

Regulatory Developments in Europe: 2018 Outlook



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“ We started to fix the European roof. But today and tomorrow we must patiently, floor by floor, moment by moment, inspiration by inspiration, continue to add new floors to the European House. We must complete the European House now that the sun is shining and whilst it still is. ”

– Jean Claude Juncker, European Commission, State of the Union address, September 2017 ¹

Overview

The initial uncertainty brought about by the Brexit vote in 2016 was followed in 2017 with a revitalised sense of solidarity among the remaining EU27 Member States, and a renewed impetus for measures to further the European project such as the European Monetary Union, Capital Markets Union, and supervisory reform. However, questions remain regarding the future relationship between the EU and the UK, and with other ‘third countries’ both in Europe and further afield going forwards.

Financial stability remains high on the agenda for both global and regional policymakers, as does sustainable finance, and considerations of the financial system’s role in tackling climate change. The latter features prominently in initiatives under the umbrella of the European Commission’s Capital Markets Union agenda, alongside a range of ongoing efforts to harmonise national capital markets and reduce barriers to the flow of capital between them.

At the beginning of 2018, a number of fundamental changes to the operation of European financial markets took place as MiFID II began to take effect. The changes made to both the operations of markets and market participants alike have been far-reaching while causing minimum disruption. Long-term, we see the emphasis on transparency and fairness to be of significant benefit to end-investors. Risks remain, however, that decisions being taken on regulation and supervision of critical market infrastructure could become entangled in the politics of Brexit, to the detriment of end-investors.

We see a continued focus on policies impacting Europe’s individual savers and institutional investors: transparency of costs and performance, suitability, and distribution of investments remain subject to heightened regulatory scrutiny. Correctly designed, these measures can improve confidence in and access to financial services. Retirement systems and pension products are also of critical importance for citizens and their Governments, and we welcome efforts to improve coverage and increase savings.

BlackRock continues to advocate for our clients and contribute to legislators’ thinking on policies that bring about positive change for retail and institutional investors.

In this *ViewPoint*, we summarise the key financial services policy developments impacting European retail investors, institutional investors, and distributors.

The opinions expressed are as of March 2018 and may change as subsequent conditions vary.

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The Impact of Brexit on European Regulation

The UK's departure from the EU in 2019 will take Europe's largest financial centre and capital market outside of the Single Market, and remove an influential and expert voice from the EU's decision-making processes. This will have implications for both the wider European regulatory ecosystem, as well as the development of EU policy in the longer-term.

A transitional period ending on 31 December 2020 will, conditional on the overall withdrawal agreement, alleviate the potential for short-term disruption to the orderly functioning of markets immediately after Brexit. In addition, the UK government announced in December 2017 its intention to set up a 'temporary permissions' regime, to enable existing funds and branches in the European Economic Area (EEA) to temporarily continue their current operations in the UK post-Brexit - even if no transitional period comes into force - subject to continued close regulatory co-operation. Such co-operation will be essential to ensure markets continue to function smoothly. This is demonstrated by the UK's announcement, as well as the statement by the European Securities and Markets Authority (ESMA) on the importance of having in place arrangements, whatever the outcome of negotiations on the future relationship of the UK and the EU.²

In the meantime, absent further clarity on the terms of the future relationship, many firms are preparing for the loss of the financial services passport, which permits firms based in the UK to operate in the rest of the EU, and vice-versa. Thereafter, regulatory divergence between the EEA and UK could be detrimental to investors and savers, if it leads to the fracturing of markets and liquidity pools that deliver economies of scale (see [page 16](#)).

Similarly, we see no reason – absent significant changes by the EU – for the UK to diverge from the UCITS and alternative investment fund (AIF) structures. These have proven a resounding success story, with over 11,700 cross-border investment funds authorised in the EU with over 96,000 cross-border registrations.³ These fund structures have served millions of investors in the UK and the EU, attracting investment from all over the world, while guaranteeing EU standards of consumer protection, and facilitating access to international expertise in fund construction and management.

Longer term, the extent to which the UK and the EU remain aligned on financial regulation will depend on the factors driving their respective policy decisions:

In the UK, tensions may emerge between the desires to keep regulatory standards aligned with Europe to maximise the ease of UK-EU business, versus the appeal of building a new UK regulatory regime with an eye towards global competitiveness.

In the EU, much depends on the new equilibrium of decision-making among the EU27. A number of considerable legislative projects remain on the cards: completion of the Banking Union and the Capital Markets Union, the reform of the European supervisory landscape, and potential Eurozone structural reforms. The outcome of these negotiations will influence the trajectory of the EU's financial markets policy. The UK has generally resisted strong institutional integration of financial markets and promoted regulation that keeps European markets as open as possible to the rest of the world. While these values are not unique to the UK, the loss of such a large Member State in EU policy negotiations will mean that other Member States will need to find new ways to put political weight behind priorities the UK once championed.

Financial Stability

The Global Financial Stability Agenda: Liquidity and Leverage

IMPACT	Asset Managers
DEC 2015	IOSCO Final Report on Liquidity Management Tools in Collective Investment Schemes set out tools that managers can use across many global jurisdictions to counter market events.
AUG 2016	FSB published its third consultation on asset management: 'Consultation on Proposed Policy Recommendations to Address Structural vulnerabilities for Asset Management Activities'.
JAN 2017	FSB published 14 final Policy Recommendations to Address Structural vulnerabilities for Asset Management Activities.
FEB 2018	IOSCO released its final recommendations on Liquidity Risk Management.
END 2018	IOSCO simple measures on leverage expected.

Liquidity Risk Management

Following the Financial Stability Board's (FSB) policy recommendations in 2017 to address structural vulnerabilities for asset management activities, and a consultation in July 2017, the International Organisation of Securities Organisations (IOSCO) has issued its final Recommendations for collective investment scheme liquidity risk management (LRM).

We are generally supportive of IOSCO's principles-based approach. However, IOSCO's standards also apply to Exchange Traded Funds (ETFs), which have not been distinguished from traditional open-ended funds in the Recommendations. We encourage further analysis and refinements to the Recommendations to better reflect the characteristics of ETFs.

Liquidity and redemption risk management is an integral part of portfolio management, and fund managers have been performing these tasks for a long time. BlackRock has, however, long been a proponent of 'raising the bar' on liquidity risk management, and supports the FSB and IOSCO's efforts, which we have engaged with extensively.

Leverage in Funds

The FSB's recommendations on leverage focus broadly on the need to collect a greater amount of quality data, to enable authorities to better monitor and compare leverage across funds.

We expect IOSCO to consult on operationalising the FSB's recommendations on leverage in the first half of 2018.

In undertaking this work, we recommend that IOSCO starts with and builds upon existing standards and measures, rather than 'reinventing the wheel'. IOSCO should first identify which data points are needed to assess a fund's leverage profile, take inventory of data reporting standards in each of its member jurisdictions, and compare these standards to identify 'best in class' methodologies that can be incorporated into national requirements. IOSCO should then establish clear data reporting deliverables at an aggregate national or regional level.

Any measures of leverage should be based on an understanding that leverage is managed at fund level, that funds are separate legal entities, and that the assets of one fund cannot be used to meet the liabilities of another. The objective of reviewing leverage data should be to apply a filtering process to exclude funds and strategies on a number of verifiable grounds, permitting regulators to focus on the funds with the largest market and/or counterparty exposures.

Prudently managed, the use of leverage can be beneficial to end-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 their core investor base.

For more detailed analysis, see our [response](#) to the FSB's Proposed Policy Recommendations to Address Structural Vulnerabilities for Asset Management Activities, and our [response](#) to IOSCO's consultation on liquidity risk management in collective investment schemes and open-ended funds.

Key features of IOSCO's LRM Recommendations:

Fund managers should:

- Maintain liquidity risk management processes and procedures.
- Incorporate liquidity considerations into the product design process.
- Regularly monitor the liquidity of fund holdings.
- Perform contingency planning to ensure backup liquidity measures are operationally feasible.
- Conduct liquidity stress testing.

Key features of FSB Recommendations on leverage:

- IOSCO develops simple and consistent measures of leverage in funds that allow authorities to meaningfully monitor and compare leverage across funds.
- National authorities collect data on leverage in funds, and monitor leverage in funds without leverage limits, or that are perceived to pose risks to the financial system.
- IOSCO collects national and regional aggregated data across member jurisdictions on the measure(s) it develops.

ESRB Recommendations on Liquidity and Leverage Risks in Investment Funds

In January 2018, the European Systemic Risk Board (ESRB) published a series of Recommendations for EU legislators and regulators to address liquidity and leverage in investment funds. At a high level, the ESRB's recommendations are that:

- The European Commission ('the Commission') should propose legislation to give a framework on the inclusion of liquidity management tools in the design of any fund originating in the EU. Legislation should also be proposed to clarify how National Competent Authorities (NCAs) might use their powers to suspend redemptions, and to clarify ESMA's role in facilitating, advising on, and coordinating these powers.
- The Commission should propose legislation to limit liquidity transformation in open-ended AIFs, addressing regulatory concerns about mismatches between liquidity offered by funds and their underlying investments.
- ESMA should develop guidance for fund managers on liquidity stress testing for individual AIFs and UCITS.
- The Commission should propose legislation to require UCITS and UCITS management companies to regularly report data on liquidity and leverage, to be made available to NCAs, ESMA, and the ESRB.
- ESMA should develop guidance on:
 - How to assess whether leverage in AIFs might contribute to systemic risk.
 - The design, calibration, and implementation of macroprudential leverage limits.

- How NCAs should notify other NCAs, ESMA, and the ESRB of their intention to implement macroprudential measures, and a basis for knowledge sharing between the authorities.

The ESRB's Recommendations follow on from the FSB and IOSCO's work on liquidity, and anticipate the upcoming IOSCO Recommendations on leverage. The ESRB's recommendations include legislative action, but on balance we believe that the aims could be achieved more quickly and with more flexibility using ESMA's supervisory convergence networks to work with NCAs to fill the gaps identified in the EU's existing framework.

For example, IOSCO analysis has shown that EU member states allow different liquidity management tools to be used. We believe that ESMA should encourage individual member states and NCAs to allow the full toolkit of measures to be used across the EU. This would prevent the need for separate EU legislation.

We welcome the ESRB's emphasis on making liquidity risk management an integral part of the fund design process, and its recognition that any stress testing should be done at the level of individual funds. Any action on leverage should be consistent with the forthcoming recommendations from IOSCO and the FSB.

Finally, much information is already reported by UCITS and UCITS management companies. We would recommend making more effective use of existing sources of data reported to NCAs and identifying possible gaps before launching new legislative initiatives.

Money Market Fund Regulation

IMPACT	All EU-domiciled money market funds – both prime and government funds
SEPT 2013	European Commission proposal for a MMF Regulation published.
NOV 2016	Agreement between Parliament and Council announced.
JUN 2017	MMF Regulation published in the Official Journal of the EU.
H1 2018	European Commission and ESMA to finalise technical standards.
JUL 2018	MMF Regulation applies to new funds.
JAN 2019	MMF Regulation applies to existing funds.

Challenging market conditions and global reform discussions have changed the Money Market Fund (MMF) industry considerably in recent years. While the US agreed and implemented its own rule changes, European discussions have been slower-moving, and a regulatory approach was only agreed in November 2016.

