HM Treasury

Short Selling Regulation

Government response - sovereign debt and credit default swaps

November 2023

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Contents

Chapter 1
Introduction

Background

1.1 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 Short Selling Regulation (SSR), which is a piece of retained EU law, includes restrictions and requirements on sovereign debt issued by the UK (sovereign debt) and UK credit default swaps which relate to UK issued sovereign debt (CDS).

1.2 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 SSR[1], which invited views on the best way to regulate short selling in the UK[2]. As part of the government's Smarter Regulatory Framework (SRF) programme[3], the Short Selling Regulation is being replaced with a UK-tailored regime which supports market integrity and bolsters the competitiveness of UK financial markets.

1.3 The December 2022 Call for Evidence focused on the equities-related aspects of the SSR. In July 2023, the government published its response to the Call for Evidence[4], and a follow-up consultation[5] on aspects of the SSR related to sovereign debt and CDS.

Follow-up consultation

1.4 The follow-up consultation sought feedback on the proposal to remove requirements currently placed on investors when taking out short positions in sovereign debt or sovereign CDS, and the related reporting requirements. The UK was opposed to these requirements when they were introduced under the EU regime, arguing that such restrictions would have a detrimental impact on the liquidity of sovereign debt markets. Since their introduction, the government has

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[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/publications/building-a-smarter-financial-services-framework-for-the-uk

[4] Short_Selling_Regulation_Review_-_Government_response__1.pdf (publishing.service.gov.uk)

[5] Short_Selling_Regulation_Review_-_sovereign_debt_and_CDS_consultation_document__1_.pdf (publishing.service.gov.uk)

not seen any evidence that these requirements were needed in sovereign debt and CDS markets.

1.5 However, the government considers it important for the Financial Conduct Authority (FCA) to have broad intervention powers relating to short selling in exceptional circumstances, noting the high bar the FCA has publicly set on interventions such as imposing short selling bans. As such, the consultation proposed to keep sovereign debt and CDS in scope of the FCA's emergency intervention powers. This is consistent with how the FCA's emergency intervention powers apply to financial instruments other than shares.

1.6 The Treasury received seven responses to the consultation, six from trade associations and one from a standard-setting organisation. The respondents represented a variety of financial market participants, including funds, investment banks and market makers.

1.7 This document summarises the feedback received in response to the consultation and, in light of the feedback received, sets out next steps. It is designed to be read alongside the draft Statutory Instrument and accompanying policy note illustrating the UK-tailored short selling regime, which have been published in parallel.

Chapter 2

Feedback to the consultation and next steps

2.1 The consultation asked for views on three questions. Firstly, it asked whether respondents agreed with the analysis of the current SSR requirements set out in the document, including the government's view on the impact on liquidity and settlement in the sovereign debt and CDS market. Secondly, it asked whether respondents agreed with the government's proposed approach, including any views on benefits and risks associated with the proposal. Finally, it asked for any further views on the matters set out in the consultation.

Views on the government's analysis of current SSR requirements

2.2 All respondents agreed with the analysis of the current SSR requirements as set out in the consultation document. Several respondents emphasised that, given the size and liquidity of sovereign debt markets, they do not see the same need for covering requirements for sovereign debt and CDS as for equity markets. One respondent highlighted that effective settlement for sovereign CDS is hardwired into CDS contracts.

Views on the government's proposal to amend the framework

2.3 All respondents agreed with the proposal to remove the current short selling restrictions on sovereign debt. Several responses emphasised that these existing requirements are unnecessary, particularly because of the highly liquid sovereign debt market. One respondent noted that they were not aware of settlement issues in corporate bond markets, where there were no comparable SSR restrictions. One respondent observed that uncovered short selling in sovereign debt markets typically does not increase settlement risk. One respondent agreed with the proposal on the basis that it would likely increase liquidity and lower borrowing costs in sovereign debt markets but suggested that the Treasury and the FCA should consider whether the change could increase settlement risk in UK sovereign debt markets.

2.4 Respondents also agreed with the proposal to remove the current SSR restrictions on sovereign CDS. Responses stressed the importance of a well-functioning sovereign CDS market, and that the current SSR restrictions limited effective hedging, which is important for risk management. One response stated that removing restrictions for shorting sovereign CDS could allow the market to hedge general UK market risks more directly. They said the impact of the SSR currently was that market participants were incentivised to take out short positions on UK entities such as UK banks instead of using sovereign CDS as a proxy for overall UK risks. The same respondent stated that removing the SSR restrictions would reduce volatility in times of market stress. Several responses thought that removing these restrictions would increase liquidity in sovereign CDS markets.

2.5 Respondents also agreed with the proposal to remove the specific reporting requirements for sovereign debt under article 7 of the SSR. In their feedback, several respondents noted that this requirement added unnecessary administrative burden.

2.6 All but one respondent agreed with the proposal for the FCA to retain emergency intervention powers in relation to sovereign debt and CDS, as they will continue to have for other financial instruments. A number stressed that they supported this on the basis that these powers only be exercised in exceptional circumstances. One respondent also reiterated feedback they had provided in response to the Treasury's December 2022 Call for Evidence on the SSR, where they had said that they would prefer for the FCA's short selling emergency intervention powers to be removed altogether. Several respondents emphasised their support for what they described as the FCA's pragmatic approach to using its emergency intervention powers to date but asked for greater clarity on the scope of the FCA's emergency intervention powers, and how they might be exercised. Two respondents asked for clarity specifically on reporting requirements for sovereign debt in exceptional circumstances, to help firms assess whether to maintain or decommission their existing sovereign debt reporting systems.

Further views

2.7 Respondents raised no further views beyond those provided in response to the questions 1 and 2 in the consultation.

Next steps

2.8 Given the support for the government's proposal in response to the consultation, the government will remove requirements currently placed on investors when taking out short positions in sovereign debt or sovereign CDS, and the related reporting requirements under the UK's new short selling regime.

2.9 The government will retain sovereign debt and CDS in scope of the FCA's emergency intervention powers for short selling, which will be treated the same as other financial instruments. As part of these retained powers, the government will require the FCA to set out its approach to using these powers. The government considers that this should provide the market with greater upfront clarity on the FCA's use of its emergency powers. The FCA will consult on this approach in due course.

2.10 The government has published a draft Statutory Instrument in parallel to this document illustrating the key features of the UK's new short selling regime as a whole. This includes the government's position on sovereign debt and CDS as set out in this document. The government would welcome any technical comments on the draft SI by 10 January 2024.

HM Treasury contacts

This document can be downloaded from www.gov.uk

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