

TO : a. **Cyprus Alternative Investment Fund Managers – ‘CAIFMs’¹**:
i. **Cyprus Alternative Investment Fund Managers**
ii. **Cyprus Sub-threshold Alternative Investment Fund Managers**

b. **Alternative Investment Funds with separate legal personality-‘AIFs’**:
i. **Alternative Investment Funds- AIFs**
ii. **Registered Alternative Investment Funds-RAIFs**
iii. **Alternative Investment Funds with Limited Number of Persons AIFLNPs**

FROM : **Cyprus Securities and Exchange Commission**

DATE : **4 April 2023**

CIRCULAR No : **C562**

SUBJECT : **Guidance to CAIFMs and AIFs, on key principles and concepts governing the Alternative Investments Fund Managers Directive 2011/61/EU (‘AIFMD’)**

The Cyprus Securities and Exchange Commission (‘**the CySEC**’) wishes to highlight to Cyprus Alternative Investment Fund Managers (CAIFMs) and/or Alternative Investment Funds (AIFs) externally managed by CAIFMs, some key aspects relevant to the application of the Alternative Investments Fund Managers Directive 2011/61/EU (AIFMD). In particular, CySEC directs CAIFMs to ensure better understanding and compliance with the single AIFM principle, the principles governing the delegation of functions and the ‘letter box entity’ concept, as well as the AIFMD and AIF scope.

Through its supervisory activity, CySEC has become aware of practices which are not always aligned with the above key principles, concepts and scope governing the AIFMD, as transposed and/or adopted in Cyprus’ legal framework (‘**the AIFM Legal Framework**’).² National laws relevant to this include ‘The Alternative Investment Fund Managers Law 56(I)/2013’ transposing the AIFMD into Cyprus national law, the ‘Alternative investment Funds Law 124(I)/2018’ governing AIF type investment undertakings and ‘The Small Alternative

¹ For clarity purposes, the term CAIFMs includes both CAIFMs acting as External Managers and Internally Managed AIFs, except where expressly stated otherwise.

² Refer to the **ANNEXES** of the present circular for the specific legal framework.

Investment Fund Managers Law 81(I)/2020', governing sub-threshold CAIFMs, (onwards '**the CAIFM Laws**'). The latter two national laws have been developed based on key definitions and principles governing the AIFMD and Law 56(I)/2013.

It is important to note that the 'Delegation Principles- 'Letter box entity' concept legal framework (Section B. of the present circular) will be further enhanced through the upcoming AIFM and UCITS Directive review³. Cyprus UCITS managers should take consideration of the present circular especially in regard to the 'Letter-box entity' concept, which will be introduced in the revised UCITS Directive.

A. SINGLE AIFM PRINCIPLE

1. The AIFM Legal Framework, details of which appear in **ANNEX 1**, aims to ensure that the CAIFM is the only legal person with ultimate responsibility to manage an AIF in accordance with the CAIFM Laws. For the purposes of CAIFMs' and AIFs' compliance with such principle, the following points should be an integral part of such parties practice:
 - 1.1 Each externally managed AIF appoints a single CAIFM, who is the person legally responsible for ensuring compliance of the management of the AIF with the CAIFM Laws. Such CAIFM is the only person responsible for providing the investment management functions as outlined under the AIFM Laws.
 - 1.2 The CAIFM should not be considered a delegate/ third party provider to the AIF i.e. managing the AIF based on a delegation arrangement of the investment management functions. The CAIFM should be the legal person appointed by the AIF to manage the fund in accordance with the CAIFM Laws. The Investment Management agreement between a CAIFM and an AIF should be construed on this basis.
 - 1.3 An externally managed AIF cannot itself perform and/or be involved in any way in the execution of functions included under Annex I of the AIFMD ('**the Functions**') incorporated in the CAIFM Laws. The role of such AIF's Board of Directors/Partners relevant to the AIF shall be limited to:

³ Refer to the ['Proposal for a Directive amending Directives 2011/61/EU and 2009/65/EC as regards the delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds'](#)

