Contents

A. Investment Services and Activities and Regulated Markets Law 144(I) of 2007 (Law 144(I)/2007), Scope, powers and Offences

1. Scope, Application and Structure

Law 144(I)/2007 is also known as the Investment Services and Activities and Regulated Markets Laws of 2007 to 2012 and regulates the provision of investment and ancillary services as well as the performance of investment activities on a professional basis in the Republic of Cyprus. It also regulates the operation of regulated markets and other related matters.

Law 144(I)/2007 harmonises the following acts of the European Community (EC):

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments as regards certain guidelines.

In addition, Law 144(I)/2007 partially harmonises with the acts of the European Community:

Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes;

Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast); and

Directive 2006/73/EC of August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

Law 144(I)/2007 also applies the act of the European Community titled *'Commission Regulation No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards to record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive'*.

Directive for the Professional Conduct of Banks when offering investment or ancillary services and when performing investment activities of the Central Bank. This Directive harmonises:

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC;

Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments, as regards certain deadlines; and

European Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

1.1 Scope and Application

Learning Objective

1.1.1 Know the scope and application of Law 144(I)/2007: regulated markets and activities; Cypriot investment firms (CIFs); banks; co-operative credit institutions; persons providing investment services

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Law 144 (I) was introduced in 2007 and has been updated regularly as the regulatory and legal requirements have changed.

The scope of Law 144(I) is limited to:

foreign and local firms that provide, or offer to provide, investment and ancillary services:
to persons who stay, reside, or are domiciled in Cyprus; or
where the relevant transaction is concluded within Cyprus; or

persons that stay, reside, or are domiciled in Cyprus who act on behalf of a third party based outside of Cyprus in providing investment and ancillary services, whether as an employee or in another capacity;

regulated markets;

other related issues.

In this context, the following definition applies:

*A **regulated market** (also known as organised market) is a multilateral system managed or operated by a market operator that brings together, or facilitates the bringing together of, multiple third-party buying or/and selling interests in financial instruments. Any trading will be conducted under the regulated market's rules and/or systems in compliance with EU Directive 2004/39/EC.*

A **Cypriot investment firm (CIF)** is a company that is:

established in Cyprus; and
authorised by the Cyprus Securities and Exchange Commission (CySEC) to provide one or more investment services to third parties and/or perform one or more investment activities.

Investment activity is any one of the following activities or services undertaken in relation to a financial instrument:

Reception and transmission of orders in relation to one or more financial instruments.
Execution of orders on behalf of clients.
Dealing on own account.
Portfolio management.
Investment advice.
Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.
Placing of financial instruments without a firm commitment basis.
Operation of a multilateral trading facility (MTF).

Financial instruments are:

transferable securities;
money market instruments;
units in collective investment undertakings;
options, futures, swaps, forward rate agreements and other derivative contracts;
financial contracts for differences.

A **bank** is defined as a body corporate licensed to carry on banking business under the provisions of the banking law, whereas a **co-operative credit institution** is defined in the Co-operative Societies Law as or in accordance with equivalent legislation in another member state.

Only legal persons authorised by CySEC under Law 144(I)/2007 are permitted to provide investment services in Cyprus.

1.2 Structure

Learning Objective

1.1.2 Know the regulatory structure in the Republic: Cyprus Securities and Exchange Commission (the Commission); Central Bank of Cyprus (the Central Bank); obligation of co-operation with other member states and the Commission's right to refuse; obligations relevant to ESMA

The **Cyprus Securities and Exchange Commission (CySEC)** operates on the basis of the CySEC (establishment and responsibilities) law and is the supervisory authority of investment firms (IFs). In this context it is the responsibility of CySEC to establish, maintain and regularly update a public register of all persons acting on behalf of a CIF or an IF of another member state. CySEC ensures these persons need to be of sufficiently good repute, and possess appropriate general, commercial and professional knowledge.

The **Central Bank of Cyprus' (CBC)** powers are laid down in the Central Bank of Cyprus Law and the banking law. In relation to CySEC, the CBC also have the following powers. The CBC can:

demand information from any person and, if necessary, summon and question them;
request telephone and data traffic records;
demand cessation of any practice that is contrary to the provisions of the law;
request the freezing and/or sequestration of assets;
temporarily prohibit the exercise of professional activity;
adopt any measure to ensure persons under their supervision continue to comply with the requirements of the law and associated directives;
carry out on-site inspections; and
allow auditors of experts to carry out verifications or investigations.

Each of the supervisory authorities (CySEC and the CBC) is responsible for supervision under the European Union (EU) directives and regulations, including the exchange of any information that is essential or relevant to the exercise of their functions and competencies. In addition, they also co-operate with every other competent authority in the Republic responsible for supervision of pension funds, insurance and reinsurance intermediaries and insurance undertakings.

CySEC is the designated contact point for the facilitation and acceleration of the co-operation and for the exchange of information for the purposes of Directive 2004/39/EC.

The supervisory authorities can exercise their powers either directly, by collaborating among themselves or with other authorities, or by application to the competent courts. Any confidential information received by the supervisory authorities may only be used in the performance of their duties and for the exercise of their functions. Any confidential information is subject to the conditions of professional secrecy.

CySEC needs to co-operate with the competent authorities of other member states as well as the European Securities and Markets Authority (ESMA) when this is necessary for the purpose of carrying out its duties.

2. The Cyprus Securities and Exchange Commission (CySEC)

Learning Objective

1.2.1 Know the responsibilities of the Cyprus Securities and Exchange Commission (the Commission)

1.2.2 Know how the Commission co-operates with other authorities: eligible authorities; conducting investigations on behalf of other authorities; exchanging information; circumstances where inside information may be shared

1.2.3 Know the extent of the Commission's power to collect information and carry out inspections and investigations

1.2.4 Know the extent of the Commission's power to impose sanctions for non-compliance with a request from the Commission to: submit information; co-operate in an onsite inspection/investigation

1.2.5 Know the powers and duties of an investigating officer

CySEC authorises and supervises CIFs, investment firms, and regulated markets to operate in the Republic. It is the responsibility of CySEC to ensure that CIFs that are authorised and established in the Republic comply with all requirements, that all CIFs are maintained in a publicly accessible register, and that all CIF authorisations, rejections and revocations are communicated to ESMA. When authorising the provision of investment services and/or the performance of investment activities CySEC makes sure that it knows the identities of all (in)direct shareholders. CySEC may revoke or, wholly or partially, suspend a CIF authorisation. As part of the authorisation process and during the period thereafter, CySEC is responsible for ensuring the sound and prudent management of the CIFs.

CySEC shall review the arrangements, strategies, processes and mechanisms implemented by the CIFs to meet the supervisory requirements and evaluate the risks the CIFs may be exposed to. The frequency and intensity of the reviews will be established based on size, systemic importance, nature, scale and complexity of the activities taking into account the principle of proportionality, but will be at least annually.

CySEC will provide assistance to competent authorities, particularly in relation to the exchange of information, co-operation in investigations and inspections of supervisory activities. In the event CySEC has reason to believe that an entity not subject to its supervision is carrying out an act contrary to EC regulation in another member state, it shall notify the competent authority in the member state as well as ESMA in as much detail as possible. In the event CySEC receives such a notification from another member state it will take the appropriate action and inform the competent authority and ESMA of the outcome of the actions and, if possible, of any significant interim developments.

CySEC will provide ESMA with all necessary information upon their request without delay. In addition, on an annual basis, CySEC will provide consolidated information of all administrative penalties imposed. CySEC will report any complaints and the relevant remedial procedures to ESMA.

In supervisory activities, inspections, and investigations, CySEC can co-operate with the competent authorities of other member states. In the event that a CIF is a remote member of a regulated market that is authorised in another member state, the competent authority of the regulated market may address the CIF directly. In this case, the authority will inform CySEC accordingly. Similarly, when CySEC decides to address an IF authorised in another member state which is a remote member of a regulated market authorised in the Republic, CySEC will inform the competent authority of the IF's home member state.

If CySEC receives a request regarding an inspection or investigation, it will:

carry out the inspection or investigation; or
allow the requesting authority to carry out the inspection or investigation; or
allow auditors or experts to carry out the inspection or investigation.

ESMA's staff may participate in the supervisory activities of CySEC, including on-site inspections carried out jointly by two or more competent authorities. Similar to competent authorities in other member states, CySEC is designated as the contact point that will immediately supply the other contact points with the information needed to carry out their functions. Some of the information CySEC shares or receives is confidential and should be treated as such. However, the fact that information is confidential does not prevent CySEC from transmitting the information to ESMA, the European Systemic Risk Board (ESRB), the CBC, other central banks of member states, and the European Central Bank (ECB), on the understanding that the information is to be treated confidentially.

Under certain circumstances CySEC may refuse to provide information or to co-operate with an investigation. This could, for instance, occur when:

such an inspection, investigation, supervisory activity or exchange of information might adversely affect the sovereignty, security or public order in the Republic;
judicial proceedings have already been initiated in respect of the same actions and the same persons before a court;
final court judgment has already been delivered in the Republic in respect of the same persons and the same actions.

If CySEC refuses to provide information or co-operation, they shall inform the competent authority of the requesting member state as well as ESMA. In addition, CySEC will inform ESMA and the European Commission in the event that measures taken by the home member state in this respect have proven to be inadequate.

Any difficulties encountered by CIFs in establishing branches or providing a service in a third country will be brought to the attention of the European Commission.

2.1 Inspections and Investigations

CySEC has the power to collect information, to carry out investigations and inspections and to impose sanctions in the event of violations of the relevant legislation.

Any investigations must be carried out as quickly as possible. CySEC may appoint an investigating officer who may be a member of the board and the representative of the governor of the Central Bank of Cyprus and/or an officer of CySEC and/or any other person.

During the course of the investigation, the investigating officer may:

be advised and accompanied by a professional adviser, by a person authorised in writing, by the competent foreign supervisory authority as their representative and/or any other person;
exercise the powers of CySEC to collect information, enter premises and investigate;
summon and hear the attestation and take a deposition, written or recorded at his discretion, from persons who may have information on or knowledge of the case who shall be obliged to appear before the investigating officer and provide the information they have.

Upon completing his investigation, the investigating officer shall provide a written report to CySEC of their findings including any opinions, recommendations and relevant documents.

3. Offences

Learning Objective

1.3.1 Know which violation constitutes both a criminal and an administrative offence

Party	Violation	Type of offence	Initial penalty	Penalty for relapse or continuation
Any Person	It is up to any person to ensure the correctness, completeness, and accuracy of all information it is required to submit to CySEC. In the event that the firm: provides false or misleading information, details, documents, or forms; or withholds material information from any application or notification submitted to CySEC	Criminal	If convicted - maximum of five years' imprisonment and/or a maximum fine of €350,000	
		Administrative	Maximum fine of €350.000	Maximum fine of €700.000
			Whole or partial withdrawal of CIF authorisation	
Person	Violation of the provisions regarding amendment of CIF details, with the exception of during the	Administrative	Maximum fine of €175.000	Maximum fine of €350.000

Party	Violation	Type of offence	Initial penalty	Penalty for relapse or continuation
	assessment process of an acquisition			
	Acquisition or increase of an (in) directly held qualifying holding, in spite of the opposition of CySEC	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
Tied Agent	Holding clients' money and/or financial instruments	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
	Violation of any other provisions or directions	Administrative	Maximum fine of €175.000	Maximum fine of €350.000
CIF	Violation of the provisions to ensure investor protection and the related directives with the exception of the provisions regarding tied agents	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
	Violation of the provisions of the chapter on market transparency and integrity or/and the directives issued pursuant to the said Chapter or/and the Regulation (EC) No 1287/2006	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
Market	Violation of the provisions	Administrative	Maximum fine	Maximum fine

Party	Violation	Type of offence	Initial penalty	Penalty for relapse or continuation
operator operating an MTF	of the chapter on market transparency and integrity or/and the directives issued pursuant to the said Chapter or/and the Regulation (EC) No 1287/2006		of €350.000	of €700.000
Credit Institution	Violation of the obligation to report transactions	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
	Not reporting a significant breach of the MTF	Administrative	Maximum fine of €350.000	Maximum fine of €700.000
All	Any violation of Law 144(I) of 2007 and the associated directives for which there is no specific administrative fine.	Administrative	Maximum fine of €350.000	Maximum fine of €700.000

End of Chapter Questions (for revision purposes)

1. Describe a regulated market.
   Section 1.1

2. List the types of activities that constitute an investment activity.
   Section 1.1

3. List the powers of the CBC in relation to CySEC.
   Section 1.2

4. Which supervisory authorities exist in the Republic?
   Section 1.2

5. What are the obligations of CySEC when they receive a request for an inspection or investigation.
   Section 2

6. Under which circumstances may CySEC refuse to provide information or co-operate with an investigation?
   Section 2

7. Which violations constitute a criminal and an administrative offence?
   Section 3

B. Cypriot investment firms (CIFs)

Cypriot investment firms (CIFs) are firms that provide investment services on a professional basis to parties inside and outside of the Republic. Law 144 provides specific provisions regarding capital requirements, the establishment of branches and authorisation. This chapter outlines the authorisation and supervision of the CIFs in the Republic. Law 144(I)/2007 is the Investment Services and Activities and Regulated Markets Laws of 2007–2012 and regulates the provision of investment and ancillary services as well as the performance of investment activities on a professional basis in the Republic of Cyprus. It also regulates the operation of regulated markets and other related matters. The Law is harmonised with the relevant EC directives as outlined in Chapter 1. All articles mentioned in the Learning Objectives relate to Law 144(I)/2007.

1. Authorisation

The obligations of a CIF do not stop once the initial approval has been obtained. The firm must ensure it meets the requirements on a continuing basis so as not to lose its authorisation.

1.1 Initial Authorisation of a Firm

Learning Objective

2.1.1 Know the conditions and procedures for granting CIF authorisation: general provisions (Article 6–9); capital requirements (Article 10); directors, shareholders and close links (Article 11–13); organisational requirements (Article 18); overseas branches; establishment of a branch in the Republic by a member state firm (Article 75); establishment of a branch in the Republic by a third country IF (Article 78); freedom for CIFs to provide investment and ancillary services abroad

1.1.1 General

A CIF is not allowed to provide professional investment services without prior authorisation from CySEC. Similarly, market operators are allowed to operate a multilateral trading facility (MTF) as long as CySEC has ascertained in advance that it complies with the authorisation provisions.

In order to obtain authorisation, the applicant needs to provide all necessary information to satisfy CySEC. Once approved by CySEC, the authorisation is valid in all EU member states. As a result, the CIF can provide all services and activities for which it has been authorised in all member states either through the establishment of a branch or directly. The authorisation specifically states the services and activities the CIF is entitled to undertake. No authorisation will be provided solely for the provision of ancillary services.

A CIF may not undertake any services or activities outside its authorisation unless it directly benefits another service it is authorised to undertake or it has received specific permission from CySEC, which is granted in exceptional circumstances.

All CIF authorisations are registered, maintained and updated in a register which is freely accessible to the public containing the CIF's name and number of authorisation, the date of authorisation, the investment and ancillary services which the CIF is authorised to provide, the investment activities which it is authorised to carry out, as well as any other information CySEC may deem necessary. CySEC communicates all CIF authorisations to ESMA.

It is the obligation of the CIF to publish their authorisation number as well as the fact that they are supervised and authorised by CySEC on any official documents. Moreover, a CIF must maintain a website, which should clearly state that it is authorised by CySEC as well as contain its number and content of authorisation.

When authorising a CIF for a subsidiary of an institution authorised in another member state, CySEC will request the opinion of the competent authorities in the member state and will exchange any information necessary in relation to the application. CySEC and the competent authorities in the member state will liaise with each other in the assessment of the suitability of the shareholders and management as well as the ongoing compliance with the relevant rules and regulations.

1.1.2 Capital Requirements

As part of the authorisation process, CIFs need to have a minimum level of capital which is dependent on the services they provide, and which is outlined in the table below:

Investment Services	Initial Capital
The CIF holds clients' money and/or clients' financial instruments and provides:	€200.000
Receipt and transmission of orders in relation to financial instruments	

Investment Services	Initial Capital
Execution of orders on behalf of clients	
Portfolio management	
Provision of investment advice	
The CIF does not hold clients' money and/or clients' financial instruments and may therefore not place itself in debt with its clients. The CIF provides one or more of the following investment services and/or performs the following investment activities:	€80.000 or €40.000 plus professional indemnity insurance covering all member states for at least €1.000.000 per claim, and €1.500.000 in aggregate per year
Receipt and transmission of orders in relation to financial instruments	
Provision of investment advice	
In the event the CIF is also registered to provide insurance services.	Initial capital is half of the above. If CIF is covered by professional indemnity insurance covering all member states then the initial capital requirement is €20.000
Dealing on own account Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis Placing of financial instruments without a firm commitment basis Operation of multilateral trading facility	€1.000.000

1.1.3 Directors, Shareholders and Close Links

Directors are defined as the persons who effectively direct the business, and they need to be of sufficiently good repute and sufficiently experienced to ensure the sound and prudent management of the CIF. CySEC may reject an application for authorisation of a CIF or an MTF if they consider the directors are not of sufficiently good repute or experience, or if CySEC believes that these directors pose a threat to the CIF's sound and prudent management. At least two members of the management of a CIF need to be classed as directors.

Prior to authorisation of investment services and/or the performance of investment activities, CySEC needs to be informed of the identity and the amount of each of the (in)direct shareholders with a qualifying holding, irrespective of whether they are natural or legal persons. A qualifying holding in this respect is an (in)direct holding in an investment firm representing 10% or more of the capital or the voting rights of an investment firm. When the shareholder is a legal person, the identity of their managers needs to be provided, as well as the names of the ultimate physical shareholders. If CySEC considers one or more of the qualifying shareholders unsuitable, they may reject the application.

Close links between the applicant and other persons are permitted, but only if they do not prevent the effective exercise of CySEC supervisory functions. However, in the event that the rules, regulations, or provisions of a third country governing one or more of the persons which have a close link with an applicant cause difficulties with the enforcement, or prevent effective supervision, the applicant will not be authorised.

The Memorandum of Association of the CIF must specifically state the company operates as a CIF as defined in the Law and provides or performs investment and ancillary services related to financial instruments within the scope of its authorisation obtained from CySEC.

1.1.4 Organisational Requirements

The Law prescribes a number of organisational requirements. A CIF must:

Establish adequate policies and procedures to comply with its legal obligations, and the appropriate rules governing personal transactions, of its managers, employees, tied agents and other relevant persons.

Maintain and operate effective organisational and administrative arrangements to prevent conflicts of interest from adversely affecting clients' interests.

Ensure continuity and regularity in performance of services and activities, by employing appropriate and proportionate systems, resources and procedures.

Ensure avoidance of undue additional operational risk when outsourcing functions to third parties.

Ensure robust governance arrangements are in place including clearly organised organisational structures with well-defined, transparent and consistent lines of responsibility.

Have sound administration and accounting procedures, internal control mechanisms, effective risk-assessment procedures, and effective control mechanisms in place.

Keep records of all services and transactions in line with the Cyprus and EU legal requirements.

Apply appropriate client identification procedures in line with the Prevention and Suppression of Money Laundering Activities Law and relevant EC directives.

Make adequate arrangements to safeguard clients' ownership rights when holding cash or financial instruments belonging to clients, particularly in the event of insolvency of the CIF, and prevent the use of these clients' funds and investments for its own account.

All procedures, processes, and arrangements related to the above need to be comprehensive and proportionate to the scale and complexity of the business.

1.1.5 Branches

A CIF may provide its services by establishing a branch in the Republic as long as the services it offers are covered by their authorisation. Ancillary services may only be provided in combination with investment services. Equally, an IF authorised and supervised by the competent authorities of a third country may provide services in the Republic through the establishment of a branch.

In order for a CIF to establish a branch in the Republic, it needs to send a written notification of their intent to CySEC. Likewise, for an IF who wishes to establish a branch in the Republic, the competent authority of the IF host member state shall communicate the following to the Commission which has to include information regarding the address, persons responsible for management, organisational structure, and a description of their operations. CySEC will make its decision to allow or prohibit the establishment of the branch within three months after receipt of the notification. In the event any information changes during the decision-making process, the CIF will immediately notify CySEC in writing.

In the case of a foreign IF, however, CySEC may also request additional information from the foreign regulator. CySEC shall grant authorisation to the IF providing that, during the period it is established, the branch complies with the relevant regulations. The branch of an IF is subject to the same rules and regulations as a branch of a CIF.

CIFs can freely provide investment and ancillary services within the territory of any other member state and/or third country as long as they are covered by its authorisation. Ancillary services may only be provided in combination with an investment service and/or activity.

1.2 Continuous CIF Obligations

Learning Objective

2.1.2 Know the continuous CIF obligations: regular internal review (Article 28); conflicts of interest (Article 29)

During its life, a CIF must at all times comply with the rules governing its authorisation. On a regular basis, a CIF needs to undertake an internal review to ensure that the rules and conditions governing its authorisation remain appropriate, effective, comprehensive, and proportionate to the nature, scale, and complexity of its business.

One of the main concerns from a regulatory perspective is associated with the management of conflicts of interest between the CIF (including its manager, employees, tied agents, and other relevant persons) and its clients or between two clients. The arrangements put in place by the CIF must be sufficient to ensure it can prevent any risk of damage to clients' interests. If the arrangements are deemed to be insufficient, the CIF must clearly disclose the general nature and/or sources of conflicts of interest to the client prior to undertaking any business on the client's behalf.

CySEC may define the steps CIFs are expected to take to identify, prevent, manage or/and disclose conflicts of interest, and the appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of a CIF.

The rules and conditions governing CIF authorisation cover organisational requirements, ongoing capital requirements and outsourcing.

1.3 Suspension and Termination of Authorisation of a Firm

Learning Objective

2.1.3 Know the circumstances under which CIF authorisation may be suspended or terminated: lapsed usage (Article 24); renouncement (Article 24); commission withdrawal (Article 25); suspension (Article 26)

In the event a CIF has not:

used its authorisation within 12 months of the date it was granted; or
an authorised CIF has not provided investment services or activities for a period of six months,

its authorisation will lapse. In the event a CIF only uses part of its authorised activities, the lapse will only apply to those services it has not performed or started to undertake.

In addition, a CIF may expressly renounce the authorisation.

The CIF authorisation lapses automatically, and it is the responsibility of the CIF to inform CySEC accordingly. In the event the CIF no longer engages in part of its authorised activities or renounces its authorisation, the CIF needs to settle its obligations from the lapsed activities within three months after the authorisation has lapsed.

CySEC may wholly or partially withdraw a CIF authorisation under the following circumstances:

The CIF has provided false or misleading information either as part of the authorisation process or since it has been authorised.
The CIF no longer meets the conditions under which authorisation was granted.
The CIF has seriously and/or systemically infringed the laws and regulations.
The CIF falls under different Cypriot legislation outside the scope of this investment services law.

When the authorisation is withdrawn, the CIF will cease to provide the associated services. Any obligations, arising as a result of the services, it may no longer provide have to be settled within three months of receiving the notification from CySEC. A CIF whose authorisation has been wholly withdrawn remains under the supervision of CySEC until CySEC is satisfied the CIF has fully withdrawn and has met all its obligations. In the event the CIF violates any of the provisions, CySEC may charge an administrative fine of up to €350.000.

In the event the authorisation has been fully withdrawn, CySEC may apply to the court to have the company liquidated and appoint a (temporary) liquidator. Any revocation of a CIF authorisation shall be reported to ESMA.

1.3.1 Suspension

CySEC may (partially) suspend a CIF authorisation at the same time as it starts the withdrawal process until it has decided whether the possible withdrawal of the authorisation may endanger the CIF's clients, the CIF's investors or the general operations of the capital market. In addition, CySEC may (partially) suspend a CIF authorisation for up to three months when there are suspicions of alleged violation of the Law 144 (I) and/or the EU directives that possibly endangers the clients' interest, investor interest, or the operations of the capital market. In the event the decision to suspend is taken independently of withdrawal proceedings, the decision to suspend can be taken by the President or the Vice-President of CySEC who will inform CySEC at the next meeting.

If CySEC is satisfied that the CIF has complied with the rules and regulations, it may withdraw the suspension. If CySEC is not satisfied, it automatically extends the suspension and commences proceedings to withdraw the relevant authorisation. The CIF will remain suspended until such a time CySEC has decided whether or not to withdraw the relevant authorisation.

During the suspension, the CIF is not allowed to provide any of the related activities. If the CIF violates its suspension CySEC may impose an administrative fine of up to €350.000.

1.4 Amendment of CIF Details

Learning Objective

2.1.4 Know the rules relating to the amendment of CIF details: reduction of share capital (Article 31); change of directors (Article 32); major shareowners and change of ownership (Article 33)

A CIF may not reduce its issued share capital without prior written authorisation by CySEC. CySEC may not authorise the reduction of the issued share capital of the CIF if it contravenes the provisions of the Law 144(I), the regular operation of the CIF or the operations of the capital market.

Any change in the appointment of the directors needs to be notified to CySEC. The CIF needs to provide all necessary details for CySEC to be able to assess that the new director is of sufficiently good repute and sufficiently experienced. This information needs to be provided one month prior to the appointment. Any directors will have to notify CySEC and the CIF in writing of a change in their personal details if these could affect the sound and prudent management of the CIF.

A qualifying holding is the direct or indirect holding in an investment firm, which represents 10% or more of the capital or of the voting rights of an investment firm. A change in ownership occurs when a person or group of persons takes the decision to acquire a qualifying holding in a CIF, or to increase their existing holding or voting rights to exceed 20%, 30% or 50% so that the CIF becomes its subsidiary. The shareowner will notify CySEC, in writing, indicating the size of the intended holding. CySEC will assess the suitability of the new share owner in the same way as it does as part of the authorisation process. In addition, a CIF shareholder with a qualifying share will need to inform CySEC of any changes in its person or its associates that could affect the sound and prudent management of the CIF.

Every shareholder of a CIF must notify CySEC of a change of the level of their qualifying holding within five working days from the date the acquisition was made. If a CIF becomes aware of any acquisitions or disposals of holdings in its capital that causes its holding to exceed or fall below 20% , 30%, or 50% it must immediately inform CySEC. Each year at the latest by 31 January, the CIF must inform CySEC of all shareholders possessing qualifying holdings during the previous calendar year.

In the event changes in the details or levels of shareholdings of a shareowner cause CySEC concern regarding the sound and prudent management of the CIF, CySEC may take any of the following measures:

suspend the exercise of voting rights for a period not exceeding five years;
nullify the votes;
prohibit the transfer of shares;
prohibit the CIF from making any payments deriving from the shares.

CySEC has 60 working days from the date of the written acknowledgement of receipt of the notification of change in ownership levels to make the assessment (assessment period).

2. Conduct of Business Obligations

During the course of their business, all CIFs need to ensure that they treat their customers fairly while at the same time ensuring that they understand their clients' requirements, knowledge, and experience. All of these elements are associated with ensuring investor protection.

2.1 Information Requirements of Potential and Existing Clients

Learning Objective

2.2.1 Understand how CIF should address the information requirements of potential and existing clients: information about the CIF, its services, proposed strategies, execution venues and cost (Article 36–1b); information about the client (Article 36–1c); professional client (Second Appendix, Section 2)

2.2.2 Know the correct procedure for dealing with clients who have not communicated sufficient levels of knowledge and experience to the CIF (Article 36–1d)

2.2.3 Understand how the provisions relating to client information are applied by CIF solely receiving and transmitting client orders (Article 36–13)

2.2.4 Know which party is responsible for the information requirements of clients when instructions are received via an authorised third party (Article 37)

In its dealings with clients, a CIF must act honestly, fairly, and professionally in accordance with the best interest of its clients and thus needs to ensure that all information addressed to clients, including the information included in marketing material, is fair, clear and not misleading. In addition, marketing material needs to be clearly identified as such.

A CIF must provide (potential) clients with comprehensive information about:

the CIF and its services;
financial instruments and proposed investment strategies, including appropriate guidance and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies;
execution venues;
costs and associated charges, in a standardised and easy to understand format.

The information needs to be transparent so that it allows the client to make informed investment decisions.

A CIF needs to obtain a record with sufficient information to understand the (potential) client's levels of knowledge and experience regarding the products or services it is offering the (potential) client, his financial situation and investment objectives. This will assist the CIF to be able to recommend the most suitable investments to the client.

In the event the CIF considers that a particular investment or financial product is not appropriate for a (potential) client, they will send a warning to the client. The warning may be in a standardised format. If the (potential) client elects not to provide any information, the CIF must inform the (potential) client that they will not be allowed to determine whether a product or service is appropriate. When the only service a CIF provides solely consists of receiving and executing client orders, the CIF does not need to assess the client's knowledge and expertise as long as the transaction is related to shares, is undertaken on the client's request, and the client has been informed the CIF does not need to assess the appropriateness of the investment.

A CIF needs to maintain client files including documentation outlining the rights and obligations of the client and the firm, as well as any legal documentation. The CIF needs to provide clients with regular, adequate reports on the products and services including, when applicable, cost.

2.2 Professional Clients

A professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risk it incurs. In order to be considered a professional client, the client must comply with the following criteria:

Entities required to be authorised or regulated to operate in the financial markets, including those authorised by an EU member state.

Large undertakings meeting two of the following size requirements:

balance sheet total at least €20.000.000;

net turnover at least €40.000.000;

own funds at least €2.000.000.

3. National and regional governments, public bodies managing public debt, central banks, international and supranational institutions and other similar international organisations.
4. Other institutional investors, whose main activity is to invest in financial instruments.

Although these clients are considered to be professional clients, they must be allowed to request non-professional treatment and higher levels of protection.

When a client is a professional client, the CIF must inform the client prior to undertaking any services that he will be treated as a professional client, unless otherwise agreed between the parties. In addition, the CIF must inform the client that he can request to be treated as non-professional, and thus be subject to a higher level of protection. It is the client's responsibility to request to be treated as a non-professional.

2.3 Instructions from Third Parties

When a CIF receives an instruction to undertake investment or other services on behalf of a client from another IF or a credit institution authorised in the Republic or another member state, the CIF may rely on the client information, as well as the completeness and accuracy of recommendations submitted by the other institution. The third party institution will remain responsible for the completeness and accuracy of the client information, as well as the appropriateness of specific client recommendations or advice. The CIF is responsible for execution of the transaction in line with the instructions.

3. Best Execution

Learning Objective

2.3.1 Know the obligations regarding best execution (Article 38)

2.3.2 Understand how client order handling rules are applied (Article 39)

Best execution of an order means that the financial institution must take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. However, the CIF will, in any case, execute the order following the specific instructions from the client.

In order to ensure best execution, the CIF needs to establish and implement effective processes and procedures. The order execution policy needs to include details on the different venues where the CIF executes its clients' orders for each class of instrument, and will include the venues that enable the CIF consistently to obtain the best possible result and the factors affecting the choice of execution venue. Prior to executing a client order, the CIF needs to communicate the order execution policy to the client and obtain its approval.

The order execution policy may provide for the possibility that client orders are executed outside a regulated market or an MTF. In this case, the CIF must inform its (potential) clients about this possibility and obtain express consent to execute their orders outside a regulated market or an MTF. This consent may be obtained either generally or on an individual transaction basis.

On a regular basis, a CIF must monitor the effectiveness of its order execution arrangements and policies and, if necessary, take any action for improvement. In particular, it needs to assess whether the execution venues continue to provide the best possible results for the client. Clients need to be notified of any material changes.

On request of the client, a CIF needs to be able to demonstrate that it has executed its orders in accordance with the order execution policy.

Procedures and arrangements have to be in place to provide for the prompt, fair, and expeditious execution relative to other client orders and its own trading interests. Comparable orders need to be executed in accordance with the time they were received by the CIF; in other words, on a first come, first served basis.

Unless the client specifically instructs otherwise, for any client orders that cannot be immediately executed under prevailing market conditions, a CIF must take measures to facilitate the earliest possible execution of the order by making the limit order public. This is achieved by, for example, transmitting the order to a regulated market and/or an MTF. For limit orders that are large in scale compared to normal market size, CySEC may waive the obligation to make the limit order public.

CySEC may issue directives that define:

the conditions and nature of the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders, as well as the situations in which, or types of transaction for which, a CIF may reasonably deviate from prompt execution so as to obtain more favourable terms for its clients;

the different methods through which a CIF may be deemed to have met its obligation to disclose executable client limit orders to the market.

4. General CIF Obligations

Learning Objective

2.4.1 Understand the obligations relating to the appointment and use of tied agents (Article 40): public register; responsibility and monitoring

2.4.2 Know the rules relating to eligible counterparties (Article 41): relevance of conduct of business

obligations; scope; express confirmation

2.4.3 Know the purpose and scope of CIF employee certification (Article 52)

4.1 Tied Agents

A tied agent means a person established in a member state, who, acting under the full and unconditional responsibility of only one IF of a member state, on whose behalf it acts, promotes investment or/and ancillary services, attracts clients or prospective clients, receives and transmits client orders in respect of investment services or financial instruments, places financial instruments or/and provides advice to clients or prospective clients in respect of those financial instruments or services. A CIF may appoint tied agents to:

promote its services;
solicit (potential) clients;
receive orders from clients and transmit them, placing financial instruments;
provide advice in respect of the financial instruments and services provided by the CIF.

Tied agents need to be registered in the public register of the Republic, or the equivalent register of a member state. The CIF remains fully and unconditionally responsible for any action or omission on the part of the tied agent when he acts on behalf of the CIF. In addition, it is the responsibility of the CIF to ensure that a tied agent discloses the capacity in which he is acting and the CIF he is representing. A CIF that appoints tied agents must take adequate measures in order to avoid any negative impact that the activities of the tied agent which are outside the scope of this Law (144(I)/2007) could have on the activities carried out by the tied agent on behalf of the CIF.

A CIF that appoints tied agents must make sure it has adequate measures in place to avoid a situation in which activities undertaken by tied agents outside the scope of the Law 144(I)/2007 have a negative impact on the activities they undertake on behalf of the CIF.

Tied agents:

are registered in a public register that is maintained by CySEC and updated regularly and is freely accessible by the public;
can be established in the Republic or another member state and need to be of sufficiently good repute and possess the appropriate general, commercial and professional knowledge;
are not allowed to hold client money and/or financial instruments;
must immediately notify CySEC of any change in their details. In the case of a legal person, the tied agent has to employ at least one natural person that fulfils the above stated conditions.

