

Brexit: Passporting through Cyprus

Cyprus is one of a very small number of ‘Anglo-centric’ jurisdictions in the EU that offers the right mix of business-friendly ingredients to UK-based financial institutions looking for a new home or alternative EU-based trading hub post-Brexit. This is the first of a series of articles from Harneys looking at how Cyprus can offer a solution to international firms and institutions seeking certainty over access to the EU Single Market. In this article we set the scene for Brexit and focus on setting up MiFID firms in Cyprus.

A dilemma for UK firms trading with Europe

The most pressing Brexit concern for UK-based credit and financial institutions relates to the terms on which they will continue to have access to the EU Single Market and related passporting rights if and when the UK leaves the European Union. This is particularly important for non-EU origin firms which have chosen the UK as their hub to provide cross border services to the rest of the European Economic Area (EEA, which includes the EU), incentivised by the passporting regime in EEA financial services legislation which permits institutions licensed in one EEA member state to “passport” their permissions elsewhere in the EEA without having to go through the time consuming and expensive exercise of applying for separate domestic licences in each target market.

Post Brexit, unless passporting rights are maintained through specific UK-EU trade agreements or the UK retains membership of the EEA, the UK will be considered a “third country” from a financial services regulatory perspective, meaning that financial institutions based there will be unable to operate throughout the EEA as seamlessly as they do today. To summarise, the EEA passport is available in the following financial services sectors:

- In the provision of ‘investment services’ and undertaking ‘investment activities’, through the implementation of the Markets in Financial Instruments Directive (**MiFID**)
- In the investment funds industry, covering EU managers of both hedge funds and private equity funds for professional investors, through the Alternative Investment Fund Managers Directive (**AIFMD**) as well

as in the context of the more retail focussed UCITS funds

- Passports are also available in various other contexts: In banking-related business under the 2012 Capital Requirements Directive and implementing regulations (**CRD IV**), insurance and insurance intermediation under the “Solvency II” Directive and the Insurance Mediation Directive, and in payment services and electronic money-related services.

There is discussion among ‘hard-Brexiteers’ and others regarding the possibility that UK financial institutions may rely on third-country equivalency status under various EU directives, such as the AIFMD, MiFID II and Solvency II. The best current example of this is the case of Bermuda which was granted equivalency status (and passporting rights) in insurance under Solvency II in 2015. Yet the reality is that this is a developing area of law with no guarantee as to when the EU machinery of government will permit third country firms to have access to the Union’s prized markets, an issue which is highly politicised in itself irrespective of Brexit considerations. Until then and unless third-country equivalence is agreed as part of the UK’s exit arrangements, the financial services industry in the UK could be set for a considerable period of uncertainty before an outcome materialises. It is entirely reasonable that firms are already looking carefully at contingency plans including the option of establishing a new subsidiary in another EU member state.

Cyprus as a solution: Overview

Cyprus is an obvious choice in a number of sectors: it is already a pre-eminent Euro-hub for foreign exchange (**FX**) broker-dealers and other MiFID business and is gathering pace as a go-to jurisdiction for professional alternative

investment and private equity funds and management business covered by AIFMD.

Cyprus is also the back office par excellence to the world's large financial centres: a position earned due to its reliable common law heritage, English-educated workforce, skilled services industry, an attractive headline corporate tax rate and lower overhead costs than those associated with most European centres.

Recent pro-business changes in domestic tax legislation and the regulatory framework bear testimony to the Cypriot government's commitment to aligning Cyprus with what professionals in the private sector have sought for years: placing Cyprus on the world map of financial services and fund-friendly jurisdictions. Tax and regulatory synergies are now in place to attract not only MiFID-firms and funds themselves but also fund service providers and their investors. Cyprus offers the full spectrum of EU regulated financial services products, the most relevant being MiFID, AIFMD, UCITS, and CRD IV. A Cyprus-based MiFID firm is able to provide investment services from Cyprus seamlessly throughout the EEA by simply "passporting" its licence in compliance with MiFID, either on a cross-border basis or by establishing a branch in the target jurisdiction.

Setting up a MiFID firm in Cyprus

Cyprus is already a go-to destination for FX, options and similar broker-dealers. New institutions and businesses are opening regularly in the jurisdiction to take advantage of its mix of opportunities. In the next few sections we examine the possibilities and opportunities involved in setting up a MiFID business in Cyprus to benefit from the EEA passport for investment services and activities.

