The obligations of Cyprus Funds under EMIR

By Mr. Alexandros Constantinou

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The European Market Infrastructure Regulation (‘EMIR’) No 648/2012, as amended, has entered into force in August 2012 with the objective of increasing the transparency of the derivatives market and reducing the systemic as well as counterparty and operational risk in the derivatives market. EMIR applies to undertakings established in the EU who enter into financial derivative contracts, including Funds and their Managers.

Pursuant to EMIR, a counterparty that enters into derivative transactions should ensure that (i) derivative contracts are reported to a Trade Repository (‘TR’), (ii) Over-The-Counter (‘OTC’) derivatives subject to the clearing obligation are cleared with a Central Counterparty (‘CCP’) and (iii) in respect of OTC derivative contracts not cleared by a CCP it applies appropriate risk mitigation measures.

The extent to which the above requirements apply to Funds depends on how Funds are classified under EMIR.

How are Funds in Cyprus classified under EMIR?

In broad terms, all Funds established in Cyprus are categorised as Financial Counterparties (‘FCs’) and are therefore subject to the full range of obligations imposed by EMIR.

AIFs and AIFLNPs whose manager is not authorised or registered in accordance to Directive 2011/61/EU (‘AIFMD’) are classified as Non-Financial Counterparties (‘NFC’) and are subject to fewer obligations compared to FCs.

However, a Cyprus/EU AIF which is managed by an authorised non-EU AIFM (subject to extension of the passport) should be classified as an FC whereas if marketed in Cyprus/EU without a passport by a non-EU AIFM it should be classified as an NFC, as it would be an undertaking established in the EU not managed by authorised or registered AIFM.

EMIR Obligations

1) Reporting to a trade repository

Due to the fact that Funds are generally the counterparties to a derivative transaction, they are expected to report the details of the derivative contract to a TR authorised by the European
Securities and Markets Authority (‘ESMA’). This information should be reported no later than the next working day following the conclusion, modification or termination of the contract. In this respect, each Fund is expected to obtain a Legal Entity Identifier (LEI) in order to fulfil its reporting obligations. In practice, the Fund Manager will usually report the transaction(s) to a TR on behalf of the Funds it manages (without prejudice to the Fund’s liability to meet its reporting obligations); in this case, the counterparty ID (i.e. LEI) should be the ID of the Fund whilst the ID of the Manager will be provided as the report-submitting entity.

It is noted that the EMIR reporting obligation applies equally to both FCs and NFCs in regards to exchange-traded and OTC derivative transactions whether cleared or not.

2) Clearing obligation

As of January 2018, the derivatives which have been declared by ESMA as being subject to the clearing obligation are certain categories of swaps (e.g. on LIBOR), forward rate agreements (e.g. on EONIA, FedFunds, SONIA etc.) and credit default swaps. ESMA may include additional classes of financial instruments as subject to the clearing obligation in the future. Counterparties to OTC derivative contracts are obliged to clear those contracts through a CCP authorised by an EEA regulator or recognised by ESMA.

This abovementioned clearing obligation applies to OTC contracts concluded between:

- Two FCs;
- One FC and one NFC that exceeds the predefined clearing thresholds (hereinafter referred to as “NFC+”);
- Two NFCs+;
- One FC/NFC+ and a third country entity that would be subject to the clearing obligation if it was established in the EU; or
- Two third country entities that would be subject to the clearing obligation if they were established in the EU but only in case the contract has ‘a direct, substantial and foreseeable effect within the Union’ or where it is ‘necessary or appropriate to prevent the evasion’ of EMIR.

3) Risk Mitigation Techniques

FCs and NFCs that enter into an OTC derivative contract not cleared by a CCP need to have appropriate procedures to mitigate operational and counterparty credit risk, including:

a. the timely confirmation of the terms of the relevant OTC derivative contract;

b. procedures to reconcile portfolios;

c. processes to identify and resolve disputes between parties and monitor the value of outstanding contracts.

FCs and NFCs+ shall mark-to-market on a daily basis the value of outstanding contracts, have risk-management procedures that require the segregated exchange of collateral with respect to OTC derivative contracts whilst FCs shall also hold adequate capital to manage the risk not covered by exchange of collateral.

