Utilisation of Funds for Investments in Cyprus

“Utilisation of Funds for Investments in Cyprus” by Mr. Constantinos Papanastasiou

Over the last few months, Cyprus has developed its appeal with more incentives and improvements to its FDI framework. These efforts are beginning to bear fruit and for the first time since the bail-out Cyprus has seen an increase in both bank deposits and in the registration of new companies establishing in the country. FDI has increased substantially during the last 12 months as a result of significant foreign investments in the capital increase of the two local banks (Bank of Cyprus and Hellenic Bank) and the successful implementation of the country’s naturalization scheme resulting in over €2 billion in FDI.

Despite the encouraging news on the economic figures and upsurge in FDI, challenges remain. Non-performing loans remain at very high levels (€27.6bn) with the non-performing loan ratio standing at 46.1 per cent of total loans in the Cypriot banking system. Liquidity from bank lending is limited with the banks maintaining rather tight lending criteria and policies scrutinizing potential borrowers.

The lack of liquidity from bank lending adversely affects attractive projects and companies that are seeking financing for their viability. An alternative solution to this financing need can be provided by utilizing fund structures and thus matching the need of borrowers for alternative financing sources with the need of foreign investors to satisfy their more tailored profiles through attractive investments in Cyprus.

We present below several example areas where fund structures can be utilized as alternative solutions to investments in Cyprus:

- for the development of large scale projects;
- for realty asset portfolios;
- and for naturalization purposes.

Introduction

Although the current economic climate remains challenging, confidence in Cyprus has seen a boost from foreign direct investors (FDI) looking at the country with renewed interest as the economy shows signs of a sooner-than-expected return to growth. So far, Cyprus has achieved all the targets set out by its international lenders and has continuously exceeded estimates – with projections of exiting recession in 2015.
Utilisation of Investment Funds for the development of large scale projects

For the recovery of the economy, the government has provided incentives and licenses for large scale projects. Although these projects are currently under the scrutiny of foreign funds and investors, the lack of size and the development risk entailed in these projects are two of the factors that adversely affect their development.

The size issue can be resolved through the establishment of an umbrella fund structure (see above) where different large scale projects can be placed under one fund with different compartments.

The sponsor of each project that would be placed in a separate compartment (sub fund) shall initially be the ultimate unit holder of each sub fund.

The Fund would be managed by an external asset manager (usually a realty asset manager of an international investment bank) that will be responsible for the initial selection of the projects to be included in the Fund as well as the management of the portfolio and the development of the project(s). An investment committee comprising of representatives of the sponsors / initial owners of the projects could advise the Investment Manager in its strategic decisions.

Potential investors in such a Fund could be international institutional investors specialized in real estate, investors seeking access to real estate opportunities (assets which would otherwise be out of reach due to the large capital required for their acquisition) and other investors that do not have expert market knowledge to place capital directly in the real estate project sector.

Similar funds have been established in various countries in Southern Europe whereas in Cyprus a similar initiative is currently been examined by Paphos Chamber of Commerce and Industry for the development of large scale multi-functional projects located in the Paphos area.

Utilisation of Investment Funds for realty portfolios

Similar to large scale projects, fund structures can be utilized for realty portfolios. Realty portfolios could be structured as umbrella funds whereby each separate asset category would be placed in a separate compartment according to its characteristics. For example an umbrella fund comprising of a realty portfolio could be structured in such a way whereby commercial assets would be placed in one compartment and residential assets in another compartment. Potential investors would then mix and match by investing in various compartments according to their investment preferences.
preferences. An investment manager specialized in the realty sector would be responsible for the management of these assets. Such a structure is anticipated to be utilized by local banks in Cyprus for their repossed asset portfolios (such as repossessed hotel portfolios) and for handling their high non-performing loan portfolios.

Utilisation of Investment Funds for naturalisation purposes

Since March 2014, the Government in Cyprus has adopted successfully a Scheme for Naturalization which grants accelerated citizenship to applicants who make substantial direct investments in Cyprus. The criteria include an investment of €5 million in eligible assets or an investment of €2.5 million in a collective investment scheme, provided the total value of the collective scheme is more than €12.5 million. In addition to that the purchase of a property of at least €500,000 is required.

