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Cypriot Alternative Investment Funds (AIF) and AIFM (Alternative Investment Funds Manager)

What is an Alternative Investment Fund?

AIFs are collective investment undertakings raising capital from a number of investors, with a view to investing such capital in accordance with a defined investment policy for the benefit of those investors, and which has not been authorised as a UCITS fund (Undertaking for Collective Investment in Transferable Securities). The commencement of operations of an AIF requires prior authorisation by the regulatory authority.

Professional Investor means an investor who is considered to be a professional client or may, on request, be treated as a professional client within the meaning of the Second Appendix of the Investment Services and Activities and Regulated Markets Law.

Well-informed investor means every investor who is not a professional investor, but fulfils the following criteria:

(a) the investor confirms in writing **(i)** that he has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks associated with the prospective investment and that he is aware of the risks associated with the prospective investment or **(ii)** that his business activity is related to the management, acquisition or sale of assets, either on the investor's own account or on behalf of third parties, and are of the same type as the investments of the AIF

b) **(i)** invests at least €125.000 in the AIF or **(ii)** has been assessed by a credit institution, an AIFM, a UCITS Management Company, an IF or an external manager of AIFs authorised in the Republic or another Member State for the management of AIFs whose assets do not exceed the limits provided for in article 4(2) of the Alternative Investment Fund Managers Law or the corresponding article 3(2) of Directive 2011/61/EU, and the above assessment shows that he has the necessary knowledge and experience in financial and business matters, to evaluate the merits and risks associated with the AIF's prospective investment based on the AIF's investment policy or **(iii)** is employed by one of the persons referred to in subparagraph (ii) of paragraph (b), receiving total remuneration that takes him into the same remuneration bracket as the natural persons who effectively conduct the business of the person referred to in subparagraph (ii) of paragraph (b) or the executive members of their governing body, who effectively conduct their business by way of derogation from paragraphs (a) and (b), the investor is a person who effectively directs the business of the AIF or its external manager or is a person engaged in the AIF's investment management functions.

Retail Investor means an investor who does not qualify as a professional investor nor as a well informed investor.

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Regulatory Framework of the AIFs and 2 Types of AIFs

The formation of a fund can take place following an application to the Cyprus Securities and Exchange Commission (CySec) which is the regulatory body for AIFs. CySec is the sole regulating authority for investment funds and investment fund managers in Cyprus, and is responsible, among others, to apply the Laws, examine applications, issue directives and generally supervise the operation of AIF of the Republic. Following the application to CySec, and subject to the fulfilment of all the requirements for the formation of the Fund, CySec will proceed with the registration of the fund.

The law governing AIFs is the Alternative Investment Funds Law of 2018 (124(I)2018). The AIF Law further provides the opportunity for the creation of two types of AIFs providing for a wider use of the funds and meeting the needs of all kind of investors. AIFs that are established under domestic Cyprus fund legislation can be sold on a private placement basis or marketed to professional investors across the EU under the AIFMD passport.

Firstly, the unlimited AIFs. These AIFs are available to an unlimited number of investors and can be marketed to any investor, encompassing retail investors. Secondly, the AIFs with a limited number of persons. These are available to 50 investors or less, and can be marketed to 'well-informed' investors (often whereby their investment in the AIF is at least EUR125.000), or 'professional' investors (those who possess the experience, knowledge and expertise to make its own investment decisions). A more detailed description of the two types of AIF are as follows:

[I] AIFs available to the public with unlimited number of investors

- This type of AIF can be marketed either to well-informed/professional investors or to retail investors;
- The management of AIFs can be either internally managed or managed by a management company, depending on the value of the assets.
- This type of AIF can be listed, and provide for the possibility to make public offerings of shares/units

- Umbrella Funds can be created where an AIF can manage multiple investment compartments where each compartment is managed in a different way, involving different investment policies with separate assets and liabilities.
- This type of AIF must, within twelve (12) months from the date its authorisation was granted, raise at least five hundred thousand euros (€500.000) worth of capital from investors.
- Reporting requirements include half yearly report, and annual report, which includes information of the fund and its activities as well as the audited financial statements.
- Subject to certain investment restrictions for the purpose of risk spreading and ensuring liquidity.