Future Developments

The European Commission has published a proposal for amending EMIR which is likely to affect the status and obligations of certain Funds that trade derivatives. Among others, the proposal broadens the definition of an FC to include all AIFs established in the Union, rather than the existing definition which covers only AIFs managed by AIFMs authorised or registered in accordance with AIFMD. As a result, some Funds will move from NFC to FC status having, in this way, additional obligations under EMIR.

Alexandros Constantinou is a Director and the Head of Compliance Services and Research Department of MAP S.Platis. He has extensive experience in advising international financial services organisations on regulatory and risk management matters.

Alexandros joined MAP S.Platis in 2008 and since then he has led and developed the compliance support services and regulatory research division of the firm. His work
involves, inter alia, the provision of consultation and opinions to a large number of internationally-active Investment Firms and Investment Managers on legislative matters such as MiFID, MiFID II/MiFIR, EMIR, AMLD 4, AIFMD, UCITS, PRIIPs/KIDs, Market Abuse, Transparency. He frequently contributes to the advancement of local and European regulation and acts as an instructor and speaker at numerous seminars, training courses and other events on regulatory and compliance matters.

Alexandros is an MCSI member of the Chartered Institute for Securities & Investment (CISI) and holds an Advanced Certification from the Cyprus Securities & Exchange Commission. He also holds a BSc in Computer Science from the University of Reading (UK) and an MSc in Finance and Investment from the University of Edinburgh (UK).

Artificial Intelligence: The rise of the machines in the Funds Industry?

By Ms. Emily Trescothick
Operations Director, Mellstock Limited

General Introduction and background

When you think of the words Artificial Intelligence or A.I., a lot of people instantly think of classic films such as the “Terminator” franchise, “Robocop”, “A.I.”, or “The Matrix” movies. In many of these films, the hero is on the run and attempting to outwit the dreaded machine who appears to be on a never-ending blood-thirsty mission of destruction. A.I. was almost always portrayed as something to be feared and caused by human’s over-reliance on machinery. In reality, though, A.I. has revolutionised the way we do business by improving organisational efficiency and streamlining processes.

For many business functions like sales, marketing and customer service etc, you can now read how A.I. can be used for that function. Such as forecasting sales, automated sales activities and optimising product placements, just to name a few. When we start looking at individual industries such as Financial Technology or FinTech, then the uses of A.I. start to become mind-blowing.

When choosing a Financial Institution, the two very human qualities you’ll most likely be looking for are trust and sound decision-making. You need to trust that institution with your deposit/capital and they need to be able to make good decisions to match your deposit with the right opportunity. Surely these kinds of very human-like tasks couldn’t possibly be carried out by a machine? Well, you may be surprised to learn just how many processes and tasks within financial businesses are carried out by an A.I. computer.

So where is A.I. used in Fintech?

Below is a list of examples where A.I. has been put to good use in the FinTech industry, (source: www.appliedAI.com, 2018):

Fraud Detection: Leverage machine learning to
detect fraudulent and abnormal financial behaviour, and/or use A.I. to improve general regulatory compliance matters and workflows. Lowering operational costs by limiting exposure to fraudulent documents.

**Insurance & InsurTech**: Leverage machine learning to quote optimal prices, manage claims effectively and improve customer satisfaction while reducing costs. Detect customer’s risk profile and provide the right plan.

**Financial Analytics Platform**: Leverage machine learning, Natural Language Processing, and other A.I. techniques for financial analysis, algorithmic trading, and other investment strategies or tools.

**Expense Reporting**: Use machine learning to improve basic business accounting, including expense reporting. Reduce approval workflows and processing cost per unit.

**Credit Lending & Scoring**: Use A.I. for robust credit lending applications. Use predictive models to uncover potentially non-performing loans and act accordingly. See the potential credit scores of customers before they apply for a loan and provide custom tailored plans.

**Billing**: Leverage accessible billing services that remind customers to pay. Increase loan recovery ratios. Use automated invoice systems for business.

**Robo-Advisory**: Use A.I. chatbot and mobile app assistant applications to monitor personal finances. Set your target savings or spending rates for your own goals. Your own finance assistant will handle the rest and provide you with insights to reach financial targets.

**Regulatory Compliance**: Use Natural Language Processing to quickly scan legal and regulatory text for compliance issues and do so at scale. Handle thousands of pieces of paperwork, without any human interaction.

