

**Cyprus: Financial Sector Assessment Program Update—Technical Note—  
Factual Update of IOSCO Core Principles of Securities Regulation**

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

# REPUBLIC OF CYPRUS

TECHNICAL NOTE

# FACTUAL UPDATE OF IOSCO CORE PRINCIPLES OF SECURITIES REGULATION

MAY 2009

INTERNATIONAL MONETARY FUND  
MONETARY AND CAPITAL MARKETS DEPARTMENT



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## GLOSSARY

ASE	Athens Stock Exchange
CIS	Collective investment scheme
CRD	Capital requirements directive
CSE	Cyprus Stock Exchange
CySEC	Securities and Exchange Commission
EU	European Union
FSAP	Financial Sector Assessment Program
ICPAC	Institute of Certified Public Accountants of Cyprus
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commission
MiFID	Markets in Financial Instruments Directive
MoF	Ministry of finance
MoU	Memorandum of understanding
OFC	Offshore Financial Center Program
OTC	Over-the-counter
SROs	Self-regulating organizations
UCITS	Undertakings in collective investment transferable securities

## SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **There is a comprehensive legislative framework, largely based on European Union (EU) law, in place for the supervision of the securities sector in Cyprus.** In general terms, the Cyprus securities regulator—the Securities and Exchange Commission (CySEC)—appears to be carrying out its function in an effective manner.

**The main recommendations of this report are the following:**

- First, that CySEC carry out an inspection of the Cyprus Stock Exchange (CSE) as a matter of urgency to satisfy itself that the CSE is well positioned to undertake its expansion plans (e.g., permitting over-the-counter (OTC) trading, stock lending and derivatives trading). On the matter of the stock exchange, the question arises as to whether the State should continue to own the exchange. It may be worth considering a privatization of it. This opens a wider issue—the continued viability of the exchange. Its level of trading is very small and in forming a common trading platform with the Athens Stock Exchange (ASE), it has lost significant business as regards its two most traded stocks. The remaining stocks on the have a relatively thin market and it is questionable if they could support the continuing viability of the exchange. Moreover, in view of the increasing ease which EU citizens can invest across the community, it may be more attractive for Cypriots to use exchanges which have more choice and are deeper and more liquid than the CSE.
- Secondly, that in supervising market intermediaries, CySEC pay particular attention to those intermediaries that are foreign-owned and provide services largely to overseas clients, particularly from a code of conduct (how they deal with their customers) and ‘know-you-customer’ point of view.
- Thirdly, that CySEC seek to ensure that it has at all times sufficient funding to fulfill its legal obligations.
- There are also a number of other, largely technical, recommendations that, in any event, are scheduled to be addressed in upcoming legislation.

## I. INTRODUCTION

2. **The analysis of the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulations (IOSCO Principles) in Cyprus was undertaken as part of the Financial Sector Assessment Program (FSAP).** In Cyprus, the CySEC is the main authority responsible for the supervision of the securities market in Cyprus. The Central Bank of Cyprus (CBC) currently supervises certain collective investment schemes (i.e., private collective schemes, which are targeted at institutional/sophisticated investors); this responsibility, however, will pass to CySEC under forthcoming legislation. Michael Deasy from the Irish Financial Services Regulatory Authority conducted the analysis.

## II. INFORMATION AND METHODOLOGY USED

3. **The analysis was based on IOSCO's Objectives and Principles of Securities Regulation.** The analysis was influenced by the structure of the securities market in Cyprus, including the existence of an international financial sector. It was heavily influenced by the accession of Cyprus to the EU in May 2004. Membership of the EU resulted in the transposition of many EU financial regulatory directives, particularly in the last two years, these include the Markets in Financial Instruments Directive (MiFID), the Prospectus Directive, the Transparency Directive, the Market Abuse Directive, the Takeover Directive, and the Undertakings in Collective Investment Transferable Securities (UCITS) Directive. In practice, the securities regulatory regime in Cyprus is almost exclusively based on these directives, the main exception being the private collective scheme regime (currently supervised by the CBC) and for which there is no corresponding EU legislation.

