Mutual Fund Administration (“MFA”) Sector Risk Assessment – December 2019

**Introduction**

## The purpose of this MFA Sector Risk Assessment conducted by the Cayman Islands Monetary Authority (CIMA) was to identify and assess the Money Laundering/ Terrorist Financing (“ML/TF”) risks faced by licensed mutual fund administrators in the Cayman Islands. Identifying the risks is the first step in the development and application of a risk-based approach to compliance and thus towards combating ML/TF. The Cayman Islands’ MFA sector is considered to be a part of the securities sector and is comprised of regulated, unregulated or exempted institutions and instruments. The focus of this sector risk assessment is on the regulated institutions, specifically mutual fund administrators.

## Under the Cayman Islands Anti-Money Laundering Regulations, mutual fund administrators are required to take steps to identify, assess, and understand their ML/TF risks in relation to customers, geographic areas, products, services and transactions, and delivery channels; and to align all aspects of their internal controls and procedures with their risk understanding, including customer due diligence procedures, transaction monitoring systems, and the independent audit function. This sectoral risk assessment is aimed to inform mutual fund administrators’ efforts with regards to their business-wide risk assessment and the development of a risk-based approach to compliance with the Anti-Money Laundering Regulations (2020 Revision).

## Assessing the risks within each supervised sector also enables CIMA to efficiently allocate its resources. On a national level, the MFA Sector Risk Assessment will further enhance the Cayman Islands´ risk understanding and inform and assist policy making and supervision in the area of Anti-Money Laundering/Counter-Financing of Terrorism (“AML/CFT”).

## In addition to the data sources utilized for the CIMA 2017 AML/CFT Sector Specific Risk Assessments, a number of key data points have been analyzed and taken into account to further strengthen the quantitative elements of this MFA Sector Risk Assessment:

## The National Risk Assessment;

## International guidance documents such as the *Guidance for a Risk-Based Approach for the Securities Sector* and the *National Money Laundering and Terrorist Financing Risk Assessment[[1]](#footnote-1)*;

## Annual AML/CFT reporting data from MFAs (more granular submissions)

## Supervisory judgment and expertise by CIMA staff;

## Discussions with industry representatives and consultants; and

* Various guidance documents issued by CIMA[[2]](#footnote-2).

## The MFA Sector Risk Assessment is not intended to cover risks that may be specific to the circumstances of individual mutual fund administrators but evaluates risks from a sectoral perspective. The MFA Sector Risk Assessment also does not assess any types of risks other than those relating to ML or TF.

**Risk Assessment Methodology**

## The MFA Sector Risk Assessment examines the inherent ML/TF risks that licensed mutual fund administrators face. Inherent risk is the risk that a particular product/service, customer, delivery channel or activity poses, regardless of the entity that offers it and does not consider any risk mitigating controls that may be in place.

## This approach allows for the creation of peer groups and for the benchmarking of expected controls. The actual controls in place will vary significantly for each mutual fund administrator and are expected to be commensurate with the inherent risk that each mutual fund administrator faces.

## Risk factors in the following categories are considered for purposes of this ML/TF risk assessment:

## Nature size and complexity of the sector, including geographic factors;

## Types of customers;

## Transactions, products and services; and

## Delivery channels.

## For each of the listed risk categories, risk increasing and decreasing factors are listed in the below table and help guide the assessment of inherent ML/TF risks.

|  |  |  |
| --- | --- | --- |
| **Risk factor** | **Higher Risk**  | **Lower Risk**  |
| Nature, size, complexity of business | * High value of assets under administration
* Unregulated instruments
* Ownership structures, private vs public
* Funds with complex structures
* Parent company, affiliate or subsidiary in higher risk countries.
 | * Simple transactions
* Parent company, affiliate or subsidiary not from high-risk countries.
 |
| Geographic risk | * Services outsourced to countries where fund administration is not a regulated activity for the purposes of AML/CFT, or the AML/CFT systems are not robust.
* Customers based in countries with no equivalent AML/CFT legislation or in countries with political turmoil or high levels of corruption.
* Transactions carried out in or from high-risk countries
 | * Customers based in countries with robust anti-money laundering and counter financing of terrorism systems.
* Transactions carried out in or from countries with sound AML/CFT systems.
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| Customer types | * Legal persons and arrangements (companies, partnerships, trusts)
* Corporate clients
* High net worth individuals
* Nominee shareholders
* Non-bank financial institutions
* Politically Exposed Persons
* Trusts arrangements
 | * Governments/public sector not from high-risk countries.
* Financial institutions not from high-risk countries.
* Non-financial institutions not from high-risk countries
* Funds are regulated in countries that are not high-risk countries.
* Low volume of Investment Managers that are UBOs
 |
| Transactions, products and services offered | * High volume and value of subscriptions and redemptions
* High volume of transfers with high-risk countries
* Registrar and transfer agent (RTA) services
* Higher percentage of services to unregulated entities
 | * Low complexity – Net Asset Value (NAV) calculation services, and directorships.
* Low value of business transactions
* Low volume of AML/CFT services outsourced
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| Distribution/delivery channels | * Non-face to face/ no direct customer interaction
* Non-face to face through nominees
* Contacts through referral or Eligible introducers
 | * High level of face to face contacts
* Introducers are not from high risk countries
* Introducers who are regulated.
* Introducers are within a group structure.
 |