Both US and European reforms emanate from recommendations made by IOSCO in 2012, but differ in their approach to addressing the most central question; how to deal with Constant Net Asset Value (CNAV) MMFs. In the US, the SEC 2a-7 rules required all prime institutional funds to convert to Variable NAV (VNAV) funds, but allowed government funds and funds offered to retail investors to remain CNAV.

The final European Regulation similarly allows for CNAV government funds, but also references two prime fund structures; the VNAV fund structure and a new 'Low-Volatility NAV' (LVNAV) fund structure. The LVNAV is intended to operate like a CNAV fund under normal market conditions (such as pricing to 2 decimal places and thus dealing on a constant share price), but will function as a VNAV during times of market stress (pricing to 4 decimal places where the mark-to market NAV has deviated from the stable NAV in excess of a prescribed tolerance level of 20bps).

Gates and fees will continue to apply under UCITS and AIFMD regulation, with the addition of liquidity threshold rules specified for CNAV and LVNAV fund structures. This contrasts with the US framework, which subjects prime VNAV funds to specified gates and fees, but exempts government CNAV funds from these provisions.

We believe that, by the time of the Regulation's implementation deadline (January 2019), the European fund structures mentioned above will offer investors a workable suite of products that seek to meet their MMF investment needs: capital preservation, intraday liquidity, counterparty credit risk diversification, and ease of accounting.

However, one critical question remains open, namely whether the use of a reverse distribution mechanism (the mechanism by which CNAV funds have coped with negative fund yields) will continue to be allowed under the new Regulation. If prohibited, CNAV and LVNAV funds denominated in euro, and other negative yielding currencies, would become operationally impractical. This outcome would, in our view, be detrimental to end investors.

Key features of the Money Market Fund Regulation:

- Constant NAV fund structures permitted only for MMFs holding government debt.
- New 'Low-Volatility NAV' fund structures introduced to cover the current prime MMF market.
- Use of reverse distribution mechanism (to cope with negative yields) subject to level II rulemaking by ESMA.

Capital Markets Union

The Capital Markets Union (CMU) – launched in 2014 as a flagship initiative of Jean-Claude Juncker's Presidency of the European Commission – remains an important political priority for the the Commission. The CMU is not a single piece of legislation itself, but a conceptual framework

housing a series of policy initiatives. It aims to remove barriers to the free flow of cross-border capital in the EU, and increase the role that market-based finance plays in channelling capital to European companies.

The legislative progress towards the CMU to date consists of: an updated regime for securitisation ([page 7](#)); replacing the Prospectus Directive with a Regulation; increasing the appeal of the EuVECA venture capital and EuSEF social enterprise vehicles; and a refreshed European Fund for Strategic Investments (EFSI) ([page 9](#)).

A number of important pillars of the CMU action plan remain under discussion or yet-to-be-proposed by the European Commission. For example: actions to tackle barriers to cross border investments includes harmonising insolvency regimes, building a cross-border framework for pensions ([page 23](#)), and addressing tax barriers ([page 24](#)).

Important priorities still under development include: a review of the functioning of corporate bond markets, and actions for FinTech to help harness technology for capital markets.

In addition, following the Commission's mid-term review in 2017, new policy focus areas have emerged against the backdrop of Brexit ([page 2](#)), and the scope and strategic direction of the CMU have shifted. The mid-term review, and subsequent amended Action Plan singled out an increased focus on using the CMU to help address non-performing loans (NPLs) in the EU banking sector ([Page 12](#)). It also elevated the debate around reform of the European Supervisory Authorities (ESAs) ([Page 6](#)), and promoting green finance ([page 11](#)) as perhaps the two most important policy areas for the CMU in the remainder of the current legislative term.

We continue to support the Commission's focus on increasing the role that market finance plays in the European economy, by diversifying the sources and potentially driving down the cost of funding for European companies and investment projects. We believe that the entirety of the CMU agenda remains important – including a number of the areas identified in the original Action Plan which have not, to date, progressed as far as other initiatives.

We also believe that the Commission should continue the ongoing assessment of the EU legislative framework they began with the 'Call for Evidence', to determine whether or not the aims of the CMU are being furthered or hindered by existing (and recently agreed) legislation. The success of the CMU will ultimately depend on the ability of each legislative initiative to reflect the interests of the savers and investors that represent the 'Capital' in the Capital Market Union.

Review of the European System of Financial Supervision

IMPACT	All financial institutions supervised in the EU
MAR 2017	European Commission published a consultation on the operations of the ESAs.
SEP 2017	European Commission published proposals on the review of the European System of Financial Supervision, including amendments to the ESAs founding Regulations.
2018	Council and Parliament expected to agree respective negotiating positions and begin negotiations.

In 2017, the European Commission launched formal legislative proposals (the ESA Review) to review and amend the rules governing the operation of the three ESAs; ESMA, the European Insurance and Occupational Pensions Authority (EIOPA), and the European Banking Authority (EBA), as well as the ESRB. The Commission's stated objective for the ESA Review is to support the growth of European capital markets in advance of the UK's withdrawal from the European Union, and to reflect stakeholder feedback. For the asset management industry, the key focus on the review of the European System of Financial Supervision (see [annex](#)) has been on the additional proposed powers to be given to ESMA (see key features below).

ESMA has a pivotal role to play in developing a better functioning European single market that puts the end-investor at its centre. As trust is the precondition for end investors to invest, building up trust in local capital markets is a precondition for developing effective EU capital markets. We believe that many of the aims of the ESA Review can be achieved through increased cooperation with local NCAs rather than by fundamentally restructuring the existing framework.

When looking at ESMA's strategic priorities, we recommend focus on the added value ESMA can bring by developing consistent standards, driving convergent supervisory approaches and ensuring that key issues of authorisation, supervision, and enforcement are effectively and consistently addressed across the EU by NCAs. This can be achieved using ESMA's existing mandate for supervisory convergence to ensure NCAs take account of matters of pan-European importance in a consistent way as and when they occur.

ESMA's other greatest potential value add in terms of supervisory convergence lies in increased coordination and standardisation of tasks, for scale and effectiveness, around data reporting, for example the development over time of

a European version of the US Securities and Exchange Commissions' Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. These steps will allow ESMA to improve its ability to analyse developments in the Single Market more effectively. The development of pan-European data analytics should not, however, undermine the ability of NCAs to obtain the data they need. We also believe that ESMA could also take the lead in developing other areas of supervisory infrastructure, which would benefit the development of the single market. These could include ESMA becoming the operator of a single European consolidated tape for equities, ETFs and fixed income; and a central hub for cross border fund notifications and marketing information.

Whilst we see strong merit in enhancing ongoing third country equivalence assessments, the EU framework for delegation continues to be fit for purpose. We believe there is merit in tasking ESMA with verifying whether the criteria or principles, on the basis of which any third-country equivalence decisions have been taken, are still applicable, in order to underpin the stability and continued supervision of third-country equivalence. Delegation, in contrast, is not about market access as is the case with equivalence – it happens on the basis of the EU's rules, not the third country's and is subject to direct supervision by European authorities. European investors get the best of both worlds: they benefit from the strong investor protection and risk management provisions embedded in the AIFMD and UCITS Directive and – through delegation – local portfolio management expertise from around the globe.

Key features of the Commission's proposals on the role of ESMA:

- Change to existing governance procedures with the creation of an executive board composed of the ESMA Chair and five independent members, instead of the existing board composed of representatives from Member State NCAs.
- Change to ESMA's funding model of EU and national funding, by replacing NCAs' contributions to the running of ESMA with direct contributions from firms.
- Stronger rule for the ESMA stakeholder group to challenge ESMA.
- Direct powers of authorisation over a range of European funds such as European Long-Term Investment Funds (ELTIFs), EuVECAs, and EuSEFs.
- Direct oversight by ESMA of NCA's decisions to permit delegation of services, or other forms of risk transference, to third countries.
- Greater focus on promoting sustainable investment in ESMA's work.

STS Securitisation

IMPACT	Securitisation issuers, sponsors, and investors (e.g. pension funds, insurance companies, banks and investment funds)
	Original risk retention rules agreed in Capital Requirements Directive II (CRD II) (2009), and subsequently extended to other investors under AIFMD (2011) and Solvency II (2009).
SEPT 2015	European Commission published its proposal for an STS Securitisation Regulation.
DEC 2017	STS Securitisation Regulation published in the Official Journal of the EU.
1 JAN 2019	Most provisions apply – with transitional arrangements for existing deals and where technical standards are to be finalised.

Stimulating the EU securitisation market to help increase banks' lending capacity and availability of credit (to the Small and Medium Enterprise [SME] sector in particular) was one of the key initiatives under the banner of the CMU Action Plan. The Commission published a legislative proposal in 2015, aimed at building a harmonised framework for investment in securitisations, including a direct legal requirement for issuer risk retention and extension of the investor rules to all European institutional investors and funds, such as UCITS. The proposal would also create a definition of 'Simple, Transparent and Standardised' (STS) securitisations – that met a range of criteria intended to minimise 'structural' risks – which would benefit from a more favourable risk weighting under various prudential frameworks (e.g. Capital Requirements Regulation [CRR] II and Solvency II).

Despite protracted negotiations over the thresholds for risk retention (which the European Parliament had sought to raise), the final agreement preserves the existing risk retention rules (subject to subsequent Level 2 work from the EBA setting out the details of risk retention methods).

The final criteria for STS transactions are largely in line with much of the work done by the EBA and others before the publication of the Commission's legislative proposal, and the CRR was amended to provide capital relief to banks for STS securitisation positions. Other pieces of legislation, such as the MMFR (see [page 4](#)), provide non-capital incentives to invest in STS securitisation. The amendment to Solvency II (see [page 8](#)) giving insurers clarity on risk weights is expected to be adopted in the first half of 2018 – however, it is unclear on how STS will fit in with (or potentially replace) the existing Type 1 or Type 2 classifications for securitisations.

The new Regulation will provide more legal certainty for investors (as risk retention and disclosure obligations will be direct requirements on EU issuers), and the ability to delegate the risk retention verification and due diligence requirements to asset managers may be attractive to some

asset owners who had previously been discouraged by the compliance burden of investing in securitisations.

Despite being compliant with local risk-retention regimes, there have been limited non-EU securitisations that are compliant with the EU rules. As the final regulation did not provide a third country equivalence regime, as the market currently stands, the end result will be to restrict the investable universe of securitisations for European investors and funds to largely EU-only deals.

Key features of the STS Securitisation Regulation:

- Original CRD risk retention requirements have been preserved, subject to Level II rulemaking from the EBA.
- Risk retention and disclosure obligations are direct requirements on EU issuers, rather than a due diligence requirement for investors.
- CRR has been amended to provide capital relief for bank's positions in STS securitisations. Similar amendments to Solvency II for insurers are expected in 2018.

Shareholder Rights Directive

IMPACT	Pension funds, insurance companies, listed companies, and asset managers
APR 2014	European Commission proposal published.
DEC 2016	Political agreement between the European Parliament, Members States, and European Commission on the Directive.
MAY 2017	Shareholder Rights Directive published in the Official Journal of the EU.
JUN 2019	Deadline for EU Member States to transpose the Directive into national law.

