

# Compliance and Operational Efficiency: Challenges Facing Today's Fund Managers



## Introduction

The alternative investment fund industry in Hong Kong and China operates within a meticulously regulated environment, where managing compliance and operational risks is essential to financial markets' integrity and stability.

To better understand the challenges and obstacles they face in today's dynamic regulatory landscape, Alter Domus asked 82 of the region's largest fund managers to participate in an online survey. The study also considered the intricate operational complexities associated with managing alternative investment funds.

This white paper summarizes the survey findings and leverages the experiences and perspectives of respondents to provide strategies for optimizing risk management practices within the industry.

## Survey Overview

To enable a comprehensive analysis, the online survey targeted a diverse group of respondents representing various levels of assets under management (AUM).

The high response rate (50%) reflects the strong engagement of industry professionals and underscores the importance and relevance of the survey topic within the fund management community.

## Survey Findings: Top 3 Compliance Risks

Compliance risk encompasses potential violations of laws, regulations, or internal policies that can lead to legal and reputational consequences for fund managers and investors.

The survey indicated that of the numerous compliance risks fund managers must address, three specific areas stand out:

### 1. **Regulatory reporting compliance was a priority for 68% of respondents.**

Fund managers operate within a complex web of regulations that vary across jurisdictions.

Failure to comply with these regulations can significantly harm the fund manager's reputation and erode investor trust. Therefore, it is imperative for fund managers to stay updated on regulatory changes and implement robust systems and processes to ensure accurate and timely regulatory reporting.

### **How do recent developments in Cayman's private fund governance affect you?**

The Cayman Islands Monetary Authority (CIMA) issued a new Statement of Guidance on Corporate Governance for Mutual Funds and Private Funds in April 2023. The new rules came into force in October 2023.

The guidance documents various obligations in seven principal areas on which fund operators should focus on. It applies to all Cayman Islands mutual and private funds that are registered with CIMA under the Mutual Funds Act and the Private Funds Act.

The guidance sets a benchmark and serves as a timely reminder for fund managers to review and enhance their fund's corporate governance arrangements and practices to ensure they comply with CIMA's minimum expectations.

Monetary Authority (Amendment) Act, 2023 allows CIMA to impose administrative fines in addition to any exercise of CIMA's enforcement power in respect of breaches of certain provision.

## **2. Anti-Money Laundering (AML) Compliance was a priority for 61% of respondents.**

Money laundering poses a significant concern for the financial industry, and fund managers must take proactive steps to prevent and detect it. Implementing effective AML programs is crucial for identifying, preventing, and reporting any suspicious activities within fund management operations.

Non-compliance with AML regulations can lead to reputational damage, hefty fines, and criminal charges. Fund managers are expected to conduct thorough due diligence on their investors, monitor transactions, and promptly report any suspicious activities to the appropriate authorities. By maintaining robust AML controls, fund managers can mitigate the risk of involvement in illicit financial activities and protect their reputation and integrity.

## **3. Data Privacy & Security Regulations were a priority for 46% of respondents.**

Fund managers handle extensive amounts of data, including personal and financial information. In the digital age, safeguarding sensitive and confidential information is of utmost importance. Data privacy and security regulations, such as the EU's General Data Protection Regulation (GDPR), impose strict requirements on organizations regarding the handling and protection of personal data. Data breaches can lead to financial loss, identity theft, and fraud for the affected individuals, potentially resulting in lawsuits against the fund manager. It is vital for fund managers to implement robust data privacy and security measures, including encryption, access controls, and regular audits, to protect sensitive information and maintain compliance with applicable regulations.

### **How do recent updates on Cayman Islands AML regulations affect you?**

CIMA published a revised version of Anti-Money Laundering Regulations (2023 Revision) ("AML Regulations") in January 2023. The key amendments include the removal of the Anti-Money Laundering Steering Group list of countries; the introduction of specific requirements for assessing the risk of money laundering or terrorist financing in a particular country or geographic area; identification and record-keeping requirements relating to transfers of virtual assets; and an amendment to the definition of "family member."

