

# BaFin bans naked short selling of financial stock

**The German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – "BaFin") has issued a general decree on 19 September 2008, as amended on 21 September 2008 (the "Decree") banning all transactions which result in a short position or in the increase of a short position in shares of the following issuers belonging to the financial sector ("Affected Shares").**

However, the ban only applies to "naked" short selling. The overall intention is to prevent speculative activities. The Decree is intended not to impair the settlement of any transaction. So-called name-to-follow transactions (Aufgabengeschäfte) by lead brokers (Skontroführer) and certain market making activities are exempted from the ban. Short sales used to hedge already existing positions are exempted.

Following the amendment published by the BaFin on 21 September 2008, also transactions entered into by trading participants with a customer for settlement of a fixed price transaction (Festpreisgeschäfte) are exempted from the scope of the Decree.

The Decree was issued under section 4 (1) of the German Securities Trading Act (Wertpapierhandelsgesetz). The Decree came into effect on 20 September 2008, 0:00 a.m. Irrespective of the publication of the amendment, the amendment provides that any transactions entered into after 19 September 2008 which are covered by the amendment are also exempted. The Decree will expire on 31 December 2008, 24:00 p.m.

The Decree may be revoked and / or amended by the BaFin. The BaFin has published FAQ and it is expected that such FAQ will be regularly updated.

The BaFin does not require banks to monitor whether their counterparties comply with the Decree but recommends that banks make their counterparties aware of the ban. Also, the insider dealing and market manipulation provisions are applicable.

The Decree does not directly address the international scope of application.

## 1. What shares are affected?

Aareal Bank AG	Deutsche Postbank AG
Allianz SE	Hannover Rückversicherung AG
AMB Generali Holding AG	Hypo Real Estate Holding AG
Commerzbank AG	MLP AG
Deutsche Bank AG	Münchener Rückversicherungs-Gesellschaft AG
Deutsche Börse AG	

## Key Issues

**BaFin ban applies to "naked" short selling only**

**Name-to-follow transactions by lead brokers and certain market making activities exempt**

**Customer transactions subject to a fixed price arrangement exempt**

**Overview of impact of BaFin's Decree**

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## 2. Scope of the Decree

The Decree defines prohibited short selling activities as transactions where the relevant "seller of the shares", when entering into the transaction:

- does not own such shares, or
- at the time of the entering into the transaction does not have any unconditionally enforceable legal claim under the law of obligations or under property law for the transfer of title in shares of the same class, or does not have any unconditionally enforceable legal claim under the law of obligations or under property law that results in the title in shares of the same class being transferred.

In addition, the Decree provides that short sales used to hedge already existing positions are also exempted, i.e. such position which existed before 20 September 2008, 0:00 a.m.

In the amendment published on 21 September 2008, the BaFin also provides for an exemption for so-called fixed price transactions (Festpreisgeschäfte).

## 3. Can you short convertibles or warrants on the Affected Shares?

The Decree does not address either convertibles or warrants. At this stage, the Decree seems not to intend to affect the issuing of convertibles and warrants but (naked) short sales to hedge positions under such instruments are only permitted if such position existed before 20 September 2008, 0:00 a.m.

## 4. Can you short derivatives on the Affected Shares?

The Decree does not explicitly address derivatives. We believe that, based on the wording of the Decree referring to the "seller of shares", the BaFin does not intend to cover derivatives but (naked) short sales to hedge positions under such instruments are only permitted if such position existed before 20 September 2008, 0:00 a.m.

## 5. Can you short index futures and derivatives where the index includes the Affected Shares?

The Decree does not explicitly address index futures and derivatives. We believe that, based on the wording of the Decree referring to the "seller of shares", the BaFin does not intend to cover futures and other derivatives, irrespective of whether or not they are linked to an index but (naked) short sales to hedge positions under such instruments are only permitted if such position existed before 20 September 2008, 0:00 a.m.

## 6. Can you short basket trades including the shares? Any difference between baskets that replicate an index and custom baskets? Are there any basket or index exemptions?

The Decree does not explicitly address basket trades. We believe that the Decree would restrict any sale of Affected Shares irrespective of whether the strategy follows an index or a (custom or tailored) basket. In the FAQ the BaFin clarifies that any removal of components of a basket instrument by way of short sale will not be permitted to the extent this involves Affected Shares.

## 7. Any market maker exemption? If so, how broad is the exemption?

Yes. Any market participants which have committed themselves to publish binding buy or sale orders (e.g. market makers, designated sponsors, qualified liquidity providers, etc. and irrespective of whether acting on a stock exchange or a futures exchange) are exempted provided that the transactions are required to fulfil their contractual obligations. Name-to-follow transactions (Aufgabegeschäfte) by lead brokers (Skontroführer)<sup>1</sup> are exempted from this ban, too.

The BaFin may grant further exemptions if requested in writing.

## 8. Does the market maker exemption allow the market maker to go short to sell to a counterparty who wants to buy?

According to the amendment published on 21 September 2008, which is grandfathering any transactions entered between 19 September and its publication, the ban on short selling shall not apply to transactions agreed by trading participants with a customer for settlement of a transaction in shares concluded at a fixed or definable price (fixed price

<sup>1</sup> According to the stock exchange rules and regulations, these financial services providers or banks must take into account all orders that have been entered before the time of the price calculation. For these purposes, lead brokers keep their own order book, i.e., a list containing all respective buy and sell orders.

transaction - Festpreisgeschäfte). The term fixed price transaction is defined as under section 1 (3) of the German banks' standardised General Business Conditions for Dealings in Securities (Sonderbedingungen für Wertpapiergeschäfte).

The BaFin may grant further exemptions if requested in writing.

**9. Can the market maker do anything else?**

We believe that, the market maker exemption is limited to market making activities which arise under pre-existing obligations (i.e. market makers which are obliged to quote).

The BaFin may grant further exemptions if requested in writing.

**10. Any exemption for shorts to hedge pre-existing positions?**

Yes. Short sales to hedge pre-existing positions are exempted from the ban since the Decree provides that short sales used to secure already existing positions are exempted, provided that such positions existed before 20 September 2008, 0:00 a.m.

The BaFin may grant further exemptions if requested in writing.

**11. Any disclosure rules?**

The Decree will not trigger any additional disclosure requirements.<sup>2</sup> The general provisions on insider dealing and market manipulation remain unaffected.

**12. Any restriction on stock lending?**

The Decree does not apply to stock lending. Since the Decree is intended to ban naked short selling it does not cover transactions which are covered by a stock loan.

**13. Any requirement to get a "locate" or "pre-borrow" where shorting is allowed?**

Whilst the Decree does not apply to stock lending as such, any "locate" or "pre-borrow" would only prevent a short selling within the meaning of the Decree if and to the extent the "locate" or the "pre-borrow" resulted in an "unconditionally enforceable legal claim" of the lender against the provider. By referring to "any unconditionally enforceable legal claim", the BaFin limits the entering into a selling position in the Affected Shares without the prior entering into a back-to-back / hedging transaction.

**14. Any new penalties for failure to settle?**

No.

**15. Any anti-avoidance rules?**

No. The Decree does not provide for any explicit anti-avoidance rules. However, the FAQ will provide further guidance on the BaFin's interpretation of the Decree.

**16. International scope of application**

The Decree was based on the general authorisation conferred to the BaFin under section 4 (1) of the German Securities Trading Act. Under this provision, the BaFin may issue decrees which are adequate and necessary to eliminate or to prevent undesirable developments.

The international scope of application of decrees issued under section 4 (1) of the German Securities Trading Act is not entirely clear. Under general principles of German administrative law, any decrees by German authorities are in principle limited to the territory of the Federal Republic of Germany.

Should any violations of this ban qualify as market manipulation, which, however, is not mentioned in the Decree, the ban could apply to all Affected Shares listed on a German ex-change irrespective of the territory in which the relevant manipulative behaviour was exercised.<sup>3</sup>

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<sup>2</sup> There are no reporting requirements specifically applicable to short sales under the German Securities Trading Act.

## 17. Sanctions

The Decree does not provide for any specific sanctions. Therefore, the general principles of German administrative law apply.

Should any violations of this ban qualify as market manipulation, which, however, is not mentioned in the Decree, the sanctions could also be those applicable to market manipulation.

### BaFin press release:

English version:

[http://www.bafin.de/clin\\_109/nn\\_720788/SharedDocs/Mitteilungen/EN/2008/pm\\_080919\\_leerv\\_en.html](http://www.bafin.de/clin_109/nn_720788/SharedDocs/Mitteilungen/EN/2008/pm_080919_leerv_en.html)

German version:

[http://www.bafin.de/clin\\_109/nn\\_722758/SharedDocs/Mitteilungen/DE/Service/PM\\_2008/pm\\_080919\\_leerverk.html](http://www.bafin.de/clin_109/nn_722758/SharedDocs/Mitteilungen/DE/Service/PM_2008/pm_080919_leerverk.html)

### Copy of BaFin's Decree:

English version:

[http://www.bafin.de/clin\\_116/nn\\_720788/SharedDocs/Aufsichtsrecht/EN/Verfuegungen/vf\\_080919\\_leerverk\\_en.html](http://www.bafin.de/clin_116/nn_720788/SharedDocs/Aufsichtsrecht/EN/Verfuegungen/vf_080919_leerverk_en.html)

German version:

[http://www.bafin.de/clin\\_109/nn\\_722758/SharedDocs/Aufsichtsrecht/DE/Verfuegungen/vf\\_080919\\_leerverk.html](http://www.bafin.de/clin_109/nn_722758/SharedDocs/Aufsichtsrecht/DE/Verfuegungen/vf_080919_leerverk.html)

### Copy of the Decree's amendment dated 21 September 2008:

English version:

[http://www.bafin.de/clin\\_116/nn\\_720788/SharedDocs/Aufsichtsrecht/EN/Verfuegungen/vf\\_080921\\_leerverk\\_en.html](http://www.bafin.de/clin_116/nn_720788/SharedDocs/Aufsichtsrecht/EN/Verfuegungen/vf_080921_leerverk_en.html)

German version:

[http://www.bafin.de/clin\\_109/nn\\_722758/SharedDocs/Aufsichtsrecht/DE/Verfuegungen/vf\\_080921leerverk\\_ausn.html](http://www.bafin.de/clin_109/nn_722758/SharedDocs/Aufsichtsrecht/DE/Verfuegungen/vf_080921leerverk_ausn.html)

### FAQs:

German version:

[http://www.bafin.de/clin\\_116/nn\\_722758/SharedDocs/Veroeffentlichungen/DE/Service/Auslegungsentscheidungen/Wertpapieraufsicht/ae\\_080922\\_faq\\_leerv.html](http://www.bafin.de/clin_116/nn_722758/SharedDocs/Veroeffentlichungen/DE/Service/Auslegungsentscheidungen/Wertpapieraufsicht/ae_080922_faq_leerv.html)

<sup>3</sup> The German Securities Trading Act does specifically address the international scope of application in section 1 (2) referring to insider dealing and market manipulation. Section 1 (2) provides that any action or omission committed outside Germany is subject to the German insider dealing and market manipulation prohibition if the underlying shares are listed on a German exchange.

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