

A recap of AIFMD principles in Cyprus

Cyprus transposed the AIFMD by enacting the Alternative Investment Fund Managers Law 2013 (**AIFM Law**). Allied to the AIFM Law is a host of circulars and directives issued by the Cyprus Securities and Exchange Commission (**CySEC**) as well as the Commission Delegated Regulation (EU) No 231/2013 (**Level II Regulation**), which substantiates the AIFMD's provisions and is directly and uniformly applicable in all EU member states.

Bespoke requirements and regulations of the AIFM Law

The AIFM Law has adapted the AIFMD to the Cypriot legal regime and in doing so provides for the following:

- The competent authority for the authorisation and supervision of Cypriot AIFMs is CySEC
- The eligible legal form for setting-up a Cypriot AIFM is a limited liability company by shares
- The minimum initial capital for a Cypriot AIFM is set at €125,000, plus professional liability insurance or additional own funds. The authorisation period is three months in principle
- In line with collective investment in transferable securities (**UCITS**) principles, the depositary of a Cypriot alternative investment fund (**AIF**) should generally be a credit institution or an investment firm based in Cyprus, however, certain AIFs can appoint other entities as depositary (eg, a fiduciary services provider). This possibility provides for closed-ended AIFs, which invest in assets other than “assets subject to custody” within the meaning of the AIFM Law, or act as private equity investment funds
- AIFMD has harmonised much of the marketing regime applicable to AIFs in the EU, in Cyprus the CySEC Marketing Directive governs the way that AIFs may be marketed and provides for a national private placement regime (**NPPR**) of sorts
- External verification of the valuation procedures or valuations of a Cypriot AIFM may be required by CySEC if the valuation function is performed internally or by an external valuer not considered to be independent
- Provisions ensuring re-domiciliation of an EU or non-EU AIFM to Cyprus
- Special rules apply for Cyprus management companies of UCITS applying to be additionally authorised as AIFMs. When their assets under management exceed €250 million, they are not required to provide the initial minimum capital of €125,000 and the additional own funds required.

Managing alternative investment funds

Definition of “managing”

The AIFM Law regulates every Cyprus-based legal person that manages one or more AIFs, regardless as to whether these are Cyprus, EU or non-EU-AIFs – though most regulation will not apply to so called “sub-threshold AIFMs” (see below).

While principally focusing on Cypriot AIFMs, the law also indirectly regulates aspects relating to AIFs managed by them. For instance, valuation and depositary requirements impose an obligation on a Cypriot AIFM to ensure compliance of the AIFs it manages with applicable law.

The AIFM Law takes a look-through approach regarding the determination of the entity that qualifies

as an AIFM under the law. Consequently, it is not important which entity is contractually designated as the principal manager of an AIF; instead, the focus is on which entity is effectively “managing” the AIF (ie providing at least risk or portfolio management services to the fund). If more than one entity is managing the AIF in this sense, only one can be chosen to act as the AIFM. As such the following structures will need to be considered closely:

- A delegate of the principal manager of the alternative investment fund, where the principal manager is considered to be a “letter-box” entity
- The principal manager of an offshore AIF
- The principal manager of a Cypriot AIF

Other regulated entities potentially affected by the law include UCITS management companies that are also managing AIFs and fall within the scope of the law. However, UCITS management companies are given the possibility to obtain a licence under the law while retaining their initial UCITS management company licence. This regulatory and business expansion is further facilitated - UCITS management companies may cross-refer to documentation already submitted during their UCITS authorisation procedure, while being exempted from paying the initial minimum capital of €125,000 provided for under the AIFM Law.

