

- Highlights of AIFM Law provisions
- Licensable AIFMs pursuant to the AIFM Law
- Depositary
- Cross-border management and marketing of AIFs (Passport)

Alternative Investment Fund Managers Directive: Cyprus in the AIFMD Era

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This briefing will present the main provisions of the AIFM Law that apply to managers of Alternative Investment Funds (AIFs) falling within the scope of the AIFM Law (“AIFMs”).

On 5 July 2013 Cyprus transposed the AIFMD by means of legislation, the Law 56 I/2013 (“AIFM Law”). By 22 July 2013 the EU Level II Regulation (“Regulation”), which substantiates AIFMD provisions and is directly and uniformly applicable in all EU Member States (“EU MS”), became also applicable in Cyprus. This briefing will present the main provisions of the AIFM Law that apply to managers of Alternative Investment Funds (AIFs) falling within the scope of the AIFM Law (“AIFMs”). These provisions relate to the authorisation, the operating conditions and organisational requirements of a Cypriot AIFM, the depositary provisions and the cross-border management and marketing of AIFs managed by a Cypriot AIFM. In a separate briefing, the bespoke provisions relating to particular types of AIFs, such as reporting and disclosure regarding private equity and the role of a prime broker within the hedge funds’ context will be presented.

1. Highlights of AIFM Law provisions:

- 1.1 Competent authority for the authorisation and supervision of Cypriot AIFMs: Cyprus Securities and Exchange Commission (“CySEC”).
- 1.2 Eligible legal form for setting-up a Cypriot AIFM: Limited liability Company by shares.

- 1.3 Minimum initial capital for a Cypriot AIFM is set at EUR 125.000 plus professional liability insurance or additional own funds. The authorisation period is 3 months in principle.
- 1.4 Localisation of the depositary of a Cypriot AIF in another MS up to 2017 possible, if the depositary is a credit institution.
- 1.5 Certain AIFs are allowed to appoint another entity than a credit institution or a MiFID Investment Firm as depositary, e.g. a fiduciary services provider. This possibility is provided 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.
- 1.6 Transitional marketing period until July 2014 for marketing of non-EU AIFs in Cyprus: Only national private placement rules (PPL) without the additional AIFM Law marketing requirements apply.
- 1.7 External verification of the valuation procedures and/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.
- 1.8 Provisions ensuring re-domiciliation of an EU or non-EU AIFM to Cyprus have been adopted.
- 1.9 Special rules for Cyprus management companies of Undertakings for Collective Investment in Transferable Securities (UCITS management companies) applying to be additionally authorised as AIFMs. They are not required to provide the initial minimum capital of EUR 125.000 and the additional own funds required, when assets under management exceed EUR 250.000.000.

2. The meaning of “*managing*” one or more “*AIFs*” and its impact on current AIF management arrangements

2.1 The meaning of “*managing*” according to the AIFM Law

The AIFM Law regulates, in transposition of the AIFMD, every Cyprus based legal person that manages one or more AIFs notwithstanding whether these AIFs are Cyprus, EU or non-EU based. From 2015 on the AIFM Law shall also apply to non-EU AIFMs having designated Cyprus as their “Member State of reference” for their management and/or marketing activities in the EU. The present briefing will describe the application of the AIFM Law to Cypriot AIFMs as of its entry into force. Although principally focusing on the Cypriot AIFM, the AIFM Law also indirectly regulates aspects relating to AIFs managed by it. This is for instance the case with the valuation and depositary requirements imposing on the Cypriot AIFM the obligation to ensure compliance of the AIFs it manages with the relevant provisions of the AIFM Law.

