

REGULATORY DEVELOPMENTS IN EUROPE: 2014 UPDATE AND ANALYSIS

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Overview

In response to the financial crisis, European policymakers have made significant progress in their efforts to build a stronger financial regulatory framework in order to restore financial stability and boost end-investor confidence. As this framework moves towards implementation, the European Union (EU) is beginning to turn its attention towards the challenge of generating economic growth and, in particular, to how capital markets can contribute to growth. A key task for the newly-elected European Parliament, the new European Commission (EC) and Council of Ministers will be to agree on legislation that promotes sustainable economic growth balanced with the need for a more robust financial ecosystem.

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

This *ViewPoint* updates our 2013 overview of the EU regulatory developments that may impact end-investors. Topics covered range from product management and investor protection to market liquidity, asset allocation and taxation.

Over the past five years, policymakers have focused on various initiatives with significant implications for end-investors. The implementation of several of these is ongoing, for example: the European Market Infrastructure Regulation (EMIR), the Capital Requirement Directive IV (CRD IV) and Solvency II. The EC, European Parliament and Council of Ministers have also reached political agreement on other measures, including the review of the Markets in Financial Instruments Directive / Regulation (MiFID II / MiFIR).¹

Additional initiatives have been launched since 2013 and early 2014. These include new EC proposals on market-based finance, including the Money Market Fund Regulation (MMFR) and the Securities Financing Transactions Regulation (SFTR) as well as on the Financial Benchmarks Regulation, the European Long-term Investment Funds (ELTIF) Regulation, the Shareholder Rights Directive (SRD), the Institutions for Occupational Retirement Provision Directive (IORPD) and the Bank Structural Reform Regulation (BSRR). These proposals are currently being discussed (a 'state of play' is provided in the [annex](#)).

Finally, since last year's *ViewPoint*, the debate about long-term investment has gained significant profile driven by the political desire to stimulate economic growth. Jean-Claude Juncker, the President of the EC, has put the creation of a Capital Markets Union (CMU) at the centre of the EC's roadmap for the next five years. The EC is expected to publish a consultation on the topic early next year and much of 2015 will be devoted to defining the components of the CMU.

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1 Fund regulation & investor protection

FUND REGULATIONS

Alternative Investment Fund Managers Directive (AIFMD)

EU Member States had to implement the AIFMD by 22 July 2013 with a one year transition period for the EU managers to apply for the necessary authorisation in their jurisdiction.

An AIF is any non-UCITS fund (with the exception of insurance products), wherever domiciled, which is either managed or marketed to professional and retail investors in the EU.² Only non-EU AIFs managed by non-EU managers not marketed in the EU are excluded from the AIFMD.

The AIFMD significantly impacts the marketing and distribution processes of AIFs in the EU. EU AIF managers are allowed to market EU AIFs to professional investors across the EU using a marketing passport – generating greater choice for EU professional investors. This will not be available for non-EU managers until early 2016. The European Securities and Markets Authority (ESMA) is consulting on how the marketing passport could be extended to AIFs managed and marketed by non-EU managers. Much will depend on how close to EU legislation rules in countries such as the Cayman Islands, Jersey, Switzerland or the US will have to be for local funds to qualify for the passport. In the meantime, both non-EU and EU managers are only able to market non-EU AIFs where allowed by local registered private placement regimes (PPRs) – particularly in the UK, the Netherlands, Finland, Sweden and Belgium. However, many other EU countries, including France and Italy, do not have a PPR, meaning that active marketing will not be possible. In other countries, such as Germany, national PPRs have become significantly more restrictive potentially limiting professional investor choice.

Even if a manager decides to cease marketing a non-EU AIF within the EU, EU professional investors can still invest in these funds by using the reverse enquiry process.³

The AIFMD also provides for greater transparency with prospectuses and other offering documents, reports and accounts including disclosure of key issues, such as management structure, scope of liabilities/duty of third-party service providers as well as risk, liquidity and leverage profiles. This will assist professional investors in developing more standardised due diligence programmes and promoting greater comparability of AIFs.

Further, professional investors will benefit from external depositaries' greater focus on due diligence and account set-up. AIFMD implementation has led to the restructuring of the operational model of AIFs using prime brokers to reflect the enhanced depositary requirements.

European Long-Term Investment Fund (ELTIF) Regulation

The ELTIF is a closed-ended vehicle marketed to both retail and institutional investors which launch was proposed by the European Commission (EC) in 2013 to finance infrastructure projects, companies or real assets as part of the EU policy agenda to drive long-term sustainable growth (please also refer to the [Long-term investing article](#)).

Eligible assets in the EC proposal include equity, loans and debt instruments issued by unlisted companies or listed SMEs as well as direct holdings of real assets (e.g. real estate, ships or aircraft). Short-selling, exposure to commodities, securities lending and repos are likely to be forbidden and derivatives must only be used for hedging.

We believe that the greatest potential for the ELTIF lies with institutional investors. The ELTIF may encourage them to allocate more to long-term assets, provided appropriate incentives are put in place. These initiatives could include more favourable regulatory capital charges or additional measures at the Member State level to remove restrictions limiting institutional investors' ability to finance loans and to apply a more consistent tax treatment. Last, we think that it would be in the investor's interest if the manager is able to offer limited redemptions where appropriate – based on the level of liquidity of the underlying assets.

The EC proposal requires ELTIF managers to meet diversification rules: at least 70% of capital must be invested in eligible long-term assets, with a maximum of 10% exposure to any single underlying asset.

For retail investors, we believe that it would be counterproductive to stipulate a minimum threshold or percentage of portfolio as this could limit personal pension access which may be one of the most likely ways for retail investors to access the ELTIF. In addition, given the illiquid nature of the eligible assets, retail investors should be provided with investment advice regarding the suitability of the ELTIF for their portfolio on top of a prospectus and a Key Information Document (KID).

Also, in the EC proposal, the ELTIF's life must be specified and measured according to the illiquidity profile and economic lifecycle of the assets and the stated long-term investment objective.

We believe that aligning the term of the ELTIF to underlying investment maturities would not be practical in many cases as managers often do not know whether a particular asset will find a market at its intrinsic value on a specific date in the future. Forcing the manager to dispose of what are typically illiquid assets on a specific date may prevent them from realising assets at the most favourable price for underlying end-investors. Subject to suitable investor disclosure, we believe that managers should be able to extend the duration of the ELTIF to allow assets to be sold at their true value.

Undertakings for Collective Investment in Transferable Securities Directive V (UCITS V)

UCITS V will come into force in March 2016. It aims to align manager remuneration with long-term performance and considers the extent to which depositaries should be liable for assets held in custody, including those held by a third-party sub-custodian.

Key members of staff who have a material influence on the UCITS will have the variable component of their pay deferred over a number of years and paid in units of the UCITS or in instruments with an equally effective outcome such as units of the investment management company. Information about where investors will be able to find a manager's remuneration policy (e.g. on its website) will be set out in the UCITS Key Investor Information Document (KIID).

Depositaries will be held strictly liable for assets held in custody even when appointing a third-party sub-custodian – leading to restitution of assets that are lost or stolen. They will also have enhanced duties to oversee assets not held in custody. Authorised and supervised credit institutions, MiFID investment firms and other investment firms subject to adequate prudential supervision will be able to act as depositaries.

Overall, we welcome the final outcomes of the UCITS V Directive and particularly the greater consistency in the treatment of the depositary's duties bringing about greater alignment with the investor protection measures in AIFMD – levelling the playing field between UCITS and AIFs in this area. We believe it is important to ensure that the final rules allow asset management firms to operate a consistent remuneration policy across all funds and client mandates they manage.

EU Money Market Funds Regulation (MMFR)

Global and regional policymakers continue to grapple with the regulation of MMFs in the wake of the financial crisis. The International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board (FSB) adopted global principles for regulating MMFs in 2012. In the US, the Securities and Exchange Commission (SEC) released its ruling in July 2014 and implementation is required by 2016.

In the EU, the European Commission (EC) published its proposal for MMFR in September 2013 with implementation estimated for 2017.

BlackRock supports the EC proposal related to portfolio diversification, minimum liquidity requirements, minimum credit and duration standards as well as the requirements for greater transparency, 'know your client' provisions and portfolio stress testing. These measures are important in reducing the potential for a MMF taking inappropriate risks.