Definition of an AIF

The AIFM Law adopts a broad approach regarding the meaning of an AIF. Only UCITS are explicitly excluded from the definition; any other undertaking for collective investment raising funds from a number of investors with a view to investing them in accordance with a defined investment policy for their benefit will qualify as an AIF. It does not matter whether the fund is closed or open-ended, internally or externally managed, listed, or distributed to the public or to a limited number of investors. Even unregulated investment vehicles may fall under the definition of an AIF. At the same time, the following are excluded from the scope of the AIFM Law:

- Holding companies
- Family offices
- Sovereign wealth funds
- Schemes managed by national, international and supranational public bodies in the public interest
- Joint ventures
- Insurance contracts
- Managed accounts
- Single investor funds

Where an alternative investment fund has not designated an external manager, but its legal form permits internal management by its governing body, the fund itself will be considered to be the AIFM.

An external AIFM may offer its services to several alternative investment funds, but an internally managed alternative investment fund cannot manage entities other than itself.

Licensable AIFMs

Determining applicability

Apart from the exempt entities mentioned above, there are a number of entities that qualify as AIFMs within the meaning of the law but may nevertheless benefit from a lighter regime than authorisation and compliance with the law. These AIFMs are subject to *registration* and not *authorisation*. They must provide CySEC with information on their identities and the identities of the alternative investment funds that they manage. Further, CySEC must be informed of:

- The investment strategies that they pursue through their alternative investment funds
- The main instruments in which they are trading and the main exposures
- The most important concentrations they hold

Sub-threshold AIFMs

Determining whether an AIFM will be subject to the registration regime is dependent on the aggregate of the assets under management in the alternative investment funds managed by it. For Cypriot AIFMs managing only unleveraged alternative investment funds with a lock-up period of five years, whose assets under management in aggregate do not exceed €500 million, the lighter regime applies. This regime also applies to Cypriot AIFMs managing alternative investment funds (including leveraged ones) whose assets under management do not exceed €100 million. The AIFM is responsible for determining whether it is above or below the AIFM Law thresholds. Regarding the calculation of the assets under management, assets of “fully invested” and “fully subscribed” alternative investment funds, as provided for in the last chapter of the law, are not included in the calculation.

Cypriot AIFMs above the thresholds will be subject to authorisation and ongoing compliance with the law. As an exchange, they will benefit from the so-called “passport”, which offers the possibility to manage and market EU alternative investment funds throughout the European Union by means of an electronic notification procedure without further authorisation being required.

Cypriot AIFMs above the thresholds that manage non-EU alternative investment funds will also be subject to authorisation under the law and compliance with most of its provisions. However, they will not be able to benefit from the passport scheme until 2015. Cypriot AIFMs below the thresholds will not be granted such passports either, unless they choose to opt in.

Of course, since the AIFM Law the Cypriot “mini-manager” regime was introduced in 2020 to regulate sub-threshold managers. A copy of our recent blog post on this regime is [here](#).

Cypriot AIFM authorisation procedure

Once the Cypriot AIFM passes the thresholds detailed under the law, it must submit an application to CySEC for authorisation as an AIFM within 30 calendar days from the date on which it exceeded the thresholds. CySEC has the right to restrict the scope of the licence to only certain alternative investment strategies. As well as a duly submitted application form, the appropriate legal form and minimum capital requirements must be met before CySEC will authorise the AIFM.

The only available legal form for the authorisation of an external Cypriot AIFM is that of a limited liability company by shares with its registered and head office in Cyprus. The initial minimum capital requirements are €125,000 for an external AIFM and €300,000 for a self-managed AIF. Both must also conclude professional indemnity insurance or provide for additional own funds against liability arising from professional negligence. External AIFMs must provide for additional own funds in cases where the assets in the AIF portfolios under their management exceed €250 million.

The cap for large-sized AIFMs is set at €10 million, including initial capital and an additional amount of own funds. UCITS management companies applying also to act as AIFMs are exempted from paying the initial minimum capital and the additional own funds required where their assets under management exceed €250 million. However, they must either conclude professional indemnity insurance or provide for additional own funds against liability arising from professional negligence.

The application to be submitted to CySEC covers information relating to the AIFM itself and to the AIFs it intends to manage. The information regarding the AIFM refers to the persons effectively conducting its business, its qualifying shareholders, its programme of activity, remuneration policy and practices and delegation arrangements. In the case of a self-managed AIF, the qualifying shareholder information

applies to the investors with qualifying participations in the AIF. Information relating to the AIFs include:

- The constitutional documentation of the funds
- Investor-related information
- Information on the appointment of the depositary
- Information about the investment strategies of the funds

The authorisation period lasts three months from the date on which the complete file is submitted. Under certain circumstances, this may be extended by another three months. In order for an application by a Cypriot AIFM to be approved, it must be authorised to provide at least portfolio and risk management to AIFs. Following its authorisation under the law, a Cypriot AIFM may additionally apply to be authorised as a Cyprus UCITS management company. In such cases, it must follow the authorisation procedure and comply with the provisions of the relevant Cypriot law on UCITS.

Finally, AIFMs may be licensed by CySEC to provide individual portfolio advisory and management (IPM) services similar to those authorised under the MiFID regime.

Conflicts of interest, risk management, valuation and delegation requirements

Conflicts of interest

When a Cypriot AIFM is establishing and implementing a conflicts of interest policy, disclosure of conflicts of interest will be the last resort. Where the Cypriot AIFM is also authorised to offer individual portfolio management according to the AIFM Law, a further requirement applies - it cannot invest all or part of the client's individual portfolio in units or shares of the AIF it manages unless it receives prior general approval from the client.

Risk management

With regards to risk management, the AIFM Law imposes obligations to establish an independent risk management function in addition to internal compliance functions.

Valuation

With regard to the valuation function, AIFMs must ensure that valuation procedures are in place for each AIF that they manage. The valuation function can either be performed internally or be assigned to an independent external valuer. Its appointment must take place according to the delegation provisions of the AIFM Law, with the external valuer not being

allowed to sub-delegate the valuation function. The appointment of an external valuer must be notified by the Cypriot AIFM to CySEC for approval. If the conditions regarding professional regulation and competence have not been met, CySEC may require that another external valuer be appointed instead.

Subject to certain conditions, the depositary of an AIF managed by a Cypriot AIFM may also assume a valuation function. Assignment of the valuation function to a third party does not exempt the Cypriot AIFM from liability towards the AIF it manages and its investors. In case of internally performed valuation, it must be functionally and hierarchically separated from the portfolio management function and possible conflicts of interest must be managed. Where internal valuation takes place, or where the external valuer is not considered to be independent, CySEC may require that the valuation procedures and/or valuations of the Cypriot AIFM be verified by another external valuer or an auditor.

Asset valuation and calculation of the net asset value must be carried out at least yearly and in accordance with the law of the country of the alternative investment fund and its constitutional documentation. However, for open-ended alternative investment funds, asset valuation and calculation of the net asset value must also take place at a frequency appropriate to the assets and the liquidity policy of the fund. For closed-ended AIFs, asset valuation and calculation of the net asset value must also take place, in case of an increase or decrease in the capital of the fund.

Delegation

The AIFM Law allows not only for the delegation of tasks on behalf of the AIFM, but also for sub-delegation and sub-sub-delegation. However, delegation or subsequent sub-delegations do not affect the AIFM's liability towards the alternative investment funds it manages and their investors. Apart from providing notification to CySEC, a valid delegation requires the substantiation and justification of the delegation arrangement. This includes:

- Submitting objective reasons for delegation
- Justifying the entire delegation structure
- The diligent selection of a sound and qualified delegate

The latter shall be subject to the instructions and ongoing review of the AIFM. These conditions will also apply in case of sub-delegation and sub-sub-delegation. Delegation, sub-delegation and sub-sub-delegation must not prevent the effective supervision of the AIFM by CySEC, or prevent the AIFM from

acting or managing the AIFs in the best interest of their investors.

However, no delegation, sub-delegation or sub-sub-delegation arrangement may result in the AIFM ending up as a letter-box entity. As mentioned above, an AIFM must at least be authorised to provide risk and portfolio management to alternative investment funds; managing an alternative investment fund means performing at least one of these functions. Thus, an AIFM not performing at least one of these functions, within the meaning of effectively exercising some investment management activities itself, will be considered a letter-box entity. Sub-delegation and sub-sub-delegation are, in addition to the delegation requirements described above, subject to the AIFM's prior consent and CySEC's prior notification.

