REGULATORY DEVELOPMENTS IN EUROPE: 2013 UPDATE AND ANALYSIS

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Executive Summary

European policymakers and regulators are focussed on reinvigorating economic growth and are considering how capital markets and investors can play a greater role in that regard. Simultaneously, they continue to pursue financial regulatory reform in response to the financial crisis, seeking to balance near-term growth requirements with the need for financial stability.

Since 2009, BlackRock has engaged with policymakers in an effort to shape financial regulatory reform and avoid unintended negative consequences for end-investors. BlackRock is generally supportive of a regulatory regime that increases transparency, extends greater protection to investors and facilitates responsible growth of capital markets, provided it also preserves consumer choice and has benefits that exceed implementation costs.

This *ViewPoint* updates our 2012 overview and analysis of regulatory developments in Europe. It details the different components of financial regulation and their implications for investors. Topics covered range from investor protection, investment products and execution venue choices through to market liquidity and investment profitability.

Over the past four years, policymakers have focussed intently on banking, but have started progressively to turn their attention to the asset management and fund industry. Agreement has been reached on a number of important initiatives (e.g., rules requiring central clearing of derivatives and a common approach to short selling), and resolution is close on others (e.g., the Markets in Financial Instruments Directive, or MiFID, the Capital Requirement Directive IV, or CRD IV, and the Market Abuse Directive, or MAD). Many of these new rules will have important implications for end-investors.

Additional regulatory initiatives were launched in 2012, including a further review of the Undertakings for Collective Investment in Transferable Securities (UCITS) and new proposals on retail investor protection, all currently under negotiation. Also, since our June 2012 *ViewPoint*, the regulatory agenda on "shadow banking" has emerged and the political debate on the Financial Transaction Tax (FTT) has evolved significantly. An Action Plan on European Company Law and Corporate Governance has been launched and long-term investing has become an important area of policy focus. Long-term investing will be at the top of the EU regulatory agenda for the next couple of years. A number of initiatives, such as FTT and the imposition of bank regulation on market finance, which undermine broader policy themes, are likely to be reconsidered in the near future given their negative impact on growth.

The current regulatory landscape is still characterised by high uncertainty, which continues to inhibit investment in Europe. BlackRock remains committed to work with policymakers to ensure the voice of the end-investor is heard in this process.

This *ViewPoint* is structured in four parts:

The opinions expressed are as of June 2013 and may change as subsequent conditions vary.

Product/Fund Management & Investor Protection

Alternative Investment Fund Managers Directive (AIFMD)

In the wake of the financial crisis, the European Commission (EC) sought to reshape and harmonise the management and marketing regulation of any Alternative Investment Funds (AIFs) managed or distributed in the European Union (EU). The AIF Managers Directive (AIFMD) introduces a comprehensive framework for the oversight and regulation of AIFs. The aims are to reduce potential risks to the overall financial system, increase investor protection and provide greater transparency to investors and regulators.

The scope of AIFMD is extremely broad. The definition of AIFs includes all non-UCITS funds (with the exception of insurance products) wherever domiciled, which are either managed or marketed to investors within the EU. The definition of AIFs includes not only hedge funds and private equity funds, but also real estate funds, Luxembourg Specialised Investment Funds (SIFs), Irish Qualifying Investor Funds (QIFs), Dutch Fonds voor de Gemene Rekening (FGRs), German Spezial fonds, UK Investment Trusts, UK charity funds, UK Non-UCITS Retail Schemes (NURS) and UK unauthorised unit trusts. AIFMD also captures US bank collective trusts and US 40 Act funds marketed within the EU. Only non-EU investment funds managed by non-EU managers and not marketed into the EU are excluded from the scope.

The greater transparency provided will assist professional investors (such as pension funds and insurance companies) in developing more standardised due diligence programmes and promote greater comparability of AIFs. Prospectuses, other offering documents, reports and accounts will cover disclosure of key issues, such as management structure and governance, scope of liabilities/duty of third-party service providers and management, risk liquidity and leverage profiles and manager remuneration.

Marketing Passport and Private Placement Regimes

AIFMD will herald important changes to the marketing of AIFs in the EU. From 22 July 2013 onward, it will provide authorised EU AIF managers with the ability to market EU AIFs to professional investors across the EU using an AIFMD marketing passport. This means potentially greater choice for EU professional investors wishing to invest in EU AIFs.

It is anticipated that the AIFMD marketing passport will operate in a similar way to the existing UCITS marketing passport, save that the AIFMD marketing passport is for professional investors alone.

The marketing passport will not be immediately available for non-EU AIFMs/AIFs. Subject to further European Commission and European Securities and Markets Authority (ESMA) approval, non-EU AIFMs/AIFs may become eligible for the EU marketing passport beginning in 2015. In the meantime, both non-EU and EU AIF managers will be able to market non-EU AIFs subject to local private placement regimes (PPRs) in certain EU countries, particularly in the UK and Netherlands. However, many other EU countries, such as France and Italy, do not have a PPR, meaning active marketing will not be possible. It should also be noted that in the future, certain EU countries may make their PPR more restrictive or potentially close it altogether.

Under the Directive, non-EU AIF managers privately placing non-EU AIFs must comply with transparency provisions to investors and regulators, but are exempt from the remainder of the Directive. For example, a Cayman hedge fund managed by a US-based manager can still be marketed under local private placement if registered to do so and subject to these additional transparency and reporting requirements. AIFMD imposes specific requirements on third-party distributors, such as private wealth managers, to ensure non-EU managed non-EU AIFs that they market meet the new transparency and reporting requirements.

Reverse Enquiries

Reverse enquiries is the process by which investors approach fund/investment service providers with specific requests tailored to their needs and investment preferences, and not as a result of marketing received from those providers. Reverse enquiries are technically out of the AIFMD scope. Non-EU AIF managers will have to show clear evidence of reverse enquiries to be free from complying with the PPR of the relevant European country and the associated transparency and reporting requirements.

Other Issues Affecting Investors

AIF investors will benefit from depositaries' greater focus on due diligence and account set-up. Enhanced requirements may mean depositaries will no longer provide custody services in certain markets. However, in such cases, managers may be able to offer indirect and synthetic exposure to such markets, leading to counterparty exposure rather than custody risk.

Political State of Play/Implementation

- The AIFMD Level 1 text was published on 8 June 2011 and Level 2 implementation measures were formally adopted in December 2012 by the EC.
- Member states have until 22 July 2013 to implement AIFMD into national law in their jurisdictions. A transition period allows AIF managers up to a year in which to apply for the necessary variation of permission, authorisation or registration in their home member state. Applications must be received before 22 July 2014.
- Member states are currently drafting their national laws. In parallel, ESMA is in the process of negotiating supervisory cooperation arrangements with regulators in various non-EU states. National regulators must execute such arrangements with non-EU supervisory authorities to maintain their national private placement regimes.

Reforms of Undertakings for Collective Investment in Transferable Securities (UCITS)

UCITS remains one of Europe's greatest regulatory successes, as it is widely promoted cross-border within and outside the EU. Policymakers have proposed a significant number of further reforms of UCITS. Taken together, these reforms will significantly affect the UCITS landscape and investors in UCITS funds. The aim is to ensure investors continue to benefit from increased transparency and enhanced protection, although this could potentially reduce flexibility and the ability of investors to reach all their investment goals.

UCITS V Directive

The UCITS V Directive focuses on the remuneration of asset managers and the role and structure of depositaries, as well as the extent to which such depositaries should be liable for assets held in custody, including those held by a third-party sub-custodian. The Directive is expected to come into force in 2015. Key provisions that could impact investors are:

- **Remuneration**: The text aims to align remuneration provisions with those in CRD IV (for credit institutions) and AIFMD. Managers' ability to align remuneration with long-term performance could potentially be restricted if the European Parliament's proposal for a cap on the amount of variable remuneration payable is adopted.
- **Depositaries' liability**: Depositaries will be held strictly liable for assets held in custody even when appointing a third-party sub-custodian – leading to restitution of assets that are lost or stolen. Depositaries will also have enhanced duties to oversee assets not held in custody.
- **Depositaries' structure**: Only authorised and supervised credit institutions and MiFID investment firms will be able to act as depositaries. It remains to be seen whether other investment firms subject to adequate prudential supervision will also be able to act as depositaries. If they are not, the choice of depository will significantly reduce in the key jurisdictions, where fund promoters set up UCITS,

The Directive seeks to ensure greater consistency in the treatment of the depositary's duties. Under UCITS V, we can expect greater alignment with the investor protection measures recently agreed in AIFMD – levelling the playing field between UCITS and AIFs in this area. Also, as with AIFMD, we will need to carefully consider whether changes in depository model will lead to increased costs of servicing specific markets or a reduction in direct market coverage.

ESMA Guidelines on Exchange Traded Funds (ETFs) and Other UCITS Issues

ESMA Guidelines on ETFs and other UCITS Issues came into force on 18 February 2013 for new funds, with transitional provisions in place for existing funds until February 2014. Member states and firms are expected to comply with the Guidelines. ESMA has introduced a number of common standards that aim to protect investors, including:

- Enhanced level of information that should be communicated with respect to index-tracking UCITS and UCITS ETFs on index composition, and for all UCITS, details of counterparty identification and diversification.
- Provisions on over-the-counter (OTC) derivative transactions and efficient portfolio management techniques, including rules on collateral management, securities lending and repo/reverse repo arrangements as well as enhanced disclosure requirements.
- Criteria for financial indices in which UCITS invest.

ESMA also recently clarified that non-UCITS funds are only eligible for inclusion in UCITS if they meet strict equivalency requirements or can meet the requirements to be treated as an eligible security. These latest requirements may lead to some restructuring of existing portfolios by the end of 2013.

Further UCITS Reforms

The EC published a consultation on the future of UCITS in July 2012 covering a broad range of topics from eligible assets; the use of derivatives; the use of efficient portfolio management (EPM) techniques such as securities lending, repo and reverse repo; the treatment of centrally cleared OTC derivatives and extraordinary liquidity management tools; a depositary passport; money market funds (MMFs) and long-term investing. No specific legislative proposals have yet been put forward, although an initiative on MMFs is expected in the second half of 2013.

Below we outline some of the proposals to enhance existing UCITS regime and their potential implications for investors. Other issues, such as EPM techniques, MMFs and long-term investing, are covered elsewhere in this *ViewPoint*.