However, we believe that some provisions in the EC proposal may inadvertently endanger the viability and attractiveness of both constant net asset value (CNAV) and variable net asset value (VNAV) MMFs. These include:

Credit rating agency (CRA) ratings

To avoid a mechanistic reliance on CRA ratings, the EC proposes that MMF managers will no longer be able to seek fund level ratings from CRAs. It fears that a downgrade in the rating of a single fund can cause an investor 'run' on all MMFs. The proposal also prohibits MMFs from referencing the ratings of CRAs in their own portfolio management processes and recommends that MMF managers develop their own internal rating scales instead.

BlackRock strongly supports the requirement that asset managers perform their own credit analysis. However, we believe that the prohibition of fund level ratings and of reference to ratings for the assets held by an MMF will make it very difficult for MMF investors to identify analogous MMFs on which to compare risk and performance and base their investment decisions.

In addition, we believe that the EC's proposed internal rating scale runs counter to best practice for MMFs. It is based on prudential regulation for banks, which specifies that different types of loans are bucketed into six categories of risk with an additional category for defaulted assets. This system is inappropriate for MMFs, where the MMF focuses on short-term liquidity risks and the possibility of a downgrade rather than longer-term credit risks and the prospect of default.

The use of asset-backed commercial papers (ABCP)

The proposed provisions on eligible assets prohibit investment in ABCPs with exposure to consumer debt. We believe that such a provision would reduce the diversification and credit quality of MMFs as well as effectively prohibit MMFs from investing in ABCP.

As MMFs represent 70% of investment in ABCP, this will eliminate the working capital benefits ABCP affords to companies, especially to SMEs and non-rated companies in Europe.

Capital buffer

The EC proposal requires CNAV MMFs to maintain a capital cushion (the 3% buffer) as it believes that this will protect interests of redeeming investors by acting as an absorbing mechanism for maintaining the constant NAV.

A capital buffer, even far smaller, will in effect eliminate CNAV MMFs given the requirement of the Capital Requirements Directive to consolidate the capital on the balance sheet of the CNAV MMF managers.

INVESTOR PROTECTION

Distribution

The current policy debate around a pan-European investor protection and distribution regime is multi-faceted. Every EU jurisdiction has its own distribution structure, market culture and investor expectations. A one-size-fits-all regulatory response will not accommodate the fragmented nature of national retail markets in the EU. Regulation such as the UK Retail Distribution Review (RDR) suiting a market where independent financial advisers predominate may not translate well in other countries with a closed architecture model that rely on banks to distribute investment products and advice.

Taken this into consideration, the Markets in Financial Instruments Directive (MiFID II) and the corresponding Regulation, coming into force in January 2017, introduces changes on distribution on a pan-European basis including:

A partial ban on commission payments

This applies to independent advisers and discretionary portfolio managers under all circumstances as well as non-independent advisers unless the commission payment is designed to enhance the quality of the service to their clients and does not impair compliance with the firm's duty to act honestly and fairly in its clients' best interest. Non-independent advisers will therefore have to justify the value of their advice to their clients and to offer a more differentiated service driven offering leading to better quality advice and greater price competition.

However, this provision runs the risk of independent advisers moving to a closed architecture model rather than face the upheaval of transitioning to a fee-based business model. In this context, it is important to recognise that open-architecture model encourage product providers competition and therefore tend to offer greater investment choice.

Also, neither MiFID nor the UK RDR address the needs of consumers who cannot afford advice. Regulators and industry are only beginning to consider how the mass market will access advice in a fee-only world, where consumers are not necessarily ready to pay for advice.

Enhanced transparency requirements

Advisers must explain to their clients which products they are entitled and qualified to advise on, whether 'whole of market', restricted to specific sectors or to the products provided by a specific bank or insurance company.

Advisers must also enhance the focus on product's suitability and appropriateness for a particular client in terms of cost and complexity.

End-investors will also benefit from full transparency on the commissions and product costs prior to the provision of the relevant investment or ancillary service.

We strongly support these requirements as we believe they empower end-investors to re-evaluate their investment options on a more well-informed basis.

Dealing commissions

Research may no longer be paid for through dealing commissions except where it fulfils the criteria of "minor non-monetary benefits". In its consultation on MiFID II implementing measures, the European Securities and Markets Authority (ESMA) advised that only generic research and not tailored advice will qualify as such. We believe that a wider range of research should be permitted provided managers set a budget, manage payment to brokers through commission sharing arrangements and clearly disclose commissions. The market should operate so that managers of all sizes can obtain research at competitive rates – avoiding barriers to entry on a globally consistent basis.



For our detailed views on Distribution, please refer to our [ViewPoint: "The changing face of European distribution: A better financial future for savers?"](#)

Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation

The PRIIPs Regulation aims to provide retail investors with consistency in the way key information on investment products is communicated – improving products comparability and enabling end-investor well-informed decisions.

A PRIIP is a financial product designed to provide investment opportunities to retail investors. Its performance is subject to market fluctuations or dependent on the performance of assets which are not directly purchased by the investor⁴. These include UCITS and retail AIFs, life insurance products, structured deposits, structured and guaranteed funds and any special purpose vehicles sold to retail investors.

The UCITS Key Investor Information Document (KIID) has been taken as a template for the PRIIPs KID, with adjustments to reflect specific features of non-UCITS PRIIPs. For example:

- ▶ It must be distributed to retail investors only.
- ▶ It must not exceed three sides of A4-sized paper (two sides in the KIID).
- ▶ It must include a new 'comprehension alert' applying to any product "whose underlying assets are not commonly invested in by retail investors", but it still remains unclear which assets this will concern.

Most of the details on the content of the PRIIPs KID will be known after the Regulation implementing measures have been completed by the end of 2015.

The Regulation is expected to come into force for all non-UCITS PRIIPs during the course of 2016. UCITS will benefit from a minimum five years' transitional period (to 2019 at the earliest) to convert the KIID into the PRIIPs KID. In the meantime, firms offering both UCITS and non-UCITS PRIIPs may have to run dual KIID / KID platforms.

2 Market structure

OTC DERIVATIVE MARKETS

European Market Infrastructure Regulation (EMIR)

The G20 mandated that standardised over-the counter (OTC) derivative contracts must be cleared through central counterparties (CCPs). This is one of the most significant reforms that emerged from the global financial crisis. Non-standard derivative contracts would continue to be traded bilaterally subject to various risk mitigation obligations and higher capital requirements. All derivative contracts would be reported to trade repositories. These measures are being implemented in the EU under EMIR, adopted into law in mid-2012 and CRD IV entered into force in January 2014 (please refer to the [CRD IV article](#)).

Central Clearing

Under EMIR, all financial institutions and a number of non-financial institutions will be subject to mandatory central clearing of eligible OTC derivatives. Pension funds were granted an exemption for three years from August 2012, which may be extended until 2018. Each CCP will be required to offer both 'omnibus client segregation' – where clearing member's assets and positions are separated from the assets and positions of its clients – and 'individual client segregation', whereby:

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

Central clearing offers counterparty risk mitigation benefits to end-investors but also incurs costs. Adding to the opportunity cost of posting initial and variation margin, end-investors will have to pay fees to the CCP and the clearing member. Only cash will be eligible as variation margin for central clearing, while the scope of eligible collateral for initial margin is limited to cash and high-quality liquid assets such as government bonds and the like. End-investors will therefore need to have sufficient cash and/or eligible assets available to meet those requirements. They also need to provision for potential future increases as the levels of margin required might fluctuate from one day to the next.

From mid-2015, CCP clearing members will be first up to clear interest rate swaps and credit default swaps, for which central clearing authorisation have already been given to several CCPs based in the EU. They include Nasdaq OMX, EUREX Clearing AG, LCH Clearnet SA, LCH Clearnet Ltd

and CME CE. Several of these are also working to broaden the range of products they can clear such as inflation swaps, swaptions and total return swaps over the next few years.

Financial counterparties who are not direct clearing members will have 18 months after the date of publication of the detailed rule-making (expected early 2015) before they are mandated to centrally clear eligible OTC derivatives.

Central clearing will be mandatory for eligible OTC derivative transactions made after the entry into force of the clearing mandate but also retroactively for those made between the publication of the detailed rule-making and the entry into force of the clearing mandate. This is known as 'front-loading'. Derivatives with less than 6 months to maturity at this point would be exempted.

CCP recovery and resolution

While BlackRock is supportive of central clearing, we believe it is crucial for the benefits of end-investors that CCPs implement measures that mitigate the risk of a potential failure. This issue is also high on the agendas of policymakers globally. The two recent CPMI-IOSCO and FSB respective reports on this issue are expected to be followed by a proposal from the European Commission (EC) in 2015.