Eligible direct investments include the purchase of Cyprus government bonds or debentures, shares in Cyprus companies, acquisition of local businesses, investment in real estate, land development and infrastructure projects, and participation in a joint venture for the execution of a government project in Cyprus.

The scheme has been particularly successful resulting in over €2 billion in FDI since its launch with most of the FDI inflows invested in government bonds and luxury real estate assets. Nonetheless, due to the substantial decrease in the yields of Cyprus government bonds over the last few months, the returns of such investments have been adversely affected.

By the use of collective investment schemes such as AIFs, potential investors not only limit their investment amount to €2.5 million (instead of €5 million) but also diversify their portfolio by investing in more than one compartment and mix across different asset classes. Additionally they have the ability to gain exposure to some other asset classes with very high barriers to entry on a stand-alone basis.

Way forward

“Foreign Direct Investment (FDI) is key for the island’s recovery. If we do not attract FDI it will simply take too long for us to come out of the crisis” one of the senior bankers of the island recently stated.

Despite its small size, Cyprus offers institutional investors highly attractive alternative funding opportunities via fund investments in large scale projects, luxury real estate, shipping and energy developments. These are already attracting significant interest – most notably from China, Russia and the Middle East.

The attractiveness of the Cyprus fund sector is greatly boosted by the harmonization of the national legislation with European Union Directives. Both UCITS and AIF legislation, the latter recently upgraded in Cyprus, could be utilized to provide stable and well managed fund structures. Funds can be used as a vehicle to invest in Cyprus and/or through Cyprus depending on the needs. It is envisaged that large projects on the island and the soon to be implemented privatization plan will attract foreign capital and investors.

Nonetheless more incentives and further reforms in the legal framework should be enacted especially in the areas of Asset Management Companies and REITS to assist the realization of such investments.

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The New Era with MiFID II

By Ms. Stella Livadiotou

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Since its implementation in November 2007, the Markets in Financial Instruments Directive (‘MiFID’) has been the ‘cornerstone of capital markets regulation in Europe’. MiFID has been successful in harmonizing
the regulatory framework for the provision of investment services and the operation of regulated markets (‘RMs’) across the EU, ensuring a high degree of investor protection and improving, at the same time, the competitiveness, integration and efficiency of the EU financial markets. However, the evolution of the financial markets, technology developments and the financial crisis, have highlighted a number of weaknesses and areas that needed reinforcement or revision and were forces that drove the creation of what has been called an ‘epochal piece of legislation’, MiFID II.

The new legislative package of MiFID II has been split into Directive 2014/65/EU and Regulation 600/2014. It was published in the Official Journal of the EU on 12 June 2014 and entered into force on 3 July 2014. Member States, including Cyprus, need to transpose Directive 2014/65/EU into national law by 3 July 2016 and then a transitional period of six months is given before it is applied, on 3 January 2017. However, market participants should have already started assessing the impact of, and preparing for the application of, MiFID II with regards to their business strategy, operating models, systems, processes, organisation and data, given the significant changes introduced, across a wide spectrum of areas.

MiFID II is an extension of MiFID I in some areas, in that it extends more requirements to more venues and more financial instruments. The list of financial instruments has been broadened to include, among others, emission allowances and derivatives of emission allowances. Certain MiFID I exemptions have been restricted, especially regarding commodity firms. Operating an Organised Trading facility (‘OTF’) – a newly created trading venue limited to non-equity instruments – has become a new investment service.

In order to implement the G20 commitment to tackle less regulated and more opaque parts of the financial system, especially over the counter (‘OTC’) trading, MiFID II reshapes how and where trading in financial instruments takes place. As far as possible, trading should be carried out on organized, regulated and subject to greater levels of transparency, venues. The pre- and post-trade transparency regime has been expanded to a broader range of trading venues and beyond equities, to cover equity-like instruments and non-equity ones. In addition, the existing waivers on the transparency requirements have been narrowed. The tightening of the transparency regime, though, has raised major concerns on the potential negative impact on liquidity.

