

German Federal Government Proposes to Extend the Ban on Short Selling in Germany

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Last week the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin) issued three decrees, dated May 18, 2010, that are aimed at banning naked short selling and certain credit default swap (CDS) transactions.¹ On May 25, as an extension of these BaFin bans, the German government pushed forward a separate discussion draft of an act designed to strengthen the stability of the capital markets (Stability Act), which bans certain transactions regarded as a threat to the capital markets' stability. The Stability Act will amend the German Securities Trading Act (*Wertpapierhandelsgesetz*, or WpHG).

To receive consent in short time (before the beginning of July) the ban on naked short selling and certain other types of transactions has been separated from its previous position in a draft of an act designed to strengthen investor protection and enhance the functionality of the capital markets (Investor Protection Act) that was published in early May. Provided that the Stability Act receives consent from the German parliament, the Investor Protection Act may enter into force this summer.

Ban on Naked Short Sales

The Stability Act bans naked short selling in shares and debt securities issued by the EU Member States that are denominated in Euro and that are admitted to trading on a regulated market of a German exchange. To prevent evasive transactions, the ban will also include transactions in derivatives that are based on the price of such shares and that may have the same effect as a naked short selling in shares or debt securities. The ban on naked short selling in shares shall not be limited to certain shares (in contrast to the BaFin's decree of May 18, 2010, which limited naked short selling to shares of certain financial institutions), but is intended to apply to all shares traded on a regulated market of a German stock exchange. Excluded, however, are shares of companies not based in Germany unless such shares are exclusively traded on a regulated market of a German stock exchange.

In accordance with the definition used by the BaFin in its May 18 decrees, the Stability Act 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

¹ To read more about these initial decrees, read the Morgan Lewis Investment Management LawFlash, "BaFin Bans Naked Short Selling and Certain Credit Default Swaps" (May 19, 2010), available online at http://www.morganlewis.com/pubs/IMLF_BaFinBansShortSelling_19may10.pdf.

number of securities of the same class. The draft of the Stability Act provides for an exemption for market maker activities as well as for transactions at a fixed or definable price.

The Stability Act also bans transactions in currency derivatives that are based on the exchange rate of the Euro, again with an exemption for market maker activities.

The Stability Act further prohibits 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 intended to create an effective hedging position. In addition, a CDS transaction that would be generally covered by the Stability Act 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 transaction, 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 that are used to close out obligations under another CDS transaction, including credit-linked notes that were issued or vested by the buyer prior to the entry into force of the Stability Act

A violation of any of these bans may be fined up to EUR 500,000. However, the Stability Act does not explicitly stipulate further consequences of a violation for the respective transaction; in particular, it does not specify whether a violation of the ban will have an impact on the validity of the underlying agreement. Violations of other statutory prohibitions in the WpHG, such as the prohibition on insider trades, do not necessarily result in the invalidity of the underlying transactions.

Transparency Requirements for Covered Short Sales

With respect to covered short selling in shares, the Stability Act takes account of a recommendation of the Committee of European Securities Regulators (CESR) and suggests the implementation of a strict transparency regime, where any covered net short selling position in an amount of at least 0.2% of the issued shares of a company that is listed on a regulated market of a German stock exchange has to be reported to the BaFin. Additional reporting is required if an additional 0.1% of the issued shares is acquired or if such position is sold. If a position of 0.5% of the issued shares of a company is achieved, exceeded, or if a position falls below this threshold, the transparency regime imposes an additional obligation to publish the position of the owner of the respective net short selling position in a public form in the federal gazette *Bundesanzeiger*. Violators of these reporting and disclosure obligations may be subject to a fine of up to EUR 200,000.

Application to Activities outside of Germany

The Stability Act provides that the ban of naked short selling in shares and debt instruments, as well the transparency requirements, shall also apply to transactions executed outside of Germany. In order to enforce the Stability Act with regard to such transactions against market participants outside of Germany, the BaFin will need the cooperation of foreign regulatory authorities. It is not clear at this time whether any foreign regulatory authorities will agree to cooperate in such enforcement. As noted below, even the scope of the May 18, 2010 BaFin decrees has drawn some criticism in other jurisdictions.

Additional Powers of the BaFin

The draft of the Stability Act substantially broadens the BaFin's power to secure the German financial systems. The BaFin shall be entitled to take actions in coordination with the German Federal Bank (*Bundesbank*) to strengthen the stability of and/or the market's trust in the functioning of the financial markets. This may entitle the BaFin, for example, to ban trading in or exposure to certain financial instruments. Pursuant to the Stability Act, the BaFin will be also entitled to impose an obligation to report to the BaFin and disclose positions in certain financial instruments. The BaFin may publish such decree on its website.

Summary

In order to enhance the stability of the financial markets, the Stability Act proposes significant reforms of existing concepts of capital markets regulation. However, the Stability Act and the already effective BaFin ban have been criticized for their single-handed approach in a European context. In particular, critics feel the Stability Act falls short of its proposed purpose to aid the financial crises, as naked short selling activities were not the cause of the financial crises. As Germany has never been a center of such activities, the Stability Act will not hinder naked short selling effectively.

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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