Under the Shareholder Rights Directive (SRD), institutional investors (such as insurers and pension funds) and asset managers will be required to provide greater transparency on their shareholder engagement policy, on how they engage with companies they or their clients invest in, and on their equity investment strategy. The aim is to incentivise a long-term approach and improve corporate governance across Europe.

The legislative text, to take effect in June 2019, requires institutional investors and asset managers to disclose a detailed shareholder engagement policy (on a 'comply or explain' basis), including voting records and voting rationale for the most significant votes. This disclosure should provide relevant and meaningful information that enables the public to understand how institutional investors and asset managers fulfil their shareholder duties.

The SRD requires institutional investors to publicise how their equity investment strategy is consistent with their long-term profile and liabilities. They will also have to disclose

elements of their arrangements with asset managers (both segregated mandates and collective investment vehicles) showing that they encourage managers to be long-term themselves. The challenge for institutional investors will be, we believe, to provide a clear picture of their overall equity investment strategy to the public (e.g., through method and time horizon of the manager’s performance).

The SRD introduces measures to align executive pay with the long-term business strategy and interests of the company. Blackrock supports the measures. Too great a focus on pay may divert shareholder and company attention away from a wider range of governance issues (such as board governance, climate risk disclosure, corporate strategy and human capital), which are critical to sustainable business performance.

Finally, the Directive provides EU companies with the right to have their shareholders who hold more than 0.5% of shares or voting rights identified. Intermediaries, (mostly custodians and Central Securities Depositories), are required to communicate details of shareholder identities without delay.

Key features of the Shareholder Rights Directive

- Disclosure of the shareholder engagement policy, including voting records and voting rationale, by institutional investors and asset managers.
- Publication of how equity investment strategies are consistent with long-term profile and liabilities by institutional investors.
- Measures to align executive pay with long-term business strategy.
- Identity of shareholders with more than 0.5% of shares or voting rights to be given to companies.

Solvency II

IMPACT	European non-life insurance, life insurance, and reinsurance companies.
JAN 2016	Solvency II entered into force.
APR 2016	Risk weights for infrastructure recalibrated.
SEP 2017	Risk weights for investment in infrastructure corporates recalibrated.
Q2 2018	Revision of risk weights to incorporate STS Securitisation framework expected.
H2 2018	Revision of risk weights for investment in private equity expected.

Solvency II, which came into force in January 2016, reviewed the prudential regime for insurance and reinsurance undertakings in the EU. It sets the valuation basis for liabilities and determines the amount of capital that insurers and reinsurers will have to hold against various market and non-market risks.

Developing an efficient investment strategy under Solvency II is an important consideration for many insurers. The proposed capital requirements for many traditional asset classes have now been stable for some time, but certain asset classes have been subject to further calibration – particularly infrastructure and securitisation, which are central to the CMU.

One of the contentious areas of Solvency II has been the capital treatment for investment in infrastructure debt and infrastructure corporates, which were perceived as too high by many market participants, potentially discouraging insurance companies from investing in such long term investments. A first relief occurred in 2016 with the Commission’s decision to reduce capital requirements for investment in infrastructure projects, and in 2017, the EU institutions adopted a relief in the Solvency II capital requirements for “qualifying infrastructure corporates” for bonds and equities. Another incentive being introduced is the treatment of infrastructure projects and infrastructure corporates to allow investments to be structured at group level. These decisions have an impact on how insurers perceive the asset class and its relative value for their portfolios. More favourable capital treatment makes them more attractive, although this is not the sole determinant of the decision by asset owners to invest in them.

Key features of Solvency II

- An insurance company may conduct its activities throughout the EU after having obtained an authorisation from the supervisor of one Member State.
- Insurance companies must hold capital in relation to their risk profiles, to guarantee that they have sufficient financial resources to withstand financial difficulties.
- Insurance companies must comply with capital requirements:
 - The minimum capital requirement is the minimum level of capital below which policyholders would be exposed to a high level of risk.
 - The solvency capital requirement is the capital that an insurance company needs in cases where significant losses must be absorbed.
- Insurance companies must put in place an adequate and transparent governance system with a clear allocation of responsibilities. They must have the administrative capacity to cope with a variety of potential issues, including risk management regulatory compliance, and internal audit.
- Insurance companies must conduct their Own Risk and Solvency Assessment (ORSA) on a regular basis. This involves assessing their solvency needs in relation to their risk profiles, as well as the financial resources required.

European Fund for Strategic Investments '2.0' and the European Long-Term Investment Fund

IMPACT	Retail and institutional investors, pension funds, insurance companies and asset managers
DEC 2015	ELTIF Regulation fully applicable.
JUN 2015	EFSI 1.0 active – initially for a three year period until 2018.
SEP 2016	Commission proposal for EFSI 2.0 published.
OCT 2017	Political agreement on extending EFSI – renewal until 2020.
JUL 2018	EFSI 2.0 extended capacity becomes available.

Inclusive growth, job creation, and enhanced competitiveness remain high priorities for the European Commission. Initiatives aimed at boosting investments to the 'real economy' (see [page 9](#)) include the European Long-Term Investment Fund (ELTIF) and the European Fund for Strategic Investments (EFSI).

The ELTIF is a type of Alternative Investment Fund (AIF) investing in infrastructure projects, unlisted companies, listed SMEs, debt issuances, and real assets, and comes with a marketing passport to both institutional and retail investors enabling it to attract investments throughout the EU. ELTIFs could be attractive to high net worth individuals and smaller institutional investors who do not have specialised teams covering the underlying investments. No special tax regime is provided for ELTIFs, and in our view resolving existing issues of tax on cross-border investment in private assets arising from BEPS and ATAD (see [page 24](#)) will be critical to the success of the fund.

We are aware of four ELTIFs that have been established since 2016. The Commission will review the ELTIF regime by June 2019. As with most new fund structures, it will take some years for managers and investors to become familiar with the structure, and to determine whether it is a success.

Meanwhile the EFSI, managed by the European Investment Bank (EIB), at its inception aimed to mobilise €315 bn of investment to fund EU infrastructure and SMEs, by providing a first loss guarantee using €21 bn of Commission and EIB capital. Three years later, EFSI has facilitated €264 bn (84% of the original target), and is active in 26 Member States, with SMEs in particular benefitting from funding. Its investment horizon has been extended until 2020 and financing target raised to €500 bn. The EU budget guarantee has been increased by €10bn to €26bn and the contribution of the EIB to €7.5bn (from €5bn).

EFSI '2.0' reinforces its focus on sustainable projects, creating a minimum quota of 40% of projects it funds to have components contributing to EU's climate goals, in line with the COP21 goals.

IFRS 9 and IFRS 17

International Financial Reporting Standard 9 (IFRS 9)

brings together the classification and measurement of impairment and hedge accounting to replace International Accounting Standard 39 (IAS 39). It applies to all companies listed on a regulated European market as of 1 January 2018. Insurance companies have the option of deferring implementation until 1 January 2021.

All equity investments in scope of IFRS 9 are measured at fair value in the profit and loss account, except for equity investments where the entity has decided to record present value changes in other comprehensive income – if the criteria to do so are met.

The new classification criteria for debt instruments are based on the entity's model for managing their financial assets and the contractual cash flow characteristics of the financial instruments they hold. Investors, particularly in investment funds, are likely to see more volatility in profit and loss accounts relative to IAS 39.

The new impairment model requires companies to recognise expected credit losses based on changes in the credit risk of financial assets they hold. Where the credit quality of financial instruments has not deteriorated significantly, IFRS 9 allows for recognition of 12-month expected credit losses (that is, credit losses expected over the subsequent 12 months) in the entity's accounts. Where there has been a significant deterioration in credit quality, or where assets become impaired, IFRS 9 requires that lifetime credit losses (that is, credit losses expected over the lifetime of the asset) are recognised in the accounts.

Changing the treatment of credit instruments from a 12-month to a lifetime basis could generate more volatility the profit and loss account. As a result, we expect investors to give more attention to the credit quality of debt instruments, so as to avoid the need to change the expected credit losses from 12-month to a lifetime basis.

IFRS 17, the International Financial Reporting Standards for insurance contracts, are due to be implemented on 1 January 2021. The new Standards will greatly impact insurers and the way investment analysts compare profitability among them. BlackRock published a [ViewPoint](#) to outline the key aspects and potential benefits of IFRS 17 for insurers, the likely impact of the new standard from an analyst and investor perspective, as well as possible unintended consequences and ways in which these can be minimised.

We welcome the EFSI's success in channelling investment, particularly to SMEs. However, it is critical that EFSI retains a strong focus on not crowding out private sector investment for otherwise viable projects with attractive investment premiums. The renewed focus on greater geographical distribution of funding in less developed regions and general focus on local presence of the European Investment Advisory Hub is welcome, but should not take place at the expense of the principles of 'additionality' or quality of the projects. We also support the set-up of the European Investment Project Portal (EIPP), providing a clearer pipeline for infrastructure and view this as a desire to address issues experienced by market participants. The EIB has a major role to play in ensuring that consistent high levels of project level transparency are provided by all EU Member States.

The critical question for EFSI and potential investors is: "Will there be users ready to pay to use the infrastructure envisaged in the first place?" We support the Commission's proposal to detail why each project was chosen, and the criteria it meets. Transparency around granting a project the EU guarantee, its 'additionality' or the EU added value of a particular operation would be welcomed by investors who are making investment allocation decisions, as such publications would bring about greater confidence.

Key Features of ELTIF and EFSI '2.0':

- ELTIF is a closed-ended investment fund vehicle investing in infrastructure projects, unlisted companies or listed SMEs, and real assets.
- EFSI provides guarantees to private sector funding for infrastructure and SMEs.
- EFSI '2.0' sets a 40% quota for sustainable projects funded by EFSI, in line with the EU's climate targets and COP21 goals.
- EFSI's financing capability is accompanied by the pillars of the Advisory Hub and the Project Portal.

Cross-Border Distribution

IMPACT	Asset managers; retail and institutional investors
JUN 2016	European Commission consultation on cross-border distribution of funds published.
JUN 2017	CMU Mid-term review published, with cross-border distribution of UCITS and AIFs as priority action.
MAR 2018	European Commission published proposals for targeted reviews to UCITS and AIFMD distribution and marketing frameworks.

In December 2015, the European Commission published a Green Paper on retail financial services for consultation, aiming to assess how the European market for retail

financial services – namely insurance, loans, payments, current and savings accounts, and other retail investments – can be further opened up.

The European Commission issued further proposals in March 2018 to encourage the increased cross-border distribution of investment funds by reducing many of the existing administrative barriers that inhibit the development of scale operators. The objective is to bring better results for consumers and firms, while maintaining investor protection. In practical terms, the measures focus on:

- Removing the obligation to appoint a local paying or facilities agent, allowing firms to rely more on the Internet to meet consumer queries about key features of products.
- Further streamlining the process for cross-border notification and payment of regulatory fees.
- Providing a more consistent approach to de-registration of individual funds.
- Encouraging more consistency and transparency of marketing standards in different Member States, including a more standardised regime for pre-marketing of AIFs.

While the proposals are not intended to change the fundamental structure of distribution in individual EU member states, we believe they will bring many operational benefits, reducing the costs to managers and investors of operating on a cross-border basis.