### **What should you know about Cayman Islands cybersecurity requirements?**

CIMA has issued rules and a statement of guidance regarding the management of cybersecurity risk for regulated entities. These rules are applicable to Cayman Islands managers, but they do not extend to Cayman Islands funds. Instead, the Cayman Islands Data Protection Act (2021 Revision) (DPA) imposes obligations on the fund vehicles. In the event of a cybersecurity attack on a fund administrator, adviser, or manager resulting in unauthorized access to personal data such as investor information for which the Cayman Islands fund is the data controller, the Cayman Islands fund is required to notify the ombudsman in accordance with these obligations.

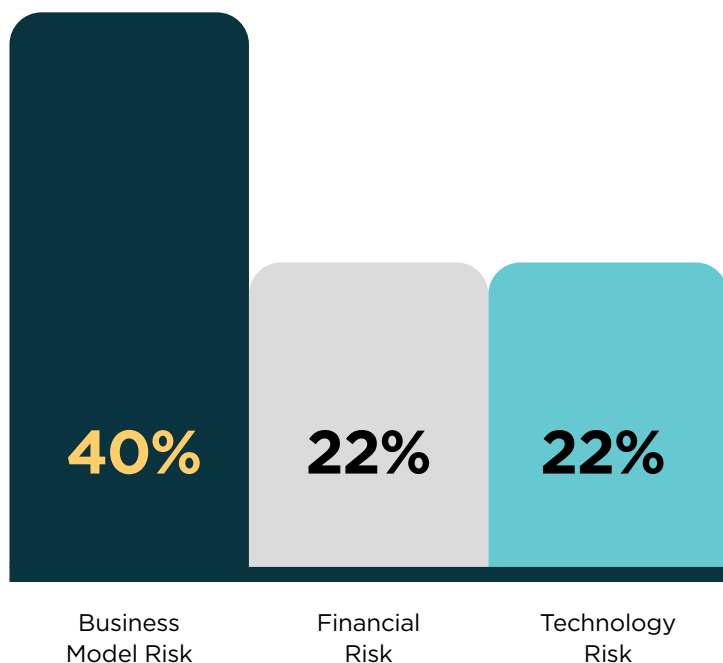
This notification requirement applies regardless of the location of the cybersecurity attack and its target, as well as whether the target is the fund itself, its manager, or another third-party service provider. Failure to comply with this requirement is considered an offense under the DPA, and conviction may result in a fine of US\$121,951.

## Survey Findings: Top 3 Operational Risks

Identifying and addressing operational risks is crucial for fund managers to proactively mitigate potential adverse events. By understanding these risks, fund managers can implement appropriate risk management strategies, controls, and processes to minimize their likelihood and impact.

Nearly 40% of respondents said business model risk was a priority; a smaller number (22% each) referred to financial risk and technology as a chief concern.

### Percentage of Respondents Treating the Operational Risk as their Top 3 Priority



### 1. Business model risk

This refers to potential threats that can negatively impact the fund manager's core business model, including changes in market conditions, shifts in investor preferences, evolving regulatory requirements, and competitive pressures.

Fund managers must continuously evaluate and adapt their business models to effectively mitigate these risks. This may involve diversifying investment strategies, exploring new markets, or enhancing operational efficiencies to maintain a competitive edge.

### 2. Financial risk

Financial risk encompasses potential adverse impacts on the financial health and stability of the fund manager. This includes risks related to investment performance, liquidity, leverage, counterparty defaults, and operational inefficiencies that could lead to financial loss or instability.

To address financial risks, fund managers must employ robust risk management frameworks, including conducting rigorous investment analysis, implementing diversification strategies, performing stress testing, and maintaining strong internal controls. Fund managers must closely monitor investment performance, ensure adequate liquidity buffers, conduct due diligence on counterparties, and implement effective risk mitigation measures to protect the financial integrity of the firm and its investors.

### 3. Technology risk

Technology risk encompasses potential disruptions or vulnerabilities associated with the use of technology within the fund manager's operations. This includes risks related to cybersecurity, data privacy, system failures, technological obsolescence, and inadequate IT infrastructure.

Fund managers must prioritize the implementation of robust cybersecurity measures, including firewalls, encryption, and regular security audits. They should also ensure compliance with data privacy regulations and establish effective disaster recovery plans to mitigate the impact of system failures. Staying ahead of technological advancements and investing in robust IT infrastructure are essential to minimize technology-related risks.

