

National Risk Assessment of Money Laundering and Terrorist Financing (ML/TF) in the Special Economic Zone

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 a number of activities that would qualify a person/entity to fall under the definition of “financial institution” under the FATF standards, and therefore are required under FATF to be licensed and regulated, are not subject to licensing or AML/CFT supervision in the Cayman Islands. One of the examples given in the NRA were entities operating within the Cayman Islands Special Economic Zone (SEZ).

2. In 2017, the Cayman Islands was assessed by the Caribbean Financial Action Task Force (CFATF) against the international standards on AML/CFT and it was found that the Cayman Islands’ licensing and supervisory framework did not cover the full scope of financial and non-financial activities as provided by the FATF, and accordingly, that the Cayman Islands was not properly assessing the risks associated with such unregulated and unsupervised activities. The CFATF therefore recommended that the Cayman Islands update and further deepen the analysis on AML/CFT risks and vulnerabilities present in those parts of the financial sector that are subject to limited or no supervision, including companies operating in the SEZ.

3. To address both the findings in the NRA and the CFATF report, the Cayman Islands in 2019 undertook to fully assess the ML/TF risks faced by the jurisdiction.

4. In relation to the risk assessment of the Special Economic Zone, the identification, collection and analysis of relevant data was conducted by a specialized working group under the umbrella of the Anti-Money Laundering Steering Group (AMLSG), with support from an international consulting firm. 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 (DCI), and the Ministry of Financial Services and Home Affairs.

5. This document discusses the findings relating to ML/TF risks associated with entities operating within the SEZ. Data used included administrative data collected from the DCI and the Special Economic Zone Authority and the data collected by CIMA for its sector risk assessment of persons excluded from the licensing requirement under the Securities and Investment Business Law (SIBL-EPs).

II. Introduction

6. The Cayman Islands Special Economic Zone Law (SEZ Law) was first adopted in 2011, allowing for the establishment of Special Economic Zones (SEZs) by way of Cabinet Orders, and establishing the SEZ Authority as the licensing and oversight authority. The

government's motivation for allowing for the creation of SEZs was to boost investment and attract new industries to the Cayman Islands relating to technology, science and international trade, to diversify the domestic economy, and create stimulus to employment and skills development opportunities for the domestic population.

7. Exemption from taxation, an easement of immigration and employment laws and permits, certain benefits under the customs laws, speedy property management services and the development of high-tech infrastructure and technology were planned as incentives for new businesses and industries to settle in the SEZ. Section 11 of the SEZ Law provides that for some Parts VII and VIII of the Companies law and Section 201 (f) of the Exempted Limited Partnership Law, SEZ companies are considered to be outside of the Islands and not in the Islands. In addition, SEZ companies are exempted from a range of laws prescribed in Schedule 3, including the Trade and Business Licensing Law, the Local Companies (Control) Law, the Electronic Transactions Laws, the Land Acquisition Law and from tax, duties and fees levied by or on behalf of the Cayman Islands Government. All others laws in force in the Cayman Islands fully apply in the SEZ, including the Proceeds of Crime Law, the Anti-Money Laundering Regulations, the Banks and Trust Companies Law, the Beneficial Ownership (Companies) Regulation, the Companies Management Law, the Insurance Law, the Securities and Investment Business Law, as well as all aspects of domestic civil, criminal and criminal procedures law.

8. To process licenses and grant SEZ permissions, the SEZ Law created a new "Special Economic Zone Authority" to serve as a liaison between SEZ companies and the Cayman Islands Government. The SEZ Authority, pursuant to Section 5 of the SEZ Law, is tasked, amongst other items, with the examination and processing of all applications with the SEZ; to enforce compliance with the financial services procedures and other requirements for preventing the unauthorized use of approved special economic zone activities; and to suspend or revoke the trade certificate of a special economic zone enterprise which is in contravention of this law or any other law in force in the islands. According to Section 3(2) of the SEZ Law, the SEZ Authority comprises of 9 members, of which in practice 6 are private sector representatives.

9. The SEZ Authority is assisted by the DCI, which serves as a secretariat to the SEZ Authority pursuant to Section 4 SEZ Law. As secretariat, the DCI is tasked with undertaking the day to day administration of the SEZ Authority, to keep minutes of meetings, decisions, and proceedings of the SEZ Authority, and to process applications for registration with the SEZ or for relevant permits and facilities.

10. The first and as of 2019 only SEZ, called the Cayman Enterprise City (CEC), was established in 2011 to attract international service-, knowledge-, and technology-based businesses. Currently, the CEC is housed in four buildings in George Town, with a new site having been designated and office buildings being currently constructed.

General Features of SEZ Companies

11. The CEC comprises a total of 7 parks, each devoted to a specific industry. As of August 2019, a total of 240 companies were operating out of the CEC parks as follows:

- The Internet Park (117 companies);
- The Media Park (37 companies);
- The Science and Technology Park (21 companies);
- The Commodities and Derivatives Park (54 companies);
- The Outsource Park (no company);
- The Academic Park (no company); and
- The Maritime and Aviation Services Park (11 companies).

12. The Special Economic Zone (Cayman Enterprise City) Order (2019 Revision) defines in very general terms the types of activities that may be conducted in each park. When comparing the description of activities in the Order with the FATF definitions of “financial institution” and “designated non-financial business and profession,” it appears that the Commodities and Derivatives Park and the Maritime and Aviation Services Park explicitly allow for businesses to offer services that fall under the FATF definition and thus are required, under international standards, to be licensed, regulated and supervised, namely:

- Commodities and derivatives fund management and advisory services;
- Security and commodity contracts brokerage or proprietary trading for own account;
- Buying and selling of commodities, derivatives, futures and options products;
- Shipping financiers; and
- Freight trading and brokerage businesses.

13. For the other parks, the SEZ Order does not explicitly permit FATF covered activities to be carried out but the permitted activities in the parks as prescribed in the Order are vague and leave room for interpretation.

14. Companies registered with the CEC are not permitted to conduct business domestically, except for the limited purposes that are ancillary to or in furtherance of business carried on outside the Islands. Schedule 3, Section 5 (d) of the SEZ Regulations (2018 Revisions) provides that companies registered in an SEZ are expected to maintain a physical presence in the Cayman Islands. The aim of these provisions was to ensure that new, international business is attracted to physically locate in the Cayman Islands but without competing with the local economy.

15. Schedule 3, Section 5(e) of the SEZ Regulations (2018 Revisions) further provides that a company registered in an SEZ may not be involved in the provision of financial services that require a license or other approval or oversight by CIMA, except for activities in the CEC’s Commodities and Derivatives Park. Schedule 2 of the Special Economic Zones

(Cayman Enterprise City) Order further provides that no entity licensed by CIMA may obtain a trade certificate for the CEC to conduct activities for which a license is required. A comparison of CIMA licensees with DCI registered SEZCs confirmed that as of June 2019, no entity currently licensed by CIMA is operating out of any park within the SEZ, including the Commodities and Derivatives Park.¹ If such a case were to arise, from a legal perspective CIMA would have all the same powers in respect of licensed entities operating in the SEZ that it has in relation to license holders outside the SEZ. The issue may become of relevance in relation to virtual currency service providers, for which the Cayman Islands Government is in the process of putting in place a supervisory system.

Inherent Risks of SEZ Companies

16. For the Commodities and Derivatives Park, of the 54 registered companies, 18 are SIBL-EPs. They are subject to the full set of AML/CFT obligations as set out in the POCL and AML Regulations and from 2020 on will be subject to full supervision by CIMA. SIBL-EPs operating within the CEC do not differ in terms of their product and service risks from those operating outside the CEC as the conditions for obtaining and maintaining the exempt status under the SIBL are the same for SEZ companies and companies operating outside the CEC. As such the inherent risks associated with activities of SIBL-EPs is the same within and outside the SEZ. For the remaining 36 companies, companies mostly engage in securities business on their own behalf and not for or on behalf of a customer, which results in the SIBL not being applicable. As such, they would appear to be operating outside the definition of the FATF standard, which covers only financial activities conducted for or on behalf of a customer.

17. The Maritime and Aviation Services Park allows for businesses to offer a wide range of services, a small portion of which – namely shipping financiers – would fall under the FATF’s definition of “financial institutions” if conducted as a business and on behalf of a customer. Accordingly, international standards would require both licensing and supervision of such activities. In practice, it does not appear that any of the currently 11 companies operating in this park do, in fact, undertake financial activities as defined by FATF.

18. For the Internet Park and Science and Technology Park, Schedule 3, Section 5 (e) of the SEZ Regulations (2018 Revisions) does not cover the issuance or trading in bitcoins or other virtual currencies as one of the activities permitted from the park. Yet, 19 companies in the internet park seem to be involved in activities that may potentially involve bitcoins or virtual currencies.² Since June 2019, the provision of virtual asset services on behalf of a customer is an activity required by FATF to be licensed and supervised. As a result, the Cayman Islands extended the scope of the POCL to cover virtual asset providers and is in the

¹ A number of cases were identified, however, where a SEZ company was structurally connected with a CIMA licensee.

² Operators in the SEZC include Ripio, one of the biggest crypto companies offering wallet, credit and online payment and loan services using a virtual currency called Ripio ICO token; and the Digital Mint Group, a large bitcoin mining company. Other companies that seem to be conducting activities covered by the FATF standards are Vertalo SEZC, UP Global SEZC, Kowala SEZC, Exposition Park Holdings SEZC, Superbloom Network, GoNetwork, and StormX.

process of putting in place a market entry and supervisory system for such service providers, covering also those operating from within the SEZ.

19. Under the SEZ Order, activities permitted to be conducted from the media park, the outsource park, the academic park do not appear to fall under the definition of “financial institutions”. The activities undertaken in those parks relate mostly to research, scientific and technical services, and thus constitute a low risk. 37 companies operate out of the media park. No companies are registered in the academic and outsource parks.

