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# Regulatory Developments in Europe: 2020 Outlook

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Following the formation of a new European Commission at the end of 2019, President Ursula von der Leyen has set out an ambitious statement of priorities for the five-year legislative term ahead. Among them, two most likely to influence the financial services policy agenda are the creation of an economy that works for people, and the development of a flagship, wide-ranging European Green Deal, which complements the EU's 2018 Sustainable Finance Action Plan.

Efforts to deepen and better connect Europe's capital markets are set to continue, as the Capital Markets Union (CMU) initiative, which defined the financial services policy of the prior Commission, is refreshed and rebooted for the term ahead. This aligns well with the objective of delivering an economy that works for people, by delivering value to long-term savers, and better connecting capital with both listed and private companies seeking funding to innovate and grow.

The renewal of the CMU agenda will see the progression of regulation already under development, as well as new initiatives. We frame these around the three pillars of promoting retail investor participation, optimising market structure with a focus on transparency and investor protection, and improving the capital raising journey for Small and Medium-sized Enterprises (SMEs). For retail investors, increasing the consistency between the array of disclosure standards, ranging from MiFID to PRIIPs to UCITS, would support informed decision making alongside efforts to increase financial inclusion and engagement in retirement planning through digital tools. This would accompany efforts to optimise the functioning of capital markets through the development of a consolidated tape of post-trade data for equities, equity-like instruments (such as ETFs) and fixed income, and better connecting investor capital with SMEs, via vehicles such as the European Long-Term Investment Fund (ELTIF).

With the additional momentum of the European Green Deal, sustainability will gain greater focus throughout EU policy making, including in financial services. The first initiatives of the 2018 Sustainable Finance Action Plan are already in progress, including the development of a taxonomy, or common language for sustainable finance, and new standards for financial institutions to disclose how they integrate Environmental, Social and Governance (ESG) considerations.

The future relationship between the UK and the EU, and implications for the financial system, remains to be determined through negotiations in 2020. Imagination will be needed on both sides to maintain economic benefits of a close relationship in the face of political challenges.

BlackRock seeks to contribute to policy debate that brings about positive change for investors. In this *ViewPoint*, we set out the developments in financial services policy, impacting retail investors, institutional investors, and distributors in Europe.


The opinions expressed are as of February 2020 and may change as subsequent conditions vary.


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# Table of contents


| | |
|---|---|
| **Developing Capital Markets in Europe** | Pg 3 |
| Promoting retail investor participation | Pg 3 |
| Optimising the capital markets ecosystem | Pg 4 |
| Enhancing the capital-raising journey in Europe | Pg 5 |
| **Product Development & Disclosure** | Pg 5 |
| Exchange-traded funds | Pg 5 |
| European Long-Term Investment Fund (ELTIF) | Pg 6 |
| Securing Value for Money | Pg 7 |
| **Sustainable Finance & Stewardship** | Pg 8 |
| A greener Europe | Pg 8 |
| The Shareholder Rights Directive | Pg 9 |
| Sustainability and stewardship in the UK | Pg 10 |
| **Planning for retirement** | Pg 12 |
| Pan-European Personal Pension | Pg 12 |
| National pension reforms | Pg 13 |
| **Constructing efficient capital markets** | Pg 15 |
| Evolving equity market structure: the consolidated tape | Pg 15 |
| LIBOR reform | Pg 16 |
| Central clearing of trades | Pg 17 |
| Share Trading Obligations | Pg 18 |
| **Risk Management and Governance** | Pg 18 |
| Oversight of fund liquidity in Europe | Pg 18 |
| Measuring leverage in investment funds | Pg 19 |
| **European markets post-Brexit** | Pg 20 |


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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 25 years. Our purpose is to help more and more people experience financial well-being.

As an asset manager, we connect the capital of diverse individuals and institutions to investments in companies, projects and governments. This helps fuel growth, jobs and innovation, to the benefit of society as a whole. Our clients include pension plans, insurers, asset managers, foundations, retail and private banks, financial advisors, official institutions, and individuals investing in diversified funds. Around two thirds of the capital we manage for clients globally relates to retirement solutions.

As an important part of our fiduciary duty to our clients, we advocate for public policies that we believe are in investors' long-term best interests. 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 examine public policy issues and assess their implications for investors, and through letters and consultations that we periodically submit to policymakers.

# Developing Capital Markets in Europe

Efforts to deepen and better connect Europe's fragmented capital markets, under the banner of the Capital Markets Union (CMU) policy initiative, were at the heart of President Jean-Claude Juncker's priorities for the 2014-19 European Commission. Signalling the transition from a financial services policy agenda rooted in the post-financial crisis recovery efforts, to one that would lay the groundwork for forward-looking growth, to the benefit of society as a whole, the CMU aimed to bolster the ability of Europe's capital markets to act as a complement to traditional bank funding, and help finance the creation of jobs, growth and innovation. Many diverse regulatory initiatives were included under this umbrella, ranging from the creation of new products such as the Pan-European Personal Pension (page 12), and the European Long-Term Investment Fund (page 6), to efforts to increase the efficient functioning of capital markets (page 4), and the development of green finance through the 2018 Sustainable Finance Action Plan (page 8).

BlackRock remains strongly supportive of the Capital Markets Union. In our view, a refreshed CMU agenda for the legislative term ahead must focus on delivering something meaningful for all European investors: **improved ability to save more effectively for the long-term and to better connect to broader economic prosperity, through investment in capital markets that offer transparency and investor protection**. The result will be mutually beneficial to European investors and companies.

We define the priorities for progressing CMU around three pillars; (i) encouraging greater retail investor participation in capital markets; (ii) delivering an investor-friendly capital markets infrastructure; (iii) and enhancing the capital-raising journey for companies in Europe. We address these issues below, and in more detail in *ViewPoint*: Putting the capital in the European Capital Markets Union.

## Promoting retail investor participation

| THIS AFFECTS | Retail and institutional investors, small and medium-sized enterprises and corporates; financial services industry at large |
|---|---|
| **OCT 2019** | Lead by Germany, France and the Netherlands, several EU member states formed the *Next CMU High-Level Group*, and published a joint report with recommendations for progressing CMU |
| **NOV 2019** | European Commission announces a High-Level Forum of experts, tasked with developing its own recommendations to progress on CMU |
| **MAY 2020** | High Level Forum on CMU expected to provide final recommendations to the European Commission |

The CMU's goal of encouraging deep and robust capital markets across Europe requires significant retail investor participation to become a reality. **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.**

BlackRock's Investor Pulse survey repeatedly shows that too many savers in Europe still sit on the side-lines of the capital markets, holding on to cash, even when saving for long term financial goals, and at a time of persistent low interest rates. Despite multiple regulatory initiatives to drive engagement in capital markets, including reviews of product disclosure and reporting rules, the European households we surveyed hold an average of 30% of financial assets in cash.[1] **Developing Europe's capital markets requires an investor-centric approach,** that helps individuals diversify their savings among different asset classes, with accessible and simple to understand investment products and services.

For most people, the driver to make the first step to investing is not the desire to buy a specific financial product, but to achieve a life goal, such as saving for retirement, or buying a house. Financial products and services are simply a means of achieving these goals, and must be offered in a way that meets these personal objectives. Financial education remains an important tool to empower retail investors, but will not be enough on its own.

> **“ 62% of non-investors in Europe find information about investing difficult to understand.[2]**

The growth of more user-friendly, digital investment tools has the potential to change the way investment services are provided to individuals, support financial inclusion, offer individuals more control over their investments.

Many investor protection-related rules are due for review in the course of the legislative term ahead. Before embarking on piecemeal amendments, we recommend the European Commission **to agree on a core set of principles to drive effective consumer engagement and to facilitate the use of digital delivery tools, which can act as a benchmark for changes across different pieces of legislation**. To support retail investor participation, we recommend the European Commission to take steps to:

1. **Simplify the investment process.** In particular, we strongly support calls to change the presentation of costs and performance scenarios in PRIIPs, to provide savers with clear and comparable information.
2. **Harness the power of digital tools to engage with consumers** as part of wider engagement on investor education

3. **Focus on value for money across the chain of distribution** with meaningful comparability and transparency of both products and advice and distribution
4. **Ensure regulation and supervision recognises changes in distribution** which represent a move away from selling products to providing multi-product solutions
5. **Encourage Member State initiatives to drive increased investment** such as auto-enrolment and the reduction of tax barriers to long term savings.

## Optimising the capital markets ecosystem

| THIS AFFECTS | Retail and institutional investors, Market ecosystem – exchanges, data vendors; CCPs, clearing members |
|---|---|
| **FEB 2020** | European Commission consultation on review of MiFID /MiFIR |
| **Q3 2020** | European Commission CMU Action Plan |
| **H2 2020** | EU CCP Recovery and Resolution Regulation negotiations expected to conclude |
| **2020-22** | Review of MiFID II / MiFIR |

Improving the functioning and efficiency of European capital market ecosystem has been a central aim of the CMU since inception in 2015, alongside the goal to strengthen cross-border integration of Europe's fragmented national capital markets. Since notable gaps in the framework remain, these remain important aims of the CMU.

