GERMANY'S NEW RULES ON NAKED SHORT-SELLING AND CREDIT DEFAULT SWAPS

May 19, 2010

To Our Clients and Friends:

Yesterday, Germany announced a ban on certain bets against euro government bonds and financial stocks. The German Financial Supervisory Authority (BaFin) said the move was due to the unusual volatility in such bonds endangering the stability of the financial system.

PRINCIPLES

The ban took effect at midnight and will remain in effect through March 31, 2011. In a nutshell, the ban prohibits:

- naked short-selling of debt securities of a euro zone country where the securities are admitted on a German exchange to trading on the regulated market;
- naked credit default swaps (CDSs) in which the reference obligation is at least also an obligation of a euro zone country or such country is at least also a reference obligor; and
- naked short-selling of the stocks of Aareal Bank, Allianz, Commerzbank, Deutsche Bank, Deutsche Börse, Deutsche Postbank, Generali Deutschland, Hannover Re, MLP and Munich Re.

EXCEPTIONS

In naked short-selling, a person sells a financial instrument, betting that its price will fall, without first holding the financial instrument or ensuring that it can be obtained, as would be done in a conventional, covered short sale. Exempted from the ban on naked short-selling are certain transactions by market makers, fixed price transactions and short sales used to secure already existing positions. BaFin may permit further exemptions upon written application.

A naked CDS is a CDS in which the protection buyer does not hedge existing default risks, i.e., an existing position in a reference obligation of the credit derivative, or another existing position in a different financial instrument whose value falls if the creditworthiness of the euro zone country which is the debtor of a reference obligation deteriorates. Exempted from the ban on naked CDSs are transactions initiated to close out positions in a credit derivative under which the protection buyer was already vested with rights and obligations before effectiveness of the new ban as well as transactions in credit-linked notes issued before such time.

MONITORING

BaFin announced that it would closely monitor compliance with these new rules on naked short-selling and CDSs. Effective as of March 25, 2010, Germany's financial watchdog had already introduced a new transparency system for net short-selling positions in the above-mentioned stocks. Under this two-tier transparency system, market participants must notify BaFin of net naked and covered short-selling positions of 0.2% or more of such stocks. Additional notifications are required when such positions reach, exceed or fall below an additional 0.1%. Positions of 0.5% or more must be published in anonymous form on BaFin's homepage. In addition to short-selling-transactions in such stocks, the transparency system also covers other financial instruments which are ultimately the equivalent of stock short-selling positions.

CHALLENGES

It is not clear how Germany can enforce the ban effectively in the government debt and CDS markets unless other countries follow suit. Such markets stretch across national borders. Most European trading in CDSs takes place in the United Kingdom, which is not part of the euro zone.

France's finance minister Christine Lagarde has already rejected the move, saying that France will not consider similar regulations. She added that she regrets Germany's unilateral action on this front. Other EU countries, such as Austria, Belgium and Spain, have expressed sympathy with Germany's ban.

In any event, BaFin will have a hard time distinguishing between investors who are buying CDSs as a legitimate hedge and those placing mere bets. Also, the ban does not prevent investors from trading CDSs in other entities which would suffer in the event of a euro zone country default.

Please feel free to contact us with any questions.

Peter Wand
+49 69 2097 5271
pwand@debevoise.com

Thomas Schürrle
+49 69 2097 5140
tschuerrle@debevoise.com

Philipp von Holst
+49 69 2097 5211
pvonholst@debevoise.com