Every time a CIF appoints or dismisses a tied agent, or becomes aware of changes in the tied agent's details, they need to report it to CySEC.

On 31 January of each year, a CIF must notify CySEC of the details of the tied agents it employed during the calendar year.

CySEC establishes and maintains a register that is freely accessible by the public, where those tied agents that comply with the conditions of registration (be of sufficiently good repute and possess appropriate general, commercial, and professional knowledge) are registered and are:

established in the Republic and act on behalf of a CIF or a credit institution that has been authorised in the Republic;

established in the Republic and act on behalf of an IF or a credit institution that has been authorised in another member state;

established in another member state and act on behalf of a CIF or credit institution that has been authorised in the Republic, but the member state in which the tied agents are established does not allow the appointment of tied agents.

CySEC supervises the compliance by the tied agents of CIFs with the provisions of this law and the associated directives. In order to be able to do so, tied agents must make their books and records available to CySEC as well as any other document CySEC requests.

The Central Bank and the ASDCS notify to the Commission information about the tied agents appointed by the banks and the co-operative credit institution authorised by the said authorities, when these tied agents comply with the conditions required in order to be registered in the public register, as well as providing all the information they receive for the tied agents.

4.2 Eligible Counterparties

Eligible counterparties are CIFs, IFs, credit institutions, insurance undertakings, UCITS and their management companies, pension funds and their management companies and other financial institutions authorised by a member state or regulated under community legislation or the national law of a member state, national governments, central banks and supranational organisations. In addition, CySEC recognises as eligible counterparties member state undertakings meeting predetermined criteria and third country entities with equivalent status.

In dealing with these counterparties, the CIF does not have to meet with the obligations related to marketing as outlined in Section 2.1 above, or the best execution procedures outlined in Section 3.

When dealing with eligible counterparties, the CIF obtains express confirmation from the counterparty that it agrees to be treated as an eligible counterparty. This can be obtained either as a general agreement or on a transaction by transaction basis.

4.3 Certification of Employees

CIF employees, in any of the following functions:

receipt and transmission of orders in relation to one or more financial instruments;
execution of orders on behalf of clients;
dealing on own account;
portfolio management;
investment advice; and
underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;

need to be of sufficiently good repute and have the necessary skills, knowledge and expertise to execute their duties. In addition, they need to be registered in the public register. The persons registered in the public register are obliged to update, without delay, the public register for each change in their information.

CySEC may allow an unregistered person to undertake any of the above-mentioned functions providing that CySEC is informed, in writing, by the CIF and approves the assumption of the duties subject to meeting a deadline for registration.

CIFs may only employ persons that comply with and fulfil the requirements mentioned above.

CySEC establishes and maintains a publicly accessible register of all the persons who have been successful in the exams held by CySEC.

5. Market Transparency and Integrity

Learning Objective

2.5.1 Know the CIF record-keeping requirements (Article 43)

2.5.2 Know the CIF transaction reporting requirements (Article 44)

2.5.3 Understand compliance monitoring requirements relating to the operation of a multilateral trading

facility (MTF) (Article 46)

2.5.4 Understand obligations related to systematic internalisers: liquid and illiquid markets (Article 47–1); pre-trade transparency requirements (Article 47–2); quotation size (Article 47–3); price obligations to retail and professional clients (Article 47–7&8); withdrawing and restricting quotes (Article 47–6)

2.5.5 Know post-trade reporting requirements for MTFs (Article 47–8)

Market transparency and integrity are important for the financial infrastructure and requires records to be kept and reports to be generated. Systematic internalisers and MTFs play an important role in this respect and need to be monitored.

5.1 CIF Record-Keeping and Reporting Requirements

A CIF must keep records of all financial transactions it has undertaken either on its own behalf or on behalf of clients. The form, type and content of records will be defined by CySEC.

The records must be kept for a period of at least five years and must be made available for review by CySEC at any time. Any records relating to agreements to provide services need to be maintained for the duration of the relationship between the CIF and the client. In exceptional circumstances CySEC may require a CIF to retain the records for longer than the stated period of five years. This is typically justified by the nature of the instrument or the transaction. After the lapse or withdrawal of the authorisation of a CIF, CySEC may request the records to be maintained for the remainder of the five-year period.

CIFs, credit institutions authorised in the Republic, and branches which execute transactions in any financial instruments admitted to trading on a regulated market, must report details of any transactions executed on or off regulated markets to CySEC as quickly as possible, and no later than the close of the following working day. CySEC ensures that all information is provided to the competent authority of the relevant market in terms of liquidity for the associated instrument. The reports need to include details of:

the name and unique identifier of the instruments bought or sold;
the quantity;
date and times of execution;
transaction prices;
means of identifying the CIF, credit institution, or branch concerned.

The transaction reports are submitted to CySEC either by the transacting institution, a third party acting on its behalf, or by an approved trade matching or reporting system or by the regulated market or MTF through whose systems the transaction was completed. When transactions are reported directly to the CySEC by a regulated market, an MTF, or a trade-matching or reporting system approved by CySEC, the obligation imposed upon the CIF or the credit institution to report details of the transactions executed is waived.

5.2 Compliance Monitoring for Multilateral Trading Facilities (MTFs)

CIFs and market operators operating an MTF must have effective policies and procedures to ensure its users are monitored for compliance with its rules. In addition, they need to monitor the transactions undertaken by its users to be able to identify breaches of the rules, disorderly trading conditions or conduct that may involve market abuse.

All authorised institutions and MTF operators must report to CySEC any significant breaches of the rules, disorderly trading conditions, or conduct that may involve market abuse and must supply any relevant information, and provide full assistance in any investigation and prosecution.

5.3 Systematic Internalisers (SIs)

On a regular basis, systematic internalisers (SIs) in shares must publish a firm quote in the shares admitted to trading on markets for which they are systematic internalisers and for which there is a liquid market. For shares for which the market is illiquid, SIs must disclose quotes on the request of the clients.

This requirement only applies when dealing in transaction sizes up to standard market size, and not for those above. The standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares.

The market for each share shall be comprised of all orders executed in the European Union in respect of that share excluding those large in scale compared to normal market size for that share. For each share, the quote must include a firm bid and/or offer price or prices for a size or sizes which could be up to standard market size for the class of shares to which the share belongs.

The prices must also reflect the prevailing market conditions for that share.

Any orders received from retail clients must be executed at quoted prices at the time of receipt of the order. Orders received from professional clients similarly need to be executed at the quoted price at the time of receipt. However, the systemic internaliser may execute the orders of professional clients at a better price providing that it falls within a public range close to market conditions and the orders are of a larger size than those normally undertaken by retail investors, or when the transaction contains multiple securities that are subject to conditions other than the current market price.

Quotes must be made public on a regular and continuous basis during business hours. An SI may update its quotes at any time and, under exceptional market conditions, withdraw them. Quotes must be made public to other market participants in an easily accessible manner on a reasonable commercial basis.

Current bid and offer prices, and depth of trading interest are made public through the MTF's systems. This information must be made available on reasonable commercial terms and on a continuous basis during normal trading hours.

6. Capital Adequacy Requirements

Learning Objective

2.6.1 Know how the main capital adequacy requirements are applied: CIF own funds (Article 67); CIF capital adequacy ratio (Article 68); CIF large exposure limits for institutions, persons, directors (Article 69)

Capital adequacy is a key part of regulation in the financial industry and ensures that the regulated firms have sufficient capital available to ensure they are capable of withstanding any foreseeable losses and thus provide a safe financial infrastructure.

A CIF must at any time hold own funds that are equal to the total of its capital requirement and under no circumstances should its capital fall below the level of initial capital (see Section 1.1.2 above). In the unlikely circumstance that the CIF's capital falls below its capital adequacy requirements or its initial capital, it must immediately inform CySEC. CySEC may, at its own discretion, set a deadline by which the CIF must remedy this. A CIF must have effective and efficient strategies and processes in place to assess and maintain the correct level of capital.

6.1 Large Exposures

CySEC defines the large exposure limits that may not be exceeded, either individually or in aggregate for a person or group of connected persons. All large exposures must be identified, recorded, maintained, and monitored by the CIF. In the unlikely event that a large exposure limit has been breached, the CIF needs to inform CySEC with immediate effect. CySEC may set a deadline for the CIF to ensure the large exposure is reduced to below the limit.

7. Regulated Markets

7.1 Application and Authorisation Requirements

Learning Objective

2.7.1 Know how the obligations apply to regulated markets: application and authorisation process (Article 86); capital requirements (Article 96); senior management requirements (Article 98); organisational requirements (Article 99); lapse, suspension and withdrawal of regulated market authorisation (Article 93–95)

Authorisations for regulated markets are granted by CySEC providing that both the market operator and its systems meet CySEC's requirements and that the regulated markets' home member state is the Republic. How the obligations are divided between the regulated market and the market operator is established by CySEC by means of directives. The authorisation document includes the name of the regulated market, its operator, the number and date of the issue of its authorisation and any other details.

An application for regulated market authorisation is made by the market operator and submitted to CySEC, and must include all necessary background information. During the assessment process, CySEC may request additional information which must be provided. The market operator is responsible for correctness, completeness, and accuracy of the application and the additional documentation provided. The market operator signs the application and confirms that he has exercised due diligence in ensuring that the information included in the application, as well as the details and documents that accompany it are correct, complete and truthful. CySEC must inform the market operator of its decision within six months from the submission of a duly completed application.

The minimum initial capital requirement for a market operator is €10.000.000, and may be adjusted by CySEC during the application process on the basis of the nature, scale, and complexity of the activities of the regulated market.

Persons who effectively direct the business and the operation of a regulated market must be of sufficiently good repute and sufficiently experienced as to ensure the sound ad prudent management and operation of the regulated market. In the event that CySEC finds these persons are not suitable, it may reject the application. Ownership of the regulated market and/or the operator must be reported to CySEC, with a specific focus on the identity and scale of interest of any person in a position to exercise significant influence over the management and operation of the regulated market. Any changes in the ownership levels of persons with significant influence must be reported to CySEC prior to the transfer of ownership, after which CySEC will notify the regulated market of its decision to permit or prohibit the share transfer within one month.

The regulated market must have arrangements in place to enable it to identify and manage any potential adverse consequences for its operation, its members and participants, owners and operators, and to be able to manage any conflict of interest. In addition, the organisational requirements for a regulated market include:

adequate risk management;
adequate management for the technical operations of the system;
transparent and non-discretionary rules and procedures to ensure fair and orderly trading;
objective criteria for efficient order execution;
effective arrangements to facilitate efficient and timely finalisation of transaction execution;
sufficient financial resources to facilitate its orderly functioning, given the nature and extent of the transactions concluded on the market and the range and degree of risk to which it is exposed.

A regulated market authorisation, that was granted by CySEC automatically lapses when the regulated market:

does not make use of its authorisation within 12 months from the date of issue of the relevant authorisation;
expressly renounces its authorisation;
has not operated for the preceding six months.

In the event the authorisation has lapsed, the person acting as a market operator before the lapse of the relevant authorisation must inform CySEC accordingly.

Authorisations may (partly) be withdrawn by CySEC when the regulated market:

has submitted false or misleading information as part of the application or has generally provided false or misleading information, details, or documents;

no longer meets the conditions for authorisation;

has seriously and/or systematically infringed the regulations; or

falls within any of the cases provided in other Cypriot legislation which provides for withdrawal of authorisation.

Once the authorisation is withdrawn, the regulated market has to cease operating as a regulated market and settle all obligations arising from activities it may no longer perform within three months after the date it has been notified of CySEC's decision. During this period, the market operator and the regulated market remain under the supervision of CySEC until CySEC is satisfied all obligations have been met. Any violation is subject to a maximum administrative fine of €350.000.

Any revocation of authorisation will be reported to ESMA.

7.2 Admission of Financial Instruments to Trading

Learning Objective

2.7.2 Understand rules relating to the admission of financial instruments to trading (Article 104)

The rules in relation to the admission of financial instruments must be clear and transparent and are in place to ensure that the instruments can be traded in a fair, orderly and efficient manner. In addition, transferable securities must be freely negotiable. The rules further ensure that the design of derivative contracts allow for their orderly pricing and the existence of effective settlement conditions for these types of instruments.

The regulated market must ensure that issuers of transferable securities that are admitted to its market comply with all regulations including initial, ongoing and ad hoc disclosure obligations. The regulated market is responsible for the establishment of arrangements that facilitate access to information for its members or participants.

On a regular basis, the regulated market must ensure compliance with the admission requirements of the instruments it admits to trading.

Financial instruments can be admitted to trading on multiple regulated markets, even without the consent of the issuer. In this case, it is sufficient for the regulated market to inform the issuer that its instruments have been admitted to trading. The issuer has no obligation to provide information directly to any regulated market that trades its instruments without his consent.

The operator of the regulated market may suspend or remove from trading a financial instrument which no longer complies with the rules of the regulated market unless such a step would be likely to cause significant damage to the investors' interests or the orderly functioning of the market.

Irrespective of the possibility for the operators of regulated markets to inform directly the operators of other regulated markets, an operator of a regulated market that suspends or removes from trading a financial instrument shall make public its decision and immediately communicate the relevant information to the Commission. The Commission shall immediately inform the competent authorities of the other member states.

7.3 Transparent and Non-Discriminatory Rules

Learning Objective

2.7.3 Understand the obligation of a regulated market to maintain transparent and non-discriminatory rules (Article 106)

The rule for obtaining access to membership of the regulated market must be based on transparent, non-discriminatory rules which are based on objective criteria. The rules have to specify all obligations for the members arising from:

constitution and administration of the regulated markets;
rules relating to transactions on the market;
professional standards imposed on member's staff;
rules and procedures for clearing and settlement.

Regulated market members can be participant CIFs, remaining IFs, credit institutions and other persons that are fit and proper, have a sufficient level of trading ability and competence, have adequate organisational arrangement and sufficient resources for the role they are going to perform.

Access to membership can be either direct or via remote participation from other member states. Any regulated market shall communicate to CySEC if it intends to provide remote participation from other member states.

A list of all members needs to be reported to CySEC on a regular basis and, in addition, to competent authorities in other member states on their request.

A regulated market authorised in the Republic may provide appropriate arrangements in other member states so as to facilitate access to and trading by remote members or participants established in the other member state. The regulated market shall communicate its intention to provide such arrangements to CySEC. Within one month CySEC will communicate this information to the member state in which the regulated market intends to provide such arrangements. On the request of the competent authority of the host member state and within a reasonable time, CySEC shall communicate the identity of the members or participants of the regulated market established in that host member state.

7.4 Compliance and Trade Transparency

Learning Objective

2.7.4 Know how regulated markets monitor compliance (Article 108)

2.7.5 Know how transparency requirements apply to regulated markets: pre-trade; post-trade (Article 109)

A regulated market must, on a regular basis, monitor compliance with its rules by its members. Individual transactions are monitored in order to identify breaches of the rules, disorderly trading conditions or market abuse. Any violations must be reported immediately by the market operator to CySEC. In the event CySEC is investigating and prosecuting market abuse, the market operator must supply the relevant information without delay and provide full assistance to CySEC.

All current bid and offer prices as well as the depth of trading interest at these prices must be made public through the trading system on reasonable commercial terms, on a continuous basis during normal trading hours, and in a non-discriminatory way. CySEC may waive the obligation to make public the information mentioned above, based on the market model or the type and size of orders, in particular in relation to transactions that are large in scale compared with the normal market size for the share or type of share in question.

End of Chapter Questions (For revision pusposes)

1. List the capital requirements for CIFs.
   Section 1.1.2

2. Name five organisational requirements a CIF must abide by.
   Section 1.1.4

3. What are the reasons a CIF needs to undertake a periodic internal review?
   Section 1.2

4. Under which circumstances may CySEC wholly or partially withdraw a CIF authorisation?
   Section 1.3

5. Define a professional client and its requirements.
   Section 2.2

6. Describe best execution and the obligations of the CIF.
   Section 3

7. List the CIF record-keeping requirements.
   Section 5.1

8. How is a senior management of a regulated market defined?
   Section 7.1

9. Describe the pre- and post-trade transparency requirements.
   Section 7.4

C. Insider Dealing and Market Manipulation (Market Abuse) Law

Introduction

Law 116(I) of 2005 is also known as the Insider Dealing and Market Manipulation (Market Abuse) Law. An integrated and efficient financial market requires market integrity, and the smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives. New financial and technical developments enhance the incentives, means and opportunities for market abuse through new products, new technologies, increasing cross-border activities and the internet. Market abuse consists of insider dealing and market manipulation, and this law covers both areas ensuring throughout a uniform framework for allocation of responsibilities, the application of the European directives and the co-operation with other competent supervisory authorities.

Insider dealing and market manipulation prevent full and proper market transparency, which is a prerequisite for trading for all economic actors in the market. There are a number of uses of inside information, but the mere fact that a person pursues their legitimate business of buying or selling financial instruments or carries out an order dutifully, should not in itself be deemed to constitute use of such inside information. Any person engaging in market abuse activities is subject to sanctions imposed by CySEC.

Prompt and fair disclosure of information to the public is important for the enhancement of market integrity, whereas selective disclosure by issuers can lead to a loss of investor confidence in the integrity of financial markets.

The Insider Dealing and Market Manipulation (Market Abuse) Law of 2005 (Law 116(I)/2005) has been harmonised for:

Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).

Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation.

Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions.

In addition, the law applies the action of the EC titled *Commission Regulation (EC) No 2273/2003 of 22 December 2003* implementing Directive 2003/06/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

1. Inside Information

Learning Objective

4.1.1 Understand the definition of inside information (Article 5)

4.1.2 Know which persons are in possession of inside information (Article 8)

4.1.3 Know when information may be considered to be 'public' (Article 6)

4.1.4 Understand the prohibitions for those in possession of inside information (Article 9)

Inside information is defined as follows:

information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have in the opinion of CySEC, a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

From this definition, it follows that if this information were to be made public it would have a significant negative or positive effect on the prices of the financial instrument the information is related to. Inside information includes information obtained from a client about their pending orders.

A person possessing insider information has this information by virtue of:

membership of the administrative, management or supervisory bodies of the issuer; or

participation in the capital of the issuer; or
having access to the information through the exercise of their employment, profession or duties; or
criminal activities; or
the information accrues (in)directly from a source or person having access to the information; or
close association with persons having access to the information (unless CySEC is satisfied that it was not feasible for them to possess the information).

Generally speaking, a possessor of inside information includes any person, other than the persons referred to above, who possesses inside information while that person knows, or should have known, that it is inside information.

In the event the person is a legal person, all the natural persons who are involved in the decision-making process relating to the transaction concerned are considered to have access to inside information. However, transactions that result from an agreement concluded prior to the person possessing inside information are not subject to the insider trading rules.

Information is considered to be made public when:

it comes to the knowledge of investors inside or outside the Republic or it may be easily and legally obtained; or
it is included in archives or other documents available to the public; or
it has been derived from public information.

Persons who are in the possession of inside information are prohibited from using this information directly or indirectly:

to buy or sell the associated financial instruments for their own account or for the account of others; and
to disclose the inside information to any other person unless it is necessary in the normal course of business; and
to recommend or tempt another person to buy or sell the associated financial instruments, irrespective of whether the other person knew the information.

This also applies to financial instruments not admitted to trading on a regulated market in a member state, but whose value depends on a financial instrument admitted in such market.

The practice of 'front running', including front running in commodity derivatives is prohibited.

In order for a violation of inside information to occur, the gaining of profit or benefit is not necessary to be proven. However, the unlawful nature of the act shall be excluded and the person responsible pursuant to the provisions of this section shall not be punished, if he proves that during the use of the information there existed any of the following conditions:

he held the reasonable belief that such information was made public, to the extent that the possibility that due to the use of this information anyone being in a privileged position in relation to others who did not possess this information was precluded;

he would have executed a transaction in any way, even if he had not possessed this information in his capacity as liquidator, receiver, bankruptcy manager, trustee, agent, and authorised representative or otherwise;

he did not expect that due to the use of this information any person would effect a transaction in financial instruments that the information concerned.

2. Provisions Relating to Issuers of Financial Instruments

Learning Objective

4.2.1 Know how issuers of financial instruments should manage inside information (Article 11)

4.2.2 Understand the circumstances in which publication of inside information might be justifiably delayed (Article 12)

4.2.3 Know the importance of keeping an updated insiders' list (Article 16)

4.2.4 Know the reasons and circumstances when a manager must report his/her transactions (Article 18)

It is the responsibility of the issuer of a financial instrument to make any inside information, as well as any significant changes to previously disclosed information, public as soon as possible and to ensure it is posted on their internet site (if they maintain an internet site). The information must remain available for at least five years. This requirement only applies to issuers whose financial instruments are traded on a regulated market in the Republic or abroad. Within this framework, an issuer is prohibited from providing information which is false, misleading or fraudulent regarding a material element of it or to conceal anything material. Directors and the executive officers of the issuer are prohibited from making any statement, promise or prediction related to the financial position of the issuer and its prospects which is false, misleading or fraudulent or to conceal anything material.

Any information that needs to be disclosed will have to be made available by announcement to:

the CSE, which will immediately publish the information on its internet site;
the CySEC; and
the internet site of the issuer (if applicable).

In the event any information, or significant changes to previously disclosed information, is scheduled to be published by means of mass communication, the issuer needs to notify the CSE and CySEC in advance, and the information will be posted on the CSE's internet preceding its publication. It should, however, not be published as part of marketing communications since this might be misleading. Instead, it should be published in a way that information is disclosed to third parties as part of their normal duties. However, this does not apply to persons who have received confidential information and who owe a duty of confidentiality to the issuer or issuers who have not admitted their financial instruments on any regulated market.

The issuer has to take reasonable care to ensure that the publication of the information is synchronised as closely as possible between all categories of investors, so as not to provide one category an advantage.

2.1 Delay in Publication of Inside Information

In the event the issuer is of the opinion that disclosure of inside information may prejudice their legitimate interests, the issuer needs to inform CySEC of this. CySEC may allow the delay of publication of the information providing that CySEC is satisfied that disclosing the information is not in the interest of the public, may cause significant damage to the issuer, non-disclosure will not result in misleading the public and the issuer may safeguard their confidentiality.

In order to safeguard the confidentiality of the information, the issuer must ensure it has established effective arrangements to ensure that access to the information is restricted solely to the persons who need it for the exercise of their functions and ensure these persons are aware that the information needs to be kept confidential and are aware of the sanctions in case of violation. In addition, measures need to be in place to allow for the immediate public disclosure of the information when required.

Legitimate reasons for delaying the disclosure of inside information are, among others:

ongoing negotiations, the outcome of which would likely be affected by public disclosure such as mergers, takeovers, and insolvency proceedings;
decisions or contracts made by one issuer's management which need to be approved by another issuer's management.

2.2 List of Persons with Access to Inside Information

Issuers as well as other entities acting on their account need to maintain an up-to-date list of all persons working for them in any capacity, both short and long term, who have access to inside information and provide the list to CySEC when required. The identity of each person on the list, the reason for inclusion and the date at which the list of insiders was created and updated needs to be recorded. The list will be updated immediately when persons are added or removed, and when the reasons for inclusion on the list change. Lists of insiders will be maintained for a period of five years after being drawn up.

The issuer needs to ensure that any person included on a list of insiders acknowledges the duties and obligations under the Law on Insider Dealing and Market Manipulation (Market Abuse) of 2005 and the sanction which he may attract in case of violation of these duties and obligations.

2.3 Managers

Persons with managerial responsibilities are defined as the members of the management or supervisory bodies or senior executives who, as part of their job, have regular access to inside information. In order to ensure they do not abuse this information, any managers of an issuer, as well as persons closely related to them such as spouse, children or other relatives who have shared the same household as that person for at least one year, need to publish all transactions they have made for their own account in financial instruments of the issuer that are traded on regulated markets and derivatives thereof.

A person who is closely associated with a person discharging managerial responsibilities within an issuer means any of the following:

the spouse of the person discharging managerial responsibilities within an issuer, or any partner of that person considered by Cyprus law as equivalent to the spouse;

according to Cyprus law, dependent children of the person discharging managerial responsibilities;

other persons who have shared the same household with the person discharging managerial responsibilities, for at least one year on the date of the transaction concerned;

any legal person, trust or partnership:

whose managerial responsibilities are discharged by a person referred to in points 1 to 3; or

is directly or indirectly controlled by a person referred to in point a above; or

that is set up for the benefit of a person referred to in point a above; or

whose economic interests are substantially equivalent to those of a person referred to in point a above.

This information needs to be made public prior to the start of the next working day of the stock exchange after the transaction has taken place. The notification will include at a minimum the following information:

name of the person;
reason for the obligation to publish;
name of the issuer;
description of the financial instrument;
nature of the transaction (buy or sell);
date and place the transaction came into effect;
price and volume.

Any violation is subject to an administrative fine of at most 200.000 CYP (€341.720), and not exceeding 400.000 CYP (€683.440) for repeat violations.

3. Market Manipulation

Learning Objective

4.3.1 Know which acts are considered to constitute market manipulation (Article 20)

4.3.2 Understand how market operators help to detect and prevent market manipulation (Article 24)

4.3.3 Know accepted market practices (Article 25)

The law specifically considers the following acts to constitute market manipulation:

Transactions or orders that give, or are likely to give, false or misleading signals regarding the demand, supply, or price of financial instruments.

Transactions or orders that secure, or are likely to secure, an abnormal or artificial price level for a financial instrument.

Transactions or orders which employ fictitious devices or any other form of deception or contrivance.

Dissemination of information through the media, including the internet or any other electronic means of communication or in any other manner which gives, or is intended to give, false or misleading signals in relation to a financial instrument and when the person knew, or ought to have known, that the information was false or misleading. When journalists act in their professional capacity such dissemination of information is to be assessed taking into account the rules governing their

profession, unless the journalists derive, in the opinion of CySEC, directly or indirectly, an advantage of profits from the dissemination of the information in question.

It is the obligation of market operators to implement processes and procedures aimed at prevention and detection of market manipulation. These include requirements regarding the:

transparency of concluded transactions;
total disclosure of price-regulating agreements;
fair systems of order pairing;
effective atypical order detection;
robust financial instrument reference price fixing; and
clear rules for suspension of transactions.

CySEC regularly reviews acceptable market practices taking into consideration changes to the market environment such as trading rules and market infrastructure. New market practices are not automatically deemed to be unacceptable, but will be considered on their merit and included as acceptable market practice if CySEC decides in its favour.

4. Provisions in Relation to Persons who Professionally Arrange Transactions

Learning Objective

4.4.1 Know how a suspicious transaction should be reported: obligations (Article 40); content and manner of report (Article 42); liability and professional secrecy (Article 44)

On an individual transaction basis, the person arranging the transaction will decide whether there are reasonable grounds to suspect that a transaction involves insider dealing or market manipulation. If a transaction is deemed to be suspicious, it must be reported to CySEC without delay, and CySEC will immediately inform the competent authorities of the regulated market concerned.

The following information needs to be transmitted to CySEC:

description of the transactions, or the orders for trading, including the type of order (such as limit order, market order) or other characteristics of the order and the type of trading markets, such as block

trade;

reasons for suspicion that the transactions, or the orders for trading might constitute market abuse;

means for identification of the persons on behalf of whom the transactions have been carried out, or the orders have been given, and of other persons involved in the relevant transactions or orders;

capacity in which the person subject to the notification obligation operates, such as for own account or on behalf of third parties;

any other information which may have significance in reviewing the suspicious transactions of the orders to trade.

If any of the above-mentioned information is not available at the time of notification, the notification shall include at least the reasons why the notifying persons suspect that the transactions or the orders for trading might constitute insider dealing or market manipulation. All other information is provided to CySEC as soon as it becomes available.

The person reporting a suspicious transaction will only report this to CySEC and not to any other party, and particularly not to the person on whose behalf the trade was carried out. Any notification made of a suspicious transaction to CySEC in good faith does not breach any restriction on the disclosure of information and does not attract a liability by the reporting party. However, if CySEC is of the opinion that the report was not made in good faith, they may impose an administrative penalty of up to 300.000 CYP (€512.580,40), and not exceeding 600.000 CYP (€1.025.160,86) for repeated violations.

The identity of the person or trades will not be disclosed in case this may cause harm to the person who made the notification to CySEC.

5. Summary of Administrative Penalties

Violation	Maximum Penalty – first violation	Maximum Penalty – subsequent violations
Not making inside information available without good reason	200.000 CYP (€341.720)	400.000 CYP (€683.440)
Not updating insiders list	200.000 CYP (€341.720)	400.000 CYP (€683.440)
Not reporting transactions by managers of an issuer or	200.000 CYP (€341.720)	400.000 CYP (€683.440)

persons closely related to them		
Failure to make a suspicious transaction report	300.000 CYP (€512.580,40)	600.000 CYP (€1.025.160,86)

End of Chapter Questions (for revision purpose)

1. List the ways in which a person may possess insider information.
   Section 1
2. List the instances in which information is considered to be made public.
   Section 1
3. List to whom information that needs to be disclosed needs to be made available by announcement.
   Section 2
4. For which reason may the publication of inside information be delayed?
   Section 2.1
5. Specify the acts of market manipulation.
   Section 3
6. Whom should suspicious transactions be reported to?
   Section 4

D. Open-Ended Undertakings for Collective Investment (UCI) Law2012

Law 78(I)/2012 is also known as the Open-Ended Undertakings for Collective Investment (UCI) Law of 2012. Its purpose is the regulation of the operation and the supervision of Open-Ended Undertakings for Collective Investment in Transferable Securities (UCITS) and of management companies, as well as the regulation of the taxation regime of open-ended UCITS.

The Law 78(I)/2012 harmonises the following:

Act of the Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS),

Articles 11 and 13 of the Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority).

In addition, the law implements:

Commission Regulation (EU) no 583/2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.

Commission Regulation (EU) no 584/2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities.

1. Undertakings for Collective Investment in Transferable Securities (UCITS)

Learning Objective

5.1.1 Know the definition and types of UCITS (Articles 4 and 40)

A UCITS is defined as an undertaking:

whose sole object is the collective investment in transferable securities and/or other liquid financial instruments;
which uses capital raised from the public;
which operates on the principle of risk spreading; and
which has units which are redeemed or repurchased out of the undertaking's assets on request of the investor.

UCITS can take the form of a common fund managed by the management company or a variable capital investment company (VCIC). A common fund is a type of open-ended fund, whereas a VCIC is a limited liability company with shares.

The following are not regarded as UCITS:

closed-ended undertakings for collective investment;
undertakings for collective investment which raise capital without promoting the sale of their units to the public within the EU or any part of it;
undertakings for collective investment the units of which, under their regulation or their instruments of incorporation may be sold only to the public in third countries;
undertakings for collective investment whose investment and borrowing policies, as regards the legislation of their home member state, does not comply with the conditions of Chapter VII and Article 83 of Directive 2009/65/EC.

Any action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value is regarded as similar to redemption or repurchase. Any deviation of the UCITS net asset value compared to the value of their units of less than 5% is deemed insignificant.

Investments in a UCITS can only comprise of one or more of the following:

Transferable securities and money market instruments admitted to or dealt in on a regulated market of the Republic or of another member state of the EU.

Transferable securities and money market instruments dealt in on another regulated market in a member state, which operates regularly and is recognised and open to the public.

Transferable securities and money market instruments admitted to official listing on a stock exchange in a third country or dealt in on another regulated market in a third country, which operates regularly, is recognised and open to the public and:

i. is approved by the Ministry of Finance on the basis of the opinion from CySEC;
ii. is included in fund regulation or instruments of incorporation.

Recently issued transferable securities, providing that the terms of issue include an undertaking that an application will be made for admission to official listing on a regulated market within a year of issue.

Units of a UCITS authorised in accordance with Directive 2009/65/EC or other collective investment undertakings, providing that they are authorised, the level of protection is equivalent to that of UCITS holders, they provide half-yearly and annual financial reports, and no more than 10% of the assets is invested in aggregate in units of other UCITS or other collective investment undertakings.

Deposits with credit institutions repayable on demand with a maturity below 12 months.

Financial derivative instruments, including equivalent cash-settled instruments, traded in regulated markets, providing that the underlying financial instrument is permitted, the counterparties are institutions subject to prudential supervision, and the OTC derivatives are subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated, or closed by an offsetting transaction at any time.

Money market instruments not traded in a regulated market providing that:

i. the issue or issuer is regulated;
ii. they are issued or guaranteed by a central, regional or local authority;
iii. they are issued by an undertaking whose securities are dealt in on regulated markets;
iv. they are issued or guaranteed by an establishment subject to prudential supervision, or prudential rules;
v. they are issued by other bodies belonging to CySEC-approved categories and have capital and reserves of at least €10.000.000.

A UCITS shall not invest more than 10% of its assets in transferable securities or money market instruments other than those mentioned above or acquire either precious metals or certificates representing them. UCITS may hold ancillary liquid assets.

Variable capital investment companies (VCICs) may acquire movable or immovable property which is essential for the direct pursuit of its business.

1.1 UCITS Operations

Learning Objective

5.1.2 Know provisions commonly applicable to the operation of UCITS (Articles 8–20)

Prior to entering into business, UCITS need to obtain an operation licence from the CySEC which will be valid for all EU member states. The management company of a UCITS common fund needs to provide CySEC with the following information:

statement regarding the assumption of obligation to deposit the initial assets of the common fund in cash;
name of the management company, the depositary of the common fund as well as the identity of the directors responsible for the management or monitoring of the activity of the common fund;
statement by the depositary confirming it agrees to exercise its duties;
draft regulation signed by the management company and the depositary;
draft prospectus of the common fund; and
draft key investor information of the common fund.

If the UCITS operates in the form of a VCIC, the company or, if applicable, its management company shall provide the same information as mentioned above with the exception of the first item, and will also provide a statement by the management company agreeing to manage the portfolio.

All information needs to be submitted in the official language of the Republic and in English or, if CySEC accepts it, only in English. The UCITS or its management company need to inform CySEC immediately of any change in the above information.

An operations licence will be granted once all documentation and the choice of management company and depositary have been approved by CySEC. UCITS established in other member states may provide their services in the Republic but will provide information on management and delegation to CySEC.

