



EUROPEAN COMMISSION
Internal Market and Services DG

The Director-General

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Mr Eddy Wymeersch
Chairman
The Committee of European
Securities Regulators
11-13 avenue de Friedland
75008 Paris

Subject: Physical short-selling in the context of the UCITS Directive – March 2007 CESR guidelines on eligible assets

Dear Mr Wymeersch,

The question has recently arisen of whether UCITS funds are entitled to engage in transactions which consist of borrowing title to a security which they have sold short. It has been suggested that where a UCITS borrows a security, it is in a position to settle any delivery obligations arising from the short sale. Consequently, the short sale would be 'covered' and the transaction would not fall foul of the UCITS (article 42) prohibition on 'uncovered sales'. Given that such an interpretation would mark a significant departure from widely held position that UCITS are not permitted to engage in physical short selling, my services have given careful consideration to this proposition.

In the course of investigating the proposition that physical short selling (backed by a securities borrowing agreement) is permitted by the UCITS Directive, attention was drawn to the drafting of the CESR level 3 guidelines on eligible assets¹. Point 24 of these guidelines contains the following wording:

"The requirement to comply with Article 21 of Directive 85/611/EEC imply in particular that if UCITS are authorized to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operation must be taken into account to calculate the global exposure of the UCITS".

It has been suggested that this wording constitutes recognition that securities can be borrowed in order to generate leverage/be sold short. This drafting is cited as critical

¹ CESR's guidelines concerning eligible assets for investment by UCITS of March 2007; CESR/07-044

in supporting the view that physical short selling (when backed by security borrowing) is compatible with the UCITS Directive.

Having carefully considered this issue, DG Internal Market and Services concludes that physical short selling of borrowed securities is inconsistent with important provisions of the UCITS Directive. Furthermore, in contrast to the provisions governing the risk-management, reporting and upper limits on derivatives generated exposures, there are no explicit provisions governing exposures through physical short selling.

As regards inconsistencies with the UCITS Directive, DG Internal Market and Services has identified the following concerns:

- Firstly, the mere existence of a stock-borrowing agreement to accompany the short sale does not mean that the transaction can be equated with a 'covered sale' – and thereby escape the prohibition of article 42 on 'uncovered sales'. 'Covered sale' should be interpreted as a sale of a security owned – not borrowed - by a market participant: this interpretation is supported by statements from IOSCO and is reflected in practice and law of many Member States. This is also the approach set out by the Commission in Recommendation 2004/383/EC² of 27 April 2004³. The mere fact of borrowing the security to cover potential obligation to settle the short sale does not mitigate the exposure of the UCITS to potentially unlimited market risk.
- Secondly, the existence of the stock-borrowing agreement contravenes the prohibition on borrowing set forth by article 36 UCITS. The prohibition on borrowing laid down in this Article – except on limited and temporary basis – is not confined to borrowing money but also extends to securities.

A further crucial consideration is the absence from the UCITS Directive of harmonised provisions governing risk management controls for physical short-selling. Discussions in the CESR Operational Task Force have highlighted that physical short selling gives rise to market risk, operational risk, and counterparty risk. It also implies additional settlement risk compared to similar exposures generated through derivatives.

EU legislation in UCITS does not provide any clear or explicit rules governing the extent to which UCITS funds can assume risk through physical short selling, or on the requirements for managing the related risks. In this important respect, exposures generated by physical short selling are to be distinguished from leverage generated through derivatives. For the latter, the Directive imposes directly applicable provisions (article 21.3) as further amplified in Commission Recommendation. This leads us

² Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) (OJ L 144, 30.4.2004)

³ In this recital, the Commission defines 'uncovered sale' as a transaction in which the UCITS is exposed to the risk of having to buy securities at a higher price than the price at which the securities are delivered and thus making a loss and the risk of not being able to deliver the underlying financial instrument for settlement at the time of maturity of the transaction.

to conclude that the UCITS Directive did not contemplate the right for UCITS to engage in physical short selling. If, despite the apparent inconsistencies with UCITS provisions, the practice were to be tolerated, it would take place in an EU legal vacuum. This would give rise to significant concerns for the consistent implementation of the UCITS Directive, and its effectiveness as a framework for the EU wide public marketing of retail investment funds.

This conclusion represents the result of careful reflection of the issues at stake. This conclusion has been heavily informed by discussions in the Operational Task Force of the CESR Investment Management Expert Group which has devoted particular attention to assessing the equivalence of/differences between exposures generated through derivatives (as explicitly permitted within strict limits by the UCITS Directive) and physical short-selling. DG Internal Market and Services has benefited significantly from the analysis undertaken by the Operational Task Force, further underlining the usefulness of inter-supervisor exchanges on practical enforcement issues.

The drafting of the relevant sections of the level 3 guidelines therefore risks giving rise to interpretations which would be incompatible with our understanding of the level 1 Directive. I would therefore like to request the deletion of all references to "securities borrowing" including "securities borrowing to generate leverage through the re-investment of collateral" in point 24 of the guidelines. In addition, I would like to suggest broader review of relevant sections of the level 3 guidelines to ensure coherent treatment of the issue of physical short selling and borrowing throughout the level 3 guidelines. In view of the uncertainty that has arisen in respect of this issue, I would also request that the decision to rescind the level 3 guidelines be undertaken as quickly as possible and be widely publicised (e.g. through circulating of notice to CESR Members and publication of corrigendum). This will lead to a consistent approach to this matter by all competent authorities, and a widespread understanding by all interested market participants. To this end, I would agree to publication of this letter as a basis for motivating this adjustment to the level 3 guidelines.

I would like to underline that these considerations arise only in respect of isolated provisions in this extensive body of complex advice. The advice provided by CESR in response to the Commission mandate on eligible assets was instrumental to the promulgation of the Commission Directive on eligible assets. The accompanying level 3 guidelines provide a crucial support in ensuring convergent implementation of this Directive.

DG Internal Market and Services was fully associated to the process of preparing the CESR level 3 guidelines. Therefore, the relevant sections of the level 3 guidelines which risk giving rise to inconsistent interpretations are best viewed as a regrettable oversight, arising in the context of a particularly complex and demanding exercise in codification of supervisory practice.


I would like to conclude by reiterating the Commission services' appreciation of the work of CESR on these important issues. Investment Management Expert Group and the Operational Task Force are currently considering several important issues related to the use of new investments powers and techniques by UCITS. This work is crucial for

the long term credibility and the good functioning of the UCITS legislative framework. The present letter is, in my view, a token of the importance that the Commission attaches to this work and our willingness to contribute by promoting a consistent interpretation of the Directive.

Yours sincerely,



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Deputy Director General

 Jörgen HOLMQUIST

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