Key features of the European Commission's Green Paper on retail financial services:

The Green Paper sought to identify barriers consumers face in making full use of the single market, and aimed to make it easier for:

- Companies based in one Member State to offer financial services in another.
- Consumers to be able to buy retail financial services offered in other Member States.
- Citizens to be able to take financial services with them when moving from one Member State to another.

Market Structure and Liquidity

MiFID II: Research

IMPACT	Asset managers, research providers, retail and institutional investors
APR 2016	Delegated Act on investment research published.
JAN 2018	MiFID II took effect.

The Markets in Financial Instruments Directive II (MiFID II) makes significant changes to how the asset management

Sustainable Finance – Growing Europe’s Sustainable Markets

The Paris Agreement on Climate Change of December 2015 has refocused policymaker’s attention on sustainable finance and the role financial institutions could play in efforts to fight climate change. In December 2016, the European Commission set up a High Level Expert Group (HLEG), made up of various stakeholder groups (pension funds, insurers, asset managers, stock exchanges, consultancies, NGOs, and academics), to provide policy recommendations on how to better integrate long-term and Environmental, Social, and Governance (ESG) considerations in the EU’s financial legislative framework.

In January 2018, the HLEG published its final report, making over 50 recommendations, from legal clarification on investor’s duties to embrace ESG factors and long termism, to developing a EU taxonomy on what constitutes ‘green’ or ‘sustainable’, and developing a pan-EU retail strategy on sustainable finance.

In March 2018, the Commission published an Action Plan on ‘financing sustainable growth’, building on the HLEG’s final report. Some of the key proposals included in the action plan are:

Developing a united EU classification system for sustainable activities: a legislative proposal in Q2 2018 on the development of an EU taxonomy for climate change, and environmentally and socially sustainable activities. The Commission is creating a technical expert group on sustainable finance to feed into this work.

Clarifying institutional investor and asset managers’ duties: a legislative proposal in Q2 2018 to explicitly require these investors to integrate sustainability considerations in the investment decision-making process, and increase transparency on how they integrate such factors into their investment decisions – in particular those concerning exposure to sustainability risks.

Promoting greater incorporation of sustainability in financial advice: amending the MiFID II and IDD rules in Q2 2018 to ensure that investor sustainability preferences are taken into account in the suitability assessments. ESMA will include provisions on the suitability assessment when it publishes its updated guidelines in Q4 2018.

Incorporating sustainability in prudential requirements: working towards including climate risks in institution’s risk management policies, and reviewing the calibration of bank’s capital requirements to take into account climate-related risks.

BlackRock believes sustainability is a driver of long-term value in companies and in the economy. Sustainability issues have increasing importance in investment processes – this could be expressed through specific asset allocation decisions, integration of material ESG factors in the analysis, and increased dialogue on ESG matters with companies.

We strongly support policy frameworks that support the goal of growing assets dedicated to sustainable investing. To achieve this objective, we recommend focusing on four sets of incentives:

1. Encourage asset owners to increase allocations to sustainable investments.

EU policymakers could further explore whether there are regulatory changes that would be appropriate for certain types of sustainable investments. Any reconsideration of capital rules would need to be measured and appropriate, so as to not encourage undue risk taking and achieve prudential aims.

2. Encourage disclosure of material information on sustainability by companies, and recognise a set of standards that can apply broadly and consistently.

Sustainability issues have material impacts on long-term financial performance. The take-up of these considerations in investment or risk management processes is hampered by the lack of clear, consistent standards for companies to report material ESG data. The Non-Financial Reporting Directive, implemented since 2018, is a clear step in the right direction. In the upcoming review of the Directive, the EU could encourage companies to provide clear and consistent data on material sustainability issues relevant to their long-term strategy, and to contribute to greater standardisation of reporting frameworks.

3. Increase the number of sustainable offerings in the marketplace.

A pan-European and commonly-agreed taxonomy can potentially provide a broader range of asset owners and asset managers the confidence and certainty to invest in and offer (respectively) ‘sustainable’ products.

4. Embrace corporate governance and stewardship standards.

Shareholder engagement is a key mechanism for asset managers and asset owners to encourage companies to adopt ESG practices and sustainability factors relevant to their businesses. Adding to national best practices of ‘stewardship disclosures’ can complement the Shareholder Rights Directive requirements and overall contribute to shareholder promotion of long-term business value creation.

BlackRock published a number of reports and white papers related to sustainable finance. For further detailed analysis, see our [response](#) to the European Commission’s consultation on investors’ duty regarding sustainability, our [response](#) to HLEG’s interim questionnaire, our [ViewPoint](#): “Exploring ESG: A Practitioner’s Perspective”, and BlackRock Investment Institute’s [Global Insights](#) paper: “Adapting portfolios to climate change”.

Insolvency and Non-Performing Loans

One policy debate at the crossroads of discussions around the Banking Union and the Capital Markets Union is the issue of how best to address the persistently high levels of NPLs on bank balance sheets in a number of EU countries.

The high volumes of NPLs throughout Europe (standing at over €1 trillion as of Q3 2017)⁴ have complicated discussions about risk mutualisation in the context of completing the EU Banking Union. A programme of 'risk reduction' of the EU banking system has been the political quid pro quo for some Member States to agree to proceed with funding common deposit protection and a backstop to the Single Resolution Mechanism.

Much of the risk reduction measures will be enacted via further reforms to the EU's capital and prudential framework for banks, but an important, and separate, strand revolves around plans to reduce the volume of outstanding NPLs in many EU countries. Alongside specific prudential measures and supervisory initiatives asking banks to come up with NPL management plans, the European Commission is aiming to leverage their work on the Capital Markets Union to help build a more robust secondary market for NPLs, to aid banks to more easily dispose of parts of their existing stock of bad loans.

The suite of measures due in the spring of 2018 seek to create a more efficient pan-EU market for distressed debt; with greater price discovery, more asset servicing capabilities, and greater harmonisation of insolvency law proceedings that can aid recovery of value in debt restructurings or foreclosures. The legislative package also foresees the introduction of a minimum level of provisioning for newly originated non-performing exposures.

industry consumes and pays for investment research.

'Research' includes:

- Access to expertise and bespoke requests: providing access to subject matter experts and requesting bespoke work from these experts.
- Written research: on macro, thematic and company specific analysis.
- Models and data: providing models of companies and analysis of data on specific sectors or industries.

Historically, most asset managers have paid for research – which is often provided by 'sell-side' investment banks and trade execution venues – through the dealing commission that these firms charge when executing trades. This

commission was then included in the dealing costs taken from client accounts.

MiFID II requires the cost of research to be unbundled from the cost of trading, in order to improve transparency for clients of asset managers' use and payment for external research. This is a further step towards breaking the link between the amount paid for external research and the volume or value of trading activity.

The options for research payments available under MiFID II are:

- Asset managers absorb the cost of external research by paying for it directly from their own resources.
- Continue to charge clients for the consumption of external research through a charge collected alongside trading but ring-fencing the money within a new Research Payment Account.

MiFID II created potential issues in consistency of global standards: while the legislation is European, the requirements relating to research apply to any funds or clients whose portfolios are managed or sub-delegated by or to European-based MiFID-regulated managers, regardless of whether the client is based in Europe. The concern was that firms operating in the US (where cash payments from a Research Payment Account would not be acceptable to most broker-dealers) would cause regulatory conflict. This has now been resolved temporarily by a no-action letter issued by the SEC in October 2017, allowing cash payments to be made from MiFID-regulated firms to U.S. broker-dealers for a period of 30 months.

The asset management industry has responded to the new requirements in a variety of ways, with some firms opting to continue to charge clients directly for research, some continuing to charge but re-assessing their fee structure, and others opting to absorb the cost themselves.

From January 2018, when MiFID II began to take effect, the costs of external research consumed by BlackRock on behalf of MiFID-impacted funds and client accounts are being paid by BlackRock, resulting in a decrease in trading costs for these portfolios.

MiFID II does not change our investment approach, and we will continue to leverage external research that adds value for our clients.

BlackRock's primary focus in our approach to investment management is to source the best ideas and research both internally and externally. We are disciplined in our consumption of external research in line with set budgets, and have significant internal research capabilities.

Key Features of MiFID II research requirements:

- Charges for investment research unbundled from costs for trading volumes.
- Asset managers to pay for research from either their own resources, or charge clients via a ring-fenced 'Research Payment Account'.
- Payments for research to be made from separate budgets, made clear to the clients ex-ante, if clients are being charged.

MiFID II: Market Structure and Reporting

IMPACT	All participants in European markets
2016-17	Finalisation of technical standards and legislation transposed into EU Member States' national law.
JAN 2018	MiFID II took effect.

MiFID II and MiFIR update the existing market structure regulatory regime in Europe, and introduce pre- and post-trade transparency requirements for 'equity-like' instruments (i.e. Exchange Traded Funds [ETFs]) and 'non-equity' instruments (fixed income, structured finance products and derivatives).

The new transparency regime is tailored to the instruments in question. Unlike equities, the 'non-equity' space is extremely diverse, typically fragmented and inventory-based, with low or dispersed liquidity (particularly in secondary market trading of corporate bonds), so it is particularly important that the regime applying to fixed income recognises the liquidity profile of the underlying instrument. MiFID II / MiFIR is an unprecedented attempt by regulators to simultaneously implement pre- and post-trade regulation in securities markets. We made recommendations to minimise the impact of these requirements on investors, companies and overall market efficiency. The final rules took a different approach to classifying thresholds with the result that the thresholds are now more bespoke to the type of instrument, and are regularly updated to capture market changes. This has alleviated some of the potential risks in terms of market impact and liquidity to, for example, trading in bonds of a certain size.

The full implications of MiFID II / MiFIR on the market ecosystem remain to be seen. Indeed, a number of requirements, for example futures transparency, have not

taken effect at this time. It will take time for trading venues to modify their business models and trading algorithms, and for new market participants to emerge. Likewise, many of the transparency requirements will be phased in over an extended period of time, with the full impact is still to be felt, but at the time of writing the regime that is in place does not appear to have materially impacted liquidity in a negative way.

It was expected that MiFID II / MiFIR would deliver the long-awaited pan-European consolidated tape (trade reporting) for equity and 'equity-like' instruments such as ETFs, as well as fixed income. The consolidated tape is intended to offer the most current information available and be accessible on a 'reasonable commercial basis', with prices disclosed throughout the trading day. We support this consolidated view of liquidity, which will facilitate more informed price discovery and could lead to increased liquidity across European markets. Further, this will help investors gain a more complete picture of an equity and 'equity-like' instrument's liquidity across venues. We are concerned, however, that a definitive pan-European consolidated tape may not be forthcoming through market forces, as foreseen by MiFID. This being the case, we would recommend that a single tape provider is mandated whether that is a private solution following competitive tender of commercial providers or more formally under the auspices of ESMA.

Although it is too early to fully assess the impact of MiFID II / MiFIR, and important gaps in the regime remain, we expect MiFID to embed a wholesale shift to electronic and automated trading solutions, and increase trading on lit venues. BlackRock has been a long standing advocate of electronic trading. We commend the efforts to improve transparency and best execution for end-investors, and look forward to participating as the dialogue evolves on how to improve on these measures.

