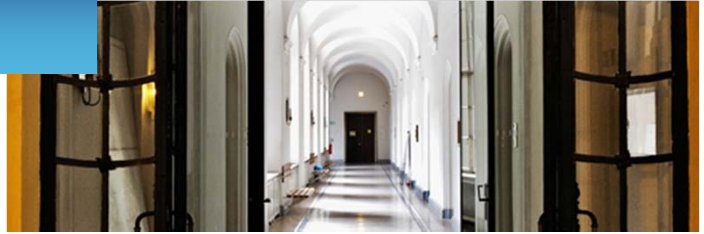


## Regulatory Developments in Europe: An Overview and Analysis



In the aftermath of the financial crisis of 2008-2009, the European asset management industry is facing an unprecedented wave of new legislation enacted at both the European and national levels, with a number of US legislative initiatives also set to impact the European financial industry in relatively short turn. In a 2 June 2010 communication, the European Commission<sup>1</sup> set out a detailed plan to complete the EU's financial reform, outlining more than 20 initiatives to be reflected in new or updated directives, regulations and recommendations.

The Commission expects to introduce the remaining proposals early this year, for decision by the Council of the European Union<sup>2</sup> and European Parliament<sup>3</sup>, and has stated that the joint goal of the European institutions should be to reach political agreement on the full reform by the end of 2011.

This ViewPoint reviews key regulatory developments affecting the European financial sector, the markets, businesses and investors. We also consider the implications - including opportunities - that could arise from the new legislation. Please

refer to the Appendices for further context on the European Union, its evolution, and regulatory framework to date.

As one of the world's leading providers of investment, advisory and risk management solutions, BlackRock is supportive of appropriate regulatory reform that addresses the causes of systemic risk and has the potential to bring about positive change for investors. We are concerned about inconsistencies between the below mentioned directives and the cumulative consequence of those directives on the end investor.

### Overview and Analysis of European Financial Reform

In the following pages, we take a closer look at the regulatory measures currently on the table and offer our analysis of the implications. For ease of reference, and in keeping with the summary table on pages 1-2, the reform measures are categorized as follows: Fund Issues, Securities and Infrastructure Issues, Prudential Issues, Taxation Issues and Other Issues. Notably, the regulatory developments are not limited to the EU, as a number of national jurisdictions have recently implemented initiatives that will affect financial services businesses on a cross-border basis. These include the UK's Bribery Act and the US Foreign Account Tax Compliance Act (FATCA).

**1 European Commission:** The executive arm of the European Union responsible for proposing legislation, implementing decisions, upholding the Union's Treaties and the day-to-day running of the Union. *See more in Appendix B.*

**2 Council of the European Union:** The institution in the legislature of the EU representing the governments of the member states and acting as co-legislator with the European Parliament on financial services issues. *See more in Appendix B.*

**3 European Parliament:** The directly elected parliamentary institution of the EU representing the citizens of Europe and co-legislator with the Council on financial services issues. *See more in Appendix B.*

#### Reform Measures at a Glance

Initiative	Current Status	Expected Implementation
<b>FUNDS ISSUES</b>		
Undertakings for Collective Investment in Transferable Securities (UCITS) IV	Level 1 and Level 2 measures enacted.	Awaiting national implementation for transposition date of 1 July 2011.
UK Retail Distribution Review (RDR)	Most rules published. Final rules on platforms expected early 2011 following November 2010 consultation	1 January 2013
Alternative Investment Fund Managers Directive (AIFMD)	Approved by European Parliament & European Council in November 2010. Level 2 measures to be defined in 2011.	Likely transposition by mid-2013.
Investor Compensation Schemes Directive (ICSD)	European Commission published Proposal for a Directive in July 2010. Ongoing negotiations in the European Council and in the European Parliament on a position.	Undecided
UCITS V Depositary liability and remuneration	Commission Consultation published December 2010	Undecided
Packaged Retail Investment Products (PRIPs)	Commission consultation published November 2010. Legislative proposals (investor information) expected by mid-2011 alongside related conduct of business proposals (delivered through MiFID and IMD) around the same time.	Undecided; will be subject to the full Lamfalussy process.

*The opinions expressed are as of February 2011 and may change as subsequent conditions vary.*

**Reform Measures at a Glance (continued)**

Initiative	Current Status	Expected Implementation
<b>SECURITIES AND INFRASTRUCTURE ISSUES</b>		
European Market Infrastructure Regulation (EMIR)	Commission Proposal for a Regulation published in September 2010. Ongoing negotiations in Council and in the European Parliament to reach political agreement.	Application likely by year-end 2012.
Short Selling	Commission Proposal for a Regulation published in September 2010. Ongoing negotiations in Council and in the European Parliament to reach political agreement.	Application likely by year-end 2012.
Markets in Financial Instruments Directive (MiFID)	Commission Consultation published December 2010. Legislative proposals expected by mid-2011.	Undecided
<b>PRUDENTIAL ISSUES</b>		
Corporate Governance	Commission Proposal for a Directive on Financial Institutions expected mid-2011 Commission to release a general Corporate Governance Green Paper in April 2011.	Undecided
Basel III/ Capital Requirements Directive (CRD) IV	Commission CRD IV Proposal for a Directive largely based on Basel III is expected by mid-2011	Implementation will be staggered from 2013 onward depending on the section of the proposal that applies.
<b>TAXATION ISSUES</b>		
US Foreign Account Tax Compliance Act (FATCA)	FATCA has been passed. Further IRS guidance expected in Q1/Q2 2011.	1 January 2013
<b>OTHER ISSUES</b>		
UK Bribery Act	Royal Assent in 2010. Further Ministry of Justice guidance outstanding.	Expected implementation in 2011.
Pensions	Commission consultative Green Paper published in 2010. Review of Institutions for Occupational Retirement Provision Directive (IORPD) scheduled for 2011	Undecided

**Fund Issues****Undertakings for Collective Investment in Transferable Securities (UCITS IV)**

The latest update of the UCITS directive, finalised in 2009, must be implemented in each EU member state by 1 July 2011. UCITS IV is focused on implementation measures.

