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Table of Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AML	Anti-Money Laundering
AMLD	Anti-Money Laundering Directive
CFT	Combatting the Financing of Terrorism
CIS	Collective Investment Scheme
CMP	Compliance Monitoring Programme
CSA	Common Supervisory Action
EPM	Efficient Portfolio Management
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETFs	Exchange Traded Funds
EU	European Union
GC	Governance and Compliance
ISA	Investment Services Act
LH	Licence Holder
LMT	Liquidity Management Tool
LRMP	Liquidity Risk Management Policy
LST	Liquidity Stress Testing
MFSA	Malta Financial Services Authority
ML	Money Laundering
MLRO	Money Laundering Reporting Officer
NCA	National Competent Authority
NAV	Net Asset Value
PIF	Professional Investor Fund
PMLFTR	Prevention of Money Laundering and the Financing of Terrorism Regulations
RMP	Risk Management Policy
RMS	Risk Monitoring System
SMS	Securities and Markets Supervision
TF	Financing of Terrorism
UCITS	Undertakings for Collective Investment in Transferable Securities

Introduction

The Securities and Markets Supervision ('SMS') function at the Malta Financial Services Authority ('MFSA') is *inter alia* responsible for the oversight and prudential supervision of investment services and investment management related activities in Malta. This includes Fund Managers (Alternative Investment Fund Managers ('AIFMs'), Undertakings for Collective Investments in Transferable Securities ('UCITS') Management Companies and De-Minimis Fund Managers), Collective Investment Schemes (Alternative Investor Funds ('AIFs'), UCITS Funds and Professional Investor Funds ('PIFs'), Recognised Persons (Recognised Fund Administrators, Recognised Incorporated Cell Companies and Private Schemes) and Custodians of Collective Investment Schemes (collectively referred to as 'Entities'). The number of Entities supervised by SMS in the investment management area, as at 31 December 2020, can be viewed from the 2020 Q4 Statistical tables issued by the MFSA.

The oversight of the Entities is executed by means of a combination of onsite and offsite supervision, following the adoption of a risk-based approach, with the aim of ensuring compliance with the applicable local and international legal frameworks.

In addition to carrying out onsite and offsite supervisory work, the SMS also carries out a substantial amount of policy work.

The purpose of this document is to describe the MFSA's approach to the supervision of the Entities mentioned above, an overview of the supervisory engagement during 2020 and the supervisory focus for 2021.

Background on Securities and Markets Supervision

Fund Managers

The MFSA ensures that Fund Managers operate in accordance with the EU regulatory framework, mainly the Alternative Investment Fund Managers Directive ('AIFMD') and the UCITS Directive as transposed within the national legislative framework, as well as any rules, guidelines and best practice documents published by the European Securities and Markets Authority ('ESMA') and the MFSA itself.

Through its onsite and offsite supervisory engagements, the MFSA *inter alia* focuses on the Fund Managers':

(i) alignment of business model and strategy with the licence/permissible activities;
(ii) profitability and regulatory capital buffers;
(iii) adequacy of internal governance and organisational structure arrangements;
(iv) investment management processes; and
(v) risk management practices.

The Authority carries out its offsite supervisory work primarily through the review of returns, annual reports and audited financial statements submitted by Fund Managers and engagements on an *ad hoc* basis in relation to specific issues which may arise from time to time. Furthermore, licence holders with serious issues or who are the subject of repetitive shortcomings are placed under enhanced supervision.

This information, together with other data requested on an *ad hoc* basis, is considered by the Authority in drawing up risk metrics and ratings for all Fund Managers, which, in turn, serves as a basis for prioritising supervisory work and onsite inspections.

Collective Investment Schemes

Similarly, collective investment schemes are also supervised to ensure compliance with the provisions of the AIFMD and the UCITS Directive as transposed within the national legislative framework, together with the local regulations governing PIFs. The offsite and onsite supervisory work carried out *inter alia* considers a scheme's:

- alignment of the underlying portfolio of assets with the investment strategy and restrictions contemplated by the relevant rules and offering documentation;
- Net Asset Value ('NAV') trends and performance; and
- adequacy of internal governance and business models, in particular substance requirements and control functions.

Offsite work carried out on Schemes follows a similar approach to that of Fund Managers, as explained in further detail above. The Authority also considers offsite information and data in identifying licence holders to be subjected to onsite inspections.

Fund Administrators

Although Fund Administrators are subject to a recognition certificate, both offsite and onsite work is carried out on such entities, with offsite work focusing amongst others on the review of financials and valuation errors and onsite focusing on the NAV calculation process, transfer agency and corporate governance.

Custodians of Collective Investment Schemes

Custodians are supervised with reference to the requirements emanating both from the AIFMD and the UCITS Directive, as transposed within the national legislative framework, Part BIV of the Investment Services Rules for Investment Services Providers and Investment Services Act (Custodians of Collective Investment Schemes) Regulations [Subsidiary Legislation 370.33]. These entities play an important role in the securities industry chain as they have a fiduciary role protecting the interests of investors. Accordingly, the MFSA's supervisory engagement with these entities has been increasing over the past years and this trend is expected to continue throughout 2021, as further explained in Section 0 of this document.

