BlackRock

Regulatory Developments in Europe: 2021 Overview

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The COVID-19 pandemic has had a profound impact on individuals, on communities, and on the economy throughout the region. While efforts to manage the public health emergency continue in Europe and around the world, a sustainable economic recovery will continue to be at the forefront of the financial services policy agenda in 2021.

As an extreme market stress event, the COVID-19 outbreak demonstrated the effectiveness of the many improvements to financial stability made over the past decade of regulatory development and also highlighted areas that require attention. International efforts, led by the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), will now assess the lessons learned in 2020, with conclusions and policy recommendations to follow over the course of the coming years.

Beyond relieving the immediate effects of COVID in the short term, policy developments can help individuals and households build-up personal financial resilience; provide companies with diverse sources of finance; support a return to growth and innovation; and ensure that the economic recovery is rooted in sustainability. Despite the significantly altered context, policy priorities such as Boris Johnson's promise to 'level up' and Ursula Von de Leyen's commitment to 'an economy that works for people', and the development of a wide-ranging European Green Deal are more relevant than ever. Efforts to deepen and better connect EU capital markets through the Capital Markets Union (CMU), and the UK Government's drive to harness productive capital, have taken on renewed urgency in the context of economic recovery.

Scheduled reviews and targeted reforms are also planned for several major legislative files in the European Union (EU) in 2021, including a review of the Markets in Financial Instruments Directive and Regulation (MiFID II / MiFIR), and a review of the Alternative Investment Fund Managers Directive (AIFMD). Many of the legislative initiatives of the EU's 2018 Sustainable Finance Action Plan including product disclosures, the incorporation of client sustainability preferences for suitability assessments, and the assessment of sustainability-related risks are also coming into force between 2021 and 2022.

Likewise, the UK Government and regulatory authorities are planning to review and make targeted changes to its own regulatory regime. These have included an examination of the UK's own regulatory framework, its Listings Regime, a Funds Review and associated launch of a new Long Term Asset Fund ('LTAF'), and will also consider financial markets regulation and the UK's own review of MiFID/R.

BlackRock seeks to contribute to policy debate that brings about positive change for investors in order to improve people's financial wellbeing, our fundamental purpose. In this ViewPoint, we set out the developments in financial services policy impacting retail investors, institutional investors, and distributors in Europe.

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About BlackRock

BlackRock is a leading provider of investment, advisory and risk management solutions, and has been present in Europe for over five decades.[1] Our purpose is to help more and more people experience financial well-being, which we do by

Helping millions of people build savings that serve them throughout their lives.

- People deserve financial security across their lifetime. As a long-term investment manager, we help millions of people achieve that. Our clients range from pension funds providing for nurses, teachers, and factory workers, to individuals saving to buy a home. Most of the money we manage pays for people's retirement.

Making investing easier and more affordable.

- The benefits of investing are not always within reach for many people, which is why we try to make investing easier and more affordable. We know there's still much to do – and we will use our expertise to help more people with savings to invest.

Advancing sustainable investing to deliver better outcomes for investors.

- We believe sustainable investing will help investors achieve better, more durable returns over the long run, and we have a responsibility to help our clients understand and navigate long-term opportunities and risks that can affect their investments. As the world moves towards a net zero economy, we are committed to helping investors prepare their portfolios for this massive transition – and, in doing so, to helping play a role in accelerating that future ourselves.

Contributing to a more resilient economy that benefits more people.

- We invest our clients' money in companies of all types and sizes, in every region of the world, helping those companies grow and create jobs, which in turn enables economies and societies to prosper. We care that the companies we invest our clients' money in do well, because our clients rely on their success to fund long-term goals like retirement. We empower investors to make better, safer decisions through our advanced risk management technology, making markets and the economy stronger.

As an important part of our fiduciary duty to our clients, we advocate for public policies that help make the financial system more resilient, sustainable, and equitable – such as advancing common standards for how companies publicly report their climate risks, and stronger retirement systems that help more people prepare for the future. We support the creation of regulatory regimes that increase financial market transparency, protect investors, and facilitate responsible growth of capital markets, while preserving choice and properly balancing benefits versus implementation costs.

We comment on public policy topics through our ViewPoints series of papers, which examines public policy issues and assess their implications for investors, and through letters and consultations that we periodically submit to policymakers.

Table of contents

Lessons from COVID-19

The COVID-19 pandemic has posed unprecedented challenges for global economies and their citizens. While the public health emergency is ongoing in many regions, we can begin to draw lessons from the market turmoil that occurred in March 2020. The outbreak of the pandemic resulted in a liquidity crisis that differed from the credit crisis experienced in the Global Financial Crisis (GFC). Market volatility increased sharply, and liquidity deteriorated significantly, including in markets traditionally seen as liquid and low risk.

As many countries moved into lockdown to contain the pandemic, issuers, banks and investors concentrated their actions on preserving liquidity and changing asset allocations to reduce their risk exposure and / or benefit from attractive valuations.

The COVID-19 outbreak was an extreme stress event. Central bank intervention helped to calm markets and restore investor confidence; and while many of the reforms made to financial markets over the past decade proved effective, the crisis highlighted other areas that require attention. We see the need for a three-pillar approach to any future reforms.

Firstly**: banks can play an important role**. The fallout from the pandemic in markets demonstrated the effectiveness of the post-GFC reforms, and the banking system went into March 2020 in a strong position: risk-taking was lower, while balance sheets, capital, and liquidity positions were much stronger. That said, banks play an important intermediation role, and were constrained during the recent crisis by their capital and liquidity requirements. While regulatory intervention created some balance sheet capacity, capital and liquidity 'buffers' became 'floors', contrary to their original purpose. Going forward we see a need for policy to strike a balance between safety and smoother market operations.

Secondly: **market structure needs modernisation**. While market infrastructures such as central clearing counterparties (CCPs) and exchanges proved resilient, those markets most reliant on bank dealer-provided liquidity – such as fixed income, corporate paper and money markets – were severely impacted by the market turmoil. Market structure should therefore evolve to reduce reliance on bank balance sheet capacity. For example: the highly electronic nature of modern equity markets was one of the reasons that, while volatile, they remained resilient throughout; in fixed income markets the process of electronification is at a much earlier stages but would be of equal benefit; and short-term commercial paper markets may need deeper reforms. Improving data quality and availability will be critical to bolstering the strength of equity markets as will bringing forward modernisation in fixed income and money markets. Developing a post-trade consolidated tape for both asset classes would be a huge step forward.

Thirdly: **reforms are warranted for specific products and activities.** While any response to the crisis must focus on the whole financial ecosystem, targeted reforms can make individual products and activities more resilient. Within the asset management sector, we stress the importance of continuing to raise best practices for liquidity risk management in open-ended funds; reviewing the functioning of liquidity buffer asset requirements in money-market funds; and developing a clearer naming convention for exchange-traded funds.

Policymaking work is currently being undertaken at the international level, led by IOSCO and the Financial Stability Board, to assess the lessons learned from COVID-19 for financial stability. This will focus primarily on the non-bank financial intermediation sector, considering both market structure and products and activities. Conclusions and policy recommendations are likely to be drawn over the course of 2021 and into 2022.

We outline the lessons we have drawn from COVID-19, and areas for further policy consideration in our ViewPoint: Lessons from COVID 19: Overview of Financial Stability and Non Bank Financial Institutions. The exhibit below summarises our main recommendations. Further detail can be found on our Lessons from COVID-19 Hub, which features a series of *ViewPoints* examining different aspects of capital markets and asset management products during the crisis and including recommendations and areas for future consideration.

Exhibit 1: Top Ten Lessons from COVID-19

1. **BANKS** entered the crisis with strong liquidity and capital positions. HOWEVER, post-GFC capital regulation constrained balance sheets even after some regulators allowed use of prudential buffers. The 'no bid' environment exacerbated problems in short-term markets.

2. **OVER THE COUNTER DERIVATIVES'** move to central clearing improved transparency and risk management. HOWEVER, margin calls were pro-cyclical and opaque. Collateral for US futures rose $104 billion (49%) over the month of March, adding to the pressure in short term markets.

3. **EXCHANGE TRADED FUNDS (ETFs)** demonstrated their ability to deliver incremental liquidity and price discovery when underlying markets seized up. Nevertheless, we have recommendations for further improvements.

4. **EQUITY MARKET STRUCTURE** reforms improved resiliency of critical utilities: Market-Wide Circuit Breakers (implemented four times in two weeks) and Limit-Up-Limit-Down halts (triggered several times) worked – markets were volatile but orderly.

5. **US TREASURY MARKET** had unprecedented liquidity issues reflecting shifts from broker-dealers to principal trading firms and hedge funds as liquidity providers. One remedy being explored is central clearing for USTs, which could reduce reliance on other intermediaries.

6. **MONEY MARKET FUND REFORM** proved beneficial in some areas – including higher quality, shorter maturity, more liquid portfolios; and increased reporting. HOWEVER, 30% weekly liquidity buffers' linkage with redemption gates and fees became the new 'breaking the buck' and should be addressed.

7. **MUTUAL FUND REFORMS** brought broader liquidity risk management toolkit, helping nearly all funds to meet redemptions in full. HOWEVER, some funds experienced stress. Main difference between US and Europe is that swing pricing is widespread in the latter; anti-dilution measures should be available in every jurisdiction.

8. **INDEX PROVIDERS** voluntarily delayed all or part of their March fixed income rebalance. Even with elevated 'fallen angels' and robust new issuance, the rebalance at April month-end went smoothly, justifying the decisions made in March.