Rapid innovation and growing complexity in instruments underline the importance of up-to-date, high levels of investor protection. Although MiFID II has not necessarily introduced revolutionary investor protection rules, it has reinforced those already in place under MiFID I. The client categorization criteria have been refined, new governance requirements have been introduced around the manufacturing and distribution of financial products, enhanced suitability and disclosure requirements have been included and the scope of activities that can be carried out on an ‘execution only’ basis, that is without the need for an appropriateness test, has been substantially narrowed. Perhaps one of the most revolutionary aspects is the ban on third party inducements, except for minor non-monetary benefits, when providing discretionary portfolio management or independent advice.

MiFID II has not been limited, though, to extending the already in place requirements and rules. It has introduced some completely new regimes, such as the ones on product intervention, position limits and algorithmic and high frequency trading. Powers are given to national regulators and the European Securities and Markets Authority (‘ESMA’) to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments in the EU. Moreover, a regime for quantitative limits on positions and position reporting is foreseen, to improve the transparency of commodity derivative markets and reduce speculative activity. However, the industry operating in sectors such as derivatives trading and commodities or high-frequency or algorithmic trading has raised concerns that it will be operationally challenging to comply with the new rules on MiFID II.

Finally, with MiFID II, a harmonized regime for third country firms is introduced. Third-country firms will be able to provide investment services to eligible counterparties and to professional clients per se, without the establishment of a branch, following an equivalence decision by the Commission.
Moreover, Cyprus, at the current stage, is positive towards exercising its discretion to allow a third country firm to provide investment services to retail clients and professional clients upon request with the establishment of a branch in Cyprus.

The Ministry of Finance of Cyprus has already conducted a public consultation on the Law transposing MiFID II into national law, which will need to undergo the whole legislative procedure, before being published in the Gazette on 3 July 2016. However, it must be noted that a lot of the detail and technical aspects that will affect how MiFID II is actually being applied will depend on the ‘level 2 measures’, such as technical standards prepared by ESMA and delegated acts adopted by the European Commission, based on ESMA’s technical advice. All the level 2 measures are expected to be adopted by the end of 2015, but some delay is also possible, due to the broad, complicated and sensitive scope of such measures. Market participants should, thus, be constantly following and understanding the new rules of the MiFID game, in order to be prepared when it broadly enters into effect, on 3 January 2017.

Ms. Stella Livadiotou graduated from the University College London with an LLB in Law and has also been awarded with an LLM in Banking and Financial Law from Boston University. She successfully passed the exams of the Legal Council for registration as an advocate in Cyprus. Ms. Livadiotou is an officer in the legal department of the Cyprus Securities and Exchange Commission and is currently seconded to the Ministry of Finance of Cyprus, providing legal services to the Department of Financial Stability of the Ministry and being part of the Project Team for the Insolvency Regime. She has previously been seconded to the Permanent Representation of Cyprus to the EU, acting as a financial services attaché and chairing the working group of financial services during the Cyprus Presidency of the Council of the EU.

UCITS V Directive: Challenges and Opportunities

By Mr. Alexios Kartalis
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As we all know, UCITS is an acronym that stands for “Undertakings of Collective Investments in Transferrable Securities”. It is the name of European Mutual Funds that follow particular rules and have some very specific characteristics.

The area of mutual funds is one sector where the European harmonization has brought significant results.

The effort for harmonization started in 1985 when the first directive UCITS I was adopted. The target was to create a common regulatory framework for mutual funds throughout Europe, so that a fund that has been registered in a certain member state could be marketed in other ones too. The basic ideas was, that from the moment a fund was licensed in a certain country, it could be sold anywhere in the E.U.

Since then, we have gone a long way. UCITS II was skipped as the member states never agreed on it. UCITS III was adopted in 1998 and it consisted of two directives, one for the Key Information Document and one for the allowed investments.

And, ten years later in 2009 UCITS IV was adopted, bringing significant changes, such as:

- Management company passport, allowing a manager licensed in one member state to managed UCITS in another country;
- Ease of cross border UCITS mergers;
- Creation of master-feeder set up; and
- Provisions for the Key Investor Information Document.

The new UCITS V directive was adopted in July 2014. Member states have 18 months (until March 2016) to incorporate it into national legislation.

The new directive started with a very ambitious agenda and taking serious changes under
consideration. Finally, some of these changes were adopted, but some others were put aside, probably to be re-discussed in the future.

