
ΠΡΟΣ	: Cyprus Investment Firms
ΑΠΟ	: Cyprus Securities and Exchange Commission
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ΘΕΜΑ	: CIFs' Supervisory function – Governance Arrangements – Risk Management

The Cyprus Securities and Exchange Commission ('the Commission') wishes, with this circular, to inform the Cyprus Investment Firms ('CIFs') about the following:

A. Supervisory Function of CIFs (board of directors and senior management)

1. During the years 2013-2014, the Commission conducted on-site inspections to a number of CIFs in order to verify, among others, the effectiveness of their supervisory function (board of directors and senior management).

As a result of the on-site inspections, the following weaknesses have been identified in relation to the persons mentioned above (mainly for the non-executive directors):

- i. They did not understand adequately their duties, obligations and responsibilities.
- ii. They were not aware, and/or were not sufficiently aware, of the legal framework governing the operations of CIFs.
- iii. They were not aware, and/or were not sufficiently aware, of the activities performed by the CIF.
- iv. They were not informed/trained on the developments in the field the CIF was operated.
- v. They did not devote sufficient time to perform their duties.
- vi. They did not act with independence of mind and rarely they challenged the decisions of the senior management (executive board members).

In addition, it was identified that the meetings of the board of directors were typical, not substantive and not frequent. No board minutes were kept or, if they were kept,

these were not detailed. The board members were not informed in detail on the topics included in the agendas, they did not set a timeframe in order their decisions to be implemented nor they monitored their implementation within the timeframe set.

2. According to paragraph 9 of the Directive DI144-2007-01 of 2012, a CIF is required to, when allocating functions internally, ensure that its senior management, and board of directors, are responsible for ensuring that the CIF complies with its obligations under the Investment Services and Activities and Regulated Markets Law ('the Law').

In particular, the senior management and the board of directors are required to assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations emanated by the Law and the Directive and to take appropriate measures to address any deficiencies.

3. For purposes of compliance with Articles 88 and 91 of the European Directive 2013/36/EE on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, the Commission has amended the Law, which it is expected to be voted by the House of Representatives and be implemented in the coming months.

In particular, the Law provides, among others, the following:

- i. All board members must commit sufficient time to perform their duties in the CIF.
- ii. Each board member must act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management, where necessary, and to effectively oversee and monitor management decision-making.
- iii. The CIF must devote adequate human and financial resources for the induction and training of the board members.
- iv. The board of directors oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of the CIF, including the separation of duties and prevention of conflicts of interest.

Those arrangements must comply with the following principles:

- (a) the board of directors must have the responsibility for the CIF and approve and oversee the implementation of CIF's strategic objectives, risk and internal governance,
- (b) the board of directors ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the Law and related standards,
- (c) the board of directors must oversee the process of disclosure and communications,
- (d) the board of directors must be responsible for providing effective oversight management.

The board of directors monitors and periodically assesses the effectiveness of the CIF's governance arrangements and takes appropriate steps to address any deficiencies.

The amendments in the Law are described in detail at paragraphs 1 and 2 of the Annex.

4. The Commission pays particular attention to the supervisory function (board of directors and senior management) of CIFs and requests **ALL** CIFs to read carefully the above mentioned provisions and where necessary, to take all appropriate measures to fully comply with them.

Furthermore, the Commission expects that board meetings will be carried out frequently and be substantial. The minutes will be kept in detail, in order to reflect the topics discussed and to enable the Commission to monitor CIFs compliance with the above provisions.

B. Board of Directors

5. For purposes of compliance with Article 91 of the European Directive 2013/36/EE, the Commission has amended the Law, by introducing provisions in relation to the composition of the board of directors. The amendments are expected to be voted by the House of Representatives and be implemented in the coming months.
6. Generally, the new provisions of the Law provide the following:
 - i. The overall composition of the Board must reflect an adequately board range of experiences.
 - ii. The board members of a CIF, which it is significant in terms of its size, internal organization and the nature, scope and complexity of its activities, must not hold more than one of the following combinations of directorships at the same time:
 - one executive directorship with two non-executive directorships,
 - four non-executive directorships.

The Law provides some exemptions from the application of the above provisions.

- iii. The board of directors must possess adequate collective knowledge, skills and experience to be able to understand the CIF's activities, including the main risks.
- iv. The chairman of the board of directors must not exercise simultaneously the functions of a chief executive officer within the same CIF, unless authorized by the Commission.

The new provisions are described in detail at point 1 of the Annex.

7. Given the fact that the above new provisions will enter into force in the next few months, the Commission requests **ALL** CIFs to review the composition of their board of directors and take the appropriate steps to fully comply with the above provisions.