**Data Gathering**: Use A.I. to efficiently gather external data such as sentiment and other market-related data. Wrangle data for your financial models and trading approaches.

**Debt Collection**: Leverage A.I. to ensure compliant and efficient debt collection process. Effectively handle any dispute and see your success right through to eventual debt collection.

**Human error, human touch?**

While all these technological advances are, and sound great, how often have you needed to speak with someone at customer support urgently only to be frustrated by the automated voice at the end of the phone? Or using a “livebot” such as the latest Facebook Business Messenger Service only to get a response of “We’re very sorry, but we didn’t understand the question?” To err, is to human, but somehow it still seems better when you have that personal touch in someone actually listening to you, and feeling that at least there is a chance of finding a solution.

It would seem like we still have some way to go yet in terms of duplicating human engagement. In 2016, Microsoft famously had to withdraw their Chatbot “Tay” after it learned how to swear and issue racial insults after engaging with people within 24 hours on Twitter. Using bad language at an irate customer would have surely ended with “Tay” appearing in a disciplinary hearing if it was a human employee.

**Buy the salesperson, not the product**

So, it would seem that the best and most harmonic solution is finding the right balance between using A.I. whilst still maintaining that all-important human touch. This is especially so when it comes to marketing and selling your product. Our purchasing choices are often driven by the emotional part of the brain even when it comes to necessary purchases such as toilet paper. If I said just two words, ‘toilet paper’ and ‘puppy’, you would probably instantly think “Andrex” and remember cute commercials of a beautiful Labrador puppy running around the house streaming tissue paper everywhere. Those emotive images help conjure up that important word trust. The best way of building trust is in establishing relationships which is why the human touch is critical.
Establishing the ‘Why’

One of the fundamental aspects of marketing your brand is in establishing the “why” in “Why we do, what we do”. It’s exactly the “why” that helps identify your unique selling point in distinguishing yourself from your competitors. One of the great Thought Leaders, Simon Sinek, says that by establishing your inspiration behind what you do, that powerful message will further inspire your customers.

Here at Mellstock, we pride ourselves in helping our customers find their “why” through the synergy of utilising technology whilst maintaining that all-important human touch. With so many advances in data mining, marketing can help select your target audience and help optimise the best places to market your fund, with human interpretation to make sure your inspiration and message is delivered correctly.

So will A.I. soon replace us?

With so many advances it would appear that the initial “fear factor” behind A.I. and technology fully replacing humans has gone. A recent study carried out by EY in March 2018, and published by the MIT Technology Review, established that the majority of those surveyed thought that although A.I. would change the workforce, more jobs would be created than lost in supporting it. One of the greatest challenges to utilising A.I. was the lack of skills necessary to support it as well as a lack of integration into work processes.

With this in mind, it would seem that “The Rise of the Machines” will also need a “Helping (Human) Hand”.

Emily manages operations within Mellstock that ensures the smooth running of client matters, including business development, client relations, creative design, finance, digital development and the day-to-day matters of the business. This is fully capitalising on her 14 years’ experience within the construction and finance industry, including senior management roles.

A Science graduate, she is also an Associate Member of the CIPD (Chartered Institute of Personnel and Development). Mellstock is based in Limassol and provides specialist marketing services to the fund management industry with clients in London, Dubai and Cyprus. It also provides capital-raising and introduction services across a number of asset classes.

Regulatory Update

By Mr. Antonis Rouvas
Board Member of KPMG Limited, Asset Management Group, Advisory Services

The investment funds sector in Cyprus is on a steady growth path. The total value of regulated funds in Cyprus grew by approximately Euro 1.7 billion over the 12 months to the end of the first quarter of this year.

Figures from the Central Bank of Cyprus show that, at the end of Q1 2018, the net asset value of all funds under management stood at Euro 3.6 billion— an increase of 60% on Q1 2017. Funds with a local focus and in particular real estate are also growing in number.

It is also worth mentioning the increasing amount of work being done by Cyprus managers and administrators for funds that are not domiciled on the island, an endorsement of the levels of expertise, innovation and responsiveness that Cyprus professionals offer.

