

## **National Risk Assessment of Money Laundering and Terrorist Financing (ML/TF) – Excluded Persons under the Securities Investment Business Law**

### **I. Background**

1. In 2015, the Cayman Islands conducted its first National Risk Assessment of Money Laundering and Terrorist Financing (“NRA”). The NRA determined that there are some activities that would qualify a person/entity to fall under the definition of “financial institution” under the Financial Action Task Force (“FATF”) international standards on AML/CFT, and therefore would require to be licensed and regulated. Up until this time these activities have not been subject to licensing or comprehensive AML/CFT supervision in the Cayman Islands. These activities included Excluded Persons (“SIBL-EPs”), which were exempt from obtaining a licence pursuant to section 5(2) and schedule 4 of the Securities and Investment Business Law (as revised) (“SIBL”).
2. In 2017, the Cayman Islands was assessed by the Caribbean Financial Action Task Force (“CFATF”) against FATF international standards on AML/CFT where it was found that the Cayman Islands’ licensing and supervisory framework did not cover the full scope of financial and non-financial activities as required by FATF. Therefore, CFATF recommended that the Cayman Islands update and further expand the analysis of AML/CFT risks and vulnerabilities present in those parts of the financial sector that are subject to limited or no supervision, such as the SIBL-EP sector. As a result, in 2019, the Cayman Islands undertook a full risk assessment of SIBL-EPs.
3. The identification, collection and analysis of relevant data was conducted by a specialised working group under the umbrella of the Anti-Money Laundering Steering Group (“AMLSG”). The following agencies were represented in the working group: Anti-Money Laundering Unit, the Cayman Islands Monetary Authority (“CIMA”), the Department of Commerce and Investment, and the Ministry of Financial Services and Home Affairs, along with support from an international consulting firm.
4. This report presents the findings on risks associated with SIBL-EPs, based on data collected from SIBL-EPs relating to their customers, products and services, delivery/distribution channels and geographic exposures, and considers the risk mitigating factors currently in place. The report also discusses the measures recently taken by the Cayman Islands to further decrease the risks associated with SIBL-EPs.
5. In June 2019, the Cayman Islands amended the SIBL to bring SIBL-EPs under the authorisation and supervisory regime of CIMA. As a result, effective January 15, 2020, the SIBL-EP regime will no longer exist. All entities currently operating as SIBL-EPs are required to re-register with CIMA and provide information pertaining to their ownership and control structure by the January 15, 2020 deadline. From January 15, 2020 onwards, such entities will be known as “registered persons” and will be subject to an authorisation

and AML/CFT supervisory engagement similar to all other financial service providers under CIMA’s mandate. The purpose of this risk assessment is thus twofold – first, to address the recommendations set out in the NRA and the CFATF Mutual Evaluation Report (“MER”); secondly, to serve as a basis for CIMA’s risk based supervisory mandate from January 15, 2020 onwards.

6. Both the NRA and the 2019 MER found that the Cayman Islands, due to the lack of authorisation and supervision, and the resulting lack of data and information on the sub-sector, had not fully assessed the risks associated with SIBL-EPs and as such an in-depth risk analysis must be conducted with regards to this sub-sector.

## METHODOLOGY

7. In preparation for the risk assessment, CIMA conducted a comprehensive data collection exercise for all SIBL-EPs during 2019 in order to gather data on customers, products/services, geographic exposure and delivery channels to assess the risk in these four categories. Of the 2,372 SIBL-EPs registered with CIMA, 94% provided a response to the data request, resulting in a comprehensive representation of the sub-sector.
8. The sub-sector was assessed against these factors alongside factors that increase or decrease risks, as follows:

Risk factor	Higher Risk	Lower Risk
The nature and size of the sector	<ul style="list-style-type: none"> <li>· High value of assets under management coupled with high volumes of transactions executed.</li> <li>· International transactions.</li> <li>· Number of clients.</li> <li>· No physical presence.</li> <li>· Parent company, affiliate or subsidiary in higher risk jurisdictions.</li> <li>· Principal place of business in higher risk jurisdictions.</li> </ul>	<ul style="list-style-type: none"> <li>· Low value of transactions.</li> <li>· Low volume of transactions.</li> <li>· No assets under management.</li> <li>· No clients (i.e. have not commenced business yet).</li> </ul>
Customer types	<ul style="list-style-type: none"> <li>· Trusts.</li> <li>· High net worth persons with KYD\$4 million.</li> <li>· Sophisticated.</li> <li>· Politically Exposed Person.</li> <li>· Non-profit organizations.</li> <li>· Corporates/financial institutions in higher risk jurisdictions.</li> <li>· Nominees.</li> <li>· Special purpose vehicles.</li> </ul>	<ul style="list-style-type: none"> <li>· Governments/public sector not from high-risk countries.</li> <li>· Financial institutions not from high-risk countries.</li> <li>· Non-financial institutions not from high-risk countries.</li> </ul>
Transactions, products and services	<ul style="list-style-type: none"> <li>· High complexity, high liquidity and/or volatile products such as shares, options, futures, contracts for differences.</li> <li>· Broker-dealers</li> <li>· Maker makers</li> <li>· Securities managers</li> </ul>	<ul style="list-style-type: none"> <li>· Low complexity securities such as instruments creating or acknowledging indebtedness, instruments giving entitlements to securities and certificates representing certain securities.</li> <li>· Advisory services solely.</li> <li>· Arranger services solely.</li> </ul>

	<ul style="list-style-type: none"> <li>· Forms of payment such as the acceptance of physical cash, travellers cheques, bearer shares, prepaid cards, virtual currencies or third party payments.</li> <li>· Acceptance of clients via the use of online platforms.</li> </ul>	<ul style="list-style-type: none"> <li>· Client base that consists of funds licensed or registered in the Cayman Islands.</li> </ul>
Distribution/delivery channel	<ul style="list-style-type: none"> <li>· Non face-to-face / no direct customer interaction</li> <li>· Use of intermediaries and eligible and non-eligible introducers / reliance on a third party.</li> </ul>	<ul style="list-style-type: none"> <li>· Face-to-face contact not from high-risk countries.</li> <li>· Intragroup referrals.</li> </ul>
Country risk	<ul style="list-style-type: none"> <li>· Customers based in/controlled or owned by persons based in high-risk jurisdictions.</li> <li>· Transactions coming from or going to high-risk jurisdictions.</li> <li>· Large overseas customer base.</li> </ul>	<ul style="list-style-type: none"> <li>· Customers based in countries with robust AML/CFT systems.</li> <li>· Transactions carried out in and/or with countries with robust AML/CFT systems.</li> </ul>

9. To allow for a structured analysis of this data, it was necessary for the working group to define the term “high risk jurisdiction.” Countries with weak or insufficient AML/CFT measures present a clear ML/TF risk as do countries associated with high degrees of bribery and corruption, tax evasion, terrorism, conflict zones and organized crime. The countries focused on for the purposes of this analysis were therefore those on the FATF list of High-Risk and Other Monitored Jurisdictions,<sup>1</sup> countries against which the United Nations has imposed sanctions<sup>2</sup>, and the first 20 countries on the Basel AML Index, issued by the Basel Institute on Governance<sup>3</sup>.

10. The rating scale used to determine inherent risks for the purpose of this exercise is as follows:

low	0 - 10%;
medium-low	11 - 30%;
medium-high	31 - 60%;
high	61% or more;

11. The results of the risk assessment confirm the original findings in the 2015 NRA whereby the SIBL-EPs sub-sector carries a medium-high risk and affirms the decision taken by the Cayman Islands government to bring the sub-sector within CIMA’s authorisation and AML/CFT supervisory framework.

<sup>1</sup> <http://www.fatf-gafi.org/countries/#high-risk>.