In the event of the financial distress of the CCP, the default 'waterfall', which specifies the resources available to a CCP for recovery or resolution and the order in which they are used, would begin with the defaulted counterparty margin and guaranty fund contributions. These would be followed by the capital of the CCP and the CCP guaranty fund before tapping into the funds of any non-defaulting clearing member customer.

We believe that CCPs should be subject to rigorous uniform stress testing to be overseen by regulators and that the transparency of their risk management practices should be increased. A resolution plan that focuses on a rapid and complete wind down of a failing CCP's positions, along with a timely and orderly repayment of margin monies, is preferable to a recovery plan that uses customer margin to prolong the existence of a failed or failing CCP. A rapid liquidation and return of margin would minimise end-investor losses and would enable clearing members and their clients to establish replacement positions in the most efficient manner.



For our detailed views on CCP recovery and resolution, please refer to our *ViewPoint*: ["Central Clearing Counterparties and Too Big to Fail"](#)

Risk mitigation for uncleared OTC derivatives

EMIR requires certain risk mitigation arrangements for uncleared OTC derivative contracts including:

- ▶ Timely confirmation where trades have to be confirmed,

by electronic means where available, as soon as possible and at the latest within specified timelines. Depending on the derivative class and the date when the trade was concluded, these can range from one to seven days.

- ▶ Financial counterparties and non-financial counterparties exceeding the clearing threshold must mark-to-market on a daily basis the value of outstanding non-cleared derivative contracts (or mark-to-model, where market conditions prevent the former).
- ▶ Agreement by counterparties on dispute resolution detailed procedures and processes.
- ▶ Agreement by counterparties on the terms on which portfolios are to be reconciled.
- ▶ Portfolio compression procedures must be in place for counterparties with 500 or more uncleared derivative contracts outstanding with a counterparty.

Trade reporting

EMIR also requires that from February 2014 a derivative contract is reported to one of the six approved trade repositories (TRs) in Europe. These are DTCC Derivatives Repository Ltd. (DDRL), Krajowy Depozyt Papierów Wartościowych S.A. (KDPW), Regis-TR S.A., UnaVista Limited, ICE Trade Vault Europe Ltd (ICE TVEL) and CME Trade Repository Ltd (CME TR).

This obligation falls on almost all participants in the derivative markets, including end-investors. The data must be reported by both sides of the trade. This obligation is problematic especially where the same trade is reported to two different TRs which are required to match the two sides between themselves. We do not believe that this helps regulators get holistic data. Also, this is not consistent with the reporting requirements in the US, where only one side of the derivative trade is required to report to a TR.

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

CRD IV and the corresponding Regulation implement the Basel III capital and liquidity standards in the EU and came into force in January 2014. They require credit institutions to hold higher capital requirements against their uncleared OTC derivatives positions and introduce an additional charge, the so-called Credit Valuation Adjustment (CVA) risk capital charge, which banks will have to keep as a provision for the deterioration of a counterparty's creditworthiness.

In general, the CVA risk charge will be higher for bilateral trades with any of the following characteristics: long-dated derivatives, directional risk profiles, uncollateralised exposures, low-rated counterparties (due to higher probability of default) and counterparties with no liquid CDS market – typically the type of trades made by long-only institutional investors. It is not yet clear how much of this cost banks will pass on to their clients in the form of increased transaction

costs. The implicit cost of trades requiring extra capital is therefore uncertain at this time.

MARKET PRACTICES AND SETTLEMENT

MiFID II/MiFIR market structure

MiFID II and the corresponding Regulation (MiFIR), to be implemented on 3 January 2017, update the existing market structure and investor protection regulatory regime in Europe (please refer to the [Distribution article](#)). The objectives of the revised MiFID regime are to establish a regulatory framework that takes into account technological innovation and new trading behaviours following the liberalisation of trading ushered in by the implementation of MiFID I in 2007, and to implement the G20 commitments to increased trading on venues and enhanced trade transparency. Politically emotive issues such as trading in 'dark pools', high frequency trading (HFT) and the impact of commodities derivatives trading dominated the policy formation 'Level 1' negotiations.

The impact of most requirements will depend to a large extent on the detailed implementing rules ('Level 2') as they will specify the exact requirements in a number of areas, such as:

- ▶ Calibration of the pre-trade transparency requirements for bonds and derivatives
- ▶ Waivers from pre-trade transparency requirements across asset classes
- ▶ Methodology to calculate commodity position limits
- ▶ The shape of the Systematic Internaliser regime
- ▶ Requirements to unbundle data
- ▶ Regulation governing algorithmic and HFT

Below we focus on the key market structure issues in the MiFID review Level 2 and discuss the potential impact of the Regulation on investors and markets. The European Securities and Markets Authority (ESMA) is expected to deliver detailed implementing rules to the European Commission (EC) in 2015.

Transparency

Pre- and post-trade transparency requirements that currently apply only to equities admitted for trading on regulated markets will be introduced for other instruments such as 'equity-like instruments' (i.e. exchange-traded funds or ETFs) and 'non-equity instruments' (fixed income, structured finance products and derivatives). These requirements will apply across all trading venues. The new regime will be tailored to the instruments in question, although it is still to be decided how the new transparency regime for non-equity trades will be calibrated. Unlike equities, the 'non-equity' space is extremely diverse, typically fragmented and inventory-based. It is also characterised by low or dispersed liquidity.

Regulators are providing incentives for 'best execution', with clearer disclosure to clients across all venues. Any reduction of liquidity due to overly zealous or unachievable transparency rules would result in greater market volatility and more expensive products.

► **Pre-trade transparency**

Market participants will have to disclose the bid and offer price of non-equity instrument transactions to which all clients will have equal access, regardless of settlement risk, market liquidity and each market maker's particular risk limits. Depending on the size and the liquidity level of the non-equity instrument in question, buyers and sellers could be less willing to reveal quotes to the whole market for fear that they find themselves in a weaker position relative to other market participants – ultimately impacting market liquidity and potentially raising the cost of investing. Non-liquid instruments, however, are exempted from pre-trade transparency rules.

It is still unclear whether regulators will be able to use one type of waiver for specific types of instruments based on market model, order size, liquidity or other relevant criteria, and apply a set of waivers to exempt other transactions from this requirement. To prevent front-running of orders in discontinuous markets such as fixed income, and to ensure against any further reduction of liquidity in already thinly traded secondary markets, end-investors will be looking for a regime which provides for appropriate reporting delays and exemptions from the broad MiFID rule.

► **Post-trade transparency**

MiFID II / MiFIR will deliver the long-awaited pan-European consolidated tape (ECT) for equity and 'equity-like' instruments which will offer the most current information available and be accessible on a "reasonable commercial basis", with prices disclosed throughout the trading day. This consolidated view of liquidity will facilitate more informed price discovery and could well lead to increased liquidity across European markets. A calibrated post-trade reporting system for fixed income and derivatives, loosely based on the existing trade reporting and compliance engine (TRACE) model in the US, will be implemented to capture European post-trade data in these markets.⁵ The ECT will require substantive work by ESMA as well as by the potential providers of the tape to develop client-focused solutions. These developments will be beneficial for end-investors, helping them to gain a more complete picture of an equity instrument's liquidity across venues.

ETF market structure

BlackRock is very vocal on the need to develop increasingly robust, transparent and liquid ETF markets in Europe. We are supportive of regulation that increases post-trade transparency in ETF markets to reduce trading costs and provide better indications of true liquidity. Effective post-trade transparency is best achieved with harmonised standards such as the Market Model Typology being developed by the FIX trading community. We also support a trade reporting regime in which availability of deferred publication for large transactions takes into account the multiple layers of liquidity inherent in ETFs. We believe that given the multiple layers of liquidity, ETFs do not have the same liquidity characteristics

as shares, and therefore the same measures (average daily transactions and average daily turnover and free float) cannot be applied to ETFs.

A key impediment to investors benefiting from pan-European liquidity is post-trade connectivity for ETFs. Open access to financial market infrastructure in terms of trading, clearing and settling of ETF orders, and also market indices, will give investors greater choice of trading and clearing services. This development will also reduce the risk of concentration in closed financial market structures and eventually lead to fewer settlement fails and lower costs.

