

New Legislative Acts Aimed to Strengthen Investor Protection and Improve Financial Markets

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Draft of Act on Strengthening Investor Protection and Improving Functionality of Capital Market

On May 3, 2010 Germany's Federal Ministry of Finance (Bundesministerium der Finanzen, BMF) submitted to market participants the draft for debate of an act on strengthening investor protection and improving the functionality of the capital market. The draft remained in the consultation stage until May 28, 2010. A hearing on the draft was held at the BMF on May 31, 2010.

The draft primarily contains proposals for amendments aimed at more efficient regulation and supervision of the capital market. The following central regulatory areas are addressed:

- Regulation of the "gray capital market" through extension of the term "financial instrument" in the German Banking Act (KWG) to cover shares in investments subject to the mandatory issuance of prospectuses – According to the draft for debate, certain provisions of Germany's Securities Trading Act (Wertpapierhandelsgesetz, WpHG) and Banking Act (Kreditwesengesetz, KWG) are to be expanded to the gray capital market for financial products. Expansion of the term "financial instrument" would ensure that other investments pursuant to § 8f of the Sales Prospectus Act (Verkaufsprospektgesetz, VerkProspG) are subject to supervision by Germany's Financial Services Regulatory Agency (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin). Based on current law, both Germany-based and non-Germany-based private equity and real estate funds are subject to regulation only if they conduct investment management activities pursuant to the KWG or are required to submit a mandatory prospectus to the BaFin because none of the exemption requirements pursuant to § 8f clause 2 of the VerkProspG have been met. As a result of the amendments to the KWG and WpHG, the gray capital market for financial products would be subject to regulation based on the proposed standards.
- Sale of closed funds – More stringent regulations for closed funds intended for public sale to non-institutional investors (so-called "retail funds") are in the draft, as well. However, funds with a minimum participation amount of €200,000 or more per investor are not considered retail

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The most important among the proposed measures are the following:

- Application of the WpHG to shares of closed funds so that stricter standards would be applied to the sales rights through the adoption of the defined MiFID standards (mandatory investor adequate consulting, publication of commissions paid, consultation paper and registration of certain employees with the BaFin); and
- Application of the KWG to shares of closed funds, which means that a permit would be required for sales and other activities related to these funds.
- Better protection of investors against false advice given by consultants – In the future, service providers would be required to comply with the conduct and organizational requirements pursuant to the WpHG when providing advice on investments and brokering of other investments pursuant to § 8f of the VerkProspG. For instance, investment consulting staff and compliance officers would be required to meet new professional knowledge and reliability standards. Furthermore, the new function of a sales officer has been defined. The individuals mentioned would be required to register with the BaFin. If they lack the required qualifications or reliability or if they violate the law, the BaFin would have the option to impose employment bans against such individuals that could remain in effect for up to two years.

To be in compliance with the VerkProspG, prospectuses would have to meet stricter requirements and contain specific information (including information regarding verifications of the prospectuses by financial auditors and information that makes it possible to rate the level of professionalism of these prospectuses). In the future, the BaFin would verify prospectuses not only for completeness, but also for plausibility and comprehensibility. Plans also include the abolishment of the short statutes of limitations for prospectus liability assump-

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tion pursuant to § 46 of the Stock Exchange Act (Börsengesetz) and § 13 of the VerkProspG.

Moreover, a product information sheet would be required for all financial instruments, which must be made available to the customer in a timely manner before a contract on a transaction is executed.

- Restrictions imposed on the daily repurchase of shares of open real estate funds and introduction of minimum retention and termination periods – According to the draft, open real estate funds would be subject to retention periods of two years, while return dates would be available no more than once every six years. The termination notice period for the return of shares would be set at a mandatory range of six to 24 months. The objective is to improve the cash flow management of these funds. The recapitalization of earnings is also slated to be limited, whereby the draft calls for a minimum disbursement of 50 percent. The valuation timeframe for the real estate comprised by the fund would also be reduced from 12 to six months. The minimum liquidity quota of the funds would be subject to a sliding scale ranging from 0 to 15 percent depending on the respective termination notice period of the investors.
- Improvement of investment and capital market transparency – To improve the transparency of investments and to prevent “undetected potential buyers from sneaking in to prepare an acquisition,” a mandatory reporting obligation has been introduced based on the Securities Trading Act. An expansion of § 25 of the WpHG to other instruments aims to add reporting obligations to the existing notification obligations for financial instruments, entitling their holders unconditionally to acquire existing shares that carry voting rights to those financial instruments that contain only a right to payment compensation, as well as tools with similar effects (e.g., dormant positions of sales options, entitlements to demand returns from securities loans and repurchase agreements in conjunction with repo transactions). The objective is to close any transparency gaps and to prevent the bypassing of the reporting requirements.

Moreover, the newly implemented § 25a of the WpHG aims to expand the reporting obligations to include such instruments that are not covered by § 25 of the WpHG and that factually or economically allow their holders to acquire stocks with inherent voting rights and other stocks (including dormant positions of a put option). In particular this comprises financial difference transactions, swaps and other transactions that make it possible to acquire voting rights due to the economic logic upon which they are based.

Draft of Act Aimed at Hindering Unfair Securities and Derivatives Transactions

The BMF has presented after a hearing on May 27, 2010

to the German government a draft on an act aimed at hindering of unfair securities and derivative transactions on June 1, 2010, in which the prohibition of short sales without coverage, which were originally going to be included in the Act Aimed at Improved Investor Protection and Optimization of the Functionality of the Capital Market, are addressed.

More stringent regulations for closed funds intended for public sale to non-institutional investors (“retail funds”) are in the draft. However, funds with a minimum participation amount of €200,000 or more per investor are not considered retail funds, so many of the new provisions would not apply to situations involving institutional investors.

The draft act comprises – among other measures – the following provisions:

- Prohibition of short sales of German stocks without coverage;
- Introduction of a transparency regime for short positions;
- Prohibition of short sales in government bonds of the Euro Zone without coverage;
- Prohibition of credit derivatives (credit default swaps) without coverage inherent in risks of states within the Euro Zone.

In addition the BMF and the BaFin have been empowered to issue ordinances or decree to define the prohibitions in more detail and state exemptions from such prohibitions. Additionally, the BMF and the BaFin are empowered to issue ordinances or decrees which prohibit other transactions, in particular:

- Derivatives which illustrate sales of German stocks without coverage;
- Derivatives which illustrate short sales in government bonds of the Euro Zone without coverage
- Currency derivatives regarding the Euro which are not used for currency hedging reasons.

The German cabinet has declared its consent to the draft on June 2, 2010.

Parallel thereto the EU Commission has started a public consultation on short selling’s, which related in particular to the report of the Committee of European Securities Regulators (CESR) recommending a Pan-European model for the disclosure of short positions in EU shares. This consultation ends on July 10, 2010. □