<sup>2</sup> <https://www.un.org/securitycouncil/sanctions/information>

<sup>3</sup> <https://www.baselgovernance.org/basel-aml-index/public-ranking>

12. When breaking down the sub-sectorial risk allocation into structural, customer, product/service, delivery channel and geographic risks, the following inherent risk ratings are assigned:

<b>Structural Risks</b>	<b>High</b>
Customer Risks	Medium-high
Product/Service Risks	Medium-high
Delivery Channel Risks	Medium-high
Geographic Risks	Medium-low
<b>Overall</b>	<b>medium-high</b>

13. As a means of reducing risk in the sub-sector, CIMA will include the re-registered population into its supervisory framework which would include higher degrees of supervision towards those SIBLs that cater to the high risk aspects of the business. It is to be seen how the size and make-up of the sub-sector changes after the transition period has expired in January 2020.

## ANALYSIS

### Structural Risks

14. The SIBL is the main law regulating the securities industry in the Cayman Islands and sets out CIMA's mandate in regards to SIBL licensed entities. Schedule 4 of the SIBL captures persons conducting activities under any of the following circumstances whom are required to be registered under the SIBL<sup>4</sup> as follows:
- a. A company within a group of companies carrying out securities investment business exclusively for one or more companies within the same group (45 SIBL-EPs solely fall in this category);
  - b. A person carrying on securities investment business exclusively for: (1) a sophisticated person, (2) a high net worth person, or (3) a company, partnership or trust, whether or not regulated as a mutual fund, of which the shareholders, unit holders or limited partners are one or more such sophisticated person or high net worth person. Where circumstance (3) applies, the SIBL EP must have a registered office in the Cayman Islands for which services are provided by a person or entity licensed to provide such services (2213 SIBL-EPs solely fall under this category); and
  - c. A person who is regulated in respect of securities investment business by a recognised overseas regulatory authority in the country or territory (other than the Islands) in which

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<sup>4</sup> At the time of the NRA and prior to June 2019, there were 6 categories under Schedule 4. Three categories were excluded and were required to register with the Authority as SIBL-EP and three categories were exempt and were never required to be registered with the Authority. The revised SIBL, which was gazetted in June 2019, now makes a clear distinction so that the exempt persons now fall under the three categories pursuant to schedule 2(A) as non-registrable persons pursuant to the SIBL, while Schedule 4 of the SIBL captures persons required to be registered as opposed to licensed under the SIBL.

the securities investment business is being conducted (49 SIBL-EPs solely fall under this category).

15. Where there are grounds for exclusion from the licensing obligation under the SIBL, a risk differentiation has to be made between persons excluded from the scope of the SIBL based on categories (a) and (c) and for (b). Persons excluded based on the circumstances listed in category (a) pose a low risk of ML. This low risk is attributed to the fact that the business they conduct is purely intra-group business; in other words that the person conducting the activities does not operate *for or on behalf of a customer*. Persons excluded from the scope of the SIBL based on category (c) are considered to have a medium-low risk as they are licensed or regulated in a recognised foreign jurisdiction.
16. The SIBL-EPs at the focus of this risk assessment are those 93% excluded from the licensing obligation based on category (b) as these are exposed to a high inherent risk based on the purpose for which they were set-up. Given the large percentage of SIBL-EPs falling in the high-risk category of (b), the sub-sector displays a higher level of inherent structural risk exposure.

## **Customer Risks**

17. *Geographic aspects:* SIBL-EPs reported a total of 22,801 customers, 70% of which predominantly originate from five countries, namely the Cayman Islands (27%), Brazil (21%), USA (12%), China and Peru (5% each). Less than 1% of all customers are from higher risk jurisdictions (other than China). Thirty-seven SIBL-EPs reported that they do not service customers, which could mean they either have not yet commenced operations or they are a family office.
18. *Customer-categories:* Of all 22,801 customers reported, approximately 63% are considered to fall within the following medium-high risk categories: natural persons (9,665), corporate entities (3,012), trusts (237), nominees (12), special purpose vehicles (1,429), and NPOs (83). Adding a geographic component to this analysis, approximately 1,413, or 6%, of all customers are medium-high risk type customers that originate from a high-risk jurisdiction, whereby China by far outnumbers other high-risk jurisdictions. Therefore, 6% of all customers are classified as high-risk customers. The remaining 13,025, or 57%, of all customers falling in the above cited categories are medium-high risk. Approximately 23% of the customer base falls within any of the following low risk categories: governments or public authorities (87); financial institutions (4,234), or non-financial institutions (1,019). A remaining 148 customers are located in a high-risk jurisdiction and therefore carry a medium-high inherent risk despite their status as financial institution, designated non-financial business, profession, or government. It should be noted that the responses from the SIBL-EPs did not include a detailed breakdown for 14% of all customers.

