Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

August 7, 2023

Securities and Markets
1 Red HM Treasury
1 Horse Guards Road
SW1A 2HQ

Re: Short Selling Regulation: Consultation—Sovereign Debt and Credit Default Swaps

Dear Sir/Madam,

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to comment on His Majesty's Treasury's ("**HMT**") Consultation on the UK's Short Selling Regulation ("**SSR**") Review in the context of Sovereign Debt and Credit Default Swaps ("**CDS**").[2] We continue to believe that the launch of the SSR Review is a critical step toward strengthening the UK's dynamic and attractive international financial services centre and were pleased to see HMT's response to the Call for Evidence on SSR, which the MFA previously commented on.[3] We believe the recent changes adopted to the SSR Review will strengthen the UK's attractive international financial services centre. In particular, the targeted modifications to public disclosure and position reporting will reinforce the efficiency of capital markets and unlock greater investment across the UK.

MFA is strongly supportive of the more recent work of the UK Government to review the Sovereign Debt and CDS framework within the SSR and through the Smarter Regulatory Framework for financial services. To that end, MFA and its members appreciated the opportunity to offer views of the alternative asset management sector at HMT's August 1 industry roundtable on sovereign debt and CDS.

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[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] *See* HMT, Short Selling Regulation Consultation—Sovereign Debt and Credit Default Swaps (July 2023), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168851/Short_Selling_Regulation_Review_-_sovereign_debt_and_CDS_consultation_document__1_.pdf.

[3] See HMT, Short Selling Regulation Review—Government Response (July 2023), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1169119/Short_Selling_Regulation_Review_-_Government_response__1.pdf. *See also* MFA Response to HMT's Call for Evidence on the UK's Short Selling Regulation (Feb. 23, 2023), available at: https://www.managedfunds.org/wp-content/uploads/2023/03/MFA-Response-to-HMT-Call-for-Evidence-on-the-Short-Selling-Regulation_Signed_FINAL.pdf.

Executive Summary

MFA is strongly supportive of the UK Government's review of the Sovereign Debt and Credit Default Swaps framework within the SSR. The UK's sovereign debt markets are critically important for fueling the UK economy and provide portfolio diversification benefits to institutional investors.

As explained in more detail below, we agree with HMT that:

- The cover requirement for sovereign debt in case of short selling is unnecessary;
- The current ban on uncovered sovereign CDS is unnecessary; and
- The reporting requirements for short selling of sovereign debt and for sovereign CDS are superfluous.

Background and Context

The UK's sovereign debt markets are critically important for fueling the UK economy. Deep, liquid gilt markets provide important portfolio diversification benefits to institutional investors given their low correlation with equities and many other securities. Notably, alternative asset managers are important investors in gilts and other sovereign debt markets, and their investment, trading and hedging activities contribute to overall market efficiency, liquidity, and resiliency.

While the sovereign CDS market is comparatively smaller than the broader CDS market, it provides important protection for investors against losses that may be incurred from "credit events" however unlikely they may be. Sovereign CDS is also a valuable tool for hedging risks associated with other assets such as domestic banks, utilities and other companies whose value is correlated with the creditworthiness of the sovereign. Moreover, the ability to manage risk through sovereign CDS helps facilitate greater investment across the economy.

MFA agrees with the Government's proposed removal of requirements related to sovereign debt and sovereign CDS under SSR. Namely, we support the removal of:

- The cover requirement for sovereign debt in case of short selling (Article 13)
- Ban on uncovered sovereign CDS positions (Article 14)
- Reporting requirement for net short positions in UK-issued sovereign debt over 0.5% of total outstanding debt and reports to regulator when covering requirements in sovereign CDS are suspended (Articles 7 and 8).