Key features of MiFID II market structure and reporting requirements:

- Existing pre- and post-trade transparency requirements for equities expanded to equity-like and non-equity financial instruments.
- Transparency requirements tailored to the characteristics of the instrument in question.
- Implementation of a number of key provisions, including futures transparency requirements, have been delayed.

The Next Generation Bond Market

Coming up to almost 10 years since the 2008 global financial crisis, we continue to see evidence that fixed income markets are going through significant structural changes. These changes are forcing investors to adapt to a new market paradigm that will challenge not only how they trade fixed income, but what types of product they use to build portfolios and manage risk. Today we can already draw on evidence of how fixed income markets have evolved through three interconnected themes:

1. The rise of a modern, networked bond market

- The traditional principal-based fixed income market is transforming into a hybrid principal-agency market.
- Driving this change is the entrance of new market participants and the emergence of all-to-all trading technologies that offer an alternative means to trade bonds, moving from bilateral and voice-driven, to multi-dimensional and electronic.
- The transition to a hybrid model is a challenge for investors, but may result in a more connected, diverse, and modern bond market with more trading participants.

2. Liquidity needs to be re-examined

- Post-crisis challenges have forced traditional bond dealers to fundamentally rethink their business models.
- Broker-dealer inventories have fallen, however at the same time the size of the investment grade corporate bond market has tripled over the past decade to around US \$7.5 trillion in debt outstanding.⁵
- Inventories have recovered somewhat recently, but relying solely on the old model will likely not suffice. Investors need to think about how best to access liquidity across products and asset classes, using a broader, more robust suite of liquidity measures and exposure vehicles.
- Not all investors have the same liquidity needs and the degree of liquidity required in part dictates the type of instrument employed for portfolio construction.

3. Index-based products are central to portfolio construction and risk management

- Today, the changing market structure means that building fixed income portfolios solely with individual securities can be increasingly costly and less efficient than in the past, leading investors to employ a range of instruments.
- Post-crisis, demand for transparent, standardised, and bundled fixed income exposure has prompted the growth of index-based products such as credit default index swaps (CDX), total return swaps (TRS) and bond ETFs. These products are fulfilling investor needs for building blocks to construct portfolios and manage risk more efficiently.
- Bond ETFs in particular have proven to be a valuable solution in meeting these needs. In the last five years, assets have grown by 25% per year while trading volume has more than doubled. Bond ETFs are on pace to be a US \$1.5 trillion market by 2022.⁶

We are pleased to see several of the above dynamics being identified by the recent publication of the European Commission Expert's Group report on developing corporate bond markets in the context of Capital Markets Union.

In addition to the above global trends we believe it is important to evaluate European fixed income market liquidity in the context of European market structure, to appreciate what is driving innovation and change on the ground.

Indeed, now that MiFID II / MiFIR have begun to take effect, we would recommend monitoring the impact on market liquidity to inform any future revisions to the framework.

For further detailed analysis, please see our [ViewPoint](#): "Addressing Market Liquidity: A Broader Perspective on Today's Euro Corporate Bond Market" and our [whitepaper](#): "The next generation bond market".

Benchmark Regulation

IMPACT	Benchmark providers and submitters. Limited impact on the users of benchmarks
APR 2013	IOSCO Principles for Financial Benchmarks published.
JUN 2016	EU Benchmarks Regulation published in the Official Journal and EU critical benchmark regime took effect.
JAN 2018	All other provisions of EU Benchmarks Regulation took effect.

The role benchmarks play in the pricing of many financial instruments makes protecting them against the risk of manipulation vital. Broad in scope, the Benchmarks Regulation (BMR) captures all financial benchmarks and market indices. Its requirements apply to administrators, submitters and users of critical benchmarks (such as interest rate benchmarks that have demonstrated obvious weaknesses like LIBOR and EURIBOR), right through to indices used by UCITS funds and alternative investment funds.

While supporting the policy intent of ensuring the integrity of benchmarks, we have maintained that a qualitative risk-based approach should be at the heart of BMR. We do not see justification to include all indices and benchmarks in the same regulatory regime. Proportionality is key, and this principle should continue to be honoured in ongoing detailed rule making by ESMA. In addition, it would be disproportionate for BMR to capture benchmarks used by third country alternative investment funds (with third country alternative investment fund managers) that are mainly targeted at non-European investors with a smaller European investor base.

For non-critical benchmarks, such as market indices, we have suggested a proportionate focus on providers, rather than individual benchmarks. It will be challenging to identify each benchmark, let alone authorise and regulate the estimated one million plus indices and benchmarks that are currently used in Europe.

In our view, the global IOSCO Principles for Financial Benchmarks should be the basis by which the non-critical benchmarks could be deemed equivalent with other jurisdictions.⁷ It appears unlikely that jurisdictions other than the EU will introduce comparable legislation to regulate all indices and benchmarks and to similar levels of intensity, so given the global nature of the benchmark and index industry, we are vigilant as to any barriers to entry into the European market created as a result of BMR.

LIBOR Reform

The UK Financial Conduct Authority's July 2017 announcement that it would no longer compel panel banks to make submissions to LIBOR⁸ signalled that the availability of LIBOR is not guaranteed after 2021. To date, regulators have focused on raising awareness of the issue, prompting cross-industry and regulatory discussions over appropriate Alternative Reference Rates (ARRs). We welcome the awareness raised and the important work being done on identifying and transitioning to suitable ARRs.

However, more work is needed. Our principal concern is the management of the significant volume of legacy positions and contracts that reference LIBOR-based benchmarks. A number of industry and official sector working groups have developed to review the potential transition issues associated with global benchmark reform, but discussions are still in very early stages.

BlackRock is committed to improving awareness of the issues surrounding the LIBOR transition, and making sure the investor voice is heard. We are actively monitoring liquidity conditions and making plans to incorporate alternative benchmarks into our risk management systems.

Key features of the Benchmark Regulation:

- Benchmark administrators are subject to new requirements over the governance and control of benchmark administration and compilation, and the quality of input data and methodologies.
- Requirements to ensure contributors to benchmarks provide accurate data and are subject to adequate controls.

Regulation of Exchange Traded Funds

Index investing has been transformational in providing low cost access to diversified investments for all investors, from institutions to individuals. It has profoundly changed the way investors seek returns, manage risk, and build portfolios. While the benefits are widely recognised, the increasing adoption of index investing has also attracted much commentary.

In May 2017, the Central Bank of Ireland (CBI) published a Discussion Paper indicative of the wider interest in the global policy community, seeking views on the features, operation, and regulation of ETFs. For more detailed analysis, see our [response](#) to the discussion paper.

In early 2018, equity market volatility increased calls from commentators and ETF issuers, including BlackRock, for a classification system that clearly distinguishes plain vanilla Exchange-Traded Funds from other more specialised types of Exchange-Traded Products, which may behave differently in stressed markets. For further details on our suggested classification, see our [ViewPoint](#): "A Primer on ETF Primary Trading and the Role of Authorized Participants".

Clearing

EMIR REFIT

IMPACT	Investors using derivatives, pension funds
MAY 2017	European Commission published a proposal for targeted review of EMIR.
DEC 2017	European Council adopted its negotiating position.
Q2 2018	European Parliament expected to agree its stance – trilogue negotiations start.

The European Market Infrastructure Regulation (EMIR) is a centrepiece of the legislation introduced in the wake of the 2008 global financial crisis to make financial markets safer and more stable. Specifically, EMIR aims to reduce risks to the financial system arising from derivatives transactions by increasing the transparency of the over-the-counter (OTC) derivatives market. The Regulation also strives to mitigate the counterparty credit risk and reduce the operational risk

associated with OTC derivatives. The European Commission has carried out an extensive assessment of EMIR to ensure that EU legislation is working effectively, efficiently, and at minimum cost, as required by the Regulation and as part of the Commission's Regulatory Fitness and Performance programme (REFIT) of 2016.

BlackRock supports a number of the key proposals set out in the EMIR REFIT, where they address issues of systemic resilience, data quality, and the costs of clearing. Specifically, we welcome the amendments relating to:

- **Clearing:** particularly those that seek to clarify that segregated omnibus and individual accounts should be insolventy remote in the event of Central Clearing Counterparties (CCPs) or Clearing Member default, and those that seek to make the EMIR requirements more proportionate - such as the removal of the frontloading requirement.
- **Reporting:** such as the clarification that it is the AIF or UCITS manager that must fulfil the reporting obligation for its funds; the introduction of single-sided reporting for Exchange Traded Derivatives (ETDs); the removal of the back loading requirement; and that non-financial counterparties' intra-group transactions will be exempted from the reporting obligation.
- **Data quality:** through a focus on data reconciliation and the scope for ESMA to impose higher fines on trade repositories, and access to data for non-EU regulators.
- **The cost of clearing:** by Clearing Members being required to offer clearing services under Fair, Reasonable, and Non-Discriminatory commercial terms. However, a balance must be found in the Level 2 rulemaking to ensure that Clearing Members will continue to provide services, thereby avoiding concentration of risk in a smaller number of counterparties.

From the perspective of the end-investor, we have made recommendations to policy makers to focus on the following issues within the context of the EMIR REFIT:

- **Reporting:** extend the move to single sided reporting across the EMIR regime to facilitate comparability and global alignment.
- **Scoping issues:** clarify the intention behind broadening the scope of financial counterparty to include all AIFs irrespective of domicile; assess unintended and materially adverse consequences of including securitisations.
- **Capital charges:** align capital charges related to clearing to incentivise additional clearing participants, liquidity, and netting efficiencies.
- **Alignment of UCITS with EMIR:** amend UCITS to take into account the clearing obligation for certain types of OTC financial derivative transaction under EMIR.

A general approach on file is expected in the course of 2018.

Key aims of the EMIR REFIT proposal

- Address disproportionate compliance costs for some entities as a result of reporting requirements.
- Address concerns around transparency, as well as the quality and usability of trade repositories' data.
- Address concerns around insufficient access to clearing, particularly for non-core market participants including some CCPs and non-financial counterparties.

Supervisory Arrangements for CCPs – 'EMIR 2.0'

IMPACT	Third-country CCPs and their users; investors using Euros.
JUN 2017	European Commission published its proposal on oversight of third-country CCPs and Euro-denominated clearing activities.
2018	European Parliament and Council to continue negotiations towards respective stances – linked to parallel Brexit and ESA Review negotiations.

A new proposal from the European Commission sets out to ensure further supervisory convergence and accelerate certain procedures regarding CCPs. The proposal also ensures closer cooperation between supervisory authorities and central banks responsible for EU currencies. Most controversially, the proposal introduces a new 'two-tier' system for classifying third-country CCPs. Non-systemically important CCPs will continue to be able to operate under the existing EMIR equivalence framework. However, systemically important CCPs (so-called Tier 2 CCPs) will be subject to stricter requirements (see key features below).

Depending on the significance of the third-country CCP's activities for the EU and Member States' financial stability, a limited number of CCPs may be of such systemic importance that the requirements are deemed insufficient to mitigate the potential risks. In such instances, the European Commission, upon request by ESMA and in agreement with the relevant central bank, can decide that a CCP will only be able to provide services in the Union if it establishes itself in the EU, thereby introducing the possibility of a location policy for derivatives and swaps denominated in Euro.