The AIFM Law takes a “look-through” approach regarding the determination of the entity that qualifies as an AIFM under the AIFM Law. Thus, it is not of importance which entity is contractually designated as the principal manager of the AIF; decisive is which entity is effectively “managing” the AIF, i.e. providing at least risk or portfolio management services to the AIF. If more than one entities are “managing” the AIF within the above sense, then only one of them will have to be chosen to act as the AIFM. This may impact regulated Cypriot entities offering asset management services to AIFs, e.g. Cypriot MiFID Investment Firms (“CIFs”) in the following cases:

- 2.1.1 When the CIF is acting as a delegate of the principal manager of the AIF, whereas the principal manager is considered to be a “letter-box” entity.
- 2.1.2 When the CIF is acting as the principal manager of an off-shore AIF.
- 2.1.3 When the CIF is acting as the principal manager of a Cypriot International Collective Investment Scheme (“ICIS”).

In these cases, if the CIF is effectively “managing” the AIF and intends to continue “managing” it, then it will have to renounce on its CIF status and apply to be authorised as an AIFM. The reason is that CIFs are not allowed to act as an AIFM, if within AIFM Law scope.

Other Cypriot regulated entities that are impacted by the AIFM Law are Cypriot UCITS management companies that are also managing AIFs and fall within the scope of the AIFM Law. However, Cypriot UCITS management companies are given the possibility to additionally obtain a license pursuant to the AIFM Law, while retaining their initial UCITS management company license. This regulatory and business expansion is further facilitated: Cypriot 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 EUR 125.000 provided for under the AIFM Law.

2.2 The meaning of an “AIF” according to the AIFM Law

The AIFM Law adopts a broad approach regarding the meaning of an “AIF”. Only UCITS are explicitly excluded from the definition of an AIF; any other undertaking for collective investment raising monies from a number of investors with a view of investing them in accordance with a defined investment policy for their benefit qualifies as an AIF. It is not of importance whether the AIF is of the closed or open-ended type, internally or externally managed, listed or not, distributed to the public or to a limited number of investors. This means that even unregulated investment vehicles would fall under the definition of an AIF according to the AIFM Law. At the same time 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 and single investor funds are excluded from the scope of the AIFM Law.

In case of an AIF that has not designated an external manager but its legal form permits internal management by its governing body, then the AIF itself shall be considered to be the AIFM, i.e. AIF=AIFM. An external AIFM may offer its services to several AIFs, whereas the internally managed AIF cannot manage other entities than itself.

3. Licensable AIFMs pursuant to the AIFM Law

3.1. Determining applicability of the AIFM Law

Apart from the exempted entities mentioned above, there are entities that qualify as AIFMs within the meaning of the AIFM Law but may nevertheless benefit from a lighter regime than authorisation and compliance with the AIFM Law. Those AIFMs are subject to registration and not authorisation. They have to provide CySEC with information on their identities and the identities of the AIFs they manage. Further, the investment strategies they pursue through their AIFs, the main instruments, in which they are trading as well as the main exposures and most important concentrations they have. Determining whether an AIFM will be subject to the registration regime depends on the aggregate of the assets under management (“AuM”) in the AIFs managed by it. For Cypriot AIFMs managing only unleveraged

AIFs with a lock-up period of 5 years, whose AuM in aggregate do not exceed EUR 500.000.000 the lighter regime applies. This regime also applies to Cypriot AIFMs managing AIFs, including leveraged ones, whose AuM do not exceed EUR 100.000.000. It is a task incumbent on the AIFM to determine whether it is above or below the AIFM Law thresholds. Regarding the calculation of the AuM it has to be said that the assets of “fully invested” and “fully subscribed” AIFs provided for in the last Chapter of the AIFM Law are not included in the calculation.

Cypriot AIFMs above thresholds will be subject to authorisation and ongoing compliance with the AIFM Law. As an exchange, they will be benefiting from the so-called “passport”. The passport offers them the possibility to manage and market EU AIFs throughout the EU by means of an electronic notification procedure without any further authorisation being required. Cypriot AIFMs above thresholds managing non-EU AIFs, will also be subject to AIFM Law authorisation and compliance with most of its provisions. However, they will not be able to benefit from the AIFM Law passport until 2015. Cypriot AIFMs below thresholds are not granted passport either, unless they choose to “opt-in”.