HFT and algorithmic trading

ESMA has drawn a helpful distinction between HFT operators (mainly market makers) that will have to provide liquidity to the market on a continuous basis and the broader, less well-defined, activity of algorithmic trading. All trading algorithms, including algorithms typically used by the buy-side to execute client orders, will be subject to harmonised and rigorous testing under MiFID II. The legislation also places a lot of emphasis on systems and controls as well as on notifying the regulator when algorithmic trading is deployed. The focus on continuous liquidity provision by market making HFTs, and a more robust framework for algorithmic trading, represents an incremental development of pan-European market structure and ensures that regulation crafted to address vulnerabilities with certain HFT strategies does not impinge upon efficient order execution, which is today generally delivered by employing broker algorithms.

Commodities derivatives

Commodities derivatives have been one of the politically sensitive areas during the Level 1 negotiations. The forthcoming rule is designed to better protect investors while reducing risks. Commodities derivatives will be subject to position limits for the first time in Europe, in an attempt to dampen volatility and more broadly control commodity prices. The national competent authorities will be in charge of applying limits in line with methodologies to be determined by ESMA. Limits will be established in spot- and non-spot months, for physically and cash-settled contracts. Reporting of positions will be "at least on a daily basis", which may open the door to intra-day reporting. In our view, ESMA's proposed rules strike the right balance between delivering on the Level 1 political commitment to introduce position limits whilst respecting the liquidity profile of commodity markets.

Market access and interoperability

Infrastructure connectivity is another politically-charged issue within the MiFID review. Barriers to access of trading venues and clearing and settlement systems ultimately fragment liquidity and create costs. Fragmented liquidity, listing on multiple exchanges and the charges levied by often captive clearing and settlement providers all translate into higher fees for end-investors and ultimately represent a drag on investment performance.

Bank balance sheet contraction – addressing the challenges for end-investors?

Excessive and off-balance-sheet leverage, coupled with inadequate levels of bank capital, combined to create the 2008 systemic crisis. Policy action since then has centred on repairing bank balance sheets and strengthening the prudential regulatory framework in which banks operate.

At the same time, collateral is becoming increasingly important, driven by a need for more secured funding and regulatory requirements to limit credit risk. Alongside rigorous counterparty selection, the availability and fluidity of high-quality collateral, commonly provided by highly-rated bond issues, is essential in the asset manager's risk management. However, a decline in liquidity is making it more challenging to source eligible collateral.

In addition, liquidity in some segments of fixed income, such as corporate debt, is currently challenged by its very structure. It also remains difficult to source for market participants. They usually hail inventory declines as good news. Falling inventories point to a future increase in activity: either demand is strong or businesses need to re-stock – or both. However, this is not the case in a post-crisis environment. Cumulatively, regulation appears to be leading to a decline in the inventory that banks are willing to hold, which is likely to result in a decline in liquidity and ultimately would increase the costs to investors holding corporate debt instruments.

We are supportive of policies aiming at strengthening bank balance sheets, insulating investors in bank securities from future losses. We also believe that restoring financial stability is key to rebuild investor confidence. However, there are a number of policy initiatives in place or in process, which contribute to constraining liquidity and collateral fluidity going forward. In the EU alone, these include:

- ▶ Higher capital and liquidity requirements for banks – CRD IV and its corresponding Regulation
- ▶ Bans on proprietary trading – Banking Structural Reform Regulation (BSRR)
- ▶ Ring-fencing of market making activities – MiFID II / MiFIR and BSRR
- ▶ Restrictions on short selling – Short Selling Regulation and ad-hoc national short selling bans
- ▶ Possible EU-wide FTT and national FTTs
- ▶ Possible future regulation on mandatory collateral haircuts and/or restrictions on re-hypothecation – FSB Shadow Banking Work Stream 5

Two examples to illustrate the unintended consequences for end-investors arising from the overhaul of banking regulation:

- ▶ The CRD and CRR will eventually be updated to include global standards on short-term (30 days) and longer term (one year) funding for banks. These rules will be based on the Basel Committee's proposed liquidity coverage ratio

and net stable funding ratio. Whilst both initiatives are designed to promote financial stability by ensuring a more stable short-term and long-term wholesale funding base for banks, taken together they will lead to increasing transaction costs for all participants due to the banks' higher cost of building and maintaining inventories of securities on their balance sheets.

- ▶ The separation of trading activities within banks will play out over the coming months as banks prepare to comply with BSRR and with MiFID II and MiFIR. Taken together with higher capital charges for banks, these are likely to limit banks' market making capacity – reducing liquidity, raising costs for the buy-side and slowing down collateral circulating in the financial system.

The BSRR proposal comes at a time when market makers in fixed income increasingly have to match buyers and sellers in real time – or not make market at all. Trading is fragmented across thousands of bonds of varying maturities. Companies tend to issue bonds whenever financing needs arise or opportunities present themselves. However, the secondary market in corporate bonds is essentially illiquid two to three days after issuance in all but a few very liquid names. This underscores the importance of market making in the absence of standardisation of issuance and other measures to encourage the trading of bonds on exchange. Furthermore, a ban on proprietary trading creates significant uncertainties for market makers, which will disrupt the markets for many securities as well as impacting collateral fluidity. A disruption in dealer activities and restrictions that will be introduced through MiFID II and MiFIR will likely result in less market liquidity, wider bid-ask spreads and higher borrowing costs.

BlackRock is seeking to address the specific liquidity challenge in secondary corporate bond markets. We are leading a conversation with the market and regulators about standardising corporate bond market issuance to bring about more exchange trading and trade printing of bonds. There is no easy solution to the liquidity challenge but there are four drivers which, in concert, have the potential to substantially improve liquidity:

1. Standardisation of new issue activity
2. Extension of trading activity to a multilateral trading environment to uncover latent liquidity
3. Adoption of new eTrading protocols, reducing reliance on scarce dealer capital
4. Behavioural changes among market participants in recognition of a fundamentally changed landscape

We believe these issues need to be addressed today since the costs of inaction will ultimately be costs felt by end-investors.



For further details, please see BlackRock Investment Institute's (BII) [The Liquidity Challenge III](#)

Securities Financing Transactions Regulation (SFTR)

In January 2014, the European Commission (EC) proposed a Regulation on reporting and transparency of securities financing transactions – i.e. securities lending and repo and reverse repo transactions – expected to be implemented mid-2017. The proposal requires the mandatory reporting of SFTs from counterparties of SFTs and parties to rehypothecation arrangements to trade repositories (TRs), with the view of making this data accessible to competent authorities. The EC proposal recommends reporting on a transaction-by-transaction basis.

We support SFT data reported on an aggregated basis (position rather than transaction level) as this will help regulators better understand risks in the markets. The proposed focus on transaction data will in contrast create a significant amount of ‘reporting noise’ which could detract regulators from identifying trends in these markets. BlackRock believes that reporting overall positions would allow regulators to carry out more meaningful analysis over time. We also call for a harmonised reporting of SFTs to authorised trade repositories on a global basis so regulators can better assess accumulation and/or transfer of risk around the financial system.

The EC proposal suggests that existing infrastructures and protocols and specifically the current EMIR regime could be leveraged to deliver the required reports. We agree that there are a number of existing SFT-specific infrastructures and protocols that provide an appropriate platform for SFT reporting – Agent Lender Disclosure (ALD) platforms are important examples. There are also a number of deficiencies within the current EMIR regime which need to be addressed before it could be used as a basis for SFTR. We also have concerns that the focus on transaction data in EMIR, rather than position or aggregated data will generate significant demands for data without delivering meaningful information to inform regulators.

Further, the EC proposal stipulates that fund managers will need to report regularly to end-investors any recourse they have to SFTs and “other structures having an equivalent economic effect”. The definition of the latter category still needs to be clarified.

We believe that to be meaningful, the information disclosed to end-investors should be at an appropriately high level and readily comparable. If the amount of data is too significant, end-investors’ focus could be diverted from the fund’s primary investment strategies that are more material. We suggest the following as meaningful elements of reporting to end-investors:

- ▶ The exposure obtained through SFTs
- ▶ The name of the counterparty
- ▶ The amount of collateral received by the fund to reduce counterparty exposure
- ▶ The revenues raised by SFTs.

EU Financial Benchmarks & Indices Regulation

The alleged manipulation of LIBOR during the pre-crisis period undermined the integrity of benchmarks, prompting policymakers across the globe to look at reforms of rate benchmarks and at assessing the extent to which reform of rate benchmarks should and could apply to market indices.

In 2013, the European Commission (EC) proposed a Regulation capturing all published financial benchmarks that are used to reference financial instruments traded, or admitted to trading, on a regulated venue or a financial contract such as a mortgage (‘comprehensive scope’). The Regulation would apply to the administrators, contributors and users of interest rate benchmarks and market indices. As it is currently drafted, the Regulation also brings in asset managers into scope where they seek to create benchmarks that measure the performance of an investment fund from two or more existing benchmarks (‘composite benchmarks’).

The proposal requires conduct of business obligations for administrators without differentiating the requirements applying to the no or low risk market indices and the higher risk rate benchmarks. These obligations cover data transparency issues and methodology used to produce a benchmark.

BlackRock believes that the Regulation as currently proposed would impact market indices administrators in a disproportionate way. In particular, we are concerned about the viability of the smaller market indices administrators if the Regulation is not meaningfully proportionate. The result of fewer administrators – given limited capacity for the smaller to meet the Regulation’s requirements – would be less competition. We believe that end-investors will be in a worse position than they are today because there would be more standardised products and less sophistication with higher costs and less choice for end-investors.

This would particularly hit end-investors seeking to track the market through passive investments by constraining asset managers’ ability to select from a variety of options to best meet end-investor-driven demand for investment in specific companies or sectors. Asset managers would instead be faced with a smaller range of off-the-shelf products from a smaller number of administrators and potentially oligopolistic pricing. This would ultimately be to the detriment of end-investors’ performance returns.

The Regulation would also impact active investing and the use of composite benchmarks. The reduced pool of market indices would mean that there would be fewer benchmarks available for performance measurement, creating a further impediment to delivering optimal investment performance to the end-investors.

Central Securities Depository Regulation (CSDR)

The CSDR aims to harmonise settlement provisions for securities within the EU by requiring:

- ▶ The dematerialisation or immobilisation of securities by 2025
- ▶ A common settlement cycle of t+2 days by 1 January 2015 – although this has in practice been introduced on 6 October 2014 for almost all European securities markets
- ▶ Measures to address settlement failures including penalties and buy-in procedures
- ▶ The licensing of central securities depositories (CSDs) according to a common set of rules. This will give issuers the freedom to choose a CSD and provide access to transaction feeds of trading venues and central counterparty clearing houses.

The CSDR was agreed in February 2014 and its detailed rule-making continued throughout the year. Implementation is expected at the end of 2015 or early 2016.

The CSDR and, more narrowly, the introduction of a consistent regulatory framework across Europe in matters such as buy-in regimes (i.e. where an investor has to repurchase shares as the seller did not deliver the securities in a timely fashion, or did not deliver them at all) and other settlement penalties, are important elements in the development of a European market infrastructure. This principle is particularly important for ETFs that are cross-listed in several European jurisdictions.

Currently, end-investors have to contend with different failed trade regimes with penalties being levied at multiple levels. The resulting distortions across European capital markets create unnecessary cost for end-investors. Establishing the same buy-in procedures or fail penalties independent of the venue used for trading, clearing or settlement would enhance the European Single Market, providing end-investors with consistent outcomes and, eventually, reduced costs. That harmonisation can only be effective if all relevant penalties are issued by a single party (be it the trading venue, the CCP or the CSD).

3 Investment & asset allocation

Solvency II

Solvency II, to be implemented on 1 January 2016, introduces a prudential regime for insurance and reinsurance undertakings in the EU. In particular, it will set the valuation basis for liabilities and determine the amount of capital that insurers and reinsurers will have to hold against each type of market risk. It will also impose the “prudent person principal”, which requires firms to invest only in “assets and instruments whose risks it can properly identify, measure, monitor, manage, control and report” and to invest in a manner that ensures the “security, quality, liquidity and profitability of the portfolio as a whole”. Solvency II will also require firms to conduct an Own Risk Solvency Assessment, covering a company’s internal risk management processes and procedures, including an assessment of its own solvency requirements and forward-looking analysis.

In parallel to complying with Solvency II, many insurers need to consider how to evolve their investment strategies to respond to this new environment. The European Commission (EC) requested the European Insurance and Occupational Pensions Authority (EIOPA) to look at the appropriate capital charges for certain long-term investments to support growth. In 2013, EIOPA studied capital requirements for a range of asset classes, including securitisation, private equity, infrastructure debt and equity, socially responsible investment and SME lending, to assess whether insurers are unduly penalised for investing in these long-term assets. Specific calibrations for these strategically important asset classes have then be lowered in the final implementing measures published by the EC in October.

For securitisation in particular (please also refer to the [Long-term investing article](#)), the capital requirements for “Type 1” (i.e. high-quality) securitisation in the final implementing measures have been significantly lowered down to promote the development of a sound securitisation market but remain high compared with other fixed income securities, such as corporate bonds, covered bonds and the underlying loan pools. For example, single-A corporate bonds or AAA covered bonds are charged in capital between 1.1% and 1.4% vs. 2.1% to 3% for “Type 1” securitisation.

Further, the “Type 1” securitisation criteria might exclude a number of securitisation vehicles that are appropriately structured in terms of good underwriting and quality servicing standards, transparent and accessible asset and transaction information, properly managed conflicts of interest, and clear and complete structures.

These structures which would not meet the restrictive “Type 1” securitisation criteria will by default fall into the “Type 2” securitisation category and be incommensurately charged in capital. This would make them non-viable for insurance companies investing in them.

Institutions for Occupational Retirement Provision Directive (IORPD)

Under discussion since 2010, the EC’s review of the IORPD originally aimed to increase IORPs’ risk mitigation mechanisms, set up a level playing field with insurance companies and harmonise IORPs at the EU level to facilitate pensions’ portability across the EU.⁶ However, the EC’s proposal published in March focuses mainly on IORPs’ governance and transparency to members and beneficiaries. The application of Solvency II rules on capital adequacy, with some adjustments, to IORPs, resisted by a number of Member States, will be reconsidered four years after the entry into force of the IORPD review.

Governance requirements

“Those running the scheme” will be required to hold “professional qualifications”. We are concerned that this would penalise volunteering member/employer-nominated trustees who are already required to have knowledge and experience in a number of Member States. Instead, we recommend a common requirement of knowledge and understanding. The IORPs will also be mandated to have an independent person assuming the internal audit function which would step beyond existing practice for most of them – incurring additional costs.

A “sound remuneration policy” and its public disclosure will be applied for “those who effectively run the institution” (i.e. the IORPs trustees as we interpret this). The details on the principles and disclosure requirements are not known yet.

Long-term investment

Member States should allow IORPs to invest in long-term instruments not traded on regulated markets and non-listed assets financing low carbon and climate resilient infrastructure projects. We support this initiative which could be a first step towards the relaxation of a number of national investment regulations currently limiting IORPs’ investments in certain types of assets.

Risk evaluation for pensions

IORPs should perform a “risk evaluation for pensions” regularly (frequency not specified yet), covering elements such as the effectiveness of the risk-management system and the ability to comply with the requirements regarding technical provisions. In our view, this would duplicate part of the asset and liability management practices of most IORPs. The risk evaluation for pensions also covers : i) the IORPs’ overall funding needs; ii) a qualitative assessment of the margin for adverse deviation; and iii) a qualitative assessment of new or emerging risks such as climate change and use of resources. The first two are very similar to Solvency II risk assessment requirements, so it is critical to ensure that additional funding requirements will not arise from these in the future. The latter could be problematic for small IORPs, potentially creating high costs without commensurate benefits in terms of additional protection for their members.

Transparency

IORPs should provide to members an annual two-page Pension Benefit Statement (PBS) (i.e. a KIID/KID-like document – please also refer to the [PRIIPs Regulation article](#)) including information such as: balance and contributions over the past 12 months by employee and employer and costs; total capital, also expressed as annuity per month; and target benefits at retirement age. We believe that an adapted KIID is a potentially valuable development. However, given the variety of IORPs and members' situation across the EU, a PBS should allow for flexibility in the format and content of the document. We would therefore recommend a different format for DB and DC schemes, for individual and collective schemes and for active and deferred members.

Depositary

As with the AIFMD and UCITS directives, the IORPs are required to appoint a depositary for safe-keeping of assets and oversight duties where members and beneficiaries bear investment risk (i.e. DC schemes). We believe that the proposal would duplicate what is already in place in a number of EU jurisdictions where an internal board of trustees provides oversight functions and where IORPs appoint an external entity to perform the safe-keeping of assets.