4. **The analysis drew heavily on the assessment carried out in 2005 under the Offshore Financial Center Program (OFC).** It was also based on a review of the relevant legislation, particularly that based on EU Directives, and its implementation, and on the factual update completed by both CySEC and the CBC. This information was supplemented by information provided by both authorities and data available on the website. Detailed discussions were held with CySEC, the CBC, the Ministry of Finance (MoF), the CSE as well as with relevant private sector companies, representative bodies and accountancy firms. Table 1 provides the status of the recommendations of the 2005 Assessment.

5. **Cooperation was freely given by all concerned.**

## III. INSTITUTIONAL AND MARKET STRUCTURE—OVERVIEW

6. **In broad terms, the securities sector in Cyprus covers the CSE, market intermediaries, and collective investment schemes.**



7. **The CSE is State-owned and has a relatively small number of listed companies.** There are 13 main listings (of which the 2 main banks dominate), 127 supplementary listings as well as 44 government, and 10 corporate bond issues. Currently, the CSE mainly deals in equities and bonds. Stock lending and short selling are prohibited.
8. **At end-August 2008, market capitalization was euro 17.4 billion, down from a figure of euro 25.3 billion at end-2007 (The fall is attributed to the current market turmoil).** The turnover for the CSE for the first 6 months of 2008 was euro 886 million and the average daily was euro 7.5 million per trading day. (This compares to turnover of euro 3.9 billion and average daily turnover of euro 15.7 million for 2007).
9. **In October 2006, the CSE entered into an agreement with the ASE, which established a common platform between the two exchanges.** The two largest companies on the CSE, the CBC, and Marfin Popular Bank are also traded on the ASE. Currently, 49 percent of trades in CBC and 61 percent of trades in Marfin are transacted on the ASE. Negotiations are currently taking place with the Romanian Stock Exchange to establish a common platform with it. The CSE also hopes to agree similar deals with exchanges in surrounding jurisdictions.
10. **The CSE is currently embarking on a plan of expansion.** Legislation is currently before parliament that would allow the operation of OTCs trading. When enacted, the CSE would also permit stock lending (which could facilitate short selling). It has also decided to cooperate with the ASE to facilitate derivatives trading.
11. **All market intermediaries providing investment services (including stock broking) and investment advice are now supervised by CySEC under the Investment Firms Law (which transposed the EU MiFID).** Currently, 67 market intermediaries have been authorized, about 40 of which are owned by Russian interests, 10 by Cypriots and the balance by other overseas interests. The Russian-owned firms largely provide investment services to overseas clients, many in Russia and the Ukraine, etc, mainly on a cross border basis. Industry sources have informed the assessors that about 60 percent of all trades on the Moscow Stock Exchange originate in Cyprus due to the favorable double taxation agreement between the two jurisdictions.
12. **At the time of the OFC assessment in 2005, the CBC was responsible for the supervision of international financial advisory firms (firms that provided investment advice to non-residents (e.g., U.K., ex-patriates located in the Middle East)).** As investment advice is a core activity of the MiFID, these firms are now supervised under the investment firm law and are included in the figure of 67 above for total market intermediaries.

13. **There are two types of collective investment scheme (CIS) regimes in Cyprus—UCITS which are supervised by CySEC and private investment schemes which are currently supervised by the CBC.** UCITS and other CIS currently marketed in Cyprus are targeted at retail investors. Because of the unfavorable tax treatment of UCITS, no UCITS has been authorized to date. Legislation is currently being prepared that is designed to harmonize taxes between shares and UCITS, and will transfer responsibility for supervision of the international investment schemes to CySEC, after which Cyprus would hope to develop a vibrant UCITS industry.

14. **The private investment schemes supervised by the CBC were originally targeted at non-resident institutional/sophisticated investors.** Following the abolition of exchange controls in 2004, these were opened up also to local institutional/sophisticated investors, although it is understood that the number of such investors is miniscule. There are about 40 of these funds with a net asset value of US\$675 million.

#### IV. PRECONDITIONS FOR EFFECTIVE SECURITIES REGULATION

15. **The regulatory regime is highly influenced by Cyprus' membership of the EU.** Almost all of its regulatory framework is determined by European law. Company law is strongly influenced by U.K. legislation. A sound legal, taxation, and accounting framework appears to be in place.