9. **CREDIT DOWNGRADES** remain high on the viewfinder. HOWEVER, concerns about mutual funds' 'forced selling upon downgrade' are overblown - many can hold 'fallen angels' beyond the downgrade and beyond their removal from the index, and are often incentivised to from an investment perspective. Likewise, asset owners are often opportunistic buyers during periods of dislocation.

10. **OPERATIONAL RESILIENCE** reflected extensive BCP. WFH pivot was quick for global ecosystem (broker-dealers, custodians, asset managers and 3rd party vendors). HOWEVER, likely contributed to early market issues with chains of command and decision-making impeded. Outsourcing concentrations have been noted, and specific functionalities should be assessed for improvements.

To read more, see *ViewPoint*: Lessons from COVID 19: Overview of Financial Stability and Non-Bank Financial Institutions.

An Action Plan for Capital Markets in Europe

As a result of the COVID-19 pandemic, many people have lost jobs and savings, and thriving companies have suffered financially. National governments have responded with unprecedented action to help bridge the gap, with major implications for sovereign balance sheets. It is clear that beyond the immediate relief measures, longer term solutions will be needed to help more individuals develop personal financial resilience in both the short and long term; to ensure companies have access to diverse sources of finance; and to ensure that the economic recovery is rooted in sustainability and global competitiveness. Efforts to refresh and reboot the Capital Markets Union (CMU), as a policy framework already targeting many of these objectives, have taken on renewed urgency in this context of economic recovery.

> **"Capital markets are vital to the recovery, because public financing alone will not be enough to get our economies back on track."**
>
> Valdis Dombrovskis, Executive Vice-President, European Commission

In September 2020, the European Commission (EC) released a renewed Action Plan, which set out sixteen legislative and non-legislative actions that the EC plans to take to finalise the creation of the CMU. This Action Plan builds on the recommendations set out by the CMU High Level Forum, a group of industry professionals, experts and academics that came together to put forward policy

Exhibit 2: Capital Markets Union 2020 Action Plan

Supporting a green, digital, inclusive and resilient economic recovery by making financing more accessible to European companies	Making the EU an even safer place for individuals to save and invest long-term	Integrating national capital markets into a genuine single market
• Making companies more visible to cross-border investors • Supporting access to public markets • Supporting vehicles for long-term investment • Encouraging more long-term and equity financing from institutional investors • Directing SMEs to alternative providers of funding • Helping banks to lend more to the real economy	• Empowering citizens through financial literacy • Building retail investors' trust in capital markets • Supporting people in their retirement	• Alleviating the tax associated burden in cross-border investment • Making the outcome of cross-border investment more predictable as regards insolvency proceedings • Facilitating shareholder engagement • Developing cross-border settlement services • Consolidated tape • Investment protection and facilitation • Supervision

Source: European Commission, September 2020

proposals in this area. The Action Plan is focused around three primary objectives:

- Supporting a green, digital, inclusive and resilient economic recovery by making financing more accessible to European companies;
- Making the EU an even safer place for individuals to save and invest longer-term; and
- Integrating national capital markets into a genuine single market.

The Action Plan recognises the potential of the CMU to support the EU's existing leadership in sustainable finance by providing the funding needed 'to deliver on the European Green Deal.' The successful implementation of this multi-faceted agenda will be pivotal to positioning Europe as a globally competitive investment centre and as a contributor to post-COVID economic recovery. Savers and investors in Europe will be best served by a CMU that positions the EU as outstanding example of a high standards economy open to global investment.

Building personal financial resilience

THIS AFFECTS	Financial services industry at large; retail and institutional investors
MAY 2020	Publication of the recommendations of the High Level Forum on Capital Markets Union (CMU)
SEPT 2020	Publication of the EC's Capital Market Union Action Plan
Q2 2022	Delivery of the EC's Retail Investment Strategy

Necessary pandemic containment efforts, including lockdowns, curfews, and the shift to homeworking have resulted in lost jobs, income, and financial security for many. This has highlighted the need to help individuals access appropriate savings and investment solutions, to gradually assist in building a degree of personal financial resilience against unexpected shocks. The longer-term trend of population aging across Europe underscores the importance of access to longer-term investment for future retirement income. **Efforts to help individuals to save and invest more effectively for the long-term must be at the heart of the next stage of the CMU.**

The EC's retail investment strategy is due to be presented in the first half of 2022. This will focus on enabling individual investors to take full advantage of capital markets, with coherent rules across different investment instruments. As outlined in the CMU Action Plan, EU legislation should reflect ongoing developments in digitalisation and sustainability, and individual investors should benefit from:

- Adequate protection;
- Bias-free advice and fair treatment;
- Open markets with a variety of competitive and cost-efficient financial services and products, and;
- Transparent, comparable, and understandable product information.

BlackRock supports the emphasis on engaging retail investors, especially in the low-interest environment. Households where individuals were able to remain in employment throughout the pandemic saw significant increases in savings, of approximately 28% in the UK,[2] and almost 2% of GDP[3] in Spain and France. However, data on European investor behaviour indicates that many savers in Europe still sit on the sidelines of the capital markets, holding on to cash, even when saving for long-term financial goals. Our 2020 People & Money report – BlackRock's annual survey of over 26,000 people in 18 markets – found that 37% of those interviewed saw investing as risky compared to cash, which 41% saw as safe. In an era of zero or negative interest rates, the opportunity costs to both citizens and society from not investing sufficiently are quickly mounting up.

To overcome barriers to retail engagement, we believe that policy efforts by both European institutions and member states should:

- Encourage investor education and capability initiatives such as the forthcoming EU financial competence framework, sponsored by public and private sector;[4]
- Provide retail investors transparency about their financial wellbeing – e.g. by introducing financial health checks, which include advice to end investors / savers on what they should do with their money;
- Use advances in technology and data sharing to simplify client onboarding through Digital IDs and encouraging the use of digital technology – pioneered in open banking – to develop portable fact finds which put consumers in charge of their own personal balance sheet giving them easy access to a comprehensive view of their assets and liabilities. The recently proposed European Digital ID represents a significant step forward;
- Using technology to make investing simpler;
- Standardise and raise financial adviser qualifications;
- Enhance trust and confidence in the advisory processes by addressing the different regulatory approaches to the effective management of conflicts of interest, e.g. the different regulatory standards for insurance and bank-based advice in the Insurance Distribution Directive (IDD) and MiFID;
- And continue to evolve financial infrastructure, enabling ease of access to competitively priced instruments, long-term investment in private markets, unlocking the possibility of higher returns.

The CMU as a catalyst for capital-raising in Europe

One of the key aims of the CMU initiative is to provide lower funding costs and more diverse funding sources for European companies. This has taken on increased importance in the last year. Europe's capital markets have been an important source of funding for many companies as they sought to meet the challenges of the pandemic.

EU policymaking process

EU legislation is initiated by the European Commission, scrutinised by the Parliament and Council, and formally agreed through trilogue negotiations involving all three.

Public consultations, hearings, and expert working groups provide opportunities for diverse public and private sector stakeholders to contribute to the policymaking process.

Moving forward, as companies seek to rebuild and innovate, and the European economy returns to growth, long-term patient risk capital will be more important than ever.

CMU reforms can play a crucial role in making the provision of capital to companies mutually beneficial for both the investor and the issuer, and by making the capital raising journey as frictionless as possible for all parties.

One facet of facilitating the growth of long-term risk capital will involve optimising the investment vehicles that present opportunities for a wider range of investors to provide capital to support long-term company growth. The European Long-Term Investment Fund (ELTIF) structure in particular seems well-placed to channel investments across both private and listed markets – and, as a result, can help support company growth at all stages. For European investors, it can give them exposure to innovative and growing companies as well as other important asset classes like infrastructure.

The ELTIF will be reviewed in this next stage of the CMU initiative, with a priority put on reforms to help it deliver on this potential, to ensure the functionality of cross-border marketing, and to make the rules more tailored to the types of investment strategies that ELTIFs are likely to be built around. BlackRock are strong supporters of the ELTIF and believe that the changes have the potential to increase the ELTIF's attractiveness to end investors.

The CMU also aims to develop a genuine single EU capital market, and a key component of this is having a post-trade consolidated tape, which would provide an accurate source of near real time information on current trading activity, and a central repository of pan-European historical trading data. This is described further on page 7.

Product Development & Disclosure

Exchange-traded funds

THIS AFFECTS	Retail and institutional investors; Market ecosystem – exchanges, liquidity providers, authorised participants
JUL 2019	FSB-IOSCO Hearing on ETFs
AUG 2019	FCA Report on ETF Primary Market Participation and Liquidity Resilience
Q3 2021	Expected IOSCO report consultation findings on ETFs

ETFs proved their resilience in the first part of 2020. Unprecedented market volatility resulting from the COVID-19 pandemic presented ETFs with the most significant test they have faced since the 2008 GFC. As liquidity in underlying markets deteriorated, especially in fixed income, ETFs continued to trade efficiently, playing a leading role in price discovery for investors and banks as they gave transparency to the values at which investors were prepared to exchange risk. A number of subsequent official sector reports that analysed the market conditions of March 2020 underlined that ETFs did not increase market volatility; instead, they were a source of stability as investors increasingly turned to ETFs to efficiently rebalance holdings, hedge portfolios and manage risk.[5]

What happened?