Supervisory Engagements, Findings and Recommendations

During 2020, thirty-seven (37) remote onsite inspections were carried out on various Entities. The SMS function continued to focus on governance and compliance, assessing practices and improvements registered in this area on an ongoing basis. In addition, a number of specific topics were also covered on an ad-hoc basis, with the first being liquidity risk management, as part of the Common Supervisory Action ('CSA') initiated by ESMA, outsourcing and delegation of services and the investment management process.

With the increasing importance of Anti-Money Laundering ('AML') and Combatting the Financing of Terrorism ('CFT'), the Supervisory Team responsible for the supervision of these Entities has also incorporated an AML aspect in all of its onsite inspections. This element was captured through interviews held with the Money Laundering Reporting Officer ('MLRO') of the respective Entity during inspections and the reviewing of the adequacy of AML/CFT practices and procedures, allowing the SMS to also get an insight on the respective MLRO's expertise and involvement in the process.

During 2020, the Authority also carried out substantial work aimed at monitoring the market uncertainty brought about by the COVID-19 pandemic. In this respect the main focus was on liquidity and business continuity.

(i) Governance and Compliance

Scope of Inspections

Through the Governance and Compliance ('GC') inspections, the MFSA has continued to assess Licence Holder (particularly Collective Investment Schemes ('CIS') and Fund Managers) practices and effectiveness with respect to a number of specific issues, namely:

- the role and level of involvement of Independent Directors on the Board of Directors;
- the quality and effectiveness of the oversight provided by the Board on delegated functions and outsourced service providers;
- conflicts of interest and how these are managed internally;
- board proceedings, board packs and minutes;
- the structure and effectiveness of the compliance function; and
- the quality and adequacy of internal procedural and policy documentation, such as the compliance procedures manual and the compliance monitoring plan.

Findings and Best Practices

1. Effectiveness of Board: Participation and Oversight

A repetitive finding in our GC inspections was the lack of evidence supporting active Board participation, particularly with respect to oversight and scrutiny. During board meetings, discussions held on the reports tabled and discussions from the directors sometimes lacked completeness, with important topics such as the performance of the underlying fund and investment management related issues not being discussed as expected. Whilst we understand that a deep dive on performance and investment management is often undertaken during investment committee meetings, board members, particularly independent directors, are expected to exercise their role of scrutinising information presented and decisions being taken at investment committee level, and that such committees adequately report to the Board. The Board is required to monitor the general performance of a fund and give high-level directions where necessary.

2. Board Proceedings, Packs and Minutes

With regards to board proceedings, whilst the Authority has encountered instances where important updates and documents were not presented during board meetings (such as the investment manager's report and other service provider reports), it has noted significant improvement from Licence Holders ('LHs') with respect to the quality and timeliness of the information pack being circulated prior to board meetings, as well as the format and structure of the meetings held.

On the other hand, the lack of detail of board minutes has been a recurring shortfall, with such minutes often not being sufficiently detailed or reflective of the nature of discussions undertaken. Whilst it is understood that a level of detail may not always be captured by the individual minuting the board minutes, sometimes due to a lack of technical expertise, LHs are expected to ensure that the salient points, discussions and decisions held during board meetings are adequately reflected in the minutes.

3. Outsourcing of the Compliance Function

The MFSA has noted an improvement in the level of liaison and communication between outsourced compliance officers and licensed entities, with such compliance officers taking a more active role and developing proper communication lines with the Board of Directors and key function holders. Nevertheless, the MFSA has observed a number of instances whereby the outsourced compliance officer was evidently unaware of key developments within the Licence Holder.

The MFSA reiterates the importance of the compliance function, especially when outsourced, to be involved beyond the submission of compliance reporting and the preparation of the

Compliance Monitoring Programme ("CMP"). Without such a level of involvement and insight on key developments and status of the respective LH, the effectiveness of compliance work carried out would be significantly hindered. The compliance officer is expected to be well versed with the operations of a LH and shall dedicate adequate time and resources in order to carry out his/her duties effectively.

4. Compliance Reporting

The compliance report tabled to the Board is expected to capture all relevant compliance related developments which occurred during the period. As highlighted in our Circular of 5 September 2018, the compliance report is expected to provide:

- updates on the CMP progress conducted throughout the year and the escalation of any findings identified;
- updates on any local and international regulatory developments relevant to the LH; and
- updates on the submission of regulatory filings.

In addition, compliance related matters such as the contraventions which occurred during the period and an update on any open contraventions and matters, which could potentially lead to contraventions, are also expected to be provided.

With respect to the update on the CMP, it has been noted that a number of LHs are still not adequately utilising the CMP as a monitoring tool and hence updates in this regard are not being included in the compliance reports. In other cases where an update was provided, this was often lacking the necessary detail or supporting documentation.

In this regard, as a minimum, the compliance report should outline the checks conducted by the compliance officer, highlighting any findings made and a recommended way forward. A report drawn by the compliance officer pursuant to the onsite/offsite checks carried out should also be annexed to the compliance report.

5. Compliance Monitoring Programme

The Compliance Monitoring Programme establishes the activities, risk areas, policies and procedures of the LH which will be monitored and tested during the year. The compliance monitoring to be carried out by the compliance officer in a particular year is to be clearly outlined in this document, ensuring to identify and monitor high-risk areas which are relevant to the LH. The MFSA has noted a number of recurring findings in this respect:

- the CMP being of a general nature, with the frequency of checks to be conducted and/or specific procedures to be monitored/tested not highlighted or identified;

- a one size fits all CMP being adopted for LHs, whereby specific features of a particular LH and/or highly relevant processes or issues are not identified or monitored in the respective CMP;
- the CMP not being a live document, with the same identical checks being carried out year after year. In this regard, the CMP is expected to be dynamic, adapting to changes within the LH, the industry and regulatory environment; and
- insufficient or no documentary evidence that the checks and tests highlighted in the CMP are being undertaken in the frequency stipulated. In this regard the MFSA has also noted lack of reports, findings and recommendations with respect to CMP items.

The MFSA would like to reiterate that LHs are not to approach the CMP as a "tick the box" exercise or simply as a regulatory calendar, but as a highly relevant compliance plan for the year, serving as the foundation for the monitoring and assessment to be undertaken on every aspect of operations of the respective LH. The compliance reviews and checks conducted should be commensurate with the nature, scale and complexity of the operations of a licence holder and should be tailor-made for the specific LH. The CMP is therefore to be based on a risk assessment exercise carried out by the compliance officer prior to the drawing up of such a plan. For instance, compliance reviews on daily dealing UCITS funds are to be carried out at more frequent intervals as opposed to PIFs with an annual dealing frequency. LHs are to refer to section 2.3 of the Circular issued by the MFSA on 5 September 2018 for further guidance on the CMP.

Furthermore, compliance officers should not only focus on the design of the CMP, but also the execution of such a plan, which is to be evidenced accordingly through supporting documentation such as offsite/onsite reports relating to the checking undertaken, also highlighting recommendations made.

(ii) Liquidity Risk Management

Effective liquidity risk management is an area of utmost importance for safeguarding the best interests of investors from risks arising from potential mismatches between the liquidity of CIS' underlying assets and redemption requests. The resultant negative effect of such risks would be that of funds not being able to honour redemptions in a timely manner in line with the applicable dealing frequencies or otherwise realising significant losses through the fire sale of illiquid assets. Another effect of weak liquidity risk management is not being able to ensure the fair and equal treatment of investors. Such a shortcoming is realised through the 'first mover advantage', when the liquid portion of a fund's portfolio is liquidated to meet a first batch of redemptions, subsequently leaving remaining investors with the illiquid portion of the fund's portfolio. Effective liquidity risk management also plays an important role in ensuring the robustness of CIS and the integrity of financial markets, ultimately curbing systemic risks.

Such a topic has continued to grow in importance in recent years, with entities such as ESMA, IOSCO, EFAMA and the ESRB issuing recommendations and guidelines addressing systemic risks relating to liquidity mismatches and liquidity stress testing ("LST"). Even more recently, in Q1 of

2020, ESMA launched a Common Supervisory Action ("CSA") on UCITS Liquidity Risk Management with the aim of assessing whether market participants are adhering to the liquidity risk management provisions within the UCITS framework. That being said, other older guidance documents provisions for liquidity risk management, such as CESR's Guidelines concerning eligible assets for investment by UCITS remain very relevant and are also to be used as a reference point by such LHs.

On the basis of the above, adopting a pro-active approach, SMS has carried out a thematic liquidity risk management exercise through a questionnaire and subsequent compliance inspections, from Q3 of 2019 onwards. A total of 15 inspections were carried out in this respect. The aim of such interactions was to assess the liquidity risk management practices adopted by UCITS management companies, AIFMs, self-managed UCITS and AIFs ('Target LHs') as well as the level of preparedness with respect to ESMA's Liquidity Stress Testing Guidelines, which came into force on 30 September 2020. It is worth noting that such compliance visits, whilst addressing a number of topics, were more governance related whilst the CSA delved into more detail with respect to investment management processes and ongoing monitoring with respect to liquidity risk.

The sections below will highlight the common weaknesses that have been identified by the Authority during the thematic compliance inspections carried out at the Target LHs. Together with the common weaknesses identified during the inspections, the following sections also aim at highlighting best practices with respect to liquidity risk management.

