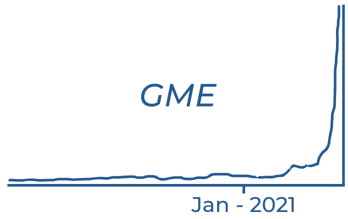
SKADI

S K A D I Impact Piece

GameStop Price Surge: Implications for Financial Institutions



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Skadi Scores: Areas of Focus

Credit Risk Management	Low	Med	High
Prime Brokerage	Low	Med	High
Stock Lending	Low	Med	High
Compliance: MAR & AML	Low	Med	High

Summary

Retail driven short squeeze

Background

GameStop shares have been on a surge in the past week, moving from $20 on the 12-Jan to over $360 on 27-Jan, an 18-fold increase in 10 days. The surge has been caused by a short squeeze (technically coupled with a short gamma squeeze), with Hedge Funds caught on one side and a group of retail traders on a Reddit forum called WallStreetBets on the other. The short squeeze has been replicated across a number of other shares with large short interest.

Prime Brokerage oversight over HF leverage

Short Term Implications

Immediate concerns within a Financial Institution will likely lie within the Credit Risk department: ensuring that the bank has control of any liabilities in its Prime Brokerage department and that underlying clients are not over-leveraged and have the requisite collateral in place.

Over 100% of free float sold short - rehypothecation issues.

Focus will also be on the stock lending desk. Given talk that short interest in GameStop was over 100% this would either be caused by naked short selling (with no borrow in place) or multiple borrows of the same line of stock (rehypothecation).

Greater scrutiny of stock loan, mechanics of borrow pools and how borrow rates are set.

Control Impact

In the medium term, we envisage a closer scrutiny by 2nd and 3rd Lines of Defence over the short selling function in banks, with particular emphasis on the line of sight over borrow pools, how borrow rates are set, and what controls are in place to allow clients to borrow pre-confirmation (auto-borrow). Certainly, the Financial Services Board (FSB) in recent reports has been urging firms to tighten up monitoring and measurement of stock loan use and re-use.

Beyond this, there may be a need to revisit Prime Broking and Stock Lending agreements to determine if any clauses have been breached, or not properly enforced.

Internal controls around products that use "natural" short positions – CBs, derivatives & Merger Arb

Domino Effects

Product groups that are heavy users of Stock Lending, for example Convertible Bond Arbitrage, Equity Derivatives, and M&A Arbitrage, will also warrant close scrutiny by internal control functions. There will be a need to revisit provision of leverage, provision of margin and market risk limits for desks that use stocks with a "natural" Short Interest (a delta hedge against a convertible bond or an M&A bidco). Stress tests now need to take account of some of the idiosyncrasies we have seen due to these short squeezes.

AML concerns around liquidity event

Compliance Impact

An event like this brings the perfect storm of liquidity, shortened holding periods and, in the case of an options trade, a security that transforms – all perfect cover for Money Laundering.