There are a number of reasons for CySEC not to grant an operating licence to a UCITS:

the management company does not comply with the conditions of the law on the operation and cross-border provision of services; or
the management company is not authorised for the management of common funds in its home member state; or

the depositary does not comply with the conditions or its directors are not of sufficiently good repute or experience; or

the UCITS is not allowed to market its units in the Republic due to its regulation or articles of incorporation; or

the legislation in a third country governing one or more natural or legal persons closely linked to a VCIC prohibit the effective exercise of the supervisory duties of CySEC.

CySEC will notify a UCITS within two months and a VCIC within six months from the date a complete application is submitted of its decision, the latter only if it has not designated a management company. The management company needs to submit a certification from the depositary for the deposit of common funds within three months of receiving its operation licence. Failure to do so will result in automatic revocation of the operation licence of the common fund. Units in a UCITS may only be advertised and promoted after its operation licence has been granted, and once the licence has been received, it will invest its assets within six months.

1.1.1 Duties of the Depositary

The depositary is assigned with the safekeeping of the assets and has the function of the UCITS' treasurer. The duties of a depositary may be undertaken by a credit institution based inside or outside the Republic, providing that it has the authority and operation licence to do so, and possesses the necessary organisation and infrastructure.

The functions of the depositary are defined as follows:

Ensure issue, marketing, redemption, repurchase, and cancellation of units, entries in the unitholder's register and the valuation of units is carried out in accordance with the appropriate rules and regulations.

Execute the orders of the management company unless they are contrary to the rules and regulations, and monitor the correct execution of its orders by the management company (for common fund UCITS only, does not apply to VCICs).

Ensure timely payment for transactions related to the assets of the common fund.

Ensure profits are distributed in line with the applicable legislation and the common fund regulation.

Co-sign the reports and accounts of the common fund or VCIC as applicable.

The depositary needs to ensure that it receives all necessary information to exercise its duties from the management company or the UCITS itself and is provided with full access to the documents concerning the UCITS.

It is the responsibility of the depositary to provide the competent authorities in the Republic (CySEC), or its member state with all information necessary or useful from a supervision perspective. For UCITS established in another member state, the depositary enters into a written contract with the management company regulating the flow of information required for the depositary to enable it to execute its duties.

The depositary may delegate the safekeeping of the assets to a third party providing that the UCITS regulation or instruments of incorporation allows for this. Safekeeping of foreign or local transferable securities and other liquid financial instruments may be delegated to an officially authorised foreign depositary, providing that the instruments are listed on a regulated market. Any delegation of safekeeping needs to be reported to the UCITS or its management company. At any time the delegation of safekeeping may be revoked by the depositary. The control of the activities of the management company and the operation of the common fund may not be outsourced to a third party.

1.1.2 Liabilities of the Depositary

The depositary is liable for any loss to the management company, unitholders, and shareholders of the management company of a VCIC caused by the depositary due to violations of their obligations. Unitholders and shareholders of the management company of a VCIC have the individual right to take legal action against the depositary either directly or indirectly via the management company. Even when safekeeping of assets has been outsourced to a third party the depositary remains fully liable for any losses caused.

1.1.3 Independence of Management

In order to ensure independence, the same company cannot undertake the duties of the depositary as well as the duties of the management company/VCIC. The depositary and the management company (if one is available) need to act independently from each other and exclusively in the interest of all unitholders.

1.1.4 Resignation of Depositary

If the depositary intends to resign from its duties, it needs to inform the management company or the UCITS in writing and give at least three months' notice. The management company or the UCITS immediately reports the resignation to CySEC and recommends a replacement depositary. In the event a replacement is not provided, the resigning depositary will propose a replacement.

CySEC either approves the depositary or requests the management company or the UCITS to propose a different depositary.

The resigning depositary will hand over the UCITS assets and all other relevant documentation to the new depositary, and will continue to exercise its duties until the new depositary has fully taken over the resigning depositary duties.

The UCITS regulation or instruments of incorporation will reflect the change in the depositary.

1.1.5 Replacement of Depositary

In case of serious violation of the depositary's obligations or to protect unitholders' interests, CySEC may request the replacement of the depositary and will approve the selection of a new one. The application for the replacement may be submitted by the management company as a representative of unitholders or by the VCIC.

When a replacement is requested, the management company or the VCIC has to recommend a new depositary. In case of a VCIC the board of directors of the company decides about the recommendation of the new depositary.

1.1.6 Purchase and Redemption of Units

In order to be able to market units and for the acquisition of units by unitholders, the management company or the UCITS needs to have the following in place:

an application to subscribe to units which may be submitted electronically;
acceptance of the UCITS regulations or instruments of incorporation; and
full payment of the purchase price per unit to the depositary in cash, transferable securities or other financial instruments accepted by the UCITS or management company.

If the funds are paid directly to the UCITS or management company, they will ensure the funds are transferred to the depositary as soon as possible, but at the latest by the following working day.

The UCITS or management company will provide key investor information, regulations or instruments of incorporation of the UCITS, prospectus, and the most recent yearly and six-monthly report to applicants free of charge on the applicant's request.

Units of the UCITS may be marketed directly or through credit institutions, firms providing investment services, or other investment firms as well as management companies.

On request of the unitholder or co-beneficiary, a certificate of participation to the UCITS will be issued by the UCITS or the management company. The certificate is issued for information purposes only and has no further value. In the event there is a difference between the certificate and the registration in the unitholder's register, the information in the register prevails. The certificate may include all participations to one or more UCITS managed by the same management company.

UCITS need to be redeemed upon written request or electronic application from the unitholder. The UCITS or the management company verifies the legal justification of the unitholder prior to redeeming the units. When a VCIC redeems its own shares, the shares are cancelled and the capital reduced by the amount of the shares.

The value of the redeemed units will be paid in cash within four working days from the date the application for redemption was made. The payment for the units is based on the number of units and the price per unit on the date the unitholder's application for redemption is submitted. The price per unit is determined by dividing the total UCITS net asset value by the number of existing units. The UCITS or the management company calculates the net asset value on a daily basis and publishes the price in at least two widely circulated daily newspapers the business day after the calculation.

In the event a unitholder applies to transfer from one investment compartment of a UCITS to another compartment of the same UCITS, or from one UCITS to another one, the application will be treated as the redemption of one investment and an initial investment in the new units.

In exceptional cases it will be permitted to suspend the redemption of units for a period of up to one month. The decision needs to be made by the UCITS or the management company and has to be in the unitholder's interest and in cases provided for in the UCITS regulations or its instruments of incorporation. A suspension may be extended for another month providing that there is a valid reason and CySEC has approved the suspension. In exceptional circumstances CySEC may allow suspension of the redemption for more than one month in order to safeguard the unitholder's interest and the smooth operation of the market. The suspension may not exceed a total of three months. The suspension will be revoked as soon as the conditions justifying the suspension cease to apply.

The UCITS or the management company will immediately submit its decision for the suspension of the redemption to CySEC for their approval and shall communicate any decision to suspend, as well as extension, revocation, and expiry of a suspension to competent authorities of the other member states where the units of the UCITS are marketed. In addition, the suspension of the redemption, its extension, expiry or revocation as well as the reasons for the suspension shall immediately be published in at least two widely published newspapers and the webpage of the UCITS or its management company.

As long as the redemption of units is suspended, unitholders will not be able to submit applications for redemption or redeem units. Any applications for redemption prior to the suspension will be honoured.

In exceptional circumstances and in the interest of the unitholders, CySEC may take the decision to suspend redemption of the units of a UCITS at its own initiative.

1.2 Specific Types of UCITS

Learning Objective

5.1.3 Know provisions applicable to specific types of UCITS: common funds; variable capital investment companies

In addition to the generic provisions outlined in Section 1.1, there are a number of provisions that apply to specific types of UCITS.

1.2.1 Common Funds

The initial assets of a common fund must have a total value of at least €200.000,00 and be fully paid up in cash. In the event the common fund consists of more than one compartment, each of the compartments will need to meet the minimum capital requirements of €200.000,00.

The assets of the common fund are divided in equal units, and may be of different categories. Each unit has a voting right, but other rights are exercised in accordance with the percentage of total assets they represent. Fractions of units do not have voting rights. Rights to profits may differ per category of funds. Common fund units have no nominal value. When purchased, the units will be fully paid for to the depositary and accepted by the management company. The unitholders are registered in the register, including the number of units they hold, but without serial numbers. The register is maintained by the management company and serves as proof of participation in the common fund. The unitholder's register contains the following information:

name and surname or legal name of the unitholder;
address of the unitholder;
ID card or passport number of the unitholder, or for legal persons the registration number;
number of units; and
any other identifying information.

In the case of multiple beneficiaries the details of all beneficiaries will be included. Co-beneficiaries may use and redeem all or some of the units of the common account without the consent of the others. As part of the account opening procedures, it may be agreed that in the event of the death of one of the co-beneficiaries the remaining co-beneficiaries will become equal owners of the units. New co-beneficiaries may only be added with the written consent of the management company and all the other co-beneficiaries.

When units are transferred from one beneficiary to another, the management company updates the unitholders' register accordingly.

Units of a common fund may be pledged as a guarantee or claim. The pledge will be registered in the unitholders' register. The pledge lender shall be satisfied when all units pledged are redeemed and the value is paid to them. As long as not all pledged units have been redeemed, the pledge lender reserves the right to the remaining units.

The common fund regulation is written by the management company and the depositary and approved by CySEC. It must contain the:

name of the common fund, management company, and depositary;
objective of the common fund which is the basis for investment goals, investment policy, and criteria of choice of the investments;
duration of the common fund or an indication it is indefinite;
valuation rules and methods of the assets, rules of calculation of the units' sale and redemption or repurchase price;
terms for issuing, marketing, cancellation, redemption or repurchase of units, and suspension of redemptions;
start and closing dates of a financial year;
remuneration and commissions paid to the management company and depositary and their calculation methods;
expenses charged to the fund;
rules for distributing proceeds and profits, particularly the time and procedure;
terms for publication of information and advertising;
procedure for amendment of the regulation;
reasons for dissolution of the common fund.

The management company may, at any time necessary, convene a unitholders' meeting when decisions need to be made for which the unitholders' approval is required. Notification of the meeting must be addressed to all unitholders, and CySEC, and be published on the website, and in at least two widely circulated papers at least 20 days prior to the meeting. The notification needs to contain the date, time and place of the meeting and the issues on the agenda. The management company may, at its own discretion, decide not to publish the meeting this way but instead send the invitations individually to each unitholder. Alternatively unitholders representing at least one third of the units may request a meeting of all unitholders in writing, which the management company will arrange accordingly. The management company appoints the chairman of the meeting. Decisions are made by majority of the units represented at the meeting, except for cases in which the regulation requires a higher percentage instead of a straight majority. This percentage may not exceed 75% of the units represented at the meeting. In the event a quorum is necessary, this may not be in excess of 20% of the common fund units. Unitholders may attend the meeting in person or via a representative. The decision of the meeting is advisory only, and does not bind the management company.

The common fund will be dissolved for the following reasons:

the operating licence is revoked by CySEC;
the management company decides that continuation is not in the interest of the unitholders;
the common fund's end date stipulated in the regulation has been reached and the regulation has not been amended to extend the duration or change it to indefinite;
the occurrence of an incident identified in the regulation as a reason for dissolving;
in case of liquidation or bankruptcy or the resignation of the management company or depositary without a replacement;
redemption of all units;
merger with another UCITS, or split in other common funds;
assets of the common fund are decreased to 25% of the threshold, and in the event the decrease continues for a period in excess of six months;
assets have decreased to become less than one-third of the initial capital.

Unitholders or their creditors cannot demand the dissolution of the common fund. Unless the dissolution is due to redemption of all units or the merger with another UCITS or its split into other common funds, the dissolution of a common fund will be followed by its liquidation and the distribution of the fund's assets. Common funds that contain several compartments are dissolved once the last existing compartment is dissolved.

Once dissolved, no new units may be issued unless it is necessary for the liquidation. The dissolution of the common fund and the reason for dissolution are immediately published in at least two widely circulated newspapers and the management company's website. At the same time, the dissolution is reported to CySEC and competent authorities of member states.

1.2.2 Variable Capital Investment Companies (VCICs)

The registered office of a VCIC needs to be in the Republic. Variable capital investment companies are required to make their financial statements, audit reports and directors report available to shareholders on their request. The words **variable capital investment company** need to be included in the company name or at a minimum VCIC.

The initial, fully paid-up, capital per investment compartment is €200.000,00, or if no management company has been appointed €300.000,00. The capital is divided into shares without a nominal value. The shares have a fluctuating value depending on the total value of the investment compartment divided by the number of shares after deducting its liabilities. The shares are registered in a shareholders' register. The shares may be listed on an exchange in the Republic or another member state. CySEC will define the obligations of the VCIC including any additional information that needs to be disclosed as a result of the listing.

The instrument of incorporation of the VCIC contains at least the:

name of the management company and depositary (if applicable);
object of the VCIC and the resulting investment goals, investment policy, and the criteria of its investments;
duration of the investment or an indication that it is indefinite;
principles and rules of the evaluation of the company's assets, and the calculation of the sale, redemption, or repurchase prices;
terms of issue, sale, cancellation, redemption or repurchase;
start and end dates of the financial year;
remuneration and fees payable to the management company and depositary, if applicable, and the method for calculation of the fees;
relationship between the VCIC, the management company and the depositary, particularly if they belong to the same group of companies;
expenses to be borne by the VCIC;
rules for distributing profits to shareholders and the time and procedure for their distribution;
terms for the publication of the VCIC's information;
procedure for the amendment of the instruments of incorporation; and
reasons for liquidation of the VCIC.

In addition, the memorandum of association of the VCIC needs to mention that the issued capital fluctuates and is equal to the net value of the assets, the shares have no nominal value, and that the shares may be redeemed from its assets following an application by the shareholders. The procedure for assignment of the management company and/or the depositary, if applicable, is also included.

When the shares of a VCIC are listed on a stock exchange in the Republic or in another member state, it is not required to have a depositary as long as:

this exemption has previously been authorised by CySEC;
at least 80% of the shares are marketed through the exchange;
any trades are made at the prices listed on the exchange;
the name of the stock exchange is included in the instruments of incorporation; and
shareholders have the same protection as the shareholders of a VCIC with a depositary.

A VCIC whose shares are listed on an exchange will state the method of calculation of the shares' net asset value in the instrument of incorporation. In addition, the VCIC will determine the net asset value of the shares on a daily basis, report it to CySEC and publish the net asset value. The VCIC will intervene in the market to prevent the listed values of their shares from deviating more than 5% from their net asset values.

Twice a month, an independent auditor shall verify that the calculation of the value of shares is undertaken correctly and that the assets of the VCIC are invested in accordance with the regulations and the instruments of incorporation.

The VCIC needs to inform CySEC of a change in the composition of the board of directors and the persons who determine the business policy of the VCIC as soon as possible, but at the latest five days after the change. In the event CySEC considers that any person managing the VCIC does not possess the necessary credibility and professional experience, they shall ask the VCIC to replace them immediately.

Any change to the instruments of incorporation has to be approved by CySEC and, upon approval, will be communicated to the shareholders immediately. Any redemption by shareholders within three months of a change in the instruments of incorporation will still be executed under the provisions prior to the change.

A variable capital investment company is liquidated and dissolved under the following circumstances:

the operation licence is revoked by CySEC;
the end date stipulated in the instrument of incorporation has been reached and the regulation has not been amended to extend the duration or to change it to indefinite;
the occurrence of an incident identified in the instrument of incorporation as a reason for dissolving;
redemption of all of its shares;
resolution of the general meeting of shareholders;
in case of liquidation or bankruptcy or the resignation of the management company or depositary without a replacement.

When the share capital of the VCIC reduces to either two-thirds or one-quarter of the minimum capital required the board of directors will convene a general meeting of shareholders to take place within 40 days of the date when the capital is reduced to below the minimum and decide on the dissolution of the VCIC. A minimum of two members is required to be present in person or represented by proxy. The decision is taken by majority of votes represented in the meeting.

When an operation licence is withdrawn, CySEC may file to the court an application for liquidation and the appointment of a liquidator. For a VCIC with multiple compartments, its dissolution becomes effective once the last compartment is dissolved.

2. Obligations of UCITS

UCITS have a number of obligations regarding their investment policies, borrowing, valuations, distribution of profits, investor information and the marketing of units in foreign jurisdictions.

2.1 UCITS Investment Policy

Learning Objective

5.2.1 Know the obligations concerning the investment policy of UCITS: permitted investments (Article 40); risk management (Article 41); permitted investment limits (Article 42); specific deviations (Article 43); UCITS that replicate the composition of a stock or debt securities index (Article 44); exchange-traded UCITS (Article 45); investing in other UCITS' units (Article 46); guaranteed assets or performance (Article 47); prohibition to acquire control (Article 48); violation of investment limits (Article 49)

UCITS may invest their funds in any of the following:

Transferable securities and money market instruments admitted to or dealt in on a regulated market of the Republic or another member state.

Transferable securities and money market instruments listed on the stock exchanges or another regulated market in a third country.

Recently issued transferable securities providing that they are listed on a regulated market within one year of issue.

Units of authorised UCITS or other collective investment undertakings providing that they are authorised and supervised, the level of protection for unitholders is similar to that of unitholders in a UCITS, the other collective investment undertaking provides half-yearly and annual reports, and no more than 10% of its assets are invested in aggregate units of other UCITS.

Deposits payable on demand, or with a maturity date shorter than 12 months with an authorised credit institution.

Financial derivative instruments or OTC derivatives based on indices, interest rates, foreign exchange rates or currencies, providing that the counterparties to an OTC derivative are subject to prudential supervision, and the OTC derivatives are subject to reliable and verifiable daily valuations and can be sold, liquidated or closed by an offsetting transaction at any time at fair value.

Money market instruments not dealt on a regulated market, but for which the issue or issuer is regulated for the purpose of protecting investors and savings.

A UCITS may not invest more than 10% of its assets in transferable securities except for those mentioned under point 1 above or acquire precious metals. A UCITS may hold ancillary liquid funds; a VCIC may acquire (im)movable property essential for the direct pursuit of its business.

A UCITS, VCIC or their management company needs to have a risk management process in place which enables it to monitor and measure the risk of the positions and their contribution to the overall risk profile of the portfolio. The risk management policy needs to include a process for accurate and independent assessment of the value of OTC derivatives, and to report the types of derivatives, associated risk, limits and risk mitigation to CySEC. UCITS may use transferable securities and money market instruments for the purpose of efficient portfolio management (EPM). Any conditions and limits for the use of derivatives in EPM must be within the rules and regulations as well as the investment objectives of the UCITS. The global exposure of derivatives may not exceed the total net value of the portfolio. The global exposure calculation includes the value of the underlying, counterparty risk, potential future market movements and the time available to liquidate positions. The risk for the underlying assets may not exceed in aggregate the investment limits. CySEC may define the criteria for assessing the adequacy of the risk management process, rules regarding the accurate and independent assessment of the value of OTC derivatives, reporting requirements, and conditions and provisions related to the use of derivative instruments.

The permitted investment limits for UCITS are as follows:

Limit	Asset
40	Aggregate value of transferable securities or money market instruments of issuing

%	bodies in which the UCITS individually invests more than 5%.
30 %	Units of other UCITS or other collective investment undertakings with no more than 20% in the units of any single UCITS or collective investment undertaking.
20 %	Deposits made with the same institution.
	Investment in transferable securities or money market instruments, deposits made with that body, and exposures arising from OTC derivatives with a single body.
10 %	Transferable securities or money market instruments issued by the same body.
	May be raised to 35% if the securities are issued or guaranteed by a member state, its local authorities, a third country, or a public international body to which one or more member states belong. Under specific circumstances this may be increased to 100% providing that: CySEC considers that the unitholders have protection equivalent to that of unitholders in UCITS; the UCITS holds at least six different issues, and no more than 30% of its assets in a single issue; the UCITS regulation or instrument of incorporation, prospectus, key investor information, and marketing communications specifically mention the issuers in which they intend to invest more than 35% or their assets.
	May be raised to 25% when bonds are issued by a regulated and supervised credit institution in a member state.
	May be raised to 20% when the UCITS objective is to replicate the composition of a certain stock or debt securities index providing that the following preconditions are met: composition of the index is sufficiently diversified; the index represents an adequate benchmark for the market it represents; the index is published appropriately.
	May be raised to 35% for a single issuer under exceptional market circumstances in which certain issues are highly dominant.

	Exposure in an OTC derivative transaction when the counterparty is a credit institution.
5%	Exposure in an OTC derivative transaction when the counterparty is not a credit institution.

The above-mentioned limits may not be combined, and therefore, the total that can be invested with a single body (whether securities or OTC) is 35%; this includes any consolidated parts of a group. The cumulative investment in transferable securities and money market instruments within the same group is permitted up to 20%.

A UCITS replicating an index which has been granted an operation licence can be listed on a market for exchange-traded UCITS operating in the Republic or another member state providing that at least one special trader has been appointed and the assets in transferable securities have been deposited with the custodian according to the composition of the index prior to the start of trading.

When a UCITS invests in other UCITS or collective investment schemes (CISs) that are managed by the same management company they will not be charged any subscription, redemption, or repurchase fees. A UCITS that invests a substantial proportion of its assets in other UCITS and collective investment undertakings needs to disclose the maximum level of management fees that may be charged to the UCITS itself and to the UCITS or collective investment undertaking in which it intends to invest. The actual levels of management fees will be reported in the annual report.

UCITS may guarantee the amount invested and its performance by means of a guarantee provided by a credit institution established in the Republic or another member state. When provided by a credit institution from another member state, the institution needs to have a branch in the Republic. The guarantee cannot be provided by the depositary of the UCITS or a credit institution that also provides depositary services. The nature of the guarantee must be reported in the key investor information and the prospectus.

VCICs and management companies connected to a common fund will not purchase any shares carrying voting rights that would enable them to exercise significant influence over the management of an issuing body. A UCITS may not obtain more than:

10% of the non-voting shares of a single issuing body;
10% of the debt securities of a single issuing body;
25% of the units of a single UCITS or other collective investment undertaking; or
10% of the money market instruments of a single issuing body.

The limits do not apply to:

transferable securities and money market instruments issued or guaranteed by a member state or its local authorities;

transferable securities and money market instruments issued or guaranteed by a third country;

transferable securities and money market instruments issued by a public international body to which one or more member states belong;

shares held by a UCITS in the capital of a company incorporated in a third country investing its assets mainly in the securities of issuing bodies having their registered offices in that country, and when this is the only way to invest in the securities of issuing bodies in that country;

shares held by one or more VCICs in the capital of a subsidiary company pursuing, exclusively on its or their behalf, only the business of management, advice or marketing in the country where the subsidiary is established, in regard to the redemption of shares at shareholders' request.

A UCITS does not violate a limit in the event a limit is breached when exercising subscription rights attached to transferable securities or money market instruments that are part of its assets. In addition, a recently authorised UCITS may deviate from the limits for a period of six months from the granting of the licence as long as the principles of risk spreading are observed. When a limit is breached for reasons outside the control of the UCITS or as a result of the exercise of subscription rights, they have to remedy this situation as soon as possible while taking the interest of the unitholders.

2.2 Borrowing, Valuation and Distribution

Learning Objective

5.2.2 Know the standing obligations of UCITS in relation to: borrowing (Article 50); valuation (Article 51); distribution of profits and income (Article 52); prohibition of credits, guarantees and uncovered sales (Article 53); free of charge unit distribution (Article 54)

Variable capital investment companies and management companies or depositaries acting on behalf of a UCITS may generally not borrow funds, but may acquire foreign currency by means of a **back-to-back** loan providing that the loan is contracted in foreign currency for the acquisition of securities of foreign issuers. Although generally borrowing is prohibited, VCICs, and management companies or depositaries acting on behalf of a UCITS may borrow on a temporary basis an amount not exceeding 10% of the net asset value of the UCITS. When borrowing for the purpose of purchase of immovable property, a VCIC may borrow up to 15% of its total net asset value. Management companies may borrow up to 15% of their own funds for the acquisition of immovable property essential for the pursuit of their business.

The UCITS' assets are valued as follows:

Type of asset	Valuation method
Transferable securities and money market instruments listed in a regulated market	Closing price of stock exchange transactions in cash on the same day. In the event this is not possible due to time differences (for assets outside the EU), the previous day's closing price will be used.
Derivative financial instruments listed in a regulated market	Closing price or, when not available, the most recently published price for same-day transactions.

In the event no transaction has occurred on the stock exchange on the day of the valuation, the price from the previous trading day will be used. Either the bid or the ask price will be applied depending on the position. For markets that only publish a single price that price will be used.

Any income as a result of interest, dividend and profits resulting from the lottery of debentures at par has to be distributed on an annual basis, net of all expenses incurred during the financial year.

Profits from the sale of transferable securities or other liquid financial instruments after deduction of any capital losses may be distributed to unitholders or reinvested at the discretion of the VCIC, the UCITS or the management company. Providing that the regulation or the instruments of incorporation allows for it, these profits may be distributed during the financial year as an interim dividend.

The VCIC, or a management company and the depositary acting on behalf of a UCITS may not grant loans or act as a guarantor on behalf of third parties. The UCITS may purchase transferable securities, money market instruments and other financial instruments which are not fully paid for. However, neither may undertake uncovered sales of these instruments.

A UCITS unit may only be issued if the equivalent of the net issue price is paid to the UCITS. Units may be distributed free of charge.

2.3 Investor Information

Learning Objective

5.2.3 Know the obligations of UCITS concerning investor information: prospectus, periodical reports and summarised statements (Article 55); key investor information (Article 62); UCITS communications (Article 66)

A prospectus as well as regular reports will be submitted to CySEC and all investors by the management company or the VCIC in accordance with the following schedule:

Report	Periodicity	Publication Date
Annual report including balance sheet and profit and loss account	Yearly	Within four months after the end of the financial year
Half-yearly report	Yearly	Within two months after the end of half of the financial year
Summarised statement of assets and expenses	1st, 2nd, and 3rd quarter	Within 15 days of the end of the period
Summarised statement of assets and expenses, including a profit and loss account and the distribution of profits for the financial year	4th quarter	Within two months of the end of the last quarter

The financial year of a UCITS ends on 31 of December. A UCITS that comprises multiple investment compartments may provide a single report for all of the compartments. The UCITS prospectus must include all information necessary for investors to be able to make an informed investment decision including all risks. A clear and easy-to-understand description of the fund's risk profile needs to be included.

All essential elements of the prospectus must be kept up to date. The prospectus will include:

categories of assets a UCITS is permitted to invest in and if it is allowed to invest in derivative instruments. In relation to financial derivatives the prospectus needs to indicate whether they may be used for efficient portfolio management and hedging, or as an investment;

when a UCITS mainly invests in other UCITS or collective investment undertakings, deposits payable on demand, financial derivative instruments or OTC derivatives, the prospectus needs to draw specific attention to the investment policy;

when the net asset value of a UCITS is likely to have high volatility due to its portfolio composition or portfolio management techniques, the prospectus needs to include a statement drawing attention to this possibility.

The regulations or instruments of incorporation are an integral part of the prospectus and either need to be attached to the prospectus, made available on request, or kept in a place where they can be accessed by investors. The management company is responsible for all losses suffered by investors as a result of false or misleading information or a failure to mention any information in the prospectus. A copy of the prospectus will be submitted to CySEC and, if relevant, the competent authorities of a member state. CySEC will ensure that the prospectus complies with all requirements. The prospectus may be published on the website or any other durable medium. Hard copies will be made available to investors on their request. Upon request of the investor, the management company will also provide supplementary information relating to the quantitative limits that apply to the risk management of the UCITS, the risk management methods, and the most recent evaluation of the main risks and yields of the investment instrument categories.

The net asset value, number of units, unit net asset value, subscription and redemption or purchase price of a UCITS must be calculated on a daily basis and published on the following business day in at least two widely circulated newspapers. The unit net asset value is determined by dividing the net asset value by the number of units. Subscription and redemption/repurchase price may differ from the net asset value by the amount of commission of the management company.

Key investor information needs to be marked as such and include appropriate information about the essential characteristics of the UCITS in a clear and transparent way so that investors are reasonably able to assess the nature and risk of the investment. The information needs to be fair, clear and not misleading and the content needs to be consistent with the prospectus. Key investor information needs to include an identification of the UCITS, short description of the investment objectives and investment policy, past-performance or performance scenarios, costs and associated charges and the risk/reward profile of the investment. In addition, a clear statement must be made as to where and how to obtain additional information, and a warning that a person does not incur any civil liability solely on the basis of the key investor information. Key investor information will be made available on the website and on paper when requested. Key investor information will be provided to CySEC.

All communications need to be fair, clear and not misleading, and marketing information needs to clearly be marked as such. Information contained in marketing communications may not contradict any key investor information. All communications must include a statement that investment in the units of a UCITS have no guaranteed return and that past performance is no guarantee to future performance.

2.4 Marketing Provisions

Learning Objective

5.2.4 Know the special provisions applicable to UCITS that market their units abroad: UCITS established in the Republic marketing units to other member states (Articles 67–68); UCITS from other member states marketing units in the Republic (Articles 69–72)

5.2.5 Know the rules and obligations relating to foreign undertakings for collective investment (Articles 105–108)

2.4.1 UCITS established in the Republic Marketing Units to other Member States

A UCITS authorised in the Republic that wants to market units in other member states must submit a notification to CySEC prior to doing so. The notification letter includes the arrangements for the marketing of the units, and, if applicable, the categories of units and whether they are marketed by the management company in the content of its cross-border business. The regulation or instruments of incorporation, prospectus, latest annual and half-yearly report, and key investor information must also be included with the notification letter. CySEC will verify the completeness of the information, send it to the competent authorities in the member state within ten days of receipt, and notify the UCITS. Once the notification letter has been sent to the competent authorities in the member state, the UCITS may start marketing its units. CySEC will ensure that the competent authorities of the host member state have electronic access to the documentation and/or any translations, and that the UCITS keeps the documents up to date.

The competent authorities will be notified by the UCITS of any amendment in the documentation. Investors in the UCITS based in the host member state will be provided with all information that investors in the Republic are provided with. This information will be provided in the way prescribed by the legislation in the host member state. Key investor information has to be translated in the official language of the member state or another approved language. Any other information may be translated at the choice of the UCITS. The UCITS will remain responsible for the translation. The frequency of publication of the information will be in accordance with the regulations in the Republic.

2.4.2 UCITS from Other Member States Marketing Units in the Republic

Authorised UCITS from other member states may market their units in the Republic after CySEC has received a notification letter from the competent authorities in the member state. The notification letter includes the arrangements for the marketing of the units, and, if applicable, the categories of units and whether they are marketed by the management company in the content of its cross-border business. The regulation or instruments of incorporation, prospectus, latest annual and half-yearly report, and key investor information must also be included with the notification letter.

CySEC will not request any additional information from the competent authorities in the member state and will ensure that the electronic transmission and filing is possible.

The UCITS will notify CySEC of any change in its regulation, instrument of incorporation, prospectus, latest annual and semi-annual report, and key investor information and indicate where the documents can be obtained in electronic form.

During the marketing of its units, the UCITS is obliged to indicate a credit institution in the Republic where it can receive and make payments to unitholders. All information that must be provided to investors in its home member state must also be provided to investors in the Republic. The information will be provided as prescribed by the legislation in the Republic. Key investor information needs to be translated into the official language of the Republic or English. Any other information may be translated at the choice of the UCITS. A UCITS authorised in another member state may use the reference to its legal form such as **investment company**, or **common fund** in its designation in the Republic as it uses it in its home member state.

2.4.3 Rules and Obligations of Foreign Collective Investment Undertakings

Open-ended investment schemes (OEICs) which are not a UCITS and are established in another member state, or a third country may only market their units in the Republic if they are authorised and subject to permanent prudential supervision including rules that aim to ensure investors' protection. These collective investment funds are subject to the rules of the Republic in relation to marketing, advertising and distribution of the units as well as the notifications to investors. CySEC may take action against any foreign collective investment fund operating in the Republic, and their authorisation may be withdrawn if:

authorisation has been obtained by making false or misleading statements or other irregular means;
the undertaking or its management company does not comply with the terms of authorisation;
any of the conditions that needed to be fulfilled for the authorisation is no longer fulfilled.

When the undertaking no longer complies with one or more of the conditions, CySEC may set a deadline within which the non-compliance needs to be addressed.

Conditions for authorisation, procedure for the distribution of units, obligations for (extra)ordinary notifications to investors, qualifications and certification of staff, and any other conditions will be determined by CySEC.

3. UCITS Structures

Learning Objective

5.3.1 Know the obligations that apply to master-feeder UCITS structures: investment policy (Article 73); general operating obligations (Article 74); dissolution (Article 75); depositary (Article 76); auditors (Article 77); compulsory information and marketing communications (Articles 78–79); specific obligations of the feeder UCITS (Article 80); specific obligations of the master UCITS (Article 81)

3.1 Investment Policy

A feeder UCITS is a UCITS or an investment compartment of a UCITS that has been approved to invest at least 85% of its total net assets in UCITS or other collective investment funds. Up to 15% of its assets may be invested in ancillary liquid assets, and financial derivatives for hedging purposes. In addition, VCICs may invest in (im)movable property.

A master UCITS is a UCITS or an investment compartment of a UCITS which has at least one feeder UCITS under its unitholders, is not a feeder UCITS, and does not hold units of a feeder UCITS.

For a feeder UCITS, the global exposure in financial derivatives is the combination of its own direct exposure plus either:

master UCITS actual exposure to financial derivative instruments in proportion to the feeder UCITS' investment into the master UCITS; or

master UCITS potential maximum global exposure to financial derivative instruments provided for in the master UCITS regulation or instruments of incorporation in proportion to the feeder UCITS' investment into the master UCITS.

A master UCITS that has at least two feeder UCITS has the choice to raise capital from other investors as well. If the master UCITS does not raise capital from the public in a member state other than the one it is established in, but only has feeder UCITS established in that member state, it does not have to provide a notification to market its investments in the other member state.

3.2 General Obligations

The master UCITS needs to provide the feeder UCITS with all documents and information for the feeder UCITS to meet its legal obligations. The agreement between the feeder and the master UCITS must be made available to unitholders of both the feeder and the master UCITS on their request. In the event the master and the feeder UCITS are managed by the same management company the agreement can be replaced by an internal conduct of business rule governing the relationship. Until such a time that the agreement is effective, the feeder UCITS must not invest more than 20% of its assets in the master UCITS. The master and feeder UCITS will co-ordinate the calculation and publication of the net asset value in order to prevent any possibility of arbitrage.