## Survey Findings: Source for Staying Updated with Regulatory Changes

Fund managers require relevant, reliable, and accurate information, which is often influenced by the communication channels sources use, the timeliness of the information being presented, and whether (and to what degree) the source is capable of providing interpretation and guidance.

Although regulatory agencies such as the Securities and Futures Commission (SFC), Securities and Exchange Commission (SEC), and Cayman Islands Monetary Authority (CIMA) play a vital role in establishing and enforcing regulations within specific industries or jurisdictions, they might not always be the primary source for fund managers seeking the latest information for two key reasons:

- Regulatory changes can occur frequently, and fund managers need to stay updated in a timely manner to ensure compliance. Regulatory agencies typically communicate regulatory changes through official channels such as websites, newsletters, press releases, and publications. However, the frequency and timelines of updates can vary, making it challenging for fund managers to solely rely on regulatory agencies for real-time information.
- Regulatory language can be complex, and understanding the implications of regulatory changes may require additional interpretation or guidance sometimes not available from the agency itself.

**Instead of relying on regulatory agencies for information about new and revised requirements, respondents said they are more likely to turn to legal and consulting firms (34%) or networking events (22%).**

Legal and consulting firms emerged as the most popular sources for fund managers to stay up-to-date with regulatory changes and ensure compliance with evolving requirements. This finding suggests that fund managers often rely on the expertise provided by external professionals to navigate the complexities of regulatory compliance.

Legal and consulting firms specialize in interpreting regulatory requirements, providing practical advice and tailored assistance to help fund managers adapt to changing regulations.

Industry networking events were identified as another significant source of information for staying updated on regulatory changes. These events provide opportunities for fund managers to learn from peers, industry experts, and regulatory professionals, fostering a collaborative environment for staying abreast of regulatory changes.

## Survey Findings: Procedures to Ensure Compliance with Sanction Regulations and Effective Cash Management

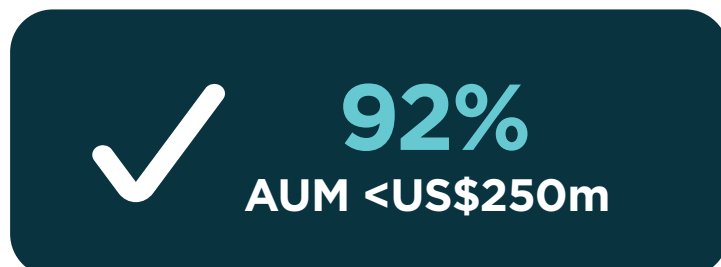
### Do you have measures in place to ensure compliance with sanctions regulations?

The survey results indicate that the majority of fund managers have implemented effective procedures to ensure compliance with sanctions regulations, demonstrating a commitment to regulatory adherence and risk management within the industry.

This aligns with the findings of the 2022 review conducted by the CIMA on Trust and Corporate Services Providers (TCSPs) compliance with Anti-Money Laundering Regulations (AMLRs), and sanction screening policies and procedures. The review highlighted the importance of TCSPs having robust systems and controls in place to conduct targeted financial sanctions (TFS) due diligence and avoid conducting business with designated persons.

However, it is noteworthy that 8% of the respondents in the survey with AUM below US\$250 million indicated that they do not have such measures in place. This insight implies that smaller entities with relatively lower AUM may face challenges or lack resources in implementing and maintaining compliance measures. These findings suggest that regulatory authorities may need to consider providing guidance on cost-effective compliance solutions to address the unique circumstances of smaller fund managers.

### Do you have internal control procedures in place to manage cash effectively and minimize the risk of fraud?



According to survey results, participants consistently implemented measures to safeguard cash and mitigate fraud risks. However, a small percentage of smaller fund managers (8%) indicated limitations in allocating resources for robust internal control procedures. These findings highlight the need to address gaps and vulnerabilities in internal control practices and compliance frameworks, specifically in relation to cash management and sanction regulations, for smaller fund managers.

One of the CIMA enforcement notices discusses an enforcement action taken by the CIMA against a company for breaches of AML regulations. The fines imposed emphasize the critical importance of effective internal control procedures, particularly in sanctions checks and cash management.

