

Delegation arrangements under the Alternative Investment Fund Managers Law of 2013

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Under the legislative framework currently in place, an Alternative Investment Fund Manager (“AIFM”) is generally allowed to delegate some of its functions to third parties provided that delegation arrangements are premised upon the following basic principles:

- (a) the AIFM retains the ultimate and complete liability towards the Alternative Investment Fund (“AIF”) it manages as well as its investors, and;
- (b) that the AIFM’s liability towards such parties is not in any way affected by the fact that the AIFM has delegated its functions to a third party.

What regulates the obligations and limitations that the AIFM will need to adhere to in case that delegation arrangements are put in place, is the nature and type of function that will be outsourced.

In general, and subject to the prior notification of the Cyprus Securities and Exchange Commission (“CySEC”), an AIFM established and licensed in the Republic of Cyprus is generally permitted by CySEC to delegate some of its functions to third parties, provided that the following conditions are met:

1. The AIFM must be able to justify its entire delegation structure on objective reasons;
2. The delegate must dispose of sufficient resources to perform the respective tasks and the persons who effectively conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced;
3. The delegation must not prevent the effectiveness of supervision of the AIFM and in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of the investors;
4. The AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question and is in a position to monitor the delegated activity, as well as to withdraw the delegation with immediate effect when this is in the interests of investors;
5. The services provided by each delegate such be reviewed on an ongoing basis; and
6. The AIFM shall not delegate its functions to the extent that it can no longer be considered as the manager of the AIF and is therefore considered as a letter-box entity.

As it becomes evident, an AIFM must not only retain the ultimate responsibility towards the AIFs and their investors but more importantly it must ensure that its regulatory obligations (arising out of the performance of its activities) are not in any way tampered with, by reason of such delegation arrangements.

The question however, is how an AIFM can secure that it in fact complies with the above principles?

1. “Objective Reasons for Delegation”

The AIFM shall provide the competent authorities with a detailed description, explanation and evidence of the objective reasons for delegation. Objective reasons are considered any of the following concepts:

- (a) optimising of business functions and processes;
- (b) cost saving;
- (c) expertise of the delegate in administration or in specific markets or investments;
- (d) access of the delegate to global trading capabilities.

Consequently, an AIFM must be in a position to objectively justify its decision of delegation. Any reason based upon the above considerations and explained in sufficient detail is likely to be accepted by the regulator as satisfying the requisite threshold.

2. “The delegate must dispose of sufficient resources to perform the respective tasks and the persons who effectively conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced”

A delegate must have sufficient resources and shall employ sufficient personnel with the skills, knowledge and expertise necessary for the proper discharge of the tasks delegated to it. Also a delegate must have an appropriate organisational structure identifying the various roles and departments, supporting in that way the performance of the delegated tasks.

In addition, the persons who conduct the activities delegated by the AIFM shall have the necessary experience and the appropriate theoretical and practical knowledge to perform these functions. Good reputation is assessed by a clean record, meaning that persons who conduct the business of the delegate shall not have any negative records, which can affect their good reputation. Negative records shall include (but shall not be limited to) criminal offences, judicial proceedings or administrative sanctions relevant for the performance of the delegated tasks.

The best way to discharge this obligation is by conducting a thorough due diligence exercise upon the delegate and its key staff personnel. What is important to note is that such due diligence exercise must be conducted prior to any delegation arrangements and once put in place, an AIFM must have the right to periodically update its findings.

3. “The delegation must not prevent the effectiveness of supervision of the AIFM and in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of the investors”

The relevant criteria and/or considerations, which are employed to determine whether delegation arrangements comply with the above principle, are the following:

- (a) whether the AIFM, its auditors and the competent authorities do not have effective access to data related to the delegated functions and to the business premises of the delegate, or the competent authorities are not able to exercise those rights of access;

(b) whether the delegate does not cooperate with the competent authorities of the AIFM in connection with the delegated functions;

(c) whether the AIFM does not make available on request to the competent authorities all information necessary to enable authorities to supervise the compliance of the performance of the delegated functions;

Outsourcing arrangements must not be used to avoid compliance with the obligations and limitations set out by the legislative framework as a regulator will always need to ensure that an AIFM is in fact compliant with the terms of its authorisation. Also an AIFM has an overriding duty to always act in the best interest of the AIFs it manages and towards their investors and in order to be able to discharge this duty it needs to have access to the information mentioned above.

4. “The AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question and is in a position to monitor the delegated activity and to withdraw the delegation with immediate effect when this is in the interests of investors”

The person to whom the functions are delegated must have the necessary expertise and experience to perform the activities in question.

What is also important to note at this point, is that delegation arrangements must be evidenced by a contract in writing which must specify the following:

(a) the AIFM ensures that the delegate protects any confidential information relating to the AIFM, the AIF affected by the delegation and the investors in that AIF;

(b) the AIFM ensures that the delegate establishes, implements and maintains a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions;

(c) that the AIFM will be able to terminate the delegation arrangements with immediate effect; and

(d) whether any sub-delegation is going to be permitted under their arrangements in its terms.

5. “The services provided by each delegate such be reviewed on an ongoing basis”

An AIFM has an underlying duty to take all reasonable steps to identify and disclose any potential conflicts of interests that arise in the course of managing AIFs between:

(a) the AIFM and the AIF managed by the AIFM or the investors in that AIF;

(b) the AIF or the investors in that AIF, and another client of the AIFM;

(c) the AIF or the investors in that AIF and another client of the AIFM;

(d) the AIF or the investors in that AIF and a UCITS managed by the AIFM or the investors in that UCITS;

(e) two clients of the AIFM.

In the same analogy, a delegate must maintain effective organisational and administrative arrangements to identify, prevent, manage and monitor conflicts of interest and prevent such conflicts for adversely affecting the interests of the AIFs and the investors. This is a continuing obligation and the delegate must be under a duty to have in place proper procedures to prevent any conflicts arising. If however, prevention is not possible then the delegate must be obliged to disclose such conflicts to the AIFM.

Also the portfolio and risk management must always be functionally and hierarchically segregated and if one of these functions is delegated to a third party then the delegate will need to prove that it complies with the segregation principles.

6. “The AIFM shall not delegate its functions to the extent that it can no longer be considered as the manager of the AIF and is therefore considered as a letter-box entity”

This is arguably the most important principle of the above. The AIFM’s liability and responsibility towards the investors shall not be affected by reason that the delegation arrangements are in place, nor shall the AIFM delegate its functions to the extent that it can no longer be considered the manager of the AIF. As the reader may appreciate, this is a balancing exercise that needs to be performed prior to any delegation arrangements are put in place.

Instances where regulators found that delegation arrangements exceeded the permissible boundaries of the legislative framework were in cases where the delegate assumed the complete and absolute right to have direct communication with the AIF and its investors for every matter of the AIFs functions and the AIFM was no longer part of the investment management of the AIF. A regulator need to have immediate, unfettered and access to the matters that it wishes to inquire about and delegate arrangements must not hinder this principle.

Furthermore, in case that the AIFM wishes to delegate one of its investment management services i.e. the portfolio or risk management, then an AIFM needs to retain in-house one of the aforesaid functions. Risk and portfolio management services can be outsourced only on undertakings, which are authorised or registered for the purpose of asset management in the European Union and subject to the approval of the home member regulator. If the delegate is a third country corporation then further requirements must be fulfilled at the level of regulators as well.

Sub-delegation arrangements

The delegate is allowed to sub-delegate its functions to another party provided that the sub-delegation shall be objectively justified and that the AIFM has provided its consent to such arrangements in writing and informed the relevant authorities.

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