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**TO:** **Alternative Investment Fund Managers (“AIFM”):**  
**i. Alternative Investment Fund Managers (“AIFM”)<sup>1</sup>**  
**ii. Alternative Investment Fund Managers below the thresholds (“AIFM below the thresholds”)<sup>2</sup>**

**FROM:** **Cyprus Securities and Exchange Commission**

**DATE:** **22 October 2020**

**CIRCULAR No.:** **C409**

**SUBJECT:** **Common deficiencies and best practice standards identified through on-site inspections regarding certain aspects of the AIFM governance**

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The Cyprus Securities and Exchange Commission (“**CySEC**”) has proceeded (through on-site inspections) to evaluate the policies/procedures established and implemented by AIFMs regarding their compliance with some operational aspects relating to the organisational requirements and the delegation of functions (“the Inspections”).

During the inspections, CySEC found that certain best practice standards were being implemented. It also found common deficiencies and/or omissions it wishes to draw all AIFMs’ attention to, despite the fact that the Inspections only covered a sample of AIFMs authorised pursuant to section 8 of the Alternative Investment Fund Managers Law, as in force under number 56(I)/2013 (“**the Law**”). The circular lists CySEC’s findings and invites all AIFMs to evaluate their compliance with the relevant governance requirements and to take corrective actions where relevant, by taking into account the principle of proportionality and the relevant regulations.

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<sup>1</sup> AIFM, includes AIFM and Internally Managed AIF of the Republic, whose managed assets either exceed the limits laid down in section 4(2)(a) or 4(2)(b) of the Alternative Investment Fund Managers Law in force at any given time under number 54(I)/2013 (“**the Law**”), or have chosen to be regulated by the Law in accordance with section 4(6) of the Law.

<sup>2</sup> AIFM below the thresholds includes AIFM and Internally Managed AIF of the Republic, whose assets under management fall below the thresholds of section 4(2)(a) or 4(2)(b). Namely, the AIFM below the thresholds could be: UCITS management companies, Investment Firms, a company whose sole purpose is managing a particular AIFLNP (in accordance with section 125(1) of the Alternative Investment Funds Law 124(I)/2018), Internally Managed AIF and Internally Managed AIFLNP.

## A. LEGAL FRAMEWORK

The Inspections covered requirements of Articles II and III of the Law, as well as the relevant supplementary provisions included in the “Commission Delegated Regulation (EU) no. 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council” (“**the Regulation**”). The relevant legal framework is set out in the Annex.

## B. OBJECTIVE/ PURPOSE OF INSPECTIONS

The purpose of the Inspections was to evaluate the AIFMs’ level of compliance with the requirements for organisation and operation arising from the legal framework contained in the Annex.

Identity of the inspected sample:

- i. The Inspections were carried out on a sampling basis.
- ii. The sample was selected based on the AIFMs’ size and level of risk.
- iii. The Inspections were carried out on-site at the AIFMs’ offices.

## C. DEFICIENCIES FOUND

### I. Risk Management Function<sup>3</sup>

1. There was no functional and hierarchical separation of risk management from the portfolio management function since:
  - i. The risk manager was supervised by the AIFM’s portfolio manager.
  - ii. The portfolio manager sat on the risk management committee with a voting right and decision-making powers.
  - iii. The risk manager was not represented on the Board of Directors with the same minimum amount of power as the portfolio manager in order to avoid conflict of interest. More specifically, the portfolio manager participated in the Board of Directors while the risk manager did not.

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<sup>3</sup> Liquidity management as provided by section 17 of the AIFM Law 56(I)/2013 in force at any given moment and section 18 of the AIF Law 124(I)/2018 is included in the risk management function and, therefore, it is also subject to the functional and hierarchical separation provisions.

- iv. The composition of the risk management committee did not ensure that its non-independent members did not have an undue influence over carrying out the risk management function since the committee only consisted of non-independent members.
2. The identification and measurement of risks regarding potential investments, in some cases (particularly in the case of AIFs investing in real estate or private equity), was executed at the portfolio management level, with no prior cooperation, consultation and supervision by the risk management function. This practice is not compatible with the requirement for preserving the functional independence of the risk management function.
3. The annual report of the risk management function included a standard description of risks for each AIF, which was repeated almost identically to each annual report. Furthermore, the report did not include any information regarding the evaluation, monitoring and the minimum annual review of the risk management systems.