(a) Thematic Liquidity Risk Management Onsite Inspections 2019/2020

The Liquidity Risk Management thematic review was kicked off by SMS in 2019, through a questionnaire which was sent to all Target LHs, obtaining information on liquidity risk management reporting, policies and procedures, ongoing monitoring, design phase liquidity risk considerations, investor behaviour analysis, use and availability of liquidity management tools, liquidity stress testing and more. Subsequently, the MFSA shortlisted 15 Target LHs and carried out focused onsite inspections, focusing on a number of key topics as outlined in the next sections.

1. Governance

1.1 Liquidity Risk Reporting

During the onsite inspections, the MFSA covered the frequency and quality of liquidity risk reporting. Common findings in this respect were as follows:

- liquidity risk not featuring in risk reporting or not covering all sub-funds under management;

- liquidity risk not being included in every quarterly risk report to the Board of Directors of the Investment Manager (and ultimately in the reporting to the Board of the underlying funds);

- the risk report not covering all of the liquidity risk management process; this was mostly seen in the form of liquidity stress testing being the only item mentioned under the liquidity risk section of the risk report;

- only quantitative information being provided in the report, with such information not being translated into meaningful conclusions and recommendations to the Board.

- new liquidity risk management procedures introduced not being backed up by relevant explanations on how the respective tool or calculation works; and

- when internal liquidity risk limits have been exceeded or are close to being exceeded, no recommended actions being put forward or reflected in the risk reports.

It is expected that liquidity risk is given prominence in risk reports presented in the quarterly Board meetings of the LH, featuring all of the calculations and exercises carried out with respect to liquidity risk monitoring. As a result, the liquidity profile of each sub-fund, particularly information on exercises being carried out (as applicable), such as, but not limited to, liquidity buckets and the outcome of liquidity stress testing, are also expected to feature in such a report.

Whilst the inclusion of quantitative figures and results from such exercises are important to be included in the report, it is highly recommended that such results are translated into a more qualitative and actionable narrative within the report. Recommendations and action points are to be made when any hard/soft limits have been breached or are close to being contravened, or even if a negative trend with respect to liquidity is being identified. In such instances, the risk manager of the LH is expected to propose an action plan for the rectification of this matter or to mitigate the realisation of such a contravention. Whilst we encourage informal discussions on risk management on an ongoing basis, any shortcomings identified, and subsequent rectification measures applied, are to be featured in the respective quarterly risk report covering that period.

When a particular liquidity risk management practice or liquidity stress testing model has been changed to be more adequate for the particular nature of the respective fund, together with an update to the Liquidity Risk Management Policy ("LRMP"), it is expected that the relevant risk report covering that particular quarter during which the change occurred is to feature an update to the Board, also explaining the rationale for such a change and an explanation on any of the new methodologies adopted. Any risk reporting being undertaken outside of the quarterly Board Meetings is to be adequately documented, with particular focus on any resultant decisions taken from deficiencies or shortcomings identified in such reporting.

Lastly, LHs are to ensure that any risk reporting to the Board of the respective Fund Manager is also to be made available to the Board of Directors of the underlying funds.

1.2 Board Meetings

A common finding identified through this thematic review is that liquidity risk management is a topic which is seldom discussed during Board meetings. With a number of Target LHs already

failing to include liquidity risk in the risk report to the Board, in various instances where liquidity risk was included, the minutes only reflect the Board members merely noting the contents of such a report, also in cases where there were apparent liquidity concerns.

Whilst we do not expect liquidity risk to be discussed in detail in each and every Board meeting, especially when there are no instances of any material shortcomings or items requiring escalation identified by the risk manager, the overall direction of the underlying fund and oversight on the exercises being carried out with respect to liquidity risk management are to be scrutinized by the Board of Directors to an extent which is proportionate to the nature and strategy of the respective fund. In this respect, together with a beefing up of the risk reporting being provided, we encourage discussions on the liquidity risk management figures and explanations being provided by the risk manager through such reports, with an aim of identifying deficiencies and possible improvements in the liquidity risk monitoring process and the actual liquidity profile, in line with the strategy of the respective fund.

That said, Directors are expected to fully understand the content being reported in the risk report and to challenge the adequacy of the methodologies applied, questioning any ambiguities and potential misalignments between the liquidity risk profile of the underlying fund and the actual liquidity risk monitoring and management employed.

1.3 Design Stage

The design phase is essential to set up the characteristics of the fund and the liquidity tools that will enable the fund manager to properly monitor the liquidity risk. At such a stage, the investment manager should ensure that the strategy of the fund, including the targeted investment portfolio are in line with the characteristics and features to be established, including the dealing frequency, liquidity management tools, valuation frequency and the target investor's risk profile. In building the liquidity risk management processes for the respective fund, the investment manager would be able to identify the need for any particular internal liquidity limits, for the early identification of liquidity shortages in line with the risk profile of the fund.

The MFSA has noted instances where the dealing frequency and other features established are not conscious of the liquidity nature of the underlying assets, and vice versa. An inadequate design could lead to a misalignment between the liquidity profile of the underlying assets and the risk appetite of the investors.