[II] AIFs with limited number of persons – AIFLNP

This type of Fund offers a flexible arrangement of AIFs. Under this arrangement investors may invest their money in the fund for a specific purpose or investment strategy which will be managed by experience and professional managers, and in the case of successful management derive profits from such investments, some of the main characteristic of this type of fund can be fund below:

- The maximum number of investors is limited to a maximum of fifty (50) natural persons
- It is addressed only to well-informed and/or professional investors.
- May be set up either as internally managed AIFLNP or an externally managed AIFLNP
- The marketing of AIFLNP units is forbidden before to the granting of authorisation and notification of authorisation by the Securities and Exchange Commission
- The AIFLNP must, within twelve (12) months from the date its authorisation was granted, raise at least €250.000 worth of capital from investors
- The internally – managed AIFLNP shall have, at any time, either in cash or assets readily convertible to cash, an initial capital of at least 50.000



- Freely transferable investor shares with the condition that their shares does not result
- in the AIF having more than 50 investors.

The AIFLNP can be marketed to 'well informed' investors (often whereby their investment in the AIF is at least EUR125.000), or 'professional' investors (those who possess the experience, knowledge and expertise to make its own investment decisions).

Umbrella funds can be created under this type of fund, where AIFLNP can manage multiple investment compartments, however in this case the limitation on the number of investors is applies to the whole scheme. An AIFLNP that consists of more than one investment compartments constitutes a single legal entity and therefore no separate fund rules or instruments of incorporation are drawn up. The value of units issued by each of the investment compartments of the umbrella AIFLNP may differ. The unit holders' rights derived from the assets of the relevant compartment they have invested in; each investment compartment is liable for the obligations created from its establishment and operations or its dissolution. Each investment compartment of the umbrella AIFLNP is being dissolved and liquidated separately, without its dissolution and liquidation resulting in the dissolution and liquidation of other compartments of the AIF or of the AIF itself.

Assets under management do not exceed the AIFMD threshold of €100 million or of EUR 500 million when the portfolios of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.

What is an Alternative Investment Fund Manager (AIFM)?

Each AIF shall have a single AIFM, which shall be responsible for ensuring compliance with the AIFM Law.

The AIFM shall be either

- a. an external manager, which is the legal person appointed by the AIF or on behalf of the AIF and which through this appointment is responsible for managing the AIF (external AIFM), or

- b. internally managed, i.e. where the legal form of the AIF permits an internal management and where the AIF's governing body chooses not to appoint an external AIFM, in which case the AIF itself shall act as AIFM.

The AIFM shall engage, at least, in the following core investment management functions when managing an AIF:

- Portfolio management
- Risk management.

The AIFM may additionally be authorised to perform any of the following functions in the course of the collective management of an AIF:

- Administration
- Legal and fund management accounting services
- Customer inquiries
- Valuation and pricing, including tax returns
- Regulatory compliance monitoring
- Maintenance of unit/shareholder register
- Distribution of income
- Issues and redemptions of unit/shares in the AIF
- Contracts settlements, including certificate dispatch
- Record keeping
- Marketing services

Activities related to the assets of the AIF, namely services necessary to meet the fiduciary duties of the AIFM, facilities management, real estate administration activities, advice to undertakings on capital structure, industrial strategy and related matters, advice and services relating to mergers and the purchase of undertakings and other services connected to the management of the AIF and the companies and other assets in which it has invested.



Additional Investment Services

Subject to compliance with the relevant MiFID rules without separate MiFID authorisation being required, an external AIFM may also be authorised to provide the following MiFID services:

- individual management of portfolios of investments, including those owned by pension funds and institutions for occupational retirement, in accordance with the mandates given by investors on a discretionary, client-by client basis;
- Along with the provision of individual portfolio management services outlined above, an AIFM may further be authorised to provide:
- investment advice
 - * safe-keeping and administration in relation to shares or units of collective investment undertakings
 - * reception and transmission of orders in relation to financial instruments.