## **II. Valuation of the AIF's Assets Function**

4. While the AIFMs appeared to have been appointing an external valuer for the valuation of the AIF's assets, they did not, however, notify the Cyprus Securities and Exchange Commission about the relevant appointment, as required by law.
5. When the valuation function was assigned to an external valuer, it was observed that he/she did not act independently from the AIFM since the latter examined and, in some cases, reviewed the final estimated value of the AIF that it received by the external valuer.
6. When the valuation of the AIF's assets was performed internally, there were no proper and consistent procedures in place to enable a proper and independent valuation thereof: for example, the portfolio manager and/or the senior management participated with voting rights in the valuation committee with decision-making powers.

## **III. Portfolio Management Function**

7. In the cases where the portfolio management was performed internally but the AIFM appointed external investment advisers, it was found that in some cases the procedure

followed did not ensure that the final investment decision was to be made by the AIFM itself. More specifically, it seems that one or more of the following scenarios applied:

- i. The AIFM received investment advice from just one external investment adviser for one or two specific investments and not for a range of investment options, which ended up being the AIFM's eventual investment.
- ii. The external investment adviser was the parent company of the AIFM and no measures were taken to ensure the independence of the eventual investment options and decisions of the AIFM.
- iii. During the investment decision-making process, other than the particular investment proposal by the external adviser, the AIFM did not adequately evaluate the suitability of the proposal they received with regard to the already-existing portfolio of the AIF and they did not also simultaneously examine/assess (whether on their own or by appointing a second investment adviser) some alternative investment options before deciding on whether to adopt that particular investment proposal or not.

#### **IV. Compliance Function**

8. When the compliance function was outsourced, the monitoring and evaluation of the adequacy and effectiveness of the measures, policies and procedures that were adopted and implemented was not performed on a regular basis (e.g. once or twice per year), contrary to the requirements of article 61(2)(a) of the Regulation.
9. The compliance function had not established a monitoring programme for the compliance of the AIFM by taking into account the work of the AIFM and by setting the priorities based on the evaluation of the compliance risk.
10. The compliance function did not seem to fully understand the concept of all the measures, policies and procedures that are or should be put in place by the AIFM in order to comply with the Legislation and was, therefore, not able to monitor their effectiveness and efficiency thereof.
11. The compliance function reports did not include information regarding the monitoring and regular evaluations carried out, the findings regarding the adequacy and effectiveness of the measures, policies and procedures adopted and implemented, nor

the deficiencies identified. Furthermore, the reports did not include information on the measures taken or to be taken to address the deficiencies.

**V. Responsibility of the external AIFM regarding managed AIFs in the form of a company/partnership.**

**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.

**VI. Organisational and operational matters of the AIFM and human resources' professional expertise**

**13.** On some occasions it was found that members of the senior management would also perform managerial duties of key<sup>4</sup> departments of the AIFM, such as risk management and/or collective portfolio management. Given the principle of proportionality, not having higher levels of control by third parties such as by independent committees with decision-making powers and/or by independent members of the board of

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<sup>4</sup> Key functions of the AIFM are the functions of portfolio management, risk management (including liquidity management), the valuation function, as well as the functions of compliance and internal control.

directors, could potentially harm the effective and independent execution of such functions.

- 14.** As for regular updates and approvals to and from senior management as required by Law, there was not always evidence of such updates/approvals being made. More specifically, CySEC expects (where applicable) to have evidence regarding:
  - i. Approval by senior management of the list of selected brokers collaborating with the AIFM.
  - ii. Receipt of up-to-date reports from senior management, at least once a year, with information regarding the conflict of interests monitoring file.
  - iii. Regular updates to senior management from the risk management function (whether internal or outsourced) regarding the current risk levels.
  - iv. Receipt of written reports regarding matters of compliance, internal control and risk management on a regular basis or at least once a year.
  - v. Receipt of reports regarding the implementation of investment strategies and internal procedures for investment decision-making on a regular basis, as required by article 60(2) of the Regulation.
  - vi. Approval by senior management of any models used to value assets, as set out in article 68 of the Regulation.
  - vii. Approval of recommendations for changes to the valuation policies and procedures.
- 15.** In cases where the AIF invested in real estate, the employees performing the risk management function did not have the necessary knowledge, expertise and understanding of the risks associated with the products the AIF invested in.
- 16.** As explained in C.II above, there were cases where despite the valuation function being allocated to an external valuer, the decision for the final valuation was made internally upon its inspection and review by the AIFM, which means that the valuation is performed internally and, consequently, all relevant provisions of the law apply.
- 17.** The employees of the AIFM engaged in the valuation function did not seem to have the skills, knowledge and expertise required to perform such a function.
- 18.** In the cases where the AIFM appointed advisers (e.g. valuation advisers or investment advisers) and their respective functions (valuation and/or portfolio management) were performed internally, the AIFM did not have written procedures with regards to the issues governing and defining such collaboration, such as the level, the frequency and

the type of communication and exchange of information between them for performing their duties.