#### V. MAIN FINDINGS<sup>1</sup>

16. **Regulator (Principles 1-5).** The regulatory responsibilities of CySEC are set down clearly in legislation and CySEC appears to apply them in a clear and consistent manner. The funding of the commission comes from a combination of State and industry sources with an increasing emphasis on the latter. Currently, CySEC employs 42 persons. It is vitally important that sufficient funding is provided to it in the future, particularly given the challenges posed by the current market turmoil, the implementation of the various EU directives transposed in recent years and an expected increase in responsibilities (e.g., the proposed transfer of supervisory responsibility for private investment funds from the CBC and the anticipated development of a UCITS market in Cyprus).

17. **One area that is being addressed in the forthcoming CySEC Law is that under current legislation,** CySEC must provide the Minister of Finance with any information that he may deem necessary for the benefit of the public interest. While this provision has never been invoked, it could potentially give rise to an abuse of power.

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<sup>1</sup> See Table 2 for a summary of findings, and Table 3 for recommendations.

18. **One of the main findings arising out of the OFC assessment of 2005 was that CySEC**, while charged with the responsibility of supervising the CSE, could not do for constitutional reasons. This issue has since been rectified and CySEC can now exercise its function without question.

19. **Self-regulatory organizations (Principles 6–7).** The CSE has a very limited self regulatory role in that it can fine members (i.e., brokerage firms ) for breaches of the listing rules (e.g., the late submission of accounts).

20. **Inspections, investigations and enforcement (Principles 8–10).** CySEC has wide powers of inspection, investigation and enforcement, largely derived from the relevant EU regulatory directives.

21. **Information sharing and cooperation (Principles 11–13).** There is provision in the law allowing for the sharing of information and cooperation with both domestic and foreign regulators. However, two difficulties arise in this area: first, CySEC cannot collect information or carry out investigations on behalf of non-EU regulators unless it has an independent interest in the matter; secondly, it has experienced difficulties in obtaining the identification of the beneficial owner of shares registered in the name of lawyers acting on behalf of the beneficial owners. Both these issues are being dealt with in the draft CySEC legislation now before parliament.

22. **Issuers (Principles 14–16).** The Cyprus law transposing the EU Prospectus and Transparency Directives, together with company law and stock exchange law, provide for accurate and timely disclosure of financial results and adequate safeguards in the fair and equitable treatment of shareholders; there is no reason to believe that these laws are not being implemented effectively. Accounting and auditing standards are in line with best international practice. Cyprus has adopted International Financial Reporting Standards (IFRSs) for accounting purposes.

23. **Collective investment schemes (Principles 17–20).** The UCITS legislation is comprehensive, but CySEC needs to introduce specific rules for the valuing of assets other than shares in listed companies held by UCITS. CySEC expects to introduce such guidelines shortly and in any event before it authorizes any UCITS.

24. **Market intermediaries (Principles 21–24).** While there appears to be a strong and effective supervisory regime in place for market intermediaries, CySEC should pay particular attention to those intermediaries (which account for most of the market), which are foreign owned and largely provide services to non-residents. In particular, it should seek to ensure that an appropriate code of conduct applies as well as effective ‘know-your-customer’

processes and procedures. It should also consider establishing memorandums of understanding (MoUs) with those jurisdictions have greatest representation in this area.<sup>2</sup>

25. **Principles for the secondary market (Principles 25–30).** The difficulties identified in the OFC assessment of 2005 whereby CySEC could not effectively supervise the CSE for constitutional reasons have been resolved and from November 1, 2007, when the MiFID was transposed into Cyprus law, CySEC has now full supervisory powers over the Exchange. However, to date it has not carried out any inspection of the CSSE—a comprehensive desk review was carried in 2008. It is essential that it does carry out such an inspection, particularly when it was not in a position to do so for the previous ten years and in light of the current turmoil in the financial markets—the authorities have scheduled such an inspection for early 2009. This recommendation must also be seen against a background where the CSE is losing business to the ASE and embarking on a plan of expansion (permitting OTC transactions, stock lending ( and possibly short selling) and derivative trading) as well as its plans to form alliances with neighboring jurisdictions. CySEC should satisfy itself that the Exchange is well positioned to undertake all these initiatives.