19. *Customer-specific circumstances:* Of the 22,801 reported customers, 890, or about 4%, were reported to have a net worth in excess of KYD4M, with 141 of these high net worth individuals originating from high-risk jurisdictions. An additional 3,180 customers were reported to qualify as sophisticated persons under SIBL<sup>5</sup> despite not being considered as high net worth individuals, with 169 of the sophisticated persons originating from a high-risk jurisdiction. Responses indicated that 340 customers of Cayman Islands SIBL-EPs have PEP status, 9 of which are from a high-risk jurisdiction. All PEPs, high net worth individuals and qualified investors that originate from a high-risk jurisdiction are considered to be higher risk, resulting in a total of 1,390 high-risk customers based on this category.
20. *Conclusion on Customer Risks:* Approximately 2,812 (12%) customers of SIBL-EPs fall under the high-risk customer category, including the 890 high net worth individuals, 340 PEPs, 1,413 customers posing a high risk based on the categories they fall under coupled with their ties with a high-risk jurisdiction, and those 169 qualified investors from a high-risk jurisdiction. Approximately 58% of all customers fall in the medium-high risk category based on their status as corporate vehicle, individual, trust, nominee, SPV or NPO or due to their geographic features despite being qualified as falling in a low risk customer category. In summary, the data shows that the sub-sector displays a medium-high inherent customer risk exposure. As a next step, through CIMA's risk-based approach, those SIBL-EPs that cater more extensively to a high-risk customer base will be identified and enhanced supervision will be implemented as a means of risk mitigation.

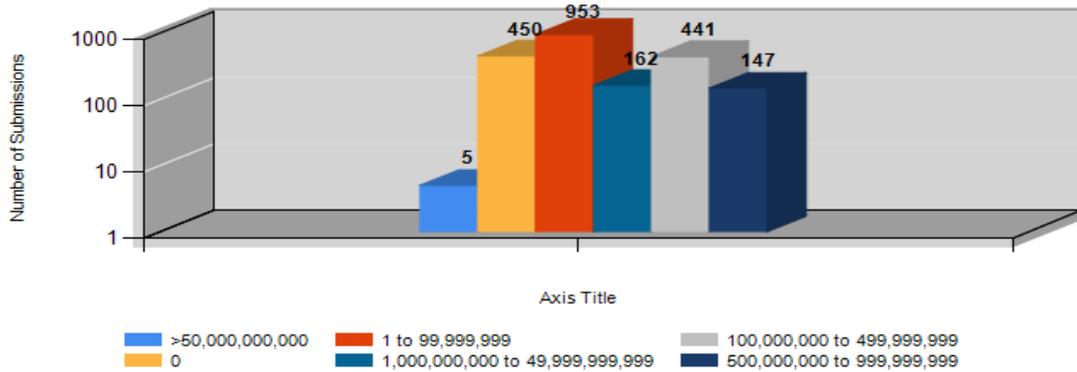
## **Product and Service Risks**

21. *Assets under Management:* As of September 2019, a total of \$1.266 trillion in assets were under management by SIBL-EPs. Almost half of SIBL-EPs responding to the data request reported approximately 100 million USD under management. Of all respondents, 6% indicated that they would manage between 500 million and one billion USD in assets, and 7% reported to have more than 1 billion USD under management. Therefore, based on the responses received from the sub-sector, 13% of SIBL-EPs hold approximately 14% of all assets under management and as such would qualify as high risk compared to the rest of the population based on the overall value of assets under management.

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<sup>5</sup> The term "sophisticated person" is defined under the SIBL to cover any of the following: a person (a) regulated by the Authority; (b) regulated by a recognised overseas regulatory authority; (c) any of whose securities are listed on recognised securities exchange; or (d) who (a) by virtue of knowledge and experience in financial and business matters is reasonably to be regarded as capable of evaluating the merits of a proposed transaction; and (ii) participates in a transaction with a value or in monetary amounts of at least \$80,000 or its equivalent in any other currency, in the case of each single transaction.