The 27 member states of the EU are Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

The directive seeks to address administrative shortcomings in the operation of the existing legislation and to increase the "international competitiveness" of the UCITS regime. The most immediate impact of the legislation is the requirement for UCITS managers to produce a Key Investor Information Document

(KIID), which will replace the existing simplified prospectus. The KIID identifies the key elements of a fund, helping investors to understand the nature and the risks of a fund and to make more informed investment decisions. All KIIDs must be updated at least annually (for example, at calendar year-end), allowing for easy comparability across different fund ranges. The requirement to produce performance and risk information for all share classes of a fund will mean that large multi-class umbrella funds will produce thousands of KIIDs. Fund managers and their distribution partners must establish the most effective way of locating and providing the correct KIID to the end investor.

UCITS IV aims to encourage the pooling of assets by providing an effective cross-border regime for merging UCITS, which has not always been available in the past. In addition, "master/feeder" UCITS will be permitted for the first time. This structure would allow a domestic UCITS to feed into a cross-border UCITS master fund that can be centrally managed. This may be advantageous for distributors wishing to create an overlay for a specific market or sector for an existing master fund. It may also encourage cross-border pooling of assets.

In the future, UCITS management companies will be subject to MiFID-style rules of business conduct. In some jurisdictions, such as the UK, the changes will be of low impact, as MiFiD

requirements have already been applied to management companies for some years. For other jurisdictions, such as Luxembourg, this represents a change to existing requirements.

Finally, the registration procedure for the cross-border UCITS passport has been simplified and timelines shortened. In the future, the regulator of the EU member state where the fund is set up (the “home state regulator”) will provide a single centre for all registration and product changes. The home state regulator will be responsible for notifying regulators in all other EU jurisdictions, where the fund wishes to be registered, of ongoing product changes.

### UK Retail Distribution Review (RDR)

Retail Distribution Review (RDR) was launched in June 2006 to address the persistent problems the UK Financial Services Authority (FSA) observed in the regulation of the retail investment market. The FSA initiated the Retail Distribution Review to address insufficient consumer confidence and protection in the retail market. The RDR represents a fundamental change to the UK distribution market. Final rules are expected in early 2011, with implementation to occur by the end of 2012. RDR covers the sale of all products to UK investors and, as such, its impact is not limited to UK products, but extends, for example, to EU funds registered for sale into the UK or sold by non-UK distributors with operations in the UK.

The basic premise is to remove the perceived commission bias for retail products sold by financial advisers by prohibiting product providers from paying rebates, commissions and other types of inducements to these intermediaries. Instead, any such remuneration will be agreed upon directly between the end investor and the financial adviser. However, this does not mean that commission payments have been removed in their entirety, as they are still permitted for “execution only” services and institutional investors, such as insurance companies or other fund managers, even where they are made in respect of underlying retail products such as unit-linked life insurance. The FSA’s aim under RDR is to: “Establish a new level of consumer confidence and trust” through enhancing the professionalism of advisers and transparency of charges (through banning payments from asset managers to distributors i.e. commissions).

A variety of practical challenges face product providers and intermediaries in adapting their business models to accommodate the new regime. The inability of product providers to rebate, defer or offset product charges to intermediaries on new business may lead to the establishment of additional share classes in order to deliver funds at “factory gate pricing.” However, transitional provisions mean that product providers will have to support a dual model, with commission payments under legacy arrangements on one hand and no commissions for new business on the other. The recent FSA consultation on platforms indicates that product providers will still be able to remunerate platforms for the aggregation services they provide. Such services, however, must be justified and payments must not include any element of commission.

An additional, and significant, challenge relates to the legacy business written before the end of 2012, where commission can continue to be paid. A number of areas under the regime remain unclear, such as how redemption switches are to be managed between old and new model arrangements.

It is clear that the changes will have a profound impact on investment advisers and the type of services provided and intermediaries active in the UK will need to rebuild the intermediary sales process, especially in light of additional adviser qualification requirements.

Once final rules are in place, product providers and intermediaries will have to renegotiate their future contractual and dealing relationships. This will require significant engagement and planning between product providers, intermediaries and platform providers if end investors are not to suffer from increased costs and reduced choice. The UK initiative is being closely followed by other European regulators with many of the RDR’s recommendations reflected in the European Commission’s consultation on MiFID.

### Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) seeks to harmonize the regulation of the alternative investment management industry in the EU. The Directive focuses on regulating of the management and administration of Alternative Investment Funds (AIFs), not the funds themselves. The AIFMD was approved by the European Parliament on 11 November 2010 and by the European Council on 17 November 2010, ending more than 18 months of intense debate over the future regulation of Alternative Investment Funds (AIFs) in the EU. The European Commission and the new European Securities and Markets Authority (ESMA) will specify wide-ranging implementing measures and technical binding standards during 2011 and 2012.