26. **The 2007 annual accounts for the CSE were not available in October 2008.** This is somewhat disturbing, particularly given that the CSE is responsible for ensuring that its listed members finalize their accounts within four months of year end

27. **The question arises as to whether the State should continue to own the CSE or whether it should consider its privatization.** This raises a wider question- the continued viability of the CSE. Its level of trading is very small and in forming a common platform with the ASE, it has loss considerable business to that CSE as regards its two most traded stocks. The remaining stocks on the CSE have a relatively thin market and it is questionable if they could support the continued viability of the CSE. Moreover, in view of the increasing ease with which EU citizens can invest throughout the community, it may be more attractive for Cypriots to use exchanges which have greater choice and are deeper and more liquid than the CSE.

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<sup>2</sup> Shortly after the FSAP mission, the authorities have signed an MoU with their Russian counterparts.

**Table 1. IOSCO OFC Assessment 2005—Recommended Action Plan**

<b>Reference Principle</b>	<b>Recommended Action</b>	<b>Status 2008</b>
Principles 1 and 25. The CySEC was unable to supervise effectively the CSE as both were public administrative bodies and one such body cannot supervise another such body.	The transposition of the EU MiFID into Cyprus law removed this anomaly.	CySEC is now without question the supervisor of the CSE.
Principle 11. The CySEC could not share information or carry out investigations on behalf of foreign regulators where CySEC did not have an independent interest in the matter under investigation.	An amendment to the law to remove this obstacle.	Partly achieved. Following the transposition of a number of EU Directives, CySEC can now share such information and carry out inspections on behalf of fellow EU regulators but not for non-EU regulators. Legislation is currently before Parliament to address this shortcoming. It is expected to be enacted late 2008/early 2009.
Principle 13. The CySEC was experiencing difficulties in obtaining the identities of the beneficial owners of shares which were registered in the name of lawyers on behalf of the beneficial owners.	An amendment to the law that would bring clarity to the matter.	Not achieved as yet but is expected to be dealt with in the proposed legislation referred to above.
Principle 2. The CySEC must provide the Minister of Finance with any information he may deem necessary for the benefit of the public good. (This was seen as potentially impacting on the independence of CySEC).	That this clause be revoked from the relevant legislation.	Not achieved as yet but is expected to be dealt with in the proposed legislation referred to above.
Principle 20. The CySEC did not have specific rules for the valuing of assets of UCITS other than for shares in listed companies.	CySEC to introduce such rules and particularly before the authorization of the first UCITS.	No local UCITS have been authorized (due to lack of clarity re. tax) but nor have any valuation rules been issued yet. The tax uncertainty is due to be dealt with soon and CySEC has indicated that it will introduce the relevant valuation rules before the first authorization of a UCITS.

**Table 2. Summary Implementation of the IOSCO Principles—ROSCs**

<b>Principle</b>	<b>Findings</b>
<b>Principle 1.</b> The responsibilities of the regulator should be clearly and objectively stated.	
<b>Principle 2.</b> The regulator should be operationally independent and accountable in the exercise of its functions and powers.	The CySEC Law contains a provision whereby CySEC must provide the Minister of Finance with any information that he may deem necessary for the benefit of the public interest. While this provision has never been invoked, it could potentially give rise to an abuse of power. There is a provision in the draft of a new CySEC law that will revoke this provision.
<b>Principle 3.</b> The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	
<b>Principle 4.</b> The regulator should adopt clear and consistent regulatory processes.	
<b>Principle 5.</b> The staff of the regulator should observe the highest professional standards.	
<b>Principle 6.</b> The regulatory regime should make appropriate use of self-regulating organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.	
<b>Principle 7.</b> SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	
<b>Principle 8.</b> The regulator should have comprehensive inspection, investigation and surveillance powers	
<b>Principle 9.</b> The regulator should have comprehensive enforcement powers.	
<b>Principle 10.</b> The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	
<b>Principle 11.</b> The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.	CySEC cannot collect information or carry out investigations on behalf of non-EU regulators unless it has an independent interest in the matter. This weakness is being addressed in the forthcoming new CySEC law.
<b>Principle 12.</b> Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	