3.2 Cypriot AIFM authorization procedure

Once the Cypriot AIFM is above the AIFM Law thresholds, it must submit an application to CySEC, for authorisation as an AIFM within 30 calendar days from exceeding the thresholds. CySEC has the right to restrict the scope of the license to only certain alternative investment strategies. Existing AIFMs, i.e. AIFMs operating before 22 July 2013, must have submitted the relevant application until 22 July 2014. AIFMs operating after 22 July 2013 must submit the relevant application without delay. Apart from a duly submitted application form, legal form and minimum capital requirements have to be met, in order for the AIFM to be authorized by CySEC.

The available legal form for the authorization of an external Cypriot AIFM is that of a limited liability company by shares having its registered and head office in Cyprus. The initial minimum capital requirements are EUR 125.000 for an external AIFM and EUR 300.000 for an internally managed AIF; both of them must also conclude a professional indemnity insurance or provide for additional own funds against liability arising from professional negligence. External AIFMs must provide for additional own funds, in case where the assets in the AIFs’ portfolios under their management exceed EUR 250.000.000. The cap is placed for “big-size” AIFMs at EUR 10.000.000, including initial capital and additional amount of own funds. UCITS management companies applying to also act as AIFMs are exempted from paying the initial minimum capital and the additional own funds required, where AuM exceed EUR 250.000.000. However, they have to either conclude a 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 program of activity, remuneration policy and practices and delegation arrangements. It has to be noted that in case of an internally managed AIF, i.e. AIF=AIFM, the qualifying shareholder information applies to the investors with qualifying participations in the AIF. Regarding the information relating to the AIFs, this includes the constitutional documentation of the AIFs, investor-related information, information on the appointment of the depositary and information about the investment strategies of the AIFs. Regarding the latter, information has, among others, to be provided about the country of establishment of the master AIF, in case of master-feeder structures. The reason is that, if the master AIF is not EU based and not managed by an AIFMD authorized AIFM, the feeder AIF loses the advantage to be marketed on an EU cross-border basis.

The authorisation period lasts 3 months from complete file submission. If special reasons apply, then it may be extended to another 3 months. In order for an application of a Cypriot AIFM to be approved, it must be authorised to provide at least portfolio and risk management to AIFs. Following its AIFM Law authorisation, a Cypriot AIFM may additionally apply to be authorised as a Cyprus UCITS management company as well. In this case it has to follow the authorisation procedure and comply with the provisions of the relevant Cypriot Law on UCITS.

4. Overview of conflicts of interest, risk management, valuation and delegation requirements

4.1. Conflicts of interest

As to the conflicts of interest policy a Cypriot AIFM is required to establish and implement, disclosure of conflicts of interest shall 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 shall not be permitted to invest all or part of the client's individual portfolio in units or shares of the AIFs it manages, unless it receives prior general approval from the client.

4.2 Risk management

Regarding risk management a new organisational requirement is introduced by the AIFM Law, namely the requirement for an independent risk management function in addition to an independent compliance function.

4.3 Valuation

As to the valuation function, Cypriot AIFMs must ensure that valuation procedures are in place for each AIF managed by them. The valuation function can be performed either internally or be assigned to an independent external valuer. The latter can be a natural or legal person, which is professionally (self)regulated or registered. Its appointment has to 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 has to be notified by the Cypriot AIFM to CySEC for approval. The latter may require that another external valuer be appointed instead, if the conditions regarding professional (self)regulation or registration, professional competence and AIFM Law compliant delegation have not been met. The depositary of an AIF managed by a Cypriot AIFM may, subject to certain conditions, assume the valuation function in addition to the depositary's one. 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 shall be functionally and hierarchically separated from the portfolio management function and possible conflicts of interest have to 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 net asset value ("NAV") calculation shall be carried out at least yearly and in accordance with the law of the country of the AIF and its constitutional documentation. However, for open-ended AIFs asset valuation and NAV calculation have to take also place at a frequency appropriate to the assets and the liquidity policy of such AIF. For closed-ended AIFs, asset valuation and NAV calculation shall take also place in case there is an increase or decrease in the capital of the AIF.