Mitigating Measures for the SEZ

20. To apply with the CEC, an applicant must first be established under Cayman law as a regular Exempted Company (EC) or Exempted Limited Partnership (ELP) under the Companies Law or the Exempted Limited Partnerships Law, respectively, and be registered with the Registrar of Companies. Once that process has been completed, the EC or ELP must enter into a facility contract with the Cayman Enterprise Company, which is the private company designated by law as the developer of the CEC. The facility agreement is filed by the EC or ELP as part of its application to the SEZ Authority for issuance of a Trade Certificate. A letter by a Cayman lawyer or TCSP has to be filed as part of the application, certifying that the customer has been onboarded subject to full due diligence measures, and indicating the park that would seem most appropriate in line with the applicant’s primary business.

21. As part of the approval process, DCI in its function as secretariat to the SEZ Authority receives and reviews the application. For all applications, DCI conducts a full due diligence checks on all natural and legal persons that appear in the application, including those indicated as beneficial owners, in line with Schedule 3 Section 6(2) of the Special Economic Zones Regulations (2018 Revision). The due diligence check involves searches of databases such as Worldcheck and Lexis Nexis, and open source internet searches. DCI further queries for civil or criminal proceedings against an applicant or beneficial owner and any OFAC, EU or UN issued sanctions lists. DCI then compiles a due diligence report, outlining all the findings resulting from the search for the board’s attention, and indicating whether DCI considers that there is any ground to believe that the information and documents provided by the applicant are inaccurate or unreliable.

22. Based on the DCI’s report and any other supporting documents, the SEZ Authority decides whether to approve the application and grant a trade certificate. If the Licensing Committee is satisfied that the applicant is appropriate for inclusion in one of the parks based on its main activities, it will issue the trade certificate with validity for 5 years, resulting in the registration of the applicant as a SEZ company, at which point the company will carry the initials SEZC as part of its name. In February 2019, the Board resolved to amend the applications process so that it would be informed by a risk assessment of applicants, with higher risk entities being subject to more rigorous screening by DCI and the application being considered by the full SEZ Board in addition to the Licensing Committee. As of June 2019, this risk assessment process had not yet been implemented. After the expiration of the trade

certificate, the company has to apply for a new trade certificate and undergo the full process again.

23. In practice, the SEZ Authority relies on the representations of the lawyer or TCSP through which a company files its application with the SEZ Authority relating to the activities intended by the applicant to be conducted from the park, and the park that the applicant is considered to fit in best. At times, this description of the business is provided in general terms. Applications are valid for 5 years, with no information being filed in between, including in cases where the nature or type of business activities may have changed. These factors make it difficult for the SEZ Authority to determine from the information obtained whether applicants or registered companies conduct activities permitted under the SEZ Order; whether the activities would in fact be required to be licensed and supervised; and more generally, to determine the associated reputational risk for Cayman Islands.

24. Neither the SEZ Law nor the SEZ Order provides a conclusive list of approval or refusal criteria. Based on the general language of Schedule 3 of the Special Economic Zones Regulations (2018 Revision), the SEZ Authority has the power to refuse new applications based over concerns of ML or TF but does not have the power to revoke existing licenses over criminal allegations or suspicions or as a result of regulatory or disciplinary action. It is also not clear from the law whether the SEZ Authority may refuse applicants in cases where a civil lawsuit was filed against or an associated judgment or settlement agreement involved the applicant. As of June 2019, a total of 5 applications had been denied.

25. A further mitigating measure under the SEZ Law is the requirement for SEZ companies to have an office lease agreement with the CEC and at least one registered employee. In practice, employment records provided by the CEC indicate that the vast majority of SEZ companies have only one employee in the Cayman Islands, leading to the conclusion that SEZ companies either do not have their main operations in the Cayman Islands or are very small operations. The local presence requirement still does have a mitigating effect on the risks involved with the SEZ as for every company there is a responsible person present and accountable in the Cayman Islands.

Conclusion for SEZ

26. The inherent risks associated with companies operating in the SEZ do not differ in any way from those associated with companies operating outside the SEZ. From the perspective of mitigating measures, all criminal, civil and regulatory laws in CI apply equally to SEZ and non-SEZ companies.

27. In practice, the SEZ Authority is allowed only limited insight into the activities conducted from the CEC. The licensing and oversight process by the SEZ could be strengthened in order to mitigate the risks associated with FATF regulated activities.

28. To address this, the Cayman Islands should consider whether to either revise the SEZ Order to more precisely define the types of activities that may be carried out from the SEZ,

taking caution to not permit the conduct of FATF covered activities that are not subject to licensing and supervision in the Cayman Islands; **OR** ensure that persons and businesses conducting, as a business and for another person, any FATF defined activities from the SEZ are properly identified, licensed and supervised for AML/CFT in the Cayman Islands.