MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

10 December 2020

The Investment Firms Regulation and Directive – 1st Briefing

1. Introduction

As outlined in the circular issued by the Malta Financial Services Authority (the "MFSA" or the "Authority"), "Change in the Prudential Regulation of Investment Firms - The Investment Firm Regulation and Directive", the current EU legislative package for investment firms (the "CRR I package"), composed of the Capital Requirements Regulation I (the "CRR I") and the Capital Requirements Directive IV (the "CRD IV), is going to be replaced by the Investment Firms Regulation (the "IFR") and the Investment Firms Directive ("the IFD"), referred to collectively as the "IFR package".

The Authority will be issuing a series of short briefings to the industry to provide information on the implementation of the revised CRR and IFR packages. The first briefing will cover *inter alia:* the new Classes pertaining to Investment Firms, the Local Firms Regime and the expected regulatory changes in the local framework. That said, these updates will not substitute the obligation of Licence Holders to read thoroughly and familiarise their understanding of these legislative packages.

2. Classes of Investment Firms

The Classes of Investment Firms and their criteria, namely Class 1, Class 1 Minus, Class 2, and Class 3, have remained the same as described in the aforementioned circular. The Licence Holders should already be familiar with the different classes through the studying of the IFR package, published in December 2019, and the data collections conducted by the MFSA, as well as public consultations done by the European Banking Authority ("the EBA").

Further guidance to the one issued on 04 June 2020 in relation to the newly introduced K-Factors and prudential requirements for investment firms, which will be used to determine own funds requirements, are expected to be published by the EBA . These changes will possibly necessitate revisions to the Investment Services Licences issued by the Authority. Further updates on the process to be followed will be provided at a later stage.

Licence Holders are encouraged to participate in all future EBA consultations and take this opportunity to obtain clarifications directly from the legislators of the IFR package.

3. K-Factors

The IFR package introduces these quantitative indicators to accurately reflect the risks which investment firms face, as opposed to the CRR I package. There are three groups of K-Factors; risk to customers, risk to market access, and risk to the firm itself.

Class 2 firms will be required to calculate their capital requirement using the K-Factors.

Class 3 firms will not be required to calculate their capital requirement using the K-factors. However, they will still need to calculate the K-factors for categorisation purposes.

Risk Type	K-Factors
Risk to Client (RtC)	K-AUM: Assets under management – under both discretionary portfolio management and non-discretionary arrangements constituting investment advice on an ongoing basis.
	K-CMH: Client money held – captures the risk of potential for harm where an investment firm holds money for its customers, taking into account the legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money. Excludes client money that is deposited in a (custodian) bank account in the name of the client itself, where the investment firm has access to these client funds via a third-party mandate.
	K-ASA: Assets safeguarded and administered – ensures that investment firms hold capital in proportion to such balances, regardless of whether they are on its own balance sheet or in third-party accounts.
	K-COH: Client orders handled – captures the potential risk to clients of an investment firm which executes its orders (in the name of the client, not in the name of the investment firm itself).
Risk to Market (RtM)	K-NPR: Net position risk – based on the market risk framework (standardised approach, or if applicable, internal models) of the CRR packages.
	K-CMG: Investment firm's clearing member – where permitted by a Member State competent authority for specific types of investment firms which deal on own account through clearing members, based on the total margins required by an investment firm's clearing member
Risk to Firm (RtF)	K-DTF: Daily trading flow – based on transactions recorded in the trading book of the investment firm dealing on own account, whether for itself or on behalf of a client, and the transactions that an investment firm enters through the execution of orders on behalf of clients in its own name.
	K-TCD: Trading counterparty default – investment firm's exposure to the default of their trading counterparties in accordance with simplified

	provisions for counterparty credit risk based on the CRR
	K-CON: Concentration – concentration risk in an investment firm's large exposures to specific counterparties based on the provisions of the CRR that apply to large exposures in the trading book.

4. Local Firms

Licence Holders which hold a Category 3 Local Firms Licence, and which were authorised by the MFSA before 26 December 2019, have to increase their own funds to €250,000 by 26 June 2021. Furthermore, they have a maximum of 5 years to increase their own funds to a minimum of €750,000, with a minimum of €100,000 increase each year. Therefore, by 2026, all these Local Firms shall have an initial capital of €750,000. All increases and calculations are to be done in accordance with the IFR package.

All other Licence Holders which hold a Category 3 Local Firms Licence do not qualify for this transitory provision, and, therefore, have to increase their own funds to a minimum of €750,000 by 26 June 2021.

5. Capital Requirements Regulation II and Capital Requirements Directive V

The CRR package I is also being overhauled through the Capital Requirements Regulation II ("the CRR II") and the Capital Requirements Directive V ("the CRD V"), referred to collectively as the CRR II package.

At the time of writing, as per the legislative text, the CRR II package will start to apply to Licence Holders at the of end of December 2020. That said, the European Commission was alerted of the difficulties in implementing the CRR II package for Class 2 and Class 3 Investment Firms for a period of six months. The European Commission is currently in the process of assessing the applicability of the CRR II package to Investment Firms during the period of 01 January 2021 to 30 June 2021.

The MFSA will keep all Licence Holders informed on the outcome of such discussions, which should be announced shortly.

6. Envisaged Changes to the Law

The CRR II package and the IFR package, as with all EU legislation, will lead to amendments in national law.

The Investment Services Act, Subsidiary Legislation ("SL") 370.15, SL 370.25, SL 371.15, and the Part BI: Rules Applicable To Investment Services Licence Holders Which Qualify As MiFID Firms ("the Part B1 Rulebook") will be amended.

The Authority is also envisioning the introduction of new SLs to transpose both packages in relation to supervisory powers, penalties, and consolidated supervision.

All of these legislative updates are due to come into force by 26 June 2020, thereby making them applicable to all Licence Holders by that date. Although the MFSA will keep all Licence Holders informed, it is their responsibility to frequently check whether relevant new laws have been enacted and whether the Part B1 Rulebook has been updated.

7. Conclusion

In view of the extensive amendments that the above changes will bring about to the Investment Firm regime as well as the pressing implementation date of 26 June 2021, the MFSA encourages Licence Holders to continue reviewing and delving into the CRR and IFR Packages, and to start planning ahead any operational changes that may be required. The MFSA will keep Licence Holders updated as developments arise.

Should you have any queries do not hesitate to contact the Investment Firms Team within the Securities and Markets Supervision Function on investmentfirms@mfsa.mt.