New Alternative Investment Funds Law of 2018

Cyprus is continuing to upscale its legal and regulatory framework in an effort to keep the jurisdiction at the forefront of fund managers’ and investors’ minds. The Registered AIF and the Limited Partnership with legal personality introduced with the replacement of the AIF Law 131(I) of 2014 which was voted on the 10th July by the Cyprus House of Representatives are two examples of the way that the investment funds space is improving in terms of innovation and regulation.
Both developments will help streamline the set-up of investment fund vehicles, while also keeping costs down and adopting a risk-based approach to investor protection and regulation.

Registered AIF

The new law provides for the establishment and operation of Registered Alternative Investment Funds (RAIFs). The new RAIF vehicle has the characteristics and structuring flexibilities of regulated Alternative Investment Funds (AIFs) managed by an authorised AIFM, except that RAIFs are not subject to CySEC supervision. Thus, in contrast to an AIF the RAIF will not be subject to prior authorisation by the CySEC before it can be launched and carry out its activities, nor to ongoing prudential supervision by CySEC. Indirect supervision of the RAIF is nevertheless ensured by the competent supervisory authority of its authorised AIFM, which shall ensure that the relevant RAIF complies with the AIFMD product rules applicable to it, including, among others, the appointment of the RAIF’s depositary and independent auditor, the content of the RAIF’s annual report and the valuation of the RAIF’s assets.

New structuring possibilities for Limited introduces

The other major development from the new law is the enhancement of the existing Limited Partnership regime which introduces new structuring possibilities. The establishment of a list of non-management safe harbours gives confidence and legal certainty to Limited Partners being admitted to a Cyprus limited partnership regarding the activities they may undertake, without undermining their crucial limited liability status. It also offers different management structures as the limited partnership may either be self-managed or appoint its general partner or another appropriately qualified entity to act as its external manager. It is expected that in the near future, further enhancement to the Partnership Law will provide greater scope for fund structuring as it will introduce limited partnerships with legal personality.

Other major changes

In addition to the above, some highlights of the new law are listed below:

- Introduction of a minimum AuM requirement to be reached within the first 12 months of the launch of the AIF (possible extension to 24 months).
- Minimum share capital requirement is now valid only for self-managed vehicles, irrespective of the category of AIF.
- Additional conditions imposed on AIFs with limited number of persons to avail of the depositary exemption for assets which are not subject to custody.
- Changes in the organizational structure, such as the requirement for an internal regulatory compliance function for AIFs with unlimited number of persons.
- Maximum number of investors limit reduced to 50 from 75 and the introduction of look through provisions for AIFLNPs.

Amendments to the taxation of Funds and Fund Managers

In another development, significant tax changes have been introduced. Investing in Cyprus common and partnership funds does not necessarily constitute a permanent establishment in Cyprus, with the result that that person’s income earned from those investments is taxed only in the country of tax residence.

Furthermore, the new law provides for the introduction of an optional, special way of taxation for the variable fee for fund managers’ (when the fee is charged based on the profitability of the organization), providing taxation with 8% rate and a minimum amount of tax payable Euro 10,000 per year. The aim of the regulation is to attract distinguished fund managers in Cyprus.

A significant development was the amendment of the legislation on the Special Contribution for the Defense of the Republic, with the abolition of the special tax rate of deemed distribution of dividends.
of 3%, aligning it to the normal 17% rate applicable where shareholders are domiciled in the Republic.

Evolving Regulation, Emerging opportunities for Cyprus fund industry

The introduction of the RAIF is widely viewed as an opportunity for Cyprus to enhance its competitiveness in the investment funds area.

Looking into the future, the funds’ sector will continue to develop and innovate. It is worth noting that the industry is seeing a number of new inquiries in the field of ICO’s and other virtual currencies. CySEC has also announced the establishment of its Innovation Hub, designed to address and explore the rise of FinTech and RegTech developments.

The trend over the last three years shows that we are on the right track and that Cyprus remains a credible and effective jurisdiction able to offer solutions and become a key player in the funds industry.

Antonis has recently returned to KPMG in the Asset Management Group of the Firm, after having served as the Group CFO of Hellenic Bank in Cyprus for 9 years. Before Hellenic Bank, Antonis led the Financial Risk Management Division of KPMG in Cyprus. Prior to that he worked for a number of years at Credit Suisse. Antonis has a broad experience in all aspects of fund management, including depositary functions, and a strong technical expertise in both operational and regulatory areas.