3.3 Dissolution

If the master UCITS temporarily suspends the subscription, redemption or repurchase of its units, each feeder UCITS is entitled to suspend the subscription, redemption or repurchase of its units. If the master UCITS is dissolved, the feeder UCITS will also be dissolved unless CySEC approves:

the investment of at least 85% of the assets of the feeder UCITS in units of another master UCITS; or
an amendment of the regulation or instruments of incorporation of the feeder UCITS to be converted into a regular UCITS.

A master UCITS may only be liquidated three months after it has informed all of its unitholders and CySEC of its decision to dissolve. In the event a master UCITS merges with another UCITS or splits into two or more UCITS, the feeder UCITS must be dissolved unless it has been granted permission from CySEC to continue to be a feeder UCITS, invests at least 85% of its assets in units of another master UCITS, or amends its regulation or instruments of incorporation in order to convert to a regular UCITS. At least 60 days' notice must be given prior to the merger or split of a master UCITS.

3.4 Depositary

The feeder UCITS may not invest in the units of the master UCITS until an information-sharing agreement is in place between their depositaries. Such an agreement is not necessary when both the master and the feeder UCITS have appointed the same depositary. Information shared between depositaries under this agreement will not constitute a breach of disclosure or data protection rules. The feeder UCITS or its management company is responsible for reporting any relevant information concerning the master UCITS to its depositary. The depositary of the master UCITS is responsible for the reporting of any irregularities relating to the master UCITS that may have a negative impact on the feeder UCITS to:

feeder UCITS;
feeder UCITS' management company (if applicable);

feeder UCITS' depositary; and
competent authorities of the master UCITS' home member state.

3.5 Auditor

The auditors of the master and the feeder UCITS will enter into an information-sharing agreement if they have different auditors.

The feeder UCITS may not invest in the units of the master UCITS until an information-sharing agreement is in place between their auditors. Such an agreement is not necessary when both the master and the feeder UCITS have appointed the same auditor. Information shared between auditors under this agreement does not constitute a breach of disclosure or data protection rules. In the audit report, the auditor of the feeder UCITS must take the audit report of the master UCITS into account. In the event the feeder and the master UCITS have different financial years, the auditor of the master UCITS must issue an ad hoc report on the closing date of the financial year of the feeder UCITS. The auditor of the feeder UCITS must pay particular attention to any irregularities mentioned in the master UCITS audit report and the impact of these on the feeder UCITS.

3.6 Compulsory Information and Marketing Communications

The prospectus of the feeder UCITS needs to include the following:

declaration it is a feeder UCITS, its master UCITS and the fact that it will permanently invest at least 85% of its assets in the master UCITS;
investment objective and policy including the risk profile, any difference in performance between the feeder and the master UCITS, and a description of the investment;
brief description of the master UCITS;
summary of the agreement between the feeder and the master UCITS;
the way unitholders can obtain further information on the master UCITS;
description of all remuneration or reimbursement of cost associated with the investment in the master UCITS; and
description of any tax implication of the investment.

The annual report of the feeder UCITS must include a statement on the aggregate charges of the feeder and the master UCITS. The feeder UCITS will send the prospectus, up-to-date key investor information, and annual and half-yearly reports of the master UCITS to CySEC. Paper copies must be provided to investors in the feeder UCITS on their request.

Feeder UCITS need to provide the following information to their unitholders:

statement from CySEC approving the investment of the feeder UCITS in the units of a master UCITS;

key investor information;

start date for the investment in the master UCITS, and the date on which it expects to exceed 20% of its assets;

statement that unitholders have the right to redeem their shares within 30 days free of charge with the exception of disinvestment cost.

The feeder UCITS may not invest more than 20% of its assets in a single UCITS or other collective investment undertaking within the first 30 days.

3.7 Special Obligations of the Feeder UCITS

The feeder UCITS needs to effectively monitor the activity of the master UCITS, and in doing so may rely on information and documents received from the master UCITS or its management company, depositary or auditor unless it has reason to believe the information may not be accurate.

Any distribution fees, commission or other financial benefit received by the feeder UCITS or its management company will be paid into the assets of the feeder UCITS.

3.8 Specific Obligations of the Master UCITS

A master UCITS established in the Republic needs to inform CySEC immediately of the identity of each feeder UCITS. In the event the feeder UCITS is based in another member state, CySEC will report this to the competent authorities of the feeder UCITS home member state.

Master UCITS may not charge subscription, redemption, or repurchase fees for the purchase or transfer of its units from the feeder UCITS. The master UCITS is responsible for the timely availability of all information it is to provide in accordance with the laws and regulations.

4. Management Companies

Learning Objective

5.4.1 Know the obligations that apply to the operation of management companies: permitted activities (Article 109); share capital (Article 110); conditions for granting an operation licence (Article 111); conditions for the exercise of activities (Article 112); financial submissions (Article 114); delegation arrangements; changes to the management company including revocation of operating licence

(Article 116); code of conduct (Article 123); complaints handling (Article 124)

5.4.2 Know the obligations that apply to the cross-border provision of services by a management company (Articles 125–136)

4.1 Management Company Operations

4.1.1 Permitted Activities

A management company is a limited company by shares, governed by companies law, which has its registered office and central administration in the Republic. Its main objective is to manage one or more UCITS. Management companies need to apply for an operating licence with the CySEC which will be valid in all member states.

The management of the UCITS includes the investment management, advertising of the UCITS, and administration of the UCITS including:

legal and UCITS management accounting services;
provision of information of the UCITS unitholders;
valuation of the portfolio and pricing of the units including taxation issues;
regulatory compliance monitoring;
maintenance of unitholder register;
distribution of profits;
issue, redemption and repurchase of units;
settlement of contractual obligations; and
record keeping.

In addition to managing one or more UCITS, a management company may also undertake related services providing that it has been authorised by CySEC. These activities include the service of management of portfolios of investment, providing investment advice, and safekeeping and administration in relation to units of undertaking for collective investment.

4.1.2 Share Capital

The management company must have a fully paid up initial capital of at least €125.000,00. In the event that the management company provides other services in addition to managing one or more UCITS, the capital needs to be higher to reflect this. The capital must never fall below the initial capital. In the event the value of the portfolio of the management company exceeds €250.000.000,00 the capital of the management company needs to be increased by 0.02% of the additional portfolio value (ie, the amount of the portfolio value exceeding €250.000.000,00) with a maximum increase of own funds to €10,000,000.00. Up to 50% of the additional capital may be provided in the form of a guarantee from a credit institution operating in the Republic or one of the member states.

The portfolio value consists of the common funds managed by the management company, common funds for which the management has been delegated to a third-party service provider, investment companies for which the management company is the designated management company, and other collective investment undertakings managed by the management company.

The own funds of the management company may never be less than 25% of its overheads of the preceding year, or the projected overheads for a company that has been in business for less than one year.

4.1.3 Conditions for Granting an Operation Licence

An operation licence may be granted when the management company meets the following conditions:

1. initial fully paid up capital of at least €125.000,00;
2. the management company:
   has the right shareholders;
   is duly organised and staffed; and
   has the required financial means and technical infrastructure;
3. the directors are of sufficient good repute and experience for their role;
4. a minimum of two directors are appointed;
5. the application includes a business plan and organisational structure;
6. the registered office and central administration are established within the territory of the Republic.

In the event the management company has close links with other natural or legal persons the authorisation will only be granted as long as those links do not prevent effective supervision.

In the event that the management company is a subsidiary or sister company of another management company, investment firm, credit institution or insurance undertaking authorised in another, or controlled by the same natural or legal person in another member state, the CySEC must ask the competent authority of that member state for their opinion.

The CySEC must notify the management company of its decision within six months after a full application has been submitted, including reasons for rejection if applicable. The management company can start operating as soon as the licence has been granted.

4.1.4 Conditions for Exercise of Activities

The management company needs to have sound administrative and accounting procedures, arrangements to control and safeguard electronic data processing, and adequate internal control mechanisms. The internal control mechanisms need to include rules for dealing on own account by staff members, and controls to enable the assessment of the origin, parties, nature, and time and place of execution of each transaction. The management company needs to be able to ensure that all transactions are in line with the rules and regulations. The management company needs to be able to manage the risk associated with conflicts of interest between it and its clients and between clients.

As part of its ongoing operation, the management company needs to maintain an internet page.

Management companies that also provide portfolio management services may not invest in the collective investment undertakings they manage unless they have obtained prior approval from the clients in writing. In addition, the management company will, in this case, be obliged to be a member of the investor compensation fund for customers of investment funds.

The CySEC is responsible for the supervision of cross-border activity related to other member states as well as other third countries.

4.1.5 Financial Submissions

Annual, semi-annual, and quarterly reports must be submitted to the CySEC, of which only the annual reports have to be audited. The submission dates from the date of the end of the period are as follows:

annual report – within four months;
semi-annual report – within two months;
quarterly report – within one month.

4.1.6 Delegation Arrangements

When a management company wants to outsource some of its tasks and functions to a third party, it may do so providing that the third party is qualified and capable to undertake the activity. A written agreement needs to be in place between the management company and the third party to enable the management company to monitor the activities. The outsourcing agreement may not hinder effective supervision of the management company. The management company remains ultimately responsible for the outsourced tasks and functions, and may provide further instructions to the third party if needed. The management company may not outsource all of its activities.

The management company must inform the CySEC of the outsourcing arrangements, who, if applicable, will inform the competent authorities in the home member state of the UCITS.

The portfolio management activity may only be outsourced to third parties authorised to manage collective investment funds, or authorised fund managers subject to prudential supervision. In the latter case, the management company has to seek prior approval from the CySEC. In the event the third party is based in a third country (non-member state), effective co-operation needs to be in place between the CySEC and the competent authority of the third party. The third party needs to manage the portfolio as defined in the investment mandate and investment allocation criteria. Portfolio management may not be outsourced to the depositary of the UCITS.

4.1.7 Changing the Management Company

A management company cannot resign from managing the UCITS or another collective investment undertaking unless it has obtained permission from the CySEC or, if applicable, the competent authority of the home member state. The CySEC will only allow the resignation of the management company if this does not violate the interests of unitholders, and a new management company is selected. The old management company will work in parallel with the new management company and will remain fully liable for all its actions and missions until the duties are fully assumed by the new management company.

The depositary may request the CySEC to replace the management company, if it is of the opinion that the management company does not work in the best interest of the UCITS and its unitholders, or does not fulfil its legal obligations. Unitholders cannot request the replacement of the management company. In case of a VCIC, the replacement of the management company may be requested by the board of directors.

The regulation or the instruments of incorporation of the UCITS must be amended to reflect the change in management company.

4.1.8 Revoking the Licence of a Management Company

In the following circumstances the CySEC must revoke the operating licence of a management company:

the licence has not been used within 12 months after it was granted;
the company explicitly resigns from it;
the company has ceased the activity for which the licence was granted for more than six months;
the licence was granted on the basis of false statements or another regular means;
the company no longer meets the criteria of the licence;
the company requests for its operation licence to be revoked; or
the company has seriously and/or repeatedly violated its obligations.

If the amount of the management company's own funds falls below the minimum capital requirements, the CySEC may set a deadline for the management company to rectify the situation. If the management company does not increase its capital within the given time frame, the CySEC will revoke the operation licence.

A licence can be partially revoked if it concerns the management of collective investment undertakings other than UCITS, or one or more specific activities. The CySEC notifies the management company, the registrar of companies and, if applicable, the competent authorities in other member states. When the licence is revoked, the management company will immediately cease to carry out any activities or services for which the licence was revoked. Any remaining obligations need to be settled within three months after the licence is revoked.

In the event the licence is fully revoked, the CySEC may apply to the court for the liquidation of the management company and the appointment of a liquidator.

The CySEC will ensure that the operations of the UCITS or collective investment undertaking are not disrupted.

For VCICs that need to have a management company, the CySEC will appoint a new management company. In the event this is not feasible, the CySEC will revoke the operation licence of the VCIC, appoint a liquidator and apply to the court for the liquidation of the VCIC.

4.1.9 Code of Conduct

The code of conduct issued by the CySEC applies to management companies authorised in the Republic and their personnel. The purpose of the code of conduct is to ensure that management companies:

act fairly, lawfully, and with due care and diligence when performing their activities;
act in the best interests of the UCITS or other collective investment undertaking they manage and of the integrity and smooth operation of the market;

employ resources with the appropriate knowledge and expertise;
act to prevent and manage conflicts of interest;
comply with all rules and regulations.

4.1.10 Complaints Handling

The VCIC or the management company needs to implement appropriate measures to ensure that all complaints made against them are assessed and the appropriate action is taken.

4.2 Cross-Border Services

Cross-border services are services provided by a company in a country that is not their home country. This can be undertaken via the establishment of a branch, or by directly offering services in a different jurisdiction. Different rules apply to member states and third countries.

4.2.1 Establishing a Branch in Another Member State

Management companies authorised in the Republic may establish a branch in another member state, but must notify the CySEC. The notification needs to include the following information:

name of the member state;
business plan;
organisation structure;
risk management procedures;
address of the management company in its host state; and
names of the staff members responsible for the management of the branch.

Providing that the CySEC has no objection, it will inform the competent authorities in the member state and the management company of their approval within two months of receiving all required information. The management company may start their business immediately thereafter. In the event the CySEC does not approve the operations in the member state, it will inform the management company of its refusal and the underlying reasons within two months of receiving all required information. Similarly, a management company authorised in another member state may start a branch in the Republic two months after the CySEC has received the required information from the competent authority in the member state.

The management company will comply with all rules of the host member state, and will be supervised by their competent authorities. The management company will notify the CySEC and the competent authorities in the host member state of any changes in their business plan, organisation structure, risk management procedures, address and staff members one month prior to the change being effected.

A management company authorised in the Republic may establish and manage a UCITS in another member state. Equally, a management company authorised in another member state may establish and manage a UCITS in the Republic.

When establishing a branch, the branch is subject to the rules of conduct in the member state where the branch is established.

4.2.2 Provision of Services in Another Member State without Establishing a Branch

Prior to offering services in another member state for the first time, a management company must notify the CySEC of their intentions. The notification must include the following information:

name of member state;
activities and services to be provided;
description of risk management process; and
additional processes and procedures.

The CySEC will inform the competent authorities of the host member state and the management company within one month of receiving all required information, and will include details of the Investor compensation fund for clients of investment firms. Upon receipt of the notification from the CySEC the management company may immediately start providing its services. Similarly, two months after the CySEC has received a notification from a competent authority in another member state, a management company authorised in that member state may provide services in the Republic as long it is authorised to undertake these services.

Any change in the activities and services, risk management procedure, or other relevant processes and procedures must be communicated to the CySEC and the competent authorities of the host member state prior to implementing the change. The management company needs to provide the competent authorities in the host member state with all information they require. Failure to do so will be reported to CySEC.

Under the freedom to provide services, the management company follows the rules of conduct of its home member state. However, the marketing of UCITS units will be in accordance with the rules and regulations of the EU.

4.2.3 Cross-Border Collective Portfolio Management Services

When offering collective portfolio management services on a cross-border basis, the management company will be subject to the supervision of the competent authorities of the UCITS home member state and will apply their rules regarding:

set-up and authorisation;
issuance, redemption and repurchase of units;
issue, redemption and repurchase price;
errors on the calculation of net asset value, and investor compensation;
investment policy, investment limits and calculation of exposure and leverage;
restrictions on borrowing, lending and uncovered selling;
valuation of assets;
accounting rules;
distribution and reinvestment of profits;
disclosure and reporting obligations;
marketing and distribution of units;
relationship with unitholders;
merging, restructuring, winding up and liquidation of the UCITS;
content of the unitholder register;
licensing and supervision fees; and
exercising unitholder voting and other rights.

The competent authorities in the management company's home member state will be responsible for ensuring the adequacy of the organisation of the management company and the application of the appropriate procedures and arrangements to comply with the UCITS regulations.

The management company must take all necessary actions to ensure it meets all requirements as they apply in both the home and host member state as applicable to the management company and the UCITS.

4.2.4 Rejection of Cross-Border Services

The CySEC may reject the request of a management company to undertake the management of a UCITS authorised in the Republic if the management company:

does not comply with the rules of the CySEC;
is not authorised by the competent authorities in its home member state to manage the type of UCITS it has applied for; or
has not provided the necessary information.

4.2.5 Reporting

A management company authorised in another member state undertaking cross-border services in the Republic periodically needs to submit reports in relation to the activities they undertake in the Republic. Similar to management companies authorised in the Republic, they have to provide the CySEC with any information required for the monitoring of their compliance with the rules and regulations on request.

4.2.6 Breaching of Rules

In the event a management company that provides cross-border services in the Republic from another member state breaches one or more rules of the Republic, the CySEC will request the management company to rectify the situation and will inform the competent authority in the management company's home member state.

In the event a management company refuses to submit any required information to the CySEC or fails to take appropriate steps to comply with its rules and regulations, the competent authority of the home member state will be requested to take the necessary steps to ensure that the management company provides the required information and complies with the rules and regulations. In the event the measures taken by the home member state are inadequate or are not applied by the management company, the CySEC may, after having informed the competent authorities in the home member state, stop the management company from undertaking any other activity within the Republic. If the management company manages a UCITS in the Republic, the CySEC may stop the management company from managing the UCITS. In the event the competent authority of the home member state of the management company does not take the appropriate action, the CySEC may refer the issue to ESMA. At any time during these proceedings the CySEC may, in exceptional circumstances, take any precautionary measures to protect investors and other parties. In this event, the CySEC will inform the management company, the EC, ESMA, and the competent authority in the home member state.

Any actions taken by the CySEC will be communicated to the management company.

The CySEC will inform the EC and ESMA of any instance in which it has refused authorisation for cross-border services.

4.2.7 Consultation between Competent Authorities

In the event the CySEC decides to withdraw the operation licence of a management company, it will inform the competent authorities of the home member state of any UCITS managed by the management company. The competent authorities in the home member state of the UCITS may take any appropriate action to protect the unitholders including preventing the management company from undertaking any further activity.

Prior to the withdrawal of the authorisation of a management company in the home member state of a UCITS it manages, the CySEC will consult with the competent authorities of the home member state.

4.2.8 Licencing

Management companies authorised in third countries or in member states that do not meet all requirements may be granted a licence by the CySEC to provide collective portfolio management services in the Republic by establishing a branch. Such a licence shall also be provided to management companies authorised in the Republic so that they can undertake portfolio management services in a third country through establishing a branch.

End of Chapter Questions (for revision purposes)

1. What is the definition of a UCITS?
   Section 1
2. List six instrument types a UCITS can hold.
   Section 1
3. List the information that needs to be provided to CySEC as part of the application for an operation licence.
   Section 1.1
4. Under which circumstances can CySEC decide not to grant a licence?
   Section 1.1
5. What are the functions of the depositary?
   Section 1.1.1
6. What needs to be in place for the purchase and redemption of units?
   Section 1.1.6
7. What are the reasons for dissolving a common fund?
   Section 1.2.1
8. List the limits for investments by UCITS in shares carrying voting rights.
   Section 2.1

9. What are the requirements for a UCITS to market in other jurisdictions?
   Section 2.4.1

10. Described the rules for dissolution of a master UCITS.
    Section 3.3

11. Define the permitted activities of a management company.
    Section 4.1.1

12. List the conditions for granting a management company licence.
    Section 4.1.3

13. List the circumstances under which a management company licence can be revoked.
    Section 4.1.8

E. The Alternative Investment Fund Managers' (AIFMs) Law

The Alternative Investment Fund Managers' (AIFMs) Law came into force in 2013 to align the rules and regulations in the Republic with various EU regulations on alternative investment managers (AIMs), and for the regulation of the tax regime of AIMs.

The Law harmonises the Act of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC, and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 excluding Articles 62 and 63 of this Directive. The Law implements the act of the European Union titled Commission Delegated Regulation (EU) No 231/2012 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.

Two types of AIFM are identified in the law: those which internally manage AIFs; and those who are appointed as external managers of alternative investment funds (AIFs).

1. Operational Conditions of AIFMs

There are a number of general requirements that apply to AIFMs that operate in the Republic including authorisation, remuneration, conflict of interest, risk management, liquidity management and transparency.

1.1 Authorisation

Learning Objective

6.1.1 Know the conditions and process of authorisation for alternative investment fund managers (AIFMs) (Articles 8–9)

AIFMs are authorised by CySEC. Authorisation will only be granted if CySEC is satisfied that they:

meet the requirements of the law;
have sufficient capital;
are controlled by persons of good repute and sufficient experience;

have shareholders with qualifying holdings that are suitable to ensure sound and prudent management; and

have a head office and registered office in the Republic.

In the event the AIFM is a subsidiary of an institution authorised in another member state, or controlled by the same natural or legal person that controls another institution authorised in another member state the CySEC will consult with the competent authorities in the other member state. Authorisation will be refused when the effective exercise of supervision is prevented by close links with other natural or legal persons or the rules and regulations in their country or authorisation.

The CySEC can grant either full or partial authorisation, with particular restrictions to the investment strategies of the AIF the AIFM is allowed to manage.

Within three months after the CySEC has received the completed application, it has to inform the applicant of its decision. This period may be extended for another three months if necessary. The AIFM may start managing AIFs in accordance with its authorisation as soon as its authorisation has been granted within one month of submitting information in relation to the services it is going to provide.

The capital requirements for AIFMs are as follows:

Type of AIFM	Portfolio < €250 million	Portfolio > €250 million
Internally Managed AIF	€300.000	additional capital of 0.02% of the amount by which the €250 million is exceeded with a maximum of €10 million
Externally Managed AIF	€125.000	additional capital of 0.02% of the amount by which the €250 million is exceeded with a maximum of €10 million

The total portfolio value does not include AIF portfolios managed by the AIFM under delegation. Up to 50% of the capital may be provided in the form of a guarantee from a credit institution or insurance undertaking with a registered office in a member state or a third country with equivalent prudential rules and regulations.

To cover any potential professional liability resulting from their activities, both internally managed AIFs and external AIFMs must either have additional own funds to cover the risk or hold professional indemnity insurance.

The own funds of an AIFM will be invested in liquid assets or assets that can readily be converted to cash at short notice. Own funds may not be invested in speculative instruments.

1.2 General Principles

Learning Objective

6.1.2 Know the 'general principles' for AIFMs (Article 13)

AIFMs have to act honestly, fairly and with due skill, care and diligence in conducting their activities. They need to act in the best interest of their investors and the integrity of the market. To this end, they need to ensure they employ effective resources and procedures necessary for the performance of their business activities. AIFMs need to take all reasonable steps to avoid or, if they cannot be avoided, to manage any conflict of interest. If necessary, conflicts of interest need to be disclosed in order to prevent them from adversely affecting the interests of the AIFs and their investors, and to ensure the fair treatment of the AIFs under their management.

An AIFM needs to comply with all relevant rules and regulations when conducting its business and treat all AIF investors fairly. Investors may not be given preferential treatment, unless such treatment is disclosed in the AIF's rules or instruments of incorporation.

An AIFM that is also authorised to undertake discretionary portfolio management services must not invest all or part of the client's portfolio in units of AIFs it manages unless the client has provided prior general approval.

1.3 Remuneration

Learning Objective

6.1.3 Know the AIFM requirements regarding remuneration (Article 14)

The remuneration policies of an AIFM need to meet the following requirements:

Consistent with and promote sound and effective risk management.

Not encourage risk taking inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage.

Apply to those categories of staff whose professional activities have a material impact on the risk profiles of the AIFMs or AIFs they manage.

Remuneration policy must meet the following requirements:

- consistent with and promote sound and effective risk management, and not encourage risk taking which is not in line with the risk profile;
- in line with the business strategy, objectives and values;
- reviewed periodically and be subject to an independent annual review;
- staff in control functions need to be compensated in accordance with the achievement of the objectives linked to their function, not the business area they control;
- remuneration of senior risk and compliance officers is directly overseen by the remuneration committee;
- performance-related remuneration is based on a combination of the assessment of the individual as well as the business unit or AIF they manage;
- performance assessment has to be set in a multi-year framework appropriate to the life cycle of the AIFs managed by the AIFM to ensure the assessment is based on longer-term performance;
- guaranteed variable remuneration is exceptional and may only be paid to new hires in their first year of employment;
- fixed and variable components of total remuneration need to be balanced appropriately with the fixed component representing a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy;
- payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;
- performance measurement for variable remuneration includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;
- subject to the legal structure of the AIF and its rules or instruments of incorporation, up to 50% of any variable remuneration may consist of shares in the AIF or similar instruments, unless the management of the AIFs accounts for less than 50% of the portfolio managed by the AIFM;
- at least 40% of the variable remuneration component needs to be deferred for a period appropriate in view of the life cycle and redemption policy of the AIF;
- variable remuneration will only be paid or invested if it is sustainable according to the financial situation of the AIFM and justified according to the performance of the business unit, and clawback arrangements may be included;
- pension policies need to be in line with the business strategy, objectives, values and long-term interests of the AIFM and the AIFs it manages;
- staff may not undertake personal hedging strategies or remuneration and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;
- variable remuneration is not paid through vehicles or methods that facilitate avoidance of the rules

and requirements of the Alternative Investment Fund Managers' Law.

Large firms must establish a remuneration committee that is competent and independent. The remuneration committee will be responsible for the preparation of decisions regarding remuneration including those with implications of the risk and risk management of the AIFM or the AIF. The members and chair of the remuneration committee must be members of the management body without executive functions.

1.4 Conflict of Interest

Learning Objective

6.1.4 Know the AIFM requirements regarding conflicts of interest (Article 15)

AIFMs are responsible for taking reasonable steps to identify conflicts of interest between the following parties:

Party I	Party II
AIFM, its managers, employees or any person (in)directly linked to the AIFM by control	AIF managed by the AIFM or its investors
AIF or its investors	Another AIF and its investors
AIF or its investors	Another client of the AIFM
AIF or its investors	UCITS managed by the AIFM or its investors
Client of the AIFM	Another client of the AIFM

The AIFM needs to establish, maintain and operate effective organisational and administrative arrangements to ensure it can take all necessary steps to identify, prevent, manage and monitor any conflicts of interest and to prevent them from adversely affecting the interests of the AIFs and their investors. One of the ways to achieve this is by segregating tasks and responsibilities which may be regarded as incompatible and may potentially generate systematic conflicts of interest. Any other material conflicts of interest will be disclosed to the investors of the AIFs.

The general nature and sources of any remaining conflicts of interest must be disclosed clearly to the investors prior to undertaking any business on their behalf, and must develop the appropriate policies and procedures to overcome or manage the conflicts.

If the AIFM uses the services of a prime broker on behalf of the AIF, the agreement with the prime broker will define the terms of their co-operation, provide for any possible transfer and reuse of the AIF's assets and the rules that apply, and the depositary must be informed of the contract. The AIFM must exercise due skill, care and diligence in the selection and appointment of prime brokers.

1.5 Risk Management

Learning Objective

6.1.5 Know the AIFM requirements regarding risk management (Article 16)

The risk management department needs to be functionally segregated from the operating units of the AIFM. CySEC will review the segregation taking into consideration the size of the AIFM and its operations. The AIFM needs to be able to demonstrate that it has procedures in place to allow the independent performance of its risk management activities and that the risk management process satisfies all requirements.

Adequate risk management systems need to be in place to identify, measure, manage and monitor all risk relevant to each AIF investment strategy and to which each AIF is or may be exposed. The risk management systems will be reviewed at least annually and amended as and when required.

The AIFM must implement appropriate, documented, and regularly updated due diligence processes when investing on behalf of the AIF which is in line with its investment strategy, objectives and risk profile.

The AIFM is responsible for ensuring that the risks associated with each investment position of the AIFs and their overall effect of the portfolio can be identified, measured, managed and monitored on an ongoing basis and that the appropriate stress-testing procedures are in place. In addition, they need to ensure that the risk profile of the AIF corresponds with its size, portfolio structure, and investment strategies and objectives.

The maximum level of leverage, and the extent of the right to use collateral or guarantees that may be employed on behalf of each AIF will be set and monitored by the AIFM, taking into consideration the type, investment strategy and leverage of the AIF. The need to limit the exposure to a single counterparty, the extent to which the leverage is collateralised, the asset-liability ratio, and the scale, nature and extent of the activity of the AIFM are also taken into consideration when determining the use of leverage and collateral.

1.6 Liquidity Management

Learning Objective

6.1.6 Know the AIFM requirements regarding liquidity management (Article 17)

For each AIF they manage with the exception of unleveraged closed-ended AIFs, the AIFM will employ an adequate liquidity management system and procedures to be able to monitor the liquidity risk of the AIF and to ensure the liquidity profiles of the AIF's investments comply with its underlying obligations. The AIFM will conduct regular stress tests applying normal and exceptional liquidity conditions to be able to assess and monitor an AIF's liquidity risk.

The AIFM will ensure that the investment strategies, liquidity profiles and redemption policies are consistent for each AIF it manages.

1.7 Transparency

Learning Objective

6.1.7 Understand the transparency requirements for AIFM (Articles 28–32)

The transparency requirements for AIFMs or their branches authorised in the Republic are related to information that needs to be provided to investors as well as annual reports and information requirements from CySEC.

Annual Report

For each of the EU AIFs the AIFM manages, as well as for each AIF it markets in the EU, it must prepare an annual report for each financial year within six months following the end of the period. The annual report must be provided to CySEC and, if applicable, to the competent authorities of the home member state of the AIF. The annual report will be made available to investors on request. When the AIF is required to make an annual financial report public in accordance with the transparency requirement or the national legislation of another member state, only the following additional information has to be made available to investors on request, either separately or as a part of the annual financial report:

balance sheet or statement of assets and liabilities;
income and expenditure account;
report on the activities;
any material changes to the fund;
total amount of variable and fixed remuneration paid to AIFM staff, the number of beneficiaries and, if relevant, carried interest paid;
aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF.

When the above are included in a publicly available annual report, the latter will be made available within four months of the end of the financial year.

The accounting information in the annual report is compiled in accordance with the accounting standards of the home member state or the third country where the AIF is based and the accounting rules established in the rules or instruments of incorporation of the AIF. The accounting information must be audited and the auditor's report will be included in the annual report. The annual report of non-EU AIFs will be subject to audit standards in force in the country where the AIF has its registered office.

Disclosures to Investors

For each of the EU AIFs the AIFM manages, as well as for each AIF it markets in the EU, it needs to disclose the following information prior to investing in the AIF:

description of the investment strategy and objectives, jurisdiction where any master AIF and any underlying funds are established, description of the type of assets, risk management techniques, any applicable investment restrictions, and rules relating to the use of leverage, collateral, and guarantees;
procedures for the changing of investment strategy and/or investment policy;
main legal implications of the contractual agreement between the AIF and investors;
identity of the AIFM, depositary, auditor and any other service provider, including a description of their duties and the investor's rights;
cover for potential professional liability;
delegated management functions, any safekeeping function delegated by the depositary, identification of the delegate and any conflicts of interest that may arise from the delegation;
valuation procedure and pricing methodology for valuing assets including methods to value hard-to-value assets;
liquidity risk management including redemption rights in normal and exceptional circumstances, and existing redemption arrangements;
fees, charges, and expenses directly borne by investors and their maximum amounts;
ensuring fair treatment of investors, when investors obtain preferential treatments, the right to preferential treatments, and, if applicable, the legal or economic links with the AIF or AIFM;
latest annual report;
procedure and conditions for the issue and sale of units;
latest net asset value of the AIF or the latest market price of a unit;
historical performance (if applicable);
identity of the prime broker, any material arrangements with the prime broker, and how potential conflicts of interests are met.

Prior to its investment in an AIF, the AIFM will inform investors of any arrangements by the depositary to contractually discharge itself from any liability. Investors will immediately be informed by the AIFM of any changes in depositary liability.

If the AIF is required to publish a prospectus, the prospectus must contain all the above-mentioned information with the exception of the items mentioned under points 1 and 2.

For each EU AIF, and for each AIF marketed in the EU, the AIFM must periodically disclose the percentage of the AIF's assets subject to special arrangements arising from their illiquid nature; new arrangements for managing liquidity; and the current risk profile and risk management systems.

When employing leverage the AIFM must periodically disclose any changes to the maximum level of leverage the AIFM may employ on behalf of the AIF as well as any right to reuse collateral or any guarantees, and the total amount of leverage amount by the AIF.

Reporting Obligations to CySEC

AIFMs regulated in the Republic must regularly report to CySEC on the principal markets and instruments in which they trade on behalf of the AIFs they manage. These reports will include the main instruments in which they are trading on behalf of the AIF, the markets of which they are a member or where they actively trade, and the principal exposures and concentrations.

For each of the EU AIFs an AIFM manages and for each of the AIFs it markets in the EU, the AIFM needs to provide the following information to CySEC:

percentage of the AIF's assets subject to special arrangements arising from their illiquid nature;
arrangements for managing liquidity;
current risk profile, and the risk management systems in place to manage market, liquidity, counterparty, operational and other risks;
main categories of assets in which the AIF is invested; and
results of stress tests.

AIFMs employing leverage on a substantial basis need to provide CySEC with the following information:

overall level of leverage employed by each AIF;
breakdown between leverage arising from borrowing of cash or securities, and leverage embedded in financial derivatives;
extent to which the AIF's assets have been reused under leveraging arrangements; and
identity of the five largest sources of borrowed cash or securities per AIF and the amount.

A non-EU AIFM with a branch in the Republic only has to report this information for the EU AIFs it manages and the non-EU AIFs it markets in the EU.

CySEC may request additional information it considers necessary for the effective monitoring of systemic risk.

2. Organisational Requirements

Learning Objective

6.2.1 Know the procedures, arrangements and mechanisms that AIFM must implement (Article 18)

6.2.2 Know the conditions AIFMs must meet in order to delegate functions to a third party: delegation (Article 20); sub-delegation (Article 21); liability (Article 22)

2.1 Procedures, Arrangements and Mechanisms

The AIFM will, at all times, employ adequate and appropriate human and technical resources that are necessary for the proper management of AIFs. This includes, but is not restricted to, sound administrative and accounting procedures, control and safeguarding arrangements for electronic data processing; and adequate internal control mechanisms. Internal control procedures need to specifically cover rules for personal transactions by its employees and the holding and management of investment for the AIFM's own account ensuring at least:

that each transaction involving the AIFs may be reconstructed according to its origin, the parties to it, its nature, and the time and place the transaction was executed;

that the assets of the AIFs managed by the AIFM are invested in accordance with the AIF rules or instruments of incorporation and the legal provisions in force.

