

Update on the Regulatory Developments in Europe: An Overview and Analysis

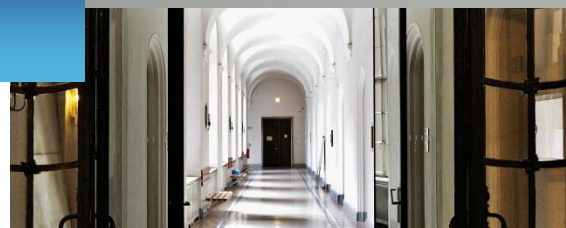
Europe is currently dealing with the sovereign debt crisis and faces the prospect of recession in 2012 followed by a low-growth recovery. Against this backdrop, policy makers face the significant challenge of instituting regulatory reform that addresses weaknesses in the regulatory environment without stifling key drivers of growth, such as investment in bonds and equities that can help provide income in retirement for individuals. BlackRock has engaged with policy makers to shape rules that avoid unintended consequences for end-investors.

This *ViewPoint* updates the 2011 BlackRock overview of the proposed regulatory initiatives that will have the greatest impact on end-investors. Since last year, policy makers have reached agreement on a number of important initiatives, such as rules requiring central clearing of derivatives and a common approach to short selling. The Markets in Financial Instruments Directive (MiFID) is currently under negotiation alongside other high profile legislative proposals. These include increased capital requirements, a tax on financial transactions, heightened market abuse provisions and further regulation of credit rating agencies. Further waves of regulatory reform that will greatly impact end-investors will be launched during 2012 – most notably in respect of a further review of the Undertakings for Collective Investment in Transferable Securities (UCITS) and a new initiative on Packaged Retail Investment Products (PRIPs). In addition, regulators are expected to focus on “shadow banking” which includes activities and entities operating outside the regular banking system and providing credit intermediation, sources of liquidity and sources of funding. Many of these issues have important implications for end-investors.

This *ViewPoint* is structured in four parts:

1. **Regulatory Reforms of Product & Fund Management & Distribution**
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3. **Systemic Risk & Prudential Rules**
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In each, we highlight both positive and negative issues related to regulatory reforms.



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REGULATORY REFORM OF PRODUCT & FUND MANAGEMENT & DISTRIBUTION

Initiative	Description	Key Issues	Expected Implementation
Alternative Investment Fund Managers Directive (AIFMD) <i>Implementation</i>	▶ EU harmonisation of regulation of the alternative investment management industry ▶ Approved in November 2010, final text issued in June 2011; Level 2 measures due by Q3 2012	▶ Scope exceedingly broad ▶ Changes in marketing process, conduct of business, transparency to clients and leverage	Transposition into national law by July 2013
Markets in Financial Instruments Directive II (MiFID II) <i>Investor Protection</i>	▶ Increase of investor protection by reforming the distribution model and introducing product intervention ▶ Proposal published in October 2011; Level 2 measures under negotiations	▶ Risk of undermining the benefits of an open-architecture distribution model and investors' choice	End 2014/early 2015
Undertakings for Collective Investment in Transferable Securities V (UCITS V) <i>Depository liability</i>	▶ Increase of liabilities of depositaries on UCITS assets ▶ Proposal expected in June 2012	▶ Greater consistency of treatment of the depository's duties	2015 (earliest)

Alternative Investment Fund Managers Directive (AIFMD) – Implementation

The Alternative Investment Fund Managers Directive (AIFMD) will harmonise the regulation of the alternative investment management industry in the European Union (EU). The AIFMD Level 1¹ text was published on 8 June 2011 and Member States have until 22 July 2013 to implement its provisions into national law. In parallel, a wide-ranging Level 2² and Level 3³ implementing measures will be finalised in 2012 and early 2013.

The AIFMD seeks to reduce systemic risk by regulating key activities conducted by Alternative Investment Funds Managers (AIFM). The key focus areas of AIFMD are:

- ▶ The conduct of business;
- ▶ The disclosure and use of leverage; and
- ▶ The appointment of key services providers such as depository and valuation agents.

The AIFMD also provides a pan-EU marketing passport to professional investors of EU Alternative Investment Fund (AIF) that will be extended to non-EU AIFs in coming years.

The range of AIFs falling within the scope of the AIFMD is broad including any non-UCITS or non-life-assurance funds set up inside or outside the EU, and managed by an AIFM, whether established inside or outside the EU. Only non-EU funds managed by a non-EU AIFM and not marketed into the EU are excluded. In practice, the AIFMD covers hedge funds, private equity funds, real estate funds, commodity funds, ETFs and a

range of institutional and retail non-UCITS funds, including UK charity funds and unauthorised unit trusts and investment trusts.

The AIFMD will bring changes in the AIF marketing process. When an EU AIFM markets EU AIFs in the EU, the AIFM will have to use a new pan-EU marketing passport. When it sells non-EU AIFs in the EU, it will be able to continue using private placement regimes (PPRs) if permitted by the Member State concerned until 2018 at least, provided a number of additional report requirements to regulators and investors are met.

The European Securities and Markets Authority (ESMA)⁴ has prepared detailed advice on implementing AIFMD which the European Commission has the discretion to adopt or amend.

Key points to watch from the November 2011 Level 2 advice as the Commission finalises the implementing text include:

Transparency to investors and competent authorities

Overall, investors will benefit from new periodic disclosures in the annual report including the percentage of assets subject to special liquidity arrangements, the risk profile of the AIF, the risk management systems used and the use of liquidity management.

In addition, ESMA has produced a pro-forma template for reporting to competent authorities applicable to all managers. The reporting template applies across all types of AIF and provides little differentiation in terms of the investment strategies used. Providing the data will be a resource-intensive exercise. BlackRock is concerned that the template will be hard-coded at Level 2 and will not allow ESMA and other regulators to update the form to allow more focused data requests and to reflect the development of international reporting standards.

1. Level 1: Key framework legislation around any initiative which may be in the form of a directive requiring further national implementation or a regulation which applies directly as national law without the need for further implementation.

2. Level 2: As part of the political agreement at Level 1, the co-legislators may agree to delegate the drafting of more technical provisions to the European Commission who will take advice from the relevant European supervisory authorities (ESAs). The European Commission may draw up Level 2 measures in the form of a directive or a regulation.

3. Level 3: As an addition to Level 2 measures, the power to draw up very specific rules may be delegated to the ESAs. These may be in the form of guidance binding on national regulators or technical standards which have the force of a directly applicable European regulation.

4. ESMA replaced the Committee of European Securities Regulators (CESR) and is part of the 3 European ESAs established 1 January 2011 (ESMA, the European Banking Agency (EBA) and the European Insurance and Occupational Pensions Agency (EIOPA)).

Service Providers

- ▶ **Depositories:** AIF investors will benefit from the greater focus on due diligence and account set-up by depositories. However, the enhanced requirements may mean that depositories will no longer provide custody services in certain markets. If so, managers may need to consider ways of offering indirect and synthetic exposure to these markets.
- ▶ **Valuation:** The AIFM will be responsible for valuation and should implement policies and procedures to ensure a sound, transparent and appropriately documented valuation process. AIFMs will need to consider whether changes will be required to the existing responsibilities in the light of the principles set out in the directive.

Conduct of business

- ▶ **Delegation:** The ESMA advice requires AIFM to justify the reasons for delegation but allows delegation to appropriately regulated third country entities, while not requiring due equivalence of regulation. BlackRock supports the proposed delegation provisions as the advice will continue to allow AIFMs to offer third country fund management experience to clients.
- ▶ **Leverage:** AIFMs must calculate two levels of leverage in fund portfolios. The levels are calculated using (i) the gross method and (ii) the UCITS-style commitment method or alternatively the advanced method. Both levels of leverage must be disclosed to regulators and investors. BlackRock supports the ability to use the advanced method which allows netting of different positions and is the closest measure to the net leverage methods commonly used in the markets. BlackRock believes that using other methods, in particular the gross leverage in some funds may cause confusion between risk and exposure.
- ▶ **Capital requirements and own funds:** AIFM must cover professional liability risks but can choose to hold either Professional Indemnity Insurance, additional capital or a combination. No maximum cap on capital is set. BlackRock supports the flexibility provided in the ESMA advice.

Markets in Financial Instruments Directive II (MiFID II) – *Investor Protection*

Strengthening appropriate investor protection and rebuilding investor confidence following the financial crisis is at the heart of the European regulatory agenda. The European Commission puts forward various ideas to address investor protection issues in the Markets in Financial Instruments Directive (MiFID) review legislative proposal published in October 2011. This proposal aims to update the existing regulatory framework in the MiFID and to set up directly applicable requirements within a new regulation known as the Markets in Financial Instruments Regulation (MiFIR).

Amongst other issues, the MiFID II and MiFIR proposals seek to increase investor protection by focusing on the distribution of investment products and by introducing greater product intervention powers to regulators.

Agreement on MiFID II / MiFIR will probably be reached in 2013 and will then come into force between 2014 and 2015.

The focus of MiFID II proposal is on a number of investment products (such as funds) and services (investment advice) provided to retail investors. Significantly, not all such products or services are included, namely insurance, pension and certain banking products are excluded. Additional elements of the consumer protection regime such as disclosure standards in retail products and a more detailed treatment of complex products are left to future proposals such as the forthcoming Packaged Retail Investment Products (PRIIPs) or amendments to existing directives such as the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive or the Insurance Mediation Directive (IMD).

BlackRock believes that it is essential that all these regulatory initiatives take a holistic view of the relationships that exist between product providers, distributors, advisers and investors in order to achieve the right balance of protections for investors.

Change in the distribution model

The current MiFID II proposal will lead to a fundamental reform of the way in which investment products are distributed. There are two main models of distribution:

1. The open architecture where an adviser can select products from a wide range of products manufacturers for his clients.
2. The closed or integrated architecture where an adviser selects products from a single manufacture with whom he is linked, typically a bank or insurance company.

The proposed text bans commissions paid to independent financial advisers who operate in an open architecture environment. Independent advice is defined as that providing an assessment of a sufficiently large number of financial products diversified by type, issuer or product provider.

Advising on a limited range of product types and/or products offered by a limited number of product providers is unlikely to be treated as giving independent advice.

However, no such prohibition of commissions is imposed on restricted financial advisers. Consequently, BlackRock believes that the proposal could encourage distributors to move to a commissions-paying closed-architecture model offering a simplified range of products where investors no longer have access to “best-in-class” products. Unless the rules are applied across all adviser types, this would create unintended consequences by restricting product choice and reversing the benefits of product and price competition that open-architecture has brought.

Product intervention

The proposed text will give ESMA and other regulators powers to intervene on MiFID instruments such as funds and certificates after launch when in the interests of investors. As discussed in our previous *ViewPoint*, BlackRock thinks that changes should be applied consistently across all products sold to retail investors and not just MiFID instruments. Otherwise, this would raise the risk of creating an unequal regulatory playing field among different types of product manufacturer to the detriment of end investors. Ideally regulators should have powers to set and review the governance standards for providers of retail investment products, by requiring product manufacturers to focus on three key areas of the product's lifecycle: design and creation of the product, marketing of the product and ongoing monitoring of the product.

For more details, see our *ViewPoint* on [Restoring Investor Confidence](#)

Undertakings for Collective Investment in Transferable Securities V (UCITS V) – *Depositary liability*

Following the Madoff fraud, concerns were raised by several EU member states over the controls exercised by depositaries over

the funds for which they act and over the inconsistency across European regulatory regimes. This was reflected in the debates on depositary liability under the Alternative Investment Fund Manager Directive (AIFMD)⁵.

Following agreement on the AIFMD Level 1 directive, the European Commission published a consultation on UCITS V in December 2010 and is about to release a legislative proposal in June 2012. This will focus on the role and structure of depositaries and remuneration policies within the management companies. These rules are an attempt to align requirements in UCITS with the measures in the AIFMD.

The key issues are the extent to which the depositary should be liable for assets held in custody (as opposed to assets that cannot be held in custody, such as derivative positions) and the extent to which, and the manner in which, the depositary should be able to contract out of its liability when it appoints a third-party sub-custodian.

Ensuring greater consistency of treatment of the depositary's duties will undoubtedly be beneficial to investors. However, a number of key definitions as to the scope of the depositary's liability still need to be defined. It is essential that, wherever possible, these definitions are consistent with those used in the AIFMD.

A significant question mark also remains over how delegation to a sub-custodian – where the depositary still has overall responsibility and liability - will work in practice. As with AIFMD, there is a risk that depositaries may cease to offer custody sources in certain jurisdictions, mainly emerging markets. If so, managers may need to consider ways of offering indirect or synthetic access to these markets.

5. Please refer to page 2.

REGULATORY REFORM OF MARKET STRUCTURE

Initiative	Description	Key Issues	Expected Implementation
Markets in Financial Instruments Directive II (MiFID II) <i>Market Issues</i>	► More efficient, resilient and transparent financial markets ► Proposal published in October 2011; Level 1 under negotiation	► New non-equity transparency standards ► Single consolidated tape ► High frequency trading risk mitigation and transparency ► Position limit on commodity derivatives	End 2014 / early 2015
European Market Infrastructure Regulation (EMIR)	► Mitigation of counterparty credit risk related to OTC derivatives ► Political agreement reached in February 2012; Level 2 measures under negotiation	► Central clearing of eligible OTC derivatives in Central Counterparties (CCPs) ► Risk mitigation techniques for OTC derivatives not eligible for clearing ► Position reporting to trade repositories of all OTC derivatives	June 2013
Short Selling and certain aspects of the Credit Default Swap (CDS) regulation (SSR)	► EU harmonisation of short selling rules ► Political agreement reached in November 2011; Level 2 measures under negotiation	► Disclosures of short positions and restrictions on naked CDS positions	November 2012
Market Abuse Directive II and Regulation (MAD II/MAR)	► Creation of a single rulebook for manipulative actions committed through derivatives ► Proposal published in October 2011; Level 1 under negotiation	► Broader definition of inside information ► Defences to insider dealing ► Uncertainties on the use of inside information ► Chinese Wall	Early 2014

Markets in Financial Instruments Directive II / Regulation (MiFID II / MiFIR) – *Market Issues*

The financial crisis revealed the need to make financial markets more efficient, resilient and transparent. To respond to this need, the European Commission published in October 2011 proposals that aim to update the existing regulatory framework in MiFID and to set up directly applicable requirements to be contained in a new regulation known as the Markets in Financial Instruments Regulation (MiFIR).

These proposals try to bring a regulatory response to new trading venues and products having come onto the scene and technological developments such as high frequency trading that have altered the landscape in recent years.

The new framework will also increase the supervisory powers of regulators and provide clear operating rules for all trading activities. Agreement on MiFID II will probably be reached in 2013 and will then come into force between 2014 and 2015.

The key issues related to financial markets stability in the MiFID II/MiFIR proposals are:

- Market infrastructure
- Pre-and post-trade transparency for non-equity products
- Commodity derivatives markets

Market infrastructure

- **OTF category:** A new type of trading venue will be introduced into MiFID regulatory framework called the Organised Trading Facility (OTF). It will capture all types of organised execution not already caught by existing venues.

This will ensure that all trading venues, broker crossing systems and "dark pools" included, have the same transparency rules and that conflicts of interest are mitigated.

However, transactions between multiple third-party buying and selling interests including client orders brought together in the system against financial institutions' proprietary capital will not be allowed on OTFs.

There is also a rigid separation of proprietary capital and third party order flow into Systematic Internalisers (SIs) and OTF categories. BlackRock welcomes the OTF category but is concerned that the requirement banning proprietary capital from OTFs and separating SIs from OTFs fragments liquidity

- **High Frequency Trading (HFT):** MiFID II states that all algorithms used by financial institutions should provide liquidity to the market on a continuous basis regardless of their characteristics and of the purpose for which they have been set up. BlackRock is concerned that this obligation would oblige participants in markets, including asset and pension fund managers using algorithms to execute transactions, to set themselves up as market makers. As an alternative, BlackRock would support a broad definition for automated trading with HFT being a subcategory thereof.

► **Consolidated tape:** MiFID II proposes a consolidated tape offering the most current information available, with prices disclosed throughout the trading day, with a comprehensive level of detail which may include a wide range of securities and investment types. Sources of the data contained on it can come from various securities exchanges, market centres, electronic communications networks, and even from third-party brokers or dealers.

BlackRock supports a pan-European consolidated tape as clearly beneficial for investment managers and end-investors helping them get a more complete picture of a security's liquidity across venues, protecting them and attracting further liquidity for better-informed investment decisions.

In addition, we believe that Exchange Traded Funds (ETFs) should be explicitly included in the scope of the equity European Consolidated Tape due to the rise of popularity of ETFs and the fragmented nature of the listings across Europe.

Pre-and post-trade transparency for non-equity products

A new trade transparency regime will be introduced for non-equities markets (i.e. bonds, structured finance products and derivatives).

BlackRock believes that the current level of pre-and post-trade transparency for "non-equity" markets in Europe is broadly appropriate. A drive to equity-like pre- and post-transparency would only be relevant for instruments that most closely share equity-like liquidity characteristics. However, the "non-equity space" is extremely diverse, typically fragmented, inventory-based and is characterised by low or dispersed liquidity. Forcing these markets to report in a similar way to equity markets could impact liquidity and efficiency in these markets, as buyers and sellers would be less willing to reveal quotes to the whole market, thus creating a worse outcome for investors.

Commodity derivatives markets

The European Commission intends to reinforce regulatory and supervisory framework for commodity derivatives markets and to address the issue of excessive price volatility as underlined by the G20 group of political leaders following the 2008 banking crisis.

BlackRock believes that regulators must receive consistent information from commodities physical and derivative markets that allows them to monitor market evolutions and, in exceptional cases, intervene to prevent or identify market abuse. However, liquidity in these markets would suffer in case of overly onerous public reporting requirements around commodity positions. Likewise, investor confidence in these markets could be undermined were regulators to have a wide-ranging ability to introduce drastic measures, such as position limits, at short notice or in an unpredictable manner. Again, there is the potential for creating worse outcomes for investors.

European Market Infrastructure Regulation (EMIR)

EMIR aims to reduce counterparty credit risk and increase transparency of OTC derivatives. The Level 1⁶ agreement was reached in February 2012 and stipulates that standard OTC derivative contracts be cleared through central counterparties (CCPs) while non-standard derivative contracts will continue to be traded bilaterally, but will be subject to higher capital requirements. In addition, information on OTC derivative contracts will be reported to trade repositories and be made available to supervisory authorities. Greater information also will be made available to all market participants.

Increased central clearing, enhanced risk mitigation of non-centrally cleared trades and position reporting to trade repositories are important and necessary regulatory reforms. BlackRock welcomes the introduction of two important investor protection measures into EMIR. First, the final text recognises the importance of client account segregation in protecting investors within the CCP environment. EMIR adopts "individual client segregation" whereby assets and positions (including excess margin) are recorded in separate accounts, netting of positions recorded on different accounts is prevented and asset covering the positions on an account are not exposed to losses connected to positions recorded on another account. Second, EMIR gives meaningful representation to the buy-side on the risk committee of CCPs. These committees will make decisions of fundamental importance to the buy-side, such as which products get cleared, details of client account segregation, pricing, transparency and default procedures.

BlackRock was also concerned over the impact of the margin requirements on pension funds. CCPs are operationally able to accept bonds for initial margin but cash only for variation margin. In order to raise this cash, a material portion of the portfolio may have to be liquidated, reducing investment performance for pension funds. The final text takes this concern into account and grants exemption for pension funds from central clearing for three years, extendable by another two years plus one year. Meanwhile, pension funds will be subjected to EMIR's risk mitigation techniques requirements for bilateral trades including procedures to mitigate operational, counterparty and credit risk, appropriate segregated exchange of collateral, levels and type of collateral. The Clearing exemption period for pension funds is designed to allow time for operational solution for non-cash variation margin.

The European Securities and Markets Authority (ESMA) has to produce over 50 detailed technical and regulatory standards to allow implementation of EMIR by June 2013. Detailed technical standards will be then published for consultation in June 2012. The drafting process is set to conclude with delivery of the standards to the Commission by 30 September 2012. These will then need to be adopted into European law – currently scheduled to conclude at end 2012.

6. Please refer to Level 1 definition on page 2.

Short Selling and Certain Aspects of the Credit Default Swap Regulation (SSR)

The regulation on short selling and Credit Default Swaps, namely SSR, aims to create a harmonised framework for coordinated action at European level, increase transparency and reduce risks. According to the European Commission, the new framework will mean regulators – national and European – will have clear powers to act when necessary, whilst preventing market fragmentation and ensuring the smooth functioning of the internal market. A harmonised European short selling regime was deemed necessary following the uncoordinated proliferation of short selling bans at national level during the 2008 banking crisis. The SSR has since come to be seen in political circles as the regulatory tool with which to “dampen speculation”.

The political agreement reached in November 2011 on the SSR stipulates, amongst other things:

- ▶ A regime of disclosures of short positions by market participants to supervisory authorities (at 0.2% of short interest) and to the public (at 0.5%)
- ▶ A requirement to locate a security with “reasonable expectations” of its delivery if it were to be shorted
- ▶ Further additional restrictions on taking out a CDS without a degree of portfolio correlation between the CDS and its corresponding underlying asset

The political agreement appeared to strike a good balance to address political concerns around speculation without overly impairing the ability to hedge exposures by taking out short positions. We would expect that balance to be reflected in the implementing text, which at the time of writing had not been released. If this fine balance is not maintained it could lead to significant systems and monitoring costs but more importantly, could detract from efficient market operations. Most notably, it might be harder for investment managers to appropriately hedge exposures in a risk sensitive and cost effective way putting clients’ investments at risk. The SSR could therefore unintentionally contribute to wider bid-ask spreads, reduce market liquidity and ultimately raise the cost of investing.

For more details, see our [Response to ESMA Consultation Paper on Technical Advice on possible Delegated Acts on SSR](#)

Market Abuse Directive II /Regulation (MAD II/MAR)

Regulators are being more involved in combating market manipulation and insider trading, especially in the light of high profile cases. The European Commission proposed in October 2011 a review of the market abuse regime by issuing a proposal for both a directive (MAD II) and a regulation (MAR). This initiative also aims to introduce common criminal sanctions for intentional insider dealing and market manipulation in each Member States and to align the differing interpretations of market abuse in member states in the original directive in MAR.

BlackRock supports this initiative but calls for clearer boundaries without which the scope of the new proposals could inhibit asset managers from engaging with companies in which they invest.

A more precise definition of “inside information”

The proposals widen the definition of “inside information” with the introduction of a new category of information which is neither precise nor price sensitive but which a reasonable investor would regard as relevant when deciding the terms of a transaction. BlackRock is concerned that almost any type of non-public information could be considered as “inside information”. The effect is that investors will be deterred from engaging with the management of a company and inhibited from dealing in the company’s securities. BlackRock recommends reformulating the definition of “inside information” so that it remains clear that inside information must be precise, price sensitive, relevant and have an effect on the market in question.

Definitions of legitimate market activity

The proposals have not retained reference to a certain number of necessary market activities such as market making. BlackRock recommends reinstating these references by including a specific list of acceptable market activities.

Uncertainty on the use of inside information

Insider dealing occurs when a person who is in possession of insider information “uses that information by acquiring or disposing of, for his own account, or for the benefit of a third party, either directly or indirectly, financial instruments to which that information relates”. This new definition of insider dealing creates additional uncertainty for market participants by effectively removing the link between possession of information and intention to use it to take an investment decision. BlackRock recommends clarifying this point to give investors certainty that they will not be committing insider dealing when inside information they hold does not affect their decision to deal.

Chinese Walls preventing the use of inside information within corporate entities

MAR requires that a company such as BlackRock can only rely on a Chinese Wall if the arrangements ensure that nobody in possession of inside information relevant to the transaction had any involvement in the decision or behaved in such a way as to influence the decision or had “any contact” with those involved in the decision. A literal interpretation of this is that firms will need to impose a complete ban on persons on either side of an information barrier ever meeting under any circumstances. This is impracticable and would prevent firms running centralised corporate governance departments. BlackRock recommends deleting the third limb of the sanction which refers to “any contact” between persons on different sides of a Chinese Wall. Instead we recommend clarifying that firms can rely on appropriately enforced arrangements designed to prevent information from crossing information barriers.

SYSTEMIC RISK & PRUDENTIAL RULES

Initiative	Description	Key Issues	Expected Implementation
Shadow Banking	► Important policy decisions to strengthen the oversight and regulation of the “shadow banking” entities and activities to be taken at the global and European level in the course of 2012 and 2013	► Potentially, regulation of exchange traded, money market and other funds, securities lending and repo, securitisation, finance companies, & mortgage insurance companies	Undecided
Capital Requirements Directive IV (CRD IV)	► Stronger regulation, supervision and risk management of the banking sector ► CRD IV proposal (based largely on the Basel III proposal) published in July 2011	► Higher capital and liquidity requirements ► Credit Valuation Adjustment (CVA) charge ► Capitalisation of banks’ exposure to the Central Counterparties (CCP)	From 2013 onward
Solvency II	► Review of the capital adequacy regime for the European insurance industry ► Under implementation	► Change in insurers and reinsurers investment decisions	Undecided
New Corporate Governance standards	► Stronger Corporate Governance standards in financial institutions and listed companies ► Green paper on Corporate Governance in listed companies issued in April 2011 ► Proposal on CRD IV for investment firms published in July 2011	► Composition, independence, qualification, gender and professional diversity of the boards of directors ► Risk management ► Supervision and sanctions by national authorities	Undecided
Credit Rating Agencies Regime (CRAs III)	► Increasing the accountability and transparency of Credit Rating Agencies ► Proposal published in November 2011; negotiations are ongoing	► Potential regulatory intervention in the ratings process ► Mandatory rotation ► Civil liability regime	June 2014
Auditors Regulation and Directive	► Increasing the quality of audits of public-interest entities and enhancing the single market for statutory audits	► Mandatory rotation of auditors ► Auditors barred from offering both audit and non-audit services	Undecided
Review of the Institutions for Occupational Retirement Provision Directive (IORPD)	► Increasing cross-border activities, harmonising and strengthening risk management rules of EU pension funds ► EIOPA advice to the European Commission issued in February 2012	► Harmonised rules for pension schemes across the EU mirroring Solvency II capital requirements	Undecided

“Shadow Banking”

“Shadow banking” refers to a system, activities and entities, operating outside the regular banking system that provides credit intermediation, sources of liquidity and sources of funding and which involves leverage and maturity transformation. Regulators globally raised concerns over the systemic risk that “shadow bank entities” may carry both directly and through their interconnectedness with the banking system and the perceived potential regulatory arbitrage between “traditional banking” and “shadow banking” products, with some banking activities driven towards “shadow banking entities” to avoid the stronger banking regulation. In response to these concerns, the G20 mandated the Financial Stability Board (FSB) to produce recommendations to strengthen the oversight and regulation of the “shadow banking” system by end-2012.

In a document published in October 2011 the FSB stated that its initial analysis of shadow banking will include Money Market Funds (MMFs), Asset-Backed Commercial Paper (ABCP), Special Investment Vehicles (SIVs), repo conduits, securitisation, securities lending and repo, mutual, pension and Exchange Traded Funds (ETFs). The FSB will produce policy recommendations in July before the G20 summit and will publish a proposal by the end of this year.

At the European level the European Commission issued a green paper on “shadow banking” in March 2012 and will publish a final communication paper in Q3 2012. In its green paper, the European Commission sets the list of entities and activities that it considers as part of the shadow banking system and presents its initial reflections on how to regulate those more, taking a similar approach as the FSB.

"Shadow banking" Entities

- ▶ Special purpose entities which perform liquidity and/or maturity transformation
- ▶ MMFs and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("runs")
- ▶ Investment funds, including ETFs, that provide credit or are leveraged
- ▶ Finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank
- ▶ Insurance and reinsurance undertakings which issue or guarantee credit products

"Shadow banking" Activities

- ▶ Securitisation
- ▶ Securities lending and repo

For each entity and activity, the European Commission considers that a right balance should be reached "between three possible and complementary means":

1. Regulations of the relations between banks and "shadow banking" entities
2. The extension or revision of the existing regulation of "shadow banking" and
3. The implementation of new regulations especially directed to "shadow banking"

The European Commission will focus on the existing EU legislations that already regulate shadow banking to which it considers that a lot of progresses are needed to adapt to the rapid evolution of the shadow banking system.

"Shadow banking" is a pejorative term as it reflects the fact that debate has hitherto been viewed through the lens of banking supervision and the prudential regulatory tool-kit. It ignores the fact that many so-called "shadow banking" entities and activities are highly regulated and perform a key role in providing appropriate protections for our clients. These activities are also important in funding the "real economy" and contribute to the liquidity and stability of financial markets. We therefore recommend that the term "shadow banking" be used to refer only to those structured finance entities sponsored by banks (the systemic issues of which would be largely addressed by bank balance sheet consolidation) and an alternative label – for example "market finance" – be used to better reflect the broader set of activities often included in discussion of shadow banking. This would better reflect the complementary role of the market finance alongside bank finance.

The "shadow banking" issue is one of BlackRock's key priorities in 2012. We are engaging with policy makers and trade associations to prevent any measures that could have negative unintended impacts on our clients and to maintain the appropriate protections that many "shadow banking" activities provide to them.

For more details, see our [ViewPoint Securities Lending: Balancing Risks and Rewards](#)

Capital Requirement Directive IV / Regulation (CRD IV/CRR)

The European Commission issued in July 2011 a proposal for the implementation of Basel III⁷ in the EU through a directive and a regulation, namely the Credit Requirements Directive IV (CRD IV) and the Credit Requirements Regulation (CRR). The proposal requires more than 8,000 EU banks:

- ▶ To maintain specific capital ratios as a buffer to counterparty risk by holding assets that meet specific quality and liquidity requirements.
- ▶ To create two new capital buffers: the capital conservation buffer and the counter-cyclical buffer
- ▶ To hold an additional capital charge for their Credit Valuation Adjustment (CVA) risk for their OTC derivatives trades that are not centrally cleared
- ▶ To capitalise their exposure to CCPs for their centrally cleared OTC derivative trades.

Finally, further capital surcharges will be imposed on systemically important banks.

Higher capital and liquidity requirements

Exacerbated by a stricter definition of Tier 1 capital, demand among banks for high-quality, liquid securities will increase as they look to meet new capital requirements. As a large investor in debt and equity securities, BlackRock is concerned that this increased demand will dramatically increase the price of high-quality liquid instruments and, in turn, the total blended cost of the capital charge imposed by banks on other market participants. A knock-on effect of higher prices in liquid markets is that end-investors will be incentivised to invest in riskier assets.

Credit Valuation Adjustment (CVA) risk charge

Counterparty risk is a primary concern of CRD IV. Reflecting similar provisions in Basel III, CRD IV imposes capital charges on banks, namely the CVA risk charge, to hedge against a deterioration in the credit quality of their counterparties for bilateral (non-clearing eligible) OTC derivatives. However, this could also negatively affect market participants in clearing-eligible OTC derivatives. Indeed, ambiguities in the proposal indicate that CRD IV could construe the client leg of a transaction that is intermediated by a clearing member, typically large banks, as a bilateral OTC derivative. If so, the clearing member would have to bear the cost of a CVA risk charge for the clearing service it provides to clients. The clearing member is therefore likely to transfer the cost of that charge to the clients. In addition to this potential cost, clients will have to post initial margin and margin calls to the clearing member. They could also indirectly share the cost of clearing member's contribution to the Central Counterparty default fund and the capitalisation of its exposures to the CCP.

7. Basel III is a set of rules designed to strengthening the regulation, supervision and risk management of the banking sector. It aims to improve the industry's ability to weather systemic shocks, enhance risk management and governance and strengthen transparency and disclosure.

Specifically, the CVA charge will have a significant impact for transactions with any of the following characteristics:

- ▶ **Long-dated derivatives:** The CVA charge considers the entire life of the derivatives exposure.
- ▶ **Directional risk profiles:** As with other counterparty risk capital charges, the CVA Risk Capital charge is based on the net exposure to a given counterparty and as a result directional portfolios are the most significantly impacted.
- ▶ **Uncollateralised exposures:** A strong CSA agreement gives significant reductions of CVA Capital.
- ▶ **Low-rated counterparties:** Higher probability of default will result in a higher CVA charge.

Capitalisation of banks' exposure to CCPs

The requirement for additional capital charge for banks' exposure to CCPs may act to disincentive the central clearing of client trades. Bank's capital charges will actually be higher for the trades it centrally clears for its clients than for bilateral trades with clients. In a centrally cleared client trade, the bank will still be subject to the bilateral capital charges as mentioned above, but, in addition, it will be subject to a 2% risk weighting on its exposure to the CCP and a charge for exposure on any collateral provided (including the default fund contribution). The proposed capital framework would provide strong incentives for bank to bank transactions to be centrally cleared, but it would likely create disincentives to client clearing transactions. The CRD IV requirements are currently being looked at and could be amended to incentivise clearing or at least to ensure it is on a level footing with bilateral trade treatment.

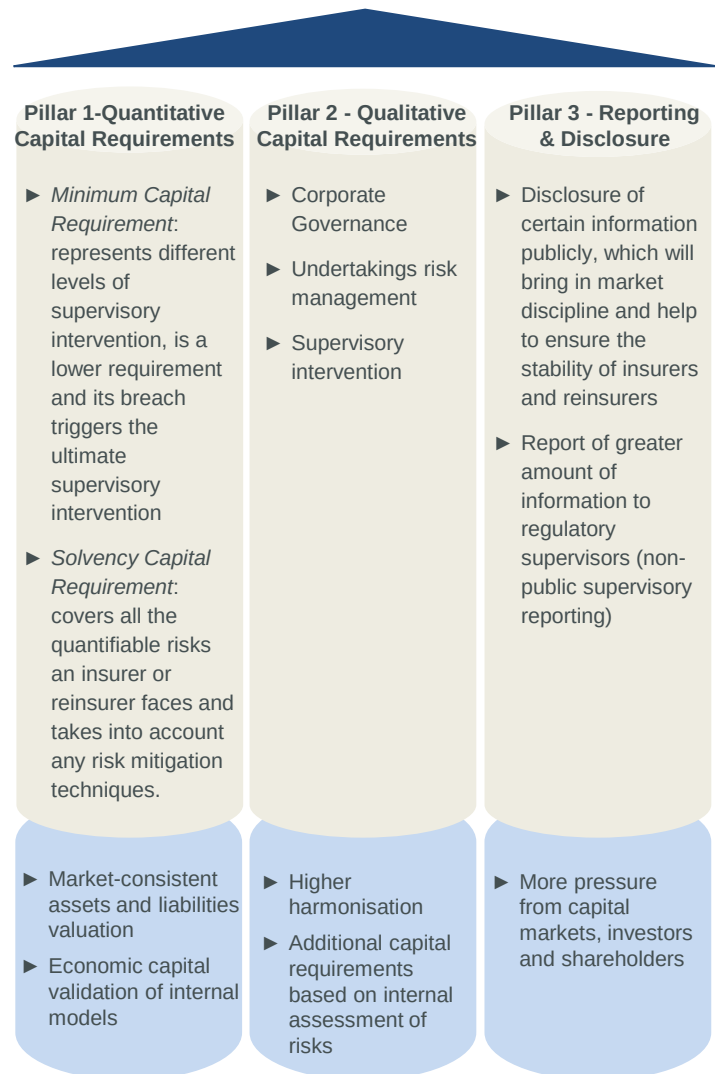
Solvency II Directive

Solvency II is the new prudential regime for most EU insurers and reinsurers that aims to align each undertaking's solvency requirements and assets with the risks inherent in its business taking into account current developments in insurance, risk management, finance techniques, international financial reporting and prudential standards.

Insurers across EU have been preparing for the implementation of the Solvency II Directive, against a backdrop of on-going uncertainty about Solvency II, both in the policy details and the timeline of its implementation. Only on 16 May 2012, the European Commission has proposed a further change of the date for transposition by Member States to be 30 June 2013, with application to firms from 1 January 2014.

However, there are still significant uncertainties on the final shape of the Solvency II directive and on how it will affect risk management, asset allocation and investment strategies. Insurers face notable challenges when building their strategies for the future.

Solvency II is based on a three pillar approach



Insurers and reinsurers face notable challenges when building their strategies for the future.

BlackRock mandated a survey in February 2012 to the Economist Intelligence Unit on 223 insurers operating in Europe. The findings demonstrate the need for the insurance industry to move beyond performance and seek full alignment of investment expertise and enterprise risk management.

Solvency II impacts on insurers and reinsurers' risk management

Insurers and reinsurers will be guided by the amount of capital they have to hold against each asset (by way of a capital charge), and also by the "prudent person principle" which requires firms to invest only in "assets and instruments whose risks it can properly identify, measure, monitor, manage, control and report" and to invest in a manner which ensures the "security, quality, liquidity and profitability of the portfolio as a whole".

Solvency II requires firms to conduct Own Risk Solvency Assessment which aims to cover a company's internal risk management processes and procedures and also assessment of its own solvency requirements. Supervisors will require reconciliation between an insurer's internal assessment of capital and the Pillar 1 Solvency Capital Charge.

Solvency II impacts on insurers and reinsurers' asset allocation

BlackRock's survey result suggests that Solvency II will generate a move away from equities towards corporate bonds among insurers and reinsurers – which is as expected. Over half of survey respondents agree that Solvency II will result in a greater use of derivatives to better match assets and liabilities.

Some asset allocation changes are less expected. More than a third of the survey respondents said they will increase their allocation to alternative assets. This suggests that highly yielding assets could remain attractive to insurers if the returns prove to be worth the higher capital charges under Solvency II.

Issues related to Solvency II Pillar 2 and Pillar 3 requirements for insurers and reinsurers

Insurance companies are concerned about meeting the requirements for the timeliness, completeness and quality of data from third parties under Pillar 3.

Based on the survey, the industry is not only worried that the reporting requirements could be overly burdensome, insurers are also anxious that they will have to limit their investment strategy as some assets demand more rigorous data requirements.

Pillar 2 requirements further reinforce the importance of data in Solvency II, as insurers need to demonstrate the quality control around data and justify their risk measurement approach in Own Risk Solvency Assessment, a key part of Solvency II as required by Pillar 2.

BlackRock maintains good relationships with financial regulators on the topic of insurance regulation development. BlackRock is also currently actively engaging our insurance clients, professional services firms and regulators where possible to identify and meet our clients' needs under Solvency II.

For more details, download our [survey on Solvency II](#)

New EU Corporate Governance Standards

The European Commission is attaching particular importance to the review of corporate governance as it believes shortcomings on corporate governance exacerbated the severity of the financial crisis in Europe. Its approach is comprehensive and was initiated through the publication of two Green Papers: one on corporate governance in financial institutions published in June 2010 and one on the corporate governance framework of listed companies issued in April 2011. The first has led to legislative proposals for banks (CRD IV), investment firms (CRD IV and MiFID II), and insurance companies (Solvency II). The Commission is scheduled to propose an initiative for listed companies in mid-2012.

The various proposals address a number of common topics namely the composition, independence, qualification, diversity of the boards of directors as well as risk management, supervision, sanctions by national authorities and remuneration.

The board of directors

The European Commission proposes that boards of directors should be composed of non-executive members with diverse views, skills and appropriate professional experience and that board members need to be able to invest sufficient time in the work of the board.

The Capital Requirement Directive (CRD IV) introduces higher corporate governance standards for financial institutions such as the mandatory separation of the CEO and chairman functions, a limit on the number of directorships (1 executive + 2 non-executive or 4 non-executive) and a gender diversity policy (without binding quotas). It also mandates a nomination committee and risk management committee, both composed of non-executive directors. The former is to be responsible for board composition, diversity and competence. The latter is to have sufficient powers and reporting lines directly to the board to improve the ability of financial institutions to reduce excessive risk-taking.

BlackRock supports those governance principles that enhance the effectiveness of boards and are consistent with the Commission's commitment to high governance standards as set out in their review.

However, BlackRock recommends focusing on board governance and in particular on the role of the chairman in the selection and monitoring of directors to achieve the objectives of ensuring sound and prudent management of firms.

For banks and financial institutions, selecting the right calibre members for the risk committee is key given the complexities associated with the industry.

Shareholders' responsibility

The proposal encourages more shareholders to focus on sustainable returns and long term performance and to be engaged on matters of leadership quality and management performance.

'Comply or explain' framework, monitoring and implementing corporate governance codes

The proposal requires listed companies to improve the quality of explanation in public statements where there is a departure from a corporate governance code. It is a responsibility of the Member States to ensure that the explanation given by listed companies is clear and comprehensive enough. BlackRock supports this approach and believes that the "comply and explain" model is best placed in ensuring sound corporate governance practices.

Credit Rating Agency Regime (CRA III)

Following the 2008 financial crisis and during the current European sovereign debt crisis, the actions of Credit Rating Agencies (CRAs) have been the subject of heightened political and regulatory scrutiny. To address concerns regarding over-reliance on ratings by the market, opacity of ratings processes and conflicts of interest coming from cross-shareholdings among agencies, the European Commission has now published a third proposal to reform the oversight and organisation of CRAs.

The main requirements of the European Commission proposal centre on:

- ▶ A general obligation for funds managers and investors to do their own credit assessment
- ▶ Disclosure to the European Securities and Markets Authority (ESMA) and investors by CRAs and rated entities of information underlying the ratings
- ▶ Obligation for CRAs to consult issuers and investors on any intended changes to their rating methodologies. Such changes would have to be communicated to ESMA which would check that applicable rules on form and due process have been respected.
- ▶ More frequent ratings of Member States
- ▶ Issuer's mandatory rotation of CRAs every three years
- ▶ Restriction on shareholdings in multiple CRAs to avoid conflict of interest: the appointment or removal members of the administrative, management or supervisory body or be member of the administrative, management or supervisory body of any other CRA or have the power to exercise, or actually exercise, dominant influence or control over any other CRAs

BlackRock supports the rationale behind many of the proposals in the CRA3 package but we are nonetheless concerned that key elements of the package could impair the investment performance and choice of our clients who include European households, pensioners and savers.

Three issues are of particular concern to us and require further consideration:

Regulatory influence in the ratings process

Requiring regulatory approval for new methodologies is fraught with unintended consequences and has serious implications for global investors. Global comparability of ratings would be undermined. Diversity of ratings would be reduced; information points for independent credit analysis would be suppressed

Mandatory rotation

The Commission proposal rightly focuses on discouraging over-reliance on ratings. The proposed mandatory rotation requirement undermines this objective by creating uncertainty, which will ultimately impact end-investor behaviour.

Civil liability regime

The proposed civil liability regime reverses the current burden of proof arrangements reducing the number of issues rated and increasing the cost of using ratings. This outcome would ultimately be to the detriment of Europe's issuers and end-investors and potentially undermines the Commission's stated goals of avoiding over-reliance on ratings.

We have therefore recommended the following alternatives to be adopted:

- ▶ Ratings support for the internal credit analysis process
- ▶ The market determines the quality of CRA analysis
- ▶ Implement existing CRA Regulations to facilitate effective supervision of CRAs by ESMA

For more details, see our [ViewPoint on Reform of Credit Rating Agency Regulation in Europe: An End-investor Perspective](#)

Auditors Regulation

The European Union on 30 November 2011 released a regulation and a directive that together provide new requirements on statutory audits of Public Interest Entities (PIEs).

The proposals could have significant impacts on all listed entities, including investment companies or funds, by broadening the definition of a PIE to “an entity whose transferable securities are admitted to trading on a regulated market, credit institutions, and insurance undertakings, including investment firms, payment institutions, undertakings for collective investments, e-money institutions, and alternative investment funds”. To avoid any unintended negative consequences on end-investors, and given that no significant audit failures related to investment companies have occurred in the past, BlackRock recommends excluding all investment funds from the definition of PIE unless they meet certain characteristics indicating a high level of complexity and risk.

The key provisions of the proposals for investment companies and end-investors are:

- ▶ Mandatory rotation of auditors at least every six years through a tendering involving two firms (one of which must have no more than 15% of its total audit fees earned from PIEs in the previous year)
- ▶ Unless there had been joint auditors during those six years, the rotation would be mandatory every nine years. A period of four years must elapse before the audit firm can audit the entity again.
- ▶ Auditors would be barred from offering both audit and non-audit services; “related financial audit services” capped at 10% of the audited entity’s statutory audit fees.

Mandatory rotation of auditors

Auditor rotation may create the risks of loss of auditor institutional knowledge and a reduced incentive for audit firms to

invest in the relationship with their clients. There are also concerns about the potential limitations on an asset manager’s ability to select an audit firm in due time and the incremental audit fees and internal resources needed to effect rotation. For a company with a significant EU subsidiary, the need for global audit rotation would bring additional costs associated with the parent company’s auditor review of subsidiary work, and the auditor’s assessment of whether they qualify under their auditing standards as the “principal auditor”. This would ultimately lead to higher Total Expense Ratios (TERs) and lower returns for investors.

BlackRock is more in favour of a mandatory review of the incumbent auditor at regular intervals, but not a required change in auditor. This approach would provide the audit committee with flexibility to select the most qualified auditor and would encourage a periodic review of policies and practices as part of the tendering process. If mandatory auditor rotation is adopted, we believe the maximum term should be at least 10 years.

