

BaFin Bans Naked Short Selling and Certain Credit Default Swaps

May 19, 2010

With three general decrees dated May 18, 2010, the German Federal Financial Supervisory Authority (BaFin) banned naked short selling (i) in debt securities issued by the EU Member States and denominated in Euro, (ii) in shares of certain German financial institutions and insurance companies, and (iii) in certain credit default swaps (CDSs). The BaFin regards the bans as appropriate and necessary to preserve and strengthen the trust of market participants in the effective functioning of the capital markets. By imposing the bans, it hopes to counteract certain recent and undesirable developments on the global capital markets. In particular, the decrees target the increased pressure on credit default risk ratings of several Eurozone countries which is believed to be generated by speculative short positions.

Ban on Naked Short Selling in Debt Securities Issued by Member States and Denominated in Euro and Shares of Certain German Financial Institutions and Insurance Companies

The BaFin defines naked short selling as the sale of securities whereby the seller of the securities is not the owner of the same and does not have any absolutely enforceable claim to be transferred title in a corresponding number of securities of the same class. The BaFin decrees ban naked short selling in debt securities issued by Member States of the EU that are denominated in Euro and that are admitted to trading on the regulated market of a German exchange. The decrees also ban naked short selling of shares of 10 German companies (Areal Bank AG, Allianz SE, Generali Deutschland Holding AG, Commerzbank AG, Deutsche Bank AG, Deutsche Börse, Deutsche Postbank AG, MLP AG and Münchner Rückversicherungs-Gesellschaft AG). Transactions at a fixed or definable price in these securities, as well as short sales used to hedge already existing positions, are exempted from the naked short selling prohibitions. The BaFin may permit further exemptions on a case-by-case basis upon receipt of a written application.

This is not the first BaFin ban on naked short selling. In September 2008, the BaFin banned naked short selling of shares of 11 German financial institutions and insurance companies. The ban was extended twice and ended in March 2009.

Ban on Certain Credit Default Swaps

The BaFin decrees also ban certain CDS transactions, including those imbedded in a credit-linked note or a total return swap, if their reference obligation includes an obligation of an EU Member State and if the transaction is not serving to create an effective hedging position (naked CDS).

There are exemptions from the ban on contracting for naked CDS positions. For example, a naked CDS is not banned if, in an economic view, it achieves more than an insignificant reduction of the credit risk under (i) an existing position in a reference liability of the respective CDS, or (ii) another existing position in a different financial instrument whose value falls if the creditworthiness of the EU Member State that serves as debtor of a reference obligation deteriorates. Also exempted are transactions used to close out obligations under another CDS, including credit-linked notes that were issued or vested by the buyer with rights and obligations prior to the entry into force of BaFin's May 18 decrees.

The three decrees entered into force on May 19, 2010 (at 00.00 hours) and will remain in force until March 31, 2011 unless repealed by BaFin.

The territorial scope of the new measures and the sanctions for contraventions are not entirely clear. It should be assumed that the ban only applies if there is at least some jurisdictional nexus to Germany. Therefore, the ban should, at least, apply to trades executed by or through market participants that are supervised by BaFin. If, however, violations of yesterday's decrees give rise to market manipulation, any such abuse will be sanctioned under the German Securities Trading Act.

We will keep you updated on further developments. If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact either of the following Morgan Lewis attorneys:

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