Although a number of Target LHs have formalised the design stage when launching a new sub-fund, the liquidity aspect was in the majority of cases overlooked. Furthermore, in instances where liquidity considerations were made during the design phase, the analysis lacked proper documentation. In this respect, it is expected that design stage considerations are adequately documented, as also emphasised by guideline 40 of the ESMA's Guidelines on liquidity stress testing in UCITS and AIFs.

1.4 Liquidity Risk Management Policy

Target LHs are expected to maintain a detailed liquidity risk management policy ("LRMP") or a dedicated liquidity risk section within the RMP, approved by the Board of Directors, which is to capture all the policies in place and tools available for monitoring and dealing with liquidity

risk of each of the underlying funds. An LRMP is expected to address how liquidity risk is identified, measured, monitored and managed, substantiating the adequacy of any of the models chosen. Whilst the policy in itself is not a procedural document, it is considered to be best practice that the policy references or is annexed by the actual procedures document relating to the relevant processes. In cases where an investment manager's LRMP captures several funds under management, distinction is to be made between the different characteristics, liquidity risk management exercises and limits implemented for each of the different funds.

From the reviews carried out on a sample of LRMPs during the onsite inspections, various deficiencies were identified with respect to the entirety of the document. Target LHs in general are to dedicate more attention into developing and beefing up the LRMP, duly considering the recommendations made above. The most common shortcomings identified in this respect were as follows:

- No LRMP or no dedicated section for liquidity in the RMP whatsoever;
- only a brief description of liquidity risk being provided, with no other information related to liquidity risk management included;
- the document only referring to LST, failing to mention any other ongoing liquidity risk monitoring and measurement practices which are actually being undertaken;
- liquidity management tools ('LMTs') not being disclosed;
- no changes log; *and*
- document not presented to and approved by the Board of Directors.

Having considered the above, it is recommended that the LRMP should, *inter alia:*

a) set out the owners responsible for the monitoring of liquidity risk;
b) indicate the frequency at which liquidity risk is measured, reviewed and monitored;
c) set out the reporting to be undertaken, clearly outlining action owners and recipients, as well as the frequency of such reporting;
d) outline the liquidity risk profile of each of the funds managed;
e) include all of the techniques and internal limits that enable the liquidity risk of the funds under management to be assessed and monitored. This should not be limited to liquidity stress testing only but is to include all such information relating to the models, parameters and metrics used to assess the liquidity of all funds under management. Apart from merely indicating which technique or tool will be adopted, a detailed explanation of how the tool works and what it intends to capture is also expected to be included in the LRMP. The reasons underlying the choice of any monitoring technique or tool is also to be disclosed. These may naturally vary from one fund to another.
f) include references to actual procedural documentation outlining the pre-trade and ongoing monitoring processes, as applicable.

g) identify the types of LMTs necessary to manage the liquidity risk of each Fund under management and the circumstances in which such tools can be used under normal and exceptional/stressed conditions;

h) include the breaches escalation procedure to be followed in relation to liquidity, indicating which circumstances and internal liquidity limits/thresholds would merit such follow-up action; and

i) the liquidity stress testing policy, to include information in relation to liquidity stress testing in line with Article 40 of the Commission Delegated Regulation 231/2013 and point 24 of the ESMA Guidelines on LST.

In addition, the LRMP (together with the RMP and the LST policy) is to be reviewed on an annual basis, with any changes implemented to be approved by the Board.

2. Ongoing Liquidity Risk Management

2.1 Ongoing Monitoring

Through our onsite inspections, it was noted that a number of licence holders did not have a liquidity risk monitoring process which is clearly established and documented. Whilst many Target LHs did carry out a form of liquidity risk monitoring, it did not form part of a robust process but rather as fragmented exercises carried out. It was noted that even in such instances, the monitoring quality and frequency were sometimes not proportionate with the dealing frequency and liquidity profile of the fund. Furthermore, liabilities were often not considered as part of ongoing liquidity risk monitoring.

The day-do-day liquidity risk management should enable the LH to regularly measure, monitor and manage the respective fund's liquidity. Through such a framework, the LH should be in a position to determine the following on an ongoing basis:

a) the time and cost to liquidate assets;

b) potential liquidity risks arising from the nature of the underlying assets, considering such an impact through the assessment of the asset class and type, credit quality, asset concentration and business prospects of the respective investment;

c) the impact of liabilities and future liquidity pressures before they arise, including redemptions patterns, dividends, margin calls, possible investor trends as well as investor behaviour; and

d) internal soft limits acting as early indicators to increasing liquidity risk pressures.

For the purposes of (c) above, the MFSA has observed good practices from licence holders, whereby in addition to redemption analyses and investor concentration analysis, certain LHs also engage in direct contact with investors holding large proportions of the respective fund's units, in order to gauge intentions with respect to possible future redemptions.

Taking the above into consideration, Target LHs are to ensure that any funds under management are continuously in a position to meet redemption requests. The considerations

mentioned above are also to be made with a view of possible stressed market conditions, through the utilization of liquidity stress testing and scenario analysis tools. In this regard, LHs are to ensure that the relevant information required to estimate and manage liquidity risk is made available consistently. Needless to say, the liquidity risk management process is to be adapted with a proportionate view of the actual liquidity risk posed through the investment strategy, underlying portfolio and dealing frequency of the respective fund, also meaning that the adequacy of any current practices adopted by the LH should be revisited on a periodic basis.

2.2 Liquidity Stress Testing

From a limited review carried out on the liquidity stress testing implemented by Target LHs when compared to ESMA's liquidity stress testing guidelines, the MFSA has noted a number of shortcomings, as partly referenced in previous sections and explained in further detail below:

- stressed scenarios chosen are not appropriate or relevant with respect to the underlying fund;
- actions are not taken with respect to red flags and liquidity concerns raised from stress testing results;
- liability side considerations, particular investor dealings and investor behaviour not being included in LST;
- LST policies not drawn up to the expected standard;
- LST undertaken not adequately documented; and
- LST results not adequately reported to the Board of the LH.

Target LHs are expected to adopt the relevant provisions of ESMA's LST guidelines both from a design and execution perspective, ensuring that any policies and procedures drawn up are adequately being undertaken and followed up with the necessary reporting and escalation measures.

With respect to the reporting of LST results, whilst the MFSA does not require the specific submission of the entire LST results for UCITS, it may request the LST results on an ad-hoc basis and these should be available for inspection at the registered office of the Investment Manager. That said, full scope AIFMs authorised in terms of the AIFMD shall continue to report stress testing results of their AIFs through the AIFMD reporting framework, as detailed in ESMA's technical guidance with reference to point (b) of Article 15(3) and 16(1) of the AIFMD.

(b) CSA on UCITS Liquidity Risk Management

As explained earlier, the CSA is a common supervisory approach initiated by ESMA with National Competent Authorities ("NCAs") across the EU, with the purpose of gauging practices and compliance with UCITS liquidity risk management requirements as well as building a common supervisory culture and approach in this regard. Through this exercise, the MFSA collected data and information from UCITS Managers and self-managed UCITS (collectively referred to as "UCITS" in this section) licensed in Malta and carried out a further in-depth assessment of

liquidity risk management practices for a smaller sample of the population. The CSA focused on several aspects surrounding liquidity risk management, primarily:

1) Pre-Trade Analysis and Forecasting;
2) Ongoing alignment of redemption policies and liquidity profiles;
3) Data Availability, reliability, sources, screening and processing; and
4) Governance and Control Mechanisms.

The MFSA approached this exercise through two stages of questionnaires and subsequent follow-ups through remote inspections. The findings and recommended best practices in this respect are summarised below.

1. Pre-Trade Liquidity Analysis and Forecasting Findings and Best Practices

Article 23(4) of the Commission Directive 2010/43/EU sets out that UCITS shall, where it is appropriate and after taking into account the nature of the target investment, formulate forecasts and perform analyses concerning the investment's contribution towards the liquidity of the portfolio, prior to carrying out the investment. The supervisory expectation to this extent is that UCITS are to be able to demonstrate and provide evidence of their pre-investment liquidity forecasts and/or analyses in relation to unlisted assets and potentially even listed assets which are less liquid or illiquid in nature and which could potentially negatively impact the liquidity profile of the underlying fund.

Any securities which may have an impact on the ability of the UCITS to meet redemption requests or on the overall liquidity profile, such as asset types which are inherently illiquid or have lower trading volumes (as an example this may include, amongst others, small cap equities and junk bonds) are to be duly considered for such an analysis, after taking into consideration the target holding as a percentage of the portfolio as well as the target percentage holding of the issue to be taken up. As a result, the presumption of liquidity contemplated by Article 2 (1) of the Commission Directive 2007/16/EC is not necessarily always justified, especially when considering certain securities which are admitted to trading on a regulated market but which are subject to low trading volumes. That being said, UCITS are to question and determine whether there is any information to suggest that the liquidity profile of the target asset is not consistent with such an assumption and whether such a security could compromise the ability of the UCITS to redeem investors on their request[1].

The modelling and forecasting of such assets should take into account both current as well as future liabilities and liquidity pressures. This is particularly important when considering that adjusting the underlying portfolio on an *ex-post* basis entails additional operational risks and creates additional costs for investors. For this reason, it is important that such liquidity risks are identified and managed prior to making investment decisions. In this regard, UCITS should set appropriate internal limits and thresholds for each fund under management, in line with the

[1] as contemplated by CESR's guidelines concerning eligible assets for UCITS

respective strategy and redemption policy, with such thresholds acting as early signals to the UCITS to carry out further in-depth liquidity analyses prior to investment.