- **Eligible assets and use of derivatives**: The current UCITS framework affords retail investors high levels of protection and allows a wide range of strategies to be carried out within a rigorous risk management framework. Potential restriction on the use of derivatives (e.g., by restricting the use of Value at Risk, or VaR) could limit fund managers' ability to effectively manage investors' risk exposures. We believe further disclosure on the impact of the use of derivative strategies on the risk profile of a UCITS and more standardised reporting on risk and leverage would be beneficial.
- **Extraordinary liquidity management rules**: Further guidance on liquidity management may be adopted to deal with liquidity issues such as those arising from some investor redemption requests. This is closely linked to UCITS requirements to maintain investment in sufficiently liquid assets to meet on-going redemption requests. The consequence of meeting redemptions in all circumstances, especially in the case of large redemptions, is that a UCITS may have to dispose of a significant amount of assets at times when market liquidity is relatively thin, thus causing re-pricing of assets and artificially depressing the net asset value (NAV) of the UCITS while incurring dealing costs to the detriment of non-redeeming investors. UCITS have a set of existing tools to manage liquidity risks (please refer to the box below). BlackRock supports the emphasis placed on portfolio constructs and on enhancing liquidity rules on underlying assets but believes measures such as capital buffers will be counterproductive.

In the Interests of Investors

UCITS currently have the following levers available to protect shareholders' interests in redemptions:

- **Prior agreement**: Provides for a phased approach to redemption to avoid diluting the value of assets of remaining shareholders.
- **Prior notice**: Allows managers more time to seek liquidity in the market to meet redemption requests.
- **In specie redemptions**: Permits assets to be redeemed in kind rather than having to be sold. Useful if investors are seeking reallocation of existing portfolios rather than cash.
- **Deferred redemption**: Allows large trades to be deferred when the size means the trade could not realistically be executed in markets in one day. A UCITS may defer redemptions that exceed 10% of NAV.

- **Additional liquidity safeguards in ETF secondary markets**: Existing rules covering market disruptions and volatility events for all traded securities are sufficient to ensure the efficient functioning of the secondary markets. However, an independent multi-dealer model, with many approved market makers and authorised participants, would ensure the best possible provision of liquidity for investors without compromising the rights of long-term fund holders.

Investor Protection

Investors' trust in the financial system has been shaken by the financial crisis, which has revealed some weaknesses in investor protection related to the quality of advice, the sale of products inappropriate to investor needs, and lack of transparency and information. This comes at a time when investors are also bearing increasing responsibility for the health of their financial futures, particularly in the retirement phase – when saved assets begin to decumulate. Clearly, it is critical to preserve choice for investors to maintain a level playing field for different product providers and advisory models, under the umbrella of consistent, transparent and appropriate regulatory protection.

Investor Protection Legislation Currently Under Discussion or on Implementation

- **Retail Distribution Review (RDR):** The UK has taken the lead on regulatory actions to improve consumers' protection when purchasing investment products with the development of the new RDR. This will abolish commission payments from product providers to their distributors and replace them with fees for advice to be agreed upfront with the client. The RDR is influencing the future of distribution in many European countries (see Figure 1) and has influenced the thinking of the Markets in Financial Instruments Directive review (MiFID II) and Regulation (MiFIR) on EU-wide initiatives on investor protection. Similar legislation is due to be put in place in the Netherlands in 2014. Regulator discussions of similar proposals are under way in Germany and Sweden.
- **MiFID II & MiFIR**: The European Commission's proposals for the review of the MiFID put forward a number of ideas concerning investor protection, particularly related to duties of distributors and advisers with a greater focus on the ability to pay commission. At a pan-European level, MiFID II may well ban inducements paid to independent financial advisers, but allow product providers to continue to pay commissions to tied or restricted advisers, though the option is left to individual member states to apply a tighter regime.

  Independent advice is defined as 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.

The review of MiFID also aims to provide greater regulatory oversight over the launch and on-going distribution of investment products.

- **Key Investor Information Document (KIID)**: The launch of the KIID in the UCITS IV Directive was an important step toward achieving meaningful transparency for investors. The KIID aims to provide a consistent framework for disclosure across products and is expected to become the benchmark for disclosure standards for all other retail products. In particular, the KIID establishes and requires a simple risk gauge from 1 (low) to 7 (high) called the Synthetic Risk and Return Indicator (SRRI).
- **Packaged Retail Investment Products (PRIPs)**: Building on the UCITS KIID, the PRIPs Directive aims to enhance transparency and disclosure related to retail investment products via the provision of easily accessible product information produced to common standards in the form of a Key Information Document (KID).

  PRIPs cover a wide range of products – from structured deposits, through national non-UCITS retail funds, AIFs, structured products and insurance products, through to long-term retirement products. It remains to be seen how the PRIPs Directive will bring a level playing field across competing bank, asset management and insurance-packaged products, especially in terms of disclosing product and distribution costs.
- **Insurance Mediation Directive (IMD) review**: The objective of the IMD review is to enhance protection of insurance companies' customers. Although the EC's aim was to provide common standards across insurance and investment products, there is a risk that the final text may end up having significant differences from MiFID. For example, it is still unclear whether IMD will end up banning commission for independent financial advisers or significantly enhancing existing disclosure of the insurance requirements.

Implications for Retail Investors/Customers

We believe these measures could have a number of positive implications for retail investors:

- The removal of commissions in the UK RDR and any perceived or real bias in the system means a significant number of products will be placed on an equal footing. This is likely to make advisers in the UK less transaction-driven and more service-orientated in their effort to win and retain clients, which should lead to better-quality advice and greater price competition. As a result, advisers may turn to greater risk profiling, leading to a closer alignment between clients' investment goals and their risk appetite. Investors will also benefit from the higher level of expertise required for financial advisers.
- The new EU-wide KID will give retail investors more transparency on details of any PRIP. It establishes a level playing field across retail products by providing clear and simple investment information to investors – helping them to make better-informed decisions.

However, the new directives and regulations could also pose a number of unintended negative consequences for retail investors.

- Post-RDR, many investors in the UK may not be willing to follow the move to upfront charging for advisory services and pay advisory fees. There is a risk that fees will become important criteria for screening investments. This could lead to less-affluent consumers receiving no advice at all or adopting a "do-it-yourself" approach to selecting their investments, potentially leading to poorer outcomes. This could persist until advisers develop charging models that meet the needs of these clients.
- The RDR could accelerate the trend to offer more cost-effective solutions to clients via passively managed products such as ETFs. This could also lead to an increase in discretionary services and in-house solution suites for clients seeking a "one-stop-shop" style offering, as well as the development of risk-based ready-packaged multi-asset products offering a time-saving device for advisers who cannot justify customised portfolio construction for cost-conscious clients. The challenge is to provide diversified exposure through a simpler and lower cost approach than in many traditional core portfolio allocations.
- The RDR may introduce regulatory arbitrage. While commissions would be precluded in the direct sale of investment products, they are being retained in the wrapped life and pension business. As such, advisers may be incentivised to move their clients out of traditional investment products into insurance-wrapped investments in order to secure commissions on contractual products. Flows to multi-manager and multi-asset "wrapped" products could also increase, as certain independent financial advisers transition to a discretionary model in which they can retain trail commission post-RDR.

  Banning commissions paid to independent financial advisers who operate in an open architecture environment and not commissions to restricted financial advisers 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. This would restrict product choice and reverse the benefits of product and price competition that open architecture has brought.

- With regard to the PRIPs Directive, it is essential for investors to benefit from a level playing field in terms of disclosure on details of the diverse range of investment products including all PRIPs, UCITS, bank and insurance products. This would help investors draw better comparisons and make investment decisions on the basis of clear and consistent information.

The consequences of RDR for UK investors are likely to be similar for EU investors once the MiFID II has been translated into national law around mid-2015. More significantly though, the adoption of MiFID II and further RDR-style legislation in continental Europe could lead to fundamental changes to the way in which investment products are distributed. There are two main models of distribution:

- The open architecture where an adviser can select products from a wide range of product manufacturers for her clients; and
- The closed or integrated architecture where an adviser selects products from a single manufacturer with which she is linked – typically a bank or insurance company.

Political State of Play

- RDR was initiated on 31 December 2012 and will be fully in place by 31 December 2013.
- Debate in MiFID II and MiFID on investor protection is still on-going and should be complete in the course of 2013. A ban on commission for independent financial advisers is expected. However, it is still too early to tell whether the rest of Europe will move to full RDR-style charging for all advisers. Alternative responses could focus purely on the independent sector, require enhanced disclosure of adviser fees or adopt a hybrid approach involving, for example, greater use of cash accounts. Implementation of the MiFID review is expected by mid-2015.

Please see related *ViewPoint*, "Retail Distribution Review: Looking Ahead" for more on this topic.

Figure 1: LIKELY INVESTOR PROTECTION PROVISIONS IN KEY EU JURISDICTIONS (EX-UK)

COUNTRY		PROVISION
	Netherlands	Ban on commissions in 2013 applies to insurance, mortgage & protection products and will be extended to funds and other asset management products in 2014 ahead of MiFID II coming into force. However, key bank distributors are moving ahead of regulation and transitioning to commission-free share classes, frequently in index funds.
	Belgium	Recent legislation would ban payment of commissions for discretionary portfolio management and to independent financial advisers, but not to tied or restricted advisers.
	Sweden	Regulators have announced they are reviewing retail distribution, explicitly referring to the UK's RDR.
	Germany	Changes to business practices in the financial advisory segment have been confined to information/disclosure requirements. Pending any changes in MiFID II, the focus has been on permitting the payment of commissions subject to increased levels of transparency as to the cost of advice, though there is much discussion by BaFin of a more radical regime, including banning commission payments to independent advisers. In the medium term, any moves to follow the Netherlands and the UK by banning commission payments across the board are only likely to gather speed with implementation of MiFID II.
	Italy	Italy banned payment of commissions for discretionary portfolio management at the time of MiFID II. Italian regulators are following the debate over commissions, but currently there are no specific plans focussed on distribution. Distributors have no plans to move ahead of regulation.
	France	France supports a ban on payment of inducements for discretionary portfolio management. The French regulator has expressed concerns that a ban on commissions will lead to increased churning of investment products. Instead, the regulator has focussed on investor protection in the form of greater disclosure rules for all savings products.

“Shadow Banking” or Market Finance?

Following the financial crisis of 2008, policymakers, both globally and in Europe, have focussed on regulatory reforms of banking and, in particular, repair of bank balance sheets. At the same time, policymakers have been considering “shadow banking” – in essence, credit intermediation, sources of liquidity and funding, especially where they involve leverage and maturity transformation – that takes place outside of the traditional banking system. In addition to mitigating systemic risk where it may occur, or when transmitted from outside the banking sector, a key policy driver behind the “shadow banking” agenda is the future avoidance of regulatory arbitrage – in other words, a regulatory approach focussed on “same risk, same rules”.