Regulatory Framework governing AIFMs

The law governing AIFMs is Law 56(I)/2013 transposing the Alternative Investment Fund Managers Directive (AIFMD 2011/61/EU) into Cyprus legislation. This is followed by the EU Regulation 231/2013 (Level 2) which supplements AIFMD 2011/61/EU and applies directly to all EU member states without the need for transposition into national law.

The AIFM Law applies in particular to the following activities:

- A Cyprus AIFM managing Cyprus AIFs or AIFs of another EU Member State or third country;
- An EU or third country AIFM managing Cyprus AIFs;
- A Cyprus AIFM marketing units or shares of AIFs they manage in other EU Member States or third countries;
- An EU or third country AIFM marketing units or shares of AIFs they manage in Cyprus .

Investment fund managers whose total assets under management of all AIFs managed do not exceed

- EUR 100 million (including leverage), or

- EUR 500 million (for unleveraged funds but with a lockup period of 5 years)

are subject to registration and reporting requirements in their home Member State. Such managers established in Cyprus may elect to opt-in to authorisation (as Cyprus AIFM) under the AIFM Law in order to enjoy the beneficial provisions of the Law such as Passporting (see below) and demonstrate substance (to tax authorities overseas). Moreover, by being authorised by a well-respected regulatory authority such as CySEC provides additional confidence to prospective investors.

Passporting

EU Passport - Cyprus AIFMs, once authorised by CySEC, can manage, market and distribute units of EU AIFs to professional investors in all other EU Member States using the simplified regulator-to-regulator notification mechanism without seeking permission from each Member State and the need to comply with different national laws. Under certain conditions, not only a Cyprus AIFM can manage AIFs established in the EU but AIFMs of another Member State can manage AIFs established in Cyprus.

Third Country Passport - Cyprus AIFMs can take advantage of Cooperation Arrangements that are in place between CySEC and regulators in third countries where non-EU AIFs are established so that, under certain conditions, a Cyprus AIFM can use the third country passport to market the units of non- EU AIFs to professional investors in the EU and/or manage non-EU AIFs marketed outside the EU. Moreover, under certain conditions, when the authorised Member State of Reference of a non-EU AIFM is Cyprus that non-EU AIFM can

- market the units of AIFs established in the EU (Cyprus or other Member State) as well as the units of non-EU AIFs to EU Member States
- manage AIFs established in Cyprus or in another EU Member State and marketed outside the EU.



The Process of Obtaining a License for the AIFM

The Cypriot AIFM are licensed and regulated by CySec. This can include governing the way that AIFs may be marketed. Moreover, 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. Also, AIFMs may be specifically licensed by CySec to provide individual portfolio advisory and management (IPM) services similar to those authorised under the MiFID regime. AIFMs 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

CySec has all supervisory and investigatory powers that are necessary for the exercise of its functions and can exercise power directly, in collaboration with other authorities, under its responsibility by delegation to entities to which tasks have been delegated, and by application to the competent judicial authorities.

In practice, this means that CySec can carry out activities such as requiring access to any document in any form and to receive a copy of it and requesting information from any person related to the activities of the AIFM or the AIF, but also summoning and questioning a person with a view to obtaining information. In addition, CySec can request existing telephone and existing data traffic records, and even demand the freezing or the sequestration of assets.

As outlined above, CySEC is the authorisation body for AIFMs in Cyprus. It usually takes CySec 3-6 months to process the application and issue a decision.