- ETFs faced two tests in the first part of 2020: unprecedented market volatility and the most extreme conditions in the bond market since the GFC.
- Elevated volumes in ETF trading, both in the aggregate and as a percentage of equity market volumes, demonstrated how investors looked to ETFs to allocate capital, adjust positions, and manage risk amidst record market turmoil.
- As bond market liquidity deteriorated, investors increasingly relied on ETFs for fixed income exposure, as evidenced by ETF trading volumes that were many multiples of trading volumes of the underlying holdings. Moreover, ETFs provided real-time transparency into bond market prices when cash bond markets were frozen or difficult to trade.
- While ETFs were resilient during the COVID-19 crisis, there are some areas that can be improved to further enhance their ability to add stability to European markets: a classification system for exchange-traded products (ETPs) and improved ETF trading transparency through the implementation of a consolidated tape and European Best Bid and Offer (EBBO).

ETF performance throughout the market volatility in the first part of 2020 demonstrated how ETFs can add stability to capital markets. In the face of record volatility, ETFs performed as designed. Instead of stepping away, Authorised Participants (APs) and market makers were engaged, facilitating heightened ETF trading volumes. In fixed income, ETFs offered price transparency and liquidity to an otherwise opaque, illiquid bond market. Throughout the pandemic and resulting market volatility, investors increasingly turned to ETFs to allocate capital and manage risk in their portfolios. While there are some areas that can be improved to further benefit investors, ETFs generally functioned well and delivered on investor expectations during the COVID-19 crisis despite facing the most turbulent market conditions in over a decade.

The forthcoming review in July 2021 of the EU Markets in Financial Instruments Regulation (MiFIR) provides an opportunity to further update the rules that govern European markets structure. BlackRock will engage in this process to make the case for a consolidated tape for fixed income (as well as equity and ETFs) in addition to bringing greater pre-trade transparency to Europe's fragmented fixed income markets via an EBBO. The consolidated tape is a key element of the EC's CMU work plan to drive integration and depth of Europe's capital markets. We believe these enhancements to European market structure would help to advance the development of the market, reduce opacity and fragmentation and ultimately underpin investor confidence.

Not all exchange-traded products are the same

While all exchange-traded products share certain characteristics, some have embedded structural risks that go beyond the scope of traditional ETFs.

BlackRock defines an ETF as a publicly offered investment fund that:

- **Trades** on an exchange.
- **Tracks** underlying securities of stocks, bonds or other investment instruments.
- Does **not** seek to provide a leveraged or inverse return

Inverse or levered products, which use derivatives to multiply the returns of the underlying index, should be clearly labelled as ETPs, rather than ETFs. These products take on additional risk that does not mirror the behaviour of traditional ETFs.

Investors need to understand what they own. BlackRock, along with others in the industry, has called for a clear-cut ETF naming convention to better serve investors.

MiFID II Recovery – Quick Fix

THIS AFFECTS	Financial services industry at large; corporates; retail and institutional investors
SUMMER 2020	EC announced a series of targeted changes to the MiFID 2 framework as part of a broader COVID-19 recovery package pending a more detailed review is planned in 2021. EC launched a public consultation on amendments to Delegated Directive (EU) 2017/593 on the research regime to help the recovery from the COVID-19 pandemic.
FEB 2021	MiFID Quick Fix Directive published in the Official Journal
NOV 2021/H1 2022	Member States to adopt legislative amendments by 28 November 2021, with a transition period until 28 February 2022.

The COVID-19 pandemic highlighted that enhancements to the MIFID II regime were needed. The EC put forward a number of proposals for a 'Quick Fix' in areas where there was a high degree of consensus for change among European policy makers in 2020 ahead of a more detailed review of the Directive later in 2022. The large-scale move to working remotely highlighted the importance of moving to electronic communication by default, and also underscored that many disclosures received were of limited relevance to many investors.

A further objective of accelerating investment into SMEs, which are responsible for a significant proportion of overall European job creation, has seen the EC revisiting the rules on investment research and a number of transparency requirements to wholesale market participants. The rule changes reflect stakeholder feedback that a number of the MiFID II provisions are unnecessarily burdensome, and do not reflect clients' own information requirements.

The final text of the MiFID II Quick Fix Directive includes, but is not limited to:

- A move to electronic communication with clients on an opt out rather than opt in basis;
- More flexibility on the timing of information to clients on costs and charges;
- Exemptions from making cost and charges disclosures to professional clients (except for the provision of investment advice and portfolio management);
- Exempting corporate bonds with make-whole clauses from the product governance requirements; and
- Temporarily suspending a number of the best execution reporting requirements;
- Removing explicit research charges if they apply to research on firms with market cap of EUR1bn or less (to encourage the provision of SME research), or if they apply to fixed income instruments (recognising that typically fixed income spreads do not contain an element of charging for research).

We welcome recognition from the EC of the need to review standardised disclosures in MiFID. Professional investors, in particular, increasingly rely more on specific sectoral disclosure standards than on the standard MiFID reports. A move to electronic communications by default reflects growing client requirements for electronic data provision, especially where data fields have to be incorporated into clients 'own reporting obligations. Finally, changes to SME research are not intended to be mandatory and as such should not affect firms such as BlackRock who rely on global processes and have decided not to charge clients for research but pay for it themselves.

Alternative Investments (AIFMD)

THIS AFFECTS	Financial services industry at large; retail and institutional investors
JAN 2019	Publication of KPMG's report to the EC which assessed the functioning of the AIFMD and provided initial areas for review
OCT 2020	EC publishes a public consultation on the review of the Alternative Investment Fund Managers Directive (AIFMD)
Q4 2021	Expected publication of EC proposed amendments to existing legislation

The introduction of the Alternative Investment Fund Managers Directive (AIFMD) in 2011 marked one of many post-2008 reforms designed to increase cohesion and security in European capital markets. It aimed to create a single market for alternative investments with a common rulebook to ensure that

- Investors were protected and had a single point of access for alternative investment products;
- And that systemwide risks would be monitored in a cohesive way.

The AIFMD focuses on regulating fund managers rather than prescribing detailed rules on the financial products it covers, which include hedge funds, private equity funds, and real estate funds, as well as a host of other institutional funds. The Directive covers a number of key areas including marketing, conduct requirements for alternative investment funds managers (AIFMs), depositary functions, reporting on leverage, liquidity and risk management, and capital requirements.

In line with many of the other EU post-financial crisis regulation, the AIFMD included a review clause, requiring the EC to reassess the application and scope of the Directive several years after implementation. The EC engaged KPMG for this review, who surveyed various market participants to ascertain how well the AIFMD was functioning. Following the publication of this report in January 2019, the EC published its own report to the European Parliament and the Council, both of which concluded that that the AIFMD was successful in creating a single market for alternative investment funds and is functioning as expected bar a few minor enhancements that could be made regarding reporting, risk management and sustainability amongst others. This conclusion represents a significant achievement of the framework, in light of the less connected state of the alternatives market pre-AIFMD.

Following the publication of both reports, a very comprehensive consultation on the review of the AIFMD was launched in October 2020 covering seven themes, as reflected below.

Functioning of the AIFMD regulatory framework, scope and authorisation requirements	Effectiveness of the AIFMD, how far it has achieved it's objectives, and questions on how to improve the passport regime
Investor Protection	Investor classification and investor access, improvements to the depositary regime, transparency and conflicts of interest, and enhancing clarity on the rules of valuation
International relations	Efficacy of delegation arrangements, preventing regulatory arbitrage, and ensuring competitiveness of EU AIF industry
Financial stability	Assessing functioning of macroprudential tools, leverage measurement and calculation, and improvements to the supervisory reporting of both
Investing in private companies	Questioning whether rules on investing in private and non-listed companies are still fit for purpose
Sustainability/ESG	Considering how to quantify ESG risks as part of risk management process and potential rules on including ESG impact for investment decisions
Miscellaneous	Range of issues including ESMA's role as a supervisor, and overlap with Undertakings for the Collective Investment in Transferable Securities (UCITS) rulebook

The AIFMD has spurred the growth of cross-border alternative funds in the EU by providing a common regulatory framework. This has simplified the process of offering products and allows investors to benefit from economies of scale and increased choice of product. Rather than changes to the primary legislation, we recommend a number of targeted changes across key areas including macroprudential oversight, supervision, and reporting.[6]

Making a broader liquidity management toolkit available to Alternative Investment Fund Managers (AIFMs) at the national level and considering how to have a more efficient regulatory data sharing process between NCAs and ESMA would provide enhanced oversight and controls in the macroprudential regulation of AIFs.

Going Digital

To support a digital transformation over the next few years, the EC outlined its Digital Finance strategy in September 2020, with four priorities:

- Removing fragmentation in the Digital Single Market;
- Adapting the EU regulatory framework to facilitate digital innovation;
- Promoting a data-driven finance and;
- Addressing the challenges and risks with digital transformation, including enhancing the digital operational resilience of the financial system.

These measures are aimed to help support Europe's economic recovery, therefore increasing the competitiveness of Europe as an investment centre. A shift to digital finance would help reduce some of the existing barriers to investing for many savers across Europe and could create opportunities to develop better financial products for consumers, including for people currently unable to access financial services. It could also unlock new ways of channelling funding to EU businesses, in particular SMEs, both of which would help accelerate the goal to build deep, well-connected capital markets, as part of the Capital Markets Union.

The Digital Operational Resilience Act (DORA) is also a key part of this strategy. The EC plans to address the increasing role technology is playing in finance, also in light of the COVID-19 pandemic where many firms had to rely on remote working. Therefore, financial services firms (and Big Tech providers) are going to need to ensure that their ICT systems are capable of withstanding disruptions and threats in order to prevent systemic risk. The EC also proposed to make Critical ICT providers subject to direct European oversight.

Currently, each national supervisor has specific requirements for reporting data in their jurisdiction, which can be challenging and burdensome for AIFMs who are present in multiple locations across Europe, trying to report the same data in multiple different formats. We support moves to filing with a centralised reporting repository. This would be further supported by being able to use a single reporting format, which would ensure there are common definitions for all and would reduce the amount of data manipulation.

A legislative proposal to reflect the amendments posed in the consultation is expected in the fourth quarter of 2021.

Sustainable Finance & Stewardship

The EU Sustainable Finance Action plan coming into force

In 2018, the EC published its Action Plan on Financing Sustainable Growth, a transformative set of policy measures intended to orient European financial markets towards the objectives set by the UN 2030 Agenda for Sustainable Development and the Paris Agreement.

As part of this Action Plan, the EC published a package of regulatory proposals, including three new Regulations:

- One setting out to establish a common taxonomy of sustainability, the Taxonomy Regulation;[7]
- One to bring low-carbon benchmarks into the existing regulatory framework for indices, and finally;
- One to mandate financial entity and investment product disclosure rules,[7] the SFDR.

Underpinning these new rules are further amendments to the existing MiFID II, UCITS and AIFMD frameworks which will change the way institutional investors are asked to integrate sustainability into their investment and risk management as well as require the investment product intermediation system in Europe to be more responsive to end-investors' sustainability preferences.

Over the course of 2020, BlackRock, in collaboration with clients, prepared for the implementation of these upcoming regulations. In this ViewPoint we focus in particular on the disclosure and taxonomy regulations and the changes to MiFID II as regards to the suitability assessment.

EU Sustainable Finance Disclosure Regulation (SFDR)

The key objective of the SFDR is to promote greater transparency around the sustainability characteristics and objectives of investment products and providers to end-investors. At the product level, a key aim for EU policymakers has been the prevention of "greenwashing". BlackRock has long supported the aim to bring more transparency around the sustainability characteristics of investment products, as we believe this helps facilitate informed asset owner choice, which will underpin the growth of sustainable finance.

SFDR introduces a series of sustainability-related disclosure obligations for financial market participants (FMPs)[8] at the entity and at the product level. Following up on a delay of the publication of Regulatory Technical Standards (RTS) the EC decided to grant more time for the financial services industry to comply with the more detailed rules in the RTS. Market participants were asked to comply with the rules as laid down by the Level 1 regulation on a principles-based and high level basis from March 2021, whilst the RTS will become applicable at a later stage (likely January 2022, though this remains to be confirmed pending adoption of the final RTS by the EC).

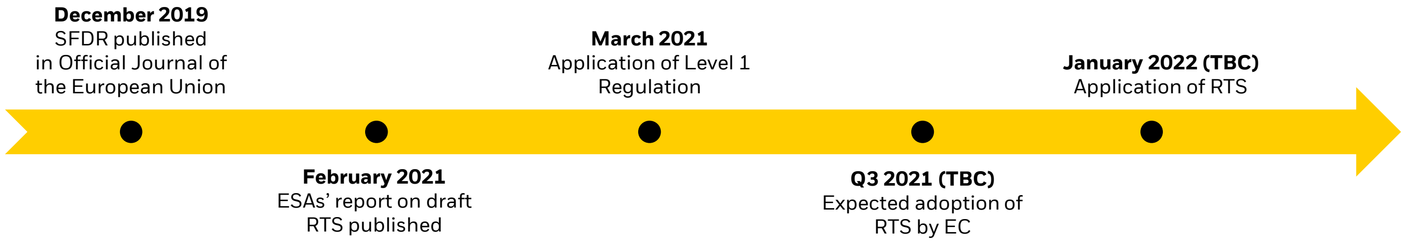
BlackRock's Net Zero Commitment

In 2020, we announced that we were making sustainability our new standard for investing. This built on our existing commitment to sustainable investing by making sustainability integral to the way we manage risk, generate alpha, build portfolios, and pursue investment stewardship, in order to help improve investment outcomes. We made this commitment on the strength of a deeply-held investment conviction: that integrating sustainability can help investors build more resilient portfolios and achieve better long-term, risk-adjusted returns. For a summary of our actions last year, see our **2020 Sustainability Actions**.

BlackRock is further deepening our commitment by supporting the goal of reaching net zero greenhouse gas emissions by 2050 or sooner, a transition we believe will fundamentally reshape the global economy.

For more detail on how we plan to address this in our investment management and stewardship efforts, see our **January 2021 letter to clients.**

SFDR Timeline



An important change that the SFDR has already ushered in is a clearer segmentation of sustainable investment products offered in Europe. SFDR asks asset managers to classify their products according to three categories:

- Investment products that have "sustainable investment" as their objective ("Art. 9" products);
- Investment products that promote environmental and social characteristics ("Art. 8" products), and;
- All other investment products without either specific sustainable investment objectives or portfolio-level environmental, social, and governance (ESG) characteristics ("Non Art. 8/9" products).

While the SFDR provides some high-level transparency and disclosure requirements at both entity- and product-levels, the forthcoming RTS provides far more granular detail as to the required disclosures (both qualitative and quantitative). These disclosures initially cover the concept of 'sustainability risks' – or the sustainability-related risks that a particular product or portfolio is exposed to – but will eventually include disclosures related to the relevant "adverse sustainability impacts" of the portfolios.

EU Taxonomy Regulation

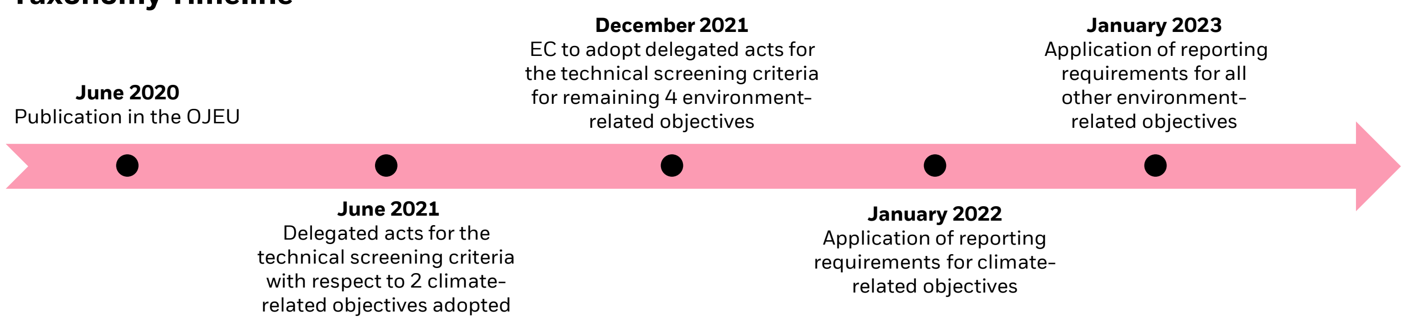
The EU Taxonomy Regulation is intended to establish a common framework for identifying to what degree specific economic activities can be considered to be environmentally sustainable. This common classification system is important to help investors understand more clearly what qualifies as green and sustainable activities for the purposes of underpinning product claims.

The EU Taxonomy Regulation will also require further sustainability-related disclosures for financial products that promote environmental and social characteristics (Article 8 under SFDR) or has sustainable investment as its objective (Article 9 under SFDR) – both in terms of how they use the taxonomy framework, but also the quantitative level of alignment of the portfolio to taxonomy-related activities.

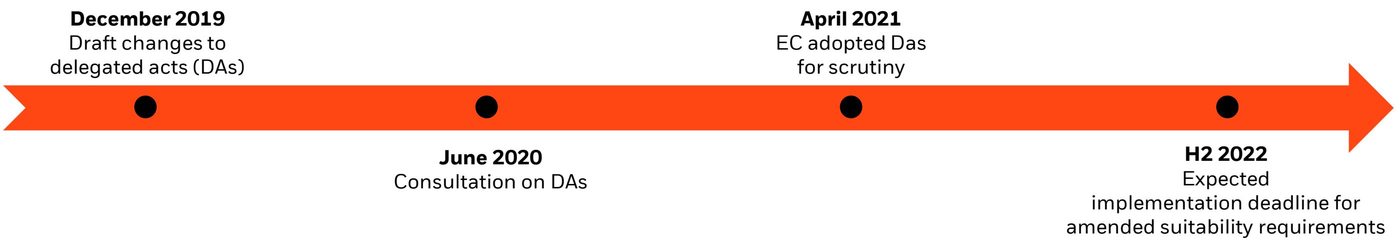
The Regulation also requires large companies[10] to report on the extent to which their turnover, and their capital and operating expenditure relates to the 'environmentally sustainable' activities identified in the taxonomy. To date, the taxonomy covers economic activities which make a substantial contribution to either climate change adaptation or mitigation. Although originally expected to be finalised by December 2020, the EC adopted the first set of criteria in June 2021 for endorsement by the European Council and European Parliament, following a period of reflection on how to treat nuclear energy and certain types of natural gas projects under the taxonomy. In the end, the decision on the treatment of these two activities, as well as agriculture and manufacturing, was further delayed to a separate delegated act that is expected after the summer.

BlackRock is supportive of the efforts to establish the EU taxonomy; we see it as a powerful example of public sector policymakers convening expertise from academia, civil society, industry and the financial sector to build a clear and objective roadmap that anchors concepts of sustainability. We recognise that the taxonomy is still in its early stages of development. We hope that the first set of criteria will be a valuable tool in helping better define the goals of the transition to a low-carbon, climate-resilient economy for many sectors, and should help aid corporate investment decision-making to that end. As data and information around the taxonomy becomes available in the coming years, further work needs to be done by the market to help the taxonomy realise its full aim, in particular: how to translate analysis of economic activities to issuer level, and how to assess issuers on their transition trajectory (future distribution of economic activities, versus economic activities today), consistent with the framework.

Taxonomy Timeline



MiFID Suitability Timeline



MiFID suitability changes

One of the core objectives of the EU Sustainable Finance Action Plan was to reorient capital flows to underpin sustainable investment objectives. In line with this objective, changes to the MiFID suitability and product governance obligations are expected to bring significant changes to advice and the types of investment products sold across Europe to investors who express a choice for sustainable investments.

The main objective of the changes is to enable investors to express their sustainability preferences through the advice and investment process. In practice, the MiFID changes are likely to incentivise the distribution of certain sustainable investment products. The amended Delegated Acts define sustainability preferences as a client's preference for financial instruments that:

- Have a minimum proportion of EU Taxonomy Regulation compliant sustainable investments
- Have a minimum proportion of SFDR compliant sustainable investments
- Consider principal adverse impacts (PAIs) on sustainability factors

While we are strongly supportive of making end-investors' sustainability preferences more central considerations in the advice and distribution process, we recognise that the changes will require significant efforts both by asset managers and distributors.

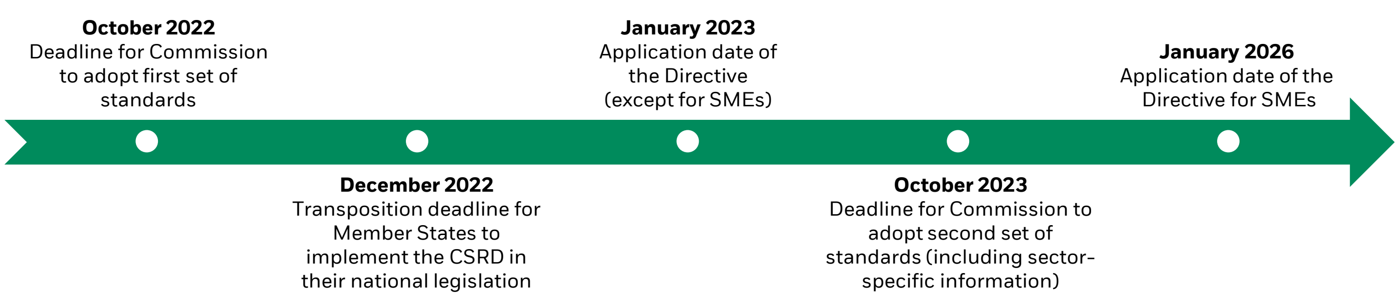
Sustainability corporate reporting and sustainable corporate governance

In April 2021, the EC published its proposal to revise the pan-European framework of ESG corporate reporting – called the 'Corporate Sustainability Reporting Directive' (CSRD), previously known as the 'Non Financial Reporting Directive'. The proposal requires large companies to report both on how sustainability issues affect their performance, position and development ('financial materiality') , and on their impact on people and the environment ('environmental & social materiality'), a concept the EC calls **'double materiality'**. The CSRD will also require companies to provide the primary source information necessary to underpin the reporting and disclosures under the SFDR and the EU Taxonomy Regulation.

Key features of the CSRD proposal:

- Scope extended to all large companies (including non-listed companies) and small and medium-sized listed companies. Large companies are those that surpass at least two of the following three criteria: balance sheet total of €20 million; net turnover of €40 million; and 250 employees. Proportionate standards for listed SMEs will also be developed.
- Sustainability reporting to include double materiality assessment.
- Mandatory EU sustainability reporting standards to be developed by the European Financial Reporting Advisory Group (EFRAG)[11] specifying the sustainability information to be reported. This will include information on environmental factors aligned with the EU Taxonomy Regulation's six objectives, among other ESG factors.
- The standards should take account of existing standards and frameworks, and seek consistency with SFDR, low-carbon benchmarks regulation and criteria set out in the EU Taxonomy Regulation.
- Limited assurance to be made by auditors.

CSRD Timeline



BlackRock welcomes the EC's support of the international momentum towards convergence of sustainability reporting standards driven by the International Financial Reporting Standards Foundation (IFRS Foundation) and IOSCO among others (see BlackRock's response to the IFRS Foundation consultation on Sustainability Reporting). Building European sustainability disclosure rules in a way that uses international standards serving as a baseline (the so called 'building block approach') will on one hand provide the global consistency and comparability both companies and investors need on key sustainability considerations, but on the other hand underline the EU's ambitions with additional reporting standards in line with double materiality objectives. We also welcome the clarification around the concept of double materiality. The concepts of 'financial materiality' and 'stakeholder materiality' are not entirely separate: businesses that meet changing societal expectations will be the ones that thrive financially over the long term. We welcome the alignment sought by the EC between the CSRD proposal and other EU initiatives on sustainable finance, in particular the SFDR and the Taxonomy Regulation.

Sustainable corporate governance is the other important financial policy aspect of companies' contribution to sustainability. The EC consulted on a possible proposal to further encourage businesses "to consider environmental, social, human and economic impact in their business decisions, and to focus on long-term sustainable value creation rather than short-term financial value." Potential requirements that were consulted on include:

- Directors to identify the company's stakeholders and interests and to identify and manage related risks and opportunities
- Additional regulation of remuneration schemes
- A role for stakeholders in the enforcement of directors' duties
- Enhancing the level of sustainability expertise on boards
- Creating a pan-EU legal framework for supply chain due diligence, leaning towards mandatory supply chain due diligence
- Enforcing due diligence duties on third-country companies

A legislative proposal is expected in Q4 2021 and will complement the CSRD proposal which focuses on the reporting. Investors want companies to incorporate the interests of all their key stakeholders and integrate sustainability considerations into the company's strategy, decisions, and oversight. Companies should strike a balance between their accountability to shareholders and their responsibility to other stakeholders as this recognises the nature of long-term value creation, benefitting both the company's shareholders and its other stakeholders. It also reflects BlackRock's belief that companies' prospects for growth are tied to their ability to foster strong sustainable relationships with their stakeholders.

The EC's expected proposal around due diligence largely reflects shareholder expectations, including our own. In our engagements, we ask that companies report on how they have determined their key stakeholders and considered their interests in business decision-making. We also ask that companies effectively address adverse impacts that could arise from their business practices and mitigate material risks with appropriate due diligence processes and board oversight.[12]

We support the introduction of an EU-level framework which will facilitate a rigorous approach to supply chain due diligence. We are concerned, however, that creating legal rights for stakeholders who are not capital providers would shake the fundamental balance directors have towards being accountable to the company's shareholders and being responsible towards other stakeholders.

The EU Sustainable Finance forward looking agenda

At the start of 2020, as part of the European Green Deal, the EC announced that they would publish a follow up to the 2018 Action Plan, a renewed Sustainable Finance strategy, that would set out the next steps on the EU's policy agenda around sustainable finance. The forthcoming strategy will aim to provide the policy tools to ensure that the financial ecosystem genuinely supports the transition of businesses towards sustainability, which is becoming even more important in a context of the recovery from the impact of the COVID-19 outbreak. Complementing work ongoing by central banks and prudential regulators around the world, it is also expected that the EC will also look more closely at how climate and environmental risks could be better integrated in the prudential framework, whether capital requirements for green assets should be adjusted, and how resilience to physical climate and environmental risks and damage from natural catastrophes can be increased.

Despite an enormous amount accomplished since the original 2018 Action Plan, sustainable finance remains a fast-moving and considerable area of focus for EU policymakers. As the first wave of changes bed down in implementation in the coming year, expect that more will follow in the coming years as the agenda continues to accelerate.

On top of EU efforts, we are also seeing a number of national initiatives building on the European agenda with either additional requirements on top of specific EU rules (as is the case in countries like France and Germany vis-à-vis the SFDR), or with national rules that sit separately to the EU framework (as is the case for a variety of national-level product labelling initiatives, whether driven by the public or private sector).

Sustainability developments in France

France has long been at the forefront of developing national rules on sustainability with a focus on:

- Financing the climate transition;
- Enhanced transparency from financial institutions when marketing and applying retail consumer ESG labels;
- Front running initiatives to protect biodiversity.

While the first phase implementation date for SFDR of 10 March 2021 was the same across the EU (page 10) French-based market participants have to comply with additional reporting requirements on climate and biodiversity risks based on Article 29 of *loi Énergie-Climat*. Any firm marketing funds into France has also to meet the requirements of the Autorité des marchés financiers (AMF) Doctrine in addition to SFDR. Article 29 and SFDR modify and extend the scope of the pre-existing Article 173 of the *loi sur la Transition Énergétique*, requiring French financial market participants to disclose a report on their ESG, carbon and climate activities.

ESG disclosure requirements applied by French financial markets participants

Entity level	Product level
• SFDR • Article 29 The entity-level SFDR measures and Article 29 replace pre-existing requirements.	• SFDR • AMF Doctrine • ISR or GreenFin Labels

For France-based market participants, the Loi Énergie-Climat sets out France's commitment to becoming carbon-neutral by 2050. Under Article 29, they must publish from 2022 an ESG risk policy setting out how they address and manage climate change risks and opportunities as well as biodiversity risks. The climate reporting framework is closely aligned to the global Taskforce for Climate-related Financial Disclosures (TCFD) framework and biodiversity reporting will likely align around the emerging Taskforce on Nature-related Financial Disclosures (TNFD) reporting framework.

For managers marketing funds in France, the policy purpose of the AMF Doctrine (AMF Position-Recommendation 2020-03) is to tackle greenwashing and ensure adequate information is provided to retail investors on sustainable investment products. From 10 March 2021, all ESG financial products have to meet the AMF's requirements. The AMF Doctrine takes a proportionate approach in describing the sustainable nature of a product in its public documentation. This means that the more the product claims to have ESG elements, the more robust and complete its disclosures should be. The AMF Doctrine distinguishes three types of approaches leading to three disclosures regimes:

a) An approach based on a "significant engagement" is explained as:
   - Requiring measurable objectives regarding the consideration of non-financial criteria;
   - The consideration of these non-financial criteria must have a significant impact on the objectives (e.g. rating upgrade, reduction of the investment universe by at least 20%).

b) An approach based on not "significantly engaging" management requires disclosure but without specific numerical targets for the investment strategy therefore disclosures are:
   - 90% of AUM is assessed on an ESG basis;
   - A definition of the methodology of the fund e.g. reduction of the universe or upgrade of the rating without a specific numerical target.

c) An approach that does not address any of the two previous approaches would only allow ESG-related disclosures in the prospectus i.e. there is no disclosure in the regulatory documents concerning the sustainable investment approach nor measurable objectives.

Separately, in 2016 the French Ministry for the Economy and Finances had created ESG Retail consumer label ISR (Investissement Socialement Responsable) and the GreenFin label. The Ministry updated its requirements last year and opened up the ISR label to real estate funds, the new rules came into force in October 2020. Proposals are currently under discussion to update the scope of the labelling requirements.

Impact on clients

French investors assessing ESG products benefit from three levels of protection from greenwashing through the combined operation of SFDR disclosure, the AMF doctrine and labelling requirements. More broadly French investors will increasingly benefit from enhanced disclosure around the assessment of climate-related and biodiversity risks.

Sustainability and stewardship in the UK

Following its exit from the European Union, the UK is now developing its own approach to sustainable finance regulation. In 2020, the UK Government announced important changes related to green finance, some of which are taking place in 2021 such as the DWP requirements on climate governance and reporting by large occupational pension schemes. Combined with hosting the UN Climate Summit (COP26) in November, this year marks the beginning of a period of accelerated green finance rule-making in the UK. This covers two main aspects: "Greening finance" and "financing green," with the overall objective of transitioning the UK economy to net zero by 2050 and turning the UK into a global centre for sustainable finance.

Greening finance

In November 2020, the Treasury announced that disclosure against the global TCFD framework will be mandatory across the UK economy by 2025, and the relevant authorities are now consulting on how to make that a reality across the financial system:

- **Department of Works and Pension (DWP):** The largest occupational pension schemes, master trusts and collective defined contribution schemes must have integrated the TCFD recommendations in their processes from October 2021 and start reporting in 2022 (see page 17 for more).
- **Financial Conduct Authority (FCA):** Following a revision of the listing rules by the FCA, premium listed issuers are required in 2022 to produce a TCFD report or explain their non-compliance.[13] In addition, asset managers, life-insurers and FCA-regulated pension schemes imminently expect an FCA consultation on climate-related disclosures to their clients, with rules aimed to be in place for 2022.
- **Department for Business, Energy & Industrial Strategy (BEIS):** BEIS issued a consultation in March 2021 to create mandatory TCFD reporting for public companies, large private companies and limited liability partnerships to come into effect in 2022.
- **Prudential Regulation Authority (PRA):** Finally, the PRA wrote to supervised entities setting the expectation that they publish a TCFD report.

See BlackRock's response to the FCA consultation here.

BlackRock supports the UK regulators' efforts to mandate disclosure of climate-related financial risks aligned to TCFD. Climate risk is investment risk, so investors must be better informed of the impact of climate change on their investments, and companies must be better equipped to manage the impact of climate change on their business. Not making TCFD mandatory for public listed companies from 2021 is a missed opportunity – not least because investors, such as large occupational pension schemes need the information for regulatory reasons this year (see page 17) and many UK public companies are already doing some form of TCFD reporting.

Reporting by both public and private companies is needed to support appropriate capital allocation and enhance understanding of the sustainability characteristics of the economy. We therefore support BEIS's efforts to introduce TCFD reporting by private companies and recognise the need for proportionality as private and smaller companies are brought in scope.

We see a role for the Government to develop a market-wide classification and naming convention for sustainable investing products, particularly as a more robust denomination of sustainable products will inspire greater confidence in end-investors. A key step the asset management industry can take to facilitate this, with public sector encouragement, is to more clearly segment and name sustainable products. We see a role for the FCA to work with industry on harmonising naming conventions and product lexicons.

Financing green

Financing the green transition is another priority area for the UK Government. Sustainable infrastructure, in particular, has become a significant priority, as illustrated by the Prime Minister's ten point plan for a green industrial revolution and the National Infrastructure Bank announced in the Spring Budget. BlackRock recognises that private capital is needed to fund green infrastructure projects, and these can be investable opportunities for long-term investors, with a supportive and stable regulatory framework. The Government can make a more consistent application of the various policy instruments at its disposal (supports, taxation and regulation) to more efficiently achieve its energy goals.

Retirement

Efforts to address the near-term health and economic emergency presented by the pandemic have taken precedent over the longer-term challenge of pension reform in many countries this year. However, the ongoing demographic trend of population aging in Europe, plus increasingly strained sovereign balance sheets, will likely put bolstering retirement frameworks back on the European policy agenda. Meanwhile, pensions reforms in the UK continue to move apace with a number of significant recent initiatives, such as enhancements to the UK's auto-enrolment framework.

EU Pensions reform

Increasing access to retirement savings solutions constitutes one of the major recommendations in the EC's Capital Markets Union Action Plan which recognises that "Strong market-based pension systems have the potential to supplement public pensions and better cater for the needs of ageing populations, provided they are designed in a broad and inclusive manner."[14] To make good on this aim the EC has indicated that it intends to facilitate the monitoring of pension adequacy in Member States through the development of pension dashboards and develop best practices for the set-up of national tracking systems for individual Europeans. The EC has also launched a study to analyse auto-enrolment practices across the world, to help inform future policy recommendations on retirement savings.

Pension reform in the UK

The regulatory environment for UK pension schemes is changing rapidly. Several reforms were rolled out in 2020, including auto-enrolment, changes to permitted links, the Defined Contribution (DC) charges' cap, and sustainability.

Auto-enrolment since 2012

After eight years of auto-enrolment in the UK, more people than ever are saving for retirement in a workplace pension: In 2019, 77% of employees were enrolled, up from 47% in 2012.[15] For many people, their workplace pension will be their only regular savings vehicle, while DC pension schemes are becoming an increasingly important source of capital for the economy.[16]

In April 2019, the national minimum contribution rate into auto-enrolment schemes increased from 5% to 8%, at least 3% of which must be paid by the employer. This was achieved with no significant change in the opt-out rate, despite the impact on incomes of the COVID crisis through 2020. Further reforms will also help the self-employed plan for retirement. The long-term success of auto-enrolment, however, will depend on its ability to provide a sufficient level of replacement income for people in retirement, where we think there is further to go.

Measures that can be put in place during the current period of Parliamentary stability to gradually escalate the savings rate to 12% or beyond over the coming decade are an opportunity not to be missed. As research by The Investing and Saving Alliance (TISA) demonstrates, the current level of savings could fall well short of what many people expect and will need to support themselves in retirement.[17] Backed up by considerable cross-party co-operation on retirement policy, the Government has an opportunity in the next few years to put auto-enrolment on a more adequate path, and so preserving widespread support for the policy into the future.

European Commission study on auto-enrolment

As population aging puts state pensions under strain, auto-enrolment systems that permit or require employers to enroll employees into a suitable workplace pension scheme, typically on an opt-out basis, have been introduced in a number of countries in varying forms.

Whether introduced on national, sector-wide, or company level basis, auto-enrolment helps overcome the inertia barrier to accessing voluntary pension savings plans, and can be successful in significantly increasing participation, by providing individuals a realistic tool to invest for retirement during working life. In the UK, auto-enrolment has brought 10 million more people into a DC pension, enabling them to invest for their retirement, as soon as they start working.

In 2020, the EC initiated a tender process for a study to identify global best practices in auto-enrolment, and all forms of in funded retirement savings schemes. The study will also measure the performance of auto-enrolment mechanisms in improving pension adequacy, and provide recommendations on the features of well-functioning auto-enrolment frameworks. The output is likely to contribute to EU and national policy consideration.

The savings rate, however, is not the only determinant of retirement incomes. Investment performance is the other significant but often overlooked factor. The Government has begun to consider further steps to facilitate ordinary savers' access to a wider range of investment opportunities.

DC pension schemes and 'productive finance'

Over recent years, successive UK Governments have brought forward initiatives aiming to facilitate more investment from DC pension schemes into what has variously been called 'productive', 'patient', or 'long-term' capital. This refers to longer-term, less liquid, often private assets such as early-stage equity or infrastructure. The longer-term investment horizons of such assets lend themselves well to retirement savings, and provide a diversified source of returns alongside traditional asset classes. For example, amendments to 'permitted links' rules mean that, from March 2020 unit-linked DC schemes will not be prevented from investing in these types of assets, subject to meeting certain specified requirements.[18] More recently, in November 2020, HM Treasury announced its intention to create the regulatory framework for a new 'long-term asset fund' in the UK.[19]

Each of these are important and necessary steps, but are not alone sufficient – a broad review of the whole ecosystem is necessary. As such, we welcome the establishment of a Working Group to facilitate investment in productive finance, led jointly by HM Treasury, the FCA, and Bank of England, in consultation with a cross-section of the financial services industry.[20] This working group is looking at ways to facilitate an ecosystem-wide shift to accommodate assets that do not trade frequently in pensions and some retail investments, for example via a move away from strictly daily dealing models.

But another equally important factor is ensuring the charges cap for workplace pensions is set in a manner that makes these types of investment feasible. In April 2021 the UK Department for Work and Pensions concluded a consultation on how to accommodate performance fees – which are common for these types of asset classes – within the charges cap: The inherent unpredictability of performance fees and their potentially irregular nature, creates a significant problem here. We suggest that performance fees should be excluded from the charges cap but that this exclusion should be applicable to no more than 35% of a pension schemes' portfolio. We believe this balances the need to solve for the problem of performance fees being unpredictable in relation to the charges cap against the need to limit the fees incurred by workplace schemes and importance of maintaining trust in the scheme, which is essential to their continued success.

Sustainability, climate and stewardship

Beginning with a requirement for pension schemes to publish a Statement of Investment Principles, the DWP has continued to require that trustees hone their understanding of climate-related financial risks and work towards scheme-specific ESG reporting.

As a result of the Pension Schemes Bill amendments approved by Parliament, which confer the DWP power to make regulations in relation to climate change, the DWP accelerated its rule-making efforts throughout 2020. It is set to require large occupational pension schemes to:

- Integrate climate considerations into their governance, strategy and risk management, and;
- Publicly disclose their climate information.

Failure to report may lead to penalties from The Pensions Regulator. The DWP intends to review the rules and possibly broaden the scope to pension schemes with net assets under £1 billion in 2024 (see DWP's workplan in Exhibit 3 below). We provided recommendations to the DWP to support their direction of travel. We are ready to support trustees in implementing these requirements as they take effect.[21]

Finally, the UK's revised 2020 Stewardship Code now enables asset owners, including pension schemes, to sign up to it. Entities that became signatories had to publish their annual stewardship report before March 2021.

Overall, these actions aim at creating a market that is fit for purpose given higher than ever participation in workplace pensions. In our view, it will be crucial to ensure all policy in this area is geared towards providing the best possible outcomes for those saving for retirement. This means ensuring scheme members have access to a wide range of investment opportunities which build long-term value and reflect their preferences, while also ensuring they receive adequate protection. It also means helping decision makers like corporates and trustees to focus more on long term outcomes, instead of short-term costs.

Exhibit 3: DWP climate risk and TCFD workplan

October 2021	November 2021	October 2022	December 2022	December 2023	2024
Requirements That trustees of schemes with >£5bn are subject to climate governance requirements	**COP 26** Glasgow	**Requirements** That trustees of schemes with >£1bn are subject to the climate governance requirements	**Requirements** That trustees of schemes with >£5bn publish a TCFD report	**Requirements** That trustees of schemes with >£1bn publish a TCFD report	**Consultation** Review of the rules and possible extension of scope
Requirements That trustees of master trust or collective money purchase schemes are subject to climate governance requirements			**Requirements** That trustees of master trust or collective money purchase schemes publish a TCFD report		

Efficient capital markets

LIBOR reform

THIS AFFECTS	Retail and institutional investors; financial services industry at large; corporates
JUL 2017	FCA announced it will not compel panel bank submissions as of end-2021.
JUL 2018	The first over-the-counter swaps linked to the new US secured overnight financing rate (SOFR) traded and cleared.
DEC 2021	Regulators have encouraged that the use of all LIBOR rates in new contracts cease by this time.

2021 will be a crucial year in terms of the market's preparedness to move away from LIBOR (the London Inter-Bank Offer Rate) and towards the adoption of Alternative Reference Rates (ARR). Following the 2012 rate-fixing scandals, the dialogue has shifted over recent years from reform of pre-existing rates to replacement with ARRs which include the Secured Overnight Financing Rate (SOFR) in the US, a reformed Sterling Overnight Index Average (SONIA) in the UK, and the Euro Short Term Rate (€STR) in the Eurozone. The catalyst for this change was a July 2017 speech by Andrew Bailey, then CEO of the UK FCA, indicating that submitting to LIBOR will no longer be required of panel banks after 2021.

With the identification of ARRs mostly behind us, investors and regulators turned their attention in 2020 to addressing legacy positions and increasing liquidity in products which reference the ARRs.

Key Features

- A major concern remains the management of existing positions that reference LIBOR. In USD LIBOR alone, at least $36 trillion in outstanding notional will not mature prior to 2023.
- The ARRs are not direct substitutes for LIBOR. The differences need to be considered as market participants decide whether to adopt them.
- The pace of ARR adoption will largely depend on the market, based on liquidity and the compatibility of ARRs with various asset classes.
- Financial transactions do not exist in isolation. The relationships between assets in a portfolio must be handled with care to avoid disruption.

Education about the costs, risks, and potential benefits of transitioning to new benchmarks will be critical to finding appropriate solutions for our clients. Going forward, industry groups and official sector bodies must focus on the implications for investors (the end-users of Reference Rates), as well as the portfolio context in which their exposure to LIBOR currently exists.

Given the magnitude of the changes necessary to achieve a transition, we believe the development of ARR term rates will further encourage market participants to move away from LIBOR by the cessation date.

Central clearing of trades

THIS AFFECTS	Investors subject to clearing mandate, Investors choosing to clear products voluntarily, Market ecosystem – CCPs, clearing members
Summer 2021	ESMA consultation on CCP R&R (CCP R&R Regulation technical standards)
AUG 2022	EU CCP R&R regime takes effect

OTC derivatives' move to central clearing has improved transparency and risk management. During the testing market conditions of March 2020, the reforms that were implemented following the GFC to shift the OTC derivatives market to a centrally cleared structure proved effective. For example, centrally cleared US futures and options hit an all-time high of 1.43 billion contracts in March. However, margin calls were pro-cyclical, unpredictable, and opaque. Collateral for futures held at US futures commission merchants (FCMs) rose $104 billion (49%) over the month of March. Heightened margin requirements and related cash-raising needs by a wide variety of market participants and corporates added pressure to short-term markets in already challenging conditions. The Financial Stability Board (FSB) announced in November 2020 that it intends to study the effect of margin calls on stressed markets, which is welcome. We also welcome the FSB's intent to continue to work on the policy framework to strengthen the resilience of CCPs, through which an increasing number of European end-investors are required to clear or choose to clear products.

Key Features

Throughout 2020, major buy-side and sell-side firms, including BlackRock, have called for regulatory action to make clearing houses safer and propose a step-change in how the market deals with clearing house failure. We see this advocacy as a key part of our fiduciary duty towards clients who are required to clear by law or choose to clear through CCPs voluntarily.

- In the spirit of ensuring on-going financial stability in times of market disruption or crisis, we have sought to better align incentives between CCPs and market participants and ensure that clearing member and end-user liabilities are limited and manageable.

- Our recommendations are comprehensive addressing key elements of resilience of a CCP, with an emphasis ensuring:
  - that CCPs are subject to appropriate risk management standards and have sufficient financial resources in place to reduce the likelihood of ever needing to enter a recovery or a resolution process and
  - requiring CCPs have sufficient capital that is structured to fully align risk management incentives.
- They also include a number of recommendations on the recovery and resolution of clearing houses that will ensure that CCPs are optimally structured to make sure the market remains resilient in the unlikely event of a meaningful disruption.

The EU's CCP recovery and resolution framework was agreed in 2020 after several years of discussion and debate. Whilst we believe the framework will be beneficial in terms of financial stability and investor protection, there are a number of important technical details outstanding that will require further work by ESMA throughout 2021. One such element is to work out how end-investors would be protected in the event a CCP fails and calls upon their variation margin to restore the CCP. Another area is to determine the scope of non-default losses for which the CCP ought to be responsible. This sits alongside very important technical specifications to ensure the European CCP recovery and resolution framework is operational and balances the interests of systemic stability and the users of CCPs, who are ultimately end-investors.

Post-Brexit Financial Markets

Share Trading Obligation

THIS AFFECTS	All classes of investors; market ecosystem – exchanges, liquidity providers; issuers
31 JAN 2020	UK withdrawal from the EU
NOV 2020	Statement from FCA on UK approach to STO
Q4 2021	EC review proposal of MiFIR (including a review of the STO)

In November 2020, the UK's Financial Conduct Authority set out its approach to share trading in the context of the future EU-UK relationship. This follows ESMA clarifying its position earlier in the year, which takes a securities identification number (ISIN) based approach, meaning that GB ISINs would be excluded from scope of the EU share trading obligation (STO).

It is interesting to observe the differing approaches being adopted by the UK and the EU in this regard. The UK's approach reinforces a company's freedom to choose where to raise capital and trade their securities, including EU trading venues, regardless of the currency of their securities. Unlike ESMA, the FCA does not therefore consider the ISIN or currency that a share carries and trades in relevant to determine the scope of the STO. Any restriction on the trading of shares based on currency does not reflect the multicurrency nature of global capital markets and limits the ability of firms to determine how best to use global capital markets to support economic activity, the FCA suggests. The FCA has also suggested that the approach favoured by ESMA would lead to disruption to investors, issuers and other market participants, leading to fragmentation of markets and liquidity in both the EU and UK.

