

German government intends to ban naked short-selling and uncovered sovereign CDS trading – Update 3

The German government has agreed on a draft act which aims to prevent abusive securities and derivatives transactions (*Regierungsentwurf eines Gesetzes zur Vorbeugung gegen missbräuchliche Wertpapier- und Derivategeschäfte*).

The draft act proposes the following short selling regime:

- prohibition of naked short sales of shares as well as of debt securities of euro zone countries if these are admitted to trading on the regulated market of a German exchange;
- prohibition of credit derivatives where the reference obligations include an obligation of a euro zone country and are not used to hedge default risks (naked credit derivative); and
- a transparency regime for covered short sales of shares admitted to trading on the regulated market of a German exchange

The draft act follows the publication of two discussion drafts published on 3 May and 25 May 2010, respectively. While the first discussion draft would effectively only have banned naked short sales of shares listed on a German exchange, the second discussion draft provided for further substantial restrictions, in particular with respect to derivatives transactions. The latest draft act is less restrictive 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 euro foreign exchange derivatives not used for hedging purposes.

Prohibitions on naked short sales

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

There is also a prohibition on naked short sales of debt securities issued by central governments, regional governments and local political subdivisions of EU member states whose lawful currency is the euro where the relevant instruments are admitted to trading on a German regulated market (including a secondary listing). However, in general only debt securities issued by Germany and Austria are 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 shall apply where the person making the sale does not own the security or does not have an unconditional, fully 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.

Key Issues

Prohibitions on naked short sales

Prohibition on uncovered CDS transactions

Exemptions to short selling prohibitions

Ad hoc measures by BaFin

Further regulation powers

Notification requirements under the large shareholding disclosure regime

Transitional provisions

Timing

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There are 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 transactions which trading participants conclude with the customer for 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 territorial scope of applicable provisions of the Securities Trading Act shall also be amended. Therefore, the afore-mentioned prohibitions on naked short sales would also apply to actions and omissions having occurred outside of Germany if they concern financial instruments admitted to trading on a German exchange.

Prohibition on uncovered CDS transactions

The prohibition on uncovered CDS transactions shall apply where someone buys protection using a credit default swap and one of the reference obligations is an obligation of a central government, regional government and local political subdivision of EU member states 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 transactions such as total return swaps or credit-linked notes which embed such a credit default swap.

The prohibition shall apply 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 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 is an exemption for market makers. The exemption can only be used upon a onetime notification to BaFin.

The international scope of the prohibition on uncovered CDS transactions differs from the international scope of application on naked short sales as described above, since 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).

Exemptions to short selling prohibitions

The German Federal Ministry of Finance (*Bundesfinanzministerium*, "BMF") will be authorised to permit further exemptions as regards both short selling prohibitions on the basis of a future regulation. It can also permit BaFin to grant further exemptions.

Ad hoc measures by BaFin

The draft act now 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 market. In particular, BaFin could temporarily issue further prohibitions including:

- prohibition of transactions in derivatives linked to the price of shares admitted on a German exchange to trading on the regulated market as well as of debt securities of euro zone countries admitted on a German exchange to trading on the regulated market where these transactions effectively result in a position economically comparable to a short position, and
- prohibition of Euro currency derivatives not used to hedge a respective currency risk.

The specific prohibitions of such types of transactions as contained in the previous proposal for the draft act have been deleted. BaFin can also put in place further transparency requirements where it deems appropriate.

Further regulation powers

The BMF would be empowered to issue regulations with the same aim as BaFin's ad hoc measures mentioned above to protect financial stability and the functionality of the financial market. These would not necessarily have to be on a temporary basis.

Notification requirements under the large shareholding disclosure regime

The draft act also contains notification requirements for cash settled derivatives (including CfDs) under the large shareholding disclosure regime. We have described these in further detail in our [client briefing](#). The proposal has remained unchanged in this respect.

Transitional provisions

Transactions entered into prior to the entering into force of the draft act will be exempted from the prohibitions unless they had been prohibited according to another regulations (such as for example the three BaFin decrees of May 2010).

Timing

Although it was intended by the BMF that the draft act is passed before summer break, it is not sure whether the approval will be received in the Bundesrat's last session before such break.

The draft act is available [here](#) with an introduction by the BMF [here](#).

Our client briefings on the BaFin prohibitions are available [here](#).

The BaFin prohibitions and the BaFin FAQs are available in [English](#) and in [German](#).

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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