

Response: ESMA Consultation Paper

On draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps

BlackRock welcomes the opportunity to comment on ESMA's Consultation Paper outlining draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps.

BlackRock is an independently-managed public company that engages solely in providing asset management and risk management services to its clients. As at 31st December 2011, we managed over €2.6 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public and multi-employer pension plans, insurance companies, mutual funds and exchange-traded funds, endowments, foundations, charities, corporations, government and other official institutions, banks and individuals around the world.

BlackRock is an active member of the European Fund and Asset Management Association (EFAMA) as well as a number of other global, regional and domestic associations representing investment managers and ultimately the interests of end-investors such as households, pensioners and savers.

We feel that the limited timeframe ESMA has had to prepare the technical requirements, and the three week consultation period available to stakeholders, has not provided sufficient time to thoroughly consider the impact of the ESMA proposals will have on the fortunes of end-investors. In particular, it has not been possible to thoroughly analyse the benefits and potential negative unintended consequences that could arise from the proposed implementing measures and technical advice. Therefore, we have focused our comments on the netting and aggregation requirements applying to investment managers whilst contributing to the responses more generally of the major financial services industry associations commenting on the Paper.

General Comments

It is widely recognised that short selling facilitates efficient price discovery, mitigates price bubbles, increases market liquidity and provides solutions for effective hedging and other risk management strategies. These benefits allow investment managers to achieve, for long-term savers, optimal investment performance, cost efficiency and stable risk profiling of products.

Whilst important for regulators to receive notifications of short positions to facilitate ongoing market monitoring and to detect cases of market manipulation, we see many risks arising from the public at large receiving information on short positions taken by a specific fund manager at a given point in time.

Concretely, we would be concerned that market efficiency and the delivery of consistent returns to investors could well be undermined by ESMA's proposals due to:

- **The risk of herding.** Publication of the positions of those seen as 'star' managers will inevitably lead others to follow suit. Since it will not be known if the 'star' manager took his position based on a view of the issuer's underlying financial condition or merely to hedge a long position in another stock, herding by others may exacerbate the negative impact on the price of short selling and could encourage volatility.
- **The possibility of short squeezes.** Identification of individual position holders will allow other market participants to move against large short positions – since the stock which was borrowed in order to short it must be returned to the lender. This puts the seller under extreme pressure to close out the position in a rising market.

- **Market distortion.** Some managers will always limit their net short positions at whatever level is necessary to remain under any applicable threshold, regardless of their view on the stock in question. They do so for a number of reasons - to avoid unduly intrusive media scrutiny, to protect their management strategies or to avoid 'issuer retaliation'.
- **Reverse engineering of short positions.** Public disclosure of positions exposes named position holders to having their proprietary management strategies (the manager's intellectual property) being "reverse engineered", diluting the value of the approach to the investors in the funds managed by the managers in question.

Independent analysis¹ has further shown that public short selling disclosure regimes decrease short sellers' participation in the equity markets by 20-25%. As short selling liquidity decreases there are material impacts to the market for the affected securities:

- Trading volumes decrease.
- Bid-ask spreads widen.
- Price discovery becomes less efficient.
- Intra-day volatility increases.

Markets adopting public short selling disclosure regimes, according to the same independent research, become more expensive and difficult venues for all investors to execute both purchases and sales of securities.

In view of these risks, it is particularly important that ESMA adopts balanced and sensitive implementing measures setting out the calculation and aggregation methodology for public disclosure.

For this reason we have concentrated our response on the relevant draft advice set out in the Consultation Paper (see appendix).

Detailed remarks in relation to ESMA's netting and aggregation proposals

BlackRock is concerned by the netting and aggregation proposals ESMA sets out in Chapter II.IV of the Consultation Paper since:

- The tracking of individual desks and "decision makers" is an **unnecessarily complicated** approach, a point which ESMA alludes to in paragraph 75, p.30 of the consultation paper.
- It is **inconsistent with the Level 1** text since the Regulation aims at disclosure of short positions so as to be able to assess the economic exposure of an entity as a whole, which would intuitively imply taking all relevant holdings in the legal entity into account for the calculation of the short position.

Stakeholders would benefit from **disclosure of the parameters and questions set out by the European Commission's Legal Services** to better understand the policy steer ESMA has received in this and in other sections of the draft advice for delegated acts.

Specifically, as regards the draft advice, we are troubled about the ESMA proposal for the following reasons:

- First, in respect of public disclosure, the calculation methodology as proposed by ESMA would likely have a significant negative impact on the market.

¹ Oliver Wyman (2010), "The effects of short-selling public disclosure regimes on equity markets: A comparative analysis of US and European markets."

- Detailed disclosure of short positions taken by individual fund managers working in investment management firms could be easily misconstrued as negative firm opinions on a given company.
- This signal would be especially unfortunate and misleading because investment managers would, in the vast majority of circumstances, and especially where they have index businesses have net long positions at the group or legal entity level.
- The detailed short disclosures by the larger and more influential investment managers could then trigger herding behaviour leading to short squeezes, market distortion and ultimately reverse engineering of short positions due to the firm's proprietary intellectual capital being exposed to the public at large.

We therefore do not share ESMA's view, as expressed in the Public Hearing of 29 February 2012.

- Second, in respect of disclosure to supervisors, the duplicative reporting that would inevitably result from ESMA's proposed calculation methodology, would impede effective ongoing market monitoring and ultimately impair the detection of market manipulation.
- Third, the one-off cost implications stemming from complicated systems builds which would be required, coupled with the ongoing surveillance and monitoring required to remain in compliance with the proposals, would ultimately erode the ability of investment managers to return optimal performance to end-investors.