- i. The definition of the Investment Policy and the approval of the Investment Strategies of the AIF.
 - ii. Monitoring the appointed CAIFM to ensure the individual carries out their responsibility to manage the AIF in accordance with the CAIFM Laws, at all times. To this end, the externally managed AIF could request that the CAIFM provides the AIF BoD/Partners with relevant reporting, the content and frequency of which could be bilaterally agreed between the two parties and elaborated on in the CAIFM's policies and procedures.
 - iii. Where necessary, co-signing agreements between the CAIFM and a service provider (e.g the Depositary), for the purposes of ensuring the AIF's BoD/Partners' compliance with the duties and obligations stemming from regulatory frameworks not related to the AIFM Regulatory framework and the AIFMD.
- 1.4 In the event of delegation of functions by the CAIFM, the AIF should only be part of the Delegation agreement signed between the CAIFM and the third party/delegate, where necessary. It is noted that the CAIFM must always be part of the Delegation agreement.
- 1.5 An externally managed AIF cannot be a 'third party' for the purposes of delegation in accordance with the 'Delegation' provisions.

CAIFMs' and AIFs' practices must be fully aligned with the content of the above paragraphs and **ANNEX 1**, otherwise the CAIFM could be assessed as not acting in the best interests of the AIF and its investors.

B. DELEGATION PRINCIPLES- 'LETTER-BOX ENTITY' CONCEPT

2. The AIFM Legal Framework, elaborated upon under **ANNEX 2**, aims to ensure that the CAIFMs and Internally Managed AIFs remain responsible for ensuring compliance with the CAIFM Laws relevant to the execution of the delegated functions and that the CAIFM should ensure at all times that it does not delegate such functions, especially investment management functions, to the extent it becomes a 'letter-box entity'. For the purposes of CAIFMs and Internally Managed AIFs compliance, the following should be an integral part of their practice:
 - 2.1 Each time a function is delegated, the sufficiency and appropriateness of human and technical resources should be assessed to ensure compliance with the principles of the

delegation of functions in the AIFM Legal Framework, particularly those that relate to the due diligence carried out on delegates at the selection stage and at the on-going monitoring stage, as well as during the supervision of each delegate performing the function.

- 2.2 In relation to the investment management functions, every time a new function is delegated, all existing delegations for a specific AIF should be taken into account. Where further delegation would cause the delegated investment management functions to substantially exceed the margin of functions performed internally for that specific AIF, they should refrain from further delegation. Article 82(1)(d)(i) to (vii) of the EU Regulation 231/2013 includes qualitative criteria that should be used when assessing the volume of delegation.
- 2.3 As highlighted above, the provisions related to the delegation of functions in the AIFM Legal Framework, especially the assessment of a 'Letter-box entity', are applicable at each AIF under management level and not at the AIFM level. It is ESMA's opinion⁴ that AIFMs (including internally managed AIFs) must perform investment management functions for each AIF they manage and they cannot delegate portfolio management and risk management functions for a particular AIF in their entirety, even where they perform such functions for other funds.

CAIFMs' practices must be fully aligned and act in accordance with the content of the above paragraphs and the **ANNEX 2** AIFM Legal Framework. Otherwise they run the risk of not being delegating 'at arm's length' and risk becoming a 'letter –box entity'.

C. AIFMD AND AIF SCOPE

3. CAIFMs should ensure at all times that their business and/or the investment undertaking fall within the AIFMD and AIF scope elaborated under **ANNEX 3**. To this end, the following points are highlighted:
 - 3.1 Investment managers which manage one or more AIFs and whose only investors are the CAIFM itself or a related party of the CAIFM do not fall under the AIFMD framework.

⁴ Refer to paragraph 56 under title 'Substance' of the [ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union](#).

- 3.2 Investment undertakings which invest the private wealth of investors without raising external capital should not be considered as AIFs meeting the AIF definition in the AIFMD.
- 3.3 In order for an investment undertaking to constitute an AIF and hence fall under the scope of the AIFM Legal Framework, it must be assessed according to the ESMA Guidance on Key Concepts of the AIFMD.