4.4 Delegation

The AIFM Law allows not only for delegation of tasks on behalf of the Cypriot 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 AIFs it manages and their investors. A valid delegation requires, apart from notifying CySEC, the substantiation and justification of the delegation arrangement. This includes submitting objective reasons for delegation, justifying the entire delegation structure and diligent selection of a sound and qualified delegate. The latter shall be subject to the instructions and ongoing review of the Cypriot AIFM. The said conditions also apply in case of sub and sub-sub-delegation. Delegation, sub-delegation and sub-sub-delegation must not prevent the effective supervision of the Cypriot AIFM by CySEC and the Cypriot AIFM from acting or managing the AIFs in the best interest of their investors. Further, no delegation, sub-delegation or sub-sub-delegation arrangement may result in the Cypriot AIFM ending-up as a letter box-entity: As mentioned above, a Cypriot AIFM must at least be authorised to provide risk and portfolio management to AIFs; "managing" an AIF means performing at least one of these functions. Thus, a Cypriot AIFM not performing at least one of these functions, within the meaning of effectively exercising some investment management activities itself, is to 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.

When the delegation of portfolio or risk management is concerned, then, 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 then CySEC's ad hoc approval is required as an alternative. Should the delegation take place to a non-EU service provider, then arrangements ensuring co-operation between CySEC and the supervisory authority of the non-EU service provider need also to be in place. The depositary or a delegate of the depositary, are not eligible delegates or sub-delegates or sub-sub-delegates of portfolio management or risk management tasks. Entities whose interests may conflict with those of the Cypriot AIFM or of the investors in the AIFs managed by the Cypriot AIFM, are also ineligible, unless the necessary safeguards and disclosures are in place.

5. Depositary

5.1 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 the Cypriot AIFM to ensure that, for each AIF it manages, a depositary is appointed by written agreement and in accordance with the AIFM Law provisions. If the AIFM cannot ensure compliance of the AIF with the depositary provisions then it has to withdraw from being the AIFM of such AIF. Cypriot AIFMs managing non-EU AIFs without marketing them in the EU are entirely exempted from complying with the depositary provisions. Yet, they have to get authorized pursuant to the AIFM Law and comply with most of its other provisions. Cypriot AIFMs managing non-EU AIFs, which are marketed in the EU, are also exempted from complying with the AIFM Law's depositary provisions. However, they need to appoint an entity to carry out the duties of a depositary laid down in the AIFM Law, in addition to authorisation and compliance with the rest of the AIFM Law's provisions. A Cypriot AIFM has to ensure that the EU AIFs under its management appoint their depositary in the EU MS, where these are established. Regarding Cypriot AIFs managed by a Cypriot AIFM or by another EU AIFM, the AIFM Law allows the appointment of a depositary elsewhere in the EU until 2017, provided such depositary is a credit institution.

The eligible depositaries of Cypriot AIFs must either have their registered office in Cyprus or be branches of entities, whose registered office is in another EU MS, without prejudice to the abovementioned exemption until 2017. These eligible depositaries may, in principle, be either credit institutions or MiFID Investment Firms. The latter must be also authorised for the ancillary service of safe-keeping, have at least own funds amounting to 730.000 EUR and be subject to the own funds provisions of the Banking Directive 2006/49/EC. However, Cypriot AIFs which 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 having their depositary appointed in their home MS. Such AIFs may also appoint as depositary any additional entity designated by the relevant MS as an eligible UCITS depositary.

5.2 Depositary duties and liability issues

The depositary duties, according to the AIFM Law, consist in broad terms of cash-flow monitoring, safe-keeping and compliance monitoring. Cash-flow monitoring applies to all inflows and outflows of cash of the AIF. Safe-keeping is divided into safe-keeping of “assets subject to custody” and of “other assets”. “Assets subject to custody” are 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 which can be registered with the issuer or its registrar or held in an account directly or indirectly in the name of the depositary. Further, it encompasses financial instruments which can be physically delivered to the depositary, such as collateral owned by the AIF or the AIFM acting on behalf of the AIF. Assets that do not qualify as “assets subject to custody” qualify and are treated as “other assets”. “Other assets” are subject to ownership verification, which can be based on information provided by the AIF or the AIFM acting on behalf of the AIF 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 to properly fulfill 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.