An application to the CySec must include AIFM documents such as the proposed Corporate Documents, Business Plan, Organisational Structure, Internal Control System: Risk Management policies, processes and procedures, Anti Money Laundering procedures, Operational Manual, Information on

delegation and sub-delegation arrangements, and Information on the Management, Directors and Shareholders (with >10% holding or voting power or exercising significant influence over the management of the AIFM). The AIF related information must also be presented. This can include constitutional documents, investment strategies, risk profiles, policy as regards the use of leverage and other information disclosing the characteristics of the of the AIFs it manages or intends to manage.

Minimum requirements for obtaining a license

There are a few minimum requirements needed for obtaining a license. Firstly, there must be physical presence. A Cyprus AIFM must base registered head-office in Cyprus and employ competent and experienced personnel of good repute. Secondly, there must be an internal control system in place. CySec will review the functional and hierarchical separation of the functions of risk management, in accordance with the principle of proportionality and understanding that the AIFM shall, in any event, be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of this section and is consistently effective. In practice, this would mean establishing adequate risk management systems; appropriate, documented and regularly updated due diligence process in compliance; liquidity management systems; sound accounting and other effective organisational and administrative arrangements. Thirdly, the shareholders of the AIFM that have qualifying holdings must be suitable taking into account the need to ensure the sound and prudent management of the AIFM. Fourthly, the initial capital if the AIFM is appointed as external manager, it's EUR 125,000. On top of this, in some cases the AIFM shall provide an additional amount of own funds, as well as own funds for potential professional liability risks. There are also further requirements if the AIFM is providing MiFID Discretionary Portfolio Management services.



Reporting Requirements for the AIFM

There are extensive reporting requirements for the AIFMs of the Republic. There must be regular reports to the Commission on the principal markets and instruments in which it trades on behalf of the AIFs they manage. AIFMs of the Republic must include in these reports information on:

- the main instruments in which it is trading on behalf of the AIF; and
- the markets of which it is a member or where it actively trades; and
- on the principal exposures and most important concentrations of each of the AIFs it manages.

These reporting obligation that must be met for on a regular basis. This mostly concerns risk-related information such as Risk Profile by risk type, including Market risk, Liquidity risk, Counterparty risk, and risk management systems. Moreover, the reporting frequency and requirements vary by total AUM. Furthermore, the AIFM must document the Annual Report for each EU AIF it manages and arrange disclosure to investors in accordance with AIF's constitutional documentation. On a good note, a lot of the risk management can be outsourced for practical advantages such as saving time, and achieving regulatory compliance at a reasonably low cost.

If an AIFM manages an EU AIFs, for each of the AIFs it markets in the Union, provide the following information to the Commission:

- the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;
- any new arrangements for managing the liquidity of the AIF;
- the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;
- information on the main categories of assets in which the AIF invested;
- the results of the stress tests performed.

Key benefits of the Cyprus AIF and AIFM

- Increased flexibility as a number of assets classes can be included in an AIF investment strategy.
- An AIF enjoys similar taxation benefit of a Cyprus tax resident company being one of the lowest corporate income tax rates in the EU at 12.5%.
- Cyprus is an EU member state compliant with EU laws and regulations.
- Dividends distributed to Cyprus tax residents are subject to 3% Social Defence Contribution (compared to 17% that normally applies).
- No subscription tax on net assets of a fund.
- Exemption from tax on profits from sale of shares and other instruments.
- No withholding tax on income repatriation or dividends paid to unit holder.
- No capital gains tax on disposal of shares/units by the holders.
- Tax exemption on capital gains from the sale of immovable property located outside Cyprus.
- Extensive Double Tax Treaties in place 50 countries worldwide.

This attractive regime is all about combining flexibility, effective regulations and incentives to investors, since the creation of the AIFs in Cyprus provides cost benefits in terms of incorporation as well as tax benefits enjoying the 12.5% corporate tax rate. The legal professionals of Andreas M. Sofocleous & Co are happy to provide specialist and tailored advice to meet your investment needs, including licensing of the AIFM, risk consulting, and advisory services, and deliver delivering the specialised and objective advice you need to clearly understand your exposure to risks, options and opportunities.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstance.