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AML compliance in Cayman

David Luu of Harbour reflects on the past, present and future of anti-money laundering compliance in the Cayman Islands

As we bid an enthusiastic farewell to 2020 as the year of Covid-19 and welcome 2021 as the year of the vaccine, we can also reflect on the developments within the Cayman Islands' fund industry and hashtag 2020 as the #YearofRegulatoryCompliance.

The pace and scale of the recent regulatory and compliance developments affecting the industry have been wide-ranging and numerous. Examples include the registration of private and limited investor funds, transition to online beneficial ownership filings, release of version 3.0 of the economic substance guidance notes, changes to the register for companies, update to version 4.0 of the fund annual return form, introduction of the Virtual Asset (Service Providers) Act (2020), launch of the new Department for International Tax Corporation portal and the introduction of the CRS compliance form.

Additional guidance was also issued on the impact of Covid-19 on data protection, and as if that was not enough, CIMA also issued rules and guidance on offering documents, cybersecurity, the segregation of assets and the calculation of asset values.

With most of these changes taking place during the pandemic, multiple deadline extensions were offered for

certain filings. Even with these accommodations, many in the industry are experiencing fatigue from the volume of changes and the expenses associated with the increase in regulatory requirements.

In addition to assisting clients with the increase in reporting, it is helpful to explain why these changes are necessary. The purpose of these ongoing updates is to continue to strengthen and enhance the anti-money laundering (AML) and regulatory frameworks of the Cayman Islands. At risk is the financial and reputational standing of our finance industry. One tangible benefit of these recent changes was that they helped the Cayman Islands secure their removal from its brief inclusion on the EU's list of non-cooperative jurisdictions for tax purposes.

As a leading global financial centre, we are all responsible for ensuring that our regulatory framework meets and exceeds relevant international standards. The Cayman Islands, as a founding member of the Caribbean Financial Action Task Force, have been a longstanding and active participant in the international efforts to disrupt organised crime and to control the AML, Countering the Financing of Terrorism and Proliferation Financing (AML/CFT/PF) risks associated with being a financial centre.

While we all respect the role of a robust regulatory regime to control the inherent risks associated with the financial services industry, CIMA is also responsible for enforcing compliance and has the authority to apply discretionary fines. Changes to the administrative fines regime made in 2020 now allow fines to be charged in accordance with the severity of the breach. These changes also extended the fines regime to apply beyond breaches of the AML regulations to include a broad spectrum of other regulatory laws in Cayman. Any administrative fines applied would be in addition to the penalties already allowed under the relevant legislation covering that matter.

The number of formal enforcement actions taken by CIMA in 2020 was at its highest level in the past five years with the total from two discretionary fines applied at the end of the year exceeding \$700,000. These particular fines were imposed on regulated entities for failing to comply with the legislative requirements of the AML regulations and for having ineffective AML policies and procedures. The quantum of these fines reflects the strategic importance of the AML laws and guidance in the Cayman Islands (together, the AML regime), which this article will discuss in further depth.

Cayman Islands AML regime

Since 2018, changes to the AML regime began to require all entities carrying out “relevant financial business” to appoint individuals to serve as AML officers. Those AML officers are responsible for reporting to the board of directors on their oversight of the operations, risks and effectiveness of the AML compliance programme. Based on a risk assessment of each entity, the AML officers are also tasked with ensuring appropriate AML policies and procedures are established and operating as intended. For a fund, testing of the downstream investor know your client procedures at the administrator and an upstream assessment of the investment policies and procedures at the investment manager should also be completed and reported on as a measure to mitigate the AML/CFT/PF risks.

The framework for the Cayman AML regime has been well established and amendments made in 2020 serve to provide clarification on the requirements. The key changes relate to the discontinuation of the equivalent jurisdictions list previously used to determine whether it was appropriate to apply simplified due diligence on a given applicant for business. Financial service providers must now independently consider country or regional risk and must document such assessment.

Recent amendments have also changed the requirements for reliance on eligible introducer letters, such that the introducer needs to confirm the identity of the customer along with any beneficial owners. The introducer must also be monitored by a supervisory authority or overseas regulatory authority and have appropriate measures in place for customer due

diligence and record-keeping procedures.

Additional information was provided on the application of a risk-based approach used to document an understanding of the AML/CFT/PF risks in relation to the customers and investment activities of the fund. The requirement for an ongoing risk assessment and monitoring are also needed, which includes consideration of targeted financial sanctions as applicable in the EU, UK and the US. Additional guidance has also been added on the countering of terrorist financing and proliferation financing and there are new requirements for information to be obtained on the payor to support the transfer of funds.

Where the future lies

In consideration of the medium-high risk rating assigned to the Cayman Islands financial sector during the National Risk Assessment completed in 2017 by the AML Steering Group, a trend towards alternative fund structures, the continued customisation of financial instruments (for example, virtual assets), and the increase in market volatility, we expect that the overall advance of regulatory developments are likely to continue.

Contrary to the expectation that additional regulation should negatively impact growth of the funds industry in Cayman, the number of registered funds has increased by 4.2% in 2020 with 11,313 CIMA registered mutual funds as at 31 December 2020. This figure does not include the 12,695 private funds and 583 limited investor funds registered as part of the changes in regulations in 2020. The Cayman Islands also continues to be an industry leader with approximately 70% of non-US domiciled alternative investment funds managed by U.S.

Securities and Exchange Commission-registered advisers domiciled in Cayman.

According to the latest quarterly HFM report, hedge funds have returned more than 12% in 2020, which was their best performance in over a decade. Net investor allocations also look promising as AuM set a new peak at \$3.5trn. There are also signs of pent-up investor demand given the Covid-19 related delays with the investment manager search and due diligence process and fewer than 300 new fund launches in 2020.

While some are speculating that we are in the late stages of a bull market, it is more practical to prepare for the risks and opportunities of the known knowns. Expansionary monetary and fiscal policies have accelerated resulting in the widespread availability of cheap accessible credit and higher than normal market volatility. These market conditions have allowed some funds to differentiate their risk adjusted returns creating a performance dispersion between investment managers using similar strategies.

If we consider all else being equal (i.e. fees, organisational quality, investment process, risk management, service providers and regulatory requirements) this differentiation in risk adjusted returns will benefit the funds industry by culling investment managers who are unable to make the grade.

Considering that all else is rarely equal outside of a laboratory, our opinion is that all aspects of the funds industry in the Cayman Islands must be first class. Regarding the regulatory environment, we also advise that it must be strategic, scalable and fit for purpose such that we can remain competitive as a leading jurisdiction for the global funds industry.