5.3 Delegation of depositary tasks and transfer of liability issues

Delegation of depositary tasks is possible regarding safe-keeping tasks only, i.e. delegation of safe-keeping of “assets subject to custody” and of “other assets” (also referred to as “sub-custody” in this section). Sub-sub-custody is also possible. Sub-custody is subject to a series of conditions, laid down in the AIFM Law, which apply proportionally to sub-sub-custody as well. There are, however, cases where 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 fulfill the sub-custody requirements of the AIFM Law. In such cases sub-custody to such entities is possible for as long as there are no local entities satisfying the delegation requirements of the AIFM Law. Further, disclosure to the investors of the AIF concerned of the legal constraints imposed by such jurisdictions is required prior to the investors' investment in such AIF. A relevant instruction by the AIF or the Cypriot AIFM acting on behalf of the AIF instructing sub-

custody to such entity is also required. Sub-custody does not affect the depositary's liability towards the AIF 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:

5.3.1 The depositary and the sub-custodian on the one hand; and

5.3.2 The depositary and the Cypriot AIFM acting on behalf of the AIF concerned or the AIF 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, then transfer of liability is still possible. It requires however a relevant provision in the constitutional documents of the AIF concerned, disclosure to investors prior to 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.

6. Cross-border management and marketing of AIFs (Passport)

A Cypriot AIFM authorised under the AIFM Law is granted, as an exchange to being subject to authorisation and ongoing requirements, the right to manage and market Cypriot and other EU AIFs throughout the EU (passport). Cross-border management of EU AIFs presupposes that the Cypriot AIFM is authorised by CySEC to manage AIFs of the intended type and a complete notification file is submitted to CySEC. The Cypriot AIFM must also provide CySEC with information on the EU MS, where it intends to manage AIFs on a cross-border basis and with a plan of activities regarding the services it intends to perform. If the Cypriot AIFM intends to establish a branch, then additional information on the organisational structure and the managers of the branch has to be provided. Upon receipt of the complete notification file, CySEC transmits it to the competent authorities of the host MS within 1 month in case of direct provision of services and within 2 months in case of establishment of a branch. Such transmission shall however occur only if the Cypriot AIFM's management of the AIF complies, and will continue to comply, with the AIFM Law and if the Cypriot AIFM otherwise complies with the AIFM Law. Upon transmission of the file, the CySEC informs the applying Cypriot AIFM thereof. Upon receipt of the transmission notification, the Cypriot AIFM may start to provide its services in the host MS.

As to the cross-border marketing of Cypriot and of other EU AIFs throughout the EU, this 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 AIF to be marketed, the identity of its depositary, prescribed information to investors and information on the distribution arrangements made in the host MS. Upon receipt of the complete notification file, CySEC transmits it to the competent authorities of the host MS within 20 days. Such transmission shall however occur only if the Cypriot AIFM's management of the AIF complies, and will continue to comply, with the AIFM Law and if the Cypriot AIFM otherwise complies with the AIFM Law. Upon transmission of the file, CySEC informs the applying Cypriot AIFM thereof, who may then start marketing the notified AIF in the host MS.

Cypriot AIFMs marketing non-EU AIFs managed by them in the EU are not granted a passport, although being subject to authorisation and compliance with the provisions of the AIFM Law, except for the depositary ones. A passport is expected to be introduced for them in 2015. In the meantime they must observe the national private placement rules of each host MS and comply with additional AIFMD requirements that have been transposed into the national laws of each MS. However, several EU regulators have decided to allow the marketing of non-EU AIFs in their territory subject to observance

only of their national private placement rules until July 2014 (transitional marketing regime). CySEC has taken the same approach regarding the marketing of non-EU AIFs in Cyprus and thus transitional marketing regime will apply in Cyprus until July 2014.

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