The first phase of the CMU saw the implementation of key market structure rules, including MiFID II, Markets in Financial Instruments Regulation (MiFIR), and the European Market Infrastructure Regulation (EMIR) review. Equally important was the effort to clearly identify the barriers to a unified approach to post-trading across EU countries, and to set out an agenda to make European corporate bond markets more efficient.

The next phase of market structure reform efforts must extend the concept of investor protection beyond a focus on product disclosures and the provision of financial advice, to include the market structures that investor capital is channelled through, which currently provides sub-optimal efficiency and protection for the end investor. Future iterations of the CMU must therefore focus on the efficiency, safeguards, and costs for investors utilising European capital markets.

Reforms that could improve investor experience of and confidence in markets lie within the existing powers of already-agreed legal frameworks, and don't depend on introducing new regulation. Two key areas are **(i)** increasing market transparency, and **(ii)** encouraging central clearing of trades.

## Defining 'investor'

In this *ViewPoint*, we make the case that the CMU should be seen as a vehicle to better engage European investors, and that the policy agenda should seek to build an investor-centric framework that balances investor protection and investor inclusion, and protects investor capital throughout the system. It is useful to be precise about what we mean by 'investor':

- **Asset owners** can manage their money directly and/or outsource this function to asset managers. Asset owners include individuals, pension funds, insurers, sovereign wealth funds, foundations, endowments and family offices. In this *ViewPoint*, we refer to asset owners also as 'savers', 'investors', 'end-investors' or 'consumers' (when referring specifically to retail investors as they consume investment products and services).
- **Asset managers** act as agent on behalf of their clients, the asset owner. Asset managers are required to act as a fiduciary and invest according to the investment guidelines set out in the legal documentation of the mandate, or the product selected by the asset owner. When looking at wholesale markets issues and how capital moves through the plumbing of the financial system, it is often the asset-owners' agent – the asset manager – to whom the concept of 'investor protection' is applied.

- **Market transparency**: MiFID II was intended to be a wide-ranging reform of market structure – covering everything from trading execution rules to price transparency and market data – and it has indeed had wide-ranging consequences for European markets. From an investor perspective, there have been several improvements regarding the volume and breadth of data reported since it came into effect in January 2018. However, there is still some way to go to turn this data into useful information for investors and regulators alike, including the provision of a consolidated tape of trading data, which would provide investors with a clearer picture of the liquidity of a security across the EU, empowering informed trading decisions, and reducing the cost of capital for companies in Europe (see page 15 for further details).
- **Central clearing**: The shift from bilateral arrangements to central clearing of trades, for securities such as derivatives, repo and securities lending transactions, is intended to mitigate counterparty credit risk through netting, margining and collateralisation. However, it must be **done in a way that protects the interest of investors participating in the system to the greatest extent possible**. We continue to engage with regulators to ensure that steps to address misalignment of incentives are taken (see page 17 for further details).

Completing this agenda, with market transparency and investor protection at its centre, would reinforce investor experience and confidence in Europe's capital markets and help to strengthen the foundations of a durable CMU.

### Enhancing the capital-raising journey in Europe

From an investor perspective, a CMU that can create a viable pathway to attractive investments would be meaningful. The provision of capital to companies must be mutually beneficial for both the investor and the issuer, for a vibrant capital market to develop. In the next phase of the CMU, policymakers will need to take realistic stock of how both listed and private companies are turning to markets to raise capital today – offering diverse investment opportunities to investors seeking potential returns – and relieve any frictions as capital travels through the markets to companies.

Companies are turning to capital markets more than ever to seek finance; a focus of the original CMU agenda. However, the traditional pathway to public equity finance is also changing as many companies are increasingly choosing to remain private for longer, supported by the continued access to varied sources of funding. This is not only due to the costs associated with listing, which the original CMU agenda focused on, but also the ongoing costs of being a listed company, such as reporting and compliance.

The trend for companies to stay private for longer is facilitated by the accompanying shift in investor behaviour; while traditionally, listing might have been the desired goal for companies and early stage investors alike to realise returns on their investment, there are increasing opportunities for investment funds to play the role of '**crossover investors' – investing in companies at different growth stages, both public and private** (see Exhibit 1). To support this and help connect more companies with sources of capital in Europe, the CMU agenda should focus on optimising investment vehicles for investment in private as well as public assets. This would help retail and institutional investors to provide capital to companies at different stages of their growth, and to access investments with return potential to help reach their financial goals.

The ELTIFs, European Venture Capital Funds (EUVECAs) and European Social Entrepreneurship Funds (EuSEFs) are just some of the initiatives we see as having the potential to connect investors to companies across varying stages of their development. The ELTIF structure in particular seems well-placed to empower those crossover investors. Enhancements to its structure and framework that could help it to fulfil this potential are discussed in further detail on page 6.

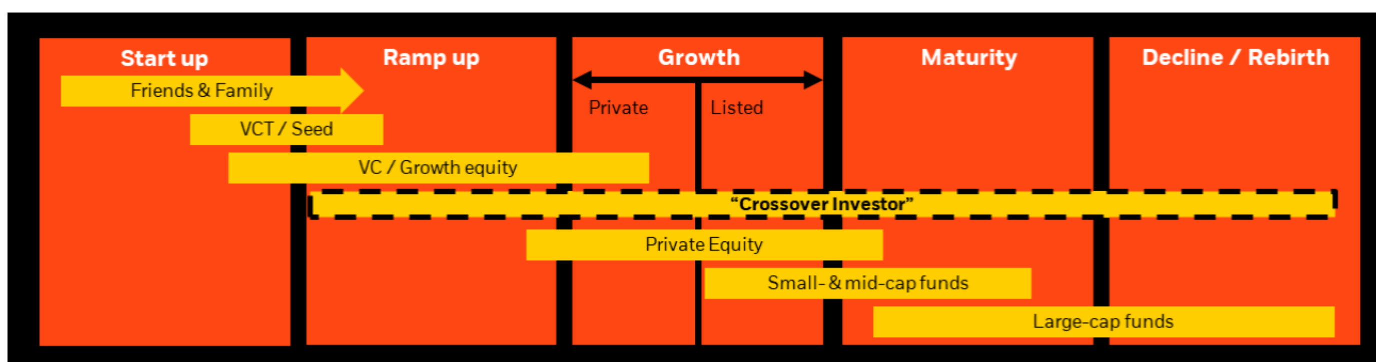
## Product Development & Disclosure

### Exchange-traded funds

| THIS AFFECTS | Retail and institutional investors; Market ecosystem – exchanges, liquidity providers, authorised participants |
|---|---|
| **JUN 2019** | FSB-IOSCO Hearing on ETFs |
| **Aug 2019** | FCA Report on ETF Primary Market Participation and Liquidity Resilience |
| **H2 2020** | Potential IOSCO consultation report on ETFs |

In 2005, just over $400 billion were invested in ETFs globally.[3] Today, this has grown to over $6 trillion. While ETFs are still a small part of global capital markets, representing just 5%,[4] their rate of growth has prompted regulators around the globe to take a closer look at index investments broadly, and the market system supporting ETFs in particular.

**Exhibit 1: Potential specialist investor bases of a company's lifecycle, including the complementary role of the crossover investor**




Source: FactSet ownership database as of 31 December 2019, accessed 16 February 2020.

2019 saw the publication of several reports by regulatory authorities on ETFs and their ecosystem. One of the most influential, published by the UK's Financial Conduct Authority (FCA) in August 2019, observed trends around participation in ETF primary markets, and presented initial evidence about the behaviour of liquidity providers in times of stress. The FCA described European ETF primary markets as concentrated, with a limited (but growing) number of authorised participants providing liquidity through the creation and redemption process, particularly for fixed income ETFs. However, they found preliminary evidence that alternative liquidity providers step in during times of market stress. **The FCA did not observe behaviours that would raise concerns for financial stability.**

In the meantime, IOSCO continues to study the ETF market and may bring forward a consultation paper recommending an update of its 2013 Principles for ETFs in the second half of 2020. **BlackRock continues to advocate for a clear classification scheme that helps investors distinguish the risks inherent in different types of exchange-traded product (ETP) structures,** as described in the adjoining box. As well as protecting investors from unknowingly investing in products less suited to their circumstances, a classification system would help regulators focus their efforts. As a global standard setter, IOSCO is well placed to explore the issue of ETP classification, helping to shape a single and authoritative approach for market participants.

Policy makers, regulators and the industry can act in several areas to strengthen the ecosystem around ETFs, decrease operational risk, and reduce the cost of trading. BlackRock believes in addition to implementing a classification system for ETPs, this should include standardising and increasing access to data. In Europe, the implementation of the consolidated tape of trading data for equity and equity-like instruments would address issues of market fragmentation and for the first time provide all investors – retail and institutional – with a holistic view of liquidity in European ETFs, as well as reducing the cost of capital for firms (see page 15).