With regard to the delegation of portfolio or risk management, in addition to the delegation conditions laid down above, this may take place only to entities authorised or registered for the purposes of asset management. If this condition cannot be satisfied, CySEC's *ad hoc* approval is required as an alternative. Should delegation take place to a non-EU service provider, arrangements ensuring co-operation between CySEC and the supervisory authority of the non-EU service provider must also be in place. The depositary, or a delegate of the depositary, is not eligible to act as a delegate, sub-delegate or sub-sub-delegate of portfolio management or risk management tasks. Entities whose interests may conflict with those of the AIFM or of the investors in the AIFs managed by the AIFM are also ineligible, unless the necessary safeguards and disclosures are in place.

Depositary provisions

Scope of depositary provisions and eligible entities

The appointment of a depositary is a task incumbent on the AIF and not on the AIFM. However, the AIFM Law requires that the AIFM ensures that a depositary is appointed for each fund it manages by written agreement and in accordance with the AIFM Law. If the AIFM cannot ensure compliance of the AIF with the depositary provisions, it must withdraw from being the AIFM of such fund. Cypriot AIFMs managing non-EU AIFs without marketing them in the European Union are entirely exempt from complying with the depositary provisions. However, they must be authorised under the law and comply with most of its other provisions.

AIFMs managing non-EU AIFs that are marketed in the European Union are also exempt from complying with the law's depositary provisions. However, they

must appoint an entity to carry out the duties of a depositary laid down in the law, in addition to authorisation under the law and compliance with the rest of the law's provisions. An AIFM must ensure that the EU AIF under its management appoint their depositary in the EU member state where these are established.

In general, the eligible depositaries of Cypriot AIFs must either have their registered office in Cyprus or be Cypriot branches of entities whose registered office is in another EU member state. In principle, these eligible depositaries may be either credit institutions or investment firms under MiFID. The latter must also:

- Be authorised for the ancillary service of safe-keeping
- Have their own funds amounting to at least €730,000
- Be subject to the own funds provisions of CRD IV

However, Cypriot AIFs that impose on their investors a lock-up period of five years following initial investment in the AIF, and do not invest in "assets subject to custody" according to the AIFM Law or act as private equity funds, have a third option - they may appoint an entity such as a fiduciary services provider as a depositary. The eligible depositary requirements described above apply proportionally to EU AIFs managed by the Cypriot AIFM and with their depositary appointed in their home member state. Such funds may also appoint as depositary any additional entity designated by the relevant member state as an eligible UCITS depositary.

Depositary duties and liability issues

According to the AIFM Law, the depositary duties consist in broad terms of cash-flow monitoring, safekeeping and compliance monitoring. Cash-flow monitoring applies to all inflows and outflows of cash of the alternative investment fund. Safe-keeping is divided into safe-keeping of assets subject to custody and other assets.

"Assets subject to custody" include all financial instruments that can be registered in accounts on the depositary's books or that can be physically delivered to the depositary. This encompasses all financial instruments that can be registered with the issuer or its registrar or held in an account directly or indirectly in the name of the depositary. It also encompasses financial instruments that can be physically delivered to the depositary, such as collateral owned by the alternative investment fund or the AIFM acting on behalf of the fund.

Assets that do not qualify as assets subject to custody qualify and are treated as "other assets". Such other assets are subject to ownership verification, which can be based on information provided by the alternative investment fund or the AIFM acting on behalf of the fund and external evidence and record-keeping. The distinction between assets subject to custody and other assets is also of importance for depositary liability reasons. Loss of the former triggers the depositary's strict liability. This means that the depositary will be exempted only if it can prove that the loss was due to an external event beyond its reasonable control and with unavoidable consequences, despite all reasonable efforts to the contrary. Loss of other assets triggers qualifying liability within the sense that negligent or intentional failure of the depositary properly to fulfil its obligations is required, whereas the onus of proof rests with the claimant.