- 19.** In some cases, the terms of reference of the established committees were incomplete and/or did not include up-to-date information since, for instance, they did not include information regarding:

- (a) The purpose and objectives of the committee.
- (b) Whether the committee has decision-making powers<sup>5</sup>.
- (c) The role, the responsibilities and powers of the committee with a very clear reference as to how that committee collaborates, supports, guides or 'orders' the person(s) responsible in the AIFM (internally or outsourced) to perform the relevant function.
- (d) The profile of its composition and its current members, taking into account the matters of independence and conflict of interest.
- (e) The stages of escalation of issues.
- (f) The frequency of meetings.
- (g) Keeping of records.

Furthermore, when there were modifications to the objectives of the relevant committee for example, the terms of reference were not revised to be consistent with the new objectives, as necessary. The committees should be established upon decision of the board of directors of the AIFM and the minutes kept should contain the details required to have a clear understanding of the matters discussed, the views exchanged and the relevant decisions made.

- 20.** In certain cases of delegation, after the delegate was appointed, the AIFM did not sufficiently exercise its rights regarding the instructions and monitoring of the delegate and/or did not keep adequate documentation in support thereof.
- 21.** In some delegation cases, it was observed that the contract for performing key functions between the AIFM and the delegate only regulated matters regarding the appointment of the delegate, without regulating in writing the established procedures and the operational aspects of the delegation such as the level and type of communication and exchange of information between them for performing their

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<sup>5</sup> Such are the Committees established by the AIFM which, in accordance with their terms of reference, have the power to make binding decisions for their field that do not need the approval of the Board of Directors: e.g. investment management and deciding on specific investment(s).

duties, the procedures and responsibilities for unitholder notices or even the escalation and troubleshooting.

#### **D. BEST PRACTICE STANDARDS**

##### **I. Control of the AIFM by the Board of Directors**

**22.** With regard to the best practice standards observed pursuant to the provisions of the legislation and the commonly-accepted governance practices as to the operation and powers of the Board of Directors, the following was observed:

- i. The meetings of the Board of Directors were held on a quarterly basis, which is satisfactory, with the physical presence of all members.
- ii. In some AIFM cases, the compliance officer sat on all meetings of the Board of Directors, thus safeguarding the consistency of the board's decisions with the relevant legislative framework.
- iii. The content of the minutes kept at the Board's meetings was satisfactory: there was a brief description of the issues discussed, a brief reference to the important views/suggestions expressed, as well as a satisfactory description of the handling/decision/suggestion put forward.
- iv. The composition of the Committees with decision-making powers, in the cases of key functions of the AIFM such as valuations, risk management or portfolio management, was sometimes strengthened by persons with independent interest and non-executive/independent members of the Board, to evaluate and efficiently challenge the decisions of such committees and to support the independence of such decisions.
- v. The terms of reference of the Board were complete and included up-to-date information such as:
  - (a) The purpose and scope of powers of the Board;
  - (b) The profile of the Board's composition;
  - (c) The role, responsibilities and powers of the Board;



- (d) The frequency of meetings;
- (e) The remuneration of the Board's members;
- (f) The procedures regarding resolutions of the Board;
- (g) The procedures regarding conflict of interest among the members of the Board.

## **II. Control from Senior Management**

- 23.** With regard to the best practice standards of the AIFMs that were inspected, having also taken into account the provisions of the law, the following is observed:
- i. The members of senior management simultaneously exercise duties of executive members of the Board. This, therefore, safeguards that the substantial information acquired by senior management under their duties pursuant to the law can be directly conveyed to the Board's meetings.
  - ii. In some cases, members of senior management of the external AIFM participated in the negotiations with the AIF's Board of Directors with regard to creating the basic investment parameters/investment strategy. This supports the sufficiency of the powers of senior management with regard to the shaping of the investment strategies of the (externally managed) AIF.

