CLIFFORD CHANCE

Client briefing
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BaFin bans naked short-selling and uncovered sovereign CDS trading – Update

The German Federal Financial Services Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – "BaFin") has announced new temporary prohibitions on naked short-sales of eurozone government bonds and 10 leading German financial stocks, together with a prohibition on entering into uncovered credit default swaps (CDS) linked to eurozone government debt. The prohibitions took effect from 00.00 hours on Wednesday 19 May 2010 and will, subject to review, remain in force until 31 March 2011. There are limited exemptions from the new rules. These new rules follow on from the new transparency rules that took effect on 25 March 2010 requiring disclosure of net short positions in the 10 financial stocks. The BaFin has also indicated some limits on the extent to which the bans apply extra-territorially.

The BaFin justifies its action by reference to the "extraordinary volatility of debt securities of countries from the eurozone" and the significant increase in credit spreads of several eurozone states. According to the BaFin, large scale short sales of debt securities and uncovered CDS trading could lead to more excessive volatility and could "jeopardise the stability of the financial system as a whole". It is not clear whether the action by the BaFin has been co-ordinated with regulators of other eurozone states whose bond markets will be affected by the new rules.

Prohibitions on naked short-sales

The prohibitions on naked short-sales apply to sales of debt securities of any eurozone government (where the debt securities are admitted to trading on a German regulated market, including secondary listings) and the 10 specified German financial stocks listed below. Many debt securities issued by eurozone governments are in fact admitted to trading on German regulated markets. The prohibition applies regardless of the currency of issue and is not limited to euro-denominated bonds.

The prohibitions apply where the person making the sale does not own the security and does not have an absolutely enforceable claim against a third party (such as from a stock borrow or repurchase agreement) entitling it to a corresponding number of securities at the time of the conclusion of the respective sale.

There are exemptions for transactions of persons who have undertaken by contract to make binding buy and sell bids (e.g. market makers) to the extent that such transactions are required for performance of their contractual obligations as well as transactions agreed by trading participants with a customer for settlement of a securities transaction concluded at a fixed or definable price (fixed price transaction).

These exemptions are the same as used for the purposes of the (now lapsed) prohibition on naked short-sales introduced in 2008 as the financial crisis intensified. It is somewhat broader than the definition used for the purpose of the March transparency rules which does not cover fixed price transactions.

Key Issues

New ban on naked short sales of eurozone government bonds and specified German financial stocks

New ban on buying protection under CDS linked to eurozone government debt, except as a hedge

Exemption from short-sale ban for hedges for existing positions

Limited exemption from short-sale (but not CDS) ban for market makers

Bans took effect at 00.00 hours on 19 May 2010 (and remain in force till 31 March 2011, subject to review)

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There are also exemptions for short sales entered into to hedge an existing position (and there is no obligation to close out existing short positions). The decrees also contemplate that the BaFin may grant other exemptions on written request.

The following shares are covered by the new rules: Aareal Bank AG, Allianz SE, Generali Deutschland Holding AG, Commerzbank AG, Deutsche Bank AG, Deutsche Börse AG, Deutsche Postbank AG, Hannover Rückversicherung AG, MLP AG and Münchener Rückversicherungs-Gesellschaft AG.

According to informal discussions with the BaFin, the decrees seem not to be intended to apply to any derivatives on any underlying covered by the decrees relating to debt securities and shares. Whether transactions relating to an index or a basket including such instruments would be covered still seems not entirely clear.

Prohibition on uncovered CDS transactions
The prohibition on uncovered CDS transactions applies where someone buys protection using a credit default swap and one of the reference obligations is an obligation of a eurozone state (and whether the transaction settles in cash or by delivery of securities). The prohibition also extends to transactions such as total return swaps or credit-linked notes which embed such a credit default transaction.

The prohibition applies unless the protection is bought to hedge an existing position in a reference obligation of the relevant CDS or in another financial instrument that would decrease in value if the creditworthiness of the eurozone state being the debtor of the reference obligation deteriorates. In addition, the hedge must from a commercial perspective result in a significant (or, in the words of the BaFin decree, a "more than insignificant") reduction of the credit risk deriving from the existing position.

Exempt from the prohibition are transactions which serve to close out existing CDS positions as well as transactions in Credit Linked Notes issued before the entering into force of the BaFin decree, but there is no obligation to close out existing uncovered positions.

There is no exemption for market makers from this prohibition.

Territorial scope of application
The BaFin decrees do not specify the territorial scope of the new requirements. While the prohibitions on naked short sales only cover debt securities admitted to trading on the regulated market of a German exchange and the shares of the ten afore-mentioned financial sector enterprises, the BaFin decree on uncovered CDS transactions is not limited to CDS on debt securities traded on a regulated market in Germany but generally extends to any CDS whose reference obligation is an obligation of a eurozone state.

As set out in the answers to frequently asked questions (FAQs) published by the BaFin in relation to the March transparency measures, the BaFin intended that such rules would apply to all holders of net short positions, irrespective of whether they are located in Germany or abroad. Informal discussions with the BaFin indicate that this may also be the case with respect to the new prohibitions on naked short sales with respect to the debt securities and shares covered by the decrees.

However, it seems that the BaFin will take a slightly more narrow approach in relation to uncovered CDS transactions. According to an informal statement by the BaFin, CDS transactions are only covered by the prohibition if either both parties enter into the contract in Germany or if at least the party accepting the offer to enter into the contract is located in Germany. While this approach may lead to some uncertainties (since it will often not be clear which party is making and which is accepting the offer), it shows that the BaFin decree is not applicable in a situation where neither party is located in Germany.

Sanctions
Like the March transparency measures, the BaFin's latest decrees are based on general powers under the German Securities Trading Act (*Wertpapierhandelsgesetz*) empowering the BaFin to make orders to counteract undesirable developments which may adversely affect the orderly conduct of trading in financial instruments or the provision of investment services or ancillary services or which may result in serious disadvantages for the financial market. However, the sanctions for contravention are not entirely clear.

While the German Securities Trading Act does not provide for any specific sanctions, the BaFin could revert to the general rules on the enforcement of administrative measures which continue to apply here. To the extent that a violation of the BaFin decrees also gives rise to market manipulation, the sanctions provided for in the German market abuse provisions would apply in any event. It was also reported but not confirmed that the legal basis for the BaFin decrees shall be amended and enhanced shortly so as to give the BaFin the right to directly apply sanctions.

The Federal Ministry of Finance (*Bundesfinanzministerium* – "**BMF**") has also announced its intention to propose legislation banning naked short selling. It recently published its draft proposals for a German Act to Strengthen Investor

Protection and Enhance Functionality of the Capital Market (*Gesetzesentwurf zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarktes*). The draft contains proposed provisions that would ban naked short-selling of all shares traded on German regulated markets and create a statutory framework for regulatory transparency rules covering those shares (accompanied by a sanctioning regime for contraventions). However, those proposals did not extend to include prohibitions on naked short-sales of or uncovered CDS transactions on government bonds.

The BaFin intends to publish answers on FAQs in relation to its decrees shortly which should further clarify the scope of the new requirements. Market participants should review these on a timely basis for updated guidance.

The BaFin's press release and decrees are available here (original German text) and here (English translation).

Our briefing on the March transparency measures is available here.