## European Long-Term Investment Fund (ELTIF)

| THIS AFFECTS | Retail and institutional investors; Small and medium-sized enterprises; |
|---|---|
| JUN 2015 | ELTIF Regulation comes into force |

The ELTIF entered into force in 2015 as a fund framework to facilitate long-term investments into sectors such as private equity, real assets, and infrastructure, for both retail and professional

## 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 "plain vanilla" 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 should be clearly labelled as ETPs, rather than 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.

investors. Given low interest rates, investors are increasingly willing to provide capital throughout the numerous different stages of company growth, and ELTIFs have the potential to play an important role in providing access to long-term investments that offer an illiquidity premium.

Five years on, a limited number of ELTIFs have now been launched on the EU market, giving investors a taste of the various benefits and challenges of using this vehicle. To allow the ELTIF to play a stronger role as the vehicle of choice for long-term investment and capital provision, we believe several reforms are needed to the product framework. We see changes to the following areas as most effective:

1. **Product structure**: The ELTIF is designed to be an investment vehicle that can provide long-term exposure to a range of long-term assets. However, there is a lack of clarity in ELTIF rules over investment in 'real assets' (e.g. infrastructure, real estate), and financial undertakings (which may be attractive early stage investments), as well as the ability to invest in other funds during the ramp up stage.
2. **Target market**: The product framework was designed to allow retail investors to participate in long-term investment strategies, and we do see appetite and potential for this. However, MiFID distribution rules do not align with the ELTIF's intended market. Updating the MiFID investor definitions and target market rules and simplifying cross-border marketing would enable the ELTIF to realise its potential as a retail investment vehicle.

3. **Tax**: For some investors, the taxation on dividends and capital gains in some EU jurisdictions, as well as the requirement to appoint a withholding tax agent, make the ELTIF less attractive. At the fund level, we continue to raise concerns with the double taxation the OECD Base Erosion and Profit Shifting (BEPS) framework creates for funds that invest cross-border in unlisted investments, which are especially significant in the low interest rate environment. While a comprehensive global solution has not been found, we believe that an EU-level solution for ELTIFs (at least) is possible and would make such funds more attractive to end-investors.

## Key features of ELTIF

- ELTIF is a closed-ended investment fund vehicle – a type of Alternative Investment Fund (AIF)
- Designed to invest in infrastructure projects, unlisted companies, listed SMEs, and real assets.
- Marketing passport to both professional and retail investors in the EU.

The ELTIF structure is well-suited as a vehicle to help both retail and professional investors access long-term investments in companies at different stages of growth, both pre- and post- IPO, in the role of a 'crossover investor', but the improvements above are needed for it to truly fulfil its potential for investors and companies (Exhibit 1).

## Securing Value for Money

| THIS AFFECTS | Retail and institutional investors ; financial services industry at large |
|---|---|
| **OCT 2017** | European Commission requests the European Supervisory Authorities (ESAs) to report on costs and charges |
| **JAN 2019** | ESMA publishes report on costs and charges in the distribution of retail investment and insurance products |
| **2020** | Further reports on costs and charges in the distribution of retail investment and insurance products expected |

In 2017, the European Commission asked the three European Supervisory Authorities (ESAs) – ESMA, EIOPA and the EBA – to report on costs and charges in the distribution of retail investment and insurance products across Europe. The report, subsequently published by ESMA in January 2019, focused more narrowly on the costs of investment funds given the availability of good data, but was unable to adequately assess the costs of distribution to investors, given a lack of comparable data. From the investor perspective, **a holistic view of costs incurred throughout the distribution chain is necessary to make an effective assessment of value for money**.

The increasing availability of data on costs and charges under PRIIPs and MiFID II rules may help provide a clearer picture, but the presence of a variety of different channels to distribute funds complicates an analysis of the full costs of distribution.

Given that this lack of available data is an even more pronounced issue for insurance products, pension products and structured deposits, it is likely that ESMA's report will be the first of a series requested by the Commission. We expect the next iteration of these reports in 2020.

The European Commission and the ESAs are discussing with national supervisors potential ways to enhance data availability and create consistency between the different methodologies underlying the presentation of fund costs and performance across the EU. At this point, the Commission does not intend to use these reports for specific regulatory initiatives, but to inform their understanding of distribution dynamics.

- The Commission has already requested a study which will focus on online distribution.
- The Commission sees that a cost calculator may be a pivotal tool in strengthening the confidence of retail investors in financial products.

To best ensure investors are receiving value for their money, we believe ESMA should not focus solely on funds to the exclusion of other retail investment products simply because better data is available, but rather, should take a holistic view across the entire spectrum of financial products. The usefulness of these reports, particularly for future possible regulation, is limited if ESMA is not able to analyse the impact of distribution costs. By way of illustration, retail funds are typically more expensive than institutional funds because of embedded distribution costs and differences in economies of scale.

We recommend that ESMA focusses on splitting out factory gate costs from headline costs, and distribution costs from manufacturing costs.  MiFID II and PRIIPs should provide more clarity to individuals on the deal they are being offered but more work is needed on how to obtain accurate median costs of distribution.

## The ESAs

The three European Supervisory Authorities (ESAs) contribute to the safeguarding of the EU's financial system. They are:

**ESMA** – The European Securities and Markets Authority

**EIOPA** – The European Insurance and Occupational Pensions Authority

**EBA** – The European Banking Authority

# Sustainable Finance & Stewardship

## A Greener Europe

Commission President Ursula von der Leyen's ambition to see Europe as the first climate-neutral continent – enshrined in her Green New Deal – firmly establishes sustainability as a defining theme across all policy areas. Within financial services, the EU's Sustainable Finance Action Plan, presented in 2018, outlined a range of policy commitments planned to promote sustainability.

The suite of new policies intends to achieve three objectives:

1. to define and build up a segment of the market for dedicated sustainable investment products;
2. to integrate sustainability into mainstream financial markets and investment approaches; and
3. to promote greater transparency, by requiring the disclosure of more sustainability-related information by market participants, investment products and issuers.

From 2020, a number of new regulatory requirements will apply, introducing a robust policy framework for sustainable investment in Europe, and helping investors make informed choices.

Early policies from the 2018 Action Plan now include new regulations agreed at the political level over the course of 2019. Among them are:

- **Sustainability Disclosures Regulation** – requiring sustainability-related disclosures for all financial market participants and products, including details about the potential 'adverse impacts' of investments.
- **Taxonomy Regulation** – a detailed classification system intended to help investment products validate sustainability-related claims related to their investments, and reduce the risk of 'greenwashing'. BlackRock makes recommendations for a path forward for ESG classification in our *ViewPoint*, Towards a Common Language for Sustainable Investing.
- **Carbon Benchmarks Regulation** – bringing EU Carbon Transition and Paris-aligned benchmarks into the EU Benchmarks Regulation, with the intent to promote greater transparency of methodology.

In parallel, the Commission is in the process of amending existing regulatory requirements to introduce sustainability-related concepts, including:

- Incorporating client sustainability preferences into the MiFID and IDD suitability assessment and ongoing product governance requirements
- Requiring institutional investors to integrate sustainability into investment and risk management process and governance (UCITS, AIFMD, MiFID, Solvency II and IORPD)

> **"Becoming the world's first climate-neutral continent is the greatest challenge and opportunity of our times**
>
> Ursula von der Leyen, 2019, President of the European Commission

Most of these new regulations are expected to apply from mid-2020, with the amendments to existing rules likely to come into force in 2021. Moving forward, the Commission intends to make further proposals on corporate governance, as well as use the Taxonomy Regulation as a basis for more detailed EU labels for investment products, green bonds, and sustainability benchmarks. The Commission and European regulators may also look at introducing preferences in prudential regulation for 'green' investments.

Both retail and institutional investors are increasingly recognizing that climate risk is investment risk. The political focus on sustainability and climate-related issues as part of the European Green Deal makes it likely that the sustainable finance policy agenda will remain an important priority in the coming years.

BlackRock welcomes the Commission's focus on sustainable finance and supports the objective of building a robust regulatory framework around this fast-growing segment of the market. **It is, however, important that the pieces of the Action Plan be implemented in a way that is capable of being operationalized by real economy companies and by financial services firms**. In this way, it will best ensure that European citizens, saving for the long-term, can meaningfully participate in this shift.

## Making sustainability our standard

We are an asset manager whose purpose it is to help more and more people experience financial well-being.

As a fiduciary to our clients, BlackRock firmly believes that Environmental, Social and Governance (ESG) issues (ranging from climate change to diversity and board effectiveness) impact long-term financial performance and therefore are important considerations for investment and risk management.

BlackRock is deepening our existing commitment to sustainability by placing sustainability considerations at the centre of our investment approach.

For more detail, see Larry Fink's letter to CEOs, and our letter to clients.