The range of AIFs falling within the scope of the AIFMD is broad. An AIF is defined as any non-UCITS fund, whether domiciled inside or outside the EU, managed by an Alternative Investment Fund Manager (AIFM), whether established inside or outside the EU, if that AIFM is marketed into the EU. Only funds managed by a non-EU AIFM and not marketed into the EU are excluded. It covers not only hedge funds, but also private equity funds, real estate funds, commodity funds, ETFs and a range of institutional and retail non-UCITS funds, including UK charity funds.

In assessing the impact this reform would have upon investors, we have focused on five key areas, which are covered in detail below.

#### Marketing Regime

The new marketing regime for AIFs is, in our view, significantly better than the original proposal of the European Commission and the more stringent version sought by the European Parliament, albeit highly complex. It means EU investors can continue to invest in EU and non-EU AIFs at their own initiative.

However, the Commission is invited to review existing legislation to assess the need to impose tighter due diligence requirements on EU investors investing on their own initiative in non-EU financial products.

In addition, upon its implementation in 2013, EU AIFMs will be able to passport within the EU their funds domiciled in the EU. As a result, professional investors across the EU will be able to invest in funds that, until now, have been marketed only under national private placement regimes. A similar passport for EU AIFMs with non-EU AIF is timetabled to come into force beginning in 2015, subject to a full review by the European Commission.

Non-EU AIFMs will be able to continue to market non-EU funds into the EU on the basis of national private placement regimes - albeit with significantly higher transparency requirements - at least until 2018. Non-EU AIFMs may be able to passport such funds throughout the EU from 2015, depending on the conditions defined for such a passport. The functioning of the passport will be assessed, most likely in 2017, and depending on the outcome, national private placement schemes may be eliminated in 2018.

#### **Delegation of Portfolio- and Risk-Management Structures**

Another key concern related to AIFMD is the extent to which portfolio management and risk management can be delegated to entities domiciled outside the EU. While the directive's initial draft was restrictive in this regard, the final compromise is significantly better for investors, allowing existing portfolio- and risk-management delegation models for AIFs to continue provided that UCITS-style conditions are met. There are no limits on the length of the sub-delegation chain, thereby accommodating the heterogeneous nature of AIF structures and the expertise of global investment management groups.

#### **Flexibility in Fund Governance Structures**

The initial text did not fully account for the multiplicity of fund structures covered by the AIFMD. The final text recognises and provides for the fact that there are different legal forms of AIFs, avoiding the extensive restructuring without additional investor benefits that would have resulted from a single model. The Level 1 text enables appropriate identification of the AIFM. For any AIF, the directive provides for a single AIFM to be the entity responsible for compliance with AIFMD, avoiding confusion and potential double authorisations. It also allows for externally or internally managed AIF which is particularly important for self-managed vehicles such as UK Investment Trusts.

#### **Regime for Depositaries and Liability Provisions**

Another concern was the restriction on the use of depositaries. The final text expands the pool of eligible depositaries beyond the initial limitation to EU credit institutions, moves away from strict depositary liability and recognises the existence of prime brokers. However, it is not ideal, as the pool of entities willing to provide depositary services may be reduced which in turn could increase costs for the end investor. Changes may be required

to the traditional prime brokerage operating model and custodian/administrator roles and functions for those managers wishing to use the passport.

#### **Provisions for Private Equity**

The directive includes specific requirements for private equity AIFM. The initial text would have led to an unlevel playing field for private equity AIFM compared to other investors. In the final text, the provisions require greater notification and disclosure than currently applies, but the information is no longer of a strategically sensitive nature. Indeed, the directive invites the Commission to review disclosure requirements applicable in case of control across the board and not with a specific investor type in mind.

#### **Investor Compensation Schemes Directive (ICSD)**

Since 1997, the Investor Compensation Scheme Directive (ICSD) has protected investors who use investment services in Europe by providing compensation in cases where an investment firm is unable to return assets belonging to an investor. The European Commission published a Proposal for a Directive in 2010 to revise the 1997 Investor Compensation Schemes Directive in parallel with changes to the bank Deposit Guarantee Scheme. The Commission's aim is to protect investors and facilitate the proper functioning of retail banking and investment across the Single Market (see Appendix A) for investment services, while also strengthening investor confidence in the use of investment services.

The main proposals include:

- ▶ Extending coverage from MiFID firms to include third-party custodians appointed by MiFID firms and to UCITS holders, compensating for loss of assets due to the failure of the depositary/sub-custodian or to the failure of UCITS depositaries.
- ▶ Increasing the compensation ceiling from a minimum of €20,000 to a fixed maximum level of €50,000 per eligible claim.
- ▶ Ensuring a basic level of pre-funding of national compensation schemes set at a level of 0.5% of the value of assets held within a client portfolio or by a UCITS to be covered by the scheme over 10 years.

The 0.5% levy is likely to lead to a significant performance drag for funds with a low cost base, such as money market funds and index tracking funds. When viewed in the context of the UCITS V revisions, which are likely to impose greater depositary liability, the risk exists that the combined effect of both directives will lead to significantly higher depositary costs to cover the potential risks and reduced investor returns, without providing significantly greater protection.