## To allow for a structured analysis of available data according to geographic exposure, it was necessary to define the term “high risk jurisdiction.” Countries with weak or insufficient AML/CFT measures present a higher ML/TF risk, as do countries associated with high degrees of bribery and corruption, tax evasion, terrorism, conflict zones and organized crime. Countries focused on for purposes of this analysis were therefore those on the FATF list of high-risk countries and other monitored jurisdictions,[[3]](#footnote-3) countries against which the United Nations has imposed sanctions[[4]](#footnote-4) and the first 20 countries on the Basel AML Index issued by the Basel Institute on Governance[[5]](#footnote-5).

## The abovementioned risk factors has been given one of the four risk ratings ***low, medium-low, medium-high, high***. This approach is in line with the CIMA 2017 AML/CFT Sector Specific Risk Assessments.

|  |  |
| --- | --- |
| low | unlikely |
| medium-low | possible |
| medium-high | likely |
| high | very likely |

## **Money Laundering (ML)/Terrorist Financing (TF) – Risk-Based Mitigation Measures**

## The Authority has taken several steps to mitigate the ML/TF exposures of its mutual fund administrator licensees. Some of these steps include:

* Enhanced risk-based supervisory framework, including risk assessment of licensees for their ML/TF exposure;
* Enhanced international corporation with overseas regulators;
* More AML/CFT focused onsite inspections; and
* AML/CFT Training and outreach programs focusing on the ML/TF risks specific to the sector.

**Description of the MFA Sector**

## In 2017, CIMA conducted sector specific risk assessments to identify the financial services sector’s inherent ML/TF risks. Each sector was rated against the five inherent risk areas recommended in the FATF 40 Recommendations. The sector specific assessment for the securities sector, inclusive of regulated mutual fund administrators, returned a rating of “Medium-High”.

## As at 30 November 2019, there were a total of 80 regulated mutual fund administrators, categorized into three types of mutual fund administration licences: Mutual Fund administration – Full (69) and Mutual Fund administration – Restricted (10) and Mutual Fund administration – Exempted (1).

## CIMA conducted a survey in December 2019 to enhance its assessment of the ML/TF exposure by the mutual fund administrators in the Cayman Islands. 81% of mutual fund administrators licensed with CIMA provided a response to the data request. The analysis conducted of the ML/TF risks for the mutual fund administrators as a sub-sector of the securities sector, results in an overall assessment of a medium-high risk rating for the sub-sector. This rating remains consistent with the rating in 2017, with similar factors such as the complexity of the underlying fund structures, the onboarding and vetting of investors through non-face-to-face channels, as well as the outsourced nature of services, having an impact on increasing the vulnerability to money laundering and terrorist financing risks. Considering the risks allocation into structural, customers, transactions products and services, delivery channel and geographic risks, the following inherent risk ratings are assigned:

|  |
| --- |
| **Mutual Fund Administrators** |
| Nature and Size: Medium High |
| Geographic: Medium - Low |
| Customers: Medium-Low |
| Transactions, products and service: Medium – High |
| Delivery channel: Medium-High |
| **Overall: Medium-High** |

**Risk Category- Nature, Size and Complexity of Business**

## Mutual fund administrators provide services to investment funds including processing subscriptions and redemptions, undertaking client due diligence and ensuring compliance with anti-money laundering procedures, processing dividend and transfer payments as well as reconciling and reporting fund transactions.

## Mutual Fund administrators include small single offices, as well as global operations, where, for example, registrar and transfer services (RTA) are provided in-house and net asset value calculation services (NAV) are outsourced to subsidiaries across the world. In some cases, there are several levels of outsourcing. While some mutual fund administrators have maintained the traditional services of RTA, NAV, principal office and registered office services, others have expanded to include Foreign Account Tax Compliance/Common Reporting Standards (FATCA/CRS) services, depositary lite[[6]](#footnote-6), directorship to funds and in recent years acting as AML Officers (MLRO, Deputy MLRO and/or AMLCO) to funds.

## The mutual fund administrators surveyed reported total asset under administration (AUA) of US$2.157 trillion. Total number of funds under administration was 16k of which 62% were unregulated. The total number of investors reported was 169k. 54% of these investors are associated with unregulated funds.

## In respect of the ownership and control structure for mutual fund administrators, 29% have parent companies located in the Cayman Islands, 16% are in the United States, 9% are in the UK and Ireland, 6% in Japan, 4% in Canada and 4% in Luxembourg. While 3% of the parent companies are in high risk countries, the remaining 29%, representing less than 2% are in other countries that are not considered high risk countries.

## The ownership structure of mutual fund administrators also indicated that 15% of their subsidiaries and affiliates are in Ireland, UK and the United States, 15% in Hong Kong, Jersey, Luxembourg and Singapore, 18% are in Guernsey, Bermuda, BVI, Bahamas, Canada and Switzerland and 8% in the Cayman Islands. While 15% of the subsidiaries and affiliates are in high risk countries, the remaining 25%, representing less than 2% are in other countries that are not considered high risk countries.

## A large percentage of mutual fund administrators, 53%, are 100% owned by their shareholders. 28% indicated a shareholding of less than 20%, 6% greater than 20% but less than 50% and with 13% held over 50% but less than 100%.

## Shareholders are located, 24% in the Cayman Islands, 14% in the UK and Ireland, 12% in the United States, 5% in Switzerland and Canada respectively, 4% in Japan and Guernsey respectively, and 5% in Bahamas, France, and Australia collectively. 19% are in other non-high risk countries with the remaining 8% in high risk countries.

## An analysis of the type of funds under administration by mutual fund administrators indicate that less than 2% of the funds were either managed accounts/fund of one, sovereign wealth or crypto funds.

**Conclusion for Risk Category Nature and Size of the Sector**

## Based on the high value of assets under administration, the higher percentage of unregulated funds and investors associated with these unregulated funds, it is likely that there is the risks of money laundering in this sub sector. Of note, from a control and ownership perspective, the parent companies, their subsidiaries and affiliates for majority of the mutual fund administrators are in countries with equivalent AML/CFT frameworks. However approximately 15% of the subsidiaries and affiliates are in high risk countries which increases the risk of money laundering and terrorist financing, and as a result the risk is assessed as Medium High.

*Risk rating: Medium High*

**Risk Category - Geographic Risk**

## All of the regulated funds are Cayman Islands regulated funds. 77.9% of the unregulated funds are incorporated in the Cayman Islands, 16.5% in the United States and 5.4% are in other non-high risks countries with equivalent AML/CFT legislation.

## In relation to all investors into both the regulated and unregulated funds, 57% of the investors are from the United States with a further 5% from the Cayman Islands, 4% from Switzerland, 3% from UK and Ireland, 2% from Canada and Luxembourg. In considering ownership and control by the investment managers, who are sometimes the promoter of funds, 1% of all investors are also investment managers of the funds. 53% of these investment managers are regulated, with the majority, 43% in the United States.

## The data showed that 67% of the RTA, NAV and AML compliance services provided by mutual fund administrators are outsourced to other entities, with 33% relating to other administrative services. Outsourcing arrangements are made up of 22% to the United States, 16% to Ireland and UK, 12% to the Cayman Islands, 7% to Canada, 5% to Hong Kong, 4% to Singapore, 3% to Luxembourg and 18% are in other non-high risks countries. Of note, 12% are outsourced to high risk countries.

## Specific to the outsourcing of AML compliance service, 34% of the mutual fund administrators outsourced their AML/CFT functions to the United States (13%) and UK and Ireland (21%). The Cayman Islands and Hong Kong comprised 9% of such outsourcing arrangements with Canada, Singapore and India at 7% and 10% in other non-high risks countries. However, 17% of such outsourcing was to high risk countries.

## Approximately 70% of the value and volume of transactions, mainly subscriptions and redemptions, are with the Cayman Islands (20%) United States (32%) and Japan (18%).

**Conclusion for Risk Category Geographic Risk**

## Although the data shows that the mutual funds administrators provide services to a high percentage of unregulated funds, a significant portion of these unregulated funds are incorporated either in the Cayman Islands or in a country with an equivalent AML/CFT framework. This is the same for the investors. While majority of the core services of NAV, RTA and AML/CFT compliance services are also outsourced, it is mainly outsourced to countries with equivalent AML/CFT framework. There is however 12-17% of the services that are outsourced to high risk countries making it possible for the risk of money laundering and terrorist financing to materialize, and as such the overall risk is assessed as Medium-Low.

*Risk rating: Medium - Low*

**Risk Category - Types of Customers**

## Customers include both funds and investors. 55% and 12% of the fund structures are Cayman incorporated companies and partnerships respectively. A further 13% are United States incorporated companies and partnerships. In relation to the legal structures for investors into the funds, 72% of the investors are companies, representing 77% of AUA, while 22% are partnerships with 19% of AUA.

## 44% of the underlying investors in these structures (corporate, partnerships, and trusts) are from the Unites States representing 35% of the AUM, while 8% and 20% of the investors and their AUM respectively are from the Cayman Islands.

## Investors generally fall within the categories of body corporates, individuals, including high net worth individuals (HNWIs) and politically exposed persons (PEPs), nominee shareholders and trusts. The data shows that 29% of the investors were body corporates, 22% individuals other than HNWIs, 12% high net worth individuals, 9% nominee shareholders and 9% trusts.

## The mutual fund administrators rated their customers, on an overall basis, as follows: 60% low risk, 36% medium risk and 4% high risk. 28% of the body corporates were rated as low risk, 31% as medium and 27% as high risk. Individuals customers (other than HNWIs or PEPs) were rated 23% low risk, 20% medium risk and 22% as high risk. 11% of the HNWIs were rated as low risk, 12% as medium risk and 15% as high risk. For nominee shareholders 12% were rated as low risk, 6% as medium and 3% as high risk and for trusts 7% were rated as low risk, 13% as medium and 4% as high risk.

**Conclusion for Risk Category Customers**

## Except for the high net worth individuals, where a higher percentage of these customers are rated as high risk, the mutual fund administrators have mostly rated their customers as either medium or low risk. Of note however, is that majority of the investors are either individuals including high net worth individuals, nominees and trusts which makes it likely for the risk of money laundering and terrorist financing to occur. This is however somewhat mitigated by the fact that majority of the fund structures and the investors are located in the Cayman Islands or the United States. The customer risk is therefore assessed as Medium Low.

*Risk rating: Medium Low*

**Risk Category – Transactions, Products and Services**

## The services that are provided by mutual fund administrators include registrar and transfer agent services, net asset value calculation, directorship services, Registered Office, Principal Office and tax reporting and Other Services (FATCA/CRS). The core services of registrar and transfer agent exposes mutual fund administrators to higher ML/TF risks. The data indicates that 74% and 71% of the mutual fund administrators provide RTA and NAV services respectively and 30% directorships. 73% provide a combination of RTA and NAVo services, while 79% of the mutual fund administrators surveyed provide Other Services in addition to the two core services.

## Further analysis of the data reveals that of those mutual fund administrators who provide the above services, 70% of the RTA services, 68% of the NAV, 61% of the directorships and 87% of the registered office services are offered to unregulated entities, increasing the sub-sector’s vulnerability to ML/TF risks.

## For the reporting period covered by the survey 1 July 2018 to 30 June 2019, data from the mutual fund administrators indicated $350 Billion in subscriptions, $328 Billion in redemptions and $63 Billion in transfers. $9 Billion (3%) of subscriptions and $42 Billion in redemptions (13%) are with PEPs. As previously indicated majority of these transactions originate with Cayman, the United States and Japan.

## 55% of respondents indicated that they provide AMLCO services to funds. Of the total funds to which these services are provided, 56% are unregulated. This is a positive signal towards reducing the risks of money laundering and terrorist financing.

**Conclusion for Risk Category Transactions, Products and Services**

## The pooling of investments, the size of the industry and the services offered, are factors that can create an avenue for money launderers to simulate the behavior of legitimate investors, enabling these instruments to be used by criminals laundering proceeds of their crime which makes it difficult to detect.

## The RTA services are the front offices services for vetting investors into and out the funds, which is critical to managing the ML/FT risks. The data shows that RTA services are a significant portion of the mutual fund administrators service offerings. NAV, which is a middle office service, deals mainly with the calculation of the value of the assets and reporting functions and as such has lower ML/CFT risks. Based on the analysis above, it is likely for the risk of money laundering and terrorist financing to occur, and as such the risks assessed for Transactions, Products and Services are deemed Medium- High.

*Risk rating: Medium High*

**Risk Category - Delivery Channels**

## Delivery channels generally include face to face and non-face-to-face customer interaction. Face-to-face include direct contact or through nominee investors. Non face-to-face includes the use of service providers or third-party introducers (eligible introducers).

## According to the data, 24% of the mutual fund administrators use face-to-face customer onboarding, while 49% use non face-to-face. 28% of the mutual fund administrators did not indicate which method.

## For non-face-to-face customer onboarding, the data shows that 53% of the mutual fund administrators either accepting the customer directly but using other non-face-to-face methods (video, photo, swift registry etc.) or through the use of nominees. Information requested in relation to country of the investor(s) indicated that 23% of these investors are located in the United States, 3% the Cayman Islands and 2% each in the UK and Ireland, Switzerland and Hong Kong. 53% of the mutual fund administrators did not identify the country of the investors, which is therefore an unquantified risk and thus an increased risk to this sub-sector.

## 19% of the mutual fund administrators also use eligible introducers. Investors introduced through these eligible introducers located and regulated in the Unites States accounted for 10% of non-face-to-face customer onboarding. This customer delivery channel was below 10% for all other countries. Information was also requested in relation to country of the investor(s); however, 75% of the respondents did not identify the country of the investors, which is therefore an unquantified risk and thus an increased risk to this sub-sector.

**Conclusion for Risk Category – Delivery Channels**

## The high percentage of non-face-to-face, together with incomplete data to appropriately assess the risk associated with countries where customers are onboarded are factors that are considered as making it very likely for increasing the risk of money laundering and terrorist financing. However, the data provided to assess the geographical risks indicate that majority of the fund structures and the investors are located in the Cayman Islands or the United States. As such the overall risk assessment is Medium-High.

*Risk rating: Medium High*

**Mitigating Measures**

## During onsite inspections, procedures are performed to ensure that mutual fund administrators have an effective program for monitoring the outsourced services, particularly AML/CFT compliance services and the onboarding of clients through non face to face channels. Enhanced due diligence procedures are also expected to be performed for customers from high risk countries, with confirmation also obtained as part of the onsite inspection procedures. Onsite inspections will continue to be conducted on mutual fund administrators in accordance with each licensee’s supervisory plan, which takes into consideration the results of the risk assessments, previous onsite inspections and remediation responses.

## In addition, mutual fund administrators, as they carry on relevant financial business as defined in Proceeds of Crime Law, are required to comply with the AMLRs. CIMA will continue to monitor their compliance with the AMLRs and Guidance Notes.

## Each regulated mutual fund administrator’s risk assessment and supervisory plan is updated periodically, in keeping with its individual risk rating and includes a consideration of major events that can potentially impact on the supervisory risk response and overall rating. The analysis of the mutual fund administrator’s annual audited financial statements will also continue to be performed, supplemented with prudential meetings.

**Overall summary and conclusion**

## CIMA has undertaken further analysis of the MFA sector, based on data collected from 81% of licensed mutual fund administrators, in order to assess the country’s risk exposure to ML/TF risks emanating from this sub-sector of the securities sector. The analysis concludes that there is a medium-high risk of mutual fund administrators being misused for ML/TF purposes. While the risks emanating from the type of customers and geographic are determined to be medium-low, the nature, size and complexity of the sector, transactions, products and services and distribution channels are determined as medium-high, The weighting of these risk factor resulted in a composite ML/TF risk rating of medium-high for the sub sector.

1. <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/risk-based-approach-banking-sector.html>

<http://www.fatf-gafi.org/publications/methodsandtrends/documents/nationalmoneylaunderingandterroristfinancingriskassessment.html> [↑](#footnote-ref-1)
2. <https://www.cima.ky/guidance-notes>. [↑](#footnote-ref-2)
3. <http://www.fatf-gafi.org/countries/#high-risk>. [↑](#footnote-ref-3)
4. <https://www.un.org/securitycouncil/sanctions/information> [↑](#footnote-ref-4)
5. <https://www.baselgovernance.org/basel-aml-index/public-ranking> [↑](#footnote-ref-5)
6. Depositary lite, refers to a service provided by UK and EU hedge fund managers that desire to market non-EU offshore hedge funds to EU investors through private placement, as a result of the Alternative Investment Fund Management Directive (“AIFMD”). It requires managers to ensure that one or more firms are appointed to perform the depositary duties of safe keeping of assets, cash flow monitoring and oversight (principally the oversight of the valuation process, subscriptions and redemptions, compliance with laws and regulations, investment restrictions and leverage). [↑](#footnote-ref-6)