D. FINAL REMARKS

4. The upcoming AIFMD and UCITS review, as indicated in the currently available *‘Proposal for a Directive amending Directives 2011/61/EU and 2009/65/EC as regards the delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds’*, will introduce important amendments relevant to delegation and the ‘Letter-box entity’ concept. CAIFMs and Cyprus UCITS Managers are encouraged to bear in mind the relevant proposals when setting up/reviewing their delegation practices, policies and procedures in accordance with the present circular.
5. It is highlighted that CAIFMs engaging in ‘white-label’ business⁵ should be particularly attentive to the content of this circular, especially sections A and B on the ‘Single AIFM’ and ‘Delegation-Letter-Box entity’ principles.
6. Where CAIFMs reviewing their practices, policies and procedures in accordance with the content of this circular identify any areas of concern, CySEC expects them to take immediate actions to ensure their compliance.

Yours sincerely,

George Karatzias
Vice Chairman
Cyprus Securities and Exchange Commission

⁵ Refer to paragraph 36 under title ‘White-label business’ of the [ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union](#), where a definition and description of such business is suggested.

SINGLE AIFM PRINCIPLE- RELEVANT LAWS AND GUIDANCE ISSUED THEREOF

A. AIFMD (2011/61/EU) and CySEC AIFM Laws (56(I)/2013, 124(I)/2018 and 81(I)/2020)

Article 5(1) of the AIFMD (transposed under Section 5(1) of Law (56(I)/2013) and adopted under Section 4(1) of Law 81(I)/2020), on the 'Determination of the AIFM' states that:

'1. Member States shall ensure that each AIF managed within the scope of this Directive shall have a single AIFM, which shall be responsible for ensuring compliance with this Directive. The AIFM shall be either:

(a) an external manager, which is the legal person appointed by the AIF or on behalf of the AIF... or

(b) 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, the AIF itself, which shall then be authorised as AIFM.'

Articles 20(1) and (3) of the AIFMD (transposed under Section 20(1) and 22 of Law (56(I)/2013) and adopted under Section 23(2) and 25 of Law 81(I)/2020) on 'Delegation' state that:

*'1. AIFMs which intend to **delegate to third parties the task of carrying out functions on their behalf** shall notify the competent authorities of their home Member State before the delegation arrangements become effective. The following conditions shall be met:...*

*3. The **AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party**, or by any further sub-delegation, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity...'*

B. ESMA Questions and Answers on the application of the AIFMD (ESMA34-32-352)

Section VIII: Delegation

Question 2 [last update 16 November 2016]: *Where the AIFM does not itself perform the functions set out in Annex I of the AIFMD, does this release the AIFM from its responsibility to ensure compliance of the relevant function(s) with the AIFMD?*

Answer 2: No. Where a third party performs a function stated in Annex I of the AIFMD, this function **should be considered as having been delegated by the AIFM to the third party.** Therefore, the AIFM should be responsible for ensuring compliance with the requirements on delegation set out in Article 20 of the AIFMD **and the principle expressed in Article 5(1) of the Directive according to which the single AIFM appointed for an AIF is responsible for ensuring compliance with the AIFMD.** For the avoidance of doubt, this applies to all functions stated in point 1 and point 2 of Annex I of the AIFMD.

Question 3: Can an externally-managed AIF itself perform the investment management functions set out in point 1 of Annex I or functions set out in point 2 of Annex I of the AIFMD or would it be possible that the external AIFM delegates the performance of these functions to the governing body or any other internal resource of the externally-managed AIF?

Answer 3: No. Externally-managed AIFs are not regulated as AIFM. The performance of the functions stated in Annex I of the AIFMD is **only permitted for AIFs which are internally managed pursuant to Article 5(1)(b) of the AIFMD.** Where the AIF appoints an external AIFM pursuant to Article 5(1)(a), **the external AIFM is through its appointment as AIFM of the AIF responsible for providing the functions stated in Annex I of the AIFMD.** The external AIFM may delegate to third parties the task of carrying out functions on its behalf in accordance with Article 20 of the AIFMD. **The AIF is, however, not a ‘third party’ in accordance with Article 20(1) of the AIFMD.**

C. CySEC Circular on Common deficiencies and best practice standards identified through on-site inspections regarding certain aspects of the AIFM governance (C409)

Paragraph 12 of Section C.V. on the Responsibility of the external AIFM regarding managed AIFs in the form of a company/partnership, elaborates as follows:

‘12. When the AIF in the form of a company/partnership appointed an external AIFM, it was found that in some cases there were practices which did not ensure that the AIFM is the only one responsible for managing the AIF:

- i. The final decisions/approvals for the specific investments of the AIF according to its investment strategy were not made by the AIFM, but instead by the AIF’s Board of Directors.
- ii. In some occasions, the final approval/decision on the risk limits was made by the Board of Directors of the AIF and not by the Board of Directors of the AIFM.

- iii. The contracts signed between the AIFM and the AIF regarding the collective management of the AIF by the AIFM (usually “Investment Management Agreement”), did not contain provisions to ensure that the AIFM, within the collective management framework, has the ultimate authority and responsibility to manage and decide on the individual investments and risks of the AIF, based on the agreed investment strategy between the AIFM and the AIF.’

DELEGATION PRINCIPLES /LETTER BOX ENTITY CONCEPT- RELEVANT LAWS AND GUIDANCE ISSUED THEREOF

A. AIFMD (2011/61/EU) and CySEC AIFM Laws (56(I)/2013, 124(I)/2018 and 81(I)/2020)

Articles 20(1) and 20(3) of the AIFMD (transposed under Sections 20(1) and 22 of Law (56(I)/2013) and adopted under Sections 23(1) and 25(2) of Law 81(I)/2020) on ‘Delegation’ state that:

*‘1. AIFMs which intend to delegate to third parties the task of carrying out functions on their behalf shall notify the competent authorities of their home Member State before the delegation arrangements become effective. **The following conditions shall be met:***

(a) the AIFM must be able to justify its entire delegation structure on objective reasons;

(b) the delegate must dispose of sufficient resources to perform the respective tasks and the persons who effectively conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced;

(c) where the delegation concerns portfolio management or risk management, it must be conferred only on undertakings which are authorised or registered for the purpose of asset management and subject to supervision or, where that condition cannot be met, only subject to prior approval by the competent authorities of the home Member State of the AIFM;

(d) where the delegation concerns portfolio management or risk management and is conferred on a third-country undertaking, in addition to the requirements in point (c), cooperation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking must be ensured;

(e) the delegation must not prevent the effectiveness of supervision of the AIFM, and, in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors;

(f) the AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors.

*...3. The AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation, nor shall the **AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity...***

B. Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU

Article 75 of Section 8 on the 'General Principles' of 'Delegation of AIFM functions' states:

'When delegating the task of carrying out one or more functions on their behalf, AIFMs shall comply, in particular, with the following general principles:

(a) the delegation structure does not allow for the circumvention of the AIFM's responsibilities or liability;

(b) the obligations of the AIFM towards the AIF and its investors are not altered as a result of the delegation;

(c) the conditions with which the AIFM must comply in order to be authorised and carry out activities in accordance with Directive 2011/61/EU are not undermined;

(d) the delegation arrangement takes the form of a written agreement concluded between the AIFM and the delegate;

(e) the AIFM ensures that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements and must establish methods and procedures for reviewing on an ongoing basis the services provided by the delegate. The AIFM shall take appropriate action if it appears that the delegate cannot carry out the functions effectively or in compliance with applicable laws and regulatory requirements;

(f) the AIFM supervises effectively the delegated functions and manages the risks associated with the delegation. For this purpose the AIFM shall have at all times the necessary expertise and resources to supervise the delegated functions. The AIFM shall set out in the agreement its right of information, inspection, admittance and access, and its instruction and monitoring rights against the delegate. The AIFM shall also ensure that the delegate properly supervises the performance of the delegated functions, and adequately manages the risks associated with the delegation;

(g) the AIFM ensures that the continuity and quality of the delegated functions or of the delegated task of carrying out functions are maintained also in the event of termination of the delegation either by transferring the delegated functions or the delegated task of carrying out functions to another third party or by performing them itself;

(h) the respective rights and obligations of the AIFM and the delegate are clearly allocated and set out in the agreement. In particular, the AIFM shall contractually ensure its instruction and termination rights, its rights of information, and its right to inspections and access to books

and premises. The agreement shall make sure that sub-delegation can take place only with the consent of the AIFM;

(i) where it concerns portfolio management, the delegation is in accordance with the investment policy of the AIF. The delegate shall be instructed by the AIFM how to implement the investment policy and the AIFM shall monitor whether the delegate complies with it on an ongoing basis;

(j) the AIFM ensures that the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;

(k) the AIFM ensures that the delegate protects any confidential information relating to the AIFM, the AIF affected by the delegation and the investors in that AIF; (l) the AIFM ensures that the delegate establishes, implements, and maintains a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

Article 82 on the 'Letter-box entity and AIFM no longer considered to be managing an AIF' states:

1. An AIFM shall be deemed a letter-box entity and shall no longer be considered to be the manager of the AIF at least in any of the following situations:

(a) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation

(b) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;

(c) the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;

(d) the AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, competent authorities shall assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:

(i) the types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;

(ii) the importance of the assets under delegation for the achievement of the investment goals of the AIF;

(iii) the geographical and sectoral spread of the AIF's investments; (iv) the risk profile of the AIF; (v) the type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF; (vi) the types of tasks delegated in relation to those retained; and (vii) the configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

2. The Commission shall monitor, in the light of market developments, the application of this Article. The Commission shall review the situation after two years and shall, if necessary, take appropriate measures to further specify the conditions under which the AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter box entity and can no longer be considered to be manager of the AIF.

C. ESMA Questions and Answers on the application of the AIFMD (ESMA34-32-352)

Section VIII: Delegation

Question 1: *An AIFM manages multiple AIFs. When assessing whether any delegation of portfolio management and/or risk management by the AIFM results in the AIFM becoming a letter-box entity as referred to in Article 20 of the AIFMD, **should the assessment be made at the level of the AIFM or at the level of each AIF?***

Answer 1: *The provisions on letter-box entities in Article 82 of the implementing Regulation **apply in relation to the management of a particular AIF and not in relation to a group of AIFs.** The assessment should therefore be carried out at the level of each individual AIF.*

Question 2 [last update 16 November 2016]: *Where the AIFM does not itself perform the functions set out in Annex I of the AIFMD, does this release the AIFM from its responsibility to ensure compliance of the relevant function(s) with the AIFMD?*

Answer 2: *No. Where a third party performs a function stated in Annex I of the AIFMD, this function should be considered as having been delegated by the AIFM to the third party. **Therefore, the AIFM should be responsible for ensuring compliance with the requirements on delegation set out in Article 20 of the AIFMD and the principle expressed in Article 5(1) of the Directive according to which the single AIFM appointed for an AIF is responsible for ensuring compliance with the AIFMD.** For the avoidance of doubt, this applies to all functions stated in point 1 and point 2 of Annex I of the AIFMD.*

AIFMD AND AIF SCOPE - RELEVANT LAWS AND GUIDANCE ISSUED THEREOF

A. AIFMD (2011/61/EU) and CySEC AIFM Laws (56(I)/2013, 124(I)/2018 and 81(I)/2020)

Recital 7 of the AIFMD states:

'7. Investment undertakings, such as family office vehicles which invest the private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with this Directive.'

Article 3(1) of the AIFMD (transposed under Section 4(1) of the AIFM Law) on 'Exceptions' states:

'This Directive shall not apply to AIFMs in so far as they manage one or more AIFs whose only investors are the AIFM or the parent undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors is itself an AIF.'

Article 4(1)(a) of the AIFMD (transposed under Section 2 of the AIFM Law) on the 'Definitions' states that:

*'1. For the purpose of this Directive, the following definitions shall apply: (a) **'AIFs'** means **collective investment undertakings**, including investment compartments thereof, which: (i) **raise capital from a number of investors**, with a view to **investing it in accordance with a defined investment policy for the benefit of those investors**; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC;'*

B. ESMA Guidelines on key concepts of the AIFMD (ESMA/2013/611)

These Guidelines shall be referred to by CAIFMs/Internally Managed AIFs, for the purposes of assessing whether the investment undertaking/s managed and/or promoted by them fall within the definition of the AIF as per Article 4(1)(a) of the AIFMD.