

German Short Selling Legislation Expected to Become Effective in July 2010

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Morgan Lewis reported recently on the short selling bans imposed by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin) and on a proposed Stability Act providing for a ban on uncovered short selling of all shares traded on a regulated market of a German stock exchange as well as a ban on uncovered credit default swaps (CDS).¹ On July 2 and July 9, respectively, the German *Bundestag* and *Bundesrat* consented to the Stability Act, which is formally referred to as the “Act Aimed at Preventing Abusive Securities and Derivatives Trading Activities” (the Act). The Act will amend the German Securities Trading Act (*Wertpapierhandelsgesetz* or WpHG). The Act is aimed at enhancing the stability of the financial markets and regaining investors’ confidence in the efficiency of the financial system. In particular because of the crisis of the Euro system that occurred this spring in connection with the deterioration of the financial situation in Greece, the European member states saw the necessity of enhancing the stability of the financial markets as well as their supervision. The German government is the first European government that has reacted to this common understanding and the Act has to be seen as an attempt to prevent abusive speculations in the financial markets.

Statutory Ban on Naked Short Selling and Exemptions under the Act

The Act provides for a ban on uncovered short selling of (i) all shares that are traded on a regulated market of a German stock exchange (i.e., not on a market segment organized under private law such as the “Open Market” of the Frankfurt Stock Exchange) and (ii) all debt securities issued by governments, regional governments, municipalities, or Member States of the Eurozone (Eurozone Government Securities) that are traded on a regulated market of a German stock exchange. Violators of this ban may be fined an amount of up to €500,000 per violation. The Act, however, does not address the consequences of a violation of the ban; in particular, it does not address how the violation would affect a transaction’s validity. Under the WpHG, a violation of a statutory prohibition does not necessarily result in the invalidity of the underlying transaction, as is the case with regard to the prohibition of insider

¹ To learn more about the proposed Stability Act and the short selling ban, read the following Morgan Lewis LawFlashes: “German Government Proposal Narrows Derivatives Ban” (June 4, 2010), available at http://www.morganlewis.com/pubs/IM_GermanDerivativesBan_LF_04jun10.pdf; “German Federal Government Proposes to Extend the Ban on Short Selling in Germany” (May 27, 2010), available at http://www.morganlewis.com/pubs/IM_ShortSellingInGermany_LF_27may10.pdf; and “BaFin Bans Naked Short Selling and Certain Credit Default Swaps” (May 19, 2010), available at http://www.morganlewis.com/pubs/IMLF_BaFinBansShortSelling_19may10.pdf.

trades. Therefore, it remains to be seen which approach German courts will take with regard to violations of the short selling prohibitions.

With regard to the ban on uncovered short selling in shares and Eurozone Government Securities, an exemption is made for transactions at a fixed or determinable price and for market maker activities to the extent that the respective transactions are necessary for the performance of the market makers' contractual obligations. The ban does also not apply to shares of companies that are established outside of Germany unless such company's shares are exclusively admitted to trading on a regulated market of a German stock exchange.

Statutory Ban on Uncovered CDS Trading and Exemptions under the Act

In addition, the Act prohibits trading in uncovered credit default swaps (CDS) if the reference obligations of such CDSs are also Eurozone Government Securities. Exempted from the ban on such uncovered CDSs are CDS transactions that, when viewed in terms of economics, achieve more than an insignificant reduction in the credit risk under either (i) already existing positions in the reference obligations of the CDS transactions or in positions in the reference obligations of the CDSs that are entered into contemporaneously (*in unmittelbarem zeitlichen Zusammenhang*) with the CDS transactions or (ii) another such position in a different financial instrument the value of which falls if the creditworthiness of the government, regional government, municipality, or Member State of the Eurozone that serves as debtor of the reference obligation of the CDS deteriorates. In contrast to previous drafts, the Act extends this exemption to positions that are entered into contemporaneously with the CDS transaction. The Act provides for an exemption for market maker activities with respect to uncovered CDS transactions to the extent that the respective transactions are necessary for the performance of the market makers' contractual obligations.

BaFin Powers under the Stability Act

If necessary for the stability of the financial markets, the BaFin is granted the power to impose—in coordination with the German Federal Bank (*Bundesbank*)—a ban (i) on derivatives that derive their value directly or indirectly from the exchange rate of the Euro if the value of these derivatives increases or if the exchange rate of the Euro decreases unless these derivatives are entered into in order to hedge against exchange rate risks; or (ii) on derivatives that synthetically replicate an uncovered short sale of shares or Eurozone Government Securities if such shares or Eurozone Government Securities are admitted to trading on a regulated market of a German stock exchange and if such derivatives are not entered into in order to hedge market risks in these shares or Eurozone Government Securities. In addition, the BaFin is authorized to suspend trading in certain financial instruments. Such bans have to be time limited to 12 months, but may be extended by the BaFin for a maximum of 12 additional months.

Amended Definition of Uncovered Short Selling

The Act defines naked short selling slightly differently than the BaFin in its decree of May 18. Under the Act, naked short selling is defined as the sale of securities whereby the seller of the securities, *at the end of the trading day* of the respective transaction, (i) is not the owner of the same and (ii) does not have any absolutely enforceable claim to be transferred title in a corresponding number of securities of the same class. Under the decrees of May 18 the BaFin defined naked short selling to exist when the seller has not fulfilled the aforesaid preconditions *at the time of the respective transaction*. The new

definition of the Act seems more precise with respect to the timing of the determination than the rather ambiguous wording that was used in the BaFin decree.

Reporting/Disclosure Obligations with Regard to Covered Short Sales

The Act imposes a reporting obligation on the owner of the short selling position (i.e., not a broker of such position) pursuant to which any covered net short selling position of at least 0.2% of the issued shares of a company that are traded in a regulated market of a German stock exchange has to be reported to the BaFin. If an additional 0.1% of the issued shares is acquired or if such position is sold, additional reporting is required. If a position of 0.5% of the issued shares of a company is achieved or exceeded, or if a position falls below this threshold, the Act requires that the position of the owner of the respective net short selling position be publicly reported in the German federal gazette (*Bundesanzeiger*). Violators of these reporting and disclosure obligations may be subject to a fine of up to €200,000 per violation.

Effectiveness of the Act

The ban on naked short selling of shares and Eurozone Government Securities and the ban on uncovered CDS trading will enter into force one day after the Act's publication in the *Bundesanzeiger*, which is expected to take place after the signing of the legislation by the German president in the week of July 12. The reporting/disclosure requirements of the Act for covered short sales will become effective 20 months following the Act's publication.

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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