According to the most commonly understood definitions of the term, “shadow banking” would include MMFs, securities lending and repo and securitisation. BlackRock has been a leading advocate in refining the nomenclature of this debate. Specifically, “shadow banking” may be appropriate for certain off-balance-sheet structured finance entities sponsored by banks (principally, term finance entities such as special Investment Vehicles - SIVs), but “market finance” better captures the positive complementary role in funding the real economy and contributing to the liquidity and stability of financial markets performed by activities such as securities lending, repo, securitisation and investing in MMFs.

We are concerned about the potential for unintended negative consequences from inappropriately calibrated prudential regulation applied to MMFs, securities lending and repo.

MMFs – Potential Changes Having the Most Implications for Investors

Policymakers globally continue to grapple with the regulation of MMFs in the wake of the financial crisis. The International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board (FSB) have adopted global principles for the regulation of MMFs, the US Securities and Exchange Commission (SEC) issues a proposal in June and the EC are expected to make a formal proposal by July 2013. The final rules may require mandatory conversion of some or all constant-NAV (CNAV) MMFs to variable-NAV (VNAV) MMFs and some CNAV MMFs may be “strengthened” by capital buffers. Some policymakers are concerned that mass client redemptions from MMFs, especially CNAV MMFs, could create funding issues for banks.

Others are concerned that sponsor support of CNAV MMFs could weaken the bank’s balance sheet (where the MMF promoter is part of a banking group). We believe any regulation of MMFs must pass two basic tests. First, it must preserve the core benefits of the product. The benefits to investors in MMFs are well-known: diversification, ease of operation and accounting, and market-competitive returns. Often overlooked are the benefits to borrowers in the capital markets (e.g., issuers of commercial paper, certificates of deposit and sovereign and supranational securities). MMFs can provide a more stable, cross-border source of funding that is able to respond rapidly and in a market-based manner to the needs of borrowers. The second test is that regulation must address the issue of runs. In 2008, for the first time in history, MMFs investing primarily in bank debt experienced unprecedented redemption demands, coupled with a complete failure of market liquidity as investors fled any exposure to banks and mortgage securities.

Converting from CNAV MMFs to VNAV MMFs fails the second of the two tests, as both types of MMFs experienced substantial redemptions during the financial crisis. The run on MMFs in 2008 did not represent investor fears regarding the pricing structure of one type of MMF, but rather, their concern regarding the creditworthiness of financial institutions in which the MMFs had invested. At the same time, all those investors requiring CNAV MMFs for tax, accounting or ease of operation, would lose this investment option and be forced instead to invest in VNAV MMFs, separate accounts or directly in bank deposits or market securities.

Similarly, while capital should make MMFs marginally safer, it will not solve the core issue that regulators are trying to solve: runs. In almost all conceivable scenarios, it will either be unnecessary or insufficient. For idiosyncratic events, most sponsors historically have had sufficient access to capital to protect their funds. For true systemic market failures, the amount of capital necessary to fully protect the funds would be so large as to destroy the commercial viability of the product.

In our view, standby liquidity fees, combined with consistent asset standards and increased transparency, are the best regulatory solution that will both preserve the benefits of MMFs for investors and borrowers, while definitively stopping a run. We recommend that, once an objective trigger has been met, a redemption fee of 1% be imposed on withdrawals. For those who want, but do not need, their money, this would act as a disincentive to run.

Securities Finance – Potential Changes Having the Most Implications for Investors

Securities lending generates incremental returns for investors' portfolios – contributing to overall investment performance. Investment vehicles make short-term loans of their securities to banks and broker-dealers, who, in return, provide collateral that is in excess of the value of the underlying loans. Securities lending also has wider benefits for financial markets, as it provides liquidity that helps to improve settlement efficiency and contributes to tighter trading spreads for investors.

Repo provides a source of short-term capital, facilitating liquidity and, therefore, efficient and stable financial markets.

While securities lending and repo transactions share some common features, important differences include different demand drivers, stakeholders and levels of post-trade complexity. For example, repo transactions are always related to financing needs, either to invest cash or to raise cash, while securities lending transactions are normally driven by the need to settle short sales and only occasionally are motivated by financing needs.

Policymakers recommend increased fund disclosures to investors on securities financing transactions. We support this initiative, which would help ensure investors are fully informed of the risks and potential returns involved in these activities. However, the high level of transparency and detailed transaction-level information that may be required from asset managers may be of little value for investors and potentially could be confusing or distracting. The disclosures proposed would provide investors with a significant amount of data about these activities when compared with the primary investment strategies used by the fund (e.g., the identity of counterparties; a number of repo, reverse repo, and securities lending data breakdowns; re-use and re-hypothecation data; information on any restrictions on type of securities; number of custodians and the amount of assets held by each; and the way securities received by the counterparty are held). This could divert investors' focus from the primary investment strategies that are truly material.

Policymakers also recommend the regulation of the use of collateral, possibly including a mandatory minimum haircut. If applied to the broadest scope of securities finance transactions, we are concerned this may unduly restrict market participants' ability to make appropriate risk-based determinations regarding collateral, to the ultimate detriment of the end-investor. By contrast, an appropriate regulatory floor of haircut as applied to all participants in these markets would be a beneficial "best practice" and would still permit investors or their investment managers to make risk-informed decisions regarding the level of haircut they believe is appropriate for a given loan or a given counterparty. An investor may reasonably choose to take a lower haircut on collateral from a high-quality counterparty, or when the collateral used is highly liquid or highly correlated with the securities on loan. We question whether mandatory haircuts on top of that level would achieve more good than the possible danger of becoming the de facto norm. Higher mandatory haircuts may seem appropriate from a systemic risk perspective, but would reduce or eliminate the attractiveness of the transaction for investors and the counterparties. The likely reduction in market liquidity as well as the reduced income to investors could outweigh any possible benefits.

With regard to (non-cash) collateral valuation and risk management suggested by policymakers, daily mark-to-market and the collection of variation margin for exposure to counterparties would be very beneficial from a risk management perspective and a greater improvement to existing processes than a minimum haircut requirement. Also, central clearing might be an appropriate way to mitigate the counterparty credit risk for highly standardised repo transactions, but not for other less standardised repo transactions as well as securities lending.

Political State of Play

- The FSB's final recommendations on securities lending and repo are expected in September 2013.
- The EC is expected to issue a proposal on MMFs by the summer 2013. Revisions to regulation governing securities finance (securities lending, repo and reverse repo) will be addressed by the proposed Securities Law Legislation and a further review of UCITS, expected later this year or in 2014.

Market Structure

OTC Derivative Markets Regulation

The 2008 financial crisis, and significant losses suffered by financial institutions' OTC derivative business, revealed weaknesses in these institutions' ability to monitor their counterparty credit risk. The G20, followed by policymakers globally, therefore mandated that standardised OTC derivative contracts must be cleared through central counterparties (CCPs), whereas non-standard derivative contracts would continue to be traded bilaterally and subject to various risk mitigation obligations and higher capital requirements. OTC derivative contracts, whether centrally cleared or not, would be reported to trade repositories.

Central Clearing of OTC Derivatives

Central clearing is the process by which financial transactions are cleared by a CCP, which becomes the buyer to the seller and the seller to the buyer of the financial contract. Central clearing of OTC derivatives mitigates counterparty credit risk – giving counterparties the opportunity to maintain existing positions and collateral in the event of defaults – and ultimately reduces systemic risk.

Scope of the Central Clearing Requirements

In Europe, the European Market Infrastructure Regulation (EMIR), adopted into law in mid-2012, legislates for mandatory central clearing of eligible OTC derivatives for all financial institutions and a number of non-financial institutions subject to certain conditions. Pension funds were granted an exemption for three to six years, but it is anticipated that a number of them will voluntarily choose to clear centrally in order to benefit from the counterparty credit risk mitigation.

Central clearing will be mandatory only for new transactions of eligible products, although front loading[1] also may be required. The initial focus has been interest rate swaps and credit default swaps. Inflation swaps, swaptions and total return swaps are not currently supported by any CCP in Europe, although several are working toward broadening their product scope to include these derivatives over the next few years.

Investor Considerations

EMIR includes measures aimed at protecting investors. The final rules allow for "individual client segregation" within CCPs whereby:

- Assets and positions (including excess margin) are recorded in separate accounts;
- Netting of positions recorded on different accounts is prevented; and
- Assets covering the positions on one account may not be used to cover losses connected to positions on another account.

EMIR also gives meaningful representation to the buy-side on the risk committee of the CCP, which makes decisions of fundamental importance to the buy-side, such as which products may be cleared, details of client account segregation, pricing, transparency and default procedures.

However, central clearing also poses a number of issues for investors. For example, fragmentation between eligible and non-eligible OTC derivatives will be problematic for portfolios containing both, where these have historically shown some level of inverse correlation (e.g., interest rate and inflation swaps). Previously, when considered in combination, the changes in value of these portfolios may have displayed some level of offsetting, reducing the volatility of any collateral requirements. This benefit is lost when each portfolio is considered in isolation.

Other examples include the opportunity cost of posting initial and variation margin and the fees payable to the CCP, clearing and executing brokers. Importantly, only cash will be eligible as variation margin at the CCP, while the scope of eligible collateral for initial margin is limited to cash and high-quality liquid assets such as government bonds and the like. Therefore, investors will need to have sufficient cash and/or eligible assets available to meet the requirement and potential future increases, which might be volatile from one day to the next.

Risk Mitigation for Uncleared OTC Derivatives

EMIR requires that financial counterparties and non-financial counterparties (meeting certain conditions) that enter into uncleared OTC derivative contracts put in place certain risk-mitigation arrangements. These include:

- **Timely confirmation**: Trades will have to be confirmed, where available by electronic means, as soon as possible and at the latest within the specific timelines that range from one to seven days, depending on the derivative class and the date when the trade was concluded. In addition, financial counterparties will need to have procedures in place to report on a monthly basis to the relevant competent authority the number of unconfirmed OTC derivative transactions that have been outstanding for more than five business days.
- **Daily mark-to-market valuations**: Financial counterparties and non-financial counterparties exceeding the clearing threshold must mark-to-market (or mark-to-model where marking-to-market is prevented by market conditions) the value of outstanding contracts on a daily basis.

- **Dispute resolution**: Counterparties must agree to detailed procedures and processes in relation to the resolution of disputes.
- **Portfolio reconciliation and compression**: Counterparties must agree to terms on which portfolios are to be reconciled. Counterparties with 500 or more uncleared derivative contracts outstanding with a counterparty must have procedures in place to conduct portfolio compression.