Let’s see now which are the main changes brought on by UCITS V. In essence the changes touch upon three areas:

- The depositary function;
- The remuneration policy; and
- The sanctions regime.

**Depositary function**

The depositary rules date back from the times of UCITS I in 1985. On top of that the new AIFMD (Alternative Investments Funds Managers Directive) imposed a strict and rigorous regime for depositaries and UCITS V aims to bring UCITS at the same level.

Under UCITS IV depositary rules are less stringent than the ones for AIFs, but also they differ substantially throughout Europe.

A new concept which creates an implementation challenge is the independence of the depositary from the manager; this is required by UCITS V and ESMA (European Securities and Markets Authority) is looking at various ways to practically enforce it.

UCITS are required under the new directive to appoint a single depositary that will hold the entire portfolio. The directive makes very clear which institutions are eligible for the depositary role. This can be a central bank, a credit institution and other entities that are authorized for this role from a competent regulatory authority. Certain capital and own funds requirements should be met.

The depositary has three main tasks under UCITS V:

1. Cash monitoring duties;
2. Supervising role for the manager and the UCITS themselves; and
3. Safekeeping of the UCITS assets.

**Cash monitoring:** this is a new task that did not exist in the previous directive. The depositary should closely monitor any cash movements and should make sure that any cash received from subscriptions is booked into the funds’ accounts.

**Supervision:** the depositary ensures that the issuance, redemption and cancelation of units is performed according to fund’s rules and the law. It makes sure that the valuation of the fund is properly done and carries out the manager’s instructions, unless it believes they contradict with the law. Assets and cash from transactions should be posted in funds’ accounts within the foreseen time limits under the care of the depositary.

**Safekeeping of assets:** Assets are kept in physical or book entry form. Securities are kept in segregated accounts in the names of the funds. Further usage of funds’ assets is only permitted under strict conditions.

In case of a depositary bankruptcy the assets of the funds cannot be used to satisfy the depositary’s creditors. If the fund’s assets cannot be subject to custody, relevant documents must exist that prove their existence and ownership.

The depositary can further delegate its custody duties but not the ones related to cash. Additionally, the depositary has the task to exercise due diligence to the entity that makes the delegation and remains fully liable for any loss or damage to the fund. Depositary’s obligations cannot be discharged.

**Remuneration policy**

The basic idea here is that managers should have a long term view on their investment targets, so that excessive risk taking is discouraged and sound risk management is promoted. Some of the key elements are the following:

- The remuneration policy applies to the people whose decisions affect the risks that UCITS undertake and to the key staff;
- The evaluation of managers’ performance has to be made in a time period corresponding to the investment view of the UCITS;
- Remuneration schemes should include a fixed and a variable part and the latter should be in principle not guaranteed; and
- At least 50% of the variable part should consist of UCITS units and at least 40% should be attributed in a time frame equal to the suggested retention period of units for the investors (not smaller than 3 years).
Sanctions regime

In order to deal with the different sanctions in the various member states, UCITS V aims to create a level playing field. Some of the provisions are:

- Member states should create a sanctions framework and should enforce its application;
- A list of 20 offenses is included in the directive and member states should foresee relevant sanctions; and
- Sanctions should be published in the website of each member state regulator, unless there are serious reasons for the contrary.

GMM Global Money Managers Ltd. is a Cypriot UCITS/AIF manager. We have already issued and we manage 16 UCITS funds in Cyprus. We have chosen Cyprus to domicile our company and our funds, due to the favourable business environment, skilled workforce and recovery expectations for the local economy.

We believe that the above mentioned changes, coming with UCITS V are for the benefit of the investors. In particular:

- Stricter depositary regime is positive as the depositary safe keeps clients assets;
- The limitations to the remuneration policy are also a positive step, as the recent financial crisis was mainly due to excessive risk taking and short-term compensation policies; and
- Last, but not least, it is for the benefit of the market to have a uniform and fair sanctions regime.

We believe that Cyprus should adopt the new directive as soon as practically possible.