The enforcement action taken by CIMA, as reported on the [CIMA website](#), serves as a reminder of the significance of implementing stringent internal control measures in cash management. It underscores the importance for businesses, particularly smaller fund managers, to allocate adequate resources to ensure the implementation of robust internal control procedures. By doing so, they can effectively mitigate the risks associated with cash management and comply with regulatory frameworks, including AMLRs and sanction regulations.

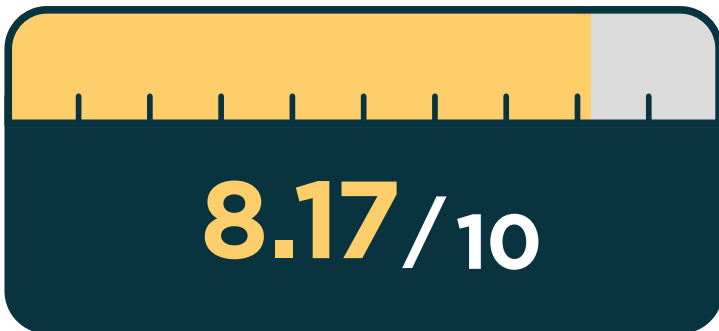
## Survey Findings: Rating on Data Management and Operational Risk

How would you rate the accuracy, security, and maintenance of data in your company, with 1 being “very poor” and 10 being “excellent?”

The average rating of 8.17 indicates that fund managers generally have a positive perception of their data management practices. They are confident that the data within their organizations is accurate, up-to-date, and free from significant errors. Moreover, they believe that their sensitive information is adequately protected from unauthorized access, breaches, and data loss.

However, the orders issued by CIMA in response to data breaches and non-compliance incidents make emphasizing robust data management and security controls even more important. enforcement

For instance, CIMA has issued enforcement orders in response to data breaches and non-compliance incidents. These cases highlight the significance of maintaining comprehensive data management policies and processes. The enforcement orders underscore the need for organizations to establish lawful grounds for processing personal data and to implement strong technical and organizational measures to prevent unauthorized or unlawful processing of personal information. Such incidents serve as a reminder of the potential risks and consequences of inadequate data management practices.

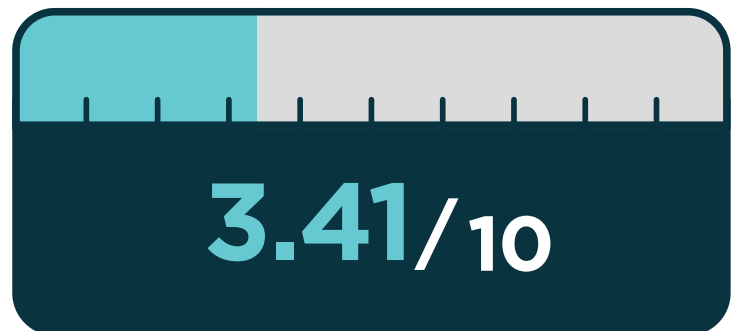


How would you rate the operational risk of your fund, with 1 being “very low” and 10 being “very high”

The average rating of 3.41 indicates that fund managers view the operational risk of their funds as comparatively low. They feel reassured about the fund’s ability to protect investments and navigate potential challenges effectively.

However, fund managers vary in how they perceive and tolerate risk. Fund managers should regularly communicate with investors and address any areas of improvement. By maintaining a proactive approach to risk management, fund managers can continually enhance their operational resilience and maintain the trust and satisfaction of investors.

Additionally, it is essential for fund managers to stay updated on industry best practices, monitor emerging risks, and adapt their risk management frameworks accordingly. By continuously evaluating and improving operational risk management practices, fund managers can ensure the long-term stability and success of their operations.





## Measures to Strengthen Control

Analyzing the survey findings has shed light on weaknesses and risks within fund management practices. In an increasingly regulated and complex landscape, fund managers must proactively address potential vulnerabilities and strengthen their operations to ensure compliance and mitigate risks.

The following checklist outlines key measures that fund managers can adopt to mitigate the top compliance and operational risks identified in the survey findings.