The Investment Services and Investment Activities Firms Law 2007 (known as the **Cyprus Investment Firms Law**, or **CIF Law**) implements MiFID locally and in consequence provides the legal framework for investment services and investment activities as well as for the registration, regulation of operations and supervision of Cyprus Investment Firms (**CIFs**). Under the provisions of the CIF Law, locally incorporated and domiciled firms operating within or from Cyprus become regulated by the Cyprus Securities and Exchange Commission (**CySEC**). CySEC is also responsible for some supervision of branches of MiFID firms from elsewhere in the EU/EEA exercising their passporting rights. Credit institutions established in Cyprus, such as banks and cooperative societies, may undertake some MiFID business alongside their core banking services but are subject to regulation by the Central Bank of Cyprus. We do not focus on banks in this article.

Capital requirements

The minimum capital requirements for a CIF depend on the type of services being offered or activities undertaken. A CIF is required to maintain initial capital of at least €200,000 if it holds clients' money, and/or clients' financial instruments, and provides one or more of the following investment services:

- Reception and transmission of orders in relation to financial instruments
- Execution of orders on behalf of clients
- Portfolio management
- Provision of investment advice

A CIF that provides the investment services stated in subsection (i) and (iv) above and does not hold clients' money and/or clients' financial instruments, and as a result may not at any time place themselves in debt to their clients, would be subject to a lower threshold of €80,000, or at least €40,000, and professional indemnity insurance covering all EU member states, or some other comparable guarantee against liability arising from professional negligence, providing at least €1,000,000, for a single claim, and on aggregate, at least €1,500,000 per annum for all claims. A CIF is required to have an initial capital of at least €1,000,000 if it provides or performs one or more of the following investment services or activities:

- Dealing on own account
- Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis
- Placing of financial instruments without a firm commitment basis

Applying to CySEC for a licence

The application documents for a CIF license must include a business plan, an operations manual with adequate policies and procedures to ensure compliance, an organisational structure with robust governance arrangements, and completed questionnaires from the members of the board, managers and shareholders. The board of a CIF must consist of at least two executive directors and two independent non-executive directors. The majority of the board should comprise individuals who are resident in Cyprus.

Management of a CIF must be undertaken by at least two individuals who should be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the CIF. One of these will be designated as the "General Manager", who must also be a resident of Cyprus, and may be one of the executive directors. The General Manager must have detailed knowledge of all of the CIF's activities and render their services in full and exclusive employment at the CIF.

It takes up to six months for CySEC to approve a complete application for a CIF licence.

Outsourcing CIF functions to third countries

Whereas the UK has traditionally been a Euro-hub for credit and financial institutions from the West, in particular the

USA, Cyprus has over the years established itself firmly as the Euro-hub destination for institutions hailing from the East, in particular the Levant, Russia and countries of the former Soviet bloc.

Cyprus regulations have therefore evolved to cater for the outsourcing of back office (and in some cases front and mid office) functionality to affiliates abroad in order to meet the business needs of the institutions in a way that is effective in practice. It is no different in the context of the CIF Law: although a (small) physical footprint is required in Cyprus in respect of every licensed CIF, CYSEC and other competent authorities are amenable to local firms outsourcing much of their operational infrastructure needs back to their jurisdiction of origin, even where such jurisdictions lie outside of the EU.

With Brexit in mind, this approach will no doubt prove invaluable for firms which are already established in the UK and who may be unwilling or unable to uproot their local workforce post-Brexit. Cyprus can offer such firms the flexibility to maintain current operations through carefully crafted outsourcing arrangements.

Taxation of a CIF: The lowest corporate tax rate in Europe

A CIF must register with the Cyprus Tax Authorities for the purposes of obtaining a Tax Identification Number within 60 days from the date of its incorporation as a company. Provided the CIF adheres to requirements rendering it tax resident in Cyprus, including by employing qualified Cyprus resident directors and establishing a staffed physical presence here, it can enjoy a very attractive taxation regime. CIFs in Cyprus are subject to corporate income tax on the same basis as other corporate structures in Cyprus ie at a flat rate of 12.5 per cent which is the lowest effective EU corporate tax rate. Profits realised from the sale of securities (defined in an expansive list of titles in accordance with a circular issued by the Inland Revenue) are fully exempt from taxation and there is no capital gains tax in Cyprus except on the sale of immovable property based in Cyprus or shares representing immovable property based in Cyprus. This makes the distinction between trading profits and capital gains from the disposal of securities obsolete, as in both instances the profits/gains will be exempted from taxation.