The MFSA has noted a number of good practices by UCITS with respect to the above, with some also employing liquidity forecasting at a pre-trade stage, when deemed necessary, by extrapolating historical liquidity indicators and trends on a forward-looking basis to determine future possible liquidity effects on the portfolio. That said, a number of findings were also made during the exercise:

- pre-trade analyses not carried out (even in relation to non-listed, illiquid assets), or declared to be carried out but not documented;
- presumption of liquidity assumed for listed assets which are evidently illiquid due to insufficient trading volumes;
- the level of pre-trade liquidity analyses undertaken not proportionate with the level of inherent liquidity risk of the target asset; and
- the level of pre-trade liquidity analyses undertaken not proportionate with the target percentage holding versus the underlying portfolio.

UCITS are to avoid adopting a one size fits all approach to pre-trade liquidity risk management or rely heavily on liquidity presumptions, duly assessing the liquidity profile of each security in a proportionate manner considering the asset type and target holding, both as a percentage of the respective fund's NAV and as a percentage of the respective market cap of such an asset. Therefore, in addition to asset level pre-trade liquidity analysis, such analysis should also be undertaken at portfolio level to determine the overall impact of the investment on the overall liquidity of the underlying fund. Pre-trade analysis is expected to be documented and readily available at the request of the MFSA.

2. Ongoing Alignment of Redemption Policies and Liquidity Profiles

Section 2 of Appendix VI to the Rules for Retail Collective investment schemes provides for the measurement and management of risk, including liquidity risk. In particular, UCITS are expected to implement appropriate techniques and have documented processes in place to ensure that the risks of positions taken, including liquidity risk, are accurately measured and monitored. In this regard, UCITS are expected to have a documented system of internal limits to manage and control such relevant risks, ensuring consistency with the respective fund's risk-profile. In addition, UCITS are expected to manage the liquidity profile of underlying assets, on an ongoing basis, to ensure that this reflects the redemption policy of the respective fund and to be able to meet redemption requests.

Through the CSA exercise, SMS gauged compliance with the above provisions and reviewed various ongoing liquidity risk monitoring practices. The majority of the UCITS reviewed had evidence to suggest that sufficient ongoing liquidity risk monitoring is in place, however, ongoing monitoring of liquidity risk with respect to liabilities was sometimes deemed to be lacking.

UCITS are expected to be able to demonstrate that robust procedures and techniques are applied to assess the liquidity risks of both assets and liabilities, and that such processes are appropriate and adequate for the particular UCITS being monitored. With respect to the liability side, it is recommended that UCITS engage with investors or representatives forming part of the distribution chain to the extent possible in order to gain an understanding of the underlying type of investor.

The comments and recommendations made under section (ii)(a)(2) above further refer.

3. Data Availability, Reliability, Sources, Screening and Processing

For liquidity risk management processes to be effective, they need to be based on up-to-date, reliable information, both in quantitative and qualitative terms. In this regard, the availability and quality of data should be considered and tested both at a pre-trade stage and on an ongoing basis. Prior to entering a trade, the UCITS must ensure that information will be accessible during the life cycle of the underlying UCITS fund for the carrying out of ongoing liquidity risk monitoring.

The MFSA has noted a high level of reliance on reputable data providers as well as metrics provided by the same data providers indicating the quantity and quality of data being provided. In this regard, UCITS should not place overreliance on one data provider and shall endeavour to reconcile such data with alternative sources, on a case-by-case basis and when this is deemed appropriate as indicated by the current quality and quantity of data. UCITS should also have contingency arrangements in place to cater for any downtime of particular data providers.

UCITS are expected to have in place arrangements to monitor the quantity and quality of data as well as escalation procedures for when such data is not deemed to be reliable or reflective of the underlying asset, with such escalation taking the form of sourcing the data from different providers or independently. In such instances when the UCITS is not comfortable with the data reliability or availability of the asset concerned, the UCITS is expected to remove such an asset from the portfolio as it would no longer enable the effective management of liquidity risk.

4. Governance and Control Mechanisms

UCITS are required to have in place liquidity risk management policies, arrangements and risk limit systems which are to be reviewed periodically in terms of design and implementation. In addition, UCITS are to ensure that appropriate reporting on compliance, internal audit and risk management is provided to the board of directors and senior management on a frequent basis and not less than annually. Such risk reporting is to fully capture all types of risks, including liquidity risk and should form part of a formalised periodic reporting process.

UCITS must also ensure that appropriate control and escalation procedures are in place to escalate and resolve any deficiencies identified by the risk manager. Without appropriate oversight and controls to deal with the information being produced by the risk management

function, liquidity analyses and monitoring would be made redundant. Needless to say, the Board, which holds the ultimate role of oversight must challenge and question the information being provided through risk reporting and action any recommendations made in this respect.

The MFSA has reviewed numerous risk reports, board minutes, LRMPs, incident reports requiring escalation, reporting lines and interaction between functions to gauge compliance and practices in relation to this section.

The findings and recommendations made under section (ii)(a)(1) above refer. That said, we reiterate the importance that UCITS Managers ensure that policies and procedures are fully reflective of the liquidity risk management practices which are actually being undertaken to ensure that there is alignment and transparency in this respect.