The extension of the ICSD to UCITS also has the potential to raise a number of unintended consequences as the proposals take insufficient account of the legal structures and distribution models for UCITS. Many retail investors, who are intended to benefit from the proposals, may be unable to make claims in



many circumstances, as the proposal ignores the intermediation of UCITS by distributors, unless specific additional rights are granted by the other European legislative developments such as the proposed Securities Law Directive which would potentially give intermediated retail clients the right to make direct claims. Conversely, many UCITS with a majority of institutional holders will be paying into a compensation scheme against which their institutional investors cannot claim, as only retail investors will be eligible claimants.

### UCITS V: Depository Liability and Remuneration

UCITS V will be aimed at increasing investor protection and creating a level playing field for UCITS investors in Europe. Following the Madoff fraud, the largest Ponzi scheme in history, a number of concerns were raised by several EU member states over the controls exercised by depositaries over the funds for which they act and over the lack of consistency across European regimes. In 2009 the Commission sought technical advice from the Committee of European Securities Regulators (CESR) on the scope of clarification and change required to the depository liability regime for UCITS. The desire for a number of changes was reflected in the debates on depository liability under the AIFMD (see discussion on page 3). Following agreement on the AIFMD Level 1 directive, the European Commission published a consultation on UCITS V in December 2010. The key issues are the extent to which the depository should be liable for assets held in custody (as opposed to assets that cannot be held in custody, such as derivative positions) and the extent to, and the manner in which, the depository should be able to contract out of its liability when it appoints a third-party sub-custodian.

**Committee of European Securities Regulators (CESR): Independent committee of securities regulators established by the European Commission in 2001 to act as an advisor to the Commission and implement legislation among EU member states. The Committee was replaced by ESMA on 1 January 2011.**

Ensuring greater consistency of treatment of the depository's duties will undoubtedly be beneficial to investors. However, a number of key definitions as to the scope of the depository's liability still need to be defined. It is essential that, wherever possible, these definitions are consistent with those used in the AIFMD.

The UCITS legislative proposals will also seek to extend remuneration provisions under the Capital Requirements Directive (CRD III) and the AIFMD to directors and staff employed by UCITS management companies to achieve a consistent treatment of remuneration.

### Packaged Retail Investment Products (PRIPs)

Packaged Retail Investment Products (PRIPs) cover a range of investment products that are marketed to retail investors and sold as packaged products. Inconsistencies in existing standards for maintaining these products can lead to competitive distortions in the retail investment market. The European Commission's objective is to create a consistent framework and level playing field for all packaged retail investment products. It will seek to achieve this by amending conduct of business requirements in the MiFID and the IMD as well as proposing a separate initiative to cover investor information.

The PRIPs initiative represents an opportunity to address consumer protection issues that arise from the choice investors face in planning for their, inter alia, long-term savings and retirement. The central theme of the initiative should be to bring consistency and comparability of information over a diverse suite of competing and substitute products.

The success of the initiative hinges on finding an appropriate definition of what would constitute a PRIP. BlackRock believes that a PRIP ought to be a product that may be constructed either as a separate entity (in whatever form) or by way of a contractual arrangement, that enables multiple retail investors to combine their investments to invest in or obtain exposure to a single asset or range of assets. The combined value is determined by reference to the value of those underlying assets. A PRIP ought not to include a direct holding of shares and securities by an investor. BlackRock supports excluding simple (non-structured) deposits, plain vanilla equity shares and bonds from the definition of a PRIP as distribution and transparency would largely not be an issue.

Disclosure of relevant information about PRIPs will be made by way of a KIID, as developed for UCITS, with a standardised risk rating, but with a different level of detail. This must be aligned to the marketing provisions of the Prospectus Directive for PRIPs that trade on a regulated market or are issued in the form of securities. In principle, the manufacturer should be responsible for producing the KIID and the distributor responsible for delivering the KIID to the investor, but more clarity is likely to emerge from the ongoing Commission consultation. It is important to note that PRIPs does not cover sales behavior. Conduct of business rules are instead covered separately by MiFID and IMD making it harder to create a level playing field for the end investor.

### Securities And Infrastructure Issues

#### European Regulation of OTC Derivatives and Short Selling

On 15 September 2010 the European Commission adopted two proposals — one for a regulation to bring greater transparency to the OTC derivatives markets and a second for a regulation on short selling and certain aspects of Credit Default Swaps (CDSs). Negotiations on both proposals are under way in

Council and Parliament. Once adopted, the regulations would apply from year-end 2012.

## European Market Infrastructure Regulation (EMIR)

The aim of the Commission's proposal on derivatives markets, otherwise known as European Market Infrastructure Regulation (EMIR), is to reduce counterparty credit risk and to increase transparency of OTC derivatives. The Commission proposes that standard OTC derivative contracts be cleared through central counterparties (CCPs). Non-standard derivative contracts deemed to be ineligible for central clearing will continue to be traded bilaterally, but will be subject to higher capital requirements. In addition, information on OTC derivative contracts will be reported to trade repositories and be made accessible to supervisory authorities. Greater information also will be made available to all market participants.

BlackRock supports initiatives to strengthen oversight of the OTC derivatives market. We are actively engaging with policymakers, central clearing houses and clearing members to shape policy that provides optimal client protection while minimizing practical implementation costs.