BlackRock fully supports efforts to ensure effective supervision of critical financial market infrastructures and of close cooperation between supervisory authorities for the benefit of global financial stability, irrespective of the political context that frames the EMIR 2.0 proposal. We furthermore support the Commission's view that the current supervisory arrangements for CCPs clearing significant volumes of Euro transactions outside the Eurozone or EU27 might benefit from being revised and enhanced in light of Brexit. This would be especially important for systemically significant services.

However, the fundamental advantages of an efficient, open, multi-currency clearing environment for the global OTC derivatives markets, which benefits the wider European economy and supports the Euro's status as the second most traded currency in the world, should not be compromised by a de facto location policy. The market has expressed very real concerns, supported by data, in respect of the impact of a location policy on financial stability, liquidity, the cost of trading, and counterparty concentration risk, which could be detrimental to end-investors. In our view, the economic and regulatory rationale for restricting clearing of Euro-denominated derivatives transactions to the Eurozone has yet to be convincingly made.

Key features of the European Commission's proposal for third-country CCPs:

- Compliance with the necessary prudential requirements for EU-based CCPs while taking into account third-country rules.
- Confirmation from the relevant EU central banks that the CCP complies with any additional requirements set by those central banks (e.g. the availability or type of collateral held in a CCP, segregation requirements, liquidity arrangements, etc.).
- Agreement of CCPs to provide ESMA with all relevant information and to enable on-site inspections, as well as the necessary safeguards confirming that such arrangements are valid in the third country.

CCP Resilience, Recovery, and Resolution

IMPACT	Investors using derivatives, whether for hedging or taking a market view.
NOV 2016	European Commission CCP Recovery and Resolution legislative proposal published.
JUL 2017	Final CPMI-IOSCO guidance on CCP Resilience, Recovery, and Resolution (RRR) published.

Clearing derivatives through a central infrastructure concentrates counterparty risk in a single CCP, which is required by law for certain products and instruments by EMIR. Central clearing also brings the benefits of greater transparency for regulators and helps to strengthen oversight of derivatives markets. End-investors are required to use CCPs, and often there is little choice of CCP for a given product. The resilience of CCPs is therefore of great importance, to limit the extent to which end-investor monies are exposed in the event that a CCP needs to be recovered or resolved. We recommend a focus on the three R's: Resilience, Recovery and Resolution.

Resilience: In our view, policy makers should seek to reinforce CCP resilience through incentives, such as

requiring CCP owners to retain a risk-based 'skin in the game' (capital) stake in protecting deposited client assets, and enhancing stress testing and disclosures to participants in clearing other than the Clearing Members.

Recovery: End-investors using CCPs, such as pension funds and insurance companies, deposit money in good faith. Undermining that trust by hair cutting Initial Margin (IM) and / or Variation Margin (VM) in recovering or resolving a CCP in difficulty will erode investor confidence in clearing, and could have pro-cyclical systemic effects. IM haircutting should not be an option, and VM haircutting considered only as a recovery tool of last resort, subject to strict conditions for eventually recovering the haircutted funds to users. BlackRock has engaged to bring the end-investor perspective to the table in respect of protecting margin in the ongoing negotiations on the EU's CCP Recovery and Resolution Regulation.

Resolution: Maintaining a CCP at all costs is not always in the best interests of the financial system. If a CCP has exhausted its default waterfall it should be required to implement a resolution plan quickly, focusing on a rapid and complete wind down of positions, along with a timely and orderly return of margin. An uncapped liability by market users towards a failing CCP will undermine investor confidence in clearing and lead to suboptimal investment and could ultimately become an additional source of volatility.

Distribution and Value for Money

MiFID II and the Insurance Distribution Directive

IMPACT	Retail investors and institutional investors, distributors, wealth managers and asset managers.
JUL 2017	ESMA final report on Product Governance published.
DEC 2017	IDD technical standards on Product Governance and Investment Products approved – publication expected in Q1 2018
JAN 2018	MiFID II took effect.
OCT 2018	IDD rules begin to apply.

MiFID II aims to enhance investor protection in distribution channels for the sale of financial products through upgrades to client servicing models, increased transparency, and product governance.

Key to enhancing the investor's experience are changes to suitability rules. These include requirements to ensure that point of sale assessments are regularly updated, to ensure distributors maintain an accurate picture of both the client's

risk profile and investment portfolio. We believe that justifying the relative cost and complexity of products in the client's portfolio and understanding the relevant target market for specific products will lead to improved risk profiling. The recently finalised target market rules from MiFID, and guidance from ESMA, will lead to greater exchange of data between manufacturers and distributors.

Product manufacturers will need to provide more data on how their products are designed to perform and build more holistic product development and governance processes drawing on a greater understanding of end investors' needs. Distributors will need to provide data on whether products have been sold as intended. This has resulted in the welcome development of a number of industry templates to facilitate the flow of information.

MiFID II will encourage greater alignment of interests between investors and managers or advisors, firstly, by preventing the retention of commission by independent advisers and discretionary portfolio managers, and secondly, by requiring that commissions paid to non-independent advisers or execution-only platforms are designed to enhance the quality of the service to the client. Commission and other payments must not prevent a firm from acting fairly and professionally in the best interest of its clients (see [page 19](#)).

The new requirements have brought into focus the importance of clarity of target market and so-called 'clean' commission free share classes where varying local distribution requirements are emerging.

There is, nevertheless, a risk (as seen in the UK Retail Distribution Review) that the cumulative effect of the additional obligations under MiFID II price out mass retail investors from accessible advice, creating an advice gap. Regulators and industry are actively considering how the mass market will access financial advice in the future, especially through the use of technology such as automated advice (see [page 20](#)).

The Insurance Distribution Directive (IDD) is similar in scope to MiFID II but applies to the distribution of insurance products and its go-live date is due to be delayed until October 2018. While the IDD has similar requirements on assessing the target market of products and cost disclosure as MiFID II, it stops short of prohibiting the retention of commissions. Rather it includes requirements that payment of commissions should not be to the detriment of the policyholder.

Key features of the MiFID II distribution requirements:

Investor protection

- Target market analysis for product sales.
- Revised suitability and appropriateness regime especially for 'complex' products. Enhanced focus on the relative

cost and complexity of products and greater focus on the ongoing suitability of products.

- Ban on retention of inducements by independent advisers and discretionary portfolio managers.
- Quality enhancement required for non-independent advisers and execution only platforms to retain commission.

Cost disclosures

- Transparency to the client on the total cost of investing, including total costs charged by the MiFID firm for services such as advice or management, and the costs charged by the products in which the client is invested.

Product governance

- Product manufacturers are required to enhance their processes and build greater connectivity with intermediaries especially in respect of the target market for their products.

Costs and Performance

IMPACT	Individual and institutional investors including pension funds, product manufacturers, advisers, consultants, and distributors
JAN 2018	MiFID II and PRIIPs took effect.
MAR 2018	European Commission published proposals for targeted reviews to UCITS and AIFMD distribution and marketing frameworks.
Q4 2018	First ESMA report on costs and past performances of retail products expected.

Improving the transparency of costs and charges for investment products continues to be a priority for EU and UK regulators. BlackRock welcomes these efforts, and we have developed a robust methodology to provide a detailed breakdown of costs and charges to meet the new requirements of MiFID II and Packaged Retail and Insurance-based Investment Products (PRIIPs).

While costs and charges need to be taken into account in any investment decision, they are one element in determining the value for money an investor receives, alongside aspects such as investment strategy and style, risk profile, performance and service.

The costs and charges shown under both PRIIPs and MiFID II fall into two categories: charges which are paid to the manager or to other service providers, such as platforms, as part of managing and administering the fund; and transaction costs, which reflect the market costs of dealing in the underlying securities in the portfolio, but which do not go to the manager.

Transaction costs are not a new cost but are already taken into account when valuing the portfolio's assets and are automatically included within the reported net performance of a fund.

A Patchwork of National Retail Distribution Reviews to Implement MiFID II

EARLY MOVERS



Netherlands

A ban on payment of commission for mortgage credit, income insurance, unit-linked insurance, annuities, and non-life insurance took effect in January 2013. An inducement ban in respect of investment services to retail came into force on 1 January 2014. The Dutch regulator is also closely monitoring the use of fund of fund products to ensure managers include an appropriate range of third party funds.



United Kingdom

The Retail Distribution Review (RDR), implemented in 2013, included higher standards of qualification for advisers and a ban on commissions between product providers and fund distributors on new business, forcing advisers to adopt fee-based models. As of January 2018, the ban has been extended to discretionary portfolio managers.

FOCUS ON PROMOTING INDEPENDENT ADVISERS



Belgium

Unlikely to move beyond MiFID II. Key focus remains on banning unsuitable products and ensuring distributors apply more stringent suitability tests



Denmark

Having reviewed the impact of RDR in the UK and Netherlands, as well as deliberations in Sweden, Denmark also decided in 2016 not to introduce general a ban on retrocessions ahead of MiFID II. Instead, the regulator brought in a number of key specific elements of MiFID II - such as the ban on the retention of commission by discretionary portfolio managers and independent financial advisers, - into effect 6 months ahead of the official go live date.



France

France supports a ban on commissions for discretionary portfolio management and has for many years banned commission payments to managers of funds of funds. As the market is dominated by the sale of unit-linked life products, arguably the greatest impact will only be felt following full implementation of the IDD. The French regulator is also following the development of independent digital advice as a way of encouraging greater competition in the market.



Germany

The Facilitation and Regulation of Fee-based Investment Advice Act (August 2014) introduced a legal framework for fee-based investment advice in financial instruments that can be offered by investment services enterprises. The Regulation introduced 'fee-based investment advice', where remuneration is paid by the client, as a distinct category to commission-based investment advice based on the disclosure of any commissions received by advisers from issuers of financial instruments or intermediaries. However, German market regulators have expressed the idea that if commission-based investment advice can still be provided under certain conditions after the implementation of MiFID II, commissions may not be collected for the benefit of the firm, without further specifying the possible consequences of this apparent doctrine change. To this end, German implementation of MiFID II proposes an additional ground for quality enhancement, namely the provision of advice through a branch network in regional areas. Smaller entities advising on a limited product range will remain exempt from the full scope of MiFID II but subject to regulation by regional chambers of commerce.



Italy

The Italian market has moved to a dual system of fee-based and commission-based advisers. A ban on discretionary managed fund platforms receiving commission has been in place since the introduction of MiFID I. Otherwise Italy is not expected to move beyond MiFID II.

BEYOND THE EU



Switzerland

The Federal Financial Services Act (FIDLEG) is intended as Switzerland's equivalent of MiFID II. Although designed to improve consumer protection through a much tighter distribution regime, this does not include a ban on commissions for investment advisers. The law is expected to come into force in 2019 at the earliest. Moves towards fee-based advice in the wealth sector are driven more by commercial than regulatory pressures.

Within PRIIPs, the transaction costs figure includes two aspects – explicit costs and implicit costs. Explicit costs cover aspects such as brokerage costs and taxes on transactions, such as UK stamp duty. Implicit costs are designed to give an indication of quality of execution and include the difference between the price of the asset at the

point at which the manager decided to deal and the price at which the transaction actually took place ('slippage') – so it includes market movement.