The MFSA's 2021 Securities Supervisory Focus and Regulatory Developments

Supervision of Costs and Fees in UCITS

The MFSA will be participating in the upcoming CSA coordinated by ESMA in the field of costs and fees charged by UCITS. Through the CSA the MFSA will be investigating whether UCITS managers, when charging costs to the fund/ its unitholders:

a) comply with the cost-related disclosure provisions in practice;
b) act honestly and fairly in conducting their business activities with due skill, care and diligence and in the best interests of the fund(s) they manage; and
c) are charging fair prices in line with market practices.

The CSA will also cover entities employing Efficient Portfolio Management ('EPM') techniques to assess whether they adhere to the requirements set out in the UCITS framework and ESMA Guidelines ETFs and other UCITS issues (ESMA/2014/937).

The CSA will take the form of a questionnaire to UCITS Managers and self-managed UCITS. The responses of the questionnaire will be used to conduct follow-up inspections on a selected number of UCITS Managers and UCITS.

Outsourcing

Building on work already carried out in 2020, SMS will continue conducting thematic supervisory interactions in relation to outsourcing of key functions to third parties. The interactions will focus on those key functions which fund managers and collective investment schemes have outsourced, specifically the due diligence conducted on service providers, both at onboarding stage as well as on an ongoing basis. The MFSA will also be determining whether Licence Holders have the appropriate substance in place in line with their nature, scale and complexity of operations.

Custodians of Collective Investment Schemes

In view that custodians have fiduciary obligations and safekeeping responsibilities, additional efforts will be made to ensure that investor interests are safeguarded, particularly in relation to monitoring and safekeeping of investments. Accordingly, during 2021, SMS will be conducting reviews on custodians.

AIFMD Review

The MFSA has recently participated in the AIFMD review consultation launched by the European Commission in October 2020. This consultation document follows a review report published in June 2020 by the European Commission which concluded that a number of areas within the directive should be improved. In its reply to the consultation document, the MFSA has focused on a number of areas.

The SMS function will continue devoting efforts towards to the AIFMD review by following up the developments in this area and implementing any changes introduced by the European Commission, with particular attention to the possibility of the extension of the passport to depositaries.

Cross Border Distribution of Funds Directive and Regulation

The new Cross Border Distribution of Funds Directive and Regulation, which apply both to AIFs and UCITS will bring a number of changes concerning the following:

a) the concept of 'pre-marketing' for AIFs, which introduces a new notification requirement;
b) a new procedure for de-notification of marketing under both the UCITS Directive and the AIFMD;
c) new standards for marketing communications; and
d) transparency on regulatory fees.

Whilst the Cross-Border Distribution of Funds Regulation applies from 1 August 2019, a number of Articles in the Regulation as well as the Directive will come into force from 2 August 2021.

ESG

2021 will see further developments in the area of sustainable finance, which encompasses three main pieces of legislative initiatives, namely the Taxonomy Regulation, the Disclosure Regulation and Benchmark Regulation. Entities are encouraged to follow any communication issued by the MFSA on this area, in particular the Circular dated 9 February 2021 relating to the Implementation of the Sustainable Finance Disclosure Regulation ("SFDR").

Concluding Remarks

This report provides an insight of the main workstreams that the SMS function has been working on throughout 2020 and the focus areas of supervision for 2021. It provides an explanation of the methodologies of supervision and supervisory engagement carried out in the investment services area related to fund managers, recognised fund administrators, custodians of collective investment schemes and collective investment schemes.

During our on-going engagement, the importance of setting the tone at the top and having a Board of Directors composed of members having different expertise in the respective areas together with the collective competence have been emphasized. In addition, the role of the Compliance Officer together with other control functions remain crucial for a Licence Holder, in order to demonstrate that a Licence Holder is operating at sufficient levels of compliance. The Authority expects a high level of regulatory compliance from its Licence Holders in order to protect the interests of investors, the sustainability of the Licence Holder and the integrity of the markets in general. In this regard, it is recommended that the Board of Directors scrutinize the standards and levels of compliance monitoring within the Licence Holder from time to time.

Moreover, a detailed analysis was provided on the common findings and best practices relating to: (a) the liquidity risk management thematic undertaken by SMS; and (b) the CSA on liquidity risk management undertaken by ESMA during 2020. The industry is encouraged to discuss the proposed best practices and take the necessary actions to ensure that Licence Holders have sufficient liquidity risk management procedures and arrangements in place in order to mitigate and manage the risks of liquidity shocks both from an asset and liability perspective, in particular by ensuring adequate pre-trade liquidity analysis and ongoing monitoring of liquidity buckets and redemption trends, with reference to internal soft limits, both in normal and stressed conditions.

The Authority expects Entities to take note of the content of this publication, evaluate it and to implement recommendations and/ or to take corrective actions, in order to meet the Authority's expectations.

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