

## **BaFin decrees of 18 May 2010 relating to short-selling of certain CDS, bonds and equities**

### **1. INTRODUCTION**

- 1.1 The following is a summary of the principal points discussed on the conference call hosted by ISDA and Allen & Overy LLP on 19 May, 2010, together with some clarifications to points raised on the call, and subsequent discussion with BaFin.
- 1.2 As noted on the call, the decrees published by BaFin are not clear in many respects, and may be subject to revision or interpretation by BaFin, or may be the subject of further guidance from BaFin. The contents of the call, and of this summary, do not constitute legal advice.
- 1.3 Allen & Overy LLP has been in contact with BaFin to discuss the interpretation and clarification of the decrees, and will continue that dialogue with a list of questions, including some which were raised on the call.
- 1.4 It is important to remember that the stated purpose of the decrees is to ban speculation and not to ban hedging.

### **2. DECREE RELATING TO CONTRACTING OF CREDIT DERIVATIVE TRANSACTIONS**

- 2.1 The ban affects the entry by protection buyers into credit derivatives transactions which reference an obligation of a Eurozone Member State, or for which a Eurozone Member State is a Reference Entity. The ban also affects credit linked notes and TRS transactions which have a similar effect.

#### **2.2 Territorial effect**

- (a) In BaFin's view the key criterion for determining if a trade falls within the scope of the decree is the location where the transaction can be said to be entered into. If neither of the parties to the transaction is acting from an establishment or branch in Germany, BaFin's view is that the decree will not be applicable. This would apply even if one or more parties were incorporated in Germany but were transacting from a branch or other establishment outside Germany.
- (b) It seems that BaFin has not considered whether the location at which a trade is booked is relevant.
- (c) The scope of the decree is not limited to financial institutions in Germany. Any party who buys protection from a presence in Germany is potentially caught unless an exemption is available.
- (d) It is less clear how the rule applies to cross-border trades where only one party is acting from within Germany. It seems likely that the rules will only apply where the party within Germany is the buyer of protection since the restriction is expressed as a ban on any protection buyer (*Sicherungsnehmer*) entering into a credit derivative without being exposed to the underlying credit risk.

#### **2.3 Consequences if a transaction is entered into in breach of the decree - generally**

If a transaction is entered into in breach of the decree, BaFin may be able to impose sanctions on the buyer, including through its general powers to require a party to stop its activities and/or unwind the transactions. However we do not believe that the transaction would itself be invalid.

#### **2.4 Consequences if a transaction is entered into in breach of the decree – ISDA Master Agreement**

We believe that there would be scope to argue that there would be a breach of the "No Violation or Conflict" representation at Section 3(a)(iii), which representation is deemed to be given on the date

the transaction is entered into, which would trigger an Event of Default under Section 5(a)(iv) – entitling the seller of protection to designate an Early Termination Date in respect of all transactions under the ISDA or to invoke the provisions of Section 2(a)(iii).

## **2.5 "Illegality" Termination Event under ISDA Master Agreement**

- (a) Since the decree does not have retroactive effect, we believe that it will not trigger the Illegality Termination Event for most transactions which are existing at the deadline of 00.00 (Berlin time) on 19 May, 2010. The performance of those transactions will not be affected by the decree.
- (b) For new transactions, the Illegality Termination Event would not be relevant since that event requires the change in law to come into effect after the date on which the transaction is entered into.

## **2.6 Amendments to ISDA Confirmations**

- (a) Given that a new transaction would not be rendered void by the decree, there may be no strict requirement for a prospective seller of protection to obtain additional representations or indemnities from its counterparty to protect itself against the consequences of a breach of the decree.
- (b) However for reputational reasons, and to protect the other party against any other possible impact of possible regulatory measures on the trade and the non-affected party, we imagine that parties will be keen to have evidence that they are not causing a breach of the decree, or knowingly entering into a trade which might trigger an Event of Default for misrepresentation. Therefore we expect that parties will wish to consider including additional representations from a buyer of protection under a CDS to ensure that either (i) the transaction does not fall within the scope of the decree or (ii) that it is within the scope of an exemption. Economically an investor in a CLN would also be a seller of protection but it is less clear whether they would be able to elicit similar comfort from the issuing entity.

## **2.7 Types of transactions caught**

- (a) Single name CDS on Eurozone sovereigns would clearly be caught by the decree.
- (b) It is sufficient, according to the decree, that a Member State of the Eurozone is "also" (i.e. among others) issuer of a reference obligation or a reference entity. It would seem to follow from this that untranched index trades which reference either an obligation of a Eurozone sovereign, or the sovereign itself, would also be caught. This would include, for instance, the Markit iTraxx SovX Western Europe Index (comprising 15 names from the Eurozone region plus Denmark, Norway, Sweden and United Kingdom that trade on Western European documentation). There are 3 other sovereign indices on the Markit website which would seem to be caught also, but these do not seem to be active at present.
- (c) We believe that tranching portfolio trades would also be caught (as would tranching trades on an Index) if they reference a Eurozone sovereign or one of its obligations. As noted below, it may be less clear to what extent the "hedging exemption" will be available for those trades
- (d) Credit linked notes are specifically referred to in the decree. So the issue by a bank of a CLN which references one or more Eurozone sovereigns (or their obligations) would be caught.
- (e) Total return swaps which have the economic effect similar to the purchase of protection on Eurozone sovereigns (or their obligations) are also specifically referred to in the decree.
- (f) Looking to the spirit of the decree, we expect that novations of CDS and other credit derivative transactions would not breach the decree where it is the protection seller's position that is being

transferred, but we expect that any novation by a protection buyer of its position would have to be assessed against the decree.

- (g) There may be existing swaption transactions under which a party can require a CDS transaction to be entered into at a future date. In light of the intent behind the decree we believe that those transactions would not violate the decree, although it may be a matter to be clarified with BaFin.

## **2.8 Transactions entered into before 00.00 (Berlin time) on 19 May, 2010**

- (a) As the decree does not have retroactive effect, transactions entered into prior to 00.00 (Berlin time) on 19 May, 2010 will not be affected. This raises a question as to whether the "trade date" for a transaction will be the reference point for these purposes, as opposed to the "effective date" or "issue date".
- (b) In our view the trade date can be taken as the relevant date for these purposes if the buyer of protection is able to demonstrate that a binding obligation arose at that point on both parties to enter into the transaction (or to issue and purchase the CLN).

## **2.9 First Exemption – where there is a reduction in the credit risk of an existing position**

- (a) The decree provides that transactions are exempt if, on an economic view, they achieve more than an insignificant reduction of the credit risk under an existing obligation. The decree uses the term of "reference obligation" (*Referenzverbindlichkeit*) here. In our view this would not be limited to a "Reference Obligation" (as defined in the 2003 ISDA Credit Derivatives Definitions) but would include any obligation of the Eurozone sovereign which satisfied the definition of "Obligation" and/or "Deliverable Obligation" under the credit derivatives terms.
- (b) It is not clear whether BaFin proposes to provide any clarification as to the meaning of "more than insignificant reduction of credit risk". However the intent behind this seems clear from the related guidance notes. BaFin will be looking to the purpose behind the transaction and will not exempt transactions where there is no, or only a subordinate, hedging purpose.
- (c) In the context of untranching portfolio or index trades, we believe that the hedging test would look to the existing exposure that the buyer had to each applicable Reference Entity.
- (d) It may be harder to identify the "existing position" with respect to tranching transactions which are dynamically hedged by the buyer, and to show that the transaction achieved a significant reduction in the credit risk applicable to a Eurozone sovereign Reference Entity or obligation. This may be an area for further consideration and/or dialogue with BaFin.
- (e) The reference to "existing position" will be tested at the time at which the party buys protection; it is not backdated to any positions held by buyer at the time at which the decree came into effect.
- (f) The BaFin decree does not require that buyer's exposure to the Eurozone sovereign is maintained throughout the life of the transaction. Equally, though, we consider that it would be against the spirit of the decree (if not the letter) if a party were to acquire an exposure to the Eurozone sovereign (for instance through the purchase of a bond) solely for the purposes of buying protection and with the intention shortly thereafter to sell the bond but keep the CDS.
- (g) We do not believe that the decree would affect the ability of dealers to broker CDS deals between the ultimate buyers and sellers of protection, provided that the dealer sells protection before it then buys. In this case it would be able to argue that the buy trade was reducing the credit risk it had assumed under the existing sell trade.

- (h) The "existing position" exemption also covers positions in different financial instruments (i.e. not the Reference Obligation or within the scope of Obligations) provided that there is a correlation in the value of that financial instrument and the creditworthiness of the Eurozone sovereign. This seems a potentially broad exemption, conceivably covering debt instruments issued by different entities or even equities. We think it would be incumbent on the buyer of protection however to show (i) that there is a sufficient degree of correlation; and (ii) that the effect of the transaction is to achieve a significant reduction in the credit risk under that different financial instrument. This is likely to impose a limit on the scope of this exemption.

#### **2.10 Second exemption – close outs of positions existing before 00.00 (Berlin time) on 19 May, 2010**

The decree makes it clear that the purchase of protection to close out credit derivative exposures that existed prior to the coming into force of the decree is exempted.

#### **2.11 Third exemption – transactions in credit linked notes issued before 00.00 (Berlin time) on 19 May, 2010**

The decree further exempts transactions in credit linked notes issued before the entry into force of the decree, i.e. before 00.00 (Berlin time) on 19 May, 2010.

### **3. DECREE RELATING TO UNCOVERED SHORT-SELLING TRANSACTIONS OF CERTAIN SHARES**

- 3.1 The ban affects the sale of shares in the ten financial institutions listed in the decree where at the time of entering into the transaction the seller is neither owner of the shares nor has any contractual or proprietary claim to have the shares delivered to it.

- 3.2 The ban is, in substance, equivalent to the ban that was imposed by BaFin in September 2008.

#### **3.3 No limitation to scope by reference to territory**

The decree is silent as to scope. Unlike the decree relating to credit derivatives, BaFin's view is that the decree applies to any transaction relating to the affected shares and thus falling within the scope of the decree, irrespective of the jurisdiction in which either party is incorporated or transacts. However, the ability of BaFin to enforce the decree will be dependent upon BaFin's territorial reach, which is in principle limited to Germany.

#### **3.4 Consequences if a transaction is entered into in breach of the decree - generally**

The consequences of a breach are the same as those that apply in relation to a breach of the credit derivative ban. However, note the discussion in paragraph 3.3 above relating to the ability of BaFin to enforce the ban in any jurisdiction other than Germany.

#### **3.5 Consequences if a transaction is entered into in breach of the decree – ISDA Master Agreement**

The consequences of a breach are the same as those that apply in relation to a breach of the credit derivative ban. Parties located outside Germany may, however, seek to argue that the decree does not constitute a "law applicable to it... or [an] order or judgment of [a] court or other agency of government applicable to it" as required in Section 3(a)(iii) of the ISDA Master Agreement.

#### **3.6 "Illegality" Termination Event under ISDA Master Agreement**

The same analysis applies as that described above in relation to the credit derivative ban.

### **3.7 2002 ISDA Equity Derivatives Definitions**

- (a) The analysis in relation to the consequences on existing equity derivative transactions referencing the affected shares incorporating the 2002 ISDA Equity Derivatives Definitions will be the same as those that applied to the short-selling ban in September 2008.
- (b) In particular:
  - (i) Limb (X) of Change in Law will not apply in relation to existing transactions, as it has not become illegal to hold, acquire or dispose of the shares. It is also unlikely that limb (Y) would apply.
  - (ii) Change in Law will not be relevant to new transactions, since Change in Law requires the change in law to come into effect after the date on which the transaction is entered into.
  - (iii) Hedging Disruption is unlikely to apply, since the decree is unlikely to prevent a party from acquiring or maintaining a hedge position.
  - (iv) Whether Increased Cost of Hedging will apply will depend on the cost of acquiring or maintaining a hedge, although we understand that this is unlikely.

### **3.8 Types of transaction caught**

- (a) The decree applies to "naked short selling" of shares in the ten German financial institutions listed in the decree.
- (b) "Naked short selling" comprises a short sale of the shares where, at the time of entering into the transaction the seller is neither owner of the shares nor has any contractual or proprietary claim to have the shares delivered to it.
- (c) The decree specifically requires a sale of a share. Transactions that do not involve the sale of a share but merely have a similar economic effect, such as cash-settled transactions should therefore fall outside the scope of the decree.
- (d) For the same reasons, transactions in respect of indices comprising one or more affected shares should not fall within the scope of the decree if they do not involve a sale of the affected shares.
- (e) BaFin has confirmed that the practice of short selling by borrowing shares and then selling them into the market is not prohibited because BaFin does not consider these to be "uncovered" or "naked" transactions. The shares must, however, be borrowed before they are sold. It is not sufficient if the securities are borrowed after the short sale.
- (f) BaFin has also confirmed that selling futures or "shorting futures" does not constitute short selling for the purposes of the decree.
- (g) For further details of the types of transaction that may constitute a "naked short sale", we refer you to list of frequently asked questions relating to the short sale ban in force from 2008 to 2009 published by BaFin and last amended on 2 November 2009, which can be found at [http://www.bafin.de/cln\\_171/nn\\_721290/SharedDocs/Veroeffentlichungen/DE/Service/Auslegung\\_sentscheidungen/Wertpapieraufsicht/ae\\_080922\\_faq\\_leerv.html? nnn=true](http://www.bafin.de/cln_171/nn_721290/SharedDocs/Veroeffentlichungen/DE/Service/Auslegung_sentscheidungen/Wertpapieraufsicht/ae_080922_faq_leerv.html? nnn=true), which BaFin has confirmed may be used as an initial guidance for this decree. In particular, note that according to that list of frequently asked questions published by BaFin transactions which have a similar economic effect to a short sale, such as the purchase of a put option, are not caught.

