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Dear Baroness McIntosh,

At the Grand Committee debate on the Financial Services Bill on 8 March, we discussed the UK's short selling regime. During the debate, I made a commitment to write on the recent Bank of International Settlements (BIS) study on the activities of bond exchanged traded fund (ETF) managers during March and April 2020. I apologise for the delay in fulfilling this commitment. I would also like to take this opportunity to revisit one or two broader points I made during the debate.

The BIS report, 'The anatomy of bond ETF arbitrage', discusses the ways in which bond ETFs differ from equity ETFs. As you know, ETFs are investment funds that often trade on stock exchanges and typically track an index or portfolio. They have grown significantly over the past decade, from less than $10 billion in 2009 to $1.2 trillion in 2021 and are largely concentrated in the US.

The report notes that, in March and April 2020, there was a decoupling between the share prices of bond ETFs and the value of their underlying assets, which was not seen in equity ETFs. It suggests that Authorised Participants – which are a special type of investor, typically a large bank or market maker, who create and redeem ETF shares – were unable to exploit price differences, through arbitrage, between ETF shares and their underlying bonds. This is notably owing to the characteristics of the bond market, which is less liquid than the equity market.

The report concludes that such decoupling may have adverse implications for market functioning if, in the long run, investors perceive that they can only redeem low-quality bonds in stressed times. That said, the report also highlights that the specific features of bond ETFs can enhance their shock-absorbing capacity, by limiting the risk of runs on ETFs, and help stabilise distressed markets.

While ETFs are often mentioned within the context of short selling, the incident described in this report is not an example of short selling.

However, I can assure you that the Government and the financial regulators are monitoring such risks appropriately. The Financial Policy Committee reported in their May and August Financial Stability Reports last year that ETF shares appeared more liquid than underlying corporate bond markets in March 2020, while highlighting the risk of

Baroness McIntosh of Pickering
House of Lords

liquidity mismatch in ETFs. There is significant work underway, both domestically and internationally, to undertake analysis on non-banks, including ETFs. This follows the severe market liquidity stress seen in March 2020, which exposed vulnerabilities in non-banks and highlighted the risks they may pose given their interconnectedness with other parts of the financial system. HM Treasury will continue to monitor market developments and work closely with the regulators and international partners on these important questions.

You also raised concerns about trading in GameStop shares in the US, the regulation of short selling, and asked whether a similar event could happen in the UK.

GameStop is a US based company, and the UK does not regulate the exchange on which it is listed. It is therefore not for me to comment on the specifics of what occurred there.

However, I can say that short selling, and the holding of a large net short position, is not in itself an abusive practice and when short sellers meet their regulatory requirements it is a legitimate investment and trading technique that can contribute to orderly and open markets. For example, a pension fund may use short selling as a part of a wider strategy to manage risk and market volatility. This allows the fund to maintain yields, which helps ensure that people receive a stable income from their pension plan.

Short selling in the UK is governed by the Short Selling Regulation, which places a number of requirements on firms. Amongst other things, the UK regime requires firms taking short positions of 0.1% or more of the issued share capital of a given company to disclose the size of their short positions to the Financial Conduct Authority (FCA). This allows the FCA to identify which firms hold short positions early on, which companies those positions are in, and what the size of those positions are. When firms take a short position that is 0.5% of the issued share capital of a given company, they must disclose their position publicly.

The UK short selling regime gives the FCA various powers to intervene in exceptional circumstances. If the FCA identifies a short position and believes the position poses a serious threat to financial stability or market confidence in the UK, the FCA has the powers to intervene. Similarly, the FCA has powers to intervene if the price of an instrument has fallen significantly during a single trading day in relation to the closing price of that instrument on the previous trading day.

In light of the existing powers set out above, I would like to reiterate the view I expressed during the debate, that the current regime is working as intended.

I am copying this letter to all those who spoke in the Committee debate on 8 March, and I am placing a copy in the Library.

BARONESS PENN