BlackRock supports and already exceeds the majority of the requirements as part of its on-going risk management process. The daily valuation of positions on a mark-to-market basis and reconciliation of positions and collateral is already standard practice. Electronic confirmations are used to confirm most OTC trades within a day or two of the trade taking place. Unconfirmed transactions (either due to a necessity to use paper confirmation for certain asset classes or because of a disagreement of terms between the two counterparties) are monitored and reported internally on a daily basis with any trades outstanding for longer than five business days being highlighted on an additional internal report so they can be prioritised. We make this information available to a competent authority as and when we are required to do so by such competent authority.

Trade Reporting Requirement

EMIR also requires that any derivative contract concluded, modified or terminated be reported to a Trade Repository (TR). The obligation to report will affect almost all participants in derivative markets (both listed and OTC) and represents a significant change to the current transaction reporting regime. There are over 60 data fields that may require reporting. These include the value of a contract and collateralisation, and for the first time, lifecycle events such as option expiries will be subject to the reporting requirements. Some information can be reported by a single party, while other fields must be reported by both sides of the trade, although this can be delegated to the counterparty or a third party.

BlackRock will seek to either report directly or have a broker report on its behalf where possible in order to remove any requirement on the underlying client.

The reporting requirements will be phased in by asset class with interest rate swap (IRS) and credit default swap (CDS) contracts being reported 90 days after the TR is authorised, with September 23 as the earliest date possible.

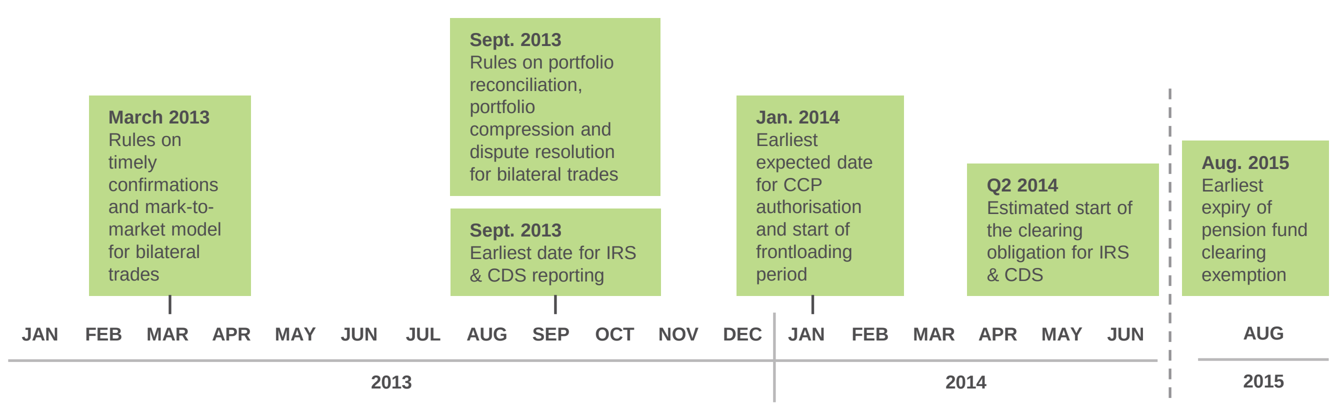
Higher Capital Requirements for Uncleared OTC Derivatives

The Capital Requirement Directive IV and Regulation (CRD IV/CRR), which aim to implement Basel III capital and liquidity standards in the EU, require credit institutions to hold higher capital requirements against their uncleared OTC derivatives positions. Basel III introduces an additional charge, the so-called Credit Valuation Adjustment (CVA) risk capital charge, which banks will have to keep as a provision for the deterioration of the creditworthiness of a counterparty. In general, the CVA risk charge will be higher for bilateral trades with any of the following characteristics: long-dated derivatives, directional risk profiles, uncollateralised exposures, low-rated counterparties (due to higher probability of default) and counterparties with no liquid CDS market – typically the type of trades made by institutional investors.

It is not yet clear how much of this cost will be passed on to the clients of a bank in the form of increased transaction cost and, therefore, the implicit cost of this extra capital for a particular trade is uncertain at this time.

We expect that EU member states will begin to transpose CRD IV in the second half of 2013, leading to the simultaneous implementation of the Regulation and Directive targeted for 1 January 2014 (see Figure 2 below).

Figure 2: CENTRAL CLEARING AND RISK MITIGATION MECHANISMS IMPLEMENTATION TIMELINE



Markets in Financial Instruments Directive II /Regulation (MiFID II/MiFIR)

The MiFID Review should precipitate a greater proportion of trading on organised trading venues, including stock exchanges. It also seeks to address perceived deficiencies from MiFID I, such as the failure to deliver a consolidated tape for equity and the continued barriers to connectivity between and across European market infrastructure. Politically emotive issues such as "dark pool trading" and high frequency trading (HFT) have dominated the negotiations up to this point. MiFID II is still under discussion, but a final agreement could be reached by the second half of 2013. We detail below what we believe to be the most likely outcomes.

Market Infrastructure

- **OTF**: A new trade execution category called Organised Trading Facility (OTF) will be introduced, but its scope is still to be determined. It will capture a significant part of trading previously deemed OTC and not initially caught in the current MiFID regime. It will further ensure that all trading venues (broker crossing systems and "dark pools" included) have the same standards of disclosure and reporting as other trading venues. This will provide greater choice of organised trading venues to better facilitate best execution of client orders. A harmonised disclosure and reporting regime for all venues will improve information to the market, which will increase investors' ability to make better-informed investment decisions.
- **HFT**: HFT operators, mainly market makers, will have to provide liquidity to the market on a continuous basis. This will be beneficial for investors as long as HFT is appropriately and clearly defined in the final rules and does not include algorithmic trading carried out by participants in markets, including asset and pension fund managers, to execute transactions. Otherwise, these would be obliged to set themselves up as market makers. Other prudential and organisational requirements for the wider category of algorithmic trading is expected to be introduced.
- **Market access and interoperability**: While not perceived as a major focus of the buy side, infrastructure connectivity is perhaps the most politically charged of issues within the MiFID review and, therefore, it is difficult to predict the final outcome at this juncture. Barriers to access between trading venues and to the clearing and settlement layers ultimately fragment liquidity and create costs. The costs of fragmented liquidity and the costs of listing on multiple exchanges, coupled with the associated costs of the respective and often captive clearing and settlement of securities, is borne by end-investors and ultimately is a drag on investment performance.

Pre- and Post-trade Transparency

Pre- and post-trade transparency requirements, imposed currently only to equities admitted to trading on regulated markets, will be introduced for other instruments, including fixed income, structured finance products and derivatives and across all trading venues. The new regime is likely to be tailored to the instruments in question and not be a simple "copy-paste" from the current equity transparency regime. However, it is still to be decided how the new transparency regime for non-equity will be calibrated. Unlike equity, the "non-equity space" is extremely diverse, typically fragmented and inventory-based, and is characterised by low or dispersed liquidity. A "one-size-fits-all" transparency regime for all non-equity instruments could stifle liquidity and make these markets less efficient.

- **Pre-trade transparency requirements:** Market participants will have to disclose the bid and offer price of any non-equity instrument transactions on which all clients will have an equal access, regardless of settlement risk, market liquidity and each market maker's particular risk limits. Depending on the size and the liquidity level of the non-equity instrument in question, buyers and sellers could be less willing to reveal quotes to the whole market for fear they find themselves in a weak bargaining position. Despite this market reality, it is still uncertain whether regulators will be able to use a waiver for specific types of instruments based on market model, order size, liquidity or other relevant criteria and apply a set of different waivers to exempt some transactions from the transparency requirements.
- **Post-trade transparency requirements:** MiFID II will deliver the long-awaited pan-European Consolidated Tape (ECT) for equity and equity-like instruments such as ETFs. The ECT will offer the most current information available, with prices disclosed throughout the trading day, with a comprehensive level of detail that 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. This is clearly beneficial for end-investors, helping them get a more complete picture of an equity instrument's liquidity across venues. This consolidated view of liquidity will facilitate more informed price discovery and could well precipitate increased liquidity cross-European markets. A calibrated post-trade reporting system for fixed income, loosely based on the existing TRACE model in the US[2], also will be implemented to capture European post-trade data in these markets.

Political State of Play

- The EC published in October 2011 proposals that aim to update the existing regulatory framework in MiFID and set up directly applicable requirements to be contained in a new regulation known as the Markets in Financial Instruments Regulation (MiFIR).
- Political agreement on the review of MiFID likely will be reached in the second half of 2013 and is then expected to come into force by the first quarter of 2015.

Financial Benchmarks

The alleged manipulation and underreporting of the London Interbank Offered Rate (LIBOR) has cast doubt on the credibility of rate benchmarks. Given the wide use of these benchmarks by investors and market participants, it is fundamental for market stability that confidence in these benchmarks be restored. As detailed in our March 2013 *ViewPoint*, "Best Practices for Better Benchmarks," policymakers globally are reviewing rate benchmarks, including LIBOR and EURIBOR, and considering potential reforms. Policymakers are also considering the extent to which reform of submission-based rate benchmarks should and could apply to transaction data-based market indices.

Use of Financial Benchmarks by Investors and Market Participants

Rate benchmarks (such as LIBOR) and market indices (such as DJ Stoxx 50 ETF) are used widely in the management of investor portfolios. Benchmarks such as LIBOR, EURIBOR, EONIA, SONIA and the Overnight Index Swap (OIS) provide the interest rate levels that can be used as reference rates for securities within a portfolio. The reference rate is used to determine the coupon paid on a security of a fund, to calculate coupon payments on a wide variety of securities (including interest rate derivatives) with a floating rate component, and as a purely indicative reference rate to calibrate the expected performance of a fund.

Market indices, such as MSCI, FTSE, Russell, S&P/Dow Jones, STOXX, Markit iBoxx, Barclays, S&P/Dow Jones GSCI and DJ-UBS, differ in a number of important ways from rate benchmarks. Market indices are typically more objective, more transparent and more easily verifiable (and hence less easily manipulated) than submission-based benchmarks. There is competition among index providers, and asset managers will actively look for benchmarks with the most desirable characteristics. Passive asset managers (or index managers) have to replicate these indices, rather than rely on a reference rate, which is another key difference between market indices and rate benchmarks.

Implications of Proposed Reforms on Investors and Market Participants

There is debate in policymaking circles about replacing rate benchmarks that are based on submissions by panels of broker-dealers ("survey-based rate benchmarks"), like LIBOR and EURIBOR, and assigning alternative benchmarks mandated for specific activities. Although politically seductive as a policy option, replacing submission-based rate benchmarks would require the renegotiation of thousands of existing contracts, which would represent excessive and unnecessary costs for market participants as well as end-investors, including corporations, municipalities and individuals through their mortgage or other consumer borrowing contracts. Also, hurried renegotiation of the existing contracts may cause market dislocation and disruption.

Policymakers globally and at the European level have included market indices in the scope of reform of rate benchmarks. BlackRock supports regulation of benchmarks in terms of sanction and transparency. However, we remain cautious about a far-reaching regulatory regime for market indices since this would likely result in significant additional costs for index providers. The costs would ultimately be passed onto the end-investor, undermining the core benefits of low-cost passive funds, while presenting barriers to entry for new market participants. This, in turn, undermines the healthy competitive environment that exists in the market index space today.

We believe there is a balance to be struck between meaningful reform of benchmarks and minimal disruption to markets and/or increased costs borne by end-investors. Our proposals include the following:

- Focus on the shorter tenors and the maturities most representative of bank funding activity (e.g., to discontinue a number of currencies and maturities of LIBOR where there is a lack of transaction data and after existing contracts based on those benchmarks have all been resolved).[3]
- Augment subjective submission data with the explicit use of transaction data, where available (with private reporting, time lags and/or aggregation as appropriate), at least until there are acceptable alternatives to submission-based benchmarks.
- Strengthen regulatory oversight and supervision, including a binding code of conduct for rate benchmark submitters with enhanced transparency and disclosure for investors (subject to independent audit), coupled with sanctions in case of market manipulation.
- Support enhanced disclosure requirements that help end-investors understand both the components and the relevant risks of index-tracking products. Ultimately, the goal must be to ensure end-investors understand how indices are constructed and the risks associated with index-tracking products, while retaining access to a broad selection of investments.
- Consider enacting a code of conduct whereby market index providers to public securities commit to a high level of transparency and conduct. Such a code would help investors clearly understand whether a given index is: (i) representative of its opportunity set; (ii) investible; and (iii) sufficiently diversified.

At the same time, we believe the reform agenda should include an explicit objective to allow market evolution. In pursuit of that end, it is important that an ample transition period to implement any reform be allowed to minimise market disruption and forced renegotiation of thousands of existing contracts.

Political State of Play

- Financial benchmark reform is being considered by multiple regulators worldwide, including the Commodity Futures Trading Commission (CFTC), IOSCO, the EC, ESMA and the European Banking Authority (EBA). Additionally, Martin Wheatley, CEO of the Financial Conduct Authority (FCA), was commissioned by the Chancellor of the Exchequer to undertake a review of LIBOR, culminating in the comprehensive "Wheatley Review of LIBOR." Mr. Wheatley and CFTC Chairman Gary Gensler co-chair the IOSCO Board Level Task Force on Financial Benchmarks.
- There is still uncertainty as to when the reforms will be effective, but we expect specific reform proposals to be developed over the course of this year.
- Additionally, a number of policymaking bodies have extended the review of LIBOR and EURIBOR to other types of financial benchmarks, such as market indices (e.g., the MSCI World Index).

Please see related *ViewPoint*, "Best Practices for Better Benchmarks: Recommendations for Financial Benchmark Reform" for more on this topic.

Taxation

Financial Transaction Tax (FTT)

The Financial Transaction Tax (FTT) has been a high-priority item for many European policymakers in the aftermath of the financial crisis. A number of EU regulators share the political belief that the tax will force financial institutions to help pay for the cost of the financial crisis; curb speculation, risk taking and high frequency trading; and raise additional public revenues.

France, Italy, Spain and Portugal are implementing or have already implemented an FTT at the national level (see Figure 3). These countries, along with Austria, Belgium, Estonia, Germany, Greece, Slovakia and Slovenia, are simultaneously making progress toward the adoption of a common FTT under an enhanced cooperation regime, forming an "FTT zone", which will supersede national FTTs when put into force.

Scope and Extraterritorial Reach

In early 2013, the EC published a proposal for a common FTT under the enhanced cooperation regime. The scope of this proposal is very broad. Both the purchase and sale[4] of any instrument negotiable on the capital market (shares and bonds), as well as derivatives contracts, will be taxed. All financial institutions will be chargeable under two conditions:

1. If one party of the transaction is established in an FTT zone member state (residence principle);
2. If the underlying transaction has been issued in an FTT zone member state (issuance principle).

In other words, financial institutions based in an FTT zone country will pay the tax on any transactions they carry out, while financial institutions domiciled outside the FTT zone will be chargeable as soon as they trade with a party based in the FTT zone or make a transaction on an FTT zone-issued instrument. Branches of financial institutions outside the FTT zone will be deemed within the zone if the institution's head office is domiciled there.

There are few exemptions from the tax. Primary market transactions, transactions with central banks in the EU member states and the European Central Bank or carried out as part of restructuring operations, as well as transactions made by Central Counterparties (CCPs), Central Securities Depositaries (CSDs) or International Central Securities Depositories (ICSDs) are exempted. However, there is no exemption for market making, pension funds, collateral transactions and securities lending and repo. Increasingly, these are being seen as controversial and untenable features of the proposed tax.

The amount of tax ultimately paid for a single financial transaction is expected to be higher than the minimum tax rates currently proposed (0.1% of securities' value and 0.01% of derivatives notional). No relief is given to the intermediaries involved in the financial transaction chain. The FTT has the potential to apply to all movements of securities between these parties. For example, the tax will apply to every link of the asset management value chain, including primary distributors, sub-distributors, transfer agents, fund vehicles, brokers and counterparties.

Costs for Investors

It is widely recognised that the FTT will be predominantly and directly paid by investors and not the financial sector itself. The FTT will be passed on to end-investors in the form of reduced fund performance (i.e., the performance of any investments made by fund managers in the FTT zone or on FTT zone-issued instruments will be hit by the FTT, reducing fund performance gains directed to end-investors).

To give a few concrete examples, MMFs and short-term fixed income funds will be severely penalised, as they will pay the tax on a far greater number of transactions. The FTT threatens to make securities lending risks economically unviable. This would further undermine fund performance, as it is likely that any revenue generated when a fund lends a number of its securities will not exceed the cost of the FTT. Also, sound asset management principles such as diversification, proper hedging and efficient execution will be undermined, exposing end-investors to greater investment risk, particularly in volatile markets. in order to deliver the same level of returns to clients, active portfolio managers 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 invest in than securities.

We are concerned that the asset management industry in the FTT zone will be significantly damaged, and FTT zone countries are likely to cease to be viable fund domiciles for all but those funds investing in local assets. Fund activity, and ultimately the fund management infrastructure that supports the current fund activity and distribution platform, will decline within the FTT zone. The proposed tax would ultimately be a significant blow to the attractiveness of the EU as an investment location compared to other regions such as Asia.

Political State of Play

- In September 2011, the EC published a proposal for the introduction of an EU-wide FTT. Given the strong opposition from the UK, the Netherlands, Sweden, Ireland, Luxembourg, Czech Republic and Malta, the EU countries in favour of an FTT opted to follow the enhanced cooperation procedure and/or implement their own FTT at a national level.
- The characteristics of the FTT under the enhanced cooperation procedure are currently being discussed among the 27 member states (only the 11 member states involved in the enhanced cooperation procedure have a vote on the proposal; the 16 non-participating countries may participate in the discussions on the FTT, but they may not vote).
- The final outcome is likely to be very different from the initial FTT proposal given the level of disagreement among the 27 member states on the scope of the FTT and the use of the proceeds of the FTT. The 11 member states must decide on the final form of the FTT by unanimity.
- The UK recently opened a legal challenge to the EC proposal denouncing its extraterritoriality. The court case seeks to create some degree of influence to those outside the FTT zone in setting the agenda of the negotiations.
- FTT implementation is currently planned for 1 January 2014 at the earliest, but political agreement among the countries involved is not likely to be reached by then.

Figure 3: EU DOMESTIC FTT

COUNTRY	OUTLINE OF FTT	KEY DATES
France	▸ Shares - 0.2% tax on shares (all shares issued by a French company with a market capitalisation>=€1bn) ▸ Tax due by investment firm executing orders; CSDs if transactions did not take place through an investment firm; and the intermediaries ▸ Primary market issuance; CCPs and CSDs; market making activities; intra-group transactions; sec lending and convertible bonds exempted ▸ HFT - 0.01% tax on all HFT firms trading on own capital with operations in France if they are trading on shares (when order cancellation/modifications>= 80%, the tax applies on all cancelled or modified orders) ▸ Market making activities exempted ▸ CDS - 0.01% tax on naked EU sovereign CDS, when bought by an entity with operations in France ▸ Market making and securities lending and repo exempted	Adopted on 31/7/2012 (started applying to transactions from 1/8/2012)
Italy	▸ 0.2% tax rate (0.22% for 2013 only) for shares and equity-like instruments traded OTC, and 0.1% (0.12% for 2013 only) for those traded on regulated platforms (all shares issued by listed Italian companies and family-owned and publicly held companies (companies with market cap < €500m excluded) ▸ Tax rates differ for derivatives depending on the type and the notional value and will be higher for transactions taking place outside the regulated markets ▸ HFT - 0.02% levy on high frequency transactions on equities and derivatives executed through an automated processing system in which a computer algorithm automatically determines the various parameters of the orders ▸ The tax is paid by the one who receives the order to execute the transaction directly from purchaser or final counterparty ▸ The tax will apply also to transactions between non-Italian intermediaries, as it is based on an issuance principle for both securities and derivatives ▸ Market making, pension funds, securities lending and repo and UCITS qualified as "ethical" or "socially responsible" are exempted	Live dates: 1/3/2013 (equity) and 1/9/2013 (derivatives)
Spain	*On hold* ▸ Spanish authorities in 2012 tabled a proposal for an FTT that bears similarities to the French FTT model. However, the proposal was not included in the 2013 Budget Law. ▸ 0.2% tax on certain shares, HFT and naked EU sovereign CDSs ▸ Market makers exempted	Supposed to go live mid-2013 (now unlikely)
Portugal	*On hold* ▸ 2013 budget law contains authorisation for the government to legislate on the introduction of an FTT. The legislative authorisation is valid for the period of one year. ▸ Expected rates, proposed by the government: 0.3% for general transactions, 0.1% for HFT transactions, 0.3% for derivatives transactions	Supposed to go live mid-2013 (now unlikely)

Foreign Account Tax Compliance Act (FATCA)

The Foreign Account Tax Compliance Act (FATCA) aims to improve information reporting on US taxpayers to prevent tax evasion. FATCA requires Foreign Financial Institutions (FFIs), i.e., local banks, asset managers, fund distributors, fund administrators and collective investment vehicles, to identify, report US account holders and withhold on certain payments to the Internal Revenue Service (IRS). FFIs that do not comply are subject to a 30% withholding tax on US-sourced income and gross proceeds on the sale of US securities.

FATCA covers US-domiciled funds held by non-US investors and non-US funds that invest in the United States, as well as segregated accounts. Certain FFIs are exempted, as outlined in Figure 4.

Figure 4: FATCA EXEMPTION STATUS

Total Exemption

Total compliance

- Exempt Beneficial Owner (e.g., certain institutions for occupational retirement provision)
- Certified Deemed Compliant (e.g., certain charities and non-profit organisations, sponsored, closely held investment vehicles and limited life debt investment entities (transitional)
- Registered Deemed Compliant (e.g., restricted funds [5], local FFIs[6] and QCIVs[7])
- Compliant but with Exempted Accounts (e.g., UK banks providing ESAs)
- Fully compliant (PFFIs)

The final FATCA regulations were released on 17 January 2013 and apply to non-IGA (Intergovernmental Agreements) jurisdictions.

Intergovernmental Agreements (IGAs)

To reduce the burden of implementation and to overcome the data protection law barriers in certain jurisdictions, Intergovernmental Agreements (IGAs) have been negotiated between the IRS and relevant foreign governments. The IGA defines the approach to FATCA compliance for FFIs in that jurisdiction. Having FATCA enforced as a national law in these countries will also raise the ability of national authorities to tailor FATCA to the individual country's specificities.

To date, nine jurisdictions have signed an IGA (UK, Spain, Denmark, Ireland, Norway, Switzerland, Mexico, Germany and Japan). The UK has taken the lead in the development of draft regulations and guidance to implement FATCA in its jurisdiction, and it is expected that other IGA jurisdictions will use these as a model. France, Germany and Italy are close to finalising their agreements, while Luxembourg has yet to start negotiating with the IRS. At this juncture, we do not have full clarity, as many jurisdictions have yet to sign an IGA or confirm that such an agreement will not be signed.

Two IGA models exist at this time. The first allows FFIs to report information on US account holders directly to their local tax authorities, who would then report onwards to the IRS. The second allows reporting of existing US accounts and non-participating FFIs to be reported in aggregate form directly to the IRS, where consent to give individual information is not given. One of the main benefits of an IGA is that all FATCA withholding obligations are removed for funds in the first IGA model. It could still apply in certain circumstances in the second model, where personally identifiable information for existing investors is requested by the IRS but consent to provide this is not obtained. The first model will be more widely adopted; however, of the above mentioned jurisdictions, Switzerland has signed the second model.

Investor Considerations

Overall, the introduction of IGAs is welcome news for investors. Where implemented, all entities within an IGA jurisdiction initially will be presumed compliant with the rules. Moreover, in general, financial institutions in IGA countries do not need to withhold against their clients. In other words, the very real financial risks to end-investors under the original US proposal are largely removed. The onus is now on the industry to implement the procedures required to comply.

Investors will, in due course, be able to verify for themselves whether the intermediaries they are dealing with and the funds in which they invest are compliant. A registration portal will be accessible for registration to financial institutions beginning no later than 15 July 2013, and the IRS will post the first list of FFI compliant entities on 2 December 2013. Thereafter, the list will be updated monthly.

FATCA-like Regime in the EU

Germany, France, the UK, Italy and Spain have announced they will exchange information on clients of asset managers and other financial firms in their jurisdiction to combat tax evasion. Reports indicate that the Netherlands, Poland, Romania and Belgium intend to join. We believe the current proposals will mainly create new monitoring and reporting requirements for fund firms: They will only be required to code an account as German, French, UK, Italian or Spanish and report to the relevant national authorities in the five jurisdictions, which will then exchange information. This may evolve into a broader European agreement over time, but may never become a true European FATCA that would place requirements on third-country investors as a condition of investing into Europe, in the way the original US FATCA does. Some commentators suggest that as fund managers have already adapted their systems to be compliant with FATCA, they will easily be able to meet the terms of these new requirements. We believe such a conclusion cannot be reached until the final rules are fully clarified. Ultimately, BlackRock remains supportive of any outcome that is both practical and effective in reducing tax evasion.

Investment & Asset Allocation

Bank Regulation

Excessive and off-balance-sheet leverage, coupled with inadequate levels of bank capital, combined to create the 2008 systemic crisis. Policy action since then has centred on repairing bank balance sheets and strengthening the prudential regulatory framework in which banks operate. A policy focus on bank recovery and resolution, including the role investors could play in re-capitalising failing banks in the future, remains a topic of intense debate in Europe.

Basel III/CRD IV

The global Basel III principles will require banks across the globe to increase the quality and quantity of their capital as well as the amount of capital held against their counterparty credit risk arising from exposures on derivatives, repos and securities financing activities. Banks also will be subjected to a Credit Valuation Adjustment (CVA) risk capital charge (see page 9, "Regulation of OTC Derivative Markets"), leverage limit and higher liquidity standards. A capital surcharge and a countercyclical capital buffer also will be imposed for Systemically Important Financial Institutions (SIFIs)[8], which are financial institutions whose failure could generate a financial crisis.

In Europe, Basel III will be adapted to the European market and its legal specificities, and implemented through the Credit Requirements Directive IV (CRD IV) and the Credit Requirements Regulation (CRR). This legislation will encompass roughly 8,000 banks operating in Europe and is expected to be fully in force by 2018.

Recovery and Resolution Regime

The political objective of the recovery and resolution regime is to limit taxpayers' potential exposure to failing banks in the future. Arguably, given this year's events in Cyprus, there is now also a political focus in some quarters to limit depositors' exposure to bank failure, which is likely to be at the expense of senior unsecured bondholders. In Europe, this will be implemented through the forthcoming Bank Recovery and Resolution Directive (BRRD).

Recovery plans detail the actions a firm would take to avoid failure by staying well-capitalised and well-funded in the case of an adverse event. The goal is to identify preventative actions to ensure an institution never reaches the point of non-viability (PoNV), thereby allowing firms to continue to operate as a "going concern". These actions could include selling subsidiaries or certain business lines.

Resolution plans, by contrast, are designed to facilitate actions by the relevant authorities to minimise any impact to the wider financial system after the PoNV. In resolution, the relevant authority is granted the power to close, liquidate or otherwise resolve a failing institution, mandating investors (both equity and senior bond holders) to bear all losses – by having the bonds they hold written down or converted into equity ("bail-in") – limiting the exposure for taxpayers.

Implications of Banking Regulations for Investors

The implementation of Basel III in Europe will strengthen bank balance sheets, insulating investors in bank securities from future losses. These measures should help to restore investor confidence in the banking system and facilitate investors' predictability on banks' earnings, provided there is clarity on how capital requirements will be implemented by the banks.

In case of an idiosyncratic adverse event, problems can ideally be addressed with a recovery plan. In situations where recovery is not possible, resolving failed institutions after the PoNV could preserve critical functions and stabilise asset prices in times of distress.

However, the theoretical possibility that bondholders could be "bailed-in" as part of a bank recovery and/or resolution process creates a degree of uncertainty and leads to heightened caution on the part of investors. If it becomes increasingly difficult for investors to assess risk of investing in bank securities, this will impact consistency and quality of pricing. Hence, clarity and predictability of recovery and resolution regimes are critically important features to facilitate the continued investability of banks.

It is also very important that the creditor hierarchy is preserved with respect to senior secured, senior unsecured, subordinated and equity claims in a resolution framework. While haircuts in resolution may avoid liquidation valuations, debt investors may be unwilling to tolerate significant or total loss while common and preferred equity remains outstanding. Maintaining a strict loss absorption waterfall during resolution increases investors' confidence in their risk/reward assumptions at all levels of the capital structure.

Effective international coordination and cooperation to set up a global level playing field between various regulators on: i) the triggers for entering resolutions; ii) the scope of resolution; iii) the path by which the institutions may be resolved; and iv) the requirements for bail-in-able securities and their terms would further enhance the prospects for volume investing in bank securities.

Political State of Play

- **CRD IV** – The EC published a proposal on CRD IV in July 2011 divided into a Directive and a Regulation. We expect that EU member states will begin to transpose CRD IV in the second half of 2013, leading to the simultaneous implementation of the Regulation and Directive targeted for 1 January 2014.
- **BRRD** – The proposal for BRRD is currently under negotiation. Agreement on the framework legislation is anticipated in 2013, although implementation of many powers is not slated to be effective until January 2015, and January 2018 in the case of bail-in for senior creditors.

Solvency II

Solvency II is the proposed prudential regime for most EU insurers and reinsurers as well as many international firms conducting business within the EU. It aims to align each undertaking's solvency capital 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 the EU have been preparing for the implementation of the Solvency II Directive against a backdrop of on-going uncertainty regarding the policy details and the timeline of its implementation.

Impacts on Insurers' and Reinsurers' Risk Management

The regime will set provisions for the amount of capital that insurers and reinsurers will have to hold against each type of market risk. It will also impose the "prudent person principal", 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 that ensures the "security, quality, liquidity and profitability of the portfolio as a whole". With the potential exception of long-term guarantee liabilities (LTGs), a Pillar 1 issue focussed on capital requirements and liability valuation, Solvency II will require the valuation of assets and liabilities at fair market value.

Solvency II also will require firms to conduct an Own Risk Solvency Assessment, which aims to cover a company's internal risk management processes and procedures as well as an 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.

Impacts on Insurers' and Reinsurers' Asset Allocation

The impact of the proposed Solvency II measures on asset allocation is very difficult to assess given the on-going debate regarding the LTG provisions and the potential effect of internal models. Nevertheless, there is an increasing expectation that internal models will only be approved by regulators if they result in similar capital charges from those under the standard model. This is likely to lead to a relative allocation toward government bonds and investment-grade credit from equity, property and alternatives. The current "zero-rated" charge for government bonds looks even more untenable given the "credit spread-like" marked-to-market volatility many government bonds have exhibited over the past three years.

Issues Related to Pillar 2 and Pillar 3 Requirements for Insurers and Reinsurers

Insurance companies remain concerned about meeting the requirements regarding timeliness, completeness and quality of data from third parties under Pillar 3. They also remain anxious that they will have to limit their investment strategy, as some assets demand more rigorous data reporting requirements that will prove difficult to meet. 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.

Political State of Play

- The implementation of Solvency II is likely to be delayed until 2016 or later. The main issue remains treatment of the LTG. The European Insurance and Occupational Pensions Authority (EIOPA) launched an LTG impact study covering 13 potential combinations of scenarios for matching adjustment, ultimate forward rate, countercyclical premium and transitional measures. The European Parliament plenary vote is scheduled to take place in October this year (originally in June), but it is not guaranteed that an agreement will be reached on time.
- Some believe the vote may never happen, as it did not happen in June (as previously planned). There is a concern that fragmentation among member states as national regulators start to apply different aspects of the regulation to their own industry. In an effort to avoid this, EIOPA published in March its "Consultations on Guidelines" outlining how to prepare for Solvency II. Final guidelines are expected by autumn 2013 and regulators will have to notify EIOPA whether they will comply with the guidelines within two months of publication or not. Guidelines are expected to apply from 1 January 2014.
- The EC recently requested that EIOPA examine whether the calibration and design of regulatory capital requirements for insurers' long-term investments necessitates any adjustment or reduction. In response, EIOPA published a consultation on its preliminary findings and suggestions on this issue.

Institutions for Occupational Retirement Provision Directive (IORPD)

The EC initiated a review of the Institutions for Occupational Retirement Provisions Directive (IORPD) in an effort to harmonise pension schemes at the EU level, to facilitate the portability of workers' pensions across EU member states and to increase IORPs' risk mitigation mechanisms in order to boost security for beneficiaries. The EC also is seeking a more level playing field with insurance companies by applying the so-called Solvency II Pillar 1 framework on capital adequacy – with some adjustments – to pension schemes. However, Commissioner Michel Barnier announced in May 2013 that the IORP legislative proposal scheduled for September 2013 will focus on governance and transparency issues and not on capital requirements.

Given the impact capital requirements might have on pension schemes, we have detailed an analysis of capital requirements below, and how they may affect end-investors.

The EC's definition of an IORP is any "institution, irrespective of its legal form, operating on a funded basis and established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or contract agreed individually or collectively between the employer(s) and employee(s) or their respective representatives, or with self-employed persons, in compliance with the legislation of the home and host member states, and which carried out activities directly arising from that purpose."

The main options for pension funds on risk mitigation currently proposed by ESMA are:

- Market-consistent valuation with capital charges for holding risk assets;
- Use of the risk-free discount rate for liabilities; and/or
- Adoption of the so-called "holistic balance sheet approach", a new method of valuing pension funds' financial exposures that takes into consideration the specific characteristics of pension funds. This method includes a valuation of sponsor covenant and pension protection schemes, which are currently unrecognised assets in the pension schemes' balance sheets.

Applying this Solvency II-like prudential regime to IORPs would require new common funding rules, potentially resulting in a significant increase in fund liabilities. The National Association of Pension Funds (NAPF) has estimated that this legislation could add as much as £330bn to the £1.2 trillion existing liabilities of UK defined-benefit (DB) schemes. An increased financial burden could reduce pension benefits and/or lead to the accelerated closure of DB pension schemes. In addition, a funding shortfall against the solvency capital requirements levels is probable, altering asset allocations and potentially shifting capital away from risk-bearing assets such as equities.

The capital requirements imposed on different asset classes in the holistic balance sheet approach might also have macro-economic consequences. Overall, the amount of capital available for investments will remain the same (or increase if higher solvency requirements are in place), but the distribution of this capital may change. There could be a switch out of equities, but it is not clear where this capital may be redeployed. If the capital is recycled to the corporate sector in the form of corporate bonds, the impact on capital available to the private sector may be minimal. However, if more capital is directed to sovereign bonds, there may be a reduction in the available capital for the private sector. BlackRock recommends that the potential macroeconomic consequences arising from such asset allocation changes be considered in combination with other regulatory changes.

Finally, the key question of what happens when a shortfall is calculated against the required capital remains unanswered in the previous Pillar 1 IORPD proposals. As long as this question is not addressed, the impact of the IORPD proposals on pension schemes, sponsors and the wider economy will be unclear.

Political State of Play

- At the end of May 2013, Commissioner Barnier announced he will not introduce a new capital regime for occupational pension funds as part of his pensions review.
- The Commission has planned improvements to be made in three key areas:
  - **Solvency**: Implicit level playing field argument. As with the future application of Solvency II, insurers who provide occupational pension will be subject to stricter capital requirements. This should also apply to occupational pension funds to "guarantee fair competition."
  - **Governance**: There are gaps in the current Directive regarding the issues of internal risk management and control systems.
  - **Transparency**: There are varying differences in existing systems between member states and the issue of home/host supervisor needs clarification.
- The new Directive (expected to be published in September 2013) will focus only on governance and communications.

Corporate Governance

Shortcomings in the corporate governance of listed companies and financial institutions are considered by many policymakers to have exacerbated the financial crisis. Improvements in corporate governance are regarded as critical to restore public trust and investor confidence in the management of companies.

In December 2012, the EC published an Action Plan on European Company Law and Corporate Governance. Most of the actions proposed involve soft law obligations and act as a road map for future actions. The objectives of the Action Plan are to:

- Enhance transparency of institutional investors about their voting and engagement policies;
- Greater engagement by shareholders on corporate governance;
- Support companies' cross-border operations to increase their competitiveness; and
- Establish a pan-EU company law code.

Since the Action Plan, reforms have mainly progressed in two areas:

- The Corporate Governance Framework with arrangements to make "the comply or explain" approach more efficient (listed companies must comply with the Corporate Governance Code applicable in the country in which they operate, or otherwise disclose which sections they have decided not to apply and explain why); and
- The Shareholders' Rights Directive with multiple proposals on transparency of voting and engagement policies, executive remuneration, related party transactions and proxy advisors.

Both proposals are expected to be released later this year.

We find the second suite of reforms to be of greater relevance for our clients. As such, we will focus our comments on the provisions in the Shareholders' Rights Directive, particularly on the proposals regarding: (i) transparency of investors voting and engagement guidelines and disclosure of voting records by investors and of companies and (ii) shareholder engagement.

Transparency by Institutional Investors on Their Corporate Governance Activities and by Companies

The European Commission is concerned with a lack of transparency and accessibility by institutional investors on their voting policy that guide their voting decision in the companies which they invest in. Regulatory steps are likely to be taken to address this concern in the upcoming Shareholders' Rights Directive. In particular, the Commission intends to establish rules of disclosure by institutional investors of their voting and engagement policies to enable end-investors to optimise their investment decisions and to progress the dialogue between companies and their shareholders.

Other initiatives, some related to transparency required from companies, deal with the disclosure by investee companies of their board diversity policy and of their non-financial information. The question of shareholder identification (issuers being able to know the identity of share owners) will be addressed in the Securities Law Legislation.

BlackRock provides its clients with regular reports on how we vote on their behalf (when asked), as well as quarterly commentaries outlining market developments and noteworthy voting and engagement. As a US-domiciled company, we file our voting record with the US SEC each August, and post it together with an annual review of our corporate governance activities on our website. We rarely make public statements or publicly disclose details of specific engagements; our preference is to engage privately with companies. This approach, we believe, enhances rather than hinders dialogue.

Shareholder Engagement

The EC seeks to strengthen shareholders' role in promoting better governance of companies by increasing interaction with investee companies' management. Some proposals to achieve this have been detailed above and others are developed below:

- **A binding vote on pay**: The EC seeks to grant shareholders the right – or duty – to vote on the investee company's remuneration policy and remuneration report. This has attracted a lot of attention over the past few years. We agree that a binding vote is likely to incentivise remuneration committees to structure pay arrangements in line with shareholders' interests but foresee a number of unintended consequences for investors. First, even more time will be spent on remuneration discussions with the companies to the detriment of engagement on other matters, such as strategy and execution, which are more directly tied to long-term shareholder value. Second, the responsibility for pay setting risks moving from the board and remuneration committees toward shareholders. BlackRock believes the responsibility should stay with the boards and remuneration committees as they are best placed to create effective policies that are appropriate for their company.
- **Potential regulation on the proxy advisory industry:** The EC is looking at ways to improve transparency by proxy advisers on the preparation of their advice and on their management of possible conflicts of interest. BlackRock believes the focus should be on transparency of their methodology and identification and

management of conflicts of interest rather than on the perceived influence proxy advisers have on investors' voting outcomes. There is a high correlation between proxy advice and voting outcomes, as the vast majority of shareholder meetings and agenda items are fairly routine, where shareholders are generally supportive of management regardless of the proxy advisors' advice. This should not result in an assumed disproportionate influence of proxy advisory firms on investors. Proxy advisory firms play an important role in information gathering and in highlighting areas of concern on which investors should focus during their engagement with issuers. This allows investors to devote efforts to additional research and engagement. These benefits should not be undermined.

- **Related party transactions**: These transactions consist of dealings between the company and its directors or majority shareholders (the "related party"), with the potential of increasing their influence over the company to the detriment of the company itself or its minority shareholders. The EC is considering the need to give shareholders greater oversight of related party transactions by imposing safeguards. BlackRock believes the approval process should safe guard against those that are not done on arm's length basis.
- **"Acting in concert"**: The EC, along with national authorities and ESMA, is seeking to clarify this concept, which, in principle, enables shareholders to exchange information and cooperate with one another. The legal boundaries of this concept are currently unclear (such cooperation can have unexpected legal implications). While we have seen a notable increase in collective engagements over the last two years, BlackRock believes that greater legal certainty is needed to enhance effective shareholder co-operation.

The Commission's Green Paper on Long-term Financing for the European Economy (more on page 22) contains important provisions on corporate governance. It seeks to incentivise shareholders' long-term behaviour, possibly with enhanced voting rights and/or dividends, as well as to reinforce asset managers' fiduciary duty.

BlackRock's Philosophy on Engagement

Our role as a fiduciary means focusing on delivering long-term value for shareholders – i.e., our clients. In our experience, the most important factors in determining success are the strong leadership and execution of a company's strategy. We believe the most effective means for communicating concerns with management and boards is through direct engagement. In 2012, we engaged with over 1100 companies around the world in preparation for voting at their shareholder meetings. Most observers are not aware of our engagement when we do so and companies adjust their approach. Change can also take time and we sometimes support management on issues in the short term, while they work through changes over the long term.

As a long-term investor, with significant investment in index-tracking strategies, we are patient and persistent in working with our portfolio companies to build trust and develop mutual understanding.