In our communication with these groups, we emphasize the following themes:

- ▶ Investor representation in the governance of central clearing
- ▶ The development of enhanced trade reporting
- ▶ The acceptance of high-quality, liquid non-cash assets as collateral
- ▶ The need to maintain customer collateral protection
- ▶ The exclusion of certain products, such as highly customized derivative contracts, from compulsory clearing
- ▶ The exclusion of FX forward contracts, from the regulatory regime governing OTC derivatives

Given the interconnectedness of the OTC derivative market, we believe it is critical that policymakers balance the needs of dealers and investors, and take an internationally-coordinated approach in order to develop a fair and consistent regulatory framework.

## Short Selling

Similarly, BlackRock supports the main objectives of the short-selling proposal to create a harmonised framework for coordinated action at the European level, increase transparency and reduce risks.

To increase transparency in short sales, the Commission's proposal requires that all share orders on trading venues be marked as "short" (so-called "flagging") if they involve a short sale. In addition, investors will have to disclose to regulators significant net short positions in shares at one threshold (0.2% of issued share capital), and to the market at a higher threshold (0.5%), including those obtained through sovereign CDS.

The proposal also gives national regulators power, in exceptional situations, to temporarily restrict or ban short selling in any financial instrument, subject to coordination by the European Securities and Markets Authority (ESMA). In addition, if the price of a financial instrument falls by a significant amount in a day, national regulators would have the power to restrict short selling in that instrument until the end of the next trading day.

The Commission further states that naked short selling has the potential to increase the risk of settlement failure. The proposal requires that to enter a short sale, an investor must have borrowed the instruments concerned, entered into an agreement to borrow them, or have an arrangement with a third party to locate and reserve them for lending so that they can be delivered by the settlement date (at the latest, four days after the transaction). Trading venues must ensure there are adequate arrangements in place for buy-in of shares or sovereign debt, as well as fines and a ban on short selling where there is a settlement failure.

BlackRock welcomes efforts to align the regulatory environment around short selling in Europe and supports the general direction of the Proposal where it aims to better mitigate the potential risks associated with short selling. However, the public disclosure requirements seem disproportionate to the actual risks being addressed and will likely negatively impact SME and retail funds the most. It should also be noted that they go beyond regulation in comparable regimes in developed capital markets globally. Unless these reforms are implemented thoughtfully, pensioners and long-term savers would be exposed at the same time to increased volatility, cost and risk from their investments alongside decreased choice, performance and return. Providing for aggregated anonymous public reporting, or even for a higher threshold (in line with the regime for disclosure of long positions), would significantly alleviate such risks.

## Markets in Financial Instruments Directive (MiFID) Review

Markets in Financial Instruments Directive Review (MiFID) is an EU law enacted by the European Parliament and Council that provides harmonised regulation for investment services across the 27 member states of the EU plus Iceland, Norway and Liechtenstein. The original MiFID directive included a review clause to assess the functioning of the directive and proposals for change. The Commission has received advice from CESR on a number of specific questions and a formal consultation was published in December 2010. It is expected that the new legislation will:

- ▶ Promote transaction and position reporting, giving regulators the ability to set position limits.
- ▶ Strengthen pre- and post-trade transparency across venues and over-the-counter (OTC) markets.
- ▶ Bring more derivatives onto organised trading venues.

- ▶ Strengthen investor protection, particularly by reviewing whether all UCITS should continue to be treated as non-complex products, as well as reviewing the regime for execution-only business and advised business.
- ▶ Further regulate commodities markets.

The proposals have the potential for increasing transparency, but there are concerns that this transparency may not be accompanied by a corresponding level of liquidity if OTC instruments move onto an exchange. Attempts to regulate “speculation” in the commodities markets may create unintended restrictions on investors in commodities and natural resources. The distribution of UCITS also may be affected if certain structured UCITS are treated as complex products and, therefore, subject to appropriateness tests even if sold on an execution-only basis.

## Prudential Issues

### Corporate Governance

The European Commission is expected to finalise a corporate governance proposal for financial institutions in mid-2011. The European Commission will also release a general corporate governance Green Paper for April 2011 with consultations through mid-2011. The European Parliament is currently preparing its own initiative report on the Commission’s Green Paper on Corporate Governance in Financial Institutions, which was published on 3 June 2010. Current areas of focus include risk management, the boards of financial institutions, external auditors and supervisory authorities, shareholder responsibilities, executive compensation, and potential conflicts of interest for financial institutions. Overall, early work from the Commission represents a move from “comply or explain” rules to increased regulation. BlackRock agrees the stated goals, but we have expressed concerns about one-size-fits-all approach. Remuneration within financial institutions also will be covered by the Commission’s proposal, and this is addressed by a number of other directives as well (e.g., Capital Requirements Directive III, commonly known as CRD III).

### Basel III

The Basel Committee on Banking Supervision developed measures to strengthen the regulation, supervision and risk management of the banking sector. The goals of Basel III are to improve the industry’s ability to weather systemic shocks; enhance risk management and governance; and strengthen transparency and disclosure.

On 13 January 2011, the Basel Committee on Banking Supervision issued minimum requirements to ensure that regulatory capital instruments are able to absorb losses in the event the issuing bank reaches the point of non-viability. These requirements were supported by the Committee’s oversight body and are one measure aimed at strengthening the resilience of the banking sector.

While we appreciate the Committee’s efforts to address concerns about moral hazard, BlackRock is concerned that the decision significantly reduces the size of the market for potential buyers of regulatory capital instruments. We question the logic of the permanent write-down feature which effectively subordinates debt investors to ordinary shareholders, while a partial write-down could be constructed to replicate the losses typically absorbed by regulatory capital in liquidation. We also believe the blended total cost of capital charge imposed on for banks is likely to increase as there will be insufficient granularity between newly issued Tier 1 and Tier 2 securities with equity conversion features. Finally, the decision lacks specificity in its definition of key terms, heightening our concerns about the inconsistent application of requirements across jurisdictions.

As a large investor in debt and equity securities, we believe this decision will result in significantly reduced demand by investors for regulatory capital instruments. This, in turn, will result in increased capital costs for banks and have a knock-on effect on customer pricing. Instead, we favour contingent capital securities, which achieve a similar outcome but with a specified conversion event and conversion price.

## Taxation Issues

### Foreign Account Tax Compliance Act (FATCA)

The Foreign Account Tax Compliance Act (FATCA) was signed into law in the US on 18 March 2010 as part of the Hiring Incentives to Restore Employment Act. The stated aim of FATCA is to ensure the US government clamps down on tax evasion by US taxpayers. This is achieved by enlisting the help of financial institutions of all descriptions; FATCA requires them to identify underlying ownership of all accounts and to report details to the IRS of any accounts or entities in which US persons have an ownership interest to the IRS. Financial institutions are powerfully incentivised to enter the regime — by subjecting any payment of sales proceeds or income from US assets made to or through a non-compliant institution to a 30% US withholding tax.

Regime effective 1 January 2013, following a rule-making period that will begin shortly, FATCA covers US-domiciled funds held by non-US investors and non-US funds that invest in the US, regardless of whether US citizens are invested in them, as well as segregated accounts where disclosure of identity to the US would be a sensitive issue. Operationally, this new reporting and withholding structure will require review and development of new account opening processes, transaction processing systems and “know your customer” procedures.

FATCA will almost certainly impose additional burdens, such as the need to seek undertakings from distributors regarding US citizen ownership and confirmation that they have contracted with the Internal Revenue Service (IRS). Failure to provide these

undertakings may, in the worst case, lead to fund managers having to discontinue business with a minority of distributors and has the potential to affect the product and distribution strategy of global fund managers. We believe this will accelerate an existing trend of preventing US citizens from investing in non-US funds, which may prove problematic for US citizens permanently resident outside the United States.

The US Treasury Department is expected to release proposed rules to implement the FATCA requirements within the next few weeks. BlackRock has been working with European associations and European and US asset managers to highlight the compliance challenges and implications for end investors.

## Other Issues

### UK Bribery Act of 2010

The Bribery Act is primarily designed to tighten the UK's regulatory framework, replacing the piecemeal and inadequate legislation currently in place. Although the primary purpose of the Act is to address legal deficiencies in the UK's regulatory framework, all of the new offences have extra-territorial application. This means the offences of paying and/or receiving a bribe, bribing a public official or a corporate failure to prevent bribery, may be prosecuted if:

- ▶ done by a British national or corporate or by a person who is ordinarily resident in the UK regardless of whether the act or omission that forms part of the offence took place outside the UK; and/or
- ▶ any act or omission that forms part of the offence occurs within the UK; and/or
- ▶ the offence was carried out by a commercial organisation that carries on a business in the UK (regardless of where the bribe is paid or whether the procedures are controlled from the UK).

The Bribery Act extends well beyond the current regime and for most global organisations will sit alongside other anti-corruption legislation, such as the US Foreign Corrupt Practices Act. The UK Act carries criminal sanctions, with a maximum custodial sentence of 10 years and unlimited fines. The Act applies to UK companies and their subsidiaries directly and in respect of their relations with their clients, service providers and distributors.

The most controversial of the offences is that of corporate failure to prevent bribery. It will be committed where:

- ▶ a person associated with a relevant commercial organization (which includes not only employees, but agents and external third parties) bribes another person (i.e., commits one of the general offences above) intending to obtain or retain a business advantage; and
- ▶ the organisation cannot show that it had adequate procedures in place to prevent bribes being paid.

Further guidance is due to be published by the Ministry of Justice. In advance of that, UK-based asset managers will need to develop appropriate procedures and processes and require commercial partners, such as distributors, anywhere in the world to ensure that monies are not received and accepted in contravention of the Bribery Act.

The Ministry of Justice published a consultation paper providing "guidance about commercial organisations preventing bribery" in September 2010 in advance of expected implementation in April 2011. The Ministry of Justice recently announced that publication of final guidance will be delayed while a number of industry issues are considered further. The Ministry of Justice has not said when new guidance will be published but has said that three months must pass between the publication of guidance and the implementation of the Bribery Act. One area that requires clearer guidance centers on corporate hospitality. The current wording in the Act could be interpreted as effectively criminalising legitimate hospitality, although the consultation paper does acknowledge that "reasonable and proportionate hospitality is a recognised and important part of doing business." Another area that requires clarity is the identity of the agency tasked with enforcement in the light of the proposed shake-up of the agencies responsible for dealing with financial crime. So far, the government has been silent on this.

