

BaFin bans naked short-selling and uncovered sovereign CDS trading / new draft law proposes further restrictions including currency derivatives – Update 2

On 18 May 2010, the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – "BaFin") issued three decrees (*Allgemeinverfügungen* – the "Decrees") prohibiting (i) naked short-sales of eurozone government bonds (the "Bond-Decree"), (ii) naked short-sales of 10 German financial stocks (the "Share-Decree"), and (iii) entering into uncovered credit default swaps ("CDS") linked to eurozone government debt (the "CDS-Decree"). The BaFin has also published Frequently Asked Questions (FAQs) on the Decrees on its website. Following our Client Briefing dated 19 May 2010 on the Decrees, this Client Briefing provides an update and a summary of the most recent developments, including a summary of a new draft act published by the German Federal Ministry of Finance (*Bundesfinanzministerium* – "BMF") which is intended to replace the Decrees and which would introduce even further restrictions.

BMF Draft Act

On 25 May 2010, the BMF published a draft of an Act for the Strengthening of the Stability of the Financial Markets (*Gesetz zur Stärkung der Stabilität der Finanzmärkte*) which replaces the BMF's earlier discussion draft of 3 May 2010 to the extent that short selling measures are concerned. The earlier discussion draft for an Act on the Strengthening of Investor Protection and Enhancing the Functionality of the Capital Market (*Diskussionsentwurf eines Gesetzes zur Stärkung des Anlegerschutzes und der Verbesserung der Funktionsfähigkeit des Kapitalmarkts*) covered, *inter alia*, a prohibition of naked short sales and transparency requirements regarding net short positions in shares admitted to trading on the regulated market of a German exchange.

Prohibition of naked short sales and uncovered CDS

The scope of the new draft is substantially wider than that of the earlier discussion draft and to a certain extent also wider than the Decrees currently in force. The draft provides for a general prohibition of naked short sales of (i) shares and (ii) debt instruments issued by central governments, regional governments and local political subdivisions of EU member states whose lawful currency is the euro, which are admitted to trading on the regulated market of a German exchange and have actually been introduced to trading.

It is important to note that the proposed prohibition of naked short sales of shares is not limited to the shares of the ten German financial sector enterprises referred to in the Share-Decree. Shares of companies located outside Germany are exempted from the prohibition provided that they are not exclusively admitted to trading on the regulated market of a German exchange. Moreover, in comparison to the Bond-Decree, the prohibition does extend not only to debt instruments issued by central governments but also to debt instruments issued by regional governments and local political subdivisions of eurozone countries.

The requirement that the shares or debt instruments have actually been introduced to trading relates to section 37 of the German Exchange Act (*Börsengesetz*) according to which bonds issued by EU/EEA member states are automatically admitted to trading on the regulated market of all German exchanges. Hence, without this further limitation, the draft could have been interpreted to cover any such government bonds.

Key Issues

Draft law proposing the following:

- Ban on naked short sales of certain shares and derivatives
- Ban on naked short sales of certain Eurozone sovereign debt instruments
- Ban on derivative instruments linked to the euro
- Ban on uncovered Eurozone sovereign CDS
- Disclosure regime for net short positions in shares
- Clarification of territorial scope

Scope and application of existing Decrees

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With respect to the prohibitions of naked short sales of shares and eurozone government bonds, there will be an exemption for market makers, i.e. persons who have undertaken by contract to make binding buy and sell bids to the extent that such transactions are required for performance of their contractual obligations.

The new draft law would also prohibit uncovered CDS where at least one reference obligation is an obligation of central governments, regional governments or local political subdivisions of EU member states whose lawful currency is the euro (irrespective of whether such reference obligations are debt instruments admitted to trading on the regulated market of a German exchange).

Moreover, the new draft restates the March 2010 transparency requirements published by the BaFin, but at the same time extends their scope to cover all shares admitted to trading on any of the regulated markets of a German exchange. It also provides for a publication of an investor's net short positions exceeding 0.5% - identifying the investor by name - in the German electronic federal register (*elektronischer Bundesanzeiger*).

Inclusion of derivatives on shares

The new draft act goes beyond the scope of the Decrees since the prohibition of naked short sales would also cover transactions in derivatives the price of which depends directly or indirectly on shares covered by the prohibition if from a commercial perspective such derivatives correspond to a short sale of shares. The relevant prohibition as well as the reasoning to the draft act seem wide enough to cover also cash-settled derivatives, however, this requires further clarification.

Prohibition of derivatives linked to the euro

Moreover, the new draft includes a prohibition of derivative instruments linked to the euro if they do not serve to hedge own currency risks. Based on the purpose of the draft to limit speculative transactions, derivative instruments linked to the euro should still be permitted if they are intended to hedge the currency risk of at least one party. However, the text of the prohibition could also be read in a way that the relevant instrument must serve to hedge the currency risks of both parties, which would rarely ever be the case. In any event, the analysis whether or not a certain transaction qualifies as a true currency hedge is likely to lead to significant technical difficulties.

Territorial scope of application

Whilst the territorial scope of application of the Decrees is not entirely clear, the draft provides for further clarifications. The prohibition of naked short sales of shares and debt instruments as well as the transparency requirements for net short positions shall apply on an international level. The scope of those provisions of the German Securities Trading Act (*Wertpapierhandelsgesetz – "WpHG"*) that are applicable on an international level is amended and will now explicitly cover the afore-mentioned prohibitions. However, the prohibition of uncovered CDS linked to debt instruments is intended to apply only to transactions concluded or entered into in Germany (corresponding to the statement of the BaFin in its FAQs on the CDS-Decree). In contrast, the territorial scope of application of the new prohibition of derivative instruments linked to the euro is not entirely clear. On the one hand (and contrary to the prohibition of naked short sales of shares and debt instruments), the prohibition shall not be included into the scope of those provisions of the WpHG that are applicable on an international level. On the other hand, the draft act does not provide either that the prohibition is intended to apply only to transactions concluded or entered into in Germany as in relation to the prohibition of uncovered CDS linked to debt instruments.

Sanctions

The BaFin shall be authorised to sanction the intentional or grossly negligent contravention of the prohibitions of naked short selling or the prohibition to enter into euro currency derivatives not serving hedging purposes with a monetary fine of up to EUR 500,000. Non-compliance with the transparency requirements regarding net short positions shall be subject to a fine of up to EUR 200,000.

Power for BaFin to impose emergency measures

In addition, by providing for a new legal authorisation the draft will extend the powers of the BaFin to temporarily limit or prohibit dealings in certain financial instruments, in particular derivatives on eurozone government bonds, and link those powers to the sanctioning regime of the WpHG. The contractual validity of transactions entered into in contravention of such an order shall remain unaffected. The BaFin shall also have the power to order that persons dealing in certain financial instruments must disclose their corresponding positions and notify the BaFin thereof.

Outlook and timeline for implementation

The proposed extension of the prohibitions to cover euro related derivatives is striking as this is not even foreshadowed by the existing framework. It is also remarkable that the draft law would extend the prohibition on short sales of shares to cover derivatives on shares since derivatives are not covered by the recent Share-Decree, according to the FAQs of the BaFin (see below). There is also no hedging exemption except for currency derivatives.

In addition, the connection between the prohibition on naked short sales and the transparency requirements in regard of net short positions will require further clarification. Due to the inclusion of derivatives in the prohibition on naked short

sales, the transparency requirements would effectively only apply to covered short positions in derivatives. However, it is difficult to imagine how such covered short positions could still result in a reportable net short position.

The timing of the further legislative process has not been determined yet. However, given the extremely short period for consultation on the new draft and the political impetus of the initiatives, it seems likely that a (consolidated) draft act will be introduced to the German parliament still before the summer recess.

BaFin Decrees

FAQs issued in relation to the Decrees

The FAQs provide important guidance on the scope of application of the Decrees, in particular on the types of transactions covered by the prohibitions on naked short selling of shares and government bonds. Since the BaFin intends to update the FAQs from time to time, market participants should regularly check the BaFin's website for any new developments.

In this context, the FAQs clarify that the prohibitions under the existing Decrees do not extend to the trading in derivative short positions, such as the sale of futures (short futures) or the purchase of put options (long puts). Also the sale of a call option (short call) would not be covered since it does not yet result in a short position in shares and because the short position only arises when the call option is exercised. Moreover, according to an informal statement of the BaFin, even the short position deriving from the exercise of an option itself would not fall within the scope of the prohibitions since the resulting delivery obligation stems from a derivative transaction, not from a naked short sale.

In addition, the FAQs state that the prohibitions under the existing Decrees do not apply to sales of basket and index products relating to shares or government bonds.

Furthermore, the FAQs clarify that with respect to CDS the existence of credit risk (which justifies the entering into a CDS) may be determined on a group level (section 10a of the German Banking Act), i.e. one group company may enter into a CDS as a protection buyer in order to hedge credit risk incurred by another group company.

Also, a CDS is exempt from the prohibition even if the credit risk protection bought does not fully (i.e. 1:1) match with the existing position to be hedged provided that the hedge results in a significant reduction of the credit risk in the protection buyer's own comprehensible evaluation.

Legal basis of the Decrees

Similar to the previous measures of the BaFin in 2008 in relation to short-selling and the disclosure obligations of March 2010, the Decrees are based on a general legal authorisation under section 4 para. 1 of the WpHG which empowers the BaFin to counteract undesirable developments that may adversely affect the orderly conduct of trading in financial instruments or the provision of investment services which may result in serious disadvantages for the financial market. The Decrees are intended to ban speculation, not to hinder any hedging and have therefore to be construed accordingly.

Transactions concluded in breach of the Decrees are not invalid. Under German law, statutory prohibitions can only have such effect if the respective legal act so provides. In order to have this effect, a prohibition would have needed to be based on section 37g of the WpHG which permits the BMF to prohibit certain financial forward transactions (*Finanztermingeschäfte*) with the consequence of the invalidity of such transactions and also of transactions being considered as a circumvention thereof.

Territorial scope of application

Of crucial importance in determining the effects of the Decrees is their territorial scope of application.

General international scope of the WpHG

Generally, the territorial scope of application of the WpHG has to be derived from its legal purpose. The WpHG is intended to protect the orderly functioning of securities trading and the capital market in Germany. This effect cannot be achieved only by applying the WpHG to purely domestic activities. With respect to insider dealing and market manipulation, the WpHG specifically sets forth its international scope of application (section 1 para. 2 of the WpHG). Accordingly, acts committed outside Germany are subject to the German insider dealing and market manipulation prohibitions if the relevant shares are listed on a German exchange. Where other provisions are intended to have an extraterritorial effect, this is specifically provided for in the WpHG.

In the absence of such an explicit provision, it is not clear whether the general legal basis chosen by the BaFin is sufficient for an extraterritorial application (as the scope of application of German administrative law generally is limited to the territory of Germany absent specific statutory provisions) although the Decrees are not intended to merely secure compliance with provisions of German law but primarily to prevent disorderly markets in Germany.

In contrast to the earlier release of March 2010 on transparency requirements for net short-selling positions in which the BaFin has taken the general view that its requirements have an extraterritorial effect, the BaFin's position in relation to the three Decrees is as follows:

- The BaFin explicitly stated in its FAQs that the CDS-Decree only applies to CDS transactions which are entered into "in Germany". In this context, the treatment of cross-border transactions is of particular importance. Whether a transaction is entered into in Germany depends on general civil law (under German law, this would be the place of receipt of the acceptance of the offer or – in specific cases – the place where such acceptance is declared). However, this question would have also to be considered under applicable private international law, in particular with reference to Article 11 of the Rome I Regulation (Regulation (EC) No 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations).
- Where one party acts from another jurisdiction whilst its contractual counterparty is located in Germany, one cannot exclude the possibility that the contract would be regarded as being "entered into in Germany". However, as this depends on the precise circumstances of the case (including, among other things, the means of contractual correspondence), this is not a criterion being capable of giving clear guidance. In any event, a contract concluded by parties located outside Germany should not be regarded as a transaction "entered into in Germany" even if one of the parties is acting as an agent for a party in Germany and/or the transaction is booked into the books of a German entity after the conclusion of the contract. The BaFin has furthermore explicitly confirmed in its FAQs that neither the place of booking nor the exchange of confirmations following a trade are of relevance. Furthermore, the prohibition is only addressed to the protection buyer, not to a protection seller.
- With respect to transactions in government bonds, BaFin states in its FAQ that "*in any case [...] transactions entered into in Germany*" are covered by the Bond-Decree. This leaves room for interpretation that other situations could also be covered by the prohibition, depending on the circumstances of the individual case. However, in contrast to the CDS-Decree, the Bond-Decree only covers short sales of bonds which are listed in one of the regulated markets of a German exchange (although it applies even if this is not the main market for the relevant bonds).
- As regards the Share-Decree, BaFin's FAQs do not contain any comment on its territorial scope. However, we assume that the BaFin would interpret the territorial scope of application of the Share-Decree in line with its recent statements regarding the interpretation of its transparency requirements promulgated in March 2010. The BaFin's FAQs on the corresponding provisions of March 2010 indicate that it intends the transparency requirements to have extraterritorial effect.

Extended scope for counteracting market manipulation

The Decrees also refer to the intention to counteract market manipulation. BaFin would generally have powers to impose extraterritorial requirements in relation to any activities involving market manipulation as long as the financial instruments concerned are traded in a German regulated market. In such a case, the scope of the Decrees could be construed more extensively. However, as mentioned above, the Decrees are not based on a potential market manipulation. Rather, in the reasoning for each Decree, the BaFin refers to the prohibition of market manipulation with an example containing additional hypothetical facts which may then give rise to a market manipulation (for example, using the media to spread rumours after previously engaging in short selling transactions and not having disclosed the resulting conflict of interest).