We do not try to micro-manage companies; we present our views as a long-term shareholder and listen to companies' responses.

We will vote against management when we judge that direct engagement has failed and when we think that to do so is in our clients' best long-term interest.

As a fiduciary, our responsibility, first and foremost, is to our clients. It is not our priority, as we sometimes hear, to make companies better. We believe protecting and enhancing the value of the companies is the responsibility of the board of directors and company executives. The two responsibilities are often confused.

Market Abuse Directive

The EU market abuse regime is currently under review to enhance and standardise sanctions taken to combat market manipulation and insider trading. We strongly support the aims of the market abuse regime to provide greater certainty to investors that the markets in which they invest are being properly policed and not abused. As highlighted by the EC, there are, however, a number of provisions that lack clarity in the new regime. Such opaqueness could prevent asset managers from engaging with the companies in which they invest on behalf of their clients, undermining efficient corporate governance practices.

In particular, a new category of inside information has been introduced that is defined in a way that is neither precise nor price sensitive. Rather, it is a subjective test relating to information that a reasonable investor would regard as relevant when deciding the terms of a transaction. Without tighter definitions, investors may be deterred from engaging with companies for fear that many types of on-going discussions on corporate governance could be construed in the future as constituting inside information.

The EC's proposals also do not contain adequate defences to a new presumption that a person is deemed to have acted on information if it is in their possession, even if the possession was not material to their investment decision. The Commission's proposal requires that nobody in possession of inside information relevant to any transactions had any involvement in the transaction decision or behaved in such way as to influence the decision or had “any contact” with those involved in the decision. This obligation would prevent companies from effectively implementing information barriers, such as Chinese Walls between different teams and departments of an asset management company whereby teams outside the wall can continue to deal while restricting dealing by teams in possession of inside information. Taken to an extreme, this could, for example, prohibit the management of active and passive strategies within the same company, as well as the work of centralised corporate governance teams.

The proposals are currently under discussion and many welcome improvements have been introduced by the European co-legislators. An agreement on final rules appears imminent, which would give more clarity on the definition of inside information and on the possession and use of inside information by investors.

Audit Regulation

The EC issued proposals at the end of 2011 seeking to enhance auditor independence, audit quality and transparency of financial statements, limit the influence of auditors on listed entities and encourage greater competition in the market for audit services. The proposals affect not only listed companies, but many other entities falling within the scope of the new public interest entity (PIE) definition (including all investment funds and investment firms, whatever their size or ownership structure). The new requirements on statutory audits are expected to be implemented in 2015.

BlackRock supports many of the proposals to improve the quality of audit, especially the role of the audit committee and the quality of the audit report. However, we recommend that investment funds, both UCITS and AIFs, are excluded from the definition of a PIE, as they are subject to on-going oversight of assets by an independent depositary.

Another key provision of the audit proposals is for the mandatory rotation of auditors every six years (or nine years for firms with joint auditors). We are not convinced that mandatory rotation will improve auditor independence and instead strongly recommend regular mandatory tenders to ensure that if an incumbent remains in place, they have benchmarked against industry best practice.

Auditor rotation is likely to create a number of new risks, including: a loss of auditor institutional knowledge; less incentive for audit firms to invest in the audit relationship by relocating the most qualified personnel or investing in travel and training to learn the business; and potentially inhibiting the audit committee in making its own decision as to the most appropriate time to change auditors.

As an investor, BlackRock would be concerned, for example, if a change of auditor was imposed during a major restructuring, as this could lead to a reduction in the quality of oversight at a critical time. Finally, for companies with a significant non-EU presence, a forced rotation at a European level could lead to global audit rotation.

Long-Term Investing

International and European policymakers are currently faced with the challenge of finding ways to finance economic growth against a backdrop of significant bank deleveraging. Initiatives to drive growth are being spearheaded by the OECD and the FSB on behalf of the G20 at a global level. In addition, the EC launched a Green Paper on the "Long-Term Financing of the European Economy” at the end of March with a number of potential policy options.

Aims of the Green Paper

The Green Paper discusses a number of ways to increase financing in key sectors of the European economy – those sectors deemed most likely to drive future economic growth and increase employment, such as infrastructure and small and medium size enterprises (SMEs). Global policymakers have not identified a single definition for long-term financing, but, in its Paper, the EC defines it as investing in the formation of long-lived productive capital (tangible and intangible). European policymakers are seeking to diversify long-term financing intermediation by increasing the role of non-bank financial institutions such as pension funds, insurance companies and asset managers in providing long-term financing through capital markets. Examples given in the Paper include infrastructure financing, project bonds, an increased role for securitisations and the development of an EU long-term investment fund (ELTIF) structure targeting investment into illiquid assets by large and mid-range institutional investors. The EC also identifies a number of obstacles restricting the development of these additional sources of long-term financing and the ability of intermediaries to channel such financing to long-term investments. There is a particular focus on whether prudential capital requirements, such as Solvency II for insurance companies, inhibit the development of long-term financing.

The policy framework also considers the governance framework of institutional investors, focusing both on greater transparency regarding their fiduciary duties and their incentives to be long-term in approach. For example, a number of options are currently under discussion to increase long-term shareholder engagement. These include granting multiple voting rights and linking dividend payments to long-term investors.

Investors' Ability to Provide Long-Term Financing

Asset managers serve as key sources of capital to the economy by providing investment solutions designed to allow their underlying investors to finance future liabilities, which often stretch many decades into the future.

As an asset manager, BlackRock recognises that focusing purely on long-term investment, in other words on a buy-and-hold strategy, may not always be in our clients' best interests. A long-term horizon can require evolving investment strategies over time. Likewise, greater volatility in markets may require the implementation of short-term strategies to protect client interests. As investors, asset managers' use of loyalty dividends and multiple voting rights can be construed as potential conflicts of interest between their clients and companies.

Long-term investment strategies used by asset managers include core strategies of investing in equities and bonds that provide considerable amounts of capital to mainstream issuers. Asset managers' long-term focus involves engagement with issuers to enhance value creation, hence our focus on corporate governance (please refer to related discussion on page 20). This is particularly true in the case of index investing, which is, by definition, a long-term activity – constituent securities in an index are held as long as that security remains in the index. Many of these core investment strategies provide daily liquidity within the investment vehicle. This is key for individual retail investors who, in addition to putting money away for the long term, generally also have unpredictable short-term liabilities. Vehicles such as UCITS meet both these needs.

Many investment opportunities related to long-term assets identified by the EC, such as infrastructure and SMEs, are specialist in nature, are not subject to public disclosure requirements and do not lend themselves to easy comparability and rating by institutional investors and other third parties. They require detailed assessment by both manager and professional investors. To develop the necessary scale, they will be more suitable and attractive to institutional investors, such as pension funds and insurance companies, particularly if prudential regulatory requirements are appropriately designed. Consistency of investor-focussed regulation is, therefore, key to sustained future long-term financing and economic growth.

BlackRock is investing heavily in the provision of long-term infrastructure solutions, as the asset class is attractive to institutional investors by providing inflation-protected yields above government debt. It is also treated equally from a capital risk weighting perspective to other equally long-term investments. However, opportunities in long-term infrastructure investment must meet a calibrated trade-off between liquidity, risk and yield and cash flows similar to liability cash flows (nominal or inflation linked). They must fit within the investor's overall portfolio strategy, i.e. they must add more value than other alternative investments. Also, the product design must not create obstacles to investment in terms of transparency and low fees, characteristics that are consistent with regulatory or accounting requirements and provide accurate long-term investment performance data.

Existing Fund Structures

The EC proposes a long-term investment fund vehicle targeting illiquid investment by large and mid-range institutional investors. In fact, institutional investors already have access to a wide variety of fund structures designed to reflect the often complex ways in which many illiquid assets are held (e.g., any structure involving real property is likely to have a number of overlapping leasehold and freehold property rights). Taken as a whole, the variety of existing fund structures is sufficient to meet the needs of institutional investors. Therefore, we believe a pan-European long-term investment fund product with strict guidelines as to asset allocation or structure is unlikely to provide enough flexibility to support the wide variety of institutional investor requirements. We would support leaving such funds firmly within the AIFMD regime, which already provides significant benefits to institutional investors of a more standardised fund governance and asset protection regime across Europe. However, we do believe that providing AIFs that meet certain criteria the opportunity to benefit from a pan-European passport allowing them to access assets on a consistent basis across the EU (e.g., consistent treatment on default or insolvency of the underlying issuer) has the potential to draw in increased pan-European capital flows.

Conclusion

BlackRock supports the creation of a regulatory regime that increases transparency, protects end-investors, and facilitates responsible growth of capital markets, while preserving consumer choice and balancing benefits versus implementation costs. BlackRock is keen to ensure that policymakers' 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 lawmakers for policies that bring about positive change for end-investors.

Endnotes

1 If a CCP is authorised to clear a certain class of derivatives by the relevant local regulator, transactions in such class of derivatives traded in the period from the date of such authorisation and the date on which such asset class is mandated for clearing, are required to be moved to a CCP by the mandatory clearing date.

2 TRACE was launched in 2002 in the US to increase transparency in US fixed income securities. At that time, dealers were required to report all secondary OTC market transactions in domestic public and private corporate bonds to TRACE. Government bond markets were subsequently considered sufficiently transparent that TRACE reporting would not benefit the market and have since been excluded from reporting requirements. Dissemination from TRACE to the public also started in July 2002. Over a period of about two years, the dissemination rules were expanded such that data on all publicly traded corporate bonds were made available. FINRA initially gave 75 minutes for dealers to report into TRACE then gradually tightened the reporting window down to where it stands today at 15 minutes. The vast majority of trades are reported in near real time. TRACE reporting and dissemination for Agency bonds (e.g., Fannie Mae, Freddie Mac and FHLB) began March 2010 and works similar to investment grade corporates.

3 In December 2012, the British Bankers' Association (BBA) proposed the discontinuation by the end of December 2013 of a number of currencies and maturities. The remaining reported currencies would include: Euro, Japanese Yen, Pound Sterling, Swiss Franc, and the US Dollar. The remaining reported maturities would include: overnight/spot-next, one week, one month, three months, six months, and twelve months.

4 Sec lending and repo in scope (outbound leg only).

5 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.

6 Local FFIs: Small and local distributors having a deemed compliant status.

7 Qualified Collective Investment Vehicle (QCIV): Funds having the deemed compliant status for only having PFFIs or exempted holders.

8 Factors for assessing whether a financial institution is a SIFI are based on the size, complexity, interconnectedness, lack of substitutability and global scope of a financial institution.

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