In our *ViewPoint*: Towards a Common Language for Sustainable Investing, we review in more detail the current global regulatory efforts to develop and implement more standardized terminology for sustainable investing, and we outline recommendations to increase clarity around (i) sustainable investment product naming conventions, (ii) corporate issuer disclosures, and (iii) sustainable economic activities.

## Shareholder Rights Directive

| **THIS AFFECTS** | **Pension funds, insurance companies, listed companies, asset managers, proxy advisers and entities providing custody and administration of listed shares** |
|---|---|
| **JUN 2019** | Implementation deadline for EU Member states |
| **SEP 2020** | Introduction of requirements regarding shareholder identification, the transmission of information, and the facilitation of the exercise of shareholders rights to apply. |

The revised Shareholder Rights Directive (SRD II) came into force in June 2019, with some EU Member States implementing later in 2019-2020. It aims to encourage long-term shareholder engagement and to enhance transparency in listed companies.  Most Member States have now reflected the Directive in their national legalisation.

The new rules require institutional investors and asset managers to develop and publicly disclose their policies for engagement in investee companies and demonstrate how these policies are implemented. This includes the annual disclosure of their voting records and the rationale for their most significant votes, on a comply or explain basis.

In 2020, we expect to see enhanced reporting from asset managers to institutional investors (insurance companies and pension schemes) on their investment strategy and its contribution to long term performance, medium to long term risks associated with investments and execution of mandate.

The revised Directive also changes the 'say on pay' regime, allowing shareholders to vote at the general meeting on directors' remuneration policy, as well as annually on a report that details individual directors' remuneration in the previous financial year. The first binding votes on companies' remuneration policies will take place in multiple markets from 2020. From 2021, the first remuneration reports based on these policies will be submitted for an advisory shareholder vote.

From the issuer perspective, companies will have the right to identify shareholders holding more than 0.5% of their shares or voting rights, from September 2020 onwards, to further facilitate engagement between issuers and their shareholders. Intermediaries, (mostly custodians and Central Securities Depositories), will be required to communicate details of shareholders' identity without delay.

**BlackRock supports these enhanced transparency measures in line with our long-term approach to investment stewardship.**

### Key features of the Shareholder Rights Directive

- Disclosure by institutional investors and asset managers of a shareholder engagement policy and its implementation, including in relation to voting.
- Publication by institutional investors of how equity investment strategies are consistent with long-term profile and liabilities.
- Changes to Say on Pay regime; binding vote on remuneration policy and advisory vote on remuneration report.
- Right for companies to identify of shareholders with more than 0.5% of shares or voting rights.

## Shareholder engagement at BlackRock

**On behalf of our clients, BlackRock looks to understand how companies help to create long-term value for their stakeholders.**

Our Investment Stewardship team works to protect and enhance our client's assets for the long term by:

- **Engaging with Companies.** We emphasize direct dialogue with companies on risks and opportunities that have a material impact on sustainable long-term financial performance.
- **Using our Vote.** We perform independent research and analysis, carefully arriving at proxy vote decisions that are consistent with our voting guidelines and that we believe are in the best long-term economic interest of our clients.
- **Promoting sound corporate governance and business practices.** We determine our engagement priorities based on our observation of market developments and emerging corporate governance themes and evolve them year over year as necessary.

## Changes we're making at BlackRock

As announced in Larry's letter to CEOs and our letter to clients, BlackRock is putting sustainability at the core of our investment processes, which includes intensifying our investment stewardship in the following ways:

- **Joining Climate Action 100+**, a group of companies that engages with companies to improve climate disclosure and align business strategy with the goals of the Paris Agreement.
- **Aligning our engagement and stewardship priorities to UN Sustainable Development Goals**. This year we will be mapping our engagement priorities to specific UN Sustainable Development Goals, such as Gender Equality and Affordable and Clean Energy. We will also be incorporating key performance indicators in our engagement policies, providing clarity on our expectations for companies.
- **Increasing transparency of our stewardship efforts**. We will be moving from annual to quarterly voting disclosures; we will promptly disclose our votes on key high profile votes, along with an explanation of our decision; and, we will provide more detail about the topics we discussed during each engagement with a company.
- **Voting against management absent progress on sustainability issues**. We are asking companies to publish a disclosure in line with industry-specific SASB guidelines, if they have not already done so, or disclose a similar set of data in a way that is relevant to their particular business, and disclose climate-related risks in line with the TCFD's recommendations, if they have not already done so. Given the groundwork we have already laid and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management when companies have not made sufficient progress.

### Sustainability and stewardship in the UK

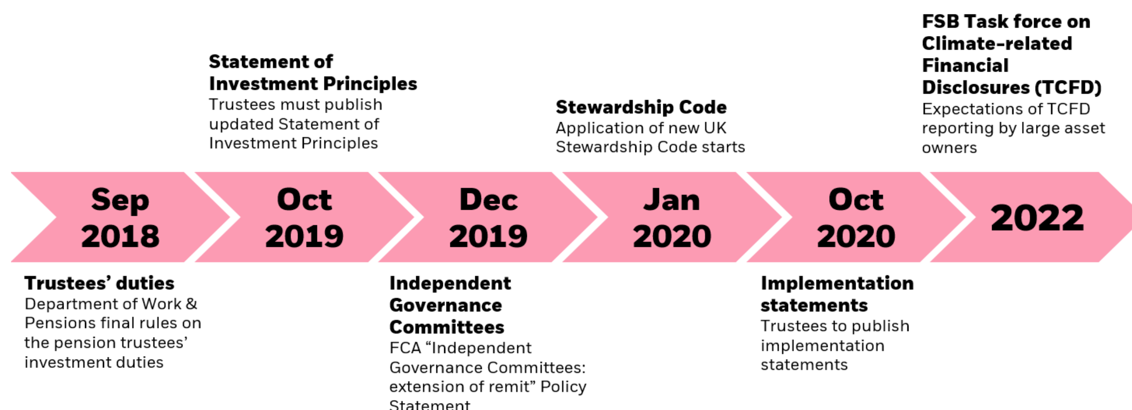
Several major reforms to sustainability and stewardship were announced in the UK in 2019, including a more ambitious UK Stewardship Code, extended duties for pension fund trustees, and an increased focus on Environmental, Social, and Governance (ESG) issues.

### A revised and more ambitious UK Stewardship Code

Following their respective consultations on stewardship in Spring 2019, the Financial Reporting Council (FRC) published the revised UK Stewardship Code, and the FCA its Feedback Statement in October. The Audit, Reporting and Governance Authority (ARGA), the successor body to the FRC, will retain primary oversight of stewardship activities based on the principles set out in the revised Code. The FCA will oversee compliance with the revised Shareholder Rights Directive.

Changes in the new UK Stewardship Code include:

- **'Apply *and* explain'**: Signatories of the Code must publish an annual report demonstrating the application of the Code's Principles. Publishing a 'compliance statement' on the website will no longer in itself be sufficient.
- **Outcome-based approach**: Signatories' reports must focus on stewardship activities and outcomes, rather than on policies and processes.
- **Expanded scope**: Signatories must now demonstrate, (i) that their organisation's purpose, strategy, governance and incentives support effective stewardship, (ii) how stewardship has been exercised across asset classes, and (iii) how stewardship insights (and ESG factors in general, notably climate risks) have been integrated with investment processes.
- **Enhanced stewardship relationships with clients**: Signatories should now explain how they incorporate clients' views, including what clients have in their own stewardship policies, into its stewardship activities and how they have communicated these activities to clients.



The revised UK Stewardship Code applies from January 2020, with the signatories' reports due by 31 March 2021.

BlackRock is committed to being transparent about our stewardship activities and welcomes the level of ambition set out by the revised UK Stewardship Code. We welcome its recognition that stewardship will be exercised differently by different asset owners and asset managers. This is important, as the investment strategies of asset owners vary to meet their individual investment objectives, and asset managers manage the investments and undertake stewardship activities on behalf of a variety of asset owners.

BlackRock's Investment Stewardship team engages with investee companies to encourage them to adopt corporate governance and business practices aligned with sustainable long-term financial performance. The team engages companies from the perspective of a long-term investor and irrespective of whether a holding is in an active or index investment strategy. **Where our clients invest through index-based strategies in which we cannot sell shares, engagement is a critical mechanism for providing feedback or signalling concerns about governance and sustainability factors affecting long-term performance**.

Certain new requirements in the revised Code raise questions about what practical steps signatories will be expected to take to meet the Code's expectations. For example, the new 'Principle 6' requires signatories to explain how their clients' stewardship views and policies have been taken into account and followed in their stewardship activities. We believe potential signatories will need to approach this expectation in a way that is workable for their clients and themselves. Principle 6 raises questions regarding its links with the new rules for trustees and IGCs, mentioned below, and the practicality of integrating their holders' individual views on stewardship. This challenge is the same for asset managers, given their multitude of clients, and we welcome the FCA's acknowledgement that a non-prescriptive approach to stewardship is necessary.

