

German parliament adopts ban on naked short-selling and uncovered sovereign CDS trading – Update 4

On 9 July 2010, the German parliament has adopted an new statute which aims at preventing supposedly abusive securities and derivatives transactions (*Gesetz zur Vorbeugung gegen missbräuchliche Wertpapier- und Derivategeschäfte*) (the "Act").

The Act introduces the following measures:

- a prohibition of naked short sales of shares as well as of debt instruments issued by euro zone countries if these are admitted to trading on the regulated market of a German exchange;
- a prohibition of credit default swaps (CDS) the reference obligations of which include an obligation of a euro zone country and which are not used for hedging purposes (naked CDS); and
- a transparency regime for covered short sales of shares admitted to trading on the regulated market of a German exchange.

The Act follows the publication of two discussion drafts and a draft by the German government of 3 May, 25 May and 8 June 2010, respectively. The Act is less restrictive than the previous drafts in that it contains neither a prohibition of transactions in equity derivatives that are commercially equivalent to a naked short sale of shares, nor a prohibition of currency derivatives linked to the euro and not used for hedging purposes, or further regulatory powers for the German Federal Ministry of Finance (*Bundesfinanzministerium* – "BMF").

Prohibitions on naked short sales

The prohibition on naked short sales will apply to naked short sales of shares admitted to trading on the regulated market of a German exchange. It does not apply to shares of companies with their registered office outside Germany unless the shares are exclusively admitted to trading on a regulated market in Germany.

There is also a prohibition on naked short sales of debt instruments issued by central governments, regional governments and local political subdivisions of EU member states whose lawful currency is the euro if the relevant instruments are admitted to trading on a German regulated market (including a secondary listing). However, only debt instruments issued by Germany and Austria are currently admitted to trading on German regulated markets. The prohibition is not limited to euro-denominated bonds but applies regardless of the currency of the relevant issuance.

The prohibitions apply where the person making the sale does not own the securities or does not have an unconditional, fully enforceable claim against a third party (such as under a securities lending or repurchase agreement) entitling it to a corresponding number of securities at the time of the conclusion of the respective sale. However, contrary to the previous drafts, the prohibitions do not apply to intra-day short positions, i.e. positions that are closed by the end of the relevant trading day.

Key Issues

Prohibitions on naked short sales

Prohibition of uncovered CDS transactions

Exemptions to short selling prohibitions

Ad hoc measures by BaFin

Notification requirement for covered short sales

Timing and transitional provisions

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There are also exemptions for transactions of persons who have undertaken by contract to purchase or sell financial instruments on a continuous basis by way of trading for own account at prices defined by them to the extent that the respective transaction is necessary for the performance of such contractual obligations (market makers), as well as for transactions which trading participants conclude with a customer for the settlement of a transaction in shares at a fixed or definable price (fixed price transaction). Each exemption can only be used upon a onetime notification to BaFin.

The Act further clarifies that the afore-mentioned prohibitions on naked short sales are applicable on an international level and thus apply to entities in and outside of Germany (provided that the relevant shares or securities are admitted to trading on a German regulated market, see above).

Prohibition of uncovered CDS transactions

The prohibition on uncovered CDS transactions has remained unchanged as compared to the earlier drafts. It applies to protection buyers entering into CDS if at least one of the reference obligations is an obligation of a central government, regional government or local political subdivision of an EU country whose lawful currency is the euro (irrespective of whether the transaction is settled in cash or by delivery of the reference obligation). The prohibition also extends to CDS that are embedded in total return swaps or credit-linked notes.

The prohibition applies unless 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 euro zone state being the debtor of the reference obligation deteriorates. In addition, the hedge must from a commercial perspective result in a significant reduction of the credit risk deriving from the existing position.

As in the case of naked short sales of shares and government debt instruments, there are exemptions for market makers. Each exemption can only be used upon a onetime notification to BaFin.

In contrast to the prohibitions on naked short sales, the Act does not extend the prohibition on uncovered CDS transactions to an international level. Rather, this prohibition only applies to transactions concluded or entered into "in Germany", which is in line with the BaFin decree of May 2010 regarding the prohibition on uncovered CDS transactions. However, in the absence of further guidance on this point by the Act, the territorial scope of this prohibition may still be subject to controversial interpretation.

Exemptions to short selling prohibitions

The BMF will be authorised to permit exemptions from the above prohibitions in regard of certain types of transactions. It may transfer this authority to BaFin.

Ad hoc measures by BaFin

The Act contains an explicit legal basis for BaFin to take any measure necessary and appropriate to counteract deficiencies threatening financial stability or trust in the functionality of the financial markets. In particular, BaFin could temporarily issue further prohibitions, including:

- a prohibition of transactions in derivatives that are linked to the price of shares or debt instruments of euro zone countries which are admitted to trading on the regulated market of a German exchange, if these transactions are not used for hedging purposes and result in a position economically comparable to a short sale;
- a prohibition of derivatives linked to the Euro and not used to hedge a corresponding currency risk; and
- a trading suspension in respect of certain financial instruments.

Any ad hoc measures by BaFin are initially limited to a period of 12 months but may be extended by another 12 months. In this case, the BMF has to report to the German parliament on the reasons for the extension.

The powers of the BMF to prohibit certain transactions by way of a regulation (as provided in the earlier drafts) has been abandoned. The expert committee of the German parliament held the view that prohibitions which are not of temporary nature only must be based on a formal law.

Notification requirement for covered short sales

The Act contains a transparency regime similar to that put in force by the BaFin decree of March 2010. Even though controversially discussed, the Act still contains the requirement to publish short positions in the electronic Federal Gazette (*elektronischer Bundesanzeiger*) if they exceed the 0.5% threshold.

Timing and transitional provisions

The prohibitions will become effective on the day after the publication of the Act in the German Federal Gazette (*Bundesanzeiger*). Transactions entered into prior to the entering into force of the Act will be exempted from the prohibitions unless they had been

prohibited according to other regulations (such as the BaFin decrees of May 2010). The notification requirements for covered short sales will only apply following a transitional period of 20 months after the publication of the Act.

Our client briefings on the BaFin decrees of May 2010 and the discussion draft are available [here](#).

Our client briefing on the BaFin decree of March 2010 is available [here](#).

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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