AIFMs need to have robust governance in place and should be managed and organised so as to minimise conflicts of interest. AIFMs should have a well-documented organisational structure that clearly assigns responsibilities, defines control mechanisms and ensures a good flow of information between all parties involved. AIFMs should also establish systems to safeguard information and ensure business continuity. When establishing those procedures and structures, AIFMs should take into account the principle of proportionality which allows procedures, mechanisms and organisational structure to be calibrated to the nature, scale and complexity of the AIFM's business and to the nature and range of activities carried out in the course of its business.

AIFMs are required to establish a permanent and effective compliance function irrespective of the size and complexity of their business. However, details of the technical and personnel organisation of the compliance function should be calibrated to the nature, scale and complexity of the AIFM's business and the nature and range of its services and activities. The AIFM should not have to establish an independent compliance unit if such a requirement would be disproportionate in view of the size of the AIFM or the nature, scale and complexity of its business.

The AIFM shall, when appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM. The internal audit function shall:

establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the AIFM's systems, internal control mechanisms and arrangements;
issue recommendations based on the results of work carried out;
verify compliance with recommendations;
report internal audit matters.

Any conflicting duties should be segregated within the organisation.

2.2 Valuation

For each AIF an AIFM manages, it needs to ensure there are appropriate and consistent procedures for the valuation of assets in accordance with the rules and regulations, applicable law, and the AIF rules or instruments of incorporation. Asset valuation rules and the calculation of the net asset value per unit is determined by the law of the country where the AIF is established. The valuation procedures must ensure that assets are valued and the net asset value per unit is calculated at least once a year. Investors will be informed of the valuations and calculations as set out in the AIF rules or instruments of incorporation. For open-ended AIFs, the valuation and calculation must also be carried out at a frequency appropriate for the assets held, and its issuance and redemption frequency. For closed-ended AIF, the valuation and calculation must also be carried out in the event of an increase or decrease of the capital by the relevant AIF.

The AIFM must ensure that the valuations are either performed by an independent external valuer, or the AIFM itself, providing that the valuation task is functionally independent from the portfolio management, the remuneration policy and conflicts of interest are mitigated.

The valuation must not be undertaken by the depositary unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as external valuer, and any potential conflicts of interest are properly identified, managed, monitored and disclosed to investors of the AIF.

The external valuer needs to be subject to mandatory professional registration recognised by law, regulatory provisions or rules of professional conduct. An external valuer needs to be able to provide sufficient professional guarantees to be able to perform its function effectively. Any appointment of a valuer needs to comply with the rules and regulations.

An appointed external valuer must not delegate its responsibility to a third party. AIFMs must notify CySEC of the appointment of an external valuer. In the event CySEC does not approve of the valuer appointed, it may require another valuer to be appointed.

Valuations will be performed with due skill, care and diligence, and impartially. If the valuation is undertaken by the AIFM, CySEC may require to have the valuation procedures and/or valuations verified by an external valuer or, if appropriate, an auditor. Even when an external valuer is appointed, the AIFM is ultimately responsible for the proper valuation of the AIF assets, and the calculation and publication of the net asset value. However, an external valuer will be liable for any losses suffered by the AIFM as a result of its negligence or intentional failure to perform its tasks.

2.3 Delegation

AIFMs are allowed to delegate functions to a third party, providing that:

the competent authority of the home member state is informed before the delegation arrangements become effective;
the AIFM can justify the delegation structure on objective reasons;
the third party has sufficient resources to undertake the tasks effectively and efficiently, and have staff of sufficiently good repute and sufficient experience;
delegating the task does not prevent effectiveness of supervision of the AIFM, and in particular should not prevent the AIFM from acting in the best interest of its investors;
the AIFM can demonstrate the third party is qualified and capable of undertaking the task in question, is carefully selected, and can be monitored effectively;
the AIFM reviews the services provided by each third party on an ongoing basis; and
the AIFM does not delegate functions to the extent that it can no longer be considered the manager of the AIF.

An AIFM may only delegate (part of) the portfolio or risk management function, if in addition to the above, the following provisions are satisfied:

delegation is only related to undertakings authorised or registered for the purpose of asset management and subject to supervision, or prior approval by competent authorities of the AIFM's home member state;

if the third party is in a third country the co-operation between the competent authorities of the third country and the supervisory authority of the AIFM home member state needs to be ensured.

All, or part, of the portfolio or risk management functions may not be delegated to the depositary or their delegate, or any other entity whose interests may conflict with those of the AIFM or the investors in the AIF unless the entity has functionally and hierarchically separated the portfolio and risk management functions from any other potentially conflicting tasks and any potential conflicts of interest are properly identified, managed, monitored and disclosed.

2.4 Sub-Delegation

The third party may sub-delegate to another party providing that all the criteria for delegation are met, the AIFM has approved the sub-delegation and has notified the competent authorities of its home member state, prior to the arrangements becoming effective.

2.5 Liability of the AIFM

Even when functions are delegated or sub-delegated, the AIFM is ultimately responsible to the AIF and its investors.

3. Managing Specific Types of AIF

Learning Objective

6.3.1 Know how the requirements apply to specific types of AIF: AIFM managing leveraged AIFs (Article 32); AIFM managing AIFs which acquire control of non-listed companies and issuers (Articles 33–37); rights of AIFM to manage and market EU AIFs in the union (Articles 38–41); rules in relation to third countries (Articles 43–44)

6.3.2 Understand the rules regarding the marketing of AIFs to retail investors in the Republic (Article 45 and 59)

Regulatory requirements apply in different ways to, for example, leveraged AIFs, AIFs acquiring control of non-listed companies and issuers, and the marketing of EU AIFS in the union.

3.1 AIFMs Managing Leveraged AIFs

Information provided to CySEC regarding the leverage of AIFs is used to identify the extent to which the use of leverage may contribute to the build-up of systemic risk in the financial system, risks of disorderly markets and risk to the long-term growth of the economy. CySEC, as the competent authority in the Republic, will ensure all information gathered on leverage is made available to competent authorities of other member states, ESMA and the ESRB. Any information pertaining to the AIFM or AIF posing a potential counterparty risk to other systemically relevant institutions in other member states will immediately be passed on to the relevant competent authority.

The AIFM has to demonstrate that the leverage limits it has set for each AIF are reasonable and that the AIF at all times complies with the limits. CySEC assesses the risks that the use of leverage poses, and if necessary may impose limits to the amount of leverage, if this is deemed necessary to ensure the stability and integrity of the financial system. In the event CySEC imposes limits to the levels of leverage an AIFM is allowed to use, it first has to notify ESMA, ESRB and the competent authorities of the relevant AIF at least ten working days prior to the date that the measure is intended to come into effect. Any relevant advice issued by ESMA shall be taken into consideration.

3.2 AIFMs Managing AIFs Acquiring Control of Non-Listed Companies and Issuers

The regulations in this section apply to AIFMs managing one or more AIFs which either individually or jointly acquire control of a non-listed company or issuer, and AIFMs who co-operate with other AIFMs for the same reason. The regulations do not apply when the non-listed companies are small- and medium-sized enterprises, or special purpose vehicles (SPVs) for the purpose of purchasing, holding or administrating real estate.

For non-listed companies, control is defined as more than 50% of the voting rights of the company, even when the exercise of the right is suspended. The percentage voting rights held by an AIF constitute directly held voting rights, those held by an undertaking controlled by the AIF and those held by natural or legal persons acting in their own name on behalf of the AIF.

3.2.1 Notification

The AIFM authorised in the Republic that manages an AIF that acquires, disposes of or holds shares of a non-listed company must notify CySEC of the proportion of voting rights it holds when it reaches, exceeds, or falls below the thresholds of 10%, 20%, 30%, 50% or 75%, within ten working days after the threshold has been reached.

The AIFM must inform the non-listed company, its shareholders, and the competent authority of the home member state of the AIFM. The notification must contain the percentage voting rights held, conditions subject to which control was acquired and the date on which control was acquired.

When notifying the non-listed company, the AIFM must request the board of directors of the company to inform the employees' representative or the employees themselves immediately.

3.2.2 Disclosure in the Case of Acquisition of Control

The AIFM must inform the company, its shareholders, the competent authorities of the home member state of the AIFM and the competent authorities of the home member state of the company of any occurrence when an AIF or combination of AIFs obtains a controlling stake in a non-listed company. The AIFM must disclose the identities of the AIFMs involved, their policy for preventing and managing conflicts of interest, and the policy for external and internal communication to the company and its employees.

The AIFM must immediately request the board of directors of the company to inform the employees or their representatives.

The AIF, or the AIFM on behalf of the AIF, is responsible for disclosing its intentions regarding the future business of the company and the potential impact on employment and conditions of employment to the company and its shareholders. The AIFM must make sure that the board of directors makes this information available to employees or their representatives.

The AIFM must provide information related to how the acquisition is financed to CySEC and the AIF's investors.

3.2.3 Specific Requirements – Annual Report

The AIFM must ensure that the annual report of an AIF that holds a controlling stake in a non-listed company includes the additional following information:

fair view of the development of the company's business at the end of the reporting period;
any important events that have occurred since the end of the financial year;
the company's likely future development; and
information concerning the acquisition of own shares.

The AIFM must ensure that the annual report is made available to the employees or their representatives by the non-listed company, or the additional information outlined above is made available to the investors in the AIF.

3.2.4 Asset Stripping

For a period of two years from the date an AIF gains control over a non-listed company, the AIFM managing the AIF is not allowed to facilitate, support, instruct or vote in favour of any distribution, capital reduction, share redemption or own share acquisition. This relates to:

distribution to shareholders (dividends and interest) that reduces net assets to below the subscribed capital plus distributable reserves;
distribution to shareholders (dividends and interest) that exceeds the amount of profits;
a share buy back that results in the value of net assets falling below the subscribed capital plus distributable reserves.

If the reduction of capital is to offset losses incurred or to increase a non-distributable reserve, the distribution to shareholders or share buy back may take place.

3.3 AIFMs Managing and Marketing EU AIFs in the EU

An AIFM authorised by CySEC may market units of any EU AIF that it manages in the Republic or in the EU providing that they meet all the necessary conditions. If the EU AIF is a feeder AIF, it can only be marketed in the Republic if the master AIF is also an EU AIF.

The AIFM will have to notify CySEC of the EU AIF it intends to market in the Republic or any other member state in writing and provide detailed information about the AIF, including the jurisdiction where it is established, the AIF rules or instruments of incorporation, name of the depositary, investor information, jurisdiction in which the master AIF is established in case of feeder AIFs, and, where relevant, any arrangements to prevent units or shares of the AIF being marketed to retail investors. Units of the EU AIF may only be marketed to professional investors.

CySEC will inform the AIFM of its decision within 20 working days following notification from the AIFM and, if applicable, the competent authorities of the home member state of the AIF. When the decision is positive, the AIFM may immediately start marketing the AIF in the Republic. The AIFM will inform CySEC and, if applicable, the competent authorities of other member states, of any material changes in the particulars at least one month prior to the change taking place. Any unplanned changes will be communicated to CySEC as soon as they have occurred. In the event a change results in a situation that the AIF or AIFM no longer complies with the rules and regulations, CySEC may take all necessary actions including the express prohibition of marketing of the AIF.

When marketing EU AIFs within the EU, CySEC must also send the notification plus all associated documentation to the competent authorities of the relevant member states and inform the AIFM of the same. In addition, CySEC must inform the competent authorities of its decision at the same time that it informs the AIFM.

All documentation may be submitted in hard copy or electronic form.

The marketing of an EU AIF in the Republic by an AIFM authorised in another member state must follow the notification and approval procedures in their home member state. The competent authorities of the member state will provide the details of the notification documentation and their decision to CySEC.

A non-EU AIFM, duly authorised by CySEC in may market the units of an EU AIF it manages to professional investors in the Republic, which is its member state of reference, with a passport, as soon as the conditions laid down in this section are met.

3.3.1 Provision of Services in Other Member States – Additional Requirements

An AIFM authorised in the Republic may manage EU AIFs established in another member state either through a branch or under the free provision of services. The AIFM must inform CySEC of the way it is intending to market the units of the AIF and must include a business plan detailing the services it is going to perform and the AIFs it intends to manage.

In the event an AIFM intends to establish a branch in another member state, it also needs to include information on the organisational structure, the address in the home member state of the AIFM, and the names and contact details of the persons responsible for the management of the branch.

CySEC will inform the AIFM within one month (or two months in case of a branch) of receiving the complete documentation, send the full documentation to the competent authority of the host member state, and inform the AIFM of the same.

When an AIFM authorised in a different member state markets EU AIFs in the Republic, the AIFM must provide the appropriate notification and approval procedures in its home member state. The competent authorities of the member state must provide the details of the notification documentation and their decision to CySEC.

3.4 Specific Rules in Relation to Third Countries

An AIFM may manage non-EU AIFs which are not marketed in the EU providing that the AIFM complies with the rules and regulations in the Republic and appropriate co-operation arrangements are in place between CySEC and the competent authorities of the third country. An AIFM authorised in the Republic may market units of non-EU AIFs it manages to professional investors in the Republic as long as the following conditions are met:

the AIFM complies with all rules and regulations;
appropriate co-operation arrangements are in place between CySEC and the competent authorities of the third country;
the third country is not listed as a non-co-operative country and territory by the Financial Action Task Force (FATF);
the third country has signed an agreement with the Republic and other relevant member states in which the units are marketed which fully complies with the relevant income and capital tax regime.

The process of notifying CySEC and any other relevant competent authorities including the timelines for CySEC to respond are the same as the process for EU AIFs and outlined in Section 3.3 above.

When an AIFM authorised in a third country markets non-EU AIFs in the Republic, the AIFM must provide the appropriate notification and approval procedures in their home country. The competent authorities of the third country must provide the details of the notification documentation and their decision to CySEC.

3.5 Marketing of AIFs to Retail Investors in the Republic

CySEC may allow AIFMs to market units of any type of AIF to retail investors in the Republic once they are authorised to do so. CySEC may impose additional obligations on the AIFM or AIF, although these may not be stricter than the EU rules and regulations.

CySEC needs to report which types of AIF may be marketed to retail investors in the Republic and the additional requirements they have imposed. CySEC will inform the EC and ESMA of any changes in the requirements.

End of Chapter Questions (for revision purposes)

1. List the conditions of authorisation.
   Section 1.1
2. List the requirements for remuneration.
   Section 1.3
3. Define the requirements for risk management.
   Section 1.5
4. What are the requirements for liquidity management?
   Section 1.6
5. List the disclosures to investors.
   Section 1.7
6. Describe the valuation process.
   Section 2.2
7. How is information regarding leverage used by CySEC?
   Section 3.1
8. What does an AIFM need to do to manage and market in the EU?
   Section 3.3

F. The Prevention and Suppression of Money Laundering and Terrorist Financing Laws

The Prevention and Suppression of Money Laundering and Terrorist Financing Laws of 2007–2010 and Directive DI144–2007–08 of 2012 for the Prevention of Money Laundering and Terrorist Financing outline the regulations for anti-money laundering and terrorist financing in the Republic. In combination these rules cover, among others, the appropriate systems and procedures applied within a risk-based approach in financial organisations, requirements related to customer identification and due diligence procedures, the responsibilities of the board of directors, the employees' obligations, education and training, the duties of the compliance officers as well as the recognition and reporting of suspicious transactions/activities.

The Law harmonises:

Directive 2005/60/EC of the European Parliament and the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

Commission Directive 2006/70/EC of 1 August 2006 laying down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards the definition of 'politically exposed person' and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis.

Introduction

Prevention of money laundering (ML) and the financing of terrorist activities is of significant importance for the global financial system. Any association with these activities has a negative impact on the reputation of institutions and in turn has the potential to undermine the banking sector, as well as the local economy. There are three stages to a successful money laundering operation:

Placement – introduction of the money into the financial system; typically, this involves placing the criminally derived cash into a bank or a co-operative credit institution account, a bureau de change or any other type of enterprise which can accept cash, such as a casino.

Layering – involves moving the money around in order to make it difficult for the authorities to link the placed funds with the ultimate beneficiary of the money. This may involve buying and selling foreign currencies, shares or bonds in rapid succession, investing in collective investment schemes, or insurance-based investment products, or moving the money from one country to another.

Integration – at this final stage, the layering has been successful and the ultimate beneficiary appears to be holding legitimate funds (clean money rather than dirty money). The money is regarded as **integrated** into the legitimate financial system.

Broadly, the international anti-money laundering provisions are aimed at requiring firms to:

identify customers and suspicious transactions at the placement and layering stages;
keep adequate records which should prevent the integration stage being reached, but also provide an audit trail for investigators;
report suspicious activity or behaviour to the relevant regulatory or legislative authority.

Many of the requirements of national and international anti-terrorism legislation on financial services firms are similar to the anti-money laundering provisions described above, and involve:

customer identification;
record-keeping;
transaction monitoring;
reporting suspicious activity.

A person generally commits an offence if they enter into, or are linked with, an arrangement that facilitates the retention or control of terrorist funds.

1. Special Provisions in Respect of Financial and Other Business Activities

This section is related to the regulations outlined in the Prevention and Suppression of Money Laundering and Terrorist Financing Law of 2007 and 2010.

Learning Objective

8.1.1 Understand the provision for financial services companies to apply adequate and appropriate systems and procedures (Article 58 and 59(6/b)): customer identification and due diligence; record-keeping; reporting procedures; internal control and risk management; transaction analysis; employee training; penalties for non-compliance (Article 67)

8.1.2 Know when simple or enhanced customer due diligence measures may be applied (Article 63)

1.1 Systems and Procedures

In order to enable the detection and prevention of money laundering and the financing of terrorism, financial institutions must have adequate and appropriate systems in place which cover the following:

Customer identification and due diligence – know the customer and his business. Due diligence is carried out at the start and on a regular basis throughout the business relationship with the customer. Additional due diligence is required in the event that the client carries out transactions for €15,000 or more whether the transaction is carried out in a single operation or in several operations which appear to be linked and in the event of suspicion of money laundering or terrorist financing regardless of the amount of the transaction, and when there are doubts about the veracity or adequacy of previous customer identification data. Customer identification procedures and customer due diligence measures comprise:

identifying the customer and verifying their identity on the basis of documents, data or information obtained from a reliable and independent source;

identifying the beneficial owner and taking risk-based and adequate measures to verify the identity on the basis of documents, data or information obtained from a reliable and independent source so that the person carrying on in financial or other business knows who the beneficial owner is; as regards legal persons, trusts and similar legal arrangements, taking risk-based and adequate measures to understand the ownership and control structure of the customer;

obtaining information on the purpose and intended nature of the business relationship;

conducting ongoing monitoring of the business relationship including scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the information and data in the possession of the person engaged in financial or other business in relation to the customer, the business and risk profile, including if necessary, the source of funds and ensuring that the documents, data or information held are kept up to date.

The extent of these measures and identification procedures may be determined on a risk-sensitive basis depending on the type of customer, business relationship, product or transaction. The persons must be able to demonstrate to the competent supervisory authorities that the extent of the measures is appropriate in view of the risks of the use of their services for the purposes of money laundering and terrorist financing.

For the purposes of identification procedures and customer due diligence requirements, proof of identity is satisfactory if it is reasonably possible to establish that the customer is the person he claims to be; and the person who examines the evidence is satisfied, in accordance with the procedures followed under this Law, that the customer is actually the person he claims to be.

Record-keeping – client and transaction information must be maintained for a period of five years following the end of a relationship with a customer.

Internal reporting and reporting to MOKAS (the unit for combating money laundering) – the appointed money laundering compliance officer needs to report any suspicious transactions both internally and to MOKAS.

Internal control, risk assessment and risk management.

Transaction examination – transactions that are considered to be particularly vulnerable to money laundering and terrorist financing, complex, unusually large transactions, and transactions with unusual patterns must be examined closely.

Informing employees – employees must be informed of systems, procedures, and legal requirements in relation to combating money laundering and terrorist financing.

Training – ongoing relevant training to employees.

In the event a person falling under its supervision fails to comply with the provisions of this part of the law, CySEC may:

require the supervised person to take measures detailed by CySEC in the required timeframe;

impose an administrative fine of up to €200.000 having first given the opportunity to the person to be heard. In case the failure continues, a fine of €1.000 may be imposed for every day the failure continues;

amend, suspend, or revoke the licence of operation of the person.

At its discretion, CySEC may publicise the imposition of the administrative fee.

An independent legal professional or auditor or external accountant who fails to comply with the provisions of this section and the directives issued by the Competent Supervisory Authority is referred by the Competent Supervisory Authority to the competent Disciplinary Board which will decide accordingly.

1.2 Simplified and Enhanced Customer Due Diligence (CDD)

Simplified customer due diligence (CDD) procedures may be applied to customers for whom it can reasonably be assumed that they are sufficiently regulated. These customers are specifically defined as:

credit or financial institutions covered by the EU Directive;
credit or financial institutions established in a country outside the European Economic Area (EEA) that are supervised under regulations for combating money laundering and terrorist financing that are equivalent to those in the EU;
listed companies trading on an exchange in the EEA or a third country subject to similar disclosure legislation;
public authorities of EEA countries.

Enhanced customer due diligence measures must be taken in all other instances which due to their nature entail a higher risk of money laundering or terrorist financing. High risk customers are:

non face-to-face customers;
accounts in the name of companies whose shares are in bearer form;
trust accounts;
'client accounts' in the name of a third person;
politically exposed persons' accounts;
electronic gambling through the internet; and
customers from countries which inadequately apply Financial Action Task Force recommendations.

2. The Responsibilities of Financial Organisations

This section is related to the regulations outlined in Directive DI144–2007–08 of 2012 of CySEC for the prevention of Money Laundering and Terrorist Financing.

Learning Objective

8.2.1 Understand the responsibilities of the board of directors of a financial organisation with respect to the prevention of money laundering and terrorist financing (Articles 5–6)

8.2.2 Know the minimum duties a compliance officer should exercise with respect to the prevention of money laundering and terrorist financing (Articles 8–10)

8.2.3 Understand how financial organisations should adopt a risk-based approach to prevent money

laundering and terrorist financing (Article 12)

8.2.4 Know examples of: suspicious transactions; activities related to money laundering and terrorist financing

2.1 The Responsibility of the Board of Directors

The board of directors of a financial institution is responsible for:

setting and approving the general principles underlying the policies for the prevention of money laundering and terrorist financing;

appointing the compliance manager and, if applicable, their assistant and communicating to them these policies;

defining the duties and responsibilities of the (assistant) compliance officer;

ensuring that effective and sufficient systems and controls are in place to enable compliance with all rules and regulations;

ensuring the (assistant) compliance officer has complete and timely access to all data required to effectively undertake their duties including, but not restricted to, concerning customer identity, transaction documentation and other relevant information maintained by the financial institution;

ensuring all employees are aware to whom they have to report any information concerning suspicious transactions;

establishing a quick and clear reporting line for the reporting of suspicious transactions;

ensuring the compliance officer has sufficient resources including competent staff and technological equipment;

assessing and approving the annual report and taking appropriate actions to remedy any weaknesses and/or deficiencies identified in the annual report.

The duties and responsibilities of the (assistant) compliance officer are incorporated in the risk management and procedures manual which is communicated to all employees that manage, monitor or control customer transactions.

2.2 Compliance Officer Duties

The compliance officer is responsible for the design of the internal practice, measures, procedures and controls related to the prevention of money laundering and terrorist financing based on the policy principles defined by the board of directors. The policies and procedures explicitly state the responsibilities of each department. The policies and procedures need to include measures to prevent abuse of new technologies and systems for the purpose of money laundering and terrorist financing. The policies and procedures will be appropriate given the risk of money laundering and terrorist financing the organisation is exposed to.

The policies and procedures need to include a policy for customer acceptance, outlining the requirements for simplified and enhanced due diligence when entering into a relationship with the customer as well as on an ongoing basis, and how to deal with suspicious transactions. The policy must be reviewed and approved by the board of directors.

The compliance function is responsible for the preparation of a risk management procedures manual, covering the risk the organisation faces regarding money laundering and terrorist financing. The procedures must include appropriate monitoring mechanisms so that the compliance function will receive all necessary information to be able to assess the level of compliance of the relevant employees and departments. If there are any shortcomings, and/or weaknesses, the compliance function will provide the necessary guidance for corrective measures to be taken. If necessary, the board of directors will be informed of the shortcomings and the prescribed actions.

All suspicious transactions will be reported to the compliance function in writing (the internal suspicion report). All such reports will be examined and analysed using all available resources and will discuss the information received with the employee and, if necessary, their superiors. The analysis will be reported in an internal evaluation report. If necessary, a written report will be sent to MOKAS. Once the report is submitted, the client, the transactions and associated accounts will be monitored closely. On request of MOKAS further investigations may need to be undertaken. During an investigation, the compliance function is the first point of contact for MOKAS. In the event the compliance officer decides it is not necessary to inform MOKAS, they will provide a full reason for this in the internal evaluation report.

The compliance function prepares and maintains a list of customers and their risk classification. Each record includes the name of the customer, their account numbers and the date of the start of the relationship. On an annual basis or, if necessary more often, all risks from existing and new customers, financial instruments, and financial services must be reviewed. If necessary, systems and procedures must be amended. Any systems implemented by third parties will be evaluated periodically.

The compliance function is responsible for ensuring that any branches and subsidiaries based outside the EEA have the necessary measures in place to achieve full compliance.

In addition the compliance function is responsible for the following:

advice and guidance to employees in relation to money laundering and terrorist financing;
acquiring the required knowledge and skills for the improvement of procedures for recognising, preventing and obstructing any transactions and activities that may be associated with money laundering or terrorist financing;
determining which departments and employees need further training, and providing an annual staff training programme;
preparing and submitting the monthly prevention statement to CySEC on a timely basis;
preparing the annual report;
responding to all requests and queries from MOKAS and CySEC and providing them with full co-operation;
maintaining a registry of all reports and other relevant information.

2.3 Risk-Based Approach

The measures and procedures implemented by the financial organisation must be appropriate given the risk it runs. This allows the institution to focus on the areas where it runs the highest risk of being used for money laundering and terrorist financing activities. The risk-based approach recognises that money laundering and terrorist financing vary across customers, countries, services and financial instruments and allows the organisation to differentiate between these different types of risk. A risk-based approach is typically seen as more cost effective and promotes the prioritisation of efforts.

To ensure the most cost-effective and proportionate way to manage money laundering and terrorist financing the organisation must identify and assess the risk associated with different customers, countries and services and ensure that the policies and procedures are effective and appropriate to manage and mitigate any risks. On an ongoing basis the processes and procedures must be monitored and, if necessary, amended.

2.4 Examples

Money laundering can take many forms including:

turning money acquired through criminal activity into **clean money**;
handling the proceeds of crimes such as theft, fraud and tax evasion;
handling stolen goods;
being directly involved with, or facilitating, the laundering of any criminal or terrorist property;
criminals investing the proceeds of their crimes in the whole range of financial products.

There are similarities between the movement of terrorist funds and the laundering of criminal property and, because terrorist groups can have links with other criminal activities, there is inevitably some overlap between anti-money laundering provisions and the rules designed to prevent the financing of terrorist acts. There are two main differences to note, however, between terrorist financing and other money laundering activities:

Often, only small sums of money are required to commit terrorist acts, making identification and tracking more difficult.

If legitimate funds are used to fund terrorist activities, it is difficult to identify when the funds become **terrorist funds**.

Terrorist organisations can, however, require significant funding and will employ modern techniques to manage them and transfer the funds between jurisdictions, hence the similarities with money laundering.

There are a large number of known activities that should arouse suspicion of money laundering including, for example:

customers that move frequently without any particular underlying reason;

the initial deposit is a wire transfer from outside the country or a large cash transaction;

customers with an address at a significant distance from the bank;

overpayments on credit line or credit cards just before going on a holiday or when other circumstances would normally prevent them from making payments;

unrelated customers sharing the same street or IP addresses.

However, those who wish to launder funds or finance terrorism are continuously finding new ways to do so and staff members of financial institutions need to be alert to anything that is out of the ordinary.

End of Chapter Questions (for revision pusposes)

1. Describe the appropriate systems that need to be in place to enable the detection of money laundering and financing of terrorism.
   Section 1.1

2. List the clients for whom simplified due diligence is sufficient.
   Section 1.2

3. List the responsibilities of the board of directors.
   Section 2.1

4. Describe the duties of the compliance function.
   Section 2.2

G. THE EUROPEAN UNION (EU)

Because Cyprus is part of the EU, there are a number of Europe-wide rules and regulations that apply to financial institutions in the Republic, which have been incorporated in the laws and regulations of the Republic.

Commission Regulation (EC) No 1287/2006 outlines the record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms.

Commission Regulation (EU) No 231/2013 supplements 2011/61/EU of the European Parliament and of the Council regarding the exemptions, general operating conditions, depositaries, leverage, transparency, and supervision for alternative investment funds (AIFs) and their managers (AIFMs).

Regulation 648/2012 covers the regulations regarding OTC derivatives, central counterparties (CCPs) and trade repositaries.

Regulation 2013/36/EU outlines the regulations regarding the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

Regulation 575/2013 is related to prudential requirements for credit institutions and investment firms and amends Regulation (EU) No 648/2012.

ESMA Guidelines for competent authorities and UCITS management companies are in place to protect investors by providing guidance on the information that should be communicated with respect to index-tracking UCITS and UCITS ETFs together with specific rules to be applied by UCITS when entering into over-the-counter financial derivative transactions and efficient portfolio management techniques. Finally, the guidelines set out criteria that should be respected by financial indices in which UCITS invest.

CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the key investor information document sets out the methodology for the synthetic risk and reward indicators that apply to all UCITS. The methodology is based on the volatility of the fund using weekly or monthly returns covering the previous five years.

1. European Commission (EC) Regulations

Learning Objective

9.1.1 Understand the main provisions of Commission regulation (EC) No 1287/2006

9.1.2 Understand the main provisions of Commission regulation (EU) No 231/2013 and Directive 2011/61/EU

9.1.3 Understand the main provisions of Directive 2013/36/EU of the European Parliament

9.1.4 Understand the main provisions of Regulation 575/2013 of the European Parliament

9.1.5 Understand the main provisions of Regulation (EU) No 648/2012 of the European Parliament and of the Council

1.1 The Markets in Financial Instruments and Investment Services

The Markets in Financial Instruments Directive (MiFID) is a comprehensive regulatory regime for the organised execution of investor transactions by stock markets, other trading systems and investment firms. It creates a single authorisation for investment firms enabling them to do business anywhere in the EU.

1.1.1 Transparency and Market Integrity

Competent authorities have an obligation to safeguard market integrity, to report transactions and to keep records which can be accessed by ESMA. The pre-trade transparency obligation requires **internalisers** (ie, firms dealing on own account by executing client orders outside regulated markets or multilateral trading facilities (MTFs)) to disclose the prices at which they are willing to buy from and/or sell to their clients. However, the rules limit the disclosure obligation to transactions not above standard market size, defined as the average size of orders executed in the market.

Each member state is responsible for establishing a list of regulated markets and communicating this to the other member states and ESMA. As a result, European wholesale markets are not be subject to the pre-trade transparency rule, and wholesale broker-dealers are not exposed to significant risks in their role as market makers.

1.1.2 Operator Protection

Protective measures for internalisers are associated with their obligation to quote, so that they can provide this essential service to clients, without running undesirable risks including the possibility of updating and withdrawing quotes. This prevents financial institutions from discriminating between such investors, eg, by offering some of them improvements to publicly quoted prices, and thus establishing a fair market for retail investors.

1.1.3 Appointing Competent Authorities

Member states must appoint their competent authorities and send the necessary information to the Commission, ESMA and the competent authorities of the other member states. The competent authorities act as a point of contact in the member states, and must co-operate closely with ESMA.

Member states and ESMA may conclude co-operation agreements concerning:

the supervision of credit institutions;
the procedures of liquidation and bankruptcy of firms;
the procedures for statutory audits of the accounts of investment firms;
the supervision of bodies involved in the procedures of liquidation and bankruptcy of investment firms;
the supervision of persons charged with carrying out statutory audits of the accounts of insurance undertakings, credit institutions, investment firms and other financial institutions.

1.2 Alternative Investment Fund Managers (AIFMs)

Regulation 231/2013 attempts to regulate the AIFMs including risk and liquidity management, valuation and delegation, requirements detailing the functions and duties of depositaries of AIFs, rules on transparency, and specific requirements relating to third countries. The regulation provides for a lighter regime applicable to AIFMs who manage portfolios of AIFs whose assets under management do not exceed the relevant thresholds as specified in the regulation. The operating conditions for AIFM are incorporated in Section 2.1 of Chapter 6 of this workbook.

1.2.1 Definitions

AIFM: Alternative Investment Fund Manager.
AIF: Alternative Investment Fund. AIFs can be managed internally or externally.

1.2.2 Functions that can be Performed by AIFMs

Member states need to ensure that AIFMs that manage AIFs have been authorised and continue to meet the conditions for authorisation. AIFMs that manage an AIF need to perform portfolio and risk management. In addition, they may perform 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;
unit/share issues and redemptions;
contract settlements, including certificate dispatch;
record-keeping.

2. Marketing.
3. Activities related to the assets of AIFs, 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.

AIFMs may not perform any other activities. However, member states may authorise an external AIFM to provide the following activities:

management of portfolios of investments, including those owned by pension funds and institutions for occupational retirement provision in accordance with mandates given by investors on a discretionary, client-by-client basis;

non-core services comprising:

investment advice;
safekeeping and administration in relation to shares or units of collective investment undertakings;
reception and transmission of orders in relation to financial instruments.

AIFMs need to be authorised for the investment management functions of portfolio and risk management in order to be allowed to undertake any of the other functions. AIFMs need to provide both portfolio and risk management services.

AIFMs need to provide the competent authorities of their home member state with the information they require to monitor compliance with the regulations. Authorised investment firms and credit institutions are not required to obtain authorisation to provide investment services such as individual portfolio management in respect of AIFs. However, investment firms shall, directly or indirectly, offer units of shares of AIFs, or place such units of shares with investors in the Union, only to the extent the units or shares can be marketed in accordance with the regulations.