### Compliance Risks

- Regulatory reporting compliance
  - Establish and maintain robust reporting systems and processes, including clear procedures for data collection, verification, and reporting.
  - Conduct regular internal audits of reporting practices to identify gaps or errors.
  - Provide training and ongoing education to staff members involved in regulatory reporting.
  - Ensure timely and accurate filing of regulatory reports and disclosures.
  - Establish and maintain a system for monitoring regulatory changes and updating internal processes accordingly.
- Data privacy and security regulations
  - Establish and maintain robust data governance frameworks, including policies and procedures for data collection, storage, access, and sharing.
  - Conduct regular data audits to assess data protection measures and identify vulnerabilities.
  - Implement strong security measures, such as encryption, access controls, and monitoring systems.
  - Provide training to staff members on data privacy and security best practices.
  - Establish and maintain an incident response plan and process for reporting and addressing data breaches or privacy incidents.
  - Assess and improve data management policies and processes on a regular basis. This may involve implementing data governance frameworks, conducting regular audits, and providing ongoing training to employees to ensure compliance with data management best practices.
- AML compliance
  - Implement robust AML procedures, including comprehensive due diligence on investors.
  - Verify identities, assess risk profiles, and monitor transactions for suspicious activities.
  - Establish and maintain strong KYC procedures to understand investors' backgrounds, sources of funds, and risk profiles.
  - Provide regular staff training on AML policies and procedures, including recognizing red flags and reporting suspicious activities.
  - Conduct periodic independent reviews of AML procedures and controls.
  - Consider leveraging the expertise of fund administrators specializing in AML compliance.



## Measures to Strengthen Control

Compliance and operational risks are dynamic, requiring continuous monitoring, updates, and adaptation to emerging regulatory changes and market conditions. To mitigate risk, fund managers should address:

- Business model risk
  - Conduct comprehensive risk assessments.
  - Diversify investment strategies to mitigate concentration risk.
  - Establish contingency plans to address potential disruptions.
  - Monitor and assess the viability of the business model on a continuous basis
  - Stay informed about industry trends and market dynamics.
- Financial risk
  - Implement robust financial controls and procedures.
  - Conduct regular stress testing to assess financial resilience.
  - Maintain adequate liquidity buffers to meet obligations.
  - Monitor and manage market and credit risks effectively.
  - Review and update financial risk management policies regularly.
- Technology risk
  - Invest in secure infrastructure and robust technology systems.
  - Employ cybersecurity measures to protect against data breaches.
  - Establish disaster recovery and business continuity plans.
  - Test and update technology systems and controls regularly.
  - Stay informed about emerging technology risks and adopt best practices.
- General best practices
  - Establish a culture of compliance and ethics throughout the organization.
  - Maintain clear documentation of compliance policies, procedures, and controls.
  - Conduct regular risk assessments to identify and mitigate emerging risks.
  - Engage legal, compliance, and technology professionals to provide guidance and support.
  - Stay informed about industry best practices and evolving regulatory requirements.
  - Foster strong communication and collaboration between compliance, legal, and operational teams.

The expertise of legal and compliance professionals and the services of experienced fund administrators can help fund managers keep compliance issues under control.

## How Alter Domus Can Help

Alter Domus uses a well-defined suite of corporate and client operational processes to consistently deliver bespoke solutions and high levels of service at low risk.

These processes link our staff and technology and are defined within detailed written policy and procedure documents (PPD). A PPD is available for each process or activity (accounting, the production of financial statements, consolidation, etc).

Although we find that the vast majority of clients are satisfied by our current standard technology and services platform, we can build additional flexibility and customization when required.

### Alter Domus Adds Value

Our global platform allows our clients to confidently navigate through evolving regulatory environments, achieve cost efficiency, consistency and scalability for continued growth in existing and new markets.

#### Supporting your growth

- Scalability across new products and markets
- Global operational consistency
- Market expertise of complex structures

#### Securing sustainable LP returns

- Enhanced cost control and transparency
- Optimized operating model
- State of the art technology

#### Mitigating your risk

- Reputation protection
- Global regulatory compliance
- Consistent quality of your deliverables

#### Confidence from our quality

- Talented, agile teams
- Strong control processes
- Leading edge technology

#### Efficiency from vertical integration

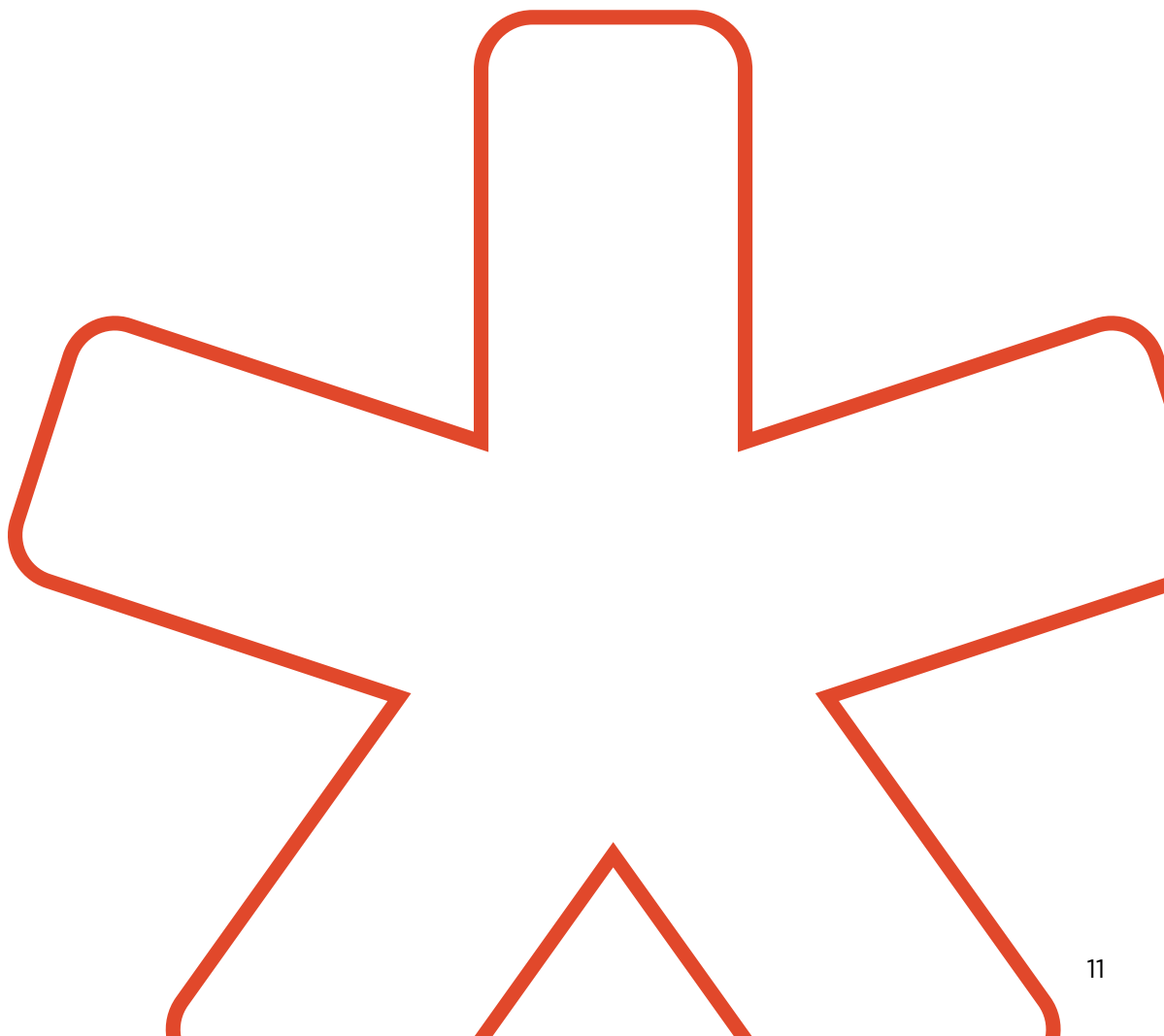
- Complete servicing model to support your growth and innovation
- Speed to market
- Reduced cost

#### Scalability through technology

- No technological volume restrictions
- One system approach
- Consolidated reporting
- Best in class security

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## Contact us

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