Investment Performance Reporting: from Obligation to Differentiation

By Mr. Savvas Pentaris
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Given the challenging global economic environment over the past few years, the investment management industry is facing increased scrutiny from all its stakeholders. One of the sector’s pressing needs is the adoption of the right processes, procedures and controls to ensure that reported and marketed performance figures are represented accurately and in a timely fashion.

A failure to meet this challenge possesses significant risks, ranging from simple process inefficiencies to damage to a firm’s brand and reputation. More importantly, firms that achieve and maintain an efficient and effective investment performance reporting framework can distance themselves from competitors.

Most firms understand the risks associated with supplying inaccurate or misleading investment performance data. Yet, many fail to address the problem. Firms must address investment performance reporting proactively from not only a bottom–up perspective, but also from the top down and in doing so create an efficient and effective operating model.

The global standard

GIPS (Global Investment Performance Standards), is a set of protocols established in 1999 by the CFA Institute and adopted by firms in more than 25 countries. These standards govern the presentation of investment performance results by asset management firms. From a risk perspective, they provide a roadmap that enables potential investors to evaluate comparable performance results based on fair representation and full disclosure. GIPS requirements ensure consistent performance presentation preventing any cherry-picking of a manager’s best performing accounts.

While asset managers are not required to adopt
GIPS, the transparency these standards provide can make the difference in a firm’s ability to compete effectively for investor capital. The standards are widely recognized as an industry best practice and add credibility to performance presentations and provide client confidence in investment managers.

Moreover by failing to gain a consistent, firmwide grasp of investment performance reporting, firms can run into reporting errors. The risks that are associated with them range up to and include allegations of fraudulent behaviour that can expose an asset manager to regulatory investigations and create havoc with a firm’s diligently earned reputation.

Despite the evident advantages for an asset manager to maintain and convey GIPS compliance, many shy away, because they may have several manual processes or potentially outdated technologies to support their investment reporting function, which means they suffer operating costs that are higher than necessary. But by creating a consistent, firmwide investment performance reporting operating model supported by the right processes, people, and up-to-date technology, asset managers can both create efficiencies as well as reduce overall risk. An effective GIPS compliance program includes policies, procedures, internal controls and information technology to support composite performance, record retention, performance reporting, disclosure, composite maintenance, policy and procedure updates, and the calculation of assets under management. The problems that firms often encounter are usually rooted in a few areas: inadequate technologies, a fragmented process, a lack of internal communication and poor governance structures.

It is critical for firms to understand that compliance is a process that involves many stakeholders. Frequently we see that minimal communication may exist among marketing, legal, operations and information technology departments, as well as up and down the management chain. Firms must create clear communication structures and protocols and allocate human capital sufficiently to be able to detect problem areas and to ensure that the processes and technology in place run smoothly. In order to sustain continued GIPS compliance, firms need effective management and oversight of the investment performance reporting infrastructure to ensure that all aspects of the performance measurement and presentation process are harmonized and standardized.

This is possible when all functional groups involved in the process (i.e., sales, marketing, operations, performance measurement) understand and adhere to the standards, assume responsibility for better information data management, improved internal controls and increased efficiency to maintain accurate and compliant firm collateral.

The ongoing introduction of sophisticated investments and the risk of a meltdown that mirrors the recent credit crisis serve as compelling arguments for institutional investors to look to GIPS-compliant firms when evaluating investment options. As asset managers continue to seek growth opportunities through branding and moving new products to market quickly, their success lies with the strength of their reputation and the reliability of their investment performance data.

Ultimately, GIPS will differentiate investment firms among investors and assert the credibility of their investment performance statements. In particular, hedge funds, which continue to increase in number and in their ability to affect change in the corporate boardroom, will increasingly need to rely on sound investment reporting practices in order to gain the trust of investors. Additionally, as investment firms, both traditional and alternative, continue to leverage new and more complex investment products such as Exchange Traded funds and new Hedge fund strategies to increase assets under management, their ability to compete and effectively market these products has a direct correlation with the reliability and accuracy with which they report the investment performance of these, and all, vehicles to investors.

Achieving and maintaining GIPS compliance represents an opportunity to possess a competitive advantage in the marketplace. By placing investment performance reporting at the forefront of their operating model, and maintaining the proper people, policies, processes and technology to maintain it, firms can be positioned to capture growth in an evolving and challenging capital market environment.

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