II-6.15: The "Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin" (the German Federal Financial Supervisory Authority), by three decrees published on May 18th 2010, prohibits uncovered short sales and CDS from May 19th 2010 to March 31th 2011.

Thursday 20 May 2010, by Lorraine Boris, Junior Editor

MAIN INFORMATION

The *Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin* (the German Federal Financial Supervisory Authority) issued on Tuesday May 18th 2010 three decrees prohibiting temporarily naked short selling. These decisions are effective from May 19th 2010 until March 31th 2011. They will be regularly assessed and can be lifted during this period.

CONTEXT AND SUMMARY

In the context of the most recent developments on the global capital markets, unusual volatility has been observed in debt securities of Member States of the European Union whose legal currency is the Euro. Moreover, yields on government bonds have risen considerably, with the yield spreads for German Government bonds likewise having widened significantly. Also, spreads of instruments known as credit default swaps, in which the default risk of countries is also included in pricing, have also widened considerably. This notably concerns the credit default risk of several Euro Zone countries. The turmoil experienced by the financial markets of the Euro Zone has been so intense that international, European and national institutions have resorted to this hitherto unprecedented support measure.[1]

Therefore, the BaFin said that extraordinary circumstances exist which might result in serious disadvantages for the financial system. More specifically large-scale short-selling may provoke excessive movements of price, and thus could destabilize the entire financial system. Hence, the BaFin's decision should reduce the exposure to this risk.

Also, the BaFin specifically invokes as a major motivation for its decision the risk of market manipulation through short-selling, arguing that some actors could use the media to spread rumors after previously engaging in such transactions and without having disclosed the resulting conflict of interest.

According to §4 paragraph 1 of the *Wertpapierhandelsgesetz* (WpHG, German Securities Trading Act of July 26th 1994) the BaFin can issue any decree to counteract undesirable developments which impair the proper execution of trading in financial instruments, investment services, or ancillary investment services; or trading which may engender serious disadvantages for the financial market. For the record, this specific provision was already used in September 2008 when Germany, alongside the US and the UK, banned short selling of bank and insurance company shares.

This is why the BaFin published an overnight ban on naked short selling on May 18th 2010 in the form of three decrees. One of these decrees bans uncovered short sales of debt securities of Euro Zone countries admitted on a domestic exchange to trading on the regulated market. Another temporarily prohibits credit default swaps (CDS) in which the reference liability is also a liability of a Euro Zone country and is not used to hedge default risks (uncovered CDS). Moreover, the BaFin also made illegal uncovered short selling of shares issued by the following companies from the financial sector:

Aareal Bank Ag, Allianz Se, Generali Deutschland Holding Ag, Commerzbank Ag, Deutsche Bank Ag, Deutsche Börse Ag, Deutsche Postbank Ag, Hannover Rückversicherung Ag, Mlp Mlp Agag and Münchener Rückversicherungs-Gesellschaft Ag[2].

---

[1] General Decree of the Federal Financial Supervisory Authority (BaFin) on the prohibition of uncovered short-selling transactions in debt securities of Member States of the EU whose legal currency is the Euro, May 18th 2010, accessible at: www.bafin.de/cln_152/nn_7207...
[2] BaFin prohibits uncovered short-selling transactions and uncovered CDS in government bonds of euro zone, May 18th 2010, accessible at: www.bafin.de/cln_152/nn_7204...

Links with other documents in the same sector

BRIEF COMMENTARY

Highly criticized by lawyers, this overnight ban appears to many as a part of a political battle against speculators. Naked short-sellings are for most of the observers, misunderstood by Berlin: this practice, neither responsible for the 2008 crisis, nor endangering the market, is defended for its role in reducing the volatility of a title, and thus improving the reality of market rates.

Above all, the unilateral decision took other European countries by surprise, thus revealing the discrepancies between the efforts to coordinate European measures and the political priorities of the German Government. On top of that, even though Austria announced it would implement similar measures, these bans, if circumscribed to Germany, will be insufficient to address the global nature of the problem. On top of that, the outcome of the previous bans on short selling proved themselves ineffective in avoiding the widening of spreads.

Furthermore, this measure highlights the evolution in the financial sector towards a greater autonomy of shares and bonds from the objects they represent. A share used to be the instrumentum (legal instrument or a contract) of a negotium, which was the debt of a company. Nowadays, shares and bonds are goods, negotia, in their own right, which as such must be the object of regulation. This fracture between financial activity and economic reality, with which it was first linked, is made possible through derivatives contracts. Thus, the German decision, in an effort to counter the dangerous systemic effects of an autopoietic financial activity—such as naked short selling—aims at grasping the underlying of derivatives contracts in order to link the financial instruments back to the shares or bonds on which they rely.