Principle	Findings
<b>Principle 13.</b> The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	CySEC has experienced difficulties in respect to the identification of the beneficial owners of shares registered in the name of lawyers acting on behalf of the beneficial owners. The issue is being addressed in the forthcoming legislation currently before parliament.
<b>Principle 14.</b> There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.	
<b>Principle 15.</b> Holders of securities in a company should be treated in a fair and equitable manner.	
<b>Principle 16.</b> Accounting and auditing standards should be of a high and internationally acceptable quality.	
<b>Principle 17.</b> The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.	
<b>Principle 18.</b> The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	
<b>Principle 19.</b> Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme	
<b>Principle 20.</b> Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme.	CySEC should introduce specific rules for the valuation of assets other than shares in listed companies as a matter of urgency and in any event no later than when it starts authorizing UCITS.
<b>Principle 21.</b> Regulation should provide for minimum entry standards for market intermediaries.	Given the unusual nature of the market intermediary sector in Cyprus whereby most of the intermediaries provide investment services to overseas clients mainly on a cross border basis, it is important that CySEC has a full understanding of the operations of these intermediaries , particularly in ensuring that they maintain segregated client asset accounts especially in the overseas operations and that they apply the necessary 'know-your-client' rules in the context of anti money laundering requirements. In overseeing a market intermediary sector with a very high overseas component, CySEC could face significant reputational damage in the event of difficulties arising. For those jurisdictions where the intermediaries have significant presences, CySEC should consider establishing MoUs with the relevant supervisors—since the FSAP mission, such an MoU was signed with the Russian supervisor.

Principle	Findings
<b>Principle 22.</b> There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	
<b>Principle 23.</b> Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.	
<b>Principle 24.</b> There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	
<b>Principle 25.</b> The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	
<b>Principle 26.</b> There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	<p>The reason for this rating relates to the fact that nearly one year after the relevant legislation was enacted, CySEC has not yet carried out an inspection of the Exchange. This is more striking given that CySEC was unable to carry out an inspection during the previous ten years and in light of the current turmoil in the financial markets. It must also be seen against a background where the Exchange is losing trading business to the Athens Stock Exchange (see Principle 26) and where it is embarking on a plan of expansion (permitting OTCs, stock lending (and possibly short selling), derivatives trading) (also Principle 26), as well as its plans to form alliances with neighboring jurisdictions.</p> <p>CySEC should satisfy itself that the CSE is well positioned to undertake all these initiatives.</p> <p>Also, CySEC should ensure that the CSE prepare timely annual accounts (The 2007 annual accounts for the CSE were not available in October 2008).</p>
<b>Principle 27.</b> Regulation should promote transparency of trading.	
<b>Principle 28.</b> Regulation should be designed to detect and deter manipulation and other unfair trading practices.	
<b>Principle 29.</b> Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	
<b>Principle 30.</b> Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	



28. The following is the recommended action plan in terms of perceived priorities.

**Table 3. Recommended Action Plan to Improve Implementation of the IOSCO Principles**

Principle	Recommended Action
Principle 26 – Stock Exchange	CySEC should carry out an immediate inspection of the CSE to satisfy itself that the CSE is well positioned to embark on its proposed expansion plans. It should also ensure that the CSE prepare timely annual accounts. On a wider level, the State should consider if it wants to remain the owner of the CSE or whether privatization should be considered. This in turn gives rise to the continued viability of the CSE, particularly in the light of its low levels of trading and its loss of business to the ASE.
Principle 21 – Market intermediaries	In supervising market intermediaries, CySEC should pay particular attention to those intermediaries which are foreign owned and provide investment services largely to overseas clients.
Principle 3 – Funding	CySEC should seek to ensure that it will have sufficient funds to carry out its statutory obligations.
Principle 11 - Information sharing	CySEC should ensure that its inability to collect information or carry out investigations on behalf of non-EU regulators where it does not have an independent interest in the matter is addressed in forthcoming legislation
Principle 13 – assistance to foreign regulators	CySEC should ensure that in forthcoming legislation its difficulties in obtaining the identities of beneficial owners of shares registered in the name of lawyers acting on behalf of the beneficial owners is addressed.
Principle 2 – Regulatory independence	The clause in existing legislation whereby the Minister of Finance can require CySEC to provide him with any information he may deem necessary for the benefit of the public interest should be revoked in forthcoming legislation. For all other corporate governance issues relating to independence/accountability, e.g., objective criteria re the appointment of directors, terms of office, removal from office, and reporting to Parliament, the law is adequate.
Principle 20- Collective investment schemes	CySEC should introduce rules for the valuation of assets other than shares in listed companies.