Shareholder Rights Directive (SRD)

In the wake of the financial crisis, regulators have turned their attention to corporate governance. Failures in corporate governance are perceived to have contributed to the financial crisis, and corporate governance is also recognised as key to the sustainable growth of companies and the real economy. This role in fostering long-term investing is highlighted in the European Commission (EC)'s Communication on the Long-Term Financing of the European Economy (please refer to our [Long-term investing article](#)). In its revisions to the Shareholder Rights Directive, released in April 2014, the EC proposes a framework aligning the interests of companies, shareholders and asset owners by increasing transparency and disclosure and by reinforcing engagement.

In the proposal, institutional investors are defined as insurance companies and pension funds and 'asset managers' as UCITS and AIF managers as well as MiFID investment firms. The proposed changes can be grouped under four areas laid out below. BlackRock supports many of the provisions, but we also have concerns about the level of detail in some of them.

Greater transparency on shareholder engagement and equity investment strategy for institutional investors and asset managers

According to the proposal, both institutional investors and asset managers will have to publicly disclose their shareholder engagement strategies annually, including how shareholder engagement is integrated into their investment strategy and how they have engaged with companies.

In addition, institutional investors have to publicly disclose their equity investment strategy and some elements of their arrangement with asset managers. The investment strategy should demonstrate the alignment of the asset manager's investment strategy for investing on behalf of the institutional investor, with the latter's profile and duration of liabilities.

Asset managers will have to disclose to their institutional investor clients their investment strategy every six months, stating how the strategy and its implementation contribute to the long-term performance of the institutional investor's assets.

BlackRock believes that transparency provides greater incentives to asset owners and asset managers to fulfil their fiduciary duty towards their clients. Meaningful transparency that is tailored to the informational needs of the reader is more effective than wider disclosure to the general public when providing detailed information about shareholder engagement and equity investment strategies. We fear that requiring too much detail may ultimately mask meaningful information. The public disclosure requirements need to be balanced with national data privacy protection laws and with the confidentiality obligations in investment mandate agreements.

'Say on executive pay'

Shareholders may be compelled to vote on companies' remuneration policies and remuneration reports. While BlackRock agrees that executive remuneration has to be clearly linked to business strategy and to the long-term interests of the company, we are concerned that too much focus on pay can divert shareholders' attention from issues that are far more critical to the long-term success of a company (such as board composition and business strategy). In our experience, poor pay practices are usually symptomatic of broader governance weaknesses rather than the cause of such weaknesses. Regulation needs to enable – not restrict – shareholders and companies to engage in constructive dialogue on issues that are key to the long-term success of the company – including but not limited to remuneration.

Related party transactions

Shareholders will vote on related party transactions representing more than 5% of assets and companies will publish transactions representing more than 1% of assets, along with an external report confirming the transaction is fair and reasonable. We believe that some shareholder oversight of related party transactions is necessary although the level of protection may well vary country by country. Minority shareholders expect the board to have an independent review process of related party transactions where potential conflicts of interest may arise to ensure that such transactions are only undertaken at fair market value and that insiders or affiliates are not unduly profiting at the expense of shareholders.

Cross-border shareholder identification

Intermediaries should offer to companies the possibility of having their shareholders (domestic and cross-border) identified and facilitate the exercise of their voting and AGM participation rights. For pan-European shareholders such as BlackRock, the overall harmonisation of rules, including the equality of status and execution of rights between domestic and cross-border shareholders, is welcome. We suggest tying the definition of 'shareholder' to the entity responsible for voting the assets as this would enhance engagement between the company and the voting authority.



For more on corporate governance, see our last Annual Review, [Taking the Long-Term View](#)

Long-term investing

Growth has become an important agenda driving regulation globally, and in the EU in particular. Whereas the primary focus after the crisis was to create resilient financial markets and robust products, policymakers are now adopting a more forward-looking approach by exploring ways to incentivise 'market finance' in order to foster sustainable growth.

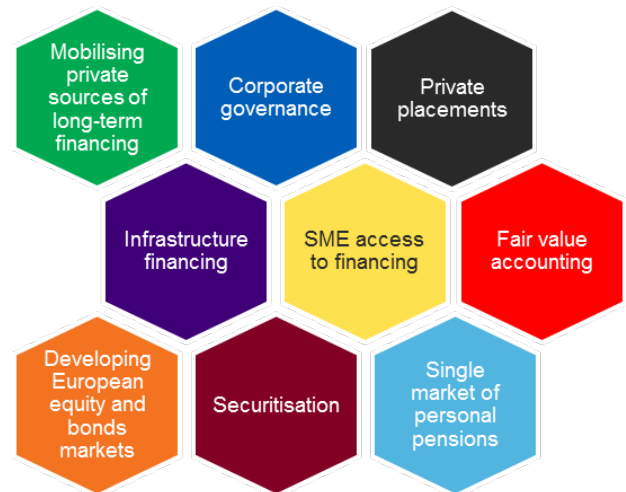
The crisis and subsequent regulation such as Basel III has left banks less equipped to fund the economy. The deleveraging of banks' balance sheets and governments' austerity policies have resulted in banks and public authorities being unable to provide enough funding to meet ambitious targets for long-term financing. As a result, regulators are looking at alternative sources of funding such as securitisation and infrastructure investing to finance the economy and increase access to capital markets. In the EU, many of these issues are likely to be picked up in proposals for a future Capital Market Union (CMU).

As a fiduciary asset manager, BlackRock is a long-term investor acting on behalf of its clients all of whom have long-term and less long-term investment horizons. We believe there are many opportunities for institutional and retail investors to participate in long-term investing. The EU and Member States have made a range of policy proposals to foster growth in European economies (see figure 1). We have looked at the main opportunities and provided some recommendations, bearing in mind that for market finance to become a reality the investment needs and liability profile of end-investors need to be taken into account. In order for our clients to invest substantially in such vehicles, regulation should support investment and protect the end-investor.

Securitisation

Global and European policymakers, as well as European central bankers, are keen to rehabilitate securitisation to increase the range of financing opportunities available to spur economic growth. The EC Communication on the Long-Term Financing of the EU Economy published in March 2014 insists on the benefits of securitisation in terms of helping financial institutions free capital, which can then be mobilised for additional lending and investment opportunities in the EU.

Figure 1: SOME AREAS THE EUROPEAN COMMISSION IS CONSIDERING TO FOSTER GROWTH



BlackRock is of the view that securitisation can promote economic growth as long as:

- ▶ Securitised product offerings consider and protect the needs of investors as well as those of the originator and sponsors.
- ▶ The various policy measures that affect securitisation in Europe are consistent and do not deter the responsible use of securitisation.
- ▶ Regulation properly accounts for differences between securitisation and other types of assets.

The EU regulatory framework around securitisation is very complex and fragmented, contains different obligations for different market participants and uses inconsistent definitions. For example, the CRR and AIFMD place different qualitative requirements on the investor in terms of thorough investment analysis prior to making an investment. We understand that a transaction can meet the retention requirements of CRR but not be compliant with the AIFMD.

EU regulations also do not consistently provide properly-calibrated incentives for investors to allocate capital to securitised instruments. For example, Solvency II rules will significantly increase the amount of capital that insurance companies are required to put aside for certain securitised exposures comparing to the underlying loans. This is deterring insurance companies from allocating new capital to securitisations (please refer to the [Solvency II article](#)).

Conscious of these issues, the EC has committed to explore a possible preferential regulatory treatment for securitisation, to work on a definition of 'high-quality' or 'qualifying' securitisations and to design global standards with the international standard setters such as the International Organisation of Securities Commissions (IOSCO) and the Basel Committee, especially on risk retention rules, standardisation and transparency.



For our detailed views on securitisation, please refer to our ViewPoint: [Securitisation: a tool for European growth](#)

Loan origination

As sources of bank finance decrease, companies are increasingly looking to capital markets and institutional investors to help finance their longer term development needs. The increased focus on loan origination by institutional investors reflects this trend. As an asset class, loans will be of interest to a number of larger institutional clients. We therefore welcome initiatives, such as that of the Central Bank of Ireland and of the Italian regulator, that will facilitate investments into this asset class as companies and individuals will benefit from access to more diversified sources of capital. We believe that:

- ▶ The design of any loan origination vehicle needs to be flexible enough to reflect the different characteristics of various loan types.
- ▶ Appropriate regulatory tools should be applied to loan funds, including increased disclosure on leverage, underwriting standards, deferred redemptions, gates and even side pockets.