Cover Requirements for Sovereign Debt in Short Selling

MFA believes that the cover requirement for sovereign debt in case of short selling is unnecessary. The main purpose of mandating that financial market participants have located or own equities positions when conducting short selling is to address risk of settlement failure. Given how highly liquid and robust the £2.4 trillion UK gilt market is, positions are very easily covered by market participants. While the sell-side is likely to be better positioned to comment on any problems surrounding settlement discipline regarding sovereign debt, MFA and its members have not observed any issues that are cause for concern or insinuate that cover requirements are needed.

Ban on Uncovered Sovereign CDS Positions

MFA agrees that the current ban on uncovered sovereign CDS is also unnecessary. Sovereign CDS improves financial markets by increasing liquidity in sovereign debt itself and, as stated above, facilitates greater long investment in corporates associated with the financial health of the sovereign. An inability to hedge using sovereign CDS can impact investment demand and result in fewer investors in the market. This results in higher borrowing costs and lower liquidity.

Reporting Requirement for Net Short Positions

The reporting requirements for short selling of sovereign debt and for sovereign CDS are also superfluous. As the Government notes in the consultation, a 0.5% of total outstanding debt is a position so large that reports are very unlikely. Yet, this requirement still necessitates that financial market participants have systems in place to monitor positions which has created unwarranted compliance burdens for firms. As the Government notes, regulators receive reporting on sovereign debt and sovereign CDS markets through other means such as Sterling Money Market data, the Markets in Financial Instruments Regulation (MiFIR), the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transaction Regulation (SFTR).

In essence, the requirements on sovereign debt and sovereign CDS cause unnecessary operational burdens on otherwise well-functioning wholesale markets. MFA believes that these requirements are the result of superimposing some of the requirements designed for position reporting of equities onto sovereign debt markets. The requirements do not take into consideration the size and depth nor the market structure or issuance process of sovereign debt which all differ greatly from equities markets. As noted in the consultation, other thriving financial markets across the globe (*e.g.*, the U.S., Canada, and Singapore) have not adopted similar requirements for these reasons. In addition, MFA notes that the UK Government's position on this issue has been consistent since 2010 when these proposals were first considered when the European Union was crafting policy and debating on the SSR.

Conclusion

MFA supports the proposed changes with respect to sovereign debt and CDS within the context of the SSR. We are not aware of compelling evidence supporting retention of rules that are largely superfluous and can result in unnecessary, costly compliance for market participants. Removing these requirements will only improve market efficiency and further enhance the competitiveness of the UK's capital markets.[4]

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[4] With respect to the FCA's emergency intervention powers noted in paragraphs 1.5 and 2.15 of the Consultation, we appreciate the high bar the FCA has publicly set on imposing short selling bans on uncovered short positions in UK sovereign CDS and the reputation it has built for using short selling emergency powers judiciously. As a general matter, we do not support short sale bans because we believe they are not effective and can produce more harm than benefit (and because other market mechanisms are available to address policy concerns). However, we are particularly concerned about the application of a short sale ban with respect to sovereign debt and sovereign CDS. While we understand that a short sale ban on uncovered short positions in UK sovereign CDS is very unlikely, we note that the market circumstances that would trigger a ban are likely times when market participants would have the greatest need to use sovereign CDS. We are further concerned that if uncovered sovereign CDS are banned, it could have a destabilizing effect on sovereign debt.

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MFA would be happy to elaborate on the points contained in this letter, should the Government wish to engage in further conversation. If you have any questions regarding this letter, or if we can provide more information, please do not hesitate to contact Andrew Malin, Manager, International Government Affairs, or the undersigned, at (202) 730-2600.

Respectfully submitted,

Jillien Flores

Executive Vice President and Managing Director,

Head of Global Government Affairs

MFA

1301 Pennsylvania Ave NW, Washington, DC 20004 | 546 5th Avenue, New York, NY 10036 | Rue d'Arlon 40, 1000 Brussels, Belgium |
14 Hanover Square, Mayfair, London, United Kingdom, W1S 1HT
ManagedFunds.org