C. Risk Management

8. For purposes of compliance with Article 76 of the European Directive 2013/36/EE, the Commission is drafting a Directive, which it will include the provisions of this Article and it is expected to be published soon.
9. Generally, the above mentioned Article provides the following:
 - i. The responsibilities of the board of directors in relation to risk management.
 - ii. The establishment of a risk committee, in case the CIF is significant in terms of its size, internal organization and the nature, scale and complexity of its activities.
 - iii. The qualifications of the members of the risk committee and their responsibilities.
 - iv. The establishment of a risk management department, where appropriate and proportionate in view of the nature, scale and complexity of the business activities of the CIF, and the nature and range of investment services and activities.

The provisions of the above Article are listed in detail at point 3 of the Annex.

10. Given the fact that these provisions will come into force in the next few months, the Commission invites **ALL** CIFs to study them carefully and take the necessary steps to fully comply with these.

C. Administrative sanctions

11. The Commission reminds the board members and senior management of CIFs that the Commission may impose administrative sanctions to them (such as administrative fines, removal from their position) in case that it is established that the violations of the CIF is due to their own fault, willful omission or negligence.

Consequently, the Commission requests **ALL** directors and senior managers of CIFs to perform all their duties with responsibility and seriousness and to fully comply, at all times, with their obligations emanated by the Law and the directives issued pursuant to.

Yours sincerely

Demetra Kalogerou
Chairman of the Cyprus Securities and Exchange Commission

1. Board of Directors

Section 12 of the Law is amended as follows:

(a) By replacing the first paragraph of subsection (1) with the following new paragraph before the second paragraph:

«(1) Members of the board of directors must at all times be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the board of directors shall reflect an adequately broad range of experiences. Members of the board of directors must, in particular, fulfil the requirements set out in subsections (4) to (10).»

(b) By adding the following new subsections (4) – (14):

«(4) All members of the board of directors must commit sufficient time to perform their functions in the institution.

(5) The number of directorships which may be held by a member of the board of directors at the same time must take into account individual circumstances and the nature, scale and complexity of the CIF's activities. Unless representing the Republic, members of the board of directors of a CIF that is significant in terms of its size, internal organization and the nature, the scope and the complexity of its activities shall, from 1 July 2014, not hold more than one of the following combinations of directorships at the same time:

- (a) one executive directorship with two non-executive director-ships,
- (b) four non-executive directorships.

(6) For the purposes of subsection 5, the following counts as a single directorship:

- (a) executive or non-executive directorships held within the same group,
- (b) executive or non-executive directorships held within:
 - (i) CIFs or credit institutions which are members of the same institutional protection scheme provided that the conditions set out in Article 113(7) of Regulation (EU) No 575/2013 are fulfilled; or
 - (ii) undertakings (including non-financial entities) in which the CIF holds a qualifying holding.

(7) Directorships in organisations which do not pursue predominantly commercial objectives do not count for the purposes of subsection 5.

(8) The Commission may authorise members of the board of directors to hold one additional non-executive directorship.

(9) The board of directors must possess adequate collective knowledge, skills and experience to be able to understand the CIF's activities, including the main risks.

(10) Each member of the board of directors must act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management decision-making.

(11) The CIF must devote adequate human and financial resources to the induction and training of members of the board of directors.

(12) The CIF and its respective nomination committee as it is mentioned in section 18A (2) must engage a broad set of qualities and competences when recruiting members to the board of directors and for that purpose to put in place a policy promoting diversity on the board of directors.

(13) The Commission must collect the information disclosed in accordance with Article 435(2)(c) of Regulation (EU) No 575/2013 and use it to benchmark diversity practices.

(14) This section is without prejudice to provisions on the representation of employees in the board of directors as provided for by the Cyprus Law».

2. Governance Arrangements

The following new Article 18A is added to the Law:

«18A.-(1) The board of directors must ensure that the management body defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of the CIF, including the segregation of duties in the organization and the prevention of conflicts of interest.

Those arrangements must comply with the following principles:

(a) the board of directors must have the overall responsibility for the CIF and approve and oversee the implementation of the CIF's strategic objectives, risk strategy and internal governance;

(b) the board of directors must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards;

(c) the board of directors must oversee the process of disclosure and communications;

(d) the board of directors must be responsible for providing effective oversight of senior management;

(e) the chairman of the board of directors of the CIF must not exercise simultaneously the functions of a chief executive officer within the same CIF, unless justified by the CIF and authorized by the Commission.

The board of directors monitors and periodically assesses the effectiveness of the institution's governance arrangements and takes appropriate steps to address any deficiencies.

(2) A CIF, that is significant in terms of its size, internal organization and the nature, scope and complexity of its activities, must establish a nomination committee composed of members of the board of directors who do not perform any executive function in the institution concerned.

The nomination committee must:

(a) identify and recommend, for the approval of the board of directors or for approval of the general meeting, candidates to fill board of directors vacancies, evaluate the balance of knowledge, skills, diversity and experience of the board of directors and prepare a description of the roles and capabilities for a particular appointment, and assess the time commitment expected.

Furthermore, the nomination committee must decide on a target for the representation of the underrepresented gender in the board of directors and prepare a policy on how to increase the number of the underrepresented gender in the board of directors in order to meet that target. The target, policy and its implementation must be made public in accordance with Article 435(2)(c) of Regulation (EU) No 575/2013;

(b) periodically, and at least annually, assess the structure, size, composition and performance of the board of directors and make recommendations to the board of directors with regard to any changes;

(c) periodically, and at least annually, assess the knowledge, skills and experience of individual members of the board of directors and of the board of directors collectively, and report to the board of directors accordingly;

(d) periodically review the policy of the board of directors for selection and appointment of senior management and make recommendations to the board of directors.

In performing its duties, the nomination committee shall, to the extent possible and on an ongoing basis, take account of the need to ensure that the board of directors' decision making is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the CIF as a whole.

The nomination committee must be able to use any forms of resources that it considers to be appropriate, including external advice, and shall receive appropriate funding to that effect.

3. Risk Management

The following paragraph is included in a Directive that will be published for compliance to purposes with the European Directive 2013/36/EE.

(1) The board of directors shall ensure that the board of directors approves and periodically reviews the strategies and policies for taking up, managing, monitoring and mitigating the risks the CIF is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

(2) The board of directors devotes sufficient time to consideration of risk issues. The board of directors shall be actively involved in and ensure that adequate resources are allocated to the management of all material risks addressed in this Directive and in Regulation (EU) No 575/2013 as well as in the valuation of assets, the use of external credit ratings and internal models relating to those risks. The CIF must establish reporting lines to the board of directors that cover all material risks and risk management policies and changes thereof.

(3) CIFs that are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities establish a risk committee composed of members of the board of directors who do not perform any executive function in CIF concerned. Members of the risk committee shall have appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the CIF.

The risk committee shall advise the board of directors on the CIF's overall current and future risk appetite and strategy and assist the board of directors in overseeing the implementation of that strategy by senior management. The board of directors must retain overall responsibility for risks.

The risk committee must review whether prices of liabilities and assets offered to clients take fully into account the CIF's business model and risk strategy. Where prices do not properly reflect risks in accordance with the business model and risk strategy, the risk committee must present a remedy plan to the board of directors.

The Commission may allow a CIF which is not considered significant as referred to in the first subparagraph to combine the risk committee with the audit committee as referred to in Article 46 of Auditors and Statutory Audits of Annual and Consolidated Accounts Law of 2009. Members of the combined committee must have the knowledge, skills and expertise required for the risk committee and for the audit committee.

(4) The board of directors where a risk committee has been established, the risk committee have adequate access to information on the risk situation of the CIF and, if necessary and appropriate, to the risk management function and to external expert advice.

The board of directors where one has been established, the risk committee shall determine the nature, the amount, the format, and the frequency of the information on risk which it is to receive. In order to assist in the establishment of sound remuneration policies and practices, the risk committee shall, without prejudice to the tasks of the remuneration committee, examine whether incentives provided by the remuneration

system take into consideration risk, capital, liquidity and the likelihood and timing of earnings.

(5) In accordance with the proportionality requirement laid down in section 6(2) of the Directive DI144-2007-01 of 2012, CIF's must ensure that they have a risk management function independent from the operational functions and which it has sufficient authority, stature, resources and access to the board of directors.

The risk management function must ensure that all material risks are identified, measured and properly reported. The risk management function is actively involved in elaborating the CIF's risk strategy and in all material risk management decisions and that it can deliver a complete view of the whole range of risks of the CIF.

Where necessary, the risk management function can report directly to the board of directors, independent from senior management, and can raise concerns and warn that body, where appropriate, where specific risk developments affect or may affect the CIF, without prejudice to the responsibilities of the board of directors pursuant to this Directive and Regulation (EU) No 575/2013.

The head of the risk management function must be an independent senior manager with distinct responsibility for the risk management function. Where the nature, scale and complexity of the activities of the CIF do not justify a specially appointed person, another senior person within the institution may fulfil that function, provided there is no conflict of interest.

The head of the risk management function must not be removed without prior approval of the board of directors and must be able to have direct access to the board of directors, where necessary.