Dividends received from non-Cyprus tax resident subsidiaries are exempted from taxation, provided certain minimum requirements are met. These requirements are fairly easy to satisfy, so that in the vast majority of cases the incoming dividend is exempted. Interest received by a CIF is deemed “active” by virtue of being closely connected with the CIF’s ordinary activities and therefore taxed only at the 12.5 per cent corporate income tax (instead of the 30 per cent defence tax normally applicable to interest income). There are no withholding taxes on dividends, interest or royalties paid to non-Cyprus residents and the eventual liquidation of a CIF will not trigger any tax if the shareholders are not tax residents of Cyprus. Importantly, the revenues of a CIF are for the most part exempt for VAT purposes in Cyprus.

Taxation of CIF staff: Introduction of an expat-friendly ‘resident non-domiciled’ regime in [2015]

Aside from corporate taxation, the Cyprus government is also stepping up efforts on individual taxation to entice corporate managers to relocate to Cyprus and create substance for the companies they manage on the ground. Significantly, for high earning individuals (income over €100,000 per annum) moving to Cyprus, a 50 per cent deduction will apply for the first 10 years. For employments commencing as from 1 January 2015, this exemption is applicable only where the individual was not resident in Cyprus prior to their employment and provided that the individual was not a Cyprus tax resident for at least three out of the five years preceding that year of employment. For employees who do not meet the €100,000 threshold, remuneration from any office or employment exercised in Cyprus by an individual who was not a resident of Cyprus before the commencement of their employment, for a period of five years will be eligible for a 20 per cent exemption of income subject to maximum of €8,550 annually.

In addition to the above exemptions, non-domicile rules have been introduced, whereby an individual who is a tax resident of Cyprus under the provisions of the Income Tax Law (183 days rule) but is not domiciled in Cyprus, will be exempt from the provisions of the Special Contribution for the Defence Law (which imposes tax on interest, rents and dividends) despite the fact that they may be Cyprus tax resident and/or the income is derived from sources within Cyprus. In a nutshell, to qualify as a non-domiciled resident of Cyprus an individual must be born to a non-Cyprus domiciled father and not have been a Cyprus tax resident for at least 17 out of the last 20 years prior to the year in which such individual applies for non-domicile status. The tax advantages which accrue to non-domiciled persons residing in Cyprus are significant: they will not be subject to the otherwise applicable SCD on dividend income at 17 per cent, interest income at 30 per cent and rental income at 3 per cent.

Cyprus as an ‘Anglo-friendly’ jurisdiction

Cyprus is possibly the most pro-UK jurisdiction within the EU. Outside of the British Isles, Cyprus is the only member state of the EU that adopts English common law as binding or persuasive principle in cases not governed by local legislation. This means that Cyprus will, in general terms, always look to the judicial precedent and opinion of the courts of England and Wales over other jurisdictions in matters of contract, negligence (civil wrongs), and commerce more generally.

Cyprus works very closely with UK-based competent authorities, law firms and consultants when drawing up the rules for its financial services regimes. Furthermore, post-Brexit Cyprus alongside Malta will be the only EU member state that is also a member of the Commonwealth. Under Commonwealth and related arrangements, special diplomatic and consular benefits exist between the member countries. For example, Cypriots resident in the UK were, unlike almost all other EU citizens, entitled to vote in the UK’s EU referendum.

As Cyprus is not a member of Schengen zone, it can determine its own immigration policy as far as third countries are concerned, and in consequence, it is expected that Cyprus will seek to maintain residency rights for UK citizens living in Cyprus presently and in the future (as it presently does with citizens of other third countries, such as those from Russia). It should also not be forgotten that, like the Republic of Ireland, the Republic of Cyprus shares a land-frontier with the UK in the form of its border with the UK Overseas Territory of Akrotiri and Dhekelia, known as the Sovereign Base Areas.

The reason for such closeness with the UK is, of course, historical: Cyprus was itself a UK Crown Dependency until independence in 1960. Cyprus' close historical and continuous association with the UK means that it will be one of the most active voices in the EU for UK interests, especially those that are of direct relevance to it and those involving financial services.

The Harneys difference

Harneys is the only international law firm based in Cyprus. We maintain excellent relations with CySEC, the Cyprus government and UK interests on-island. We advise the world's top financial and credit institutions on the Cyprus financial services sector and work with numerous reputable service providers on-island. We are on the ground in Cyprus to assist international firms and institutions looking to establish in the jurisdiction through a turn-key cost-effective solution.



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