- (h) We understand from BaFin that it intends to publish a list of frequently asked questions in relation to the current decree shortly.

### **3.9 Transactions entered into before 00:00 local time on 19 May 2010**

The same analysis applies as that described above in relation to the credit derivative ban.

### **3.10 First Exemption – market-making activities**

- (a) Transactions entered into by 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 are exempted, to the extent that the short sale is necessary for the performance of those contractual obligations.
- (b) The market-making activity must be a contractual obligation of the market-maker (although note that the contractual obligation may be owed to any person, not necessarily the issuer or the shares or the counterparty to the short sale). The mere fact that a person undertakes market-making activities without being under a contractual obligation to do so does not mean that the market-maker is able to rely upon the exemption.

### **3.11 Second Exemption – transactions to fulfil fixed price client transactions**

Transactions which market participants conclude with a view to fulfil another transaction in the shares previously concluded with a client at a fixed price are also exempted.

### **3.12 Third Exemption – hedging already existing positions**

Transactions which hedge already existing positions are also exempted. While the precise scope of this exemption is unclear, in our view, the purpose of this exemption is to permit short sales which are intended to hedge an existing long cash or physical position.

## **4. DECREE RELATING TO UNCOVERED SHORT-SELLING TRANSACTIONS OF CERTAIN DEBT SECURITIES**

- 4.1 The ban affects the sale of certain types of debt securities (as described below), where at the time of entering into the transaction the seller is neither owner of the securities nor has any contractual or proprietary claim to have the securities delivered to it.
- 4.2 The decree relates to any bonds issued by Member States of the European Union, the legal currency of which is the euro, and which are admitted to trading on regulated market of a German stock exchange. BaFin did not consider § 37 German Stock Exchange Act pursuant to which any sovereign bond issued by any Member State of the European Union is automatically admitted to trading on any regulated market in Germany. BaFin has emphasised that it was not the intention of the decree to extend the rules to all such government bonds. Rather, it was the intention (and it will continue to be BaFin's view) that the decree applies only to the government bonds of euro-zone countries which are actually traded on regulated markets in Germany. BaFin has confirmed that, as such, the rules currently only apply to German government bonds and some Austrian government bonds since only these are traded on a regulated market in Germany. We have not separately verified this however,
- 4.3 The ban is, in substance, equivalent to the ban applicable to uncovered short sales of shares in certain financial institutions.

#### **4.4 No limitation to scope by reference to territory**

The same analysis applies as that described above in relation to the short-selling of shares ban.

#### **4.5 Consequences if a transaction is entered into in breach of the decree - generally**

The same analysis applies as that described above in relation to the short-selling of shares ban.

#### **4.6 Consequences if a transaction is entered into in breach of the decree – ISDA Master Agreement**

The consequences of a breach are the same as those that apply in relation to the short-selling of shares ban.

#### **4.7 "Illegality" Termination Event under ISDA Master Agreement**

The same analysis applies as that described above in relation to the short-selling of shares ban.

#### **4.8 1997 ISDA Government Bond Option Definitions**

There are no specific consequences of the decree on the 1997 ISDA Government Bond Option Definitions.

#### **4.9 Types of transaction caught**

The same analysis applies as that described above in relation to the short-selling of shares ban. BaFin has expressly confirmed that that selling bond futures does not constitute short selling for the purposes of the decree.

#### **4.10 Transactions entered into before 00:00 on 19 May 2010**

The same analysis applies as that described above in relation to the short-selling of shares ban.

#### **4.11 Exemptions**

The same analysis applies as that described above in relation to the short-selling of shares ban.

This note has been prepared by Allen & Overy LLP and its affiliated undertakings. The note has been prepared for the purposes of summarising the issues discussed in the conference call hosted by ISDA and Allen & Overy on 19 May 2010 in relation to the recent decrees issued by BaFin, and has been updated to reflect discussions with BaFin later on 19 May 2010. While the note expresses the views of Allen & Overy as at 19 May 2010 based on the limited time and information available, it does not constitute legal advice and ISDA members should seek advice from their advisors as appropriate. Neither ISDA nor Allen & Overy accepts responsibility for any party's reliance on the attached note. ISDA members should consider any further announcements made by BaFin which could affect the conclusions reached in the note, including the Q&A posted by BaFin on its website on 20 May 2010.