As an asset manager, BlackRock sees stewardship as a core part of our fiduciary duty to clients, so we engage with our clients to understand their outlook on topics like governance, forming an important input to our consideration of stewardship issues. We believe it is then for asset managers like us to determine their approach to stewardship based on what is considered material, through a fiduciary lens. This may not necessarily equate to following beneficiaries' or clients' individual stewardship views.

BlackRock's fiduciary duty of protecting and enhancing the assets clients entrust to us has long informed our approach to engagement and voting, and we will continue to support the goal of sustainable long-term value creation through the exercise of stewardship.

## Pension trustees' investment duties

Since October 2019, trustees of occupational pension schemes are required by the Department of Work and Pensions (DWP) to set out, in their Statement of Investment Principles (SIP), how **financially material considerations** (including ESG factors) and **stewardship** are considered in their investment decisions and policies, and how they have been implemented or changed.

In addition to what is expected in the new Stewardship Code, trustees must now consider how to approach stewardship in a default fund, and whether the policies of the selected pooled fund managers are appropriate. Trustees are also expected to monitor and develop their stewardship policies over time and are given the option to report (separate from the SIP) their policy on 'non-financial factors' such as ethical views and ESG considerations.

## Independent Governance Committees' extended duties

In December 2019, the FCA published final rules and guidance extending the remit of Independent Governance Committees (IGCs) of workplace personal pensions. The new rules come into force in April 2020, introducing two new duties for IGCs. Firstly, to consider and report on their firm's policies on ESG issues, member concerns, and investment stewardship, for the products that IGCs oversee. Secondly, to oversee the value for money of investment pathway solutions for pension drawdown.

While there are similarities with the changes in the trustees' duties per the above, IGCs do not hold the same legal duties, and do not determine their firm's policies. Instead, the firm decides whether and how to change its policies in response to the IGC's concerns.

The IGCs' new oversight of their firms' policies regarding ESG issues revolves around three aspects:

1. **Reporting on their firm's policies** on ESG considerations, member concerns and investment stewardship. The IGC will consider and report on the firm's policies and their implementation for any consideration which the IGC considers to be financially material. Firms remain responsible for the products they offer to consumers.
2. **Reporting on the firm's implementation** of these policies. IGCs will report publicly on their consideration of the quality and adequacy of what the firm has done in practice. IGCs should consider whether the firm's policies do enough to address all relevant and significant risks and opportunities, and whether the firm's policies are sufficiently robust to achieve good consumer outcomes.
3. **Providing guidance for firms** on long-term investment decision-making, clarifying how firms should think

about ESG risks and consumer concerns when making investment decisions on behalf of consumers.

Under the new rules for signatories of the UK Stewardship Code, pension trustees and IGCs will need to contribute to greater integration of material ESG factors and stewardship considerations in their investment policies and give greater transparency around their stewardship activities. **We support the focus on *material* ESG considerations because our investment conviction is that integrating ESG factors that are relevant to our clients' investments can lead to better risk-adjusted returns.**

### TCFD reporting

The UK Green Finance Strategy, published in July 2019, sets out the UK's plans to align investor capital with sustainable growth and to strengthen the competitiveness of the UK financial sector. One of the several actions laid out to by the UK Government to achieve this relates to UK listed companies and large asset owners disclosing their climate risk-related information in line with the FSB's private sector Task Force on Climate-related Financial Disclosures (TCFD) recommendations, by 2022. BlackRock is asking all its investee companies to publish TCFD-aligned disclosures (as well as disclosures consistent with the Sustainability Accounting Standards Board guidelines). This should include the company's plan for reflecting the Paris Agreement's goal of limiting global warming to less than two degrees. BlackRock has laid the groundwork for engaging on disclosures and the growing investment risks surrounding sustainability.  In view of this, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and business practices, and the plans underlying them.

## Planning for Retirement

| THIS AFFECTS | Retail investors, asset managers, insurers, banks |
|---|---|
| **2019** | Political agreement on the Regulation establishing the PEPP product framework. |
| **2020** | Consultations on implementing measures such as the detailed framework for lifecycle investing, standards of investor disclosure and costs. |
| **DEC 2021** | Earliest go-live date for the PEPP at European level. Actual start date depends on Member States clarifying the national tax treatment. |

The Pan-European Personal Pension Product (PEPP) was designed as a pension product that could be offered across the EU by a broad range of financial providers, including insurers,
asset managers, banks, certain investment firms and certain occupational pension funds. As a flexible, EU-wide savings option, it is intended to complement, rather than replace, national state, workplace and personal schemes, and to be capable of channelling long-term savings into the economy, through companies and projects. By offering a standardised personal pension vehicle, with a specific authorisation regime for PEPP managers, and common rules on product design and selling practices, the PEPP is geared towards protecting customers' best interests.

### Key features of the PEPP framework

- **Default investment option**: Providers must offer a basic PEPP with either a capital guarantee at the start of decumulation or a risk-mitigation technique such as lifecycle investing, which is consistent with the objective of helping savers to recoup their capital at the start of decumulation.
- **Cross-border distribution**: Providers must commit to provide compartments of the PEPP in at least two Member States within 3 years of launch.
- **Fee cap:** A total fee cap of 1% for the Basic PEPP (including advice), to be reviewed on a regular basis.
- **Tax treatment**: Each PEPP has the same tax treatment as the personal pension products in each Member State.
- **Distribution**: A Key Information Document will set out the risks, costs and performance of the product, and include a benefit statement. Savers invested in a Basic PEPP will be offered advice on a retirement-related demands-and-needs test and the provision of pension benefit projections before conclusion of a PEPP contract.
- **Portability and switching**: Savers can continue contributing to a different 'compartment' of their PEPP if they move between Member States. Switches are limited to once every five years.
- **Decumulation**: Decisions on retirement age and minimum investment periods before decumulation are left to the discretion of Member States.

The future success and viability of the PEPP depends at national level on the clarity and attractiveness of tax treatments, and competitiveness with equivalent domestic products. At the European level, we expect to see EIOPA's final guidelines on the use of life-cycle investment approaches, the specifics of the scope and application of the fee cap, and the investor disclosure framework, especially in relation to risk.

## Capital guarantees in pension products

Most consumers are unlikely to be aware of the high opportunity-cost they are effectively paying for capital guarantees, where these are a feature of products they invest in. Guarantees force managers into a highly conservative asset allocation, leaving them unable to maximise investment value, or take full advantage of risk diversification. As a result, individuals risk receiving a significantly lower income than without guarantees.

Through the use of alternative risk mitigation techniques free from guarantees – such as life-cycle investing - capital can be more effectively allocated to a wider range of assets. This also opens up a new channel of capital to the economy.

# National pension reforms

### France

| THIS AFFECTS | Retail investors and pensions providers in France |
|---|---|
| **2018** | The French Government announced ambitious corporate law reforms and relaunch of the French Pillar 3 pensions system |
| **JUL 2018** | Final implementing texts available |
| **OCT 2019** | Ability to launch the new PER products |

In 2019, the implementation of Loi Pacte brought in a set of reforms aimed at encouraging pension savings in France. Key among them was the introduction of the Plan d'Epargne Retraite (PER), a vehicle aimed at harmonising the array of Pillar Three supplementary workplace plans in France.

The pension reforms aim to complement the broader company law reforms in the Loi Pacte and encourage greater workplace savings into the economy through low risk or guaranteed products.

### Key features of Plan d'Epargne Retraite (PER)

- Life cycle investing in the accumulation (saving) phase, with a high proportion of initial equity allocation. The aim is to encourage long term equity investment, with tax incentives for investment in less liquid growth companies. The secondary legislation includes a number of ways to reduce risk depending on the saver's risk appetite:
- The ability to access savings during accumulation for a limited number of significant life events
- Freedom to draw down pension benefits on retirement through annuities or capital draw down
- Tax advantages for employer contributions
- No specific fee caps but an expectation that increased competition in the market from new providers will drive down costs

The proposals enable French savers to benefit from a wider range of long-term investment vehicles, supplementing the existing pay as you go system. Uptake of the product will depend on the how well providers can service small and intermediate-sized companies efficiently and at scale – in the first three months of its launch, more than 80,000 accounts had been opened, demonstrating consumer appetite for the product.[5]

French citizens currently save for the long-term by investing in short-term, highly liquid instruments with low returns, and risk profiles. Success of the PER will be judged by its ability to incentivise French savers to adopt life cycle investing, and therefore gain access to longer-term equity allocations with greater return potential. Workplace education and support around the efficiency of the risk mitigation techniques as well as consistency in the applications of tax incentives across different tax brackets will be critical drivers to establishing the PER as a key building block in an individual's savings toolkit.

## Lifecycle investing explained

The concept of 'lifecycle investing' is that an investor's asset allocation should change as they go through life, to manage different risks at different points in their life based on their time horizon. This investment approach should aim to deliver income during retirement that is consistent with spending patterns prior to retirement.

