vulnerabilities. The operators of the fund, accordingly, need to determine protocols around who will have access to the cryptowallet, and thus potentially, access to all of the fund's cryptoassets. Anyone can send cryptocurrency to a cryptowallet address. However, only the person who has the “private key” of the corresponding recipient cryptowallet address can use it.

Anti-money laundering

Cryptoassets do also raise anti-money laundering (AML) challenges. Even if AML regimes may not necessarily require counterparties to be verified according to Know Your Customer (KYC) guidelines, it would be prudent to acquire counterparty information for anti-terrorism watchlist and sanctions compliance. For example, the fund operators should ensure that all cryptoasset transactions are conducted by the fund with a “whitelisted addressee” – namely one that is linked to a verified (KYCd) and AML compliant profile. Cryptoasset issuers taking a proactive stance on AML compliance therefore ought to be more attractive to funds acquiring assets in this space.

In addition to the usual AML protocols, where a fund is looking at accepting cryptoassets by way of a subscription *in specie*, the fund should also ensure that “clean” cryptoassets are contributed to

Definitions

Cryptoassets in general can be defined as cryptocurrencies, cryptocommodities and cryptotokens.

Cryptocurrencies are digital or virtual currencies cryptographically encrypted that typically have one or more characteristics of currencies, such as storage of value, unit of account and a means of exchange. Bitcoin, first released in 2009, has been followed by many others that are regarded, or regard themselves, as cryptocurrencies. For example, Altcoin (more often referred to as coins) refers to alternatives to Bitcoin (even though many are best classified as cryptotokens). These cryptocurrencies are built using blockchain technology.

Cryptocommodities include blockchain networks that commoditise computing power, storage capacity (cloud based or physical) and network bandwidth. Ethereum, the public distributed computing platform upon which decentralised blockchain applications can be built is in itself a cryptocommodity (whereas Ether is the cryptotoken that powers, not "funds", the network built on the Ethereum platform).

Cryptotokens (more often simply called tokens), on the other hand, embody the representation of a particular asset (which could include tradeable services or goods) or a utility that resides on another blockchain (and thus facilitate various decentralised applications). For example, cryptotokens could represent customer appreciation points, certificates and game points (not dissimilar to frequent flyer points in some cases). Cryptotokens are used as a means to fund project development by public distribution through an Initial Coin Offering (ICO) which can be viewed as something akin to crowdfunding (but not necessarily equity crowdfunding).

the fund. Cryptoassets can become "tainted" if they come from an address that is controlled by a non KYC/AML compliant person. Accordingly, the path of ownership of the cryptoasset should be traced and cryptoassets whose history has been destroyed by mixing (ie combining "clean" coins with tainted coins) or tumbling (ie coin swaps between users) should be avoided. Identifying and linking the source of funds (where cryptoassets are used to pay for a fund subscription) can also be challenging as there may be no obvious link to the subscriber.

Accounting

Accounting for cryptoassets is an emerging area. Due to the diversity of cryptoassets, the accounting treatment will have to be evaluated on the basis of individual facts and circumstances. The author is not a qualified public accountant but notes the following standards provide guidance for treatment:

(a) Cash (IAS 7 Statement of Cash Flows; IFRS 9 Financial Instruments). It is unlikely that cryptoassets (and in particular cryptocurrencies) qualify to be accounted for as cash or a cash equivalent.
(b) Non-cash financial assets (IAS 32 Financial Instruments: Presentation, IFRS 9 Financial Instruments). The holder of a cryptoasset generally does not have any such contractual right to receive cash or another financial asset from another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the holder and, accordingly, cryptoassets do not seem to meet the definition of a non-cash financial asset. However, certain contracts to buy or sell cryptoassets in the future (eg forward contracts or options) or other contracts that settle in cash based on movements in the value of a particular cryptoasset may meet the definition of a derivative and be subject to financial instruments accounting.
(c) Investment properties (IAS 40 Investment Property). Cryptoassets do not meet the definition of property (ie land or buildings) specified.
(d) Intangible assets (IAS 38 Intangible Assets). Many cryptoassets are likely to meet the definition of intangible assets and are therefore within the scope of IAS 38.
(e) Inventory (IAS 2 Inventories). IAS 38 does not apply to intangible assets held for sale in the normal course of business. Such intangible cryptoassets are to be accounted for in accordance with IAS 2.[2]

Audit and tax

Prior to the acquisition of cryptoassets, it would be prudent for a fund proposing to acquire such assets to have a discussion with its auditor. The fund's auditor may need to (re)consider the audit plan and audit strategy to ensure the risks associated with this specific asset class are documented and considered. Controls surrounding the use of cryptowallets and arrangements for the auditor to view the cryptowallet information for the purposes of the audit need to be established. Valuation methodology for cryptoassets is another issue – in particular valuation of fund subscriptions-in-kind by way of cryptoassets. Audit materiality guidelines should also be discussed to determine the level of investment in cryptoassets that would be deemed to be material. Finally, auditors will themselves need to also consider the capabilities of their engagement teams to address complex technological processes involving cryptoassets.

A lot of uncertainty surrounds the taxation of cryptoassets globally. For example, it is understood that in the US the IRS treats cryptocurrencies as property and general tax principles (such as capital gains) applicable to property will apply; and crypto-to-crypto trades occurring after 31 December 2017 cannot be treated as like-kind exchanges. Accordingly, specific tax advice needs to be sought to determine if cryptoasset transactions/exchanges/purchases may be taxable in a particular jurisdiction. Cryptowallet transaction history can assist in the determination of gains and losses.

Disclosures and corporate governance

In terms of corporate governance, the board of directors oversee the fund's risk management policies and procedures. CIMA's "Statement of Guidance on Corporate Governance for Regulated Mutual Funds"[3] provides guidance on the minimum expectations for the sound and prudent governance of a regulated mutual fund. It outlines that the governing body should oversee and supervise the activities of the fund. Although cryptoassets introduce a level of complexity, funds with material cryptoasset holdings at the minimum need to provide appropriate risk factor and other transparent disclosures. The types of cryptoasset should be described in detail. Valuation methodology in particular in relation to NAV calculations should also be discussed. Additional non-financial disclosures such as the impact of cryptoasset holdings on liquidity and its impact on fund investor redemptions need to be considered.

Regulatory

Treating cryptoassets as an asset class within the confines of the existing regulatory framework is likely to limit its appeal for funds given that such framework often is not sympathetic to those types of assets. In contrast, some degree of regulation of cryptoassets and service providers such as cryptocustodians and cryptoexchanges would add legitimacy to this asset class and perhaps lead to a more orderly market.

The Cayman Islands government and CIMA have worked continuously with global governments and international authorities over many years to ensure that the Cayman Islands is trusted as internationally compliant, committed to information exchange, well-regulated, cooperative and transparent. The Cayman Islands was an early introducer of comprehensive and strict AML and KYC rules and regulations for funds. Although there has been no specific regulatory guidance targeting funds investing in cryptoassets, CIMA has, in accordance with international standards, taken a risk- based approach recognising the commercial and technical challenges relating to cryptoassets. Development of FinTech and regulation is also high on the legislative priority list for the Cayman Islands government, which is keen to adopt good business and regulatory practices to position the Cayman Islands as a leader in this space. **THFJ**

FOOTNOTES

1. https://www.cima.ky/upimages/noticedoc/1524507769PublicAdvisory-VirtualCurrencies_1524507769.pdf
2. For a detailed analysis, An Introduction to Accounting for Cryptocurrencies May 2018, Chartered Professional Accountants of Canada may be of interest. https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/international-financial-reporting-standards-ifrs/publications/accounting-for-cryptocurrencies-under-ifrs
3. This can be found at www.cima.ky

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