Joint audit

Joint audits could duplicate efforts and be very costly for little benefits as this will not necessarily result in better audit quality given the inherent difficulty in coordinating complex, global engagements and the potential risks associated with overlapping responsibilities between two auditor firms. This practice has not been widely adopted either within, or outside, the EU.

Ban on non-audit services for auditors

Companies need related financial audit services provided by auditors that are in the best position to perform them. The 10% threshold is not likely to be sufficient to cover some existing requirements, such as interim financial statement audits. Therefore, BlackRock believes that it would be more appropriate to provide a conceptual framework of acceptable services with pre-clearance by the audit committee rather than an arbitrary 10% threshold.

Review of the Institutions for Occupational Retirement Provision Directive (IORPD)

European regulators intend to review the directive for Institutions for Occupational Retirement Provision (IORPD) order to simplify the establishment of cross-border pension schemes and enhance harmonisation and mutual recognition of European pension schemes. The European Insurance and Occupational Pension Authority (EIOPA) published technical advice to the European Commission in February 2012 on the IORPD review following two calls for evidence to the industry run in 2011. The European Commission legislative proposal is expected at the end of 2012 or early 2013.

EIOPA's advice recommends greater harmonisation and increased risk-mitigation mechanisms for pension schemes across the EU. The broad thrust mirrors Solvency II capital requirements with some adjustments to the pension schemes. According to EIOPA, this would remove barriers to cross-border schemes, set up a level playing field with insurance companies and increase security for beneficiaries. The main options given by EIOPA are:

- ▶ A holistic balance sheet approach which accounts for sponsors covenant and pension protection schemes.
- ▶ Capital charges for holding risk assets conditional on the outcomes of a quantitative impact study.
- ▶ Risk-free discount rate for liabilities

BlackRock believes that the reform of the IORPD as proposed by EIOPA will have negative unintended consequences on EU pensioners:

- ▶ A harmonised approach is neither appropriate nor desirable given the great diversity of pension arrangements in the EU and a common methodology, whether based on the holistic balance sheet approach or alternative approaches, would only be appropriate for pension funds wishing to operate on a cross-border basis. Yet, this is only the case of 84 out of around 140,000 IORPs in Europe⁸.
- ▶ EIOPA's recommendations will not encourage greater use of cross-border pension schemes in the EU. Even if common solvency rules are adopted by EU pension funds, other factors, such as differing national tax treatments, will still represent a greater obstacle to cross border arrangements.
- ▶ The different mechanisms that already exist in a number of Member States are not taken into account by EIOPA. In some countries, such as the UK and Netherlands, the level of security is already very high. The danger is very real that IORPs in those countries will face considerable costs in complying with new regulations without any significant benefit.

- ▶ Substantial differences exist between pension schemes and life insurance companies. Consequently, we do not believe that they should be subjected to similar prudential treatments and that the application of a Solvency-II like prudential system for IORPs is appropriate. The differences include:

Insurance companies	"Shadow banking" Activities
Insurance products can be bought through a variety of distribution channels and are offered to a large public	Pension benefits are restricted to a company employees that are members of an IORP. As such, pensions are conditional on employment.
The primary motivation is profit.	IORPs are not for profit institutions. They operate for the ultimate benefit of employees and are managed to minimise the cost of pension provision.
Investment decisions are guided typically by return on capital and solvency motivations.	Investment decisions are guided by the will to meet the pension commitments to employees over the long term in a quite predictable manner. Hence, IORPs tend to take a longer term investment view and have longer portfolio duration.
Solvency rules provide security to policies holders.	Member's benefits are already strongly protected by the sponsor employer covenant in some countries (e.g. in the Netherlands by the FTK and in the UK by the work of the Pension Regulator and by the Pension Protection Fund).
Almost 5,000 insurance companies' operations are cross-border in the EU. ⁹	There are around 140,000 IORPs in Europe out of which 84 are cross-border.

- ▶ The application of some elements of Solvency II will increase significantly funding requirements for pension funds and unnecessarily penalise European pensioners. Additional funding demands on sponsoring employers would deprive them *ex ante* of an amount that could be used to tackle *ex post* problems. The resulting financial burden would reduce the sponsoring employer's ability to invest and create jobs. This would weaken these companies, increasing their insolvency risk and undermining their credit ratings. The 'sponsor covenant' would be weaker accordingly. Finally, employers would be forced to reduce or cease providing pension benefits to their employees, resulting in less generous benefits for scheme members.

BlackRock believes that it is vital to find the right balance between a high level of security for all occupational schemes and European citizens' access to complementary occupational and private pensions.

For more details, see our [Response to EIOPA on the IORPD review](#)

8. Source: EIOPA <http://www.efrp.org/LinkClick.aspx?fileticket=8liNE8ylyzA%3D&tabid=1402>

9. Source: CEA, the European insurance and reinsurance federation <http://www.cea.eu/uploads/Modules/Publications/key-facts-2011.pdf>

TAXATION ISSUES

Initiative	Description	Key Issues	Expected Implementation
Financial Transaction Tax (FTT)	▶ Taxing Financial Transactions in the EU ▶ Proposal issued in September 2011	▶ Tax on purchases, sales, lending and borrowing of financial instruments and on clients' subscriptions and redemptions in unit trusts and other funds/collective investment schemes	January 2014
Value Added Tax (VAT) Review	▶ Reconsideration of the financial and insurance services exemption	▶ VAT applied to financial and insurance services ▶ Exemption of management of all collective investment funds and pension funds	Undecided
US Foreign Account Tax Compliance Act (FATCA)	▶ Combat US taxpayers' evasion FATCA has been passed; further IRS guidance issued in 2012.	▶ Foreign Financial Institutions will be forced to identify and report US 'account holders' and withholding on certain payments	July 2013

Financial Transaction Tax (FTT)

The idea of taxing financial transactions has a long history, dating back to 1694, when the UK stamp duty at the London Stock Exchange came into force.

The debate intensified in the aftermath of the financial crisis, due to regulatory concerns over speculation and high frequency trading. In September 2011, the European Commission published a proposal for the introduction of an FTT in the European Union (EU) to make financial institutions pay a fair contribution to the cost of the financial crisis, curb speculation and risk taking and generate additional public revenues for the EU Member States.

If the European Commission proposal is adopted, financial institutions will have to pay a tax on their financial transactions where one party of the financial transaction is established in an EU Member State. The tax will catch purchases, sales, lending and borrowing of financial instruments. Clients' subscriptions and redemptions in unit trusts and other funds/collective investment schemes will also be captured.

Securities and shares in unit trusts and other funds/collective investment schemes will be taxed 0.1% of their value and derivatives 0.01% of the notional. However, the final rates will ultimately be much higher as the FTT does not give any relief to the intermediaries of the financial transactions. The FTT has a cascading effect and this means that the FTT impact would be multiples of the headline rates.

BlackRock is concerned about the impact on pensions, savings and other investment income of European citizens. A FTT will hit investment performance hard, reducing savings and retirement income at the very time when Europe's pensioners, savers and households are struggling to recover from the financial crisis and are being asked to take greater responsibility for their own financial futures. BlackRock is also concerned that funds such as fixed income portfolios and Money Market Funds (MMF) which invest in short-dated instruments would be subject to a greater number of transactions.

The more frequent the number of transactions at the portfolio or fund level, the greater the hit on investment performance for the end-investor.

Sound asset management principles such as diversification, proper hedging and efficient execution will be undermined by such a tax. Reducing diversification and hedging will expose pensioners and savers to greater investment risk especially in volatile market conditions. In addition, to deliver the same level of returns to clients, active portfolios will be forced to take higher levels of risk and/or invest to a greater extent in derivatives, as these instruments will be less expensive to deal than securities.

Finally, in addition to significantly reducing investment income and creating unintended investment incentives, a FTT will reduce investment in the real economy and discourage corporate governance as investment managers invest less in equities and more in derivatives.

For more details, see our [Response to the House of Lords Call for Evidence on FTT](#)

Review of the European VAT Regime for Financial and Insurance Services

The current European Value Added Tax (VAT) law exempts many financial and insurance services. In 2006, the European Commission announced a review of the VAT system as it applies in this sector and as part of this review published a draft directive and regulation as a possible blue print for reform of the VAT regime. This reform was considered necessary because the existing VAT system did not provide certainty to suppliers and recipients of financial services as it was out of date, imprecise, varied in its application and liable to cause fiscal distortion.

Since 2006, and despite intensive debate at Commission level, successive Presidencies have failed to produce a final draft of the revised VAT legislation that is acceptable to all 27 Member States.

The continuing process of review of the directive and regulation has identified, inter alia, the following items as key issues:

- ▶ the treatment of outsourcing in the financial and insurance services sector; and
- ▶ the scope of the exemption for the management of collective investment funds and pension funds.

The application of VAT exemption to the management of collective investment funds varies between the 27 Member States. For example, the UK and the Netherlands have a narrowly defined group of funds to which VAT exemption applies, whereas Luxembourg and Ireland apply the exemption more liberally. The current drafts of the directive and regulation reflect the view of the majority of Member States that prefer the wider definition of funds which would qualify for exemption. Specifically, as currently drafted, the directive and regulation would mean exemption for the management of all collective investment funds (irrespective of the type of investor they are aimed at) and also of pension funds. If this is eventually agreed, a major concern for BlackRock and the rest of our industry is that related services which are essential and integral to the operation of our business, such as distribution, should also continue to qualify for exemption. The application of VAT to these services would result in an unnecessary and distortively cascading VAT cost.

BlackRock considers it essential that the VAT system should operate in a consistent manner so that suppliers and recipients of financial services can enter into agreements with full certainty around what the VAT treatment will be. Furthermore, BlackRock believes that services which are essential to the operation of the fund management industry should also be exempt to avoid the creation of a hidden VAT cost.

On the regulatory front, measures such as MiFID and the Retail Distribution Review in the UK, will, amongst other things, impact the way in which intermediaries are remunerated. This change could result in charge which is currently VAT exempted as intermediation becoming VATable, leading to a potentially negative financial impact for the intermediary and/or the end-consumer.

Foreign Account Tax Compliance Act (“FATCA”)

The Foreign Account Tax Compliance Act (FATCA) aims to ensure the US government clamps down on US taxpayers’ evasion. This is achieved by requiring Foreign Financial Institutions (FFIs) to identify and report US ‘account holders’ and withholding on certain payments to the Internal Revenue Service (IRS). If FFIs do not enter into a binding agreement to comply with FATCA, any payment of sales proceeds or income from US assets made to or through these institutions will be subjected to 30% US withholding tax.

FATCA will be effective on a phased basis starting 1 January 2013 and covers US-domiciled funds held by non-US investors and non-US funds that invest in the US, as well as segregated accounts. Asset managers must work together over the weeks ahead to convince the US Treasury to make further changes to the proposed rule and, at the same time, design a consistent and low impact experience for investors that complies with the final rule.

The IRS released new draft regulations on 8 February 2012 which introduced some significant reliefs to the asset management industry compared with the original proposed rules – though at the potential expense of a considerably more complex implementation project. The stance on the documentation required was not amended. The US authorities also agreed to set up a partnership with a number of European countries for the implementation of FATCA, amongst which are France, Germany, Italy, Spain and the UK. This has been materialised by a joint statement setting up a common approach to prevent tax evasion, where firms would report information on foreign taxpayers to their local authorities.

Amongst other reliefs, the newly proposed regulations set up different FATCA exemption statuses as follows:

FATCA Exemption Statuses	
Total exemption	▶ Exempt Beneficial Owner (e.g. certain institutions for occupational retirement provision) ▶ Certified Deemed Compliant (e.g. certain charities and non-profit organisations) ▶ Registered Deemed Compliant (e.g. restricted funds¹⁰, local FFIs¹¹ and QCIVs¹²) ▶ Compliant but with Exempted Accounts (e.g. UK banks providing ESAs)
	
Total compliance	▶ Fully compliant (PFFIs)

Another relief is that the threshold limit for which an individual account maintained by a Participating FFI (PFFI) only needs to be checked for US indicia has been increased from the pre-existing \$500k to \$1m. Asset managers are also relieved by having the possibility of using existing ‘know your customer’ or anti-money laundering processes, though there are markets, such as the UK where it is not at all clear that existing processes will meet the minimum FATCA requirements. In addition, firms in countries having a FATCA partnership with the US authorities will no longer need to apply withholding on payments within those countries in return for FATCA being enforced under local law.

Local banks, asset managers, fund distributors, fund administrators and collective investment vehicles in these countries will not have to enter into a detailed agreement with the IRS, but only “register” with the local tax authority. Information reporting will be made to the FATCA partner rather than directly to the IRS. Having FATCA enforced as a national law in these countries will also raise the ability of national authorities to tailor FATCA to the countries’ specificities.

10. Restricted Fund: funds that exclude US investors and can bind their distributors to do this. Restricted Distributor: distributors who agree to participate in the above.

11. Local FFIs: small and local distributors having a deemed compliant status.

12. Qualified Collective Investment Vehicle (“QCIV”): funds having the deemed compliant status for only having PFFIs or exempted holders.

Despite these reliefs, there is still considerable uncertainty. The registration process for FFI's with the IRS is not finalised, the timing and extent of changes in the final regulations is unclear, and the proposed partnership agreements introduce a new dimension, in terms of timing, practical application and extent of variation across sovereign states' agreements. Three points are clear:

1. The asset management industry and its service providers must work together to design a consistent and low-impact experience for investors.
2. The timescales to implementation are short and so the industry must move quickly towards defining solutions.
3. The total cost of compliance across the industry will be substantial and these costs can only partially be mitigated by adopting a consistent approach.

BlackRock continues to believe in the fundamental validity of FATCA and is very engaged directly with the US Treasury and IRS in making the case that further changes need to be made to the rule that are important to asset managers and end-investors. BlackRock is also proactively engaging industry bodies and partners to achieve both a common-sense risk-based approach and a consistent, low-impact experience for investors.

For more details, see our [Testimony to the IRS on FATCA](#) and our [Comment Letter to the US Treasury and IRS on FATCA Proposed Guidance](#)

Conclusion

BlackRock supports regulatory reform that addresses the causes of systemic risk and has the potential to bring about positive change for end-investors and clients. BlackRock is keen to ensure that law makers' thinking in Brussels and elsewhere remains global, so that good practice can be adopted on a worldwide basis. BlackRock, therefore, engages in the European legislative process on issues with the greatest potential to affect clients and seeks to ensure that high-quality technical expertise is delivered in a timely manner. BlackRock delivers technical advice across the breadth of its client base as it seeks to become the independent global asset- and risk-management partner of choice. We are concerned that a large number of complex and interrelated proposals remain on the table, in Europe and around the globe. We will continue to be a vigorous advocate for end-investors with regulators and policymakers for policies that increase transparency and investor protection whilst preserving customer choice and taking a balanced view on benefits versus implementation costs.

Related ViewPoint Papers

- ▶ [Regulatory Developments in Europe: An Overview and Analysis](#)
- ▶ [Restoring Investor Confidence](#)
- ▶ [Reform of Credit Rating Agency Regulation in Europe: An End-investor Perspective](#)
- ▶ [Securities Lending: Balancing Risks and Rewards](#)

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