

Covered Short
Sales by Irish
UCITS Funds
Financial
Regulatory
Policy Change

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■ COVERED SHORT SALES BY IRISH UCITS FUNDS FINANCIAL REGULATOR POLICY CHANGE

Policy Change Highlights

The Financial Regulator issued a revised policy note on October 5, 2007 in relation to physical short selling by UCITS.

Under this revised policy, UCITS will now be permitted to engage in covered physical short sales where the cover is provided through stock borrowing. Additional rules apply as set out below. Going forward, this will mean that UCITS will be able to pursue long/short strategies without being limited to synthetic replication through derivatives.

Whilst of particular relevance for 130/30 type funds (see further below), this revised policy has broad application for UCITS wishing to short sell.

Background to Policy Change

Prior to the release of this revised policy note, UCITS were not permitted to engage in physical short selling but were able to pursue synthetic shorting strategies by taking short positions through the use of derivatives, subject to the overriding requirement that global exposure did not exceed 100% of net assets.

Whilst that global exposure limit remains, the new policy reflects what is happening in the market place and the market's understanding of what constitutes "cover" and is clearly a welcome development.

The key point is the acceptance of a distinction between covered and uncovered short sales.

The position in relation to uncovered short sales remains – they are prohibited under Regulation 72 the UCITS Regulations¹.

¹ European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 (SI. No 211 of 2003) (as amended).

The Revised Policy

The revised policy now provides that where stock is borrowed before entering into a physical short sale of that stock, the stock borrowing arrangement will be considered to constitute cover for the short sale.

The new policy is subject to the following parameters:

- ▣ Short sales are covered through a stock borrowing at the outset, in accordance with the UCITS Regulations;
- ▣ The stock borrowing arrangement must be in accordance with the CESR guidelines and the assets used by the fund to support the stock borrowing cannot be passed to the stocklender (although a charge over such assets may be given by the fund's trustee/custodian);
- ▣ General leverage limits are not exceeded;
- ▣ The strategy is adequately disclosed in the fund's prospectus and risk management process;
- ▣ The prospectus must disclose a clear description of the covered short sale strategy. A risk factor must outline the unlimited risk of an increase in the market price of the security that is the subject of the short position;
- ▣ The prospectus must contain an indication of the expected level of leverage and confirm that leverage will be calculated taking into account the short exposure as well as any exposure created through the use of derivatives.

UCITS Notice 12 and Guidance Note 3/03 will be revised shortly to reflect the change in policy.

130/30 UCITS

130/30 is the term used to describe the strategy that falls between the traditional long only strategy and the long/short strategy where a fund sells short 30% of its equity portfolio and

applies the proceeds to purchase an additional 30% of long positions – resulting in a leveraged equity portfolio with a net market exposure of 100%.

We are seeing an increasing number of 130/30 type UCITS, and variations thereof, being established in Ireland for which this new policy is of particular interest.

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