



HM Treasury

Short Selling Regulation

Consultation - sovereign debt and credit default swaps

July 2023

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Chapter 1

Introduction

1.1 The Chancellor's Edinburgh Reforms, announced on 9 December 2022, set out a package of changes to drive growth and competitiveness in the financial services sector. This included publishing a Call for Evidence on the Short Selling Regulation (SSR)¹, which invited views on the best way to regulate short selling in the UK². As part of the government's Smarter Regulatory Framework (SRF) programme, the Short Selling Regulation will be replaced with a UK-tailored regime which supports market integrity and bolsters the competitiveness of UK financial markets.

1.2 The government has now published its response to the December 2022 Call for Evidence on the SSR³. That Call for Evidence focused on the equity-related aspects of the SSR. However, as noted in the document, the SSR also contains provisions on sovereign debt issued by the UK (sovereign debt) and UK credit default swaps which relate to UK issued sovereign debt (CDS). The government said in the December document that we would separately consider sovereign debt and sovereign debt CDS. This consultation is focused specifically on short selling in sovereign debt markets.

1.3 Based on evidence gathered to-date, including engagement with the relevant regulatory authorities, the government proposes to entirely do away with the requirements currently placed on investors when taking out short positions in sovereign debt or sovereign CDS, and the related reporting requirements.

1.4 The government's view is that this is an unnecessary part of the regulatory regime that does not achieve its policy objective that we have inherited from the EU. The UK originally raised concerns about these aspects of the regime when the SSR was being negotiated in the EU, on the basis that they could have a detrimental impact on liquidity in UK sovereign debt markets.

1.5 Under the government's proposed approach, sovereign debt and CDS would be kept in scope of the FCA's emergency intervention powers⁴. In practice, this means that in future the UK's short selling

¹ Regulation 236/2012/EU of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, as it has been retained in UK law following EU Exit

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1130913/SSR_CfE_-_Official_Publication_FINAL.pdf

³ <https://www.gov.uk/government/consultations/short-selling-regulation-call-for-evidence>

⁴ Emergency intervention powers as set out in chapter V of the SSR

regime will focus on equities, with the FCA keeping its ability to intervene in exceptional circumstances for a broader range of financial instruments, including sovereign debt and CDS. The government's view is that this approach will not in any way impact market integrity or financial stability, while reducing burdens for market participants.

1.6 Ahead of making a final decision in relation to sovereign debt and CDS aspects of the regime, the government is interested in views from market participants on the benefits and any risks associated with this proposal.

Responding to this consultation

1.7 The government welcomes views on these proposals from all interested stakeholders, including but not limited to investors, market makers, trading venues and other market participants. The consultation will remain open for 4 weeks.

1.8 This document should be read alongside the December 2022 Call for Evidence on the SSR and the government response to this Call for Evidence.

Chapter 2

Sovereign debt and CDS aspects of the SSR

Current SSR requirements

2.1 Short selling of sovereign debt and owning sovereign CDS generally contribute to the healthy functioning of sovereign debt markets, promoting liquidity and facilitating price discovery. The current UK short selling regime, which is a piece of retained EU law, includes restrictions and requirements concerning UK sovereign debt and sovereign CDS.

2.2 For sovereign debt, firms need to have borrowed or located the sovereign debt (or have made alternative provisions resulting in a similar legal effect) before entering into an unhedged short sale of sovereign debt. The SSR sets out more detail on what is considered to be a hedged position. For sovereign CDS, firms can only enter into a sovereign CDS transaction where that transaction does not lead to an uncovered position in a sovereign debt CDS. There are detailed regulatory requirements which set out what constitutes permitted hedging for the purposes of SSR⁵.

2.3 The SSR also includes a requirement to report net short positions in UK-issued sovereign debt that exceed 0.5% of duration-adjusted outstanding UK sovereign debt to the FCA. This amounts to a net short position in UK sovereign debt worth roughly £118.6bn.⁶

2.4 There is no public disclosure for the sovereign debt/sovereign CDS aspects of the SSR. There is an exemption for authorised primary dealers and market makers from the requirements detailed in paragraphs 2.2 and 2.3.