1.2.3 Depositary Responsibility

The depositary is responsible for the safekeeping and oversight of all assets. The way in which the safekeeping and oversight function is performed depends on the type of asset and the geographical location the AIF wishes to invest in. The depositary will maintain a list of countries as well as a procedure for adding and withdrawing countries from the list. The list needs to be consistent with the information provided for in the AIF rules, instruments of incorporation, and offering documents regarding the assets in which the AIF may invest. The depositary's responsibility shall not be affected by any delegation of the custody function unless it has discharged itself of its responsibility in accordance with the law.

1.2.4 Passporting

Authorised EU AIFMs may market to professional investors in the Union or in third countries units or shares of non-EU AIFs it manages and of EU feeder AIFs under a passporting arrangement. Appropriate co-operation arrangements must be in place between the competent authorities of the home member state of the AIFM and the supervisory authorities of the country where the AIF is established in order to ensure at least an efficient exchange of information. When passporting to third countries, the country may not be listed as a non-co-operative country and territory by FATF, and needs to have signed an agreement with the home member state of the authorised AIFM and each other member state in which the units or shares of the non-EU AIF are intended to be marketed. If an AIFM intends to market units or shares of non-EU AIFs in its home member state, the AIFM shall submit a notification to the competent authorities of its home member state in respect of each non-EU AIF that it intends to market. The competent authorities of the home member state of the AIFM will inform ESMA that the AIFM may start marketing the units or shares of the AIF in the home member state.

If an AIFM intends to market units or shares of AIFs in another member state it needs to submit a notification to the competent authorities of its home member state. Providing that the AIFM's management of the AIF complies and continues to comply with the regulations, the competent authorities will notify the competent authorities in the other member state where the AIF is intended to be marketed. The competent authorities of the home member state will include a statement to the effect that the AIFM concerned is authorised to manage AIFs with a particular investment strategy.

Any amendments in the AIFM need to be reported to the competent authorities in the home member state, who will in turn report to the other member states if required.

Member states may allow an authorised EU AIFM to market to professional investors in their territory without a passport.

1.3 Access to the Activity of Credit Institutions and Investment Firms

Directive 2013/36/EU is also referred to as the Capital Requirements Directive IV (CRD IV) and aims to co-ordinate national regulations concerning access to the activity of credit institutions and investment firms, their governance and the supervisory framework. CRD IV represents the incorporation of the Basel III accord into European regulations, and aims at strengthening requirements on banks on capital adequacy. CRD IV introduces rules requiring the maintenance of capital conservation and countercyclical capital buffers, and provides a framework for new regulatory requirements concerning liquidity and the leverage ratio, as well as additional own funds requirements for systemically important institutions.

The main provisions of the Directive are as follows:

Governance – the management body defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of an institution, including the segregation of duties in the organisation and the prevention of conflicts of interest. The role of non-executive members of the management body within an institution shall include:

i. constructively challenging the strategy of the institution;
ii. scrutinising the performance of management in achieving agreed objectives;
iii. satisfying themselves that financial information is accurate;
iv. scrutinising the design and implementation of the institution's remuneration policy.

When appointing members of the management body, the shareholders or members of an institution must consider whether the candidates have the knowledge, qualifications and skills necessary to safeguard proper and prudent management of the institution.

Transparency – from 1 January 2015, member states shall require each institution to disclose annually the following information on a consolidated basis for the financial year:

name(s), nature of activities and geographical location;
turnover;
number of employees on a full time equivalent basis;
profit or loss before tax;
tax on profit or loss;
public subsidies received.

The information needs to be provided by the member state and by the third country in which it has

an establishment.

Requirement for the maintenance of capital conservation – the directive establishes additional requirements concerning the maintenance of a capital conservation buffer of common equity tier (CET) 1 capital equal to 2.5% of their total risk exposure amount, identical for all banks in the EU, as well as a countercyclical capital buffer specific to each institution, not exceeding 2.5%.

In addition, member states may:

introduce an additional systemic risk buffer of CET 1 capital for the financial sector or one or more subsets of that sector, or buffers for systemically important institutions;

apply, without requiring CySEC's prior approval, systemic risk buffers from between 1% and 3% for all exposures, and up to 5% for national exposures and exposures located in third countries;

impose larger buffers requiring the prior approval of CySEC, in the form of an implementing act.

Requirements regarding buffers specific to institutions of systemic importance shall be compulsory for institutions of systemic importance at global level, but optional for other systemically important institutions (at EU or national levels). Globally systemically important institutions will be assigned to one of five sub-categories, depending on their systemic importance. They will be subject to progressive additional CET 1 capital requirements, ranging from 1% to 2.5% for the first four groups, while a buffer of 3.5% will apply to the highest sub-category. The systemic risk buffer and buffers for global systemically important institutions and other systemically important institutions will generally not be cumulative. Only the highest of the three buffers will apply.

1.3.1 Remuneration Policies

The remuneration policy shall draw a clear distinction between criteria for setting basic fixed remuneration and criteria for setting variable remuneration, the latter of which should reflect a sustainable and risk-adjusted performance. The variable component shall not exceed 100% of the fixed component of the total remuneration for each individual. This ratio may rise to 200% if shareholders or owners or members of the institution act by a majority of at least 66%, providing that at least 50% of the shares or equivalent ownership rights are represented or, failing that, by a majority of 75% of the ownership rights represented. Member states may allow institutions to apply the discount rate referred to in this directive to a maximum of 25% of total variable remuneration providing that it is paid in instruments that are deferred for a period of not less than five years.

1.3.2 Enlargement of the Tasks of the European Banking Authority (EBA)

The EBA is entrusted with developing draft technical standards and guidelines and recommendations to ensure supervisory convergence and consistency of supervisory outcomes within the EU. The range of situations in which the EBA may play a mediation role on its own initiative and have binding mediation powers has been extended with a view to enhancing the consistency of supervisory practices.

1.3.3 Harmonisation of Supervisory Practices

Transparent, predictable and harmonised supervisory practices and decisions are necessary for conducting business and steering cross-border groups of credit institutions. The EBA shall therefore enhance harmonisation of supervisory practices. Co-operation between the competent authorities of the home and host member states should be strengthened through a higher degree of transparency and information sharing.

1.3.4 Supervisory Powers and Powers to Impose Penalties

Competent authorities shall be given all supervisory powers to intervene in the activity of institutions that are necessary for the exercise of their function, including, in particular, the right to withdraw an authorisation. The administrative penalties and other administrative measures shall be effective, proportionate and dissuasive.

The new directive introduces an information exchange system for the purposes of assessing the good repute of directors and members of a management body. In this context, the EBA, subject to professional secrecy and data protection requirements, shall be entitled to maintain a central database containing details of administrative penalties, including any appeals in relation thereto, which is accessible to competent authorities only.

1.4 Prudential Requirements for Credit Institutions and Investment Firms

Regulation 575/2013 and Directive 2013/36/EU form the legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment firms in the internal market. Regulation 575/2013 is specifically aimed at preventing divergences in implementation at national level. It:

requires banks and investment firms to hold CET 1 capital of 4.5% of risk weighted assets (until December 2014 between 4% to 4.5%), up from 2% applicable under current rules. The total capital requirement, which includes tier 1 and tier 2 capital, remains unchanged at 8% of risk-weighted assets;

defines CET 1 capital instruments using 14 criteria, similar to those set out in Basel III, and mandates the EBA to monitor the quality of instruments issued by institutions.

1.4.1 Liquidity Requirements

The regulation introduces EU liquidity requirements from 2015, after an initial observation period. Based on the observations and supported by reports from the EBA, the Commission is empowered to adopt a delegated act to introduce liquidity coverage requirements for the EU. Institutions will be required to hold liquid assets, the total value of which will cover the net liquidity outflows that may be experienced under gravely stressed conditions over a period of 30 days. During times of stress, institutions will be allowed to use their liquid assets to cover their net liquidity outflows.

During the observation period provided in the regulation, the EBA should review and assess the appropriateness of a threshold of 60% on level 1 liquid assets, a cap of 75% of inflows to outflows and the phase-in of the liquidity coverage requirement from 60% from 1 January 2015, increasing on a graduated basis to 100% in 2018.

A review will take place in 2016 to enable the European Commission to delay the introduction of the 100% ratio, if justified by international developments. Until the liquidity coverage ratio is fully introduced, member states may maintain or introduce national liquidity requirements.

1.4.2 Leverage Ratio

The regulation contains provisions on the introduction of a leverage ratio from 1 January 2018, if agreed by the Council and Parliament on the basis of a report to be presented by the Commission by 31 December 2016. This will follow an initial observation period; from 1 January 2015 institutions will be required to disclose their leverage ratio.

To address longer term funding issues, the Commission will submit, by 31 December 2016, a legislative proposal aimed at ensuring that institutions use stable sources of funding. The Commission will review the relevant exemptions for large exposures by 31 December 2015.

1.4.3 National Flexibility (Macro-Prudential Powers)

The regulation will enable member states to impose, for up to two years (extendable), stricter macro-prudential requirements for domestically authorised financial institutions in order to address increased risks to financial stability. These stricter measures can apply to:

i. the level of own funds;
ii. liquidity requirements;

iii. large exposures requirements;
iv. the level of the capital conservation buffer;
v. public disclosure requirements;
vi. intra-financial sector exposures; and
vii. risk weights for targeting asset bubbles in the property sector.

The Council can reject, by qualified majority, stricter national measures proposed by a member state.

1.4.4 Enlargement of EBA Tasks

The EBA must be able to transmit to the ESRB all relevant information gathered by competent authorities in accordance with the reporting obligations set out in the regulation. It must also keep an up-to-date list of all of the forms of capital instruments in each member state that qualify as CET 1 instruments. On the basis of data received and the findings of the supervisory review during an observation period, the EBA, in co-operation with competent authorities, must develop a classification of business models and risks.

1.4.5 Separation of Retail and Investment Banking Activities

The regulation states that the structural separation of retail and investment banking activities within a banking group could be one of the key tools for supporting the objective of ensuring the operation of services vital to the real economy while limiting the risk of moral hazard. No provision in the regulation will therefore prevent the introduction of measures to effect such a separation. The Commission will be required to analyse the issue of structural separation in the EU and produce a report, accompanied, if appropriate, by legislative proposals.

1.5 OTC Derivatives, Central Counterparties, and Trade Repositories

The regulations related to the European System of Financial Supervision, include the creation of three European Supervisory Authorities (ESAs) to contribute to a consistent application of Union legislation and to the establishment of high-quality common regulatory and supervisory standards and practices. The ESAs comprise:

The European Supervisory Authority (European Banking Authority) (EBA).
The European Supervisory Authority (European Insurance and Occupational Pensions Authority) (EIOPA).
The European Supervisory Authority (European Securities and Markets Authority) (ESMA).

The ESAs have a crucial role to play in safeguarding the stability of the financial sector. It is therefore essential to ensure continuously that the development of their work is a matter of high political priority and that they are adequately resourced.

Over-the-counter derivatives (OTC derivative contracts) lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This regulation lays down conditions for mitigating those risks and improving the transparency of derivative contracts. OTC derivatives contracts need to be cleared through a central counterparty (CCP). For this purpose the EC needs to co-operate with third country authorities to explore mutually supportive solutions.

ESMA needs to safeguard the stability of financial markets in emergency situations ensuring the consistent application of Union rules by national supervisory authorities and settling disagreements between them. It is also entrusted with developing draft regulatory and implementing technical standards, and has a central role in the authorisation and monitoring of CCPs and trade repositories. One of the basic tasks to be carried out through the European System of Central Banks (ESCB) is to promote the smooth operation of payment systems. It is the responsibility of the European Central Bank (ECB) and national central banks (NCBs) to ensure efficient and sound clearing and payment systems. Mandatory CCP clearing requirements for OTC derivatives contracts are necessary to ensure the use of CCPs.

All OTC derivative contracts need to be reported to trade repositories recognised by ESMA to provide services to entities established in the Union. They can be based either in the Union or in a third country. Market participants need to report all details regarding the derivatives contracts they have entered into in trade repositories. As a result, information on the risks inherent in derivatives markets will be centrally stored and easily accessible to ESMA, the relevant competent authorities, the European Systemic Risk Boards (ESRB) and the relevant central banks of the ESCB. Competition may be hampered by the fact that provision of trade repository services is characterised by economies of scale. Trade repositories are required to provide access to the information held in the repository on fair, reasonable and non-discriminatory terms subject to necessary precautions on data protection. This will ensure a level playing field in the post-trade sector is not compromised by a possible natural monopoly in the provision of trade repository services. Both CCP-cleared and non-CCP-cleared derivatives need to be reported to trade repositories in order to allow for a comprehensive overview of the market and for assessing systemic risk.

All OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation need to be cleared through an authorised EU CCP or a third country CCP recognised by ESMA if they fulfil the following conditions:

they have been concluded in one of the following ways:

i. between two financial counterparties;
ii. between a financial counterparty and certain non-financial counterparty;
iii. between two non-financial counterparties that both meet the clearing threshold;

iv. between a (non)financial counterparty and an entity established in a third country that would be subject to the clearing obligation if it were established in the Union; or
v. between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the Union providing that the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of this regulation; and

they are entered into or novated either on or after the date from which the clearing obligation takes effect; or on or after notification but before the date from which the clearing obligation takes effect if the contracts have a remaining maturity higher than the minimum remaining maturity determined by the European Commission.

OTC derivative contracts that are intragroup transactions shall not be subject to the clearing obligation. This exemption only applies when two counterparties established in the Union belonging to the same group have first notified their respective competent authorities in writing that they intend to make use of the exemption for the OTC derivative contracts concluded between each other not less than 30 calendar days before the use of the exemption. In addition this exemption applies to OTC derivative contracts between two counterparties belonging to the same group which are established in a member state and in a third country, where the counterparty established in the Union has been authorised to apply the exemption by its competent authority within 30 calendar days after it has been notified by the counterparty established in the Union.

Risk Mitigation Techniques for OTC Derivative Contracts not Cleared by a CCP

Financial counterparties and non-financial counterparties that enter into an OTC derivative contract not cleared by a CCP, shall ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least:

the timely confirmation, where available, by electronic means, of the terms of the relevant OTC derivative contract;

formalised processes which are robust, resilient and auditable in order to reconcile portfolios, to manage the associated risk and to identify disputes between parties early and resolve them, and to monitor the value of outstanding contracts.

The value of outstanding contracts shall be mark-to-market on a daily basis. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used. Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that were entered into on or after 16 August 2012. Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the clearing threshold is exceeded (this does not apply to intergroup transactions). Financial counterparties shall hold an appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral.

An intragroup transaction between counterparties which are established in different member states shall be exempt, totally or partially, from these requirements on the basis of a positive decision of both the relevant competent authorities.

2. European Securities and Markets Authority (ESMA)

Learning Objective

9.2.1 Understand the main provisions of ESMA guidelines for competent authorities and UCITS management companies

9.2.2 Understand the main provisions for the calculation of synthetic risk and reward indicators in key investor information documents

2.1 ESMA Guidelines for Competent Authorities and UCITS Management Companies

The purpose of the guidelines is to protect investors by providing guidance on the information that should be communicated with respect to index-tracking UCITS and UCITS exchanged-traded funds (ETFs), together with specific rules to be applied by UCITS when entering into over-the-counter (OTC) financial derivative transactions and efficient portfolio management techniques. Finally, the guidelines set out criteria that should be respected by financial indices in which UCITS invest.

The guidelines cover index-tracking UCITS, index-tracking leveraged UCITS, UCITS ETFs, actively managed UCITS ETFs, treatment of secondary market investors of UCITS ETFs, efficient portfolio management techniques, financial derivative instruments, the management of collateral for OTC financial derivative transactions and efficient portfolio management techniques, and financial indices. For each of the funds, the rules identify the information that needs to be included in the prospectus which should also be included in summary form in the key investor information.

Index-tracking UCITS – the annual and half-yearly reports must include the tracking error at the end of the period and should include an explanation of any differences in the tracking error between the UCITS and the index it tracks.

Index-tracking leveraged UCITS – these types of UCITS should comply with limits and rules on global exposure established in the UCITS Directive. Global exposure needs to be calculated using the commitment approach or the relative value-at-risk (VaR) approach.

UCITS ETFs – a UCITS ETF is an exchange-traded fund and should use the term UCITS ETF in its name. Policies regarding portfolio transparency and where this information can be found, as well as the calculation method of the net asset value, and whether or not it is actively managed must to be included in the prospectus and the key investor information. The prospectus and marketing information needs to include a warning to the effect that UCITS ETFs purchased in the secondary market are not redeemable from the fund. Investors should have the right to sell their units back to the UCITS ETF when the stock exchange value of the units significantly varies from the net asset value.

Efficient Portfolio Management (EPM) techniques – techniques and instruments used for the effective management of the portfolio need to be disclosed in the prospectus, including a detailed description of the risks involved. Techniques and instruments used in relation to transferable securities and money market instruments should not result in a change of the investment objectives of the UCITS or add substantial additional risk. Costs should be disclosed, and all returns after cost will be returned to the UCITS. At any time, the UCITS should be able to recall any security that has been lent out, or any (reverse) repurchase agreement.

Financial derivative instruments – when a UCITS enters into financial derivatives, the assets held by the UCITS should comply with the relevant investment limits. The underlying exposures should be taken into account when calculating the investment limits. Financial derivatives exposures and the exposures to their counterparties need to be disclosed in the annual report.

Collateral for OTC derivatives – collateral should be included in the calculation of the risk exposures. When entering into OTC derivative transactions, collateral used to reduce counterparty risk exposure needs to meet a number of criteria regarding issuer credit quality, liquidity, correlation and valuation. Clear haircut policies need to be in place.

Financial indices – UCITS should not invest in a financial index that has a single component that has an impact on the overall index return which exceeds the relevant diversification limits. In addition UCITS should not invest in commodity indices that do not consist of different commodities. Generally, the indices invested in need to satisfy the relevant index criteria.

2.2 Synthetic Risk and Reward Indicators

The methodology for the calculation of synthetic risk and reward indicators is designed in line with the following criteria:

provide investors with a meaningful indication of the overall risk and reward profile of the UCITS;
ensure an appropriate spread of UCITS across different asset classes;
applicable to all types of UCITS;
no room for manipulation;
easy and cost effective to implement;
easy to understand by auditors, advisers and distributors;
enable easy and effective supervision; and
achieve an adequate degree of stability of the risk classification process with respect to normal trends and fluctuations in the markets.

The methodology for the synthetic risk and reward indicator applies to all UCITS and is based on the volatility of the fund using weekly or monthly returns covering the previous five years. In light of the outcome of the volatility calculation, the UCITS is assigned to the appropriate category on a numerical scale of one to seven. The methodology sets out how the volatility intervals should be defined as well as detailed rules on how to assess migrations. There are specific rules on application of the methodology to absolute return funds, total return funds, life cycle funds and structured funds. In the latter case, the indicator is calculated on the basis of the annualised volatility corresponding to the 99% VaR at maturity.

End of Chapter Questions (for revision purposes)

1. Describe the main purpose and objectives of MiFID.
   Section 1.1
2. Describe the requirements for transparency and market integrity.
   Section 1.1.1
3. List the entities the Alternative Investment Directive does not apply to.
   Section 1.2
4. Describe the main provisions of CRD IV.
   Section 1.3

I. GUIDELINES FOR INVESTMENT FIRMS

1. Professional Standards

Guideline GD–IF–01 contains the guidelines for compliance with the authorisation and operating conditions of persons employed by the CIF including academic and professional requirements and integrity and morals of the employee.

Learning Objective

10.1.1 Understand how CIFs ascertain the integrity, morals and credibility of employees (Article 15)

10.1.2 Understand the academic and professional requirements for CIF employees: documentary submissions (Article 17); public register (Article 53) (Article 18); language ability (Article 19)

The guidelines for compliance with authorisation and operating conditions include the professional standards requirements for employees of CIFs.

Any person employed by a CIF must be of sufficiently good repute, and have the requisite skills, knowledge and expertise to undertake their job. Employees must have integrity, morals, and credibility and the CIF needs to maintain information certifying the employee is not bankrupt, has no criminal record and references from previous employers.

Any person employed by a CIF must have the appropriate academic and/or professional qualifications and professional experience to be able to undertake the responsibilities assigned to them. For this purpose, the CIF needs to request the following information to be submitted:

copies of academic degrees or diplomas and/or professional qualifications; and
certificates from previous employers that the person has the relevant experience.

These documents must be maintained in the CIF's records.

In addition, the CIF needs to ensure that persons it employs have a very good knowledge of Greek and English, and are, when applicable, registered in the public register of Article 53 of the Law. A CIF may employ a person who is not registered, providing that they have obtained prior approval from CySEC.

2. Compliance Function

Guideline GD–IF–06 contains the guidelines for certain aspects of the compliance function.

Learning Objective

10.2.1 Understand the 10 general guidelines on the legal requirements of a compliance function (Articles 11–75)

The compliance function of a CIF has to abide by ten general principles which are summarised in this section.

2.1 General Guideline 1 – Compliance Risk Assessment

The compliance function of an investment firm needs to take a risk-based approach when allocating its resources. The focus of the monitoring and advisory activities is determined, based on a compliance risk assessment. The compliance risk assessment needs to be performed regularly to ensure that the focus and the scope of compliance monitoring and advisory activities remain valid.

Investment firms need to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the investment firm to comply with its obligations. As part of this, the compliance function should identify the level of compliance risk the investment firm faces, taking into account the investment services, activities and ancillary services provided by the investment firm, as well as the types of financial instruments traded and distributed.

The compliance risk assessment should take into account the following:

applicable obligations under the law and associated directives;
policies, procedures, systems and controls implemented within the investment firm in the area of investment services and activities;
results of any monitoring activities and of any relevant internal or external audit findings.

The risk assessment forms the basis for the compliance work plan and needs to be subjected to regular reviews as well as ad hoc reviews when necessary to ensure that any new risks are taken into consideration, such as new business areas and changes in the structure of the investment firm.

2.2 General Guideline 2 – Monitoring Obligations of the Compliance Function

The compliance function needs to establish a monitoring programme that takes into consideration all the activities and services provided to the client. The programme needs to reflect the priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored.

The objective of the monitoring programme is to ensure that the investment firm's business is conducted in compliance with its obligations under the law, and whether their internal guidelines, organisation and control measures remain effective and appropriate.

Investment firms that are part of a group are responsible for monitoring their own compliance risk, even when the compliance tasks are outsourced to another firm within the group. The compliance function within the investment firm should, however, take into consideration that they are part of a group, and work closely with audit, legal, regulatory and compliance staff in other parts of the group.

The risk-based approach to compliance should be the basis to determine the appropriate tools and methodologies used by the compliance function, as well as the extent of the monitoring programme and the frequency of monitoring activities performed by the compliance function.

The monitoring activities should not be solely desk-based, and should also include verification of how policies and procedures are implemented in practice, for example, through on-site inspections. The monitoring of activities can, for example, be done via:

aggregated risk measurements, such as risk indicators;
exception reporting and issues logs;
targeted surveillance of trades;
observation of procedures;
desk reviews;
interviews.

The monitoring programme needs to reflect any changes in the risk investment firm's profile as and when they arise, as well as the following:

implementation and effectiveness of any remedial measures taken in response to breaches of the law;
obligation to comply with regulatory requirements;
first level controls in place in individual departments; and
reviews by risk management, internal control, internal audit and any other control function.

The compliance function has a role in overseeing the operation of the complaints process and should consider complaints as a source of relevant information in the context of its general monitoring responsibilities. The compliance function is not required to have a role in the determination of the outcome of complaints but merely access to all customer complaints referred by the investment firm.

2.3 General Guideline 3 – Reporting Obligations of the Compliance Function

Regular written compliance reports must be sent to the persons who effectively direct the business of the investment firm. The reports must include a description of the implementation and effectiveness of the overall control environment for investment services and activities, ancillary services and other business, and a summary of the risks that have been identified, as well as any remedies identified and/or implemented. The reports must be prepared at least annually and, if necessary, more often. Any significant findings need to be reported immediately.

Compliance reports need to cover all business units. In the event any of the business units is not covered, the report should clearly state the reasons for the exclusion. When relevant, the report needs to include the following:

description of the implementation and effectiveness of the overall control environment;
description of the monitoring programme;
summary of major findings of the review of the policies and procedures;
summary of the reviews performed, and the breaches and deficiencies discovered;
risks identified in the scope of the compliance function's monitoring activities;
relevant changes and developments in regulatory requirements during the reporting requirements and in measures taken to ensure compliance;
other significant compliance issues that have occurred during the reporting period; and
material correspondence with competent authorities.

In addition to the periodic report, any compliance matters, such as material breaches of the law and legislations, need to be reported to the persons who effectively direct the business in a timely manner. The report should also contain advice on the necessary remedial steps. Additional reporting lines to group compliance need to be considered as required.

Minutes of the meetings of the board of directors in which the compliance reports are discussed must be submitted to CySEC.

2.4 General Guideline 4 – Advisory Responsibilities

The compliance function is responsible for providing:

support for training staff;
day-to-day assistance; and
participation in the establishment of new policies and procedures.

Investment firms should promote a **compliance culture** establishing the overall environment in which compliance matters are treated, at the same time engaging staff with the principle of improving investor protection.

All staff must be adequately trained and the compliance function should support the business units in the area of investment services and activities with any training requirements. Training and other support should focus particularly, but not exclusively, on:

internal policies and procedures;
organisational structure in the area of investment services and activities; and
law and associated directives and other relevant supervisory and regulatory requirements as well as any changes to these.

Training should be appropriate, and performed on a regular basis, as well as on a needs basis.

Compliance staff should also provide assistance to staff from the operational units in their day-to-day business and be available to answer any related questions.

The compliance function needs to be involved in the development of the relevant policies and procedures in the area of investment services, activities and ancillary services. In order to achieve this, the compliance function should, for example, be able to provide compliance expertise and advice to business units about strategic decisions, new business models and the launch of an advertising strategy. In the event the business unit does not follow compliance's advice, the compliance function is responsible for documenting this and including it in the compliance reports.

The compliance function needs to be involved in all significant changes in the organisation structure of the investment firm related to investment services, activities and ancillary services, including the decision-making process related to the approval of new business lines or new financial products. Business units should be encouraged to consult with the compliance function regarding their operations.

The compliance function should be aware of all material non-routine correspondence with CySEC regarding investment services and activities.

2.5 General Guideline 5 – Organisation of the Compliance Function

When considering the appropriate allocation of resources to the compliance function, the investment firm needs to take into account the scale and types of their investment services, activities and ancillary services.

Compliance staff need to have the authority necessary to exercise their duties effectively, as well as access to all relevant information concerning the investment services and activities, and ancillary services undertaken.

The compliance officer should have sufficiently broad knowledge and experience and a sufficiently high level of expertise to be able to assume the responsibility for the compliance function as a whole and ensure that it is effective.

The resources (staff, IT and other resources) required for the compliance function depends to a large extent on the nature of the business undertaken by the firm. As a result, additional compliance resources may be required when the business is significantly expanded.

It is the responsibility of the persons who effectively direct the business of the investment firm to regularly monitor that the resource levels of the compliance function remain adequate for the fulfilment of their duties.

If the investment firm establishes budgets for specific functions or units, the budget allocated to the compliance function should be consistent with the level of compliance risk the firm is exposed to. The budget should be set in consultation with the compliance officer. Any significant cuts in the budget should be documented in writing and contain detailed explanations.

The investment firm must ensure that compliance staff have access to the relevant information at all times, including databases, internal and external audit reports, and any other reports needed for the appropriate execution of their function. If relevant, the compliance officer should also be able to attend meetings of the board of directors.

In-depth knowledge of the investment firm's organisation, corporate culture and decision-making processes is required in order to be able to identify which meetings are important for the compliance officer to attend.

In order to ensure that compliance staff have the authority required for their duties, the persons who effectively direct the business should support them in the exercise of these duties. Authority implies possessing adequate expertise and relevant personal skills, and may be enhanced by the investment firm's compliance policy explicitly acknowledging the specific authority of the compliance staff.

All compliance staff should have knowledge of the law and regulations governing the operation of the investment firm, as far as these are relevant for the performance of their tasks. Compliance staff should be regularly trained in order to maintain their knowledge. A higher level of expertise is necessary for the designated compliance officer.

The compliance officer should demonstrate sufficient professional experience to be able to assess the compliance risks and conflicts of interest inherent in the business activities. In addition, the compliance officer should have specific knowledge of the different business activities of the investment firm.

2.6 General Guideline 6 – Performance of the Compliance Function

Investment firms need to ensure that the compliance function performs its tasks and responsibilities on a permanent basis, and should establish adequate arrangements for ensuring the responsibilities of the compliance officer are fulfilled when they are absent and adequate arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis.

The investment firm should ensure that the responsibilities of the compliance function are fulfilled adequately during any absence of the compliance officer, for example, by means of internal procedures and stand-in arrangements.

The authority of the compliance officer, their responsibilities and competences, need to be defined in a **compliance policy** or other general policies or internal rules that take account of the scope and nature of the investment firm's business. The policy needs to include information on the monitoring programme and the reporting duties of the compliance function, as well as information on the compliance function's risk-based approach to monitoring activities. Relevant amendments to regulatory provisions should be reflected promptly by adapting these policies or rules.

The compliance function is permanent and not just for specific circumstances. This requires regular monitoring on the basis of a monitoring schedule, which should cover all key areas of investment services and activities taking into account the compliance risk associated with the business areas. The compliance function should be able to respond rapidly to unforeseen events, and if necessary promptly change the focus of their activities.

2.7 General Guideline 7 – Independence of the Compliance Function

The compliance function needs to hold a position in the organisational structure that ensures that it can act independently when performing its tasks. The compliance officer is appointed and replaced by the board of directors.

While the persons who effectively direct the business of the firm are responsible for establishing an appropriate compliance organisation and for monitoring the effectiveness of the organisation that has been implemented, the tasks performed by the compliance function are carried out independently from senior management and other units.

Business units may not issue instructions or otherwise influence compliance staff and their activities.

In the event senior management deviates from important recommendations or assessments issued by the compliance function, these need to be documented and included in the compliance reports.

2.8 General Guideline 8 – Exemptions

In the event the investment firm considers that compliance with one or more of the requirements related to compliance staff is not proportionate to the nature, scale, and complexity of its business, it must assess whether the effectiveness of the compliance function is compromised by the proposed arrangements. This assessment should be reviewed regularly.

Investment firms are responsible for deciding which measures, including organisational measures and the level of resources, are best suited to ensuring the effectiveness of the compliance function in the investment firm's particular circumstances. Investment firms should take the following criteria into account in their decision-making process:

type of business activities provided;
interaction between the different business activities carried out;
scope and volume of the business activities, balance sheet total and income from commissions and fees, and other income;
type of financial instruments offered to clients;
type of clients targeted (professional, retail, eligible counterparties);
staff headcount;
whether the investment firm is part of an economic group;
services provided through a commercial network, such as tied agents or branches;
cross-border activities; and
organisation and sophistication of the IT systems.

Proportionality exemption may, for example, be applied when the performance of the necessary compliance tasks does not require a full-time position, due to the nature, scale and complexity of the business, and the nature and range of the investment services, activities and ancillary services offered.

Smaller firms may not require a dedicated compliance officer (ie, one that does not perform any other function), and in this case, the investment firm needs to ensure that conflicts of interest are minimised.

An investment firm may combine the compliance and legal functions, although this should be avoided for larger firms or firms with more complex activities when it could undermine the compliance function's independence.

An investment firm that uses the proportionality exemption needs to record its justification so that the competent authority is able to assess this.

2.9 General Guideline 9 – Combining the Compliance Function with Other Internal Control Functions

The compliance function should generally not be combined with the internal audit function, although it may be combined with other control functions as long as this does not compromise the effectiveness and independence of the compliance function. The chosen combination of functions and the underlying reasons need to be documented in order for CySEC to be able to assess whether the proposed combination of functions is appropriate for the investment firm.

In general, compliance staff should not be involved in any of the activities they monitor, but combining the compliance function with other control units such as money laundering prevention, may be acceptable, as long as it does not generate any conflicts of interest.

The combination of compliance and internal audit is likely to undermine the independence of the compliance function since internal audit is responsible for the oversight of the compliance function and this combination should therefore be avoided. There are, however, circumstances in which this combination may be the most appropriate, for example, in an investment firm that consists of only two people. In this event, the investment firm should discuss the proposed combination with CySEC. In any case it will be the responsibility of the investment firm to ensure that the responsibilities of each function are properly discharged (ie, soundly, honestly and professionally).

Whether or not the compliance function is combined with other control functions, the compliance function should co-ordinate its activities with the second-level control activities performed by other units.

2.10 General Guideline 10 – Outsourcing of the Compliance Function

When outsourcing all or part of the compliance function, the investment firm must ensure that all applicable requirements are fulfilled. When outsourcing all or part of the compliance function, the investment firm has to ensure it meets all outsourcing requirements for critical or important functions outlined in the law. The persons who effectively direct the business of an investment firm remain responsible for the fulfilment of the existing responsibilities.

As part of the assessment of a service provider, the investment firm should perform due diligence to ensure that the service provider meets the relevant criteria. The investment firm needs to ensure that the service provider has the necessary authority, resources, expertise and access to all relevant information in order to perform the outsourced compliance tasks effectively. The extent of the due diligence assessment depends on the nature, scale, complexity and risk of the tasks and processes that are outsourced.

Investment firms must ensure that the outsourced compliance function remains permanent in nature, ie, the service provider should be able to perform the function on an ongoing basis and not only in specific circumstances.

The investment firm needs to monitor whether the service provider performs its duties adequately, including monitoring of the quality and the quantity of the services provided. The persons who effectively direct the business of an investment firm are responsible for the supervision and monitoring of the outsourced function on an ongoing basis, and need to have the necessary resources and expertise to be able to fulfil this responsibility. They may appoint a specific person to supervise and monitor the outsourced function on their behalf.

Outsourcing of the compliance function within a group does not reduce the level of responsibility for the senior management of the investment firm. However, a centralised group compliance function can, in some cases, provide the compliance officer with better access to information, and lead to greater efficiency of the function, especially if the entities share the same premises.

Outsourcing is likely to be an appropriate alternative when an investment firm, due to the nature, size and scope of its business activities, is unable to employ compliance staff who are independent of the performance of services they monitor.

2.11 Training

Learning Objective

10.2.2 Understand the role compliance has in training and maintaining competence and awareness (Articles 31–39)

In line with General Guideline 4, it is the responsibility of the investment firm to ensure that their staff are adequately experienced and trained. The compliance function needs to support the business units in their training needs, and in particular all staff that are (in)directly involved in the provision and performance of investment services and activities.