Therefore, to mitigate the risks identified above we would propose that ESMA:

- Includes a **definition of "Fund Management Company"** in its advice to the European Commission. This would help to establish the appropriate reporting level for net short positions.
 - In particular, it should be clear whether this term is intended to refer specifically to an operator of a collective investment scheme or more broadly, an investment manager acting on behalf of its clients regardless of legal form.
 - It would also be helpful to ensure consistent use of terms and ensure clear definitions, for instance "managed portfolio" and "managed fund".
- **Clarifies the policy intent** behind requiring the fund management company reporting when it does not act in the capacity of "Decision Maker."
 - We would assert that the "Decision Maker" (and therefore the reporting-level entity) should be the entity managing the investments rather than other entities such as the operator of a collective investment scheme (unless such person also manages investments for the collective investment scheme) or the holder of record e.g. depositary or holding-company.
- Remains faithful to the **principle of reporting at the legal entity level** as set out in the Level 1 text.
 - It should also be possible to aggregate positions managed within the same legal entity managing investments such that the legal form of the underlying portfolio is irrelevant, for instance, positions held by collective investment schemes and separately-managed accounts under the same investment manager should be aggregated.
 - It should be possible to aggregate discretionary and non-discretionary managed portfolios (Box 5 only refers to the former).

- Sets out how its proposals would work where **fund management functions and decisions are delegated** to other legal and non-legal persons and/or entities.
 - In particular, paragraph 5 of Box 5 refers only to funds delegated “to an external party”. Where management of portfolios are delegated to a group entity or other affiliated company, it would seem sensible that the reporting would be undertaken by this entity, not the entity delegating the portfolio since decisions would be made by the entity managing the portfolio.
 - Where management of a single fund is delegated to more than one party, it would be unnecessarily complicated to require information-exchange such that one of these entities to be appointed to report on behalf of all. It would seem sensible that reporting should take place only at Decision-Maker level i.e. the legal entity that is the investment manager.

Finally, we agree that it is entirely appropriate for regulators to receive more granular information regarding short positions to detect potential build up of systemic risk and possible cases of market manipulation. Provided that duplicative reporting of short interest could be avoided, we would be more comfortable with **disclosure by the fund manager or desk on the basis that ESMA takes into account current reporting requirements**. This recommendation is aimed at minimising the costs of systems design, build, implementation and monitoring being ultimately and indirectly passed on to end-investors.

Appendix

Draft Advice on the method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds:

1) Definitions

a. Decision Maker means a single natural person or several natural persons, a body within a legal entity or a legal entity within a group pursuing the same investment strategy in relation to a particular issuer through one sub entity or different sub entities within the same legal entity or within a group.

b. Investment Strategy means the strategy that is pursued by an investor, regarding a particular issuer, to have either a net short or a net long position taken through transactions in various financial instruments issued by this particular issuer or that relate to that issuer.

2) Group: a legal entity constituted of several legal entities.

3) For fund management activities related to several funds,

a. the calculation of the net short position in a particular issuer shall be made in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) for each individual fund, irrespective of its legal form.

b. the net positions of the funds managed by the same decision maker and for which the same investment strategy is pursued in relation to a particular issuer shall be aggregated.

c. the net short and long positions of all the funds under the responsibility of a management company shall be aggregated and netted.

4) The fund management company shall report, or disclose where relevant, the net short position that results from 2(a), 2(b) or 2(c) above when it reaches or exceeds a relevant notification or disclosure thresholds, or, the highest of the net short positions determined under 2(a), 2(b) and 2(c) above when more than one of them reaches or crosses such thresholds.

5) When the management of funds has been delegated by one or more management companies to an external party, that party shall be considered as the decision maker for the purpose of article 3(7)(c) of the Regulation. It shall aggregate the position of all the funds under its management having net short position in relation to a particular issuer and where relevant proceed with the net short position notification or disclosure. The management companies delegating the fund management still aggregate and net the positions of the respective funds according to paragraph.

6) When the management of a single fund has been delegated to more than one external party by a fund management company, there should be an arrangement in place to ensure that either these parties, independent from each other, report the relevant information to the fund management company to calculate the net short position and where relevant notify or disclose it or that one of these parties is entrusted by the fund management company to conduct the calculation and notify or report a net short position, provided that party receives the relevant information from the other party(ies).

7) When different legal entities within a group have long or short positions in relation to a particular issuer,

a. the calculation of the net short position shall be made in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) for each legal entity constituting the group;

b. the net positions of these legal entities that are managed by the same decision maker and

for which the same investment strategy is pursued in relation to a particular issuer shall be aggregated;

c. the net short and long positions of all the legal entities constituting the group shall be aggregated and netted.

8) The group shall report, or disclose where relevant, the net short position that results from 7(a), 7(b) or 7(c) above when it reaches or exceeds a relevant notification or disclosure thresholds, or the highest of the net short positions determined under 7(a), 7(b) and 7(c) above when more than one of them reaches or crosses such thresholds.

9) Where two or more portfolios are managed on a discretionary basis by the same decision maker pursuing the same investment strategy in relation to a particular issuer, the positions of all the managed portfolios having a net short position should be aggregated and notified or disclosed where relevant by the firm in charge of the management of these managed portfolio when a notification or disclosure threshold is reached or exceeded.

10) In relation to a legal entity constituted of several different non-legal entities with different activities,

a. the calculation of the net short position shall be made in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) at the level of each of the decision makers to be considered as the separate business lines (which normally will be separated from the other businesses at least by information barriers)

b. The net short and long positions of all the decision makers within this legal entity shall be aggregated and netted.

11) The legal entity shall report, or disclose where relevant, the net short position that results from 10(a), or 10(b) above when it reaches or exceeds a relevant notification or disclosure thresholds, or, the highest of the net short positions determined under 10(a), or 10(b) above when both reach or cross such thresholds.