What individuals should expect and want from a lifecycle product is the ability to have consistent spending throughout their lives. This is a simple idea that can be applied in different ways.

- In the UK, lifecycle approaches typically move an investor automatically between different funds as they age, in a process known as 'lifestyling'.
- In the US, target date funds are common, and do the same thing within one investment vehicle, by tapering off risk as members approach retirement.

We believe a properly designed target date fund should be able to accompany and help support an investor throughout their entire life from the accumulation to the decumulation phase.

## Germany

In March 2020, the independent Retirement Commission set up by the Government in 2018 is due to report back to the Bundestag, with recommendations for the direction of retirement policy beyond 2025.

More than 60 years after the formalization of the current pay-as-you-go state retirement system, rapid changes to demographics and employment trends require Germany to position itself at the forefront of pension reform and innovation. To ensure it remains sustainable and generationally fair, the Commission will need to take a holistic view of all three pillars of the pension system and of the reform efforts to date.

The introduction of a framework for Defined Contribution workplace pensions, through the Occupational Pension Reform Act 2017, in theory removed a significant barrier to the expansion of coverage of workplace pensions in Germany, especially for smaller firms that are unable to assume liability for guarantees. However, the requirement for DC schemes to be negotiated with trade unions led to delays in their introduction.

The Retirement Commission is also expected to comment on the way forward for the state-incentivised third pillar Riester products, which were singled out for reform in the 2018 Government Coalition Agreement. Introducing a framework for a reformed Riester product, without the restrictive requirement for qualifying products to offer capital guarantees, has the potential to significantly improve outcomes and value for individuals by supporting state and workplace retirement savings, **ensuring there are options for savers to secure their financial futures across the three pillars.** It will also help to remove barriers to further product development and innovation.

Supporting the long-term sustainability of the pensions system will mean **ensuring more individuals are able to draw on the state, workplace and private pension provision to support their standard of living in old age.**

## Netherlands

In June 2019, Dutch employers, unions and the government concluded the Pensions Accord; an agreement which has significant potential impact on the first and second pillars of the Dutch retirement system.

**The core aspects of the Accord were:**

- **To slow down the increase of the retirement age** for the state pension (AOW) by three years, to reach 67 in 2024 (starting from 1 January 2020).
- **To abolish the current method of varying contribution rate by the member's age.** These age-independent contributions will translate into higher accruals for younger members and lower ones for older members.
- **To modernise pensions contracts, developing a more flexible and transparent system** better aligned to the ageing population and changing labour market dynamics. A Steering Group will be set up with representatives of the government and the social partners to develop two pensions contract options.

The Steering Group, consisting of cabinet and social partner representatives and advised by many pension funds, has been asked to translate the different components of the Pensions Accord into concrete measures. The objective is to finalise the Steering Group's work by end of 2020, followed by draft legislation beginning of 2021 and implementation by January 2022.

The unprecedented decline in bond yields in Europe has been an issue of concern for most Dutch pension funds and other long-term investors. This decline has pushed the discount rate used to calculate the present value of future liabilities lower, pushing coverage ratios below 100%, leading to potential cuts in benefits to existing pensioners, and further weakening the likelihood of the pension system being able to deliver for citizens. While Dutch pension funds will receive one year's respite with respect to cutting pay-outs as announced by the Dutch Minister of Social Affairs and Employment last November, the Ministry and the Dutch Central Bank have resisted calls to change the discount rate as part of the pension reforms.

## UK

**Auto-enrolment in the UK means more and more people are saving for retirement through DC pension schemes, introducing a new set of investors to the markets**. This makes it imperative that scheme members have access to a wide range of investment options which build long-term value, and reflect their preferences, including ESG. The UK Government has recognised this, and over recent years has put forward policies that aim to facilitate more DC scheme investment in long-term assets, and to encourage schemes to articulate their ESG preferences.

As of October 2019, trustees must document their approach to ESG and investment stewardship in their Statement of Investment Principles (SIP). They will need to assess their own understanding of the issues, and work with advisers to fill in any gaps, before ascertaining their member's beliefs, and setting out an investment policy accordingly. From October 2020 onwards, they must publish in an Implementation Statement disclosing how

the policy is carried out, covering their asset allocation, asset manager selection, and stewardship plans. [6] BlackRock has a range of resources in place to help trustees meet these obligations.

The Government's efforts to facilitate more DC investment into longer-term, less liquid assets has been an ongoing process. The Patient Capital Review, which began in November 2016, identified DC schemes as an under-utilised source of long-term finance for the UK economy. The 2018 Budget proposed measures to reduce the direct and indirect barriers to DC schemes of investing in alternative and less liquid asset classes, a measure which will help to grow pension savings, while supporting investment in infrastructure and real estate.

One direct barrier is the 'permitted links' rules for 'unit-linked' DC schemes, which prevent investment in long-term illiquid assets by requiring that all investments are 'readily realisable'. In December 2018, the Financial Conduct Authority proposed new rules allowing unit-linked schemes to hold a wider range of investments, including infrastructure and unlisted equities. While these are a good first step, BlackRock has raised concerns with the conditions that would negate schemes' ability to hold them in practice. We hope that these issues will be resolved when the FCA issues its final policy statement.

Since many alternative investment strategies charge performance fees, the charges cap for default investment options poses an indirect barrier to schemes looking to access them. The Department for Work and Pensions (DWP) recognises this problem, and issued a consultation on possible solutions in February 2019. As BlackRock highlighted in our response, **the fundamental issue schemes face is that the exact level of outsized returns achieved by a scheme that trigger performance fees** – and therefore the maximum overall fee – **cannot be known in advance.** A fixed charges cap is therefore likely to restrict (or make impossible) allocations to alternative strategies that charge performance fees. Since these fee structures align the incentives of end-investors and asset managers, and are only charged when investments outperform, we believe there should be a more flexible application of the fee cap that allows some schemes to exclude performance fees from the fee cap. The DWP is considering this issue and we expect its revised policy to be issued soon.

# Constructing efficient capital markets

## Evolving equity market structure: the consolidated tape of trading data

| THIS AFFECTS | Retail and institutional investors<br>Market ecosystem – exchanges, data providers, liquidity providers |
|---|---|
| **JUN 2019 – ongoing** | European Commission feasibility and scoping project |
| **DEC 2019** | ESMA report on data costs and consolidated tape |
| **2020-2022** | Review of MiFID II / MiFIR |

Equal and sufficient access to market data for all types of investors, large and small, underpins the development of any capital market, and is the same for the EU with the Capital Markets Union (CMU). Market data integrity serves as the foundation for investor protection and public confidence in markets. **A publicly available, aggregated view of the market is a fundamental requirement in today's fragmented and complex equity markets.** Market data must be timely, accurate, and delivered on an equitable and efficient basis.

Following a public consultation, in December 2019 ESMA published their review of how data on stocks and bonds are disseminated, recommending the development of an EU-wide real-time consolidated tape for equity instruments. This responds to widely held concerns that **trading information is currently too disjointed and expensive to help investors accurately measure trading costs and performance.**

**A consolidated tape should be a de facto utility for markets:** an accurate source of near real-time information on current trading activity, and a central repository of pan-European historical trading data. Any investor should be able to compare their own trades against most recent market activity and measure best execution – retail and institutional alike.

To maximise the benefit of the tape, all instruments that are in scope for the various trade reporting regulations under MiFID II and MiFIR should be included. This includes equities, "equity-like products" such as ETFs, other Exchange Traded Products (such as Exchange Traded Notes and Commodities), and bonds. As the scope of data fields can vary across instruments – for example for bonds and equities – we see the case for separate feeds rather than one single tape.

BlackRock's preference has long been for **a single consolidated tape provider per asset class to be mandated and overseen by ESMA.** We recommend that potential providers tender for a specific initial amount of time, with the contract open to be re-tendered after an appropriate period. ESMA would specify the request for proposal (RFP) appropriately with clear delivery guidelines, latency requirements and other specifications.

In a second stage, it would be appropriate to analyse the benefits and costs of a consolidated tape that eventually provides pre- and post-trade data across all asset classes which are in scope of MiFID. Clearly, it will not be possible to deliver all aspects of the tape at once, so a phased approach could be delivered in three-stages:

1. Real-time post trade consolidated tape for equity / equity-like instruments
2. Extension of the real-time post trade consolidated tape to bonds and other instruments
3. Pre-trade European Best Bid and Offer (EBBO).

Although less discussed than the tape of post trade information, **the EBBO would be equally important to enhance market quality through its potential to increase pre-trade transparency and improve the public availability of pricing information to investors.**

Investors of all types would benefit from the increased market transparency that a consolidated tape of trades could provide, in turn increasing the attractiveness of European capital markets overall. We address these issues in more detail our response to ESMA's consultation on the Development in Prices for Pre- and Post-Trade Data and on the Consolidated Tape for Equity Instruments, September 2019.

## 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 | Submission to LIBOR requirement ends. |

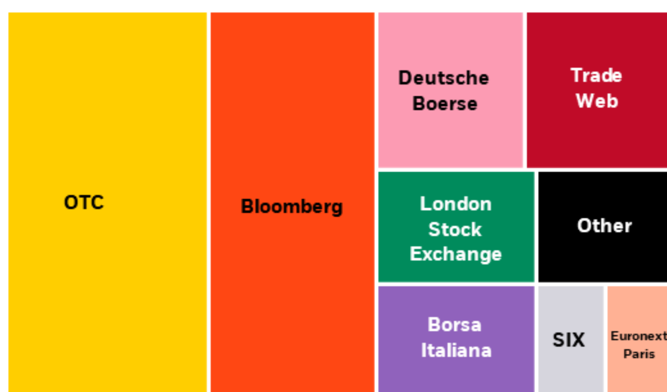
**The future of LIBOR (the London Inter-Bank Offer Rate) is in doubt post-2021.** Following the 2012 rate-fixing scandals, substantial improvements have been made to LIBOR, a benchmark used as a reference rate in a wide range of wholesale and retail financial products, the total notional outstanding value of which once exceeded USD 240 trillion.

The dialogue has shifted from reform of pre-existing rates to replacement with Alternative Reference Rates (ARRs), including Secured Overnight Financing Rate (SOFR) in the US, a reformed Sterling Overnight Index Average (SONIA) in the UK, and the Euro Short Term Rate (ESTER) in the Eurozone. The catalyst for this change was a July 2017 speech by Andrew Bailey, CEO of the UK FCA, indicating that submitting to LIBOR will no longer be required of panel banks after 2021.

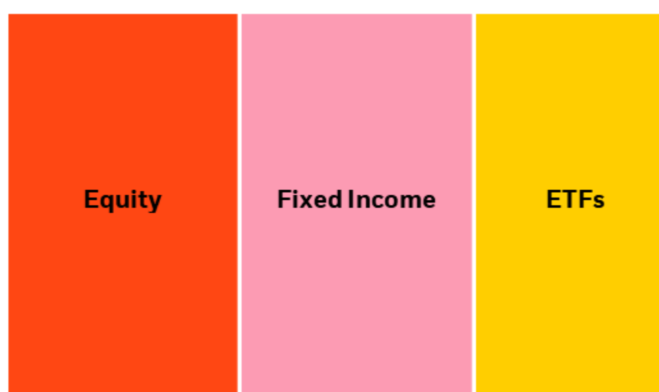
**With the identification of ARRs mostly behind us, investors and regulators must continue to turn their attention to addressing legacy positions in a coordinated manner across asset classes and currencies.**

### Exhibit 2: Comparing the current situation of European ETF trading volume (by venue type) to the aspiration of a pan-European consolidated tape

**Current situation:** Fragmented picture of ETF trading volume by venue type




**Aspirational situation:** Data consolidated into a single feed per asset class for all investors in European securities




Source: Bloomberg, BlackRock as of end 2018. For illustrative purposes only.

**Key features of LIBOR reform**

- For investors and supervisors, a major concern is the management of existing positions that reference LIBOR. In USD LIBOR alone, at least $36 trillion in outstanding notional will not mature prior to 2022.[7]
- The ARRs are not direct substitutes for LIBOR. The differences need to be considered as market participants decide whether to adopt them.
- The market will determine the pace of ARR adoption 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.

Going forward, industry groups and official sector bodies must continue to focus on the implications for investors (the end-users of LIBOR). It is also important to remember that financial transactions do not exist in isolation within a portfolio, and one position in a portfolio may have economic relationships to other positions. To adequately manage potential risk, the portfolio context requires careful consideration and underscores the need for coordination across asset classes and currencies.

We encourage issuers to be proactive in moving to ARRs. We encourage early transition and therefore not rely on a pre-cessation trigger, a feature of the transition debate around which the market currently has concerns.

## Central clearing of trades

| THIS AFFECTS | Investors subject to clearing mandate, Investors choosing to clear products voluntarily, Market ecosystem – CCPs, clearing members |
|---|---|
| **SEP 2018** | NASDAQ Clearing default |
| **JUN 2019** | Revised EMIR framework takes effect. |
| **H2 2020** | EU CCP Recovery and Resolution Regulation negotiations conclude. |

In 2012, the Principles for Financial Market Infrastructures (PFMIs) agreed by global standards-setting bodies established a foundation of risk management standards for central counterparty (CCP) trade clearing houses**, the institutions which help guarantee both sides of a trade, reducing default risk.** These principles have largely been incorporated into regulatory regimes in key jurisdictions, such as EMIR and CCP Recovery and Resolution Regulation in the EU. They provide meaningful frameworks to enhance CCP safety and soundness, particularly in light of CCPs' increased systemic importance following derivative market reforms.

Throughout this process, clearing participants have provided diverse perspectives and detailed feedback to CCPs and regulators through individual firm and industry association position papers, targeted comment letters, and participation in regulatory and industry forums on a global scale. While CCPs and the regulatory community have taken significant steps to address the feedback received, there remain outstanding issues that require additional attention.

**Last year's major default by a member of Nasdaq Clearing AB notably raised broader concerns related to CCP governance as well as risk and default management standards and practices.** Most CCP owners bear only a small portion of the CCP's losses because the default fund and recovery tools available transfer a large portion of the losses to clearing members and end users, such as end-investors and members of pension schemes. This exposes investors to risk.

As a result, **for-profit CCP incentives have the potential to be materially misaligned.** Although CCP shareholders take 100% of the returns a CCP earns from clearing revenues, they bear only a small portion of the losses the CCP incurs as a result of a default.

Throughout 2020 and beyond, **BlackRock will continue to engage with regulators to ensure that steps to address misalignment of incentives are addressed,** including by requiring:

- Incorporating liquidity and concentration factors into initial margin (IM) calculations and applying appropriate margin periods of risk that factor in time needed to liquidate portfolios
- CCPs to have in place material 'skin in the game' throughout the default waterfall;
- sufficient capital for non-default losses;
- additional resources for recapitalisation in resolution;
- consultative governance; and
- more robust disclosures.

We will also continue to advocate for regulators to require CCPs to have conservatively sized prefunded resources and well-developed risk management procedures that fully comply with the PFMIs and their related enhanced guidance. Regulators should also require CCPs to adopt clear and concrete mechanisms and procedures for recovery and resolution that allow the CCP to limit the spill over of losses to the broader economy and to end-investors.

We discuss these issues in further detail in A Path Forward for CCP Resilience, Recovery, and Resolution, a cross-industry paper which brings together perspectives across the spectrum from clearing members to end users.

## Share Trading Obligation

| THIS AFFECTS | All classes of investors; market ecosystem – exchanges, liquidity providers; issuers |
|---|---|
| **31 JAN 2020** | Scheduled date for the UK to withdraw from the EU |
| **Q1 2020** | Expected guidance from FCA on UK approach to STO |
| **2020-2022** | Review of MiFID II / MiFIR (including a review of the STO) |

**Uncertainty remains over the scope and impact of the MiFID II Share Trading Obligation (STO), in the event of there not being an agreement between the UK and EU at the end of the 2020 transition period.** The STO dictates where European brokers and some investment managers can trade, seeking to limit trading to European primary markets, European MTFs and European Systematic Internalisers (SIs) and "equivalent" non-European venues, for shares traded significantly in Europe.

ESMA has taken a securities identification number (ISIN) based approach in contingency planning, meaning that GB ISINs would be excluded from scope of the STO. This was a step in the right direction from an operational continuity perspective, as it will still be acceptable to trade UK stocks in the EU and the UK (unless the UK reciprocates and requires GB ISINs to be traded on UK venues). However, this approach becomes problematic when trading EU27 shares that have their main market outside the country in which the issuer is incorporated. London continues to lead on share trading for a significant proportion of EU trading shares.

The FCA continues to advocate for best execution and the granting of reciprocal equivalence as the better solution all-round. This outcome is, however, in no way guaranteed, given that equivalence decisions are often hostage to the prevailing politics of the day. We expect the FCA to announce its own plans for a UK STO, despite there being significant reservations about its usefulness in some quarters of the UK policy making establishment, to remain aligned with the EU on 1 January 2021.

BlackRock has received assurances from the liquidity providers regarding continued access to liquidity across a range of Brexit scenarios. However, **if this issue remains unresolved there are concerns that the proposed approach could fragment liquidity in cash equities between EU and UK pools to the ultimate detriment of end-investors,** given an expected increase in cost and complexity in transacting in shallower liquidity pools.

Even if there is no overlap between the shares subject to the EU STO and those subject to the UK STO, restrictions on liquidity access will remain for both EU firms and UK firms in respect of certain shares. A particular challenge may be accessing primary market liquidity in names with a dual-listing on both a UK and an EU regulated market. The greater the degree of overlap between the EU STO and the UK STO, the more complicated and challenging it will be for EU and UK investors to access liquidity in certain shares.

**BlackRock will continue to monitor these developments and engage with policymakers on this issue in 2020.**

# Risk Management & Governance

## Oversight of fund liquidity in Europe

Over the course of 2019, a small number of open-ended funds experienced isolated difficulties related to the liquidity of their assets and redemptions. Liquidity in open-ended funds has been a high-profile issue for policymakers for a number of years, but the recent events have sharpened their focus. As a result, several European policymakers are looking into further measures to manage liquidity risk in funds. Among them, the Bank of England and the UK Financial Conduct Authority (FCA) announced a review of the appropriate combination of notice periods and price discounts (swing pricing) for redeeming investors.[8]

BlackRock and the wider asset management industry have long integrated liquidity risk considerations into portfolio management activities. **We strongly support regulatory efforts to raise standards and promote best practises as these help to protect investors' capital** and believe this has been done, to a large extent, through the IOSCO's 2018 Recommendations for Liquidity Risk Management in Collective Investment Schemes. The Recommendations set out a principles-based approach to liquidity risk management and specify the range of tools asset managers should have in place to manage liquidity and redemptions.

At the same time, other regulation at the EU level has continued to raise standards and has prompted developments that enhance asset managers' ability to assess liquidity risk. More recently, ESMA set out new guidelines on liquidity stress testing for UCITS and AIFs, and additional requirements for MMFs, creating new standards for liquidity stress testing design and procedures – these will come into force from 20 September 2020.

Taking a longer view, the wide-ranging post-trade transparency requirements implemented as part of MiFID II have made new data on fixed income and equity trades available. Paired with improving analytical capabilities, this is allowing asset managers to combine different data sources in more sophisticated models that use data science and machine learning techniques, helping to manage and measure liquidity risk across asset classes. **Regulatory developments and new modelling capabilities mean liquidity risk management standards have improved notably over the past ten years.**

As policymakers continue to look at measures to address liquidity risk in open-ended funds, it is important to recognise the progress made to date, and to ensure that the best practises and standards that are already in place are applied rigorously and consistently across all jurisdictions. For a detailed discussion of the pros ad cons of various regulatory measures, see Barbara Novick's remarks at the OeNB Macroprudential Policy Conference. We support the toolkit provided for in IOSCO's Recommendations for Liquidity Risk Management, which should be implemented in full. As such, we welcome the announcements by IOSCO and ESMA that they will pursue (separate) initiatives that, respectively, will review how the recommendations have been implemented in practice globally; and look to harmonise the application of liquidity risk management standards at the EU level.

## Measuring leverage in investment funds

| THIS AFFECTS | Asset managers, retail and institutional investors |
|---|---|
| **NOV 2018** | IOSCO released a consultation on simple measures of leverage. |
| **DEC 2019** | Final report from IOSCO published |
| **MAR 2020** | European Commission due to issue a report on proposed amendments to the AIFMD which is likely to operationalise the IOSCO recommendations |

In 2017, the Financial Stability Board (FSB) asked the International Organisation of Securities Organisations (IOSCO) to develop measures of leverage in investment funds, in order to collect better quality data, which would enable authorities to monitor and compare leverage across investment funds. The primary focus was to collect data on leverage in funds, and monitor leverage in funds without leverage limits, or those that are perceived to pose risks to the financial system.

For both supervisors and investors, **this has the potential to result in the development of more consistent measures for identifying and comparing the different levels of leverage between funds in different jurisdictions**. IOSCO proposed a two-step approach in its Final Report of December 2019.

- At **Step 1,** IOSCO recommends using at least one notional exposure metric (gross notional exposure or adjusted gross national exposure) complete with netting or hedging assumptions where relevant. Regulators should capture information on the directionality, through the collection of data broken-down by asset class, and long and short exposures. This enables the identification of a subset of investment funds that can be further scrutinized through a risk-based analysis.
- At **Step 2,** IOSCO calls for risk-based analysis of the first sub-set, involving relevant and risk-based adjusted metrics that can be employed by regulators – either in combination or on a standalone basis – depending on the characteristics of a fund; e.g. its investment strategy, the underlying asset class volatility and liquidity, portfolio diversification, the market footprint of a fund and/or its redemption.

In our view, any additional measures of leverage at Step 2 should recognise that **(i)** leverage is managed at the fund level; **(ii)** that funds are separate pools of assets; and (iii), that the assets of one fund cannot be used to meet the liabilities of another.

The potential for caps on the level of permitted leverage (e.g. as set out in AIFMD) could be problematic, given the multiple ways in which leverage can be expressed in a portfolio, **an ongoing concern remains that these leverage measures subsequently lead to caps on the level of permissible leverage**. This could prevent investors from achieving desired outcomes, or from managing risk (e.g. through hedging or liability management using long dated derivative contracts). Prudently managed, the use of leverage can be beneficial to investors. The use of leverage, whether for investment exposure or for hedging, varies between funds, and the ability of funds to use leverage is limited by the requirements and constraints of their core investor base.

IOSCO's measures are similar, though not identical, to existing European reporting requirements for UCITS and AIFs. It remains to be seen whether there will be changes to existing EU reporting and investor disclosure requirements.

## European markets post-Brexit

Imagination will be needed on both sides to maintain economic benefits for investors in the face of political challenges ahead.

The UK and EU embark on this new relationship from the best possible starting point. Their laws and regulation are already fully aligned; excellent relationships exist between the UK and other European supervisory authorities - both at EU and Member State levels - and both sides face similar challenges and opportunities. Moreover, they share the same overriding objectives of protecting consumers, safeguarding financial stability, encouraging innovation, and ensuring the financial sector facilitates growth.

A close collaborative relationship that preserves as far as possible the pan-European financial ecosystem is therefore attainable. However, both sides will need to overcome the political challenges this poses if the economic benefits for Europe's citizens are to be maintained. From the perspective of end-users this is highly desirable, as investors all over Europe, particularly millions saving for retirement, currently enjoy cheaper trading costs through integrated liquidity markets, as well as access to products and expertise in Europe's integrated market and beyond.

To illustrate, 7,200 of the approximately 10,000 different funds available to UK investors are based elsewhere in Europe,[9] and market integration, while incomplete in the EU, benefits the end-investor since their asset managers access deeper and broader pools of liquidity in a more efficient way. These reduced frictional costs translate into a reduction of average costs borne by the end-investor.

The form of future co-operation will be a subject of discussions between the UK and the EU, but we hope the perspective of the end-user will be first and foremost in the authorities' minds as they embark on this new relationship, and that decisions on both sides avoid unnecessary politicisation or horse-trading.

Protracted disputes regarding governance should not get in the way of the EU and the UK working together for the benefit of consumers who depend on predictable, well-functioning markets. This is particularly important to encourage greater global co-operation, given governments all over the world will be watching closely to see how independent jurisdictions can deliver the benefits of integrated markets to investors which will also avoid the risks to stability of fragmentation.

# Endnotes

1. As at December 2017, percentage of total financial assets. CEPS Rebranding Capital Markets Union: A market finance action plan, Eurostat and OECD.
2. BlackRock, Global Investor Pulse 2019, accessed 13 February 2020. Data represents an average of Germany, Italy, Switzerland, UK. Available at: https://www.blackrock.com/corporate/insights/investor-pulse#barrier-information
3. ETFGI, published 12 March 2019. Available at: https://etfgi.com/news/press-releases/2019/03/etfgi-reports-assets-invested-global-etf-and-etp-industry-reached
4. Percentage of total market capitalisation of equity and fixed-income markets globally. World Federation of Exchange Database (data as of Dec. 2018), BIS (data as of Q2 2018), HFR, Cerulli, Simfund (data as of Dec. 2018), iShares GBI (data as of Dec. 2018), Global Heat Map, McKinsey Cube (data as of Dec. 2017). Active and index projections calculated from Simfund and Broadridge data; ETF data from iShares GBI.
5. Bruno le Maire, Minister for Finance and the Economy, BFM Business, January 2020. Available at: https://bfmbusiness.bfmtv.com/votre-argent/84-000-plans-epargne-retraite-per-ont-ete-ouverts-en-3-mois-1845943.html
6. For a comprehensive overview of these requirements, see the Pension and Lifetime Savings Association's 2019 document: *ESG and Stewardship: A Practical Guide to Trustee Duties*.
7. Federal Reserve Bank of New York, Alternative Reference Rates Committee, Second Report (Mar. 2018), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report (ARRC March 2018 Report) at 2
8. Bank of England, Financial Stability Report, December 2019. Available at: *https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf?la=en&hash=4A650CF0FB871B5094C614C99689D9AD930CAA01*
9. 7,200 UCITS funds based outside the UK, taken from the FCA Register of authorised funds. As of 20 December 2019. Available at: https://www.fca.org.uk/firms/authorised-recognised-funds. 10,000 funds also taken from FCA Register and the Investment Association's Investment Management Survey, as of September 2019. Available at: https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf.

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