In particular, training and other support should focus on the following:

internal policies and procedures of the investment firm and its organisational structure in the area of investment services and activities; and
the law, relevant directives, and other supervisory and regulatory requirements that may be relevant, as well as any changes to these.

Training should be performed on a regular basis, with needs-based training performed when necessary. Training should be delivered as appropriate, for example, to the investment firm's entire staff as a whole, specific business units, or a particular individual.

Training should be developed on an ongoing basis so that it takes into account all relevant changes such as new legislation, standards or guidelines issued by CySEC, and changes in the investment firm's business model.

The compliance function should periodically assess whether staff in the area of investment services and activities hold the necessary level of awareness and are able to apply the firm's policies and procedures correctly.

3. Systems and Controls in an Automated Trading Environment

Guideline GD–IF–05 covers:

the operation of an electronic trading system by a regulated market or a multilateral trading facility;
the use of an electronic trading system, including a trading algorithm, by a CIF for dealing on own account or for the execution of orders on behalf of clients; and
the provision of direct market access or sponsored access by a CIF as part of the service of the execution of orders on behalf of clients.

Learning Objective

10.3.1 Understand the eight general guidelines on systems and controls in an automated trading environment for trading platforms and CIFs (Articles 14–113)

10.3.2 Assess the effectiveness of business continuity arrangements

10.3.3 Apply suitable testing methodologies for a compliance monitoring programme

10.3.4 Assess trading scenarios to determine the likelihood of market manipulation: ping orders; quote stuffing; momentum ignition; layering and spoofing (Articles 74)

There are eight general guidelines for systems and controls in automated trading environments relating to trading platforms and CIFs operating in the Republic.

3.1 General Guideline 1 – Suitability of Trading Systems – Regulated Markets and MTFs

The electronic trading system(s) of regulated markets or MTFs must be compliant with the relevant laws and directives, while taking into consideration technological advancements and trends in the use of technology by their members/participants or users. Any system(s) should be well adapted to the business they cater for and robust enough to ensure continuity and regularity in the performance of the automated market(s) operated by the market operator or CIF.

Trading platforms need, at a minimum, to take into account the following:

a. **Governance** – trading platforms must procure and monitor their electronic trading systems through a clear and formalised governance process, embedding compliance and risk management principles.
b. **Capacity and resilience** – regulated markets' and MTF's electronic trading systems should have sufficient capacity to accommodate expected future trading volumes.
c. **Business continuity** – trading platforms must have effective business continuity

arrangements in relation to their electronic trading system(s) to address disruptive incidents.

d. **Testing** – the implementation of an electronic trading system or any updates to the system(s) must be subject to clearly defined development and testing methodologies.
e. **Monitoring and review** – electronic trading systems should be monitored in real time, and any problems identified as soon as possible, prioritised, and adequately dealt with. Trading platforms need to review and evaluate their electronic trading systems and associated processes and procedures periodically in order to make sure that they remain continually effective.
f. **Security** – physical and electronic security needs to be in place, designed to protect the electronic trading systems from misuse and unauthorised access, and to ensure the integrity of the data.
g. **Staffing** – trading platforms must ensure they employ sufficient numbers of staff with the necessary skills and expertise to manage, monitor and test their electronic trading system(s) and the type of trading that will be undertaken using the system(s).
h. **Record-keeping and co-operation** – records need to be maintained to cover the above in sufficient detail to allow CySEC to monitor compliance with the relevant obligations. CySEC needs to be informed of any significant risk that may affect the sound management of the technical operations of the system and major incidents that could give rise to these risks.

3.2 General Guideline 2 – CIF's Electronic Trading Systems

The electronic trading system(s) of a CIF and the trading algorithms need to comply with the applicable rules and regulations, as well as the rules of the trading platforms to which it sends orders. The system(s) should be well suited to the types of transactions it processes and needs to be robust enough to ensure continuity and regularity of its operations. The following needs to be taken into account:

a. **Governance** – CIFs need to procure and monitor their electronic trading systems through a clear and formalised governance process, embedding compliance and risk management principles.
b. **Capacity and resilience** – CIFs electronic trading systems should have sufficient capacity to accommodate expected future trading volumes.
c. **Business continuity** – CIFs must have effective business continuity arrangements in relation to their electronic trading system(s) to address disruptive incidents.
d. **Testing** – CIFs need to subject the implementation of their electronic trading system(s) or any updates to the system(s) to clearly defined development and testing methodologies.
e. **Monitoring and review** – CIFs should monitor their electronic trading systems in real time, and any problems need to be identified as soon as possible, prioritised and adequately dealt with. They also need to periodically review and evaluate their electronic trading systems and associated processes and procedures in order to make sure that they remain continually effective.
f. **Security** – CIFs should have in place arrangements for physical and electronic security, designed to protect the electronic trading systems from misuse and unauthorised access, and to ensure the integrity of the data.

g. **Staffing** – CIFs need to ensure they employ sufficient numbers of staff with the necessary skills and expertise to manage, monitor, and test their electronic trading system(s) and the type of trading that will be undertaken using the system(s).
h. **Record-keeping and co-operation** – CIFs should maintain records for at least five years to cover the above in sufficient detail to allow CySEC to monitor compliance with the relevant obligations. CySEC should be informed of any significant risk that may affect the sound management of the technical operations of the system and major incidents that could give rise to these risks.

3.3 General Guideline 3 – Fair and Orderly Trading – Regulated Markets and MTFs

The rules and procedures of regulated markets and MTFs relating to fair and orderly trading on their electronic platforms must be appropriate to the nature and scale of trading, the types of members, participants, users and trading strategies. Rules and procedures need to include, at a minimum, the following:

a. **Members or participants who are not credit institutions or investment firms** – adequate due diligence needs to be undertaken on persons who are not credit institutions or investment firms under EU law, their trades need to be monitored and associated risks need to be managed. Non-CIF members or participants should follow the CIF guidelines.
b. **IT compatibility** – standardised conformance testing should be in place to ensure that the IT systems used by members and participants to access the platform have a minimum level of functionality compatible with the trading platform's IT system(s) and will not pose a threat to fair and orderly trading.
c. **Pre- and post-trade controls** – trading platforms need to have minimum requirements for pre- and post-trade controls on the trading activities of the members and participants. In addition to controls for unauthorised access, the controls should include filtering on price and quantity.
d. **Trader access and knowledge** – standards need to be in place covering the knowledge of members and participants who will be using the order entry systems.
e. **Limits to access and intervention on transactions** – trading platforms need to have the ability to deny members or participants access to all or part of their systems and to cancel, amend or correct a transaction. The processes and procedures need to be transparent to all participants.
f. **Excessive flooding of the order book** – procedures need to be in place limiting participants on order entry capacity.
g. **Capacity limits** – procedures need to be in place to prevent capacity limits on messaging being breached.
h. **Constrain or halt trading** – in order to maintain an orderly market, arrangements such as volatility interruptions or the automatic rejection of orders outside a predefined set of volume and price thresholds to constrain trading or to halt trading in financial instruments need to be in place.
i. **Obtaining information** – members and participants need to provide information to facilitate the monitoring of compliance with the rules and procedures of the regulated market or MTF.
j. **Monitoring** – markets need to be monitored as close to real time as possible for signs of

disorderly trading by staff who understand the functioning of the market. These staff members need to be accessible to CySEC and have the authorisation to take remedial action when necessary to ensure fair and orderly trading.

k. **Record-keeping and co-operation** – records need to be maintained to cover the above in sufficient detail to allow CySEC to monitor compliance with the relevant obligations. CySEC needs to be informed of any significant risk that may affect the sound management of the technical operations of the system and major incidents that could give rise to these risks.

3.4 General Guideline 4 – Fair and Orderly Trading

CIFs must have policies and procedures to ensure that their automated trading activities comply with the rules and regulations, and in particular that risks related to the trading activities are covered. The following points need to be included:

a. Price or size parameters.
b. CIFs should be able to block or cancel orders automatically when:
   the order does not meet predefined price or size parameters for the type of financial instrument;
   the trader does not have permission to trade in the specific financial instrument;
   the risk compromises the CIF's own risk-management thresholds.
c. **Consistency with regulatory and legal framework** – the electronic systems of CIFs and the orders these generate, should be consistent with the applicable rules and regulations.
d. **Reporting to supervisors** – CySEC needs to be informed of any significant risk that may affect the fair and orderly trading and major incidents that could give rise to these risks.
e. **Overriding of pre-trade controls** – procedures need to be in place to deal with orders that have been blocked automatically by the pre-trade controls but that can be executed. Any overrides of pre-trade controls need to be reported to compliance and risk management and require their approval prior to overriding the cancellation.
f. **Training on order entry** – employees involved in order entry need to have adequate training in order entry procedures and the compliance with requirements imposed by trading platforms.
g. **Monitoring and accessibility of knowledgeable and mandated staff** – orders should be monitored in as close to real time as possible for potential signs of disorderly trading by staff who understand the trading flow. These staff members need to be accessible to CySEC and the trading platforms on which the CIF is active. In addition, they should have the authority to take the necessary remedial action.
h. **Close scrutiny by compliance staff** – in order to be able to respond to and correct any failures and breaches of regulations quickly, the compliance function needs to be able to closely follow the CIF's electronic trading activities.
i. **Control of messaging traffic** – CIFs need to be able to control messaging traffic to individual trading platforms.
j. **Operational risk** – appropriate and proportionate governance arrangements, internal controls, and internal reporting systems need to be in place to manage operational risks.
k. **IT compatibility** – systems used to access a trading platform need to have a minimum level of compatibility that is compatible with the trading platform's electronic trading

systems and does not pose a threat to fair and orderly trading.

l. **Record-keeping and co-operation** – records need to be maintained for at least five years to cover the above in sufficient detail to allow CySEC to monitor compliance with the relevant obligations. CySEC needs to be informed of any significant risk that may affect the sound management of the technical operations of the system and major incidents that could give rise to these risks.

3.5 General Guideline 5 – Preventing Market Abuse – Regulated Markets and MTFs

Trading platforms should have effective policies and procedures to identify any conduct by its members or participants that may involve market abuse, and in particular market manipulation. Potential cases of market manipulation that are of particular concern in an automated trading environment include:

1. **Ping Orders** – entering small orders to ascertain the level of hidden orders, particularly used to assess what is resting on a dark platform.
2. **Quote Stuffing** – entering large numbers of orders and/or cancellations/updates to orders so as to create uncertainty for other participants, slowing down their process and to camouflage their own strategy.
3. **Momentum Ignition** – entry of orders, or a series of orders, intended to start or exacerbate a trend, and to encourage other participants to accelerate or extend the trend in order to create an opportunity to unwind/open a position at a favourable price.
4. **Layering and Spoofing** – submitting multiple orders often away from the touch on one side of the order book, with the intention of executing a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed.

Arrangements and procedures in relation to the identification and prevention of market abuse and market manipulation need to include:

a. **Staffing** – trading platforms need to have sufficient staff with an understanding of regulation and trading activity, the skill to monitor trading activity in an automated trading environment, and identify behaviour giving rise to suspicions of market abuse.
b. **Monitoring** – the systems should have sufficient capacity to monitor orders and transactions with a sufficient level of time granularity including high frequency generation of orders, low latency transmission, and any behaviour that may involve market abuse.
c. **Identification and reporting of suspicious transactions** – arrangements to identify and report suspicious transactions should also cover orders that require a suspicious transaction report (STR) to CySEC.
d. **Review** – periodic reviews and internal audits need to be undertaken to prevent and identify possible market abuse.
e. **Record-keeping** – records need to be maintained for at least five years to cover the above, including effective audit trails in sufficient detail to allow CySEC to monitor compliance with the relevant obligations. CySEC needs to be informed of any significant risk that may affect the sound management of the technical operations of the system.

3.6 General Guideline 6 – Preventing Market Abuse – Investment Firms

CIFs should have policies and procedures in place to minimise the risk that their automated trading activity gives rise to market abuse and, in particular, market manipulation. Particular types of market manipulation that are of concern are outlined in Guideline 5 above.

In addition, the arrangements and procedures in relation to the identification and prevention of market abuse and market manipulation need to include:

a. **Compliance staff** – CIF compliance staff should have sufficient understanding, skill and authority to challenge trading staff when the trading activity gives rise to suspicions of market abuse (in particular market manipulation).
b. **Training** – initial and regular refresher training on what constitutes market abuse for all individuals involved in executing orders on behalf of clients and dealing on own accounts.
c. **Monitoring activity** – adequate systems need to be in place to monitor activities of individuals and algorithms trading on behalf of the CIF, as well as trading activities of clients.
d. **Identification and reporting of suspicious transactions** – arrangements to identify and report suspicious transactions should also cover orders that require an STR to CySEC.
e. **Review** – periodic reviews and internal audits need to be undertaken to prevent and identify possible market abuse.
f. **Access to staff and record-keeping** – CIFs should maintain sufficiently detailed records for at least five years of the above arrangements and procedures, including audits and STRs made to CySEC and how the alerting of possible suspicious behaviour is dealt with.

3.7 General Guideline 7 – Providing Direct Market Access – Regulated Markets and MTFs

When members or participants are allowed to provide direct market access (DMA)/sponsored access (SA) they need to ensure it is compatible with fair and orderly trading. Trading platforms and their members or participants need to retain control of, and closely monitor, their systems to minimise any potential disruption caused by third parties to avoid trading platforms that are vulnerable to either the potential misconduct or market abuse of DMA/SA clients or to their inadequate/erroneous systems.

Trading platforms should determine whether or not it is permissible for their members or participants to offer DMA and/or SA. If they allow members or participants to offer DMA and/or SA, their rules and procedures should at least take account of the following:

a. **Ultimate responsibility for messages and orders** – the member/participant remains solely responsible for all messages and orders entered under its trading codes and therefore may be subject to interventions and sanctions for any breaches of the rules or procedures in respect of those orders.
b. **Subsidiary responsibility** – DMA/SA arrangements between trading platforms and a DMA/SA provider firm should stress that the provider remains responsible to the

trading platform for all trades using their market participant code.

c. **Requirements to provide DMA/SA** – members or participants need to have adequate systems and effective controls, including pre- and post-trade controls, to ensure that the provision of DMA/SA does not adversely affect compliance with the rules of the regulated market or MTF, lead to disorderly trading or facilitate conduct that may involve market abuse.
d. **Due diligence** – members or participants are responsible for due diligence on clients to which they provide DMA/SA.
e. **Right of access** – requests for members or participants to allow a client to be provided with SA may be refused when the regulated market or MTF is not satisfied that this is consistent with its rules and procedures for fair and orderly trading.
f. **Monitoring** – orders sent to their systems by a member or participants' SA clients need to be monitored by the trading platform.
g. **Potential interventions** – trading platforms should be able to suspend or withdraw an SA or stop an individual's orders if the regulated market or MTF is not satisfied that continued access is consistent with its rules and procedures for fair and orderly trading. Trading platforms should have the ability to stop orders from a person trading through SA separately from the orders of the member or participant sponsoring that person's access. Trading platforms should be allowed to undertake a review of a member's or participant's internal risk control systems in relation to their sponsored access or direct market access clients.
h. **Record-keeping** – trading platforms should keep records for at least five years of their policies and procedures relating to DMA/SA and any significant incidents relating to SA trading. The records should be sufficiently detailed to enable CySEC to monitor compliance with the relevant obligations of trading platforms.

3.8 General Guideline 8 – Providing Direct Market Access – CIFs

CIFs offering DMA/SA to clients are responsible for the trading of those clients and need to establish policies and procedures to ensure the trading of those clients complies with the rules and procedures of the relevant trading platforms.

CIFs should at least take account of the following:

a. **Due diligence** – CIFs are responsible for conducting due diligence assessment on prospective DMA/SA clients which should be reviewed periodically.
b. **Pre-trade controls** – pre-trade controls should be carried out on orders of DMA/SA clients to ensure fair and orderly trading.
c. **Market access** – the practice of sending client orders to a regulated market or MTF (naked or unfiltered market access) is prohibited by law. All SA client orders must pass through the CIF's pre-trade controls.
d. **Monitoring** – orders sent to a trading platform by a CIF's DMA/SA client need to be monitored by the CIF.
e. **Rights and obligations** – CIFs need to establish clarity about rights and obligations of both parties in relation to the DMA/SA service.
f. **Record-keeping** – CIFs should keep, for at least five years, records of their policies and procedures relating to DMA/SA and any significant incidents relating to SA trading.

The records should be sufficiently detailed to enable the Commission to monitor compliance with the relevant obligations of trading platforms.

3.9 Business Continuity Planning (BCP)

Business continuity plans (BCPs) are concerned with ensuring that the firm is able to recover from an emergency, such as utility disruptions, software failures and hardware failures.

This should extend to incorporate disaster recovery, which is the process of regaining access to the data, hardware and software necessary to resume critical business operations after a natural or human-induced disaster. A disaster recovery plan (DRP) should also include plans for coping with the unexpected or sudden loss of key personnel.

DRP is part of the larger process of BCP.

A 'disaster' could be any one or more of the following kinds of events, ranked by increasing severity:

One or more of the applications that the firm uses to process its business is lost, either as a result of a software or hardware failure. The failure is in one of the firm's own systems, and it is the only firm affected.

An external application on which the firm is dependent (such as one provided by an exchange or clearing house system or an information provider's system) is lost, either as a result of a software or hardware failure. Other user firms with which the firm trades are also dependent on this application.

The firm is the victim of an event such as fire, flood or criminal or terrorist-related activity, and has lost access to one of its key buildings. Other neighbouring businesses may also be affected. In locations such as the City of London or downtown Manhattan, where there is a large concentration of investment firms, there is the likelihood that many of the firm's trading parties and critical suppliers may also be affected.

3.10 Effectiveness of BCP Arrangements

Testing the effectiveness of BCP arrangements is important due to the significant reliance on IT systems. The plans need to be up to date and tested, for example, by undertaking an exercise in which it is assumed that the bank's systems are no longer working and that the BCP need to be invoked. The results of the test, including any problems that have occurred, need to be reported and addressed.

3.11 Suitable Testing Methodology for Compliance Monitoring

Firms need to establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm with the rules and regulations. Managers, employees and representatives need to comply with all obligations under the regulatory system, and compliance needs to be tested using, for example, spot reviews of departments, and sample testing of transactions. Compliance monitoring needs to be tested on a regular basis to ensure ongoing compliance and to ensure that the institution is not used for money laundering, the financing of terrorism, or any other form of fraud or deception. Any test should be proportional to the risk.

3.12 Examples of Market Manipulation

There are a number of types of transactions that constitute market manipulation. In order to ensure transactions are not entered into with the intent to manipulate prices, they need to be monitored on a regular basis. The most common types of market manipulation are outlined in this section.

Ping Orders

Ping orders are small orders entered in order to ascertain the level of hidden orders and are particularly used to assess what is resting on a dark platform. Ping orders are a way for market participants to assess the market direction, and are not automatically an offence.

Quote Stuffing

Quote stuffing is defined as the tactic of quickly entering and subsequently withdrawing large orders in an attempt to flood the market with quotes that competitors have to process, thus causing them to lose their competitive edge in high-frequency trading. Quote stuffing is made possible by the application of high-frequency trading programmes that can execute market actions with incredible speed. This type of market manipulation requires a direct link to the exchange in order to be effective and can therefore only be undertaken by market makers and other large players in the market.

Momentum Ignition

Momentum ignition is a strategy that attempts to trigger other market participants to trade quickly and thus cause a temporary movement in price. The originator profits from the price change by being able to buy or sell at the new price level. The price typically reverts back to the original price levels after the initial change. Momentum ignition is affiliated with high frequency trading strategies, and typically occurs when the originator has taken a pre-position. Momentum ignition can be identified from volume spikes and outsized price movements.

The below example from Credit Suisse research provides some further insight into this strategy.[1]

Example

Daimler AG, 13 July 2012

Source: Credit Suisse AES Analysis

[1] http://www.zerohedge.com/news/2012-12-14/momentum-ignition-markets-parasitic-stop-hunt-phenomenon-explained quoting from Credit Suisse research

To pinpoint momentum ignition, we search for:

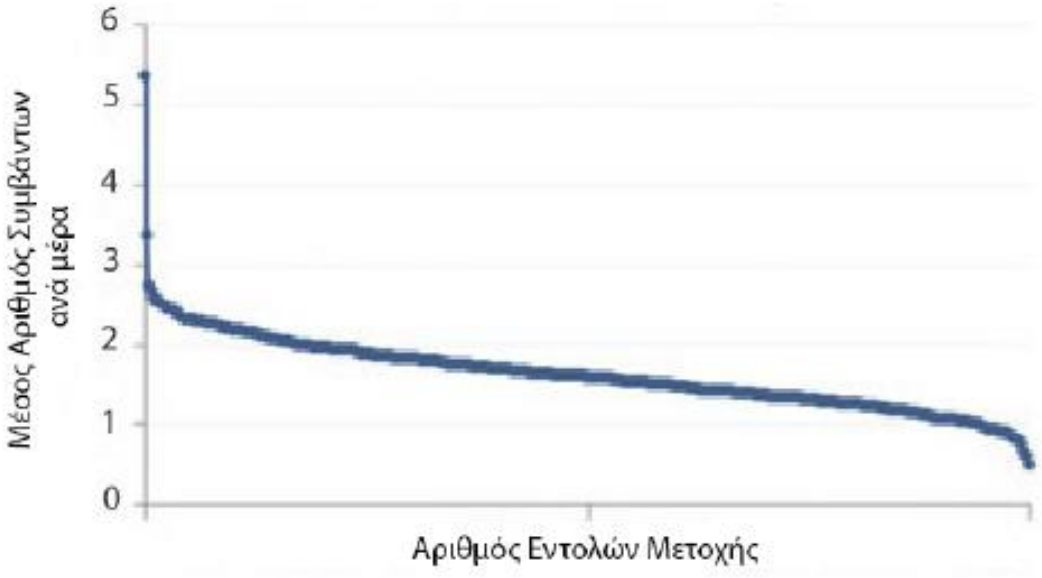
Stable prices and a spike in volume (Box 1).
A large price move compared to the intraday volatility (Box 2).
Reversion (Box 3).

Though we cannot conclusively determine the intention behind every trade, this is the kind of pattern we would expect to emerge from momentum ignition. We use this as a proxy to estimate the likelihood and frequency of these events.

Likelihood and Rapid Price Moves

As shown in the following figure, we estimate that momentum ignition occurred on average 1.6 times per stock per day for STOXX 600 names in Q3 2012, with almost every stock in the STOXX 600 exhibiting this pattern on average once a day or more.

Frequency of Momentum Ignition Patterns



Source: Credit Suisse AES Analysis, STOXX 600 Jul – Sep 2012

In addition, we note that the average price move is 38bps (but over 5% are more than 75bps, with some significantly higher), and the time it takes for that move to occur is approximately 1.5 minutes.

4. Suitability Requirements

Guideline GD–IF–04 assesses the suitability requirements ensuring the CIF, when providing investment and ancillary services to clients, acts honestly, fairly and professionally in accordance with the best interests of its clients.

Learning Objective

10.4.1 Understand the nine guidelines relating to aspects of the suitability requirements (Articles 6–62)

10.4.2 Evaluate the effectiveness of a suitability assessment (Articles 6–62)

10.4.3 Apply appropriate information-gathering techniques for the following financial instruments: complex; risky; illiquid (Articles 32)

10.4.4 Evaluate the reliability of client information (Articles 44–45)

There are nine guidelines related to the assessment of suitability of investments and financial instruments for clients that investment firms need to follow.

4.1 General Guideline 1 – Assessing Suitability

Investment firms should inform clients, clearly and simply, that the reason for assessing suitability is to enable the firm to act in the client's best interest. The investment firm's own responsibilities should be made clear. Information on investment advice and portfolio management services should include information about the suitability assessment which refers to the process of collecting information about a client, and the subsequent assessment of the suitability of a given financial instrument for that client. The suitability assessment is not limited to recommendations to buy a financial instrument and every recommendation should be suitable irrespective of whether it is a recommendation to buy, hold or sell.

Information about the suitability assessment should help clients to understand the purpose of the requirements and should encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation and investment objectives.

The investment firm needs to ensure that the client understands the importance to gather complete and accurate information so that the investment firm can recommend suitable products or services. It is the investment firm's responsibility to make sure that the client understands investment risk, and the relationship between risk and return. To enable the client to understand investment risk, investment firms should consider using indicative, comprehensible examples of the levels of loss that may arise depending on the level of risk taken, and should assess the client's response to each scenario to assess the client's risk appetite and to determine the suitable types of financial instruments.

Investment firms need to ensure they do not give the impression that the client decides on the suitability of the investment, or that the client establishes which financial instruments fit his own risk profile.

For example, the investment firm should avoid indicating to the client that a certain financial instrument is the one that the client chose as being suitable, or requiring the client to confirm that an instrument or service is suitable.

4.2 General Guideline 2 – Understanding Clients and Investments

Policies and procedures need to be in place that enable the investment firm to understand essential information about the client and the characteristics of the financial instruments available to the client.

The policies and procedures need to enable the investment firm to collect and assess all information necessary to conduct a suitability assessment for each client. Information can, for example, be collected by using questionnaires to be completed by the client or during a discussion with the client.

The information necessary to conduct a suitability assessment includes different elements that may impact, for example, the client's financial situation or investment objectives. Examples of essential information include their age, marital status (especially the client's legal capacity to commit assets that may belong also to his partner); family situation and the impact on their financial situation; employment situation; and their need for liquidity. When determining what information is necessary, the investment firm should bear in mind the impact that any change in the information may have when assessing suitability of a financial instrument or investment strategy.

In addition investment firms should have good knowledge of the investments they offer, and they need to implement policies and procedures designed to ensure that they only recommend investments, or make investments on behalf of their clients, if the investment firm understands the characteristics of the product, or financial instrument, involved.

4.3 General Guideline 3 – Staff Qualifications

All investment firms need to make sure that all staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise relevant to their position. Staff members must understand the role they play in the suitability assessment process and possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulatory requirements and procedures, to discharge their responsibilities.

Staff members must have the skills necessary to be able to assess the needs and circumstances of the client, and in addition need to have sufficient expertise in financial markets to understand the financial instruments to be recommended (or purchased on the client's behalf), and to determine that the features of the instrument match the needs and circumstances of the client. Any staff members providing investment services, investment advice and portfolio management must be certified.

4.4 General Guideline 4 – Extent of Information to be Collected

Investment firms need to determine the extent of information to be collected from clients taking into consideration all features of the investment services that will be provided to the client.

Before providing investment advice or portfolio management services, an investment firm needs to collect **necessary information** about the client's knowledge and experience, their financial situation and their investment objectives. The extent of information that needs to be collected may vary depending on the client's requirements. In determining what information is necessary and relevant, the investment firm should consider:

the type of financial instruments or transactions the investment firm may recommend or undertake;
the nature and extent of the service that the investment firm may provide;
the nature, needs and circumstances of the client.

Although the extent of the information to be collected may vary, the standard for ensuring that a recommendation or an investment made on the client's behalf is suitable for the client will always remain the same. Investment firms can determine the level of information to be collected proportionate to the products and services they offer, or on which the client requests specific investment advice or portfolio management services. However, the investment firm may not lower the level of protection due to clients. For example, when providing access to complex or risky financial instruments, investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex or risky instruments are at stake. This is to ensure the investment firm can assess the client's capacity to understand, and financially bear, the risks associated with such instruments.

For illiquid financial instruments, the **necessary information** includes information on the length of time for which the client is prepared to hold the investment.

As information about a client's financial situation will always need to be collected, the extent of information to be collected may depend on the type of financial instruments to be recommended or entered into. For example, for illiquid or risky financial instruments, the **necessary information** to be collected may include all of the following:

the extent of the client's regular income and total income, whether the income is earned on a permanent or temporary basis, and the source of this income;

the client's assets, including liquid assets, investments and real property, including financial investments, personal and investment property, pension funds, and any cash deposits;
the client's regular financial commitments.

In determining the information to be collected, the investment firm should also take into account the nature of the service to be provided. Practically, this means that:

when providing investment advice services the investment firm should collect sufficient information in order to be able to assess the ability of the client to understand the risks and nature of each of the financial instruments that may be recommended to them;
when providing portfolio management services the level of knowledge and experience needed by the client may be less detailed, as long as the client understands the overall risks of the portfolio and possesses a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio.

The extent of the service requested by the client impacts the level of detail collected about the client. Investment firms should, for example, collect more information when a client is asking for investment advice covering their entire financial portfolio than for clients asking for specific advice on how to invest a relatively small part of their overall portfolio.

In addition, the nature of the client needs to be taken into consideration. More in-depth information is, for example, typically needed for older and potentially vulnerable clients asking for investment advice services for the first time. When dealing with professional clients, however, the investment firm may generally assume that the client has the necessary level of experience and knowledge, and therefore the investment firm does not need to collect data for these areas. Similarly, when dealing with a **per se professional client** the investment firm may assume that the client is able financially to bear any related investment risks consistent with the investment objectives of that client and therefore is not required to obtain information on the financial situation of the client. However, when the client's investment objectives demand it, for example, if the client is seeking to hedge a risk, the investment firm will need to collect further information.

The needs and circumstances of the client further determine the level of data to be collected. For example, a firm is likely to need more detailed information about the client's financial situation if the client's investment objectives are multiple and/or long-term than when the client seeks a short-term secure investment.

If an investment firm cannot obtain sufficient information to provide investment advice or portfolio management services suitable to the client, the investment firm must refrain from providing services to that client.

4.5 General Guideline 5 – Reliability of Client Information

Investment firms need to take reasonable steps to ensure that the information collected about clients is reliable. In particular, investment firms should:

a. **Not rely unduly on clients' self-assessment in relation to knowledge, experience and**

financial situation – self-assessments should use objective criteria. For example instead of asking:

a client whether he feels sufficiently experienced to invest in certain instruments, the investment firm could ask the client what types of instruments the client is familiar with;

whether clients believe they have sufficient funds to invest, the investment firm could ask for factual information about the client's financial situation;

whether a client feels comfortable with taking risk, the investment firm could ask what level of loss over a given time period the client is willing to accept, either on the individual investment or on the overall portfolio.

b. **Ensure that all tools employed in the suitability assessment process are appropriately designed** – when an investment firm relies on tools to be used by clients as part of the suitability process, such as online questionnaires or risk-profiling software, the investment firm needs to ensure that it has appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. For example, risk-profiling software could include controls of coherence of the replies provided by clients in order to highlight contradictions between different pieces of information collected. Reasonable steps need to be taken to mitigate any potential risks associated with the use of tools, for example, in situations when clients change their answers to obtain access to financial instruments not suitable for them.
c. **Take steps to ensure the consistency of client information** – in order to ensure the consistency of client information, firms should view the information collected as a whole. Investment firms should be alert to any relevant contradictions between different pieces of information collected, and contact the client in order to resolve any material potential inconsistencies or inaccuracies. Examples of such contradictions are clients who have little knowledge or experience and an aggressive attitude to risk, or who have a prudent risk profile and ambitious investment objectives.

Clients are expected to provide correct, up-to-date and complete information necessary for the suitability assessment. However, it is the responsibility of the investment firm to take reasonable steps to check the reliability of information collected, and to ensure that the information is adequate. The investment firm needs to make sure that the questions they address to their clients are likely to be understood correctly and that any other method used to collect information is designed in way to get the information required for a suitability assessment.

4.6 General Guideline 6 – Updating Client Information

If an investment firm has an ongoing relationship with the client, it needs to establish appropriate procedures in order to maintain adequate and updated information about the client in order to be able to perform the required suitability assessment.

Investment firms need to adopt procedures defining:

which information needs to be updated and with which frequency;

how the information needs to be updated and actions that need to be taken when additional information is received or in the event the client fails to provide the requested

information.

The frequency with which information needs to be updated may vary depending on, for example, clients' risk profiles. A higher risk profile is likely to require more frequent updating than a lower risk profile. In addition, certain events may trigger an update of information, such as reaching the age of retirement. Updating of information can, for example, be done as part of the periodic meetings with clients or by sending an updating questionnaire to clients. Relevant actions might include changing the client's profile based on the updated information collected.

4.7 General Guideline 7 – Client Information for Legal Entities or Groups

Investment firms need to rely on the applicable legal framework when identifying who should be subject to a suitability assessment in the following cases:

the client is a legal person; or
the client is a group of two or more natural persons; or
one or more natural persons are represented by another natural person.

In the event the legal framework does not provide sufficient indications in this regard, and no sole representative has been appointed the investment firm, based on a policy it has defined beforehand, needs to agree with the relevant persons who should be subject to the suitability assessment and how this assessment will be undertaken. This includes agreement on who will be providing information about knowledge and experience, financial situation and investment objectives.

The assessment of **expertise, experience and knowledge** required for small entities requesting to be treated as professional should be performed on **the person authorised to carry out transactions on behalf of the entity**. This applies equally to suitability assessment purposes and to cases where a natural person is represented by another natural person. Investment firms need to have a policy in place detailing how to deal with these situations, which should provide that the best interests of all the persons concerned and their need for protection are taken into consideration.

When there is no agreement on the most appropriate person, the investment firm should consider the following to be the most relevant persons:

a. **financial situations of the persons** – the person with the weakest financial situation;
b. **investment objectives** – the person with the most conservative investment objectives;
c. **experience and knowledge** – the person with the least experience and knowledge.

In situations when two or more persons are authorised to carry out transactions jointly on behalf of the group, the client profile, as defined by the investment firm, should reflect the ability of the different relevant persons to take investment decisions, as well as the potential impact of such decisions on their individual financial situation and investment objectives.

4.8 General Guideline 8 – Suitability of an Investment

Investment firms need to have policies and procedures in place for the matching of clients with suitable investments which need to ensure that they consistently take into account:

all available information about the client that is likely to be relevant in assessing whether an investment is suitable, including the client's current portfolio of investments (and asset allocation within that portfolio);
all material characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.

When an investment firm relies on tools in the suitability assessment process such as model portfolios, asset allocation software or a risk-profiling tool for potential investments, they should have appropriate systems and controls in place to ensure that the tools are fit for purpose and produce satisfactory results. These tools should be designed so that they take account of all the relevant specificities of each client or financial instrument. For example, tools that broadly classify clients or financial instruments are not fit for purpose.