The regimes may be slightly different, and so the numbers may differ, depending on whether the manager is reporting in accordance with PRIIPs or MiFID II (or indeed in line with a domestic regime).

Automated Investment Advice

Technology can democratise access to financial services, including investment products, particularly where market gaps exist. Automated investment advice can be transformational for individual investors, allowing them to gain confidence when making investment decisions and access to professional help.

Automated advisors incorporate web and model based technology into their investment processes – primarily through the use of algorithms designed to optimise various elements of wealth management such as asset allocation, product selection, and trade execution. As savers grapple with global and geopolitical uncertainty, prolonged low and negative interest rates, and longer lifespans, the need for cost-effective investment advice has never been greater.

Regulators such as the UK Financial Conduct Authority (FCA) are increasingly looking at the recent growth of automated advice as a valuable means to promote competition and improve the affordability and accessibility of advice. The FCA's Advice Unit, for example, has been partnering with start-ups and established players by providing feedback to firms developing automated models and industry guidance based on its own experiences.⁹ The FCA sees potential for efficiencies and risk-reduction from well-made automated models, while acknowledging that automated investment advice brings its own regulatory risks and challenges.

Rules and regulatory outcomes are neutral to the distribution channel. MiFID II emphasised the fact that use of electronic systems would not diminish firms' responsibilities to their clients to provide investment products that are suitable and meet clients' needs. In July 2017, ESMA issued a consultation paper on certain aspects of these suitability requirements under MiFID II. The purpose of the consultation paper was to enhance clarity and foster convergence in the implementation of certain aspects of the new MiFID II suitability requirements taking into consideration the increased use of automated advice tools.

Firms providing automated investment advice are subject to the same framework of regulation and supervision as

traditional advisors. It is important to ensure that consistent regulatory outcomes are achieved while allowing for differences based on the specific risks and features of digital distribution channels and automated tools. Regulatory guidance should continue to focus on the following core factors:

- **Know your customer and suitability:** Suitability requirements across the globe require advisors to make suitable investment recommendations to clients based on their knowledge of the clients' circumstances and objectives. These rules apply equally to automated advice, though the means of assessing suitability will continue to evolve alongside digital technologies.
- **Algorithm design and oversight:** Advisors should ensure that investment professionals with sufficient expertise are closely involved in the development and ongoing oversight of algorithms and establish appropriate measures to prevent and detect flaws. Algorithm assumptions should be based on generally accepted investment theories. Any use of third party algorithms should entail robust vendor due diligence before the algorithms used and a strong monitoring framework.
- **Disclosure standards and cost transparency:** Disclosure is central to ensuring that clients understand what services they are receiving as well as the risks and potential conflicts involved. Like traditional advisors, firms providing automated investment advice should clearly disclose costs, fees, and other forms of compensation prior to the provision of services. They should similarly disclose relevant technological, operational, and market risks, and provide a description of key algorithm assumptions and limitations in a plain language form.
- **Cybersecurity and data protection:** Data protection should be at the heart of the provision of automated advice. Firms should conduct vendor risk management, obtain cybersecurity insurance, and implement incident management frameworks, including understanding and complying with the evolving regulatory requirements in the relevant jurisdictions.

For more details, see our [ViewPoint](#): "Digital Investment Advice: RoboAdvisors Come of Age".

BlackRock is well positioned to respond to the evolving regulatory landscape, as we have been incorporating transaction cost analysis into our portfolio management strategies for over ten years. Our priority when managing portfolios is to meet our clients' investment objectives, and we believe that net performance remains the best like-for-like comparator of products.

Our approach to transaction costs typically does not include the bid-ask spread that arises from buying or selling units in a fund. Indeed many funds operate an anti-dilution mechanism that protects existing investors from costs incurred by other investors buying or selling units.

Investors are likely to be more concerned with the net performance they receive after fees, expenses, and taxes. Transaction costs are important because they impact net performance. As noted above, these costs can be either explicit, with easily accessible data that can be used to report to investors; or implicit, where managers have developed different methodologies and estimates to account for these costs.

We therefore welcome the overall legislative aim of developing a standardised and meaningful approach to reporting on costs and charges, particularly transaction costs. Correctly designed, this will help investors to compare the relative charges, costs, and performance of competing investment products and investment services such as investment advice and discretionary management. The ability under recent regulations to use a number of different methodologies for the calculation of transaction costs by different providers makes it difficult to compare transaction costs without understanding the specific method used by a particular manager.

Until a harmonised approach emerges, we encourage investors to consider both net performance and costs and charges together to evaluate whether they are commensurate with the investment strategy required to meet the investment objective, whether the fund has delivered the expected net performance, and what effect the costs and charges may have had on net performance.

Retirement

Reforming Retirement Systems in Europe

Several Member States pressed ahead in 2017 with efforts to reduce dependence on state retirement provision, by making workplace and private regimes more attractive. Developing personal engagement with retirement planning remains an ongoing challenge, but work continues to reduce barriers to long term saving and investing.



FRANCE

French pension reform was a major plank of President Macron's election campaign. The French pensions system for both public sector and private sector employees is effectively an unfunded Defined Benefit pay as you go system (système de répartition) with a strong element of intergenerational risk transference.

Due to increases in longevity and unemployment in recent decades the system has been running a structural deficit which successive Governments have been trying to fix by:

- Increasing contributions periods (up to 42 years).
- Spreading out the benefit calculation period (average of 25 years highest pay for benefit calculation).
- The creation of the French Retirement Reserve fund – designed to finance the gap between contributions and liabilities in the system.

Economically the system is dependent on maintaining the balance of employed workers compared to retired workers. Contributions are based on percentage of wages and benefits paid out are linked to inflation, so the system is also dependent on wages growing faster than prices and continued productivity growth to drive wage growth and reduce structural unemployment.

2018 will see the establishment of a Commission to determine the detailed framework of the reform. At this stage the key elements of the reforms include:

- Consolidation of the various existing pension regimes into a single model so that each euro contributed gives rise to the same level of benefits.
- Changes to the nature of the system by transforming it into an unfunded pay as you go Defined Contribution (DC) system with the level of retirement income payouts automatically adjusting in accordance with longevity and the structural deficit in the system. The government is proposing to do this by converting existing accrued benefits into a points based system. On retirement the level of points would give rise to a notional capital account which would be divided by the average remaining life expectancy for someone at that age.

The potential benefit of the reform along this line is to bring in a system which automatically rebalances with longevity and the level of contributions being made into the system by future generations.

The reforms also come with a major push on engagement with citizens, with calls for an easy to use 'pensions dashboard' allowing people to see their notional entitlement and project what sort of pension income this will bring them.



GERMANY

In 2017 retirement was high on the policy agenda, with two key measures set to reform workplace pensions.

Legislation approved by the Bundestag in June, and effective as of January 2018, reforms the existing occupational retirement framework, introducing a mechanism for auto-enrolment into occupational pension schemes, and introducing a framework for DC schemes without guarantees. The introduction of auto-enrolment as voluntary at the firm level (for review in 2023), rather than the phased but mandatory approach seen in the UK, may prove to be a missed opportunity to increase workplace pension coverage now. The requirement that DC schemes be collectively negotiated by the social partners should not be allowed to form a barrier to firms who are not members of such trade bodies to offer DC schemes.

Legislation on flexibility came into force in July 2017. We welcome the introduction of flexibility around the transition from employment to retirement, reflecting more diverse careers and individual needs. We welcome measures that support those who want to work beyond the statutory retirement age to do so. This new flexibility is just as important as the retirement age increasing. Many individuals in Germany and beyond will need to work past the current statutory retirement age in order to maintain their standard of living in old age.

For more detailed analysis, see our [ViewPoint](#): “Planning for retirement: Long-term savings and investment in Germany”. Also available in [German](#).



ITALY

The 2017 budget included new measures to enable some limited categories of workers to retire at 63, although the overall statutory retirement age is increasing to 67 by 2019. Following years of reforms, most pension funds – except legacy plans – are DC. Despite the roll back of state provision, participation in workplace schemes is still low, however auto-enrolment in some sector-specific schemes may help increase this.



SWITZERLAND

A package of pension reforms known as ‘AV2020’, aimed at improving the sustainability of state and occupational pensions, was passed through the national parliament in May 2017; the package proposed three notable reforms to AHV (Alters-und Hinterlassenenversicherung, the state pension) and BVG (Berufliche Vorsorge, occupational pensions):

- Firstly, ‘flexible retirement’, equalising retirement age at 65 for both men and women by 2021, allowing individuals to bring forward or postpone retirement between ages 62 and 70, with adjustments made to benefits made accordingly.
- Secondly, a reduction of the conversion (annuity) rate for BVG from 6.8% to 6% over the course of four years.
- Thirdly, an increase in to AHV financing via an increase in VAT. Finally, the package proposed a reduction in the minimum income threshold for obligatory BVG contributions.

A number of these reforms proved unpopular, and the package was rejected at a public vote in September 2017. This topic remains a priority for Swiss policymakers, and we expect continued debate and amendments to the proposal in the future.



UNITED KINGDOM

Since 2012, employers in the UK have been required to automatically enroll their employees into a pension scheme, unless the employee actively opts out. This ‘nudge’ increased the number of workers enrolled in workplace pension schemes by nearly 6.9 million in 2016 and is expected to rise above 10 million by 2020.¹⁰ Since then, we have seen a number of other reforms to savings and retirement; in 2015, the requirement to annuitise pensions at retirement was removed, and in 2017, the Government introduced the ‘Lifetime ISA’, a tax-free savings product aimed at incentivising long-term savings through Government top-ups. However, low levels of contributions remain the single most important barrier to delivering successful retirement outcomes.

In our [ViewPoint](#): “Planning for retirement: Long-term savings and investment in the UK”, we discuss some of the barriers individuals face to saving more, and make recommendations for how the Government could tackle the issues, including ‘auto-escalation’ of contributions rates to 15%.

The Pan-European Personal Pension

IMPACT	Individuals looking for a personal pension, insurance companies, asset managers, and other pension providers
JUL 2016	European Insurance and Occupational Pensions Authority published advice for the Commission on potential for an EU internal market for personal pensions.
JUN 2017	European Commission published a proposal for a Pan-European Personal Pension product.
Q3 2018	European Parliament expected to adopt its negotiating position.
Q4 2018	Earliest possible start for trilogue negotiations – pending agreement on Member States' position

With pension products providing an important link between long-term savings and investments, the European Commission has made proposals for a Pan-European Personal Pension (PEPP) product that could play a role in both encouraging EU citizens to save adequately for retirement, and channel those savings into the economy, via companies and projects that deliver a return for the saver.

The PEPP aims to offer a standardised personal pension, with a specific authorisation regime for PEPP managers, common rules on product design as well as rules on selling practices to ensure the product meets the best interests of customers. This is intended to complement, rather than replace, national schemes at state level ('Pillar 1') as well as workplace schemes ('Pillar 2').

We believe that the PEPP as a 'Pillar 3' product regime with a number of standardised features could be beneficial in addressing the retirement income gap increasingly faced by European citizens.