## **III. Organisation of the AIFM and human resources' professional expertise**

- 24.** With regard to the best practice standards of the AIFMs that were inspected, having also taken into account the provisions of the law, the following is observed:
- i. With regard to performing the portfolio management function and the risk management function, as well as the valuation, in some cases committees were established, with either decision-making powers or aiming to support the performance of such functions.
  - ii. The content of the minutes kept at the Committees' meetings was satisfactory: there was a brief description of the issues discussed, a brief reference to the important views/suggestions expressed, as well as a satisfactory description of the handling/decision/suggestion put forward.

iii. Regarding delegation matters:

(a) In some cases of AIFMs whose managed AIFs invested in illiquid or non-liquid assets and did not offer the right of redemption to investors, they used so-called ‘audit valuers’. These delegates were appointed after the acquisition of an illiquid or non-liquid asset which had previously been valued by another, expert valuer in that field, for the purpose of valuation.

(b) All of the AIFMs had delegated the duties regarding the provision of administration services to AIFs, to delegates with whom they had no close links. Hence, independence is safeguarded, investor protection is strengthened and the risk of conflict of interest at the expense of the managed AIF is reduced.

**E. THE NEXT STEPS**

The publication of best practices and common deficiencies and/or omissions established during the Inspections carried out by CySEC, was designed to help AIFMs enhance their compliance with the relevant Legislation.

The AIFMs, by taking into account the matters raised in the relevant legal framework and the relevant provisions thereof, are invited to re-examine and review, where necessary, their practices, policies and procedures and take immediate corrective action.

Yours sincerely,

Demetra Kalogerou  
Chairwoman of the Cyprus Securities and Exchange Commission

**A. THE ALTERNATIVE INVESTMENT FUND MANAGERS LAW 56(I)/2013**

**PART II - AUTHORISATION OF AIFMs**

- Section 6 - Conditions for taking up activities as an AIFM in the Republic
- Section 7 - Application for authorisation
- Section 8 - Conditions for granting authorisation

**PART III - OPERATING CONDITIONS FOR AIFMs**

**CHAPTER 1 - General Requirements**

- Section 13 - General principles
- Section 15 - Conflict of interest
- Section 16 - Risk management
- Section 17 - Liquidity management

**CHAPTER 2 - Organisational Requirements**

- Section 18 - Procedures, arrangements and mechanisms applied by AIFMs
- Section 19 - Valuation

**CHAPTER 3 - Assignment of AIFM functions**

- Section 20 - Assignment of AIFM functions
- Section 21 - Sub-assignment of AIFM functions
- Section 22 - AIFM's liability in case of assignment of functions or any further sub-assignment.

**CHAPTER 4 - AIF Depositary**

- Section 23 - Appointment of AIF depositary.

**B. COMMISSION DELEGATED REGULATION (EU) no. 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision**

**CHAPTER III - OPERATING CONDITIONS FOR AIFMs**

**SECTION 1 - General Principles**

- Article 20 - Due diligence in the selection and appointment of counterparties and prime brokers
- Article 21 - Acting honestly, fairly and with due skills
- Article 22 - Resources
- Article 23 - Fair treatment of investors in the AIF

**SECTION 2 - Conflict of Interest**

- Article 30 - Types of conflict of interest
- Article 31 - Conflict of interest policy
- Article 34 - Managing conflict of interest
- Article 35 - Monitoring conflict of interest

**SECTION 3 - Risk Management**

- Article 38 - Risk management systems
- Article 39 - Permanent risk management function
- Article 40 - Risk management policy
- Article 41 - Assessment, monitoring and review of the risk management systems
- Article 42 - Functional and hierarchical separation of the risk management function
- Article 43 - Safeguards against conflict of interest
- Article 44 - Risk limits

**SECTION 6 - Organisational Requirements - General principles**

- Article 57 - General requirements



- Article 60 - Control by the governing body, senior management and supervisory function
- Article 61 - Permanent compliance function
- Article 62 - Permanent internal audit function

#### **SECTION 7 - Valuation**

- Article 67 - Policies and procedures for the valuation of the assets of the AIF
- Article 68 - Use of models to value assets

#### **SECTION 8 - Assignment of AIFM functions**

- Article 75 - General principles
- Article 76 - Objective reasons for assignment
- Article 77 - Features of the assignee
- Article 78 - Assignment of portfolio or risk management
- Article 79 - Effective supervision
- Article 80 - Conflict of interest
- Article 81 - Consent and notification of sub-delegation
- Article 82 - Letter-box entity and AIFM no longer considered to be managing an AIF

### **CHAPTER IV - DEPOSITARY**

#### **SECTION 1 - Particulars of the written contract**

- Article 83 - Contractual particulars