Investment firms need to establish policies and procedures which enable them to ensure that:

the advice and portfolio management services provided to the client take account of an appropriate degree of risk diversification;
the client has an adequate understanding of the relationship between risk and return, for example, of the necessarily low remuneration of risk-free assets, the incidence of time horizon on this relationship, and the impact of costs on his investments;
the financial situation of the client can finance the investments and the client can bear any possible losses resulting from the investments;
any personal recommendation or transaction entered into in the course of providing an investment advice or portfolio management service, when an illiquid product is involved, takes into account the length of time for which the client is prepared to hold the investment; and
any conflicts of interest are prevented from adversely affecting the quality of the suitability assessment.

4.9 General Guideline 9 – Record-Keeping

At a minimum investment firms need to:

maintain adequate recording and retention arrangements to ensure orderly and transparent record-keeping regarding the suitability assessment, including any investment advice provided and all (dis)investments made;
ensure that record-keeping arrangements are designed to enable the detection of failures regarding the suitability assessment, such as misselling;
ensure that records kept are accessible to the relevant persons in the investment firm, and to competent authorities;
have adequate processes to mitigate any shortcomings or limitations of the record-keeping arrangements.

Record-keeping arrangements must be designed to enable the investment firm to track ex-post why an investment was made. This could be important in the event of a dispute between a client and the investment firm but is also important for control purposes. Failures in record-keeping may hamper a competent authority's assessment of the quality of an investment firm's suitability process, and may weaken the ability of management information to identify risks of misselling. To prevent this, investment firms are required to record all relevant information about the suitability assessment, such as information about the client, including how the information is used and interpreted to define the client's risk profile, and information about financial instruments recommended to the client or purchased on the client's behalf. Those records should include:

any changes made by the investment firm as part of the suitability assessment, in particular any change to the client's investment risk profile; and

the types of financial instruments that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them.

End of Chapter Questions (for revision purposes)

1. List the academic and professional requirements for CIF employees.
   Section 1

2. Describe each of the general guidelines for compliance.
   Section 2.1–2.10
3. What are the requirements for training?
   Section 2.11

4. Describe each of the general guidelines for automated trading.
   Section 3.1–3.8

5. What is the purpose of a business continuity plan?
   Section 3.9

6. Describe each of the suitability requirements.
   Section 4.1–4.9

1. The Supervisory Review and Evaluation Process (SREP)

The SREP is the supervisory tool for establishing the appropriate level of capital resources that a CIF should hold in order to meet its present and future capital requirements over a period of up to five years. **Guideline GD–IF–03** outlines how CySEC applies the supervisory review and evaluation process (SREP) when reviewing the CIFs' internal capital adequacy assessment processes (ICAAP) under the framework of the relevant paragraph of the Directive. The Directive is a transposition of the Directive 2006/48/EC and 2006/49/EC of the European Commission, which are based on the rules set by the Basel II Capital Accord of the Bank of International Settlements.

1.1 The Five Stages of SREP

Learning Objective

11.1.1 Understand the purpose of SREP (Section 2)

The supervisory review and evaluation process (SREP) comprises the processes and measures applied by CySEC to ensure that CIFs have sufficient capital to support all material risks to which their business exposes them and includes:

the review and evaluation of the CIF's internal capital adequacy assessment process (ICAAP) and strategies, as well as its ability to monitor and ensure its compliance with own funds requirements;

the imposition of supervisory measures in response to identified weaknesses in the internal control systems and risk management processes of the CIF. These measures include, among others, the additional capital in order to cover the risks encountered adequately, and the requirement to reinforce the arrangements, processes, mechanisms and strategies implemented by the CIF.

In determining the SREP framework, CySEC takes into account the following principles:

Risk approach – the SREP is an essential part of CySEC's risk-based overall supervisory approach.

Levels of application – all CIFs subject to the directive are required to prepare an ICAAP report and are subject to the SREP.

Activities – CySEC considers in the SREP all the activities of the CIF and all business units that give rise to significant risks, whether these are related to domestic or non-domestic operations.

Risks and governance – CySEC formally evaluates the CIF's business risks and internal governance (including risk controls, compliance and internal audit). The evaluation will focus on identifying each CIF's risk profile and assessing the quality of the CIF's risk management system. CySEC reviews the controls that have been put in place to mitigate risk, as well as the adequacy and composition of capital held against those risks. The evaluation is forward looking and it will use both qualitative and quantitative techniques.

Assessment and review – CySEC assesses the CIF's ICAAP as part of its SREP, including a consideration of the assumptions, components, methodology, coverage and outcome of the CIF's ICAAP.

Compliance assessment – as part of the SREP, CySEC evaluates the CIF's compliance with the minimum requirements under the CRD, in addition to the ICAAP requirement, eg, large exposures requirements.

Identification of risks and deficiencies – the SREP identifies existing or potential problems and key risks faced by the CIF, deficiencies in its control and risk management frameworks, and assesses the degree of reliance that can be placed on the outputs of the ICAAP. This enables CySEC to tailor its supervisory approach to each individual CIF, and encourage CIFs to improve their risk management systems.

Measures – as part of the SREP, the CySEC needs to have sufficient information to identify any supervisory actions or prudential measures that need to be applied to the CIF.

Communication – as part of the dialogue between the CIF and the supervisory authority, CySEC will communicate the results of its risk assessment to the management or/and the board of directors of the CIF, including any supervisory measures that have been applied. CySEC may also provide qualitative feedback to the CIF about the adequacy of its risk management and internal controls in relation to its business risk profile.

Evaluation and revision – the annual review does not constitute a full risk assessment of the CIF. On a periodic basis, CySEC will assess any significant changes to the overall risk profile of the CIF. This will take into account the results of any supervisory visits, inspections and other information received during the period, and will consider whether the timing of the next full assessment remains appropriate. Any significant new information received in the course of ongoing monitoring and supervision which may affect the CIF's risk profile will trigger consideration of the need for a formal review or full risk assessment.

1.2 The Five Stages of SREP

Learning Objective

11.1.2 Understand the five key stages of the SREP: planning; review and assessment of ICAAP; review of

CySEC has implemented the SREP process as outlined in the diagram below, identifying five stages from planning through to validation.

Planning – this phase refers to CySEC's internal planning of the SREP for each CIF. Part of this relates to CySEC's request to a CIF to submit an ICAAP report.

Review and assessment of ICAAP submission – during this phase CySEC typically undertakes a desk-based review of the ICAAP, the process followed by the CIF in the preparation and any additional documentation supporting ICAAP. In addition, this phase may include an on-site assessment of the implementation of the ICAAP process.

Review of additional information – this phase includes the outcome of the ongoing supervision and other inspections or visits that have taken place in the most recent past and that are relevant to the ICAAP. In addition, the CIF's controls and governance, as well as the results of the SREP onsite review and overall compliance with the rules and regulations, may be subject to review.

Supervisory measures for risk mitigation – during this phase, CySEC sets the capital resource requirements for Pillar 2, and imposes any necessary supervisory measures for mitigating risks.

SREP validation – CySEC's internal validation process of the results of the SREP.

Communication between the CIF and CySEC will take place throughout the process.

1.3 SREP Outcomes

Learning Objective

11.1.3 Understand SREP outcomes (Section 7)

The outcome of the SREP should define the level of capital that the CIF should hold, in order to cover the full spectrum of risks it faces. This level of capital, which may be higher than the capital calculated in the CIF's own assessment (ICAAP), will form the CIF's capital requirement.

The CIF's management is responsible for monitoring the level of capital resources held against the capital requirements set at the SREP, and ensuring that it has sufficient capital to cover the requirements set. The CIF is responsible for informing CySEC if the level of capital resources is below the capital requirements set at the SREP, or if it is expected to fall below it in the CIF's planning horizon.

Once the SREP is completed, subsequent periodic reviews will take place with different frequencies per CIF depending on their complexity, the nature of their business, risks and systemic importance. At least annually, any change in circumstances needs to be assessed. In case any of the key assumptions underpinning the CIF's ICAAP change, or its risk profile alters, and this results in a situation in which the capital requirement no longer adequately reflects the underlying risks, the re-assessment may need to be brought forward. In any event, it is expected that the CIF will notify CySEC of any such changes.

2. The Purpose of the Internal Capital Adequacy Assessment Process (ICAAP)

The outcome of the internal capital adequacy assessment process (ICAAP) represents the view of the CIF on the capital it should hold, given its risk profile and complexity of its business. It serves as input to the SREP. **Guideline GD–IF–02** addresses the distinctive components and framework for the implementation of the internal capital adequacy assessment process (ICAAP) providing the guidelines on how the provisions of the Directive in terms of the ICAAP should be interpreted and applied in practice. Furthermore, this document, in conjunction with the document regarding the supervisory review and evaluation process (SREP), sets out the principles and methods which the Commission intends to apply for assessing the capital requirement calculations of the CIFs under its supervision. The Directive is a transposition of Directives 2006/48/EC and 2006/49/EC of the European Commission, which are based on the rules set by the Basel II Capital Accord of the Bank of International Settlements.

2.1 General Guideline 1 – Compliance Risk Assessment

Learning Objective

11.2.1 Understand the purpose of the ICAAP process (Section 1.3.1)

The ICAAP is a set of processes, procedures and measures implemented by a CIF to ensure:

appropriate identification and measurement of risks;
appropriate level of internal capital in relation to their risk profile; and
application and further development of suitable risk management and internal control systems.

2.2 Principles for Implementation

Learning Objective

11.2.2 Understand the principles for the implementation of an ICAAP (Section 2)

The implementation of an ICAAP process is subject to the following principles:

Assessment of capital adequacy relative to risk profile – every CIF must have an effective and sound ICAAP process in place.

Responsibility for ICAAP – the CIF is responsible for implementing the ICAAP process, based on regulatory requirements and guidelines, and for setting target levels of own funds, consistent with its risk profile and operating environment. Even when part or all of the ICAAP procedures are outsourced, the CIF remains fully responsible for its ICAAP.

Design, documentation and implementation – the ICAAP's design should be fully specified and the capital policy needs to be fully documented. The responsibility for initiating and designing the ICAAP rests with the board of directors and senior management of the CIF. The board of directors should approve the design of the ICAAP, while the detailed implementation is the responsibility of senior management. The CIF's ICAAP should be formally documented. The results of the ICAAP should be reported to the management and the board of directors of the CIF.

Integral part of management process and decision-making culture – the ICAAP should form an integral part of the CIF's management processes, so as to enable the board of directors and senior management of the CIF to assess, on an ongoing basis, the risks that are inherent in their activities and material to the CIF.

Regular review – the ICAAP should be reviewed by the CIF at least annually or, if required, more frequently to ensure that risks are covered adequately and that capital coverage reflects their actual risk profile. The ICAAP and its review process should be subject to independent assessment by a function or person that has not been involved in the ICAAP process, such as the internal audit function. Any changes in the CIF's strategic focus, business plan, operating environment or other factors that materially affect assumptions or methodologies used in the ICAAP should initiate appropriate adjustments to the ICAAP.

Risk-based – the additional capital charge for the CIF will be significantly dependent on its risk profile and operating environment. All considerations and factors taken into account for the set of an internal capital target need to be presented through the dialogue with CySEC and the assessment procedure for each one should be explained and documented.

Comprehensive – the ICAAP should capture all material risks to which the CIF is exposed. Although no standard categorisation of risk types and definition of materiality is provided, ICAAP should cover risks covered under Pillar 1, risks not fully captured under Pillar 1 (eg, operational risk, concentration risk) and all risks covered under Pillar 2 (eg, strategic risk, liquidity risk, reputation risk).

Forward looking – the ICAAP should be strongly interconnected with the strategic plans of the CIF and a forward capital plan should be put in place for a three- to five-year period. The CIF should conduct appropriate stress tests which take into account, all the material risks identified and analyse the impact of the test to the future capital requirements of the CIF.

Measurement and assessment – effective assessment and measurement processes need to be in place for all risks faced, taking into consideration the complexity of operations and availability of resources. The approaches and methodologies adopted could either be quantitative or qualitative.

Reasonable outcome – the ICAAP should produce a reasonable overall capital number and assessment. The CIF should be able to provide CySEC with the adequate evidence and justification of the methods used to derive the final capital requirements for Pillar 2.

2.3 Roles and Responsibilities of Stakeholders

Learning Objective

11.2.3 Understand the roles and responsibilities of CIF stakeholders in the ICAAP process: board of directors and senior management (Section 3.5); risk management function; finance function; internal audit function; departments; external consultants

In line with the rules and regulations, CIFs have the freedom to design their ICAAP, as long as they incorporate suitable measures and processes. CIFs need to be able to demonstrate to CySEC that their ICAAP is complete and appropriate given the risks inherent in their business. The ICAAP should be an integral part of the risk management practices of the firm, and not just used for supervisory purposes.

Given the ICAAP's key importance, its definition, design and ongoing development is the responsibility of the board of directors and senior management. The ICAAP may not be seen in isolation and needs to be incorporated into the CIF's strategic and operations management. The essential parameters of ICAAP need to be determined in the strategic management process, and include the CIF's risk strategy and risk policy principles. Clear and transparent reporting lines and responsibilities for implementation need to be established. The ICAAP forms part of ongoing risk management. The results and reports generated by the ICAAP should serve as a basis for management decisions and control.

Key players in the implementation of the ICAAP and their responsibilities are presented in the table below.

CIF Stakeholder	ICAAP Responsibility
Board of Directors and Senior Management	Definition of corporate objectives and risk strategies; risk profile; and the associated processes, procedures, and documentation. Definition of strategies and procedures for adherence to capital requirements (limits) and for risk-based capital allocation. Dissemination of information on these strategies and procedures to the employees concerned. Establishment of a suitable internal control system, paying particular attention to the ICAAP. Functional and organisational segregation of responsibilities and management of conflicts of interest. Ensuring that employees have the necessary qualifications. At least annually review the systems, procedures and processes and make amendments if necessary. Review, approval and understanding of the ICAAP.
Risk Management Function	Design of the risk management system. Preparation of the risk management policies and procedures. Identification of all risks. Establishment of methods of risk monitoring and measurement. Preparation and implementation of the ICAAP. Application of stress testing scenarios and analysis of the results. Proposal for a capital allocation for Pillar 2. Provision of ICAAP training to relevant employees and senior management.
Finance Function	Preparation of the budgets in accordance with the strategic plan approved by the board of directors. Preparation of the capital plan based on the budgets in co-ordination with the risk management function.
Internal Audit Function	Independent confirmation that the process followed is according to board of directors' requirements. Independent review of the risk assessment, stress testing and

	capital allocation exercises performed and confirmation of their compliance with the policies and procedures approved by the board of directors. Independent validation of all numbers included in the ICAAP report and confirmation of their agreement with the financial records of the CIF.
Departments	Compliance and co-operation with the request for collection of data for the implementation of the ICAAP and preparation of the ICAAP report. Provision of information and support to the application and adoption of all risk management policies and procedures approved by the board of directors.

2.4 Pillar 1 Risks

Learning Objective

11.2.4 Understand types of Pillar 1 risk (Section 4.4.3.1)

Under Pillar 1 of the Capital Requirements Directive (CRD) and the Basel Capital Accord, three types of risks are identified that need to be managed.

2.4.1 Credit Risk

Credit risk is the risk of loss of principal or financial reward caused by the borrower's failure to repay a loan or otherwise meet a financial obligation. The percentage interest due on a loan reflects the risk taken by the lender.

CIFs should ensure that they effectively identify, measure, monitor and control credit risk which could include an assessment of whether the CIF's credit risk is fully captured in the capital assessed by Pillar 1. Credit risks that should be assessed include the following:

granting credit limits to clients for trading purposes;
investments in bonds and other instruments when there is counterparty credit risk;
provision of loans to other entities.

2.4.2 Market Risk

Market risk is the risk to value, earnings, or capital arising from movements of risk factors in financial markets. This risk includes interest rate risk (including real- and nominal interest rates, credit spreads and basis spreads), currency risk, equity risk (including dividend risk), and commodity risk (including precious metals) and risks from changes in volatilities or correlations. Market risk is one of the Pillar 1 risks.

CIFs dealing on their own account are directly exposed to market risk. In addition, indirect exposure to market risk occurs when the firm acts as an agent to fulfil a customer order in the event that the transaction does not clear or settle properly.

2.4.3 Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

Although operational risk is one of the most significant risks CIFs are exposed to, its calculation under the Basel Capital Accord is based on approximation, not a true calculation of the actual risk. Therefore, additional factors need to be considered when determining the exposure of the CIF, including the impact of the loss of key individuals on the ability to operate normally, consequences of not complying with conduct of business requirements, and internal or external fraud. In addition, the consequences of an operational risk event occurring need to be considered, bearing in mind the systems and controls in place to mitigate these risks. Tolerance for errors and losses needs to be taken into account.

As part of their risk assessment process CIFs should consider historical operational costs arising due to matters such as trading errors or other unexpected costs. Similarly, the CIF should ensure that it has adequately tested its business continuity procedures to ensure that they function adequately and are suitable as risk mitigants.

In order to evidence adequate capital has been earmarked to ensure the continued existence of the CIF, senior management should be able to demonstrate that the possibility of severe operational risk losses has been considered. Any deficiencies need to be addressed by applying risk mitigants other than capital.

Risk resulting from limitations in control and management could be a significant factor for smaller CIFs. The concept of proportionality means that supervisors will not expect the same degree of sophistication of governance arrangements and controls that could be found in a large CIF. The overall risk profile of a smaller CIF may, however, be higher and smaller CIFs are expected to consider the risk resulting from limitations in control and management as part of their internal capital assessment. Important focus should be given to the control mechanisms in place to safeguard client's assets held by the CIF.

2.5 Risks not Fully Covered in Pillar 1

Learning Objective

11.2.5 Understand risk typologies not fully covered in Pillar 1 (Section 4.4.3.2): credit concentration risk; residual risk; securitisation risk; settlement risk; foreign exchange risk

There are a number of risk types that are not fully covered within Pillar 1 of the CRD and Basel Capital Accord.

Credit concentration risk – a risk concentration is any single exposure or group of similar exposures (eg, to the same borrower or counterparty, geographic area, industry or other risk factors) with the potential to produce losses large enough (relative to a CIF's earnings, capital, total assets or overall risk level) to threaten a CIF's ability to maintain its core operations or a material change in a CIF's risk profile. Risk concentrations should be analysed at both a local legal entity level and a consolidated basis. An unmanaged concentration in a subsidiary may appear immaterial at the consolidated level, but can still threaten the viability of the subsidiary itself. For most CIFs concentration risk is significant and is most likely the result of large exposures to a limited number of counterparties, a large transaction or a single product type.

Residual risk – occurs, for example, as a result of the low performance or failure of credit risk mitigation techniques such as ineffective documentation, or delay or inability to realise payment from a client in a timely manner.

Securitisation risk – is represented by the effect of a securitisation arrangement failing, or of the values and risks transferred not emerging as expected on the financial position of a CIF. When assessing securitisation exposure, a CIF should ensure that it fully understands the credit quality and risk characteristics of the underlying exposures in structured credit transactions, including any risk concentrations.

Settlement risk – is the risk that one party fails to deliver the asset or cash value at the time of settlement of a trade. This is of particular importance when transferring funds on behalf of clients.

Foreign exchange risk – is the risk of movement in foreign exchange rates resulting in a loss for the CIF. Due to the high liquidity and volatility of the market, these losses can be significant and it is therefore essential for CIFs to identify, measure and manage their foreign exchange risk effectively. The risk is not confined to proprietary positions and extends to known profit flows in foreign currencies, client-driven transactions and provisions for bad debts denominated in foreign currency.

2.6 Pillar 2 Risks

Learning Objective

11.2.6 Understand types of Pillar 2 risk (Section 4.4.3.3)

In addition to credit, market, and operational risk, there are a number of risks that are identified in Pillar 2.

2.6.1 Liquidity Risk

Liquidity risk is defined as the risk that a CIF has insufficient financial resources to meet its current and prospective obligations, as they fall due, or can only secure these resources at excessive costs. Liquidity risk can arise from:

inability to manage unplanned decreases or changes in funding sources;
failure to recognise or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

CIFs need to assess their exposure to liquidity risk, their ability to respond to liquidity drainage in the market and their ability to repay all their obligations to clients at all times. A liquidity contingency plan needs to be in place to enable the CIF to handle liquidity shortages.

2.6.2 Business Risk

Capital is risk sensitive and may vary over time as business cycles and conditions change. Deterioration in business or economic conditions may result in a situation that additional capital is required at a time when market conditions are unfavourable. In order to assess expected capital requirements over economic and business cycles, CIFs need to project their financial position forward, taking into consideration their business strategy, expected growth, an assessment of the changes in economic and business cycles, and other factors such as competition, and lower than expected performance. This will enable the CIF to assess the level of changes it can sustain in its environment. Projections will need to be made for a three- to five-year period to calculate the projected capital resource requirement. The CIF needs to assess whether it can meet the projected capital requirements from its expected financial resources.

CIFs are exposed to performance risk and need to assess how they will manage their relationships with clients during periods of poor performance. In addition, performance risk may affect a CIF's ability to generate income.

2.6.3 Legal and Compliance Risk

Legal and compliance risk may arise as a result of breaches or non-compliance with legislation, regulations, practices or ethical standards:

investment advice – legal risk of breaching the customer's obligations, for example, by providing unsuitable advice;
execution-only services – risk of not executing orders appropriately.

Additionally non-compliance and possible penalties from CySEC should be taken into consideration under this risk category. Anti-money laundering practices should also be assessed as part of the compliance with regulatory requirements.

2.6.4 Reputational Risk

Reputational risk is the adverse perception of the image of the CIF by customers, counterparties, investors or regulators.

It may arise from providing poor customer service or from fines imposed by CySEC that create a negative feeling towards the CIF from the market.

2.6.5 Strategic Risk

Strategic risk occurs as a result of adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

A CIF needs to assess the impact of its business plans on its capital over the time horizon which it uses in its business plan.

2.6.6 Group Risk

Group risk applies to all subsidiaries that are part of a group which is established either in the Republic, another member state, or a third country. Group risk relates to the risks that emanate from the relationship that the CIF has with other group entities. For example, a CIF that has a parent in a third country which does not apply Basel II rules and has exposure to high political risk, needs to assess the possibility of being indirectly adversely impacted from a political event in the set-up stage of the parent company.

CySEC considers this risk of high importance and requires that each CIF which falls into this category adequately evaluates the risks that could arise from the relationship with other entities of the group or the parent.

2.6.7 Additional Risks Identified

When assessing the adequacy of their capital, CIFs should consider the impact of external factors. Material risks arising from the ICAAP review itself should be detailed in the report including the nature of the risks and their possible impact. The effectiveness of any mitigating controls needs to be considered and, for Pillar 2 purposes, an adequate amount of capital should be held.

2.7 Risk Register and Stress Testing

Learning Objective

11.2.7 Understand the following risk management tools: risk register (Section 4.4.3.4); stress testing (Section 4.5)

2.7.1 Risk Register

A risk register is used by a CIF to document and categorise all risks that it is, or could be, exposed to in the future. The risk register includes an indication of severity of the risk and the adverse impact it could have had on the CIF if it had remained unidentified.

The impact can be measured either in quantitative or qualitative terms, such as economic loss, capital loss, reputational loss and loss of human life. The result of the assessment will be the profiling of risks in different categories of severity.

2.7.2 Stress Testing

Stress testing is a general term, covering quantitative and qualitative techniques and risk management methodologies that can be applied by financial institutions to obtain an overview of their exposure or vulnerability to the impacts of exceptional but possible events that may occur due to rare risk events that can have severe consequences. Stress testing has gained significant importance as a result of the most recent financial and economic crisis and needs to be an integral part of the ICAAP and risk management framework of every CIF.

The purpose of stress tests required in the ICAAP is to assess all material risks of the CIF in a comprehensive, integrated and forward-looking manner. The scope of stress tests includes the consideration of the impact of all market, economic, institutional or political risk factors which may have a perceivable, substantial impact on the prudent and solvent operation of the CIF.

CySEC believes that there is no single **correct** stress testing methodology. The range of approaches acceptable for a specific CIF depends on its size, activities, risk appetite and the quality of risk management. The applied stress-testing methodology needs to be sufficiently sophisticated given its circumstances, and needs to comply with the regulations. Stress tests applied under the framework of the ICAAP in business and regulatory practice usually relate to three main methods:

Sensitivity analysis – based on less complex methodologies, the sensitivity analysis illustrates how a CIF's position changes in the event a single relevant risk factor is modified, while all other factors remain equal. The main advantage is that the magnitude of losses and risks for a specific factor are relatively easy to determine. The main disadvantage is that sensitivity analysis considers factors in isolation, which is not the case in real life.

Scenario analysis – assumes the simultaneous change of several risk factors and quantifies their combined impact on the position of a CIF. The analysis is based on expected, hypothetical and historic scenarios. The main advantage is that scenario analysis takes the relationship between risk factors into consideration, which allows for an integrated approach to risk. The main disadvantage is that, in the event of a crisis, interrelations between risk factors are not necessarily stable.

Reverse stress testing – primarily designed to be a risk management tool for the identification of vulnerabilities and defects in the business model, reverse stress testing requires a CIF to assess scenarios and circumstances that would render its business models unviable. Reverse stress testing starts with the outcome of a business failure and identifies the circumstances under which these outcomes might occur. Based on the analysis of the results, senior management should determine whether triggers are required for future action in the event a particular scenario would develop.

Stress tests need to meet the following characteristics:

must be defined with a view to the CIF's portfolio characteristics and assumed risks, and in line with the external environment;

need to be reviewed annually, as well as at the time of any (expected) changes to the factors and revised as necessary;

need to be suitable for the specific circumstances, risk profile and operational model of the CIF;

must be forward looking, and therefore take into consideration the current position as well as any future strategic developments;

the impact of adverse scenarios must demonstrate any future impacts on the profitability and capital adequacy of the CIF.

As part of the assessment process, management actions need to be defined and assigned to responsible people and departments for implementation. Once implemented, the stress test should be run again to observe any changes on the impact.

End of Chapter Questions (for revision pusposes)

1. Describe the five stages of the SREP process.
   Sections 1.1 and 1.2

2. Summarise the SREP outcomes.
   Section 1.3

3. List the ICAAP principles.
   Section 2.2

4. Describe the responsibilities of the risk management function in ICAAP.
   Section 2.3

5. Define operational risk.
   Section 2.4.3

6. List the typologies not fully covered in Pillar 1.
   Section 2.5

7. Describe business risk.
   Section 2.6.2

8. Define the three methods of stress testing.
   Section 2.7.2

GLOSSARY

Alternative Investment Fund (AIF)

A collective investment scheme (CIS) as defined by the Alternative Investment Fund Manager Directive (AIFMD).

Alternative Investment Fund Manager (AIFM)

A firm authorised and regulated by CySEC for the provision of fund management control of an alternative investment fund.

Authority for the Supervision and Development of Co-operative Societies (ASDCS)

The supervisory authority for co-operative credit institutions, and its powers are outlined in the co-operative societies law.

Bank

Body corporate licensed to carry on banking business under the provisions of the banking law.

Best Execution

The financial institution needs to obtain the best price for a trade in the shortest possible time. It is a precautionary measure placed on financial institutions to ensure they meet their clients' best interests.

Business Continuity Plan (BCP)

Business continuity plans are concerned with ensuring that the firm is able to recover from an emergency such as utility disruptions, software failures and hardware failures.

Capital Adequacy

Amount of capital a financial institution is required to hold as prescribed by the regulator.

Collective Investment Scheme (CIS)

A generic term encompassing authorised unit trusts, common investment funds, CISs and investment trust companies.

Compliance Function

Operates independently and is responsible for:

monitoring and assessing the adequacy and effectiveness of the policies and procedures; and
advising and assisting of the relevant persons responsible for carrying out investment services and activities.

Cypriot Investment Firm (CIF)

A company that is:

established in Cyprus; and

authorised by the Cyprus Securities and Exchange Commission (CySEC) to provide one or more investment services to third parties and/or perform one or more investment activities.

Cyprus Securities and Exchange Commission (CySEC)

CySEC operates on the basis of the Cyprus Securities and Exchange Commission (establishment and responsibilities) law and is the supervisory authority of investment firms (IFs).

Depositary

Party assigned with the safekeeping of the assets. The depositary has the function of the treasurer.

Disaster Recovery

The process of regaining access to the data, hardware and software necessary to resume critical business operations after a natural or human-induced disaster.

Eligible Counterparty

Authorised financial institution and national government and their corresponding offices.

European Securities and Markets Authority (ESMA)

An EU authority which is responsible both for drafting the legislation and for guiding it through EU implementation, overseeing national implementation and enforcement.

Feeder Undertaking for Collective Investment in Transferable Securities (UCITS)

UCITS or investment compartment of a UCITS that has been approved to invest at least 85% of its total net assets in UCITS or other collective investment funds.

Inducement

Receipt of a fee, commission, or non-monetary benefit specifically aimed at the bank making an investment decision without consideration whether this is in the best interest of the client.

Inside Information

Information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have in the opinion of CySEC, a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

Integration

Third and final step in the money laundering process. At this final stage, the layering has been successful and the ultimate beneficiary appears to be holding legitimate funds (clean money rather than dirty money). The money is regarded as integrated into the legitimate financial system.

Investment Activity

Activities or services undertaken in relation to a financial instrument.

Investment Services and Activities Regulated Markets Law 144(I) of 2007 (Law 144(I))

Amended a number of times between 2007 and 2012. It defines investment services and activities, and how regulated markets can operate in the Republic of Cyprus.

Investor Compensation Fund

Fund to secure the claims of the covered clients against the members of the fund through the payment of compensation.

Layering

Second stage of the money laundering process. Involves moving the money around in order to make it difficult for the authorities to link the placed funds with the ultimate beneficiary of the money. This may involve buying and selling foreign currencies, shares or bonds in rapid succession, investing in CISs, or insurance-based investment products, or moving the money from one country to another.

Management Company

Company managing one or more UCITS, collective investment schemes, or VCICs.

Market Manipulation

Transactions or orders that give, or are likely to give, false or misleading signals regarding the demand, supply or price of financial instruments.

Transactions or orders that secure, or are likely to secure, an abnormal or artificial price level for a financial instrument.

Transactions or orders which employ fictitious devices or any other form of deception or contrivance.

Dissemination of information which gives, or is intended to give, false or misleading signals in relation to a financial instrument and when the person knew, or ought to have known that the information was false or misleading.

Master Undertaking for Collective Investment in Transferable Securities (UCITS)

UCITS or investment compartment of a UCITS which has at least one feeder UCITS under its unitholders, is not a feeder UCITS, and does not hold units of a feeder UCITS.

Member State

State within the European Union (EU).

Pillar 1

The rules in the New Basel Capital Accord that define the minimum ratio of capital to risk-weighted assets.

Pillar 2

The supervisory review pillar of the New Basel Capital Accord which requires supervisors to undertake a qualitative review of a bank's capital allocation techniques and compliance with relevant standards.

Placement

First stage of a money laundering process. Introduction of the money into the financial system; typically, this involves placing the criminally derived cash into a bank or a co-operative credit institution account, a bureau de change or any other type of enterprise which can accept cash, such as a casino.

Professional Client

Clients that meet the following criteria:

Entities required to be authorised or regulated to operate in the financial markets, including those authorised by an EU member state.

Large undertakings meeting two of the following size requirements:

balance sheet total at least €20.000.000;

net turnover at least €40.000.000;

own funds at least €2.000.000.

3. National and regional governments, public bodies managing public debt, central banks, international and supranational institutions and other similar international organisations.
4. Other institutional investors whose main activity is to invest in financial instruments.

Regulated Market

Multilateral system managed or operated by a market operator that brings together, or facilitates the bringing together, of multiple third-party buying and/or selling interests in financial instruments.

Risk Management

The risk management function is responsible for the implementation and maintenance of adequate risk management policies and procedures that enable the bank to identify all risks they are subject to and risk tolerance levels will be set.

Senior management

Persons who are in the position to (in)directly exercise significant influence over management.

Supervisory Review and Evaluation Process (SREP)

The processes and measures applied to ensure that CIFs have sufficient capital to support all material risks to which their business exposes them.

Tied Agent

A person established in a member state, who, acting under the full and unconditional responsibility of only one IF of a member state, on whose behalf it acts, promotes investment or/and ancillary services, attracts clients or prospective clients, receives and transmits client orders in respect of investment services or financial instruments, places financial instruments or/and provides advice to clients or prospective clients in respect of those financial instruments or services

Undertaking for Collective Investment in Transferable Securities (UCITS)

An undertaking with the sole object of:

being the collective investment in transferable securities and/or other liquid financial instruments;
using capital raised from the public;
operating on the principle of risk-spreading; and
having units which are redeemed or repurchased out of the undertaking's assets on request of the investor.

AIF

Alternative Investment Fund

AIFM

Alternative Investment Fund Manager

AIM

Alternative Investment Manager

ASDCS

Authority for the Supervision and Development of Co-operative Societies

BCP

Business Continuity Planning

CBC

Central Bank of Cyprus

CDD

Customer Due Diligence

CET

Common Equity Tier

CIF

Cypriot Investment Firm

CIS

Collective Investment Scheme

CPD

Continuous Professional Development

CRD

Capital Requirements Directive

CSE

Cyprus Stock Exchange.

CySEC

Cyprus Securities and Exchange Commission

DMA

Direct Market Access

DRP

Disaster Recovery Plan

EBA

European Banking Authority

EC

European Commission

ECB

European Central Bank

EEA

European Economic Area

EPM

Efficient Portfolio Management

ESMA

European Securities and Markets Authority

ESRB

European Systemic Risk Board

ETF

Exchanged-Traded Fund

EU

European Union

FATF

Financial Action Task Force

FCA

Financial Conduct Authority

ICAAP

Internal Capital Adequacy Assessment Process

IF

Investment Firm

MiFID

Markets in Financial Instruments Directive

ML

Money Laundering

MOKAS

The Unit for Combating Money Laundering

MTF

Multilateral Trading Facility

OEIC

Open-Ended Collective Investment Scheme

OTC

Over-The-Counter

SA

Sponsored Access

SI

Systematic Internaliser

SPV

Special Purpose Vehicle

SREP

Supervisory Review and Evaluation Process

STR

Suspicious Transaction Report

UCI

Undertakings for Collective Investment

UCITS

Undertakings for Collective Investment in Transferable Securities

VaR

Value-at-Risk

VCIC

Variable Capital Investment Company