**TOTAL NUMBER OF SUBMISSIONS OF ASSETS UNDER MANAGEMENT WITHIN THE PAST 12 MONTHS**



22. Of the various types of activities SIBL-EPs indicated to be engaged in, CIMA considers that the services of broker/dealer (1% of SIBL-EP population), market maker (0.6% of SIBL-EP population) and securities manager activities (57% of the SIBL-EP population) constitute a high risk as these type of service providers have the greatest level of discretion coupled with funds management authority. Providing services in the function of securities advisor (19%) or securities arranger (5%) is considered medium-low risk as those services, by definition, do not involve any trading activities or cash management.
23. From a product perspective, trading in shares, options, futures and contracts for differences pose a high risk because of their greater level of volatility, trading volume, and market leveraging implication. Instruments creating or acknowledging indebtedness or giving entitlements to securities and certificates representing certain securities pose a medium-high risk. Of all respondents, 55% indicated that the services they provide relate to at least one of the high-risk instruments, namely shares. All other instruments seem to be utilized by about 25% of the sub-sector.
24. Based on these classifications, 57% of SIBL-EPs fall in high-risk service categories, and 55% in the high-risk product category. In summary, the data shows that the sub-sector thus displays a medium-high inherent product/service risk exposure.

**Delivery Channel Risks**

25. Information was sourced from SIBL-EPs on the channels used to onboard clients and on payment methods.
26. *Client Onboarding Channels:* SIBL-EPs reported that about 50% of customers were onboarded directly by the SIBL-EP, of which 90% by way of face-to-face interaction deemed to be lower-risk. An additional 3% were onboarded by way of an intra-group referral, which is a lower risk method when assuming a greater level of group-oversight and control over the customer and business relationship. Based on data provided, of all clients onboarded by way of a low risk methods, face-to-face or intra-group methods,

1,244 or 5% stem from a high-risk jurisdiction and would thus constitute high risk despite the lower-risk onboarding channel being used.

27. About 1,300 customers were onboarded directly through a medium-risk direct, non-face-to-face contact. An additional 1,228 SIBL-EP customers were onboarded using an eligible introducer. Of all customers onboarded through an eligible introducer, 591 or 2% originate from a high-risk jurisdiction and would thus constitute higher risk despite the medium-risk onboarding channel used.
28. Approximately 1% of customers were onboarded by way of a non-eligible introducer<sup>6</sup>, which constitutes a high-risk onboarding method. Furthermore, 1% of SIBL-EPs indicated that they would utilize high-risk online platforms to onboard customers and the geographic region of these clients was predominantly China.
29. *Payment Channels Used:* The main payment channel used by SIBL-EPs are international wire transfers. In terms of both value and volume of transactions this method poses a medium-high inherent risk. Some respondents advised, by way of ranking, that they would accept physical cash (0.6%) third-party payments (0.5%), virtual currencies (0.2%), travellers' cheques (0.2%), pre-paid cards (0.2%) and bearer shares (0.2%), all of which would constitute a high payment channel risk.
30. In conclusion, the sub-sector displays a medium-high inherent risk based on the delivery channel category, with approximately 10% of all customers qualifying as high-risk, and the majority of SIBL-EPs falling in the medium-high risk category based on payment channel risk factors. SIBL-EPs relying on non-eligible introducers or online platforms or utilising higher risk payment channels display a high inherent risk and will be focused on as part of the supervisory engagement.

## Geographic Risks

31. *Shareholder and management aspects:* From an ownership and controls perspective, the sub-sector seems to be heavily utilised by persons from the far-East, followed by the USA and UK, and in the context of domestic business, the Cayman Islands. SIBL-EPs reported a total of 2,557 shareholders, predominantly located in the Cayman Islands (18%), followed by Hong Kong (15%), the British Virgin Islands (11%), China (9%), the USA (7%) and the UK (7%). A total of 1.6% of shareholders were reported to be nationals of high-risk jurisdictions (other than China). The control structure of SIBL-EPs closely mirrors that of the ownership, with a total of 2,390 controllers also originating from Hong Kong (21%), followed by the Cayman Islands (13%), China (11%), USA (8%), the UK (7%), and the British Virgin Islands (5%). A total of 1.5% of customers were reported to be located in a high-risk jurisdiction (other than China). Of the SIBL-EPs that provided responses to the data request, 82% indicated ties with associated entities (parent company,

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<sup>6</sup> An entity outside of the entity's group which does not qualify as an eligible introducer per the AML Guidance Notes.

affiliate or subsidiary) located in the Cayman Islands (27%), followed by Hong Kong (14%), the US Virgin Islands (9%), the USA, the UK and China (6% each). About 1.7% of associated entities are located in high-risk jurisdictions other than China.

32. *Customer aspects:* The geographic exposure of the sub-sector has already been discussed to some extent as part of the customer risk analysis, indicating customers in Brazil, China/Hong Kong, the US, Peru and the Cayman Islands, and an only small number of customers from high-risk jurisdictions other than China.
33. *Funds flow aspects:* In addition, SIBL-EPs were requested to provide information on the jurisdictions their client's funds are either received from or transferred to. The main destinations for client funds were reported to be the Cayman Islands, followed by Hong Kong, the USA and Singapore. About 20% of respondents reported a high-risk jurisdiction to constitute the destination jurisdiction of client funds', with China featuring most prominently. For client funds transferred out, the jurisdictions of origin were identified as the Cayman Islands, followed by Hong Kong, USA, UK, Singapore and Switzerland. Of all respondents, 4% reported a high-risk jurisdiction to be the originator of client funds, again with China being on top of the list.
34. *Conclusion on Geographic Risks:* The geographic breakdown reported by the sub-sector illustrates that SIBL-EPs are used by persons and entities all over the world to conduct business but closer direct ties can be identified with China/Hong Kong, the USA, the UK and the Cayman Islands itself. Some direct ties with high-risk ML countries other than China exist, but to a lesser extent. All those SIBL-EPs with direct ties to a high-risk jurisdiction, whether by way of customers, owners/controllers, by way of affiliates/subsidiaries/parent companies, or by way of the products and services they provide, are considered to be high-risk from a geographic perspective and will be the focus of CIMA's supervisory engagement. From purely a funds flow perspective, the sub-sector displays a medium-low inherent geographic risk.

## **MITIGATING MEASURES**

35. SIBL-EPs have been subject to the scope of the POCL since 2004 therefore the Cayman Islands AML/CFT legislation applies. Since the adoption of the MER in November 2018, a range of significant mitigating measures have been implemented for the sub-sector. These measures include the amendment of the SIBL in June 2019 to bring SIBL-EPs under the authorisation and supervisory regime of CIMA. Effective January 15, 2020, SIBL-EPs will no longer exist as a sub-sector of SIBL. Until that date, all entities currently operating as SIBL-EPs are required to re-register with CIMA and must provide information for the assessment of fitness and propriety of shareholders, beneficial owners, directors and officers. From January 15, 2020 onwards, such entities will be known as "registered persons" and will be subject to an authorisation and AML/CFT supervisory engagement similar to all other financial service providers under CIMA's mandate. As the transition process is ongoing, the rating for the sub-sector as outlined in

this report refers only to the inherent risks and does not take into account the mitigating measures in place.

36. In May 2019, a comprehensive AML/CFT questionnaire was sent to all SIBL-EPs, with an impressive response rate of 94%. In addition, annual declaration forms were required to be filed by each SIBL-EP, providing information on the ownership, the control structure, and the business activities conducted.
37. Since the CFATF assessment, CIMA required 88 SIBL-EPs to conduct an external AML audit based on Section 17 of the SIBL. The entities were chosen based on risk criteria such as the existence of adverse media/information and a lack of association with the regulated sector. These entities also included those SIBL-EPs operating from the Cayman Island Special Economic Zone. In respect of the 88 cases, CIMA is monitoring the remediation of the relevant SIBL-EPs to address negative findings identified in their respective audit reports and also to conduct further analysis of the information provided on the entity.