Equity and corporate bond markets

The EC intends to consider whether further measures to create a liquid and transparent secondary corporate bonds market in a post-MiFID II EU is necessary. Implementing TRACE-like post trade transparency framework (which we discuss in the MiFID II market structure article) is an important step in this direction. We welcome the EC's focus on additional measures to address secondary market liquidity in corporate bonds, which will result in lowering the cost of debt issuance for Europe's small and medium enterprises. Standardising corporate bond market issuance is one such initiative we believe would bring about more trading on venues and would facilitate post trade transparency, thereby leading to greater secondary market liquidity and reduced cost for our clients. Further, standardised issuance would provide greater transparency and access for retail investors and result in lower new issue concessions and volatility, and more reliable market access for issuers. We are leading a conversation with clients, our sell-side peers and regulators to further develop this agenda in the coming months.



For further details, please see the BII report: [The Liquidity Challenge III](#)

Infrastructure investing

We welcome the focus on both infrastructure debt and equity investing. Institutional investors are increasingly looking at alternative asset classes as part of their investment portfolio. Infrastructure, as well as other asset classes, is attractive investment for such investors. Given the very long timeframe and private nature of many of these types of investment, a consistent regulatory framework with a clear pipeline of projects in equity and debt, transparent procurement processes and predictable pricing structures is critical. Investors lack consistent sources of data to be able to carry an effective risk analysis of infrastructure projects and

therefore require clear pipelines to warrant the investment in the specialised expertise needed to access this asset class. Contractual and regulatory uncertainty translates into higher required risk premia for investors.

A number of positive steps have been taken by regulators to support investment in infrastructure. For example, under Solvency II final implementing measures, infrastructure project bonds are treated as corporate bonds. However, there are still a number of regulatory hurdles that governments can tackle to unlock infrastructure investing:

- ▶ Many jurisdictions do not allow institutional investors to act as lender of record. This leads to additional structuring and costs for institutions accessing the primary infrastructure debt market.
- ▶ A database of credit statistics on infrastructure projects, together with a set-up of a single-point collection and dissemination of project bond issue data, to ensure pan-European consistency of data available with respect to transaction performance.

Regulators can also issue policies to promote the supply of long-term financing by insurers to infrastructure:

- ▶ Establish greater regulatory capital incentives for insurers to invest in infrastructure debt recognising those assets with a lower risk profile which tends to improve over time
- ▶ Remove the restrictions on acting as lender of record would reduce the costs of structuring and increase investor appetite for infrastructure debt.

Private placements

Originally developed in the US as a way of connecting issuers with US insurance companies using a high-level standardised rating process overseen by the National Association of Insurance Commissioners, we see a growing number of different 'private placement' initiatives in the EU, with different characteristics and risk profiles.

Private placements are increasingly seen by EU policymakers as a valid alternative to bank lending and public corporate bond issuance, increasing the range of financing opportunities available. Private placement is a loosely defined term relating to a very broad spectrum of private credit, typically where securities are sold to a limited number of select investors as a way of raising capital as opposed to a public issue where securities are made available for sale on the open market.

We believe that some investors can find private placement attractive because the term of the placements matches the longer-term nature of their liabilities. However, the market is still relatively immature and heterogeneous in Europe and investors are likely to need to hold this debt to maturity due to limited secondary marketing trading.

Further assessments of private placement markets in Europe is likely to come as part of the CMU proposals. This may lead to policy recommendations on how to replicate successes in other locations / practices more widely in the EU and mitigate potential risks related to lack of transparency and illiquidity.

4 Tax initiatives impacting the EU

Financial Transaction Tax (FTT)

The FTT continues to be a priority for a number of European policymakers. France and Italy implemented a national FTT in 2013. The European Commission (EC) published a proposal for a common FTT under an enhanced cooperation regime early 2013. Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain agreed to pursue the adoption with the aim of forming an 'FTT zone' that will supersede national FTTs when the EU FTT is implemented.

The EC proposal requires that financial institutions based in the 'FTT-zone' (residence principle) are taxable on any transactions they carry out (both the purchase and sale of shares and bonds, as well as derivatives contracts) while financial institutions domiciled outside the zone are chargeable when they trade with a party based in the zone or on an instrument issued in the zone (issuance principle).

No relief is given in the proposal for the intermediaries involved in the transaction chain. If this is not rectified in the final FTT text, the ultimate tax amount for a single transaction will be much higher than the tax rates proposed by the EC (0.1% of a securities' value and 0.01% of a derivatives' notional value). As currently proposed, the FTT has the potential to apply to all movements of securities between these parties.

End-investors will be hit directly because of the cost of the FTT on the transactions undertaken in their portfolios, and indirectly because the 'trading spread' will increase. If the FTT applies to client redemptions from pooled investment vehicles, the FTT will breach the principle that investing via investment funds should be tax-neutral compared to direct investment in the underlying fund assets.

However, the extent to which the performance for the end-investors will be impacted will be hugely dependent on the final form of the FTT. A common agreement on the final shape of the FTT under enhanced cooperation has not yet been reached between the supportive EU countries. The Ecofin meeting in May 2014 agreed to pursue a progressive implementation, beginning with taxation of shares and some derivatives on 1 January 2016. However, there is no clarity yet on the principle(s) the tax will be raised on (issuance vs. residence principles or a mix of both), the scope of derivatives, the potential exemptions (including treatment of intermediaries / market makers and the tax collection mechanism and liabilities). It is therefore unclear what (if anything) will be implemented on 1 January 2016.



For our detailed views on FTT, please refer to our [ViewPoint: "The EU financial transaction tax: a tax on savers"](#)

Base Erosion and Profit Shifting (BEPS)

The BEPS is a global initiative run by the Organisation for Economic Co-operation and Development (OECD) at the request of the G20 involving 42 jurisdictions (including 25 European jurisdictions and the EU) to address tax avoidance by corporates, with a particular emphasis on so-called stateless income.⁷ BEPS will recommend a new set of international standards to avoid double non-taxation and the "artificial shifting of profits", and to increase transparency. The overall BEPS programme consists of 15 Action Plans. Although the primary target is multinational companies, the proposals, as they currently stand, may heavily impact funds and investors, especially in a cross-border context.

BlackRock believes that both mainstream funds (collective investment vehicles – CIVs) and alternative funds (including infrastructure, real estate, private equity, hedge funds, fund of funds and certain credit funds) could be adversely affected by the BEPS Action Plans although the exact impact is difficult to determine as the precise changes to international rules have yet to be agreed.

Impacts on CIVs

Although the tax treatment of CIVs is dependent on the specific structure and country in which they are organised or managed, all CIVs have the consistent goal of ensuring that a single level of tax is paid at either the CIV or CIV investor level. CIVs do not have the purpose of achieving double non-taxation. Rather, such funds seek to achieve a broadly tax-neutral outcome such that investors are taxed on a basis comparable to direct investment in the underlying assets. If CIVs face an unwarranted additional tax burden over direct investment, they will become unattractive.

OECD is conscious of the potential of BEPS to damage CIVs and intends to work accordingly within the framework of the 2010 report on CIV tax treaty access. Further, there is willingness that the Treaty Relief and Compliance Enhancement (TRACE) project be developed to allow a practical framework that leave the power to tax authorities (both source-country and investor-country) to appropriately tax CIVs.⁸

Impact on alternative funds

Alternative funds can provide institutional investors with access to specialist asset classes that would otherwise be unavailable to them. The loss of treaty access for these funds and their intermediary entities (e.g. aggregating vehicles, holding companies or financing entities) may make them unviable. The position regarding alternative funds is more complex, and we believe that a workable system must be found whereby tax authorities can be assured that a broadly tax-neutral outcome is not exceeded. Further, we believe that it is essential in the short-term that an appropriate level of treaty access (proportionate upon the treaty eligibility of the investors) is safeguarded.

In the longer term, a more comprehensive solution should be possible, allowing transparency of reporting to both source and investor-taxing authorities. Such transparency should allow a move away from taxation driven by the fund structure itself, towards taxation of the economic outcome of the investment. However, such a solution will take significant time, and significant detail engagement between the official sector and the industry. It is important that the necessary time is allowed for such a longer term solution to be developed.

FATCA and other initiatives

Foreign Account Tax Compliance Act (FATCA)

The FATCA came into force on 1 July 2014⁹ and aims to improve information reporting on US taxpayers to prevent tax evasion. It requires Foreign Financial Institutions (FFIs), such as local banks, asset managers, fund distributors, fund administrators and CIVs, to identify and declare US account holders, and withhold on certain payments to the Internal Revenue Service (IRS). It covers US-domiciled funds held by non-US investors and non-US funds that invest in the US, as well as segregated accounts.