**BlackRock supports financial regulatory reform that increases transparency, protects investors and facilitates responsible growth of capital markets, while preserving customer choice and assessing benefits versus implementation costs.**

## Pensions

In Europe, there is increasing concern about governments' ability to continue funding state pensions and about the private pension market potentially being unable to close the gap in retirement funding. The European Commission has published a consultative green paper "towards adequate, sustainable and safe European pension systems" as part of an initiative to provide a deeper and more integrated market for private pensions in Europe. Part of the green paper addresses questions of high-level public policy, such as the sustainability of public finances and the overall retirement age. The paper also seeks answers on how the European private pension market can increase its cross-border efficiency, the development of a defined-benefit or defined-contribution UCITS-style retail product and what regulatory environment might be necessary to facilitate this.



We agree that the recent financial and economic crisis has aggravated and amplified the impact of the severe trend in demographic ageing and has highlighted the challenges in achieving an adequate and sustainable retirement income for EU citizens now and in the future. While we also agree with many of the suggestions for improvement, in particular that longer life expectancies should translate into longer working lives and increased retirement ages, we do not agree with some of the other suggestions in relation to alternative scheme designs and guarantees.

In the UK, for example, most sponsors have chosen to go straight to DC schemes. As such, we believe it is already too late to encourage any significant risk sharing through hybrid schemes in the UK. While minimum pension guarantees might serve to provide certainty of outcome, they would not necessarily improve the outcome and the costs ultimately would be borne by the member. We do, however, agree that much more could be done to educate members about risk versus reward and to create improved investment outcomes using “lifestyle” processes and “target date” funds to mitigate some of the risks of failing to take enough investment risk, or taking too much investment risk, at inappropriate times.

## Conclusion

As one of the world’s leading providers of investment, advisory and risk-management solutions, BlackRock is supportive of appropriate regulatory reform that addresses the causes of systemic risk and has the potential to bring about positive change for investors. BlackRock is keen to ensure that lawmakers’ thinking in Brussels and elsewhere remains global, so that good practice can be adopted on a worldwide basis. BlackRock, therefore, engages in the European legislative process on issues with the greatest potential to affect clients and seeks to ensure that high-quality technical expertise is delivered in a timely manner. BlackRock delivers technical advice across the breadth of its client base and across the broad spectrum of product and capital market sectors as it seeks to become the independent global asset- and risk-management partner of choice. Many proposals remain on the table, in Europe and around the globe, and we will continue to be a vigorous advocate for investors with regulators and legislators to ensure that policy is carefully and thoughtfully implemented.

## Appendix A – Background

An analysis of present-day regulatory reform in Europe would not be complete without some context around the European Union, its evolution and financial regulatory framework to date. The mission of today's EU has moved far beyond that established by the founding members. The interdependence between the European Coal and Steel Community members of the post-war period created a basis for peace and cooperation in Europe. Today's EU of 27 member states has more than 500 million people and could be variously seen as Europe's response to globalisation and/or an area of stability and prosperity based on core fundamental values. The EU currently has exclusive competence in areas, such as monetary policy in countries whose currency is the euro (the Eurozone) and the customs union, amongst others.

Importantly, the EU member states share competency in respect of the internal market and consumer protection policy, meaning the EU is at the origin of the vast majority of legislation covering financial services.

### Legal System

The EU is based on a series of treaties establishing its competencies, institutions and the legal powers to enable the institutions to deliver the EU's objectives. The legal powers enshrined in the Treaties include the ability of the EU to enact legislation that binds its member states.

The main legal acts of the EU come in three forms: regulations, directives and decisions. Directives permit a degree of flexibility in the implementation process at a national level, while regulations come into force in the member states as soon as they are adopted without further implementing measures. The European single market in financial services has come into being through a mix of regulations and directives. Decisions, by contrast, are typically handed down by the European Commission in the field of competition, where it enjoys significant powers, and are directly applicable to individuals, companies and/or member states. Regulations, directives and decisions are of equal legal value and apply without any formal hierarchy.

### The European Single Market

The development of the Common Market, later renamed the Single Market, and the establishment of a customs union amongst member states were two core objectives of the former European Economic Community (EEC), a predecessor of today's EU. The Single Market is built on the principles of the free circulation of goods, capital, people and services within the EU.

The free movement of capital is intended to permit the movement of investments (i.e., property, shares, etc.) across EU borders. Firms authorised by their respective supervisory agency in one EU member state also have the right to establish branches in another member state. These two elements underpin the fundamental importance of the EU's existence to global operations such as BlackRock.

After a sluggish and difficult start, renewed impetus to create the European Single Market in financial services arrived in May 1999 in the shape of a Communication from the European Commission known as the Financial Services

Action Plan (FSAP). The FSAP set out a series of legislative proposals, recommendations and communications to harmonise legislation governing, in particular, European wholesale markets.

The recent financial crisis struck at a time when much of the legislative work to deliver the FSAP was either recently completed or in the process of being implemented in the member states. As a result, no sooner had financial services companies begun to adapt to the new pan-European rules laid down in the FSAP, than large swathes of the regulatory framework were set to be revised to address the popular and regulatory concerns that emerged as a result of the crisis.

Today's regulatory overhaul in financial services is, for the most part, the EU's response to the financial crisis and is underpinned by the G20 commitments of September 2009 to reduce systemic risk by global regulatory reform. Building the single market in financial services remains a priority for the European Commission, but consumer protection concerns have come to the fore in the post-crisis period.