The European Commission's June 2017 proposals on the PEPP, published in the form of a draft regulation, included the following 'building blocks':

- **Default investment option:** including an element of capital protection which would allow savers to recoup all of the capital invested. Ongoing discussions may lead to a widening out of the default option to include lifestyling with risk mitigation techniques.
- **Tax treatment:** the regulation suggests that the PEPP should be given the same tax treatment as personal pension products do in each Member State. This proposal has proved politically divisive.
- **Distribution:** rules would combine elements of the MiFID, PRIIPs, and IDD frameworks, and information would be provided electronically and free of charge. PEPPs would have a PRIIPs-like Key Information Document, and a benefit statement in line with the Institutions for Occupational Retirement Provision (IORP) Directive.

- **Portability and switching:** portability is a key element of the proposal, and allows savers to continue contributing to a different 'compartment' of their PEPP if they move between member states. Switches would be limited to once every five years.
- **Decumulation:** decisions such as retirement age and minimum period savers should be invested in a PEPP before decumulation are left at the discretion of Member States. The proposals would give PEPP savers the choice between annuities, lump sums, and drawdown as a means of accessing their savings.
- **Approval process:** EIOPA will authorise PEPP providers to manufacture and distribute the products throughout all Member States.

We support the Commission's proposals on portability and switching for the PEPP. Portability is indeed a crucial feature to ensure EU citizens save for their retirement, and while it is important that savers should be able to switch in order to move to a more competitive provider or consolidate their savings, switching should not be so frequent as to inhibit investments in longer-term assets.

We welcome the recommendation that the PEPP should receive the most favourable tax treatment available under national rules. This will be an important factor for potential PEPP providers before they start to invest in developing PEPPs, and we are keen to see greater clarification as to how and by which Member States this will be applied.

We welcome ongoing discussions to allow the provider's default option to provide lifestyling as an alternative to capital guarantees. Guarantees can be expensive to provide and may lead to sub-optimal long term investment allocation decisions. While many consumers may want the security of a guaranteed return of capital contributions, we believe that many others will benefit in the long term to greater exposure to markets.

For more details, see a [paper](#) co-authored by BlackRock and Irish Funds: "The Pan European Personal Pension Product (PEPP): A golden opportunity to bridge the pensions gap."

Key features of the European Commission's proposal for a Pan-European Personal Pension product:

- A high degree of standardisation, in order to set a high minimum standard for product quality and governance.
- Penalties for premature draw down of capital accumulated, to encourage long-term saving.
- A stand-alone authorisation regime for providers, unless already licensed under Solvency II, CRD IV, IORPD and / or MiFID II.

- A Product Passport based on a system of co-operation between competent authorities to allow for easy marketing in host Member States.
- Investment rules regarding quality, liquidity (as necessary given the long-term investment profile to be expected), return and diversification (including pooling of risk).
- PEPPs should be suitable to be marketed using modern technologies, and sold via the internet.
- The product characteristics and disclosures should be simple enough that limited or no advice is required.

Taxation

This ViewPoint series has, over the years, consistently covered taxation impacting Europe’s end-investors. Traditionally, and according to the Treaty on the Functioning of the EU, tax legislation has a ‘special status’ in EU policymaking. Collecting tax and combating tax fraud and evasion remain national competences. As movements of people and capital are becoming more globalised, the EU is looking more and more at effectively handling tax-related cross-border issues, such as tax evasion, tax avoidance, and the effective functioning of the tax system. The high level of tax-related activities by the EU continues, for example as the European Commission looks at an approach to the taxation of the digital economy.

BEPS and ATAD

IMPACT	Investors in cross-border pooled funds investing in private assets
OCT 2015	Final Organisation for Economic Cooperation and Development (OECD) BEPS package published (Actions 1 to 15).
JUL 2016	EU Anti-Tax Avoidance Directive (ATAD) published in the EU Official Journal.
JUN 2017	Additional EU rules on hybrid mismatches (ATAD2) published in the EU Official Journal – application staged until Dec 2022.
MAR 2018	Member States agree to EU rules on mandatory disclosure for potentially aggressive tax planning.
JAN 2019	Deadline for Member States to bring their national frameworks in line with the majority of ATAD provisions – with the exception of exit taxation (Jan 2020) and interest deduction measures (Jan 2024).

The Base Erosion Profit Shifting (BEPS) initiative of the OECD seeks to curb double non-taxation by multinational corporations. In the EU, the European Commission published the Anti-Tax Avoidance Directive (ATAD) as its means of implementing BEPS. We support the goal of addressing excessive tax planning. However, the final

OECD proposals of October 2015 inadvertently impact cross-border funds investing in private assets, and ATAD does not provide a safe haven for investors in such funds.

The unintended consequences of BEPS could result in the risk of double taxation for cross-border investment via funds – typically ‘alternative’ funds investing in SMEs, infrastructure, real estate, and renewable energy. If the principle of tax neutrality between investing directly or via funds is undermined through an additional tax burden, investments channelled by these vehicles into companies and projects will be reduced.

In our view, this will deter investment, with Europe particularly impacted, given the highly integrated cross-border nature of the Single Market. A path has not emerged in the OECD or in the EU to address this. We urge Member States to request that the Commission propose a comprehensive European fund framework linked to a taxation regime that enables funds to continue to invest in assets such as infrastructure and SMEs cross-border, and delivers a balanced and principled outcome to both investors and tax authorities.

Solutions are possible, and we must explore them to avoid a negative impact on European growth and diminishing the success of initiatives such as the ELTIF, EFSI, and the CMU.

Key features of BEPS:

- BEPS consists of 15 work streams (‘Actions’) to equip governments with the domestic and international instruments needed to implement BEPS.
- Action 15 (multilateral instrument) is the only outstanding work stream.
- The Action most relevant to mainstream funds is Action 6 (treaty relief).
- Alternative funds may additionally be impacted by Action 2 (hybrid mismatches), Action 4 (interest deductions), and Action 7 (permanent establishment).

Financial Transaction Tax

IMPACT	All asset owners investing in funds impacted by FTT
FEB 2013	European Commission published a proposal for an FTT under the enhanced cooperation procedure.
2017	Momentum slowed down among the 10 pro-FTT EU Member States. Discussions in halt.
2018	Possible revival of negotiations.

The initial policy objectives behind a pan-EU Financial Transaction Tax (FTT) were to ensure that financial

institutions make a fair and substantial contribution to covering the costs of the 2008 Global Financial Crisis and to disincentivise transactions that do not enhance the efficiency of financial markets. Almost a decade after the Crisis, an EU FTT is still on the table between the 10 Member States still in favour of creating an FTT zone.

Political agreement has been elusive due to a lack of agreement on various issues of scope and implementation. Although agreement on a compromise package deal at political level had seemed possible by end of 2016, several deadlines for political agreements have been missed. In addition, concerns expressed by some smaller Member States have caused doubts about the viability of the FTT project. Work is still needed at technical level, and discussions are now set to resume.

BlackRock is opposed to any financial transaction tax as it will impact the end-investor as well as financial institutions. The extent to which end-investors will be impacted will depend on the final form of the FTT. A common agreement on the final shape of the FTT has not been reached yet and there is still no clarity 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.

As it stands, 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.

Key features of the FTT proposal:

- The 10 pro-FTT Member States are: Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain.
- 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).
- 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).
- All securities are in scope on each leg of a transaction: Equities and bonds are chargeable at 10 bps; Derivatives are chargeable at 1bps, but corresponding physical hedges, collateral movements carry the full 10 bps charge.
- No relief for the intermediaries involved in the transaction chain.
- France and Italy implemented a domestic FTT in 2013. The pan-EU FTT will supersede national FTTs, once implemented.

For more information

For access to our full collection of public policy commentaries, including the *ViewPoint* series and comment letters to regulators, please visit www.blackrock.com/corporate/insights/public-policy/viewpoints-letters-consultations

ANNEX - The European System of Financial Supervision

The European System of Financial Supervision (ESFS), is a decentralised, multi-layered system of micro- and macro-prudential authorities established by the European institutions in order to deliver consistent and coherent financial supervision in the EU.

The main objective of the ESFS is to ensure that the rules applicable to the financial sector are adequately implemented in order to preserve financial stability and to promote confidence in the financial system as a whole, and provide sufficient protection for consumers.

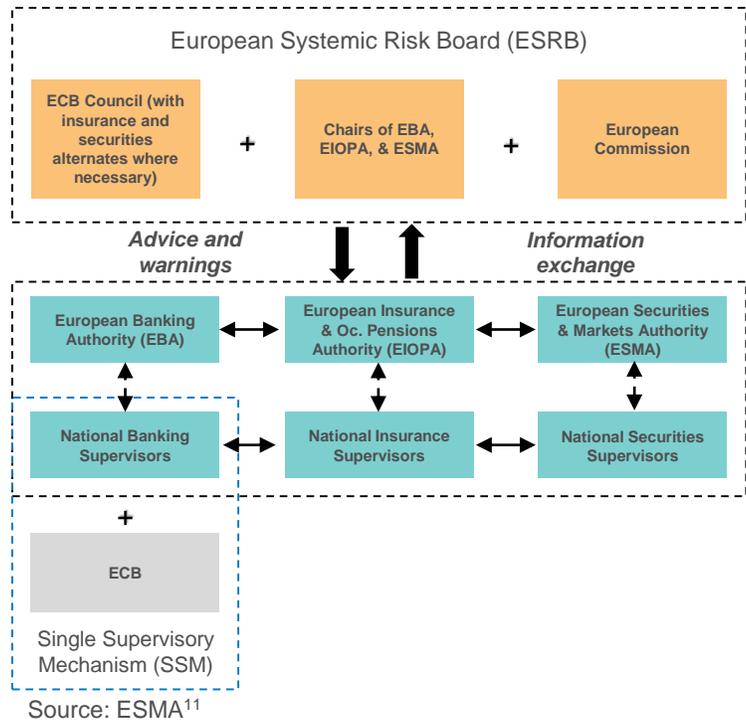
This system consists of:

- The three European Supervisory Authorities (ESAs):
 - The European Securities and Markets Authority (ESMA), based in Paris.
 - The European Banking Authority (EBA), currently based in London but moving to Paris after the UK's withdrawal from the EU.
 - The European Insurance and Occupational Pensions Authority (EIOPA), based in Frankfurt.
- The European Systemic Risk Board (ESRB), based in Frankfurt
- The Joint Committee of the ESAs.
- The national competent or supervisory authorities (NCAs) of each Member State.

While national supervisory authorities remain in charge of supervising individual financial institutions, the objective of the ESAs is to improve the functioning of the internal market by ensuring appropriate, efficient, and harmonised European regulation, through the development of a common rule book, and supervision through the use of supervisory convergence.

Along with the two other European Supervisory Authorities, EBA and EIOPA, ESMA forms part of the Joint Committee which works to ensure cross-sectoral consistency and joint positions in the area of supervision of financial conglomerates and on other cross-sectoral issues.

The ESRB carries out macro-prudential oversight of financial markets at the European level. Its objective is to prevent and mitigate systemic financial stability risk in the European Union in the light of macro-economic developments. The ESRB carries out a range of tasks including the collection and analysis of relevant information, risk identification and prioritisation, issuing warnings and recommendations and monitoring their follow-up, and providing assessments to the Council on the existence of any emergency situations that may arise. It also cooperates with other members of the ESFS and coordinates actions with other international financial organisations such as the International Monetary Fund (IMF) and the Financial Stability Board (FSB).



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