Sanctions

The Decrees are based on the general powers of the BaFin under the WpHG. The WpHG does not provide for any specific sanctions for contravention of decrees under these powers. Rather, the BaFin would need to rely on the general rules on the enforcement of administrative measures.

General sanctions

According to the German Act on Administrative Enforcements (*Verwaltungsvollstreckungsgesetz*) and the Act on the Financial Services Supervisory Authority (*Finanzdienstleistungsaufsichtsgesetz*), the BaFin may issue various sanctions for breaches of the prohibitions. The Decrees are immediately enforceable, i.e. sanctions can be immediately taken, depending on the circumstances of the case, even without previous announcement.

In particular, the BaFin is entitled to issue a fine in the form of a penalty payment. Such a penalty payment may amount to EUR 250,000 per breach and may be repeatedly issued until compliance with the prohibition is effected or ensured.

Furthermore, upon the breach of a Decree, the BaFin has the possibility to repeatedly issue more specific prohibitions against specific market participants which then may also be enforced in accordance with the above principles.

Market manipulation

To the extent that a violation of the Decrees also constitutes a market manipulation based on additional facts proven by BaFin, the BaFin could take measures to prevent and to sanction such market abuse. These sanctions would not necessarily be limited to the above-mentioned fines. As activities being considered as market abuse may even qualify as

a criminal offence, sanctions under criminal law could be taken against the responsible (natural) persons. In addition, a financial sanction could be imposed on the relevant company (consisting of a fixed component, plus, as the case may be, an amount equal to the proceeds (*Ertrag*) made in connection with the prohibited activity).

Measures regarding regulated entities

With respect to entities regulated in Germany breach of any Decree could also lead to further investigations by the BaFin with respect to the proper conduct of business of the relevant entity and questions about whether it complies with general requirements to maintain an orderly business organisation. Enforcement of any of these measures outside Germany would depend on the cooperation of foreign competent authorities.

Further developments

The proposed new statutory rules and the Decrees are not the only initiatives regarding a stricter regulation of uncovered short sales.

BaFin

In 2008, as the financial crisis intensified, the BaFin had issued a prohibition on naked short sales of shares of initially eleven German financial sector enterprises in 2008. This prohibition was extended repeatedly but lapsed on 31 January 2010.

On 4 March 2010, the BaFin issued a decree on net short position transparency requirements for ten of the initially eleven German financial stocks. The decree requires market participants to notify net short positions of 0.2% or more to the BaFin which will publish an anonymised version of the report on its website if the net short position amounts to 0.5% or more. This decree entered into force on 25 March 2010 and applies until 31 January 2011. For more information on these reporting requirements, please refer to our Client Briefing "Germany imposes transparency rules on short positions in financial stocks". The new Share-Decree applies in parallel to the already existing March 2010 transparency regime. Hence, short positions that continue to be permitted under the Share-Decree may still need to be reported to the BaFin under the March 2010 transparency requirements.

European developments

On 2 March 2010, the Committee of European Securities Regulators ("**CESR**") submitted a report to the EU Commission recommending the introduction of a pan-European disclosure regime for net short positions in shares. The short selling disclosure regime proposed by CESR is a two tier-model for the disclosure of significant net short positions in shares that are admitted to trading on an EEA regulated market or an EEA multilateral trading facility. While the CESR report also recommends an entry reporting threshold of 0.2% for net short positions, it does not demand a prohibition of naked short sales. However, the report points out that CESR respects the right of the single states to maintain their own measures on short selling "beyond enhancing transparency", including prohibitions on naked short selling.

On 25 May 2010, CESR announced in a press release that it will further complement its work by evaluating enhanced transparency for government bonds markets and related CDSs in the light of recent developments, especially given the decision by the BaFin to introduce a short selling ban. CESR members would be closely monitoring the situation along with national finance ministers and central banks. CESR also stated that "if necessary, co-ordination of any further action will take place within CESR". In addition, the EU Commission said that it will examine the German bans closely and plans to outline its own proposals for regulation within the next few weeks. The impact of these consultations on the German framework still remains to be seen.

The BaFin Decrees and FAQs are available [here](#) (original German text) and [here](#) (English translation).

Our briefing on the March transparency measures is available [here](#). Please click [here](#) to download our newsletter of 19 May.

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