The IRS and a number of foreign governments have negotiated IGAs to reduce the burden of implementation and to overcome the barriers created by data protection laws. The IGA defines the approach to FATCA compliance for FFIs in that jurisdiction. Enforcing FATCA as a national law in these countries will also allow national authorities to tailor FATCA to the individual country's specificities.

To date, 70 jurisdictions have either signed an IGA (including UK, Spain, Denmark, Ireland, Norway, Switzerland, Mexico, Germany, Cayman Islands, Luxembourg, Italy, the Netherlands, Switzerland, France and Japan) or are treated as having a signed one.

Overall, the introduction of IGAs is positive for investors. Where implemented, all entities within an IGA jurisdiction will be presumed compliant with the rules. Moreover, in general, financial institutions in IGA countries do not need to withhold against their clients.

UK Crown Dependencies and Overseas Territories (CDOTs) rules

Other leading OECD members became very interested in the FATCA model of automatic tax information exchange to combat offshore tax evasion. All the UK CDOTs have entered into this type of agreement with the UK. Like IGAs, these are bilateral but with the aim of providing information about holders to the UK (not US) authorities.

These apply to UK entities and to those entities domiciled in the CDOT countries (such as the British Virgin Islands, Bermuda, the Cayman Islands, Gibraltar, Guernsey, the Isle of Man and Jersey).

The rules came into force at the same time as FATCA and are broadly similar to FATCA, although the reporting starts in 2016 (2015 under FACTA). CDOT will be phased out as soon as the multilateral OECD-based system described below is ready to replace it.

OECD Common Reporting Standard

In 2013, the G20 identified the prevention of offshore tax evasion as a high priority, and the analysis of high volume, automatically exchanged information about offshore financial assets as the best way to do this. The OECD was mandated to urgently develop such a system based on the FATCA model. The OECD released a template for an Automatic Exchange of Information (AEOI) earlier this year, comprising:

1. The Common Reporting Standard (CRS) prescribes a standard regime (to be enacted in locals laws) under which financial institutions resident in each signatory country must provide information on cross-border accounts to their local tax authority.
2. The Model Competent Authority Agreement provides for automatic exchange of the financial account information gathered via the CRS with the tax authorities of the other countries.

The final version of the official OECD commentary was published on 21 July 2014, thus substantially completing the OECD's process and passing the work over to national governments. The UK published draft implementing regulations on 31 July 2014, the first participating government to do so.

There are approximately 60 countries that have so far expressed some interest in implementing AEOI, meaning the system is likely to cover a very large part of the global economy. The target timeframe is for a first wave of early adopter countries to enact local legislation with an effective date of 1 January 2016.

We expect the impact of CRS on those financial institutions and investors that were already involved in US markets (including BlackRock and its clients) to be incremental compared with US FATCA. However, for those institutions that achieved FATCA compliance by essentially excluding all US clients through the ordinary terms of their business model, CRS is likely to be a much bigger step change.

Conclusion

BlackRock supports the creation of a regulatory regime that increases transparency, protects end-investors, and facilitates responsible growth of capital markets, while preserving consumer choice and balancing benefits versus implementation costs. BlackRock is keen to ensure that policymakers' thinking in Brussels and elsewhere remains global and consistent, so that sound regulatory frameworks can be adopted on a worldwide basis.

BlackRock engages in the European legislative process on issues with the greatest potential to affect retail and institutional clients and seeks to ensure that the 'voice of the end-investor' is expressed in a timely manner. Policymakers have legislated, profoundly and extensively, many parts of the overall financial ecosystem – and a large number of complex and interrelated proposals remain on the table. We will continue to be a vigorous advocate for our clients and contribute to legislators' thinking for policies that bring about positive change for end-investors.

Annex: STATE OF PLAY OF KEY POLICY INITIATIVES STILL BEING FORMULATED IN THE EU

ELTIF Regulation	<ul style="list-style-type: none"> ▶ In April 2014, the European Parliament (EP) voted a resolution on the European Commission (EC) proposal (published in June 2013). ▶ In June 2014, the European Council reached an agreement on the Regulation. ▶ The negotiations between the EC, the EP and the European Council, the so-called trilogue, started in October 2014. December 2014 is still targeted for the final political agreement.
MMFR	<ul style="list-style-type: none"> ▶ In September 2013, the EC published a proposal. ▶ In March 2014, the ECON committee of the EP voted to defer a final vote until after the EP elections. The EP has just started their renewed discussions and a vote in the ECON committee is expected in February 2015. ▶ The European Council started to discuss the EC proposal in July. A General Approach is not expected before early next year.
BSRR	<ul style="list-style-type: none"> ▶ In January 2014, the EC published a proposal that is currently being discussed by the EP and the European Council. ▶ The proposal includes a transitional period before some of the most important elements take effect. The proprietary trading ban is not expected to apply before Q4 2017 and the effective separation of other trading activities not before Q3 2019.
SFTR	<ul style="list-style-type: none"> ▶ In January 2014, the EC published a proposal, ▶ In October 2014, the European Council reached an agreement on the EC proposal while negotiations in the EP have just started.
Benchmarks Regulation	<ul style="list-style-type: none"> ▶ In September 2013, the EC published a proposal. ▶ In March 2014, the ECON committee of the EP voted to defer a final vote until after the EP elections. The renewed negotiations started in fall with an expectation to adopt ECON report in March 2015. ▶ The European Council has been discussing the EC proposal since April 2014. An agreement among Member States is not expected before Q1 2015.
IORPD	<ul style="list-style-type: none"> ▶ In March 2014, the EC published a proposal focusing mainly on IORPs' governance and transparency to members and beneficiaries. ▶ The proposal is currently being discussed at the European Council while negotiations in the EP are not expected to start before early 2015.
SRD	<ul style="list-style-type: none"> ▶ In April 2014, the EC published a proposal. ▶ The discussions in the Council started over the summer and in the EP in November. ▶ The Member States will have 18 months to transpose the Directive in their national jurisdictions once a single text has been agreed by the EC, EP and European Council.
FTT	<ul style="list-style-type: none"> ▶ In September 2011, the EC published a proposal for the introduction of an EU-wide FTT. Given the strong opposition from a number of EU Member States, the 11 countries in favour of an FTT (the FTT11) opted to follow the enhanced cooperation procedure. ▶ In February 2013, the EC published a proposal for an FTT under the enhanced cooperation procedure. ▶ Progress towards a potential agreement between the FTT11 by the end of this year is limited with no clarity as yet on the final shape of the FTT.

Endnotes

1. Regulation or Directive: the legislation around any regulatory initiative may be in the form of a regulation which applies directly as national law without the need for further implementation or a directive requiring further national implementation
2. This includes hedge funds, private equity funds, real estate funds, Luxembourg Specialised Investment Funds, Irish Qualifying Investor Funds, Dutch Fonds voor de Gemene Rekening, German Spezial fonds, UK Investment Trusts, UK charity funds, UK Non-UCITS retail schemes and UK unauthorised unit trusts.
3. Reverse enquiry: process through which investors approach providers with specific requests tailored to their needs and not as a result of marketing from the providers. It is out of the AIFMD scope. Non-EU AIFMs will have to show clear evidence of reverse enquiries to be free from complying with the PPR requirements of the relevant Member State.
4. Insurance products not providing investment opportunities to retail investors (e.g. non-life insurance products), traditional deposits, direct investments in shares or bonds, and individual and occupational pension products are not caught by the Regulation. However, uncertainty remains about the scope of the Regulation in individual EU Member States as national regulators will have the power to apply the KID to a wider range of products.
5. Trade Reporting And Compliance Engine – TRACE is a programme developed by the National Association of Securities Dealers in the US which allows for the reporting of OTC transactions pertaining to eligible fixed income securities. Brokers, who are NASD members and deal with specific fixed income securities, are required to report their transactions by SEC rules.
6. IORP is an institution operating on a funded basis to provide pension benefits in the context of an occupational activity on the basis of an agreement between the employer(s) and the employee(s), or with a group of self-employed persons.
7. 'Stateless income' refers to income located or retained by multinational companies in low or no-tax jurisdictions to avoid or reduce taxation.
8. Treaty Relief and Compliance Enhancement ("TRACE") is a proposed form of Authorised Intermediary system for claiming withholding tax relief at source on portfolio investments. It seeks to reduce the barriers affecting portfolio investors ability to claim the reduced rates of withholding tax to which they are entitled pursuant to tax treaties or domestic law.
9. US Treasury and the IRS announced a six-month transitional period until January 2015 only to apply to due diligence, withholding and reporting.

FOR MORE INFORMATION

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