### Pan-European Supervision

To facilitate the swift adoption of highly technical FSAP measures, the Committee of European Securities Regulators (CESR) was established in 2001 and was joined by the Committee of Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions (CEIOPS) in November 2003 as pan-European supervisory committees for banking and insurance and pensions, respectively. Together they formed the three Level 3 Committees (3L3).

The banking crisis of 2008 highlighted the inadequacies of these existing arrangements, especially the lack of coordination between the supervision of macro-prudential risks and the micro-level supervision of firms. As a result, the De Larosière Report set out a blueprint for regulatory reform in Europe, including a new supervisory architecture for financial services supervision. Agreed by European legislators in autumn 2010, three new European Supervisory Agencies (ESAs) come into being on 1 January 2011, replacing the 3L3 Committees.

The three ESAs will have powers acquired by the medium of Delegated Acts, a feature of the Lisbon Treaty that came into force on 1 November 2009, to improve the functioning and efficiency of the EU. In particular, the ESAs will be able to intervene in the supervision of firms in emergency situations under very specific circumstances, prepare advice on implementing measures and issue binding guidance. The European Securities and Markets Agency (ESMA) will, moreover, have direct oversight of credit rating agencies and significant coordination powers over other pieces of infrastructure such as Central Clearing Counterparties (CCPs).

The ESAs will be complemented by the European Systemic Risk Board (ESRB), composed of the heads of the 27 national supervisory authorities, the three Chairpersons of the ESAs, the Eurosystem (national central banks of the Eurozone) and the European Central Bank (ECB).

The European System of Financial Supervisors (ESFS) is the collective term for the new financial regulatory architecture in Europe.

## Appendix B — Key Terms

### Significant European Institutions

The EU is governed by seven institutions. The four most important to the making of financial services regulation are listed here:

#### European Commission

The executive arm of the European Union responsible for proposing legislation, implementing decisions, upholding the Union's Treaties and the day-to-day running of the Union.

- ▶ The ultimate decision-making body of the European Commission is the College of Commissioners, which is comprised of 27 senior figures with one drawn from each member state and portfolios allocated according to a variety of factors including profile, nationality and gender.

#### Council of the European Union

The institution in the legislature of the EU representing the governments of the member states and acting as co-legislator with the European Parliament on financial services issues.

- ▶ The 27 member states of the EU are Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.
- ▶ In the absence of a consensus on financial services legislation, Council decisions are taken on a qualified majority (QMV) basis. Votes are allocated to member states in function of their population. As such, Germany has the most votes (16.5% of the total votes in Council) and Malta the fewest (0.1%).
- ▶ Each member state is obliged to organise the agenda and convene meetings of the Council for a period of six months in strict rotation. However, during this period of "rotating presidencies," the President of the European Union remains constant for a five-year term and a post currently held by the Belgian Herman van Rompuy.

#### European Parliament (EP)

The directly elected parliamentary institution of the EU representing the citizens of Europe and acting as co-legislator with the Council on financial services issues.

- ▶ The EP comprises 751 members (MEPs) that sit in political groupings rather than by nationality. The number of MEPs from each member state is based on population. As such, Germany has the most (96) and Malta the fewest (6).
- ▶ MEPs join committees of the European Parliament to work on specific pieces of legislation per their interest and/or background. The Economic and Monetary Affairs Committee (ECON) has primary responsibility for legislation related to financial services issues.
- ▶ Although each Committee has a chairperson, it is the job of the Rapporteur to write the EP's report on a given piece of legislation with the input of the Shadow Rapporteurs from other groups. The Committee Chairs, Rapporteurs and Shadow Rapporteurs are, therefore, very influential in the EP's legislative process.

#### European Central Bank

The central bank of the Eurozone that controls monetary policy in that area with an avowed aim of price stability.

- ▶ The ECB also houses the EU's macro-prudential risk oversight body — the European Supervisory Risk Board (ESRB) — which was established 1 January 2011.

#### European Supervisory Agencies

The European Supervisory Agencies (ESAs) were established 1 January 2011, and comprise the national supervisory authorities of the EU. The ESAs replace the three Level 3 Committees (as outlined below). The mission of each ESA corresponds to the securities (fund and markets), banking and insurance and occupational pension sectors, respectively. On 1 January 2011, the ESAs were as follows:

- ▶ ESMA: The European Securities and Markets Agency, which replaces the Committee of European Securities Regulators (CESR) and will continue to be based in Paris.
- ▶ EBA: The European Banking Agency, which replaces the Committee of European Banking Supervisors (CEBS) and will continue to be based in London.
- ▶ EIOPA: The European Insurance and Occupational Pensions Agency, which replaces the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and will continue to be based in Frankfurt.

The ESAs will meet in an overarching committee to discuss and assess cross-sectoral emergence of risk and supervisory issues. The chair of each ESA will have a seat in the ESRB to ensure a strong link between the macro- and micro-prudential supervision on a pan-European basis.

### Treaty of Lisbon and Implications

The Treaty of Lisbon amended the two treaties that comprised the constitutional basis of the European Union and came into force on 1 November 2009. The purpose of the Treaty was to enhance the efficiency and democratic legitimacy of the Union and to improve the coherence of its action.

The Lisbon Treaty has a number of important implications in terms of the relative power and influence of the respective European institutions for the EU as a whole. However, in the financial services space, the changes it heralded were relatively minor, as this area was already subject to co-decision — that is, both the Council and Parliament were required to approve legislation and Council decisions on financial services were already taken by qualified majority voting (QMV).

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