Compliance monitoring has the same content as with the duties of a UCITS depositary of contractual form. The strict liability regime applies to safe-keeping of assets subject to custody. For safe-keeping of other assets and for the rest of the depositary duties, the qualifying liability regime applies.

Delegation of depositary tasks and transfer of liability issues

Delegation of depositary tasks is possible regarding safe-keeping tasks only (ie delegation of safekeeping of assets subject to custody and of other assets), also referred to as sub-custody. Sub-sub-custody is also possible.

Sub-custody is subject to a series of conditions, laid down in the AIFM Law, which also apply proportionally to sub-sub-custody. However, in certain cases, the law of a non-EU jurisdiction requires that certain local financial instruments be held by a local entity. At the same time, these local entities may not fulfil the sub-custody requirements of the AIFM Law. In such cases, sub-custody to such entities is possible as long as no local entities satisfy the delegation requirements of the law. Furthermore, disclosure to the investors of the alternative investment fund concerned of the legal constraints imposed by such jurisdictions is required before the investors' investment in such fund. A relevant instruction by the alternative investment fund or the Cypriot AIFM acting on behalf of the fund instructing sub-custody to such entity is also required.

Sub-custody does not affect the depositary's liability towards the fund concerned or its investors. Nevertheless, transfer of liability to the sub-custodian is possible if the AIFM Law sub-custody conditions have been observed and such transfer of liability has

been contractually agreed between the depositary and the sub-custodian on the one hand and the depositary and the Cypriot AIFM acting on behalf of the alternative investment fund concerned on the other.

Where the sub-custody conditions of the AIFM Law cannot be observed due to the legal constraints imposed by non-EU jurisdictions as described above, transfer of liability is still possible. However, it requires a relevant provision in the constitutional documents of the AIF concerned, disclosure to investors before their investment, a relevant sub-custody instruction to the depositary, and the transfer of liability to be contractually agreed between the parties as described above.

Cross-border management and marketing

An AIFM authorised under the AIFM Law is granted the right to manage and market Cypriot and other EU alternative investment funds throughout the European Union (under the passport system), provided that it remains subject to authorisation and ongoing requirements. Cross-border management of EU AIFs presupposes that the AIFM is authorised by CySEC to manage funds of the intended type and a complete notification file has been submitted to CySEC.

The AIFM must also provide CySEC with information on the EU member state in which it intends to manage AIF on a cross-border basis, and with a plan of activities regarding the services it intends to perform. If the AIFM intends to establish a branch, additional information on the organisational structure and the managers of the branch must be provided.

On receipt of the complete notification file, CySEC must transmit it to the competent authorities of the host member state within one month in case of direct provision of services, and within two months in case of establishment of a branch. On transmission of the file, CySEC must inform the applying AIFM that it has done so. On receipt of the transmission notification, the AIFM may start to provide its services in the member state.

The cross-border marketing of Cypriot and of other EU AIFs throughout the European Union is possible towards professional investors within the meaning of MiFID. The notification file to be submitted once more to CySEC must contain:

- A notification letter
- The constitutional documents of the alternative investment fund to be marketed
- The identity of its depositary
- Prescribed information to investors
- Information on the distribution arrangements made in the host member state

On receipt of the complete notification file, CySEC must transmit it to the competent authorities of the host member state within 20 days. On transmission of the file, CySEC must inform the applying AIFM, which may then start marketing the notified AIF in the host member state.

AIFMs marketing non-EU AIFs managed by them in the EU are not granted a passport, despite being subject to authorisation and compliance with the provisions of the AIFM Law. As such AIFMs must observe the NPPRs of each host member state and comply with additional requirements under the AIFMD that have been transposed into the national laws of each member state.

A similar Harneys article to the above was published by ILO in 2013 around the time of the enactment of the AIFM Law.