The UK's approach is to mirror the EU STO but explicitly allow EU venues for trading. Best execution determines where execution takes place in this case and minimises market disruption for the vast majority of clients served by global asset managers.

We expect the EU's approach to the STO to be confirmed as part of the Review of MiFIR which will be live during Q4 2021. BlackRock will continue to monitor developments and engage with policymakers on this issue in 2021 with aim of minimising the impact on liquidity and portfolios.

UK-EU financial services post-Brexit

The end of the Brexit transition period on 1st January 2021 brought with it a so-called 'hard Brexit' for financial services. Financial services are not included to any substantive degree in the UK-EU Trade and Co-operation Agreement, and the EU did only what it considered strictly necessary from a systemic risk perspective to minimise the cliff-edge for market participants, e.g. in OTC derivatives clearing. A significant proportion of trading in European equities has migrated from London to Amsterdam to satisfy EU share trading obligation requirements, but operational disruption to markets has so far been minimal, due largely to measures deployed by the private sector, which on the whole was well prepared.

A Memorandum of Understanding (MOU) establishing a regulatory dialogue between the UK Treasury and EC was agreed in March but is awaiting the final political sign off by the EU. This creates a useful framework for future co-operation and discussion of common concerns to complement ongoing discussions between the authorities, but is not a side-deal on trade in financial services nor an agreement on equivalence decisions – the process by which the EU grants market access to firms in non-EU countries.

Looking ahead, although both sides will continue to operate within similar international frameworks, it is increasingly clear that they will do so independently and in accordance with their own interests. The UK has launched a series of reviews aimed at calibrating onshored EU rules to the specificities of the UK market while aiming to enhance the

UK's attractiveness in areas like new issuers; sustainable finance, and financial technology.[22] The UK has legislated for an overseas funds regime, sparing pension schemes and other investors from significant redomiciling costs and an expensive tax hit, and also enabling them to continue benefiting from access to economies of scale into the future. At the same time, if the UK gets the details of its recently announced Long-Term Asset Fund right, it will enhance its status as a centre for alternative fund management.

For its part, the EU too is doubling down on sustainable finance while progressing the Capital Markets Union, including 'independence when it comes to financial market infrastructures.'[23] Progress has been made in this regard with respect to share trading, while derivatives trading has been more widely dispersed across global financial centres, including in the US. The long-term strategic aim of the EU is to build up its own capital markets infrastructure which likely implies reducing its reliance on London-based financial services, including clearing services, which after

The future of the UK Financial Services regime

Now that the UK has left the EU, it has the freedom to determine its own policies for financial services, and has begun the process of adapting the body of inherited EU law to the specificities of the UK market. While there is no appetite in the UK for overhauling or drastically changing these rules, the Government has made it clear that rules designed as a compromise for 27 Member States in a single market it no longer has access to – all the more so in the wake of the EU's refusal to grant equivalence decisions - will not necessarily be best suited to its future needs. For example, in May 2021, the Treasury announced that it will permanently remove the open access regime for Exchange Traded Derivatives (ETDs) under the UK MiFIR.

One cornerstone of this work is the 'Future Regulatory Framework' review being conducted by HM Treasury. This is considering how the 'institutional architecture' of the UK's regulatory framework may need to be adapted in light of its new rule-making responsibilities. A first phase of the review looked at the coordination between the UK's main regulators, and how to manage the combined impact of regulation on firms. A second phase looked at the allocation of responsibilities for policymaking and scrutiny between Parliament, the Government, and the regulatory agencies; as well as an open question of whether the core objectives of UK financial services policy – financial stability, market integrity, and consumer protection – should be bolstered. In addition to those aims, we believe this an opportunity to help orientate policymaking for financial markets around their primary purpose of funding the economy while providing end-investors with a means of generating returns.[24]

There is also a series of thematic reviews being undertaken. An early example of which was the review of the UK Listing Regime, that looked to improve the attractiveness of the UK market for companies to list through tweaks to requirements around voting rights, the free float, and prospectus requirements. More recently, a review of the UK Funds Regime looked at the taxation and regulation of UK-domiciled funds – with a view to improving the effectiveness of the regime and to 'fill any gaps' in the UK's fund offering. This work, combined with another initiative looking at how the UK can best leverage productive capital which BlackRock has been pleased to contribute to, will be an important component of the project to launch a fully operational 'Long-term Assets Fund' in the UK (see page 16). Finally, over the course of this year we expect the UK to launch a review of the regulatory framework for wholesale capital markets and market infrastructure – covered in large part by the on-shored Markets in Financial Instruments Directive/Regulation. We expect any proposals in this area to be highly targeted, in line with the UK's overall intention to 'tailor' the rulebook, rather than overhaul it.

In the meantime, and in addition to overhauling existing rules, the UK is seeking to promote itself as a centre for FinTech and green finance. The Kalifa Review, published in February 2021, made recommendations on making the UK a more attractive place for new technology firms to list and grow, for instance the adoption of a regulatory 'scale box.' And in the run-up to hosting COP26 in November, the UK has set the pace in terms of mandating TCFD reporting, which will apply across the UK economy by 2025, and is planning to create a green taxonomy adapted to the UK economy and taking the scientific metrics in the EU taxonomy as its basis.

Brexit are out of scope of its jurisdiction. Market participants are currently feeding in their views to the EC as to how best to manage a transition to a multi-Central Clearing Counterparty (CCP) framework, where it is expected that over time Euro-denominated derivative positions would be generally managed by CCPs based in the EU. The conclusions of this process will determine how the expiry of temporary EU-UK CCP equivalence at the end of June 2022 will ultimately play out.

End-investors, both in the UK and the EU, benefit from continued co-operation, access to products, and larger pools of liquidity. A focus on consumer interests, while the EU develops its capital markets and the UK charts its own path, should help guide decision-making in the months to come. Properly managed and invested in, the new relationship can be productive for both sides.

Conclusion

The COVID-19 pandemic has had a profound impact on individuals, communities, and the economy over the past year, and continues to present a public health emergency in many parts of the world. As a market stress event, the outbreak of the pandemic demonstrated the effectiveness of the many improvements to financial stability made over the past decade of regulatory development. As policy efforts turn to the future, it is clear that economic recovery must be sustainable, reflecting increasingly green consumer expectations, and providing a central thread running throughout both new policy initiatives and the scheduled reviews of current legislation. The EU and the UK share this and many other policy priorities and continue to operate within the same international frameworks, but it is increasingly clear that they will find their way independently.

Endnotes

1. Including predecessor companies.
2. Bank of England-NMG Consulting biannual household survey, September 2020 https://www.bankofengland.co.uk/bank-overground/2020/how-has-covid-affected-household-savings. CaixaBank Research, based on data on from ECB https://www.caixabankresearch.com/en/economics-markets/activity-growth/savings-and-covid-19-how-far-will-europes-saving-fever-go
3. CaixaBank Research, based on data on from ECB https://www.caixabankresearch.com/en/economics-markets/activity-growth/savings-and-covid-19-how-far-will-europes-saving-fever-go
4. OECD/ European Commission Financial Competency Framework https://www.oecd.org/finance/launch-eu-financial-competence-framework.htm
5. For example, see the Bank of England's Interim Financial Stability Report, May 2020.
6. See our response to the European Commission's Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD) for further detail.
7. Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
8. Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.
9. For asset manager the definition of FMPs includes MiFID firms providing portfolio management, AIFMs, UCITS management companies, Solvency II-regulation insurers, and IORPs. SFDR also applies to insurance-based investment products and certain pensions products. A sub-set of the rules applies to financial advisers and certain insurance intermediaries .
10. Definition under the Non Financial Reporting Directive as proposed to be amended by the proposed Corporate Sustainability Reporting Directive, see page 12.
11. EFRAG is a private group of accounting professionals, preparers, users, and national standard-setters, established to provide technical expertise to the EC concerning the use of international accounting standards in Europe.
12. https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-engprinciples-global.pdf
13. See BlackRock's response to the FCA consultation here.
14. European Commission: A Capital Markets Union for people and businesses, 2020
15. Source: Office for National Statistics (March 2020). "Employee workplace pensions in the UK: 2019 provisional and 2018 final results".
16. As of 2019, UK DC schemes held over £71bn in assets, an increase of over 210% since 2012. See The Pensions Regulator (February 2020). "DC trust: scheme return data 2019 – 2020".
17. https://www.tisa.uk.com/wp-content/uploads/2020/02/Getting-Retirement-Right.pdf
18. See BlackRock's response to FCA CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules.
19. See HM Treasury, Chancellor statement to the House – Financial Services, November 2020
20. https://www.bankofengland.co.uk/financial-stability/working-group-on-productive-finance
21. For more information on the proposals, and BlackRock's views on the challenges it poses, see our response to the DWP's consultation, "Taking action on climate risk: Improving governance and reporting by occupational pension schemes"
22. https://www.gov.uk/government/speeches/chancellor-statement-to-the-house-financial-services
23. https://ec.europa.eu/info/sites/info/files/speech-barnier-eurofi-30062020_en.pdf
24. https://www.blackrock.com/corporate/literature/publication/hmt-financial-services-future-regulatory-framework-review-phase-ii-consultation-021921.pdf

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