Government position

2.5 The UK is a leader internationally in maintaining consistently high regulatory standards, which includes contributing and adhering to international standards set by global bodies such as the International

⁵ This includes further detail out in Commission Delegated Regulation EU/2012/918 Regulation 236/2012/EU of 5th July 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events, as it has been retained in UK law following EU Exit

⁶ <https://www.fca.org.uk/markets/short-selling/notification-disclosure-net-short-positions>

Organisation of Securities Commissions (IOSCO). While IOSCO's standards for short selling regulation explicitly apply to equities and equity derivatives, they do not include short positions in sovereign debt or sovereign CDS. Other jurisdictions, such as the US and Singapore, do not have short selling rules for sovereign debt and CDS. The UK's short selling regime before the SSR was introduced did not include covering or disclosure requirements for sovereign debt or CDS.

2.6 Moreover, the EU SSR was drafted during the European debt crisis, so was written at a time where there were particular fears among several EU member states around the impact of short selling and CDS trading on the price of their sovereign debt, their borrowing costs, and their ability to raise capital. The legislation includes complex arrangements to recognise these concerns while continuing to enable hedging activity via short selling of sovereign debt and trading of sovereign CDS.

2.7 As an EU member state at the time, the UK was opposed to introducing short-selling related restrictions and requirements on sovereign debt and CDS, arguing that restrictions would have a detrimental impact on the liquidity of sovereign debt markets, and that the European Commission proposal had failed to produce an evidence base to support the introduction of these requirements⁷. The UK was the only EU member state to abstain from voting in favour of the final package of short selling requirements, which included these restrictions and requirements on sovereign debt and CDS. Studies by both the IMF⁸ and ESMA⁹ since the introduction of SSR sovereign debt and CDS requirement found potential negative impacts on liquidity.

Covering requirements

2.8 While the government sees a clear purpose for covering requirements for the short selling of shares, it is not necessarily the case that the same requirements should apply to sovereign debt markets. The purpose of covering requirements is to prevent settlement failure, which can arise from the short selling of more shares than are available in the market. However, while these requirements are critical for equity markets, there are fundamental differences between equity and sovereign debt markets. For example, as of 31 March 2022, the size of the UK gilt market is roughly £2.4tn¹⁰, larger than the market cap of all the companies in the FTSE100 and FTSE250 combined.¹¹ While it is conceivable that in extreme circumstances, without covering requirements, short selling of shares in an individual issuer could exceed share availability, the government considers this risk to be

⁷ <https://publications.parliament.uk/pa/cm201011/cmgeneral/euro/110405/110405s01.htm>

⁸ <https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Old-Risks-New-Challenges>

⁹ https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-614_final_report_on_ssr_evaluation.pdf

¹⁰ <https://www.dmo.gov.uk/media/4vbe3gwh/jan-mar-2023.pdf>

¹¹ <https://www.londonstockexchange.com/indices/ftse-100>; <https://www.londonstockexchange.com/indices/ftse-250>

almost non-existent in sovereign debt markets, given the size and liquidity of the market. Other types of debt like corporate bonds are not subject to covering requirements under the SSR. The government does not have any evidence that the covering arrangements are needed in sovereign debt and CDS markets.

Sovereign debt disclosure requirements

2.9 Similarly, the government does not think the regulatory reporting regime is working. Unlike the short selling disclosure regime for shares, where the FCA receives roughly 3250 reports per month, the current reporting threshold for sovereign debt means that firms are very unlikely to take out a position big enough to be reportable. In practice, the FCA has received very few net short position reports on sovereign debt since the regime has been in place, which were all as a result of the current calculation methodology artificially inflating the true size of the net short position, due to the methodology calculating cash and derivative positions differently. As a result, firms are required to implement extensive requirements on how to calculate a net short position in sovereign debt when the likelihood or usefulness of reporting is very low in practice.

2.10 The government also notes that regulatory authorities already receive relevant data from industry on sovereign debt and CDS via other regulatory regimes, such as Sterling Money Market data, the Markets in Financial Instruments Regulation, the European Market Infrastructure Regulation and the Securities Financing Transaction Regulation. The government therefore thinks that the current reporting regime is not needed.

Feedback to-date

2.11 The Call for Evidence published in December 2022 was clear that it was not seeking views on the short selling regime for sovereign debt and sovereign CDS, and in response a sizeable number of respondents indicated that they would provide views at a later stage.

2.12 In HMT's market engagement beyond the Call for Evidence, we have heard from other market participants that sovereign debt and CDS aspects of the SSR add no benefit to the functioning of UK markets and should be removed.

Proposal

2.13 Given the government's original opposition to these requirements when introduced, and the lack of evidence to-date of any substantial benefits that these requirements provide to UK markets in terms of mitigating risks, the government is inclined to:

1. Remove restrictions on uncovered short positions in UK sovereign debt (Article 13 of the SSR)
2. Remove restrictions on uncovered short positions in UK sovereign CDS (Article 14 of the SSR)

3. Remove requirements to report sovereign debt positions to the FCA (Article 7 of the SSR) and remove requirements to report sovereign CDS positions to the FCA in the case that covering requirements are suspended (not currently in force) (Article 8 of the SSR)

2.14 The government would amend other parts of the short selling regime where necessary, such as the market maker and authorised primary dealer exemptions (article 17) to reflect these changes.

2.15 However, the government considers it important for the FCA to have broad intervention powers relating to short selling in exceptional circumstances, noting the high bar the FCA has publicly set on imposing short selling bans, and the reputation it has built for using short selling emergency powers judiciously. The government envisages these continuing to extend to sovereign debt and CDS in the same way as they apply to other non-equity financial instruments. This includes emergency powers to request information and to ban short selling.

2.16 Ahead of making a final decision on sovereign debt and CDS-related provisions of the SSR, the government is seeking views from market participants on benefits and drawbacks of these aspects of the current regime, as well as any risks of removing these requirements.

Box 2.A Questions

1. Do you agree with the analysis of the current SSR requirements set out in paragraphs 2.5-2.10 (including our view on the impact on liquidity and settlement)?
2. Do you agree with the proposal set out in paragraphs 2.13-2.15? Please provide details to support your view, including any views on benefits and risks associated with the proposal.
3. Do you have any further views on the matters set out in this consultation?

Chapter 3

When and how to submit your responses

3.1 This consultation will remain open for 4 weeks, and close on 7 August 2023. Please submit your responses to MarketConduct@hmtreasury.gov.uk

Chapter 4

Privacy notice

4.1 This section sets out how we will use your personal data and explains your relevant rights under the UK General Data Protection Regulation (UK GDPR). For the purposes of the UK GDPR, HM Treasury is the data controller for any personal data you provide in response to this consultation.

Data subjects

The personal data we will collect relates to individuals responding to this consultation. These responses will come from a wide group of stakeholders with knowledge of a particular issue.

The personal data we collect

The personal data will be collected through email submissions and are likely to include respondents' names, email addresses, their job titles, and employers as well as their opinions.

How we will use the personal data

This personal data will only be processed for the purpose of obtaining opinions about government policies, proposals, or an issue of public interest.

Processing of this personal data is necessary to help us understand who has responded to this consultation and, in some cases, contact certain respondents to discuss their response.

HM Treasury will not include any personal data when publishing its response to this consultation.

Lawful basis for processing the personal data

The lawful basis we are relying on to process the personal data is Article 6(1)(e) of the UK GDPR; the processing is necessary for the performance of a task we are carrying out in the public interest. This task is consulting on the development of departmental policies or proposals to help us to develop good effective policies.

Who will have access to the personal data

The personal data will only be made available to those with a legitimate need to see it as part of consultation process.

We sometimes conduct consultations in partnership with other agencies and government departments and, when we do this, it will be apparent from the consultation itself. For these joint consultations,

personal data received in responses will be shared with these partner organisations in order for them to also understand who responded to the consultation.

As the personal data is stored on our IT infrastructure, it will be accessible to our IT service providers. They will only process this personal data for our purposes and in fulfilment with the contractual obligations they have with us.

How long we hold the personal data for

We will retain the personal data until the consultation process has been completed and the policy is implemented. After this, we will only retain personal data if it is embedded in a response, but we will not use it for any unrelated purposes.

Your data protection rights

You have the right to:

- request information about how we process your personal data and request a copy of it
- object to the processing of your personal data
- request that any inaccuracies in your personal data are rectified without delay
- request that your personal data are erased if there is no longer a justification for them to be processed
- complain to the Information Commissioner's Office if you are unhappy with the way in which we have processed your personal data

How to submit a data subject access request (DSAR)

To request access to your personal data that HM Treasury holds, contact:

The Information Rights Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

dsar@hmtreasury.gov.uk

Complaints

If you have concerns about our use of your personal data, please contact the Treasury's Data Protection Officer (DPO) in the first instance at privacy@hmtreasury.gov.uk

If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner at casework